CONCEPT & THEORY QUESTIONS:
UNIVERSITY PAST PAPERS SUMMARY
PAPER PATTERN

SECTION 1 (COMPULSORY)
CONCEPTS: 4 CONCEPTS 3 MARKS EACH TOTALLING 12 MARKS
2 CASE STUDIES TOTALLING 18 MARKS

SECTION 2 (5 or 6 QUESTIONS 10 MARKS EACH; 2 NUMERICALS, 3 or 4 THEORY) ANSWER ANY 3 TOTALLING 30 MARKS.

YEAR	CONCEPT QUESTIONS	THEORY QUESTIONS
NOV 2001	**1.** Distinguish between permanent and temporary working capital. **2.** What is business risk? **3.** What do leverage ratios indicate? **4.** Explain 'Inter-corporate deposits.	**1.** Explain the methods of measuring cost of debt and cost of equity with illustrations. **2.** A businessman wants to invest Rs 50000, 70000 & 100000. Suggest investment avenues. **3.** Explain the steps involved in credit analysis in detail.
MAY 2002	**1.** Explain the significance of the capital gearing ratio. **2.** What is gross & networking capital? **3.** What is cash cycle? **4.** Explain 'factoring'	**1.** Profit vs wealth maximization. **2.** What are comparative, common-size and trend analysis statements? When and why are they used? **3.** Ratio analysis is only a tool and not a final decision. Discuss.
NOV 2002	**1.** Explain the significance of liquidity ratios. **2.** Is the cost of debt less than the cost of equity? Is it always so? **3.** What is a letter of credit? **4.** What are common-size statements?	**1.** What are Motives for holding cash? **2.** What are the determinants of working capital? **3.** What is the meaning of: a. Commercial paper. b. Bills discounting
MAY 2003	**1.** Distinguish between cash budget and cash flow statement. **2.** What are ROI and ROCE? **3.** What is the relevance of operating and financial leverage in business decisions? **4.** What are the precautions to be taken in trend analysis?	**1.** Costs associated with receivables? **2.** What are the various long-term sources of finance? **3.** Explain with reasons if the following result in a flow of funds: **a.** Revaluation of building. **b.** Writing off preliminary expenses. **c.** Purchase of land on lease. **d.** Provision of depreciation.
NOV 2003	**1.** Explain the significance of the WACC **2.** State 3 functions of finance manager. **3.** What is cash operating cycle? **4.** Distinguish between hypothecation and pledge	**1.** Explain the concept of working capital. How is it affected by (a) sales (b) price level changes (c) technology and manufacturing policy? **2.** Ratio analysis is a technique for making judgment and not a substitute for it. **3.** Explain the pros and cons of equity and

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		preference shares as a source of finance.
MAY 2004	Explain: **1.** Wealth vs Profit maximisation. **2.** Motives for holding cash. **3.** Financial break even point. **4.** Financial break even point. **5.** Delinquency cost and del credre cost	**1.** What are FFS and CFS? Distinguish. **2.** What are sources of long term finance? **3.** What is financial management? State the functions of a finance manager.
NOV 2004	**1.** What is the conservative approach? **2.** What is WACC? **3.** What is margin of safety? **4.** What is owed fund?	**1.** Discuss various cash management models. **2.** What are the factors affecting working capital requirements? **3.** What are sources of short term and long term finance?
MAY 2005	**1.** What is meant by Matching Concept? **2.** What are non cash expenses? **3.** What is trading on equity? **4.** What are sources of long term finance?	**1.** FFS and CFS are similar but not same. Discuss. **2.** What are the factors affecting working capital requirements? **3.** Financial Management: art and science. Discuss.
NOV 2005	**1.** Explain the following: **a.** Cost of debt **b.** Trading on equity **c.** Intercorporate deposit. **d.** Profit maximisation	**1.** What are financial statements? What is the importance and who are the interested parties? **2.** Explain leverage and distinguish between operating and financial leverage. **3.** What are the factors affecting working capital requirements?
MAY 2006	Explain the following: **a.** Motives for holding cash. **b.** Financial stability ratio. **c.** Commercial paper. **d.** Credit granting decision	**1.** State the functions of a finance manager. **2.** What is credit evaluation? **3.** What are sources of long term finance?
NOV 2006	Explain the following: **a.** Diff risks in financial management. **b.** Break even point. **c.** Concept of conservatism. **d.** ICRA	**1.** What are the advantages of vertical statements? Draw a vertical balance sheet **2.** Merits & demerits of equity shares Importance of cash management
NOV 2007	Explain the following: **a.** Letter of credit **b.** Trading on equity. **c.** Non-diversifiable risk. **d.** Float	**1.** State the functions of a finance manager. **2.** MM Theory. **3.** What is leasing? What are operating & financial leases
MAY 2008	Explain the following: **a.** Profit and profitability	**1.** What are the factors affecting capital structure?

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	b. Reserve Capital **c.** Capital employed **d.** Depreciation & amortization.	**2.** Explain the difference between a horizontal & vertical balance sheet. **3.** What are the factors affecting working capital?
MAY 2009	**a.** Accounting Concept. **b.** Break even point. **c.** Debentures **d.** Finance Function	**1.** What are sources of short term finance? **2.** Explain in brief. **a.** Financial Leverage **b.** Operating Leverage. **3.** Discuss Importance of **a.** Trend analysis **b.** Common size statement

Additional Concepts:

1. **ASBA:-** Applications Supported by Blocked Amount in case of Application in Public Issue.
2. **SCODA:-** Sebi Committee On Disclosures & Accounting standards
3. **DUAL LISTING:-**Put simply, it's a process that allows a company to be listed on the stock exchanges of two different countries. The company's shares, which enjoy voting rights, can be traded on both the bourses.

When two companies in two countries enter into an equity alliance without an outright merger, dual listing means continued listing of the firms in both the countries. The key point to note here is that shareholders can buy and sell shares of both the companies on bourses in the two countries. In otherwords, if the Bharti MTN deal happens with a dual listing rider, a Bharti share can be sold on the Johannesburg Stock Exchange & vice-versa.

How common is it?

Well, not exactly, mainly because of the complexities involved. However, there are enough examples to prove that it works: Royal Dutch Shell (UK/ Netherlands), BHP Billiton (Australia/ UK) Rio Tinto Group (Australia/ UK), Unilever (UK/ Netherlands)

Is it allowed in India?

No. Dual listing will need major amendments to key corporate laws of the country.

Like...

To begin with, the existing Companies Act and its proposed successor would both need to be amended.

In the case of a dual listed company, an investor can buy shares in one country and sell it in an overseas market. That would need the Indian rupee to be fully convertible, something that the central bank is yet to allow.

How is it different from ADRs/GDRs?

In case of ADRs/GDRs, the companies deposit their equity shares with a custodian, say a bank, which in turn issues depository receipts to the investors. These receipts have all the rights, barring voting rights. Investors can convert ADRs/GDRs into underlying shares, which can be issued only within India and traded only on domestic bourses.

Financial Statement
Mumbai University Question Bank
Workshop 2001

I. Introduction to Financial Management

Concept Testing:

(1) Give any four functions of financial management.
(2) State some new functions of finance manager.

Theory Questions:

(1) Profit maximization **(2)** Wealth maximization
(3) Explain any 3 roles of finance manager
(4) Discuss changing roles of the finance manager

II. Analysis of financial statements- Common size statements, Comparative statements, Trend Analysis, Cash Flow, Funds Flow, and Ratio Analysis.

Concept Testing:

(1) Gross working capital **(2)** Accounts receivable **(3)** Net worth
(4) Capital Employed **(5)** ROI / ROCE **(6)** Common size statement
(7) State the merits / limitations of common size statements, comparative statement, trend analysis, cash flow, funds flow, and Ratio analysis
(8) Any three specific reasons for change in
(a) Expense Ratio **(b)** Current Ratio
(9) Give any three objectives of financial analysis.
(10) Why are Common Size Statements so called?
(11) Differentiate between static and dynamic analysis
(12) Give any 3 specific interpretations of decreasing trend in sales / expenses.
(13) State any 3 uses of common size statements, comparative statements, trend analysis, cash flow, funds flow, and ratio analysis
(14) Importance of cash flow statements.
(15) Funds from operations.
(16) Differences between funds flow and cash flow statements.
(17) Name any 5 sources of funds and classify them into short-term and long-term funds.
(18) Name 3 short terms and 3 long term application of funds.
(19) What does a funds flow statement denote?
(20) State 5 uses of funds flow statement.

Theory Questions:

(1) Explain the impact of the following on current ratio:
(a) Cash sales. **(b)** Credit sales.
(c) Sale of fixed assets **(d)** Redemption of debentures.
(2) ‘Ratio analysis is only a tool and not a final decision’ Discuss.
(3) The following financial results indicate a mismatch between sales and profits, an increase in sales is followed by decrease in profits or vice versa. Discuss various possible reasons.
(4) Explain the various components of the given ratios with illustrative example.

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(5) What are the common size statement, comparative statement and trend analysis? When and why they are used?
(6) Explain the implications of an improvement in a current ratio from 1 in 2008 to 2.5 in 2009.
(7) As a creditor / investor / finance manager, suggest any 3 ratios to be used for analysis with reasons.
(8) Explain the superiority of ratio analysis over comparative and common size statements.
(9) Explain the precautions to be taken in trend analysis.
(10) Classify and explain profitability / solvency ratios, etc.
(11) Which of the financial ratios of a company would you most likely refer to in each of the following situations? Give reasons.
- **(a)** The company ask you to sell material on credit.
- **(b)** You are thinking of investing Rs.25,000/- in the company's debentures.
- **(c)** You are thinking investing Rs.25,000/- in the company's shares.

(12) What do you mean by liquidity of firms? How can the liquidity of the firm be assessed?
(13) What are the Common Size Statements, Comparative Statements, trend analysis, and ratio analysis? What are merits and demerits of each?
(14) What is short term solvency and long term solvency? How do they differ? As a shareholder / debenture holder which will you be concerned about?
(15) **"**The liquidity of business is explained by Cash Flow Statement**"**. Discuss.
(16) Importance and shortcomings of funds flow statement.
(17) **'**Increase in working capital is an application of funds whereas decreasing in working capital is a source of fund'. Comment with illustration.
(18) What is the effect of following on the funds flow statement?
- **(a)** Amortization of assets.
- **(b)** Transfer to reserves.
- **(c)** Depreciation.
- **(d)** Proposed dividend.
- **(e)** Interim dividend.
- **(f)** Provision of tax.

Case study:
(1) Given a concise balance sheet and income statement of two companies in same industry, the industry average / standard ratio, calculate the ratios and comment.
(2) Given ratios and percentage relating to 2-3 companies in same type of business. State, which company has put in best performance and followed best financial policies.
(3) Given a mismatch in trend of sales and profits…comment.
(4) Given a cash flow statement, analysis the quality of cash management.

Problem:
(1) Specific problems in preparation of common size, trend, comparative statements or ratio analysis.

Case Study / Problem:
(1) Two divisions of XYZ Limited, start the current year with identical balance sheets but the position changes by the end of the years as shown below:

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PARTICULARS	DIVISION A		DIVISION B	
Rupees	Beginning of the year	End of the year	Beginning Of the year	End of the year
Current Assets	625,000	625,000	625,000	625,000
Current Liabilities	375,000	375,000	375,000	500,000
Working Capital	250,000	250,000	250,000	125,000
Fixed Assets (Net)	250,000	625,000	250,000	500,000
Capital Employed	500,000	875,000	500,000	625,000
Finance by Long Term Debt		250,000		
Equity and Reserves	500,000	625,000	500,000	625,000

Additional information:

(a) Both the divisions have identical earning power.
(b) Each division earns a net profit of Rs.65,000 after taxation @ 35%
(c) Depreciation amounts to Rs.4,00,000
You are required to prepare funds flow statements for each division and comment on the financial policy and practiced followed by each as revealed by the funds flow statement.

(2) The following entry was recorded during a current year.

	Rs.	Rs.
Plant and Equipment	Dr. 900000	
Goodwill	Dr. 100000	
To Equity Capital		600000
To Debentures		200000
To Bank		200000

Describe the ways in which this transaction can be reported in a statement of changes in financial position on working capital basis. Give your views.

III. Theory of Capital Structure and Cost of Capital

Note: Theories of capital structure has been excluded

Concept Testing:

(1) What is cost of capital?
(2) What is opportunity cost of capital?
(3) What is average cost of capital?
(4) Name the components of cost of capital.
(5) Financial leverage.**(6)** Operating leverage.
(7) Combined leverage.

Theory Questions:

(1) Determinants of capital structure.
(2) How would you measure the cost of debt capital and cost of preference capital?
(3) “The equity capital is cost free” comment.

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(4) How is weighted average cost of capital calculated? What weights should be used in its calculation?
(5) Cost of Capital is dependent only on cost of long term funds. Discuss.
(6) Cost of Preference capital is less than the Cost of Equity Capital. Discuss.
(7) Cost of Capital can most appropriately be measured on post tax basis. Explain.
(8) Explain dividend approach to calculate cost of equity.

Case Study:

(1) A Company is considering to distribute additional Rs.80,000/- to its ordinary shareholders. The shareholders are expected to earn 18% on their investment. They are in 30% individual tax bracket and incur an average brokerage fee of 3% on the reinvestments of dividends received. The firm can earn a return of 12% on the retained earnings. Should the company distribute or retain Rs.80,000/-

(2) Give the following data

Income Statement

	Company A	Company B
Sales	50 L	50 L
PBIT @ 10%	5 L	5 L
Interest	0.48 L	1.92 L
PBT	4.52 L	3.08 L
Tax @ 40%	1.80 L	1.20 L
PAT	2.72 L	1.88 L

Sources of Funds

	Company A	Company B
Equity	16 L	4 L
12% Debenture	4 L	16 L
	20 L	20 L

Company A is better than Company B since the profit is higher in Company A than Company B. Do you agree? Discuss.

Problem:

(1) The capital structure of a firm is as follows:
Overall Cost of Capital=14%, Cost of debt 12%
Market value of the debt=Rs.200 Lacs. Market value of equity=Rs.150 Lacs.
Calculate: **(a)** Cost of Equity. **(b)** If the debt equity ratio is adjusted to 1.5, then what will be the cost of equity?

(2) The company has adopted the following structure of capital for its new project:

	Rs. In Lacs
Equity Share Capital	20
10% Preference shares	10
11% Debentures	20
12% Term Loans	10

Cost of equity is 15%, tax rate is 40%, Return on investment is 14% (post tax).
It is worthwhile for the company to invest in the project?

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IV. Working Capital

Cash Budget

Concepts:

(1) Distinguish between cash budget and cash forecast.
(2) Distinguish between Cash Flow Statement and Cash Budget.
(3) State the need for preparing a cash budget.
(4) State the uses of cash budget or when do you prepare a cash budget?
(5) Explain in brief the importance of marketable securities.
(6) What are marketable securities?

Theory Questions:

(1) Discuss the cash budget as a management tool with illustrative example.
(2) Distinguish between Cash Budget and Cash Flow Statement.

Case Study:

(1) Given a cash budget with surplus and deficit in different periods, discuss how to handle the problem.

Problem:

(1) Construct a simple cash budget with interpretation of surplus / deficit.

Receivables Management

Concepts:

(1) Risk and Return tradeoff in credit policies
(2) Policies of collection of receivables
(3) Type of risk **(4)** Collection Cost **(5)** Default Cost **(6)** Capital Cost
(7) Delinquency Cost **(8)** Del Credere Commission / Agent
(9) Cost of Credit. **(10)** Objectives of Rec. Mgt.
(11) Significance of Rec. Mgt.

Theory Questions:

(1) Discuss the various collection methods from receivables
(2) Risk and return tradeoff in credit policies. Explain.
(3) Importance of Cash and Trade Discount in Receivable management.
(4) Diversification of Receivable reduces risk. Discuss.
(5) Explain the different types of Risk.
(6) Explain the steps involved in Credit Analysis / Evaluation.
(7) Explain the different costs associated with Accounts Receivables.
(8) Explain the various approaches to evaluation of credit policies.
(9) Explain the controlled mechanisms of Receivables management.

Case Study:

(1) Receivables management for different types of customers given different periods of credit.
(2) Given relevant financial data of 2 companies, comment on which company would you prefer to supply goods on credit.

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Cash and Marketable Securities Management

Concepts Testing:

1. Treasury Bills.**(2)** Inter Corporate Deposits **(3)** Bills Discounting.
4. Objectives of Cash Management.

Theory Questions:

1) What is cash operating cycle? Can it be shortened?
2) What are marketable securities? Are they important in working capital management decisions? Discuss.
3) Discuss the motives for holding cash.
4) Explain the options for interesting surplus funds.
5) Explain the types of marketable securities.
6) Discuss the factors determining cash needs.

Management of Working Capital

Concept Testing:

1. Working Capital
2. Permanent and Temporary Working Capital
3. Peak Working Capital
4. Net Working Capital and Gross working capital

Theory Questions:

1. Determinants of Working Capital
2. Working Capital Cycle
3. Sources of Working Capital
4. Risk-Return Tradeoff in Working Capital

Problem / Case Study:

1. Estimation of working capital requirement given the operating cycle.
2. Calculation of period of operating cycle and comment.

SOURCES OF FINANCING

Concept Testing:

(1) ADR **(2)**GDR **(3)** ECB **(4)** FCD **(5)** Issue price Vs Market price
(6) Factoring **(7)** Letter of Credit **(8)** Lease finance V/S Hire purchase
(9) Retained Earnings and Surplus **(10)** Short Term Finance
(11) Long Term Finance

Theory Questions:

1. Explain various Sources of Short Term Finance
2. Explain various Sources of Long Term Finance.

Case Studies:

(1) Given the capital Structure and Financial Requirement of an Organization, different sources of finance need to be identified.

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Chapter : Study of Financial Statement (I & II)

In order to analyze financial statements it is advisable that they are presented in the vertical format as the vertical format dose not require knowledge of accounting rules and is more user-friendly.

Financial statement Analysis can be broadly categorized into two types, vertical & horizontal.

Vertical/Static	Horizontal/dynamic
Requires financial statement of one year of one company.	Requires financial statement of two or more year or companies..
Deals with different accounting items of same year.	Deals with same accounting item of different years or companies.
Gives information in a percentage form.	Gives information in a percentage and absolute form.
Indicates changing proportions.	Indicates change in financial position.
Eg. are common-size statements etc.	Eg. are comparative statements, trend analysis etc.

It may be noted that these two types of analysis (static and dynamic) are not mutually exclusive, they can be done simultaneously also / however, all the different types of analysis suffer from four common limitations:-

If the data in financial statement is incorrect than any analysis is meaningless.

2. Inflation affects the value of the accounting items and may mislead the analyst.
3. Companies sometimes resort to painting a rosy picture in the financial statements (window dressing).
4. There are inconsistent accounting policies, which makes comparison difficult.

But inspite of these limitations it is important to analyse financial statements. The different financial tools of analysis are:

1. Vertical statements
2. Comparative statements
3. Common-size statements
4. Trend analysis
5. Ratios analysis
6. Fund flow statements
7. Cash flow statements etc

Multiple Choice Questions:

(1) Which of the following is an item of Current Assets?

(a) Bank Overdraft.
(b) Receivables.
(c) Outstanding Expenses.
(d) Short Term Loan taken.

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CHAPTER : WORKING CAPITAL

Factors / Determinants of Working Capital Requirement:-

All firms do not have the same working capital needs. It depends on several factors, which are listed as follows.

1. **Nature and size of business:-** The working capital requirement of a firm is closely related to the nature of the business. We can say that trading and financial firms have less investment in fixed assets but require a large some of money to be invested in working capital. Also, a firm with a large scale of operation will obviously require more working capital than the smaller firm.
2. **Method of Production:-** Whether the company follows job, batch or flow production also affect working capital requirement.
3. **Manufacturing cycle:-** It starts with the purchase and use of raw materials and completes with the production of finished goods. Longer the manufacturing cycle larger will be working capital requirement, this is seen mostly in the industrial products.
4. **Business cycles:-** When there is an upward swing in the economic, sells will increase also the firm's investment in inventories and book debts will also increase, thus it will increase the working capital requirement of the firm and vice-versa.
5. **Production policy:-** To maintain an efficient level of production the firms may resort to normal production even during the slack season. These will lead excess production and hence the funds will be blocked in the form of inventories for a long time, hence provisions should be made accordingly.
6. **Firm's credit policy:-** If the firm has liberal credit policy, its funds will remain blocked for long time in form of debtors and vice-versa. Normally, industrial goods manufacturing will have a liberal policy whereas dealers of consumer goods will have a tight credit policy.
7. **Availability of credit:-** If the firm gets credit on liberal terms, it will require less working capital since it can always pay its creditors later and vice-versa.
8. **Growth and expansion activities:-** It is difficult precisely to determine the relationship between volumes of sales and need for working capital. The need for working capital does not follow the growth but precedes it. Hence, if the firm is planning to increase its business activities, it needs to plan its working capital requirements during the growth period.(e.g classic failure Subhiksha.
9. **Conditions of supply of raw material and stock policy:-** If the supply of raw material is scarce the firm may need more working capital to stock up on the inventory. The decision to follow JIC and JIT is also a factor.
10. **Profit margin and profit appropriation:-** A high net profit margin contributes towards the working capital. Also, tax liability is unavoidable and hence provision for its payment must be in the working capital plan, otherwise it may impose a strain on the working capital.
11. **Price level changes:-** Changes the price level due to inflation or other reason also affect the requirement of working capital. Rising prices necessitate the use of more funds for maintaining an existing level of activity. Rising prices will require higher level of working capital and vice-versa.
12. **Dividend policy:-** Also if the firm's policy is it to retain profits it will increase their funds available for working capital and if they decide to pay their dividends it will weaken their working capital position, as the cash flows out. So dividend policy of the Company is a important factor affecting requirement of working capital.
13. **Depreciation policy:-** The depreciation of the firm, through the effect on tax liability and retained earnings, has an influence on the working capital. The firm may charge a high rate of depreciation, which will reduce the tax payable. Thus depreciation is an indirect way of retaining profits and preserving the firm's working capital position.

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CHAPTER : FUND FLOW STATEMENT

Funs flow statement is a statement indicating changes occurring in the financial position of an organization. It is summary of the sources of funds and the application or use of these sources in a given period of time. It helps answer the questions:

1. What has been the primary investment activity?
2. What factors are responsible for the change in equity, borrowed fund, assets and liabilities?
3. How have the assets been financed?
4. Does the company have adequate working capital?
5. Why has the company paid/ not paid dividend?
6. What are the funds generated from the operation of the business?

Fund flow statements are prepared on the basis of other financial statements so as to overcome the limitations of the balance sheet and income statement. They are designed to supplement financial statements.

Difference between Balance sheet and Fund Flow Statement

POINT OF DISTINCTION	BALANCE SHEET	FUND FLOW STATEMENT
1. Meaning	Statement of assets and liabilities	Statement of changes in assets and liabilities.
2. Objective	Ascertain financial position	Ascertain reasons for changes in financial position
3. Legality	Obligatory in a prescribed format	Not obligatory and no fixed format
4. Format	Assets and liabilities	Sources and application of funds
5. Basis of preparation	Ledger balance and additional information	Two consecutive balance sheets and additional information

Difference between Income Statement and Fund Flow Statement:

POINT OF DISTINCTION	INCOME STATEMENT	FUND FLOW STATEMENT
1. Meaning	Statement showing the results of the business activities	Statement of changes in assets and liabilities
2. Objective	Ascertain profit or loss	Ascertain reasons for changes in financial position and how profits have been utilised
3. Legality	Obligatory in a required format	Not obligatory and no fixed format
4. Treatment of difference	Difference is the profit or loss	Difference is the increase or decrease in working capital
5. Basis of preparation	Nominal account balances and additional information	Two consecutive balance sheets and additional information

Limitations of fund flow statements (in addition to the 4 common limitations)

1. They ignore non-fund transactions
2. Changes in cash resources which are more significant are not shown separately but are part of working capital
3. They are not an original evidence of financial status.

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Fund Flow Statement Adjustments

Treatment of Balance Sheet entries when there is no adjustment					
	2008	**2009**	**Difference**	**Meaning**	**Effect**
Share Capital	2,00,000	3,00,000	1,00,000	Issue of Shares	Receipt – Source
Preference Share Capital	1,00,000	50,000	50,000	Redemption of Shares	Payment – Application
General Reserve	60,000	1,00,000	40,000	Profit trfrd to GR	Dr P/L a/c
Plant Replacement Res	75,000	50,000	25,000	Profit trfrd from PRR	Cr P/L a/c
Share premium	80,000	1,00,000	20,000	Premium received	Receipt – Source
Share premium	50,000	25,000	25,000	Premium Paid	Payment – Application
Donation		1,00,000	1,00,000	Donation declared	Dr P/L a/c
Debentures	3,00,000	2,00,000	1,00,000	Redemption of Debentures	Payment – Application
Debentures	1,20,000	1,40,000	20,000	Issues of Debentures	Payment – Application
Proposed Dividend	50,000	60,000	50,000	Old amount paid	Payment – Application
			60,000	New amount provided	Dr P/L a/c
Provision for Tax	30,000	35,000	30,000	Old amount Paid	Payment – Application
			35,000	New amount Provided	Dr P/L a/c
Goodwill	4,0000	30,000	10,000	Goodwill W/off	Dr P/L a/c
Land & Building	2,00,000	1,90,000	10,000	Depreciation on Blgd	Dr P/L a/c
Provision for Depreciation	2,00,000	2,75,000	75,000	Depreciation for the year	Dr P/L a/c
Freehold land	35,000	50,000	15,000	FHL Purchased	Payment – Application
Investments	1,00,000	1,50,000	50,000	Invst Purchased	Payment – Application
Preliminary Expenses	10,000	8,000	2000	Preliminary Exps w/off	Dr P/L a/c

ADDITIONAL ADJUSTMENT

1. Opening stock was undervalued by Rs.3,600

(+) to opening stock Rs.3,600 (+) to opening P/L a/c Rs.3,600

2. During the year Fixed Assets Costing Rs.30,000, Accumulated Depreciation Rs.14,000, sold for Rs.20,000

Cost 30,000 – PFD 14,000 = WDV 16,000 – SP 20,000 = Profit 4,000

Cash/Bank A/c Dr. To Fixed asset A/c	20,000	 20,000
Fixed asset A/c Dr. To P/L a/c (Profit)	4,000	 4,000
PFD a/c Dr. To Fixed asset A/c	14,000	 14,000

3. Closing Stock was overvalued by Rs. 5,000

(-) From Closing stock Rs.5,000 (-) From Closing P/L a/c Rs.5,000

4. Depreciation provision on 31.12.07 and 31.12.08 amounted to Rs.4,70,000 & Rs.5,10,000

Add. to WDV given in Balance Sheet to find cost. Then open Machinery a/c at cost & Provision for Depreciation a/c.

5. Debentures were redeemed at a premium of 5%

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Particulars	Dr.	Cr.
Debentures A/c Dr. To Cash / Bank A/c	1,00,000	 1,00,000
P/L a/c (Premium) Dr. To Cash / Bank A/c	5,000	 5,000

6. Rs.5,000 Loss due to fall in value of investments was written off P & L a/c.

Particulars	Dr.	Cr.
P/L a/c Dr. To Investments A/c (Loss)	5,000	 5,000

7. Dividend received of Rs.15,000 of Which Rs.5,000 for pre acquisition period was credited to Investment account

Particulars	Dr.	Cr.
Cash/Bank a/c (Dividend) Dr. To Investments A/c To P/L A/c	15,000	 5,000 10,000

8. Debentures of Rs. 1,00,000 were redeemed at a discount of 10%

Particulars	Dr.	Cr.
Debentures A/c Dr. To Cash/Bank a/c To P/L A/c (Discount)	1,00,000	 90,000 10,000

9. During the year Plant value was appreciated by Rs.20,000

Particulars	Dr.	Cr.
Plant a/c Dr. To P/L a/c (Appreciation)	20,000	 20,000

10. Assets of another company were purchased for a consideration of Rs.50,000 payable in shares. It consists of Stock 20,000 & Machinery Rs.25,000

Particulars	Dr.	Cr.
Stock (Sources of fund) a/c Dr. Machinery a/c Dr. Goodwill a/c (Bal. Fig.) Dr. To share Capital a/c	20,000 25,000 5,000	 50,000

11. Net Profit for the year was Rs.66,100

Ignore this NP. We require or consider FFO in FFS

12. Decided to write off Fixed Assets (fully depreciated) costing Rs.20,000

Particulars	Dr.	Cr.
PFD a/c Dr. To Fixed assets a/c	20,000	 20,000

13. During the year Bonus Shares of Rs.1,00,000 issued were out of General Reserve.

Particulars	Dr.	Cr.
General Reserve a/c Dr. To Equity Share cap a/c	1,00,000	 1,00,000

14. Depreciation for the year was Rs.80,000 (When separate Provision for Depreciation a/c is maintained)

Particulars	Dr.	Cr.
P/L a/c (Depreciation) Dr. To Prov for Depr a/c	80,000	 80,000

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CHAPTER : CASH FLOW STATEMENT

Cash Flow Statement is a statement indicating transactions which have affected the cash balance of an organization. It is summary of the sources of cash and the application or use these sources in a given period of time.

According the AS 3 format issued by the ICAI the objective of a cash flow statement is to provide information about the cash flows from operating activities, investing and financing activities.

Operating activities are the principal revenue generating activities, investing activities are the acquisition and sale of long term assets while financing activities are those that result in a change in the size and composition of the capital.

Objectives of a cash flow statement:

2. Shows the movement of cash inflows and outflows.
3. Helps in planning for optimum utilization of cash i.e. cash planning.
4. Facilitates to analyse ability of timely payment of interest, dividend and tax.
5. Exhibits the company's ability to meet short term obligations.
6. Investors can gauge the company's capacity to generate cash from operations.

Limitations of Cash Flow Statements (in addition to 4 limitations)

1. It does not take into account non-cash transactions.
2. Liquidity position portrayed by the cash statement cannot be absolutely reliable since it is easily influenced by decisions such as rush purchases or postponed purchases.

Inter-industry or inter-firm comparison of cash flows is misleading due to differences in terms of purchase and sale

Treatment of Balance Sheet entries when there is no adjustment					
	2008	2009	Difference	Meaning	Effect
Share Capital	2,00,000	3,00,000	1,00,000	Issue of Shares	
Preference Share Capital	1,00,000	50,000	50,000	Redemption of Shares	
General Reserve	60,000	1,00,000	40,000	Profit trfrd to GR	
Plant Replacement Res	75,000	50,000	25,000	Profit trfrd from PRR	
Share premium	80,000	1,00,000	20,000	Premium received	
Share premium	50,000	25,000	25,000	Premium Paid	
Donation		1,00,000	1,00,000	Donation declared	
Debentures	3,00,000	2,00,000	1,00,000	Redemption of Debentures	
Debentures	1,20,000	1,40,000	20,000	Issues of Debentures	
Proposed Dividend	50,000	60,000	50,000	Old amount paid	
			60,000	New amount provided	
Provision for Tax	30,000	35,000	30,000	Old amount Paid	
			35,000	New amount Provided	
Goodwill	4,0000	30,000	10,000	Goodwill W/off	
Land & Building	2,00,000	1,90,000	10,000	Depreciation on Blgd	
Provision for Depreciation	2,00,000	2,75,000	75,000	Depreciation for the year	
Freehold land	35,000	50,000	15,000	FHL Purchased	
Investments	1,00,000	1,50,000	50,000	Invst Purchased	
Preliminary Expenses	10,000	8,000	2000	Preliminary Exps w/off	

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CHAPTER : Capital Structure

Factors / Determinants for Capital Structure Planning

Following are the important factors to be considered while planning a capital structure:

1. **Financial Leverage**:- The financial manager should take advantage of debt capital as much as possible because use of debt capital increases the earnings on equity since interest payments give a tax shield. However, an important fact to be kept in view is that beyond a particular point of leverage, weighted average cost of capital may go up.

2. **Operating leverage**:- This leverage depends on the operating fixed cost of the firm. If a higher percentage of a firm's total costs are fixed operating costs, the firm is said to have a high degree of operating leverage. Operating leverage measures the operating risk of a firm. Operating risk is the variability of operating profit or EBIT to sales. A financial manager should attempt at an appropriate combination of the two leverages.

3. **EBIT / EPS Analysis**:- This analysis is an important tool of measuring a company's performance. Normally a financial plan, which will give maximum value of EPS will be selected as the most desirable mix. The greater the level of EBIT, the more beneficial it is to employ debt capital in capital structure. However EPS analysis ignores risk.

4. **Cost of capital**:- The financial manager aims to select a combination of debt and equity, that maximizes the value of the firm and maximizes the overall cost of capital. It should always be borne in mind that overall cost of capital is an important variable in the decision-making relating to selection of debt-equity mix.

5. **Growth and stability of sales:-** The growth and stability of sales is an important factor in selection of desired mix of debt and equity. The firms with stable sales are likely to employ high degree of leverage. For e.g. the sale of consumer goods show wide fluctuation. Therefore, they do not employ large amount of debt. On the other hand, sales of public utilities are comparatively stable and predictable. Therefore, it is observed that public utilities services relatively employ higher debt in their capital structure.

6. **Cash Flow Analysis**:- The capital structure of a firm should be so planned that it should be able to service its fixed charges of interest and principal under any reasonable predictable adverse circumstances. The companies expecting larger and stable cash inflows in future can employ a large amount of debt in their capital structure. If companies unstable cash inflows in future employ sources of finance with fixed charges, it will be risky. In planning the capital structure, financial manager must consider coverage ratios. The greater the coverage, the greater will be the amount of debt capital that a firm may use.

7. **Flexibility**:- It means the ability of the company to adapt its capital structure in response to changing conditions. The main point is that company should be able to raise funds without undue delay and cost whenever needed to finance the profitable investment. Debt capital is more flexible than equity capital, because it can be redeemed when circumstances are favorable. Equity does not enjoy flexibility as equity shares cannot be redeemed except on

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liquidation or buyback which is an expensive exercise. Preference shares can be redeemed under certain circumstances.

8. **Control:-** Ordinary or equity shareholders have the legal right to vote. In fact, they are the real owners and they can exercise the control over the overall affairs. In the event of issuing fresh equity shares, there remains a risk of loss of control. When a choice is made between debt and equity to raise additional funds, normally debt is preferred to equity in order to avoid loss of control. However, now banks and FIs introduced a lot of restrictions (restrictive covenants) in the loan agreement to protect their interest. At times, the loan agreement includes the right to nominate a director to oversee the activities of the firm.

9. **Size and Nature of the Company:-** It is also an important consideration in selection of sources of finance. A small firm finds it extremely difficult to raise long-term loans and normally small companies depend on share capital and retained earnings for this long term fund. A large company relatively enjoys greater degree of flexibility in designing its capital structure. A firm should make best use of its size in planning its capital structure. Nature of industry is also an important consideration in designing the capital structure.

10. **Marketability / Capital Market Conditions:-** The conditions in capital are continuously changing. At one time the capital market favours the debenture issue and at other time it readily accept share issues. Based on the changing market sentiments, decision should be taken regarding raising the funds through debt or equity.

11. **Floatation Costs (cost of raising finance):-** Floatation costs are incurred only when the funds are raised. Normally cost of floating a debt is less than the cost of floating an equity issue. It is not a very significant factor, but it should be considered in designing a capital structure. QIP floating cost is less than public issue floating cost.

12. **Legal Constraints:-** In a regulated economy, a firm has to comply with legal requirements in this respect. Eg. Dual listing not allowed in India, Capital a/c convertibility.

Cost of Capital.

The cost of capital for a firm is the average return required by the provides of long term finance i.e. debt, preference capital and equity capital (includes retained earnings). It is a central concept in financial decision and is used for capital budgeting decisions, to evaluate sources of finance and for top management performance appraisal. It is also used to calculate EVA.

Cost of capital may be implicit (eg. Opportunity cost) or explicit (eg. Interest). The two main methods to calculate cost of capital are:

a. Marginal cost of capital which is the additional cost of raising additional funds.
b. Weighted cost of capital

Weighted average cost of capital (WACC) is calculated taking into account the relative weights of each component of the capital structure namely debt, preference and equity.

Concept question: Is the cost of debt lower than the cost of equity? Is it always so?

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Yes:- Cost of debt is usually lower than the cost of equity because

1. Debt gives a tax shield.
2. Debt has low floatation cost.
3. Debt earns fixed returns.
4. Debt gives rise to financial leverage.

No it is not always so when the company is making losses or is not paying taxes. (Tax holiday, EOU status etc.)

Concept question: <u>Opportunity cost of capital?</u>

Opportunity cost of capital is "the rate of return associated with the best investment opportunity for the firm and or its share holders that will be foregone if the project presently under consideration by the firm were accepted". It is also called 'implicit cost' in case of retained earnings, it is the income which the shareholders could have earned if such earnings would have been distributed and invested by them. (e.g. BOD of Infosys Ltd, needs to consider 'Implicit Cost' & thereby have to declare high rate of dividend, to avoid excess unutilized Cash/Cash equivalent balance.)

Concept question: <u>Window Dressing</u>:

Window dressing refers to the art of showing the position of an organization at a better level than the existing one. It means that the true value of the assets, liabilities and profitability is not shown in the financial statement. The actual state of affairs is concealed and instead a sound financial is projected on the face of the financial statement. In case of window dressing a rosy picture of assets and liabilities of the business is projected and the "True and Fair" view is distorted. It can be done by any of the following methods.

a. Provision of inadequate depreciation on fixed assets.
b. Not providing for doubtful debts on debtors.
c. Revenue expenditure treated as capital expenditure.
d. Overvaluing stock.
e. Showing the items of slow moving, obsolete, damaged stock, etc. at full cost.
f. Actual liability shown as contingent liability.
g. Underestimating liabilities.
h. Showing fictitious credit sales and thereby higher profitability.

Window dressing is manipulation of account in which certain adjustment is made in such a way by the management that the financial statement shows the position / profitability of the company much better and sound than the actual position. E.g. Satyam Ltd., Maytas Ltd., Enron Ltd., Lehman Brothers, etc.

Concept question: <u>Break-Even Analysis:</u>

Break Even Analysis is considered as an important tool to profit planning. Break even analysis indicates at what level costs and revenue are in equilibrium. The break-even-point is a "no-profit, no-loss point", where total cost equal total selling price / total revenue.

Multiple Choice Questions:

(1) Decision involving purchase of fixed assets are also termed as:

(a) Capital Structure Decision. **(b)** Capital Budgeting.
(c) Capital Restructuring. **(d)** Capital Mix Decisions.

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CHAPTER : CASH MANAGEMENT

Cash management is the process whereby the cash inflows and outflows are controlled so that current obligations will be met in time and any excess cash will earn income. It also includes the ability to obtain credit so that the enterprise can have access to cash to finance temporary cash deficits. The cash cycle (like the operating cycle) covers the period from when an enterprise identifies the need for goods and services to when payment is realized from sales.

Methods / Tools of Cash Management:

The following are the popular methods of cash management.

1. **Cash budgets.**
2. **Long term cash forecasting:** This involves planning for cash requirements for a period of over a year and includes capital expenditure decisions, sale of fixed assets, issue of shares, redemption etc.
3. **Reports:** Most firms used there management information system (MIS) to prepare regular and sometimes even daily treasury reports to report the cash position.
4. **Prompt billing:** Invoices should be promptly sent to customers to minimize billing float.
5. **Obtaining favorable credit terms of purchase:** This depends on the company's bargaining power with the suppliers.
6. **Concentration banking:** In concentration banking the company establishes a number of strategic collection centers in different region instead of a single collection at the head office. Payments received by the different collection centres are deposited with their respective local bank which in turn transfers all surplus funds to the concentration bank to the head office. The concentration with which the company has its major bank account is generally located at the headquarters. This system reduces the period between the time a customer mails in his remittances and time when they become spendable funds with the company. Concentration banking is one important and popular way of reducing the size of the float. (Float is the time taken to convert a transaction into cash.) Any where banking across nation wide Branches is another facility (SBI, ICICI, etc.)
7. **Lock Box System:-** Under this system, customers deposit their cheques in special boxes and the local branch collects them and deposits them immediately. For example, the system used by mobile phone and electric companies.
8. **Playing the float:-** Playing the float can maximizes availability of cash. In this, a firm estimates accurately the time when the cheques issued will be presented for payment and thus utilizes the float period to its advantage by issuing more cheques but having in the bank a lesser cash balance.

The term float is used to refer to the periods that affect cash as it moves through the different stages of the collection process. Four kinds of float with reference to management of cash are:

- **Billing float:** An invoice is the formal document that a seller prepares and sends to the purchaser as the payment request for goods sold or services provided. The time between the sale and the mailing of the invoice is the billing float.
- **Mail float:** This is the time when a cheque is being processed by the post office, courier messenger service or other means of delivery.

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- **Cheque processing float:** This is the time required to sort, record and deposit the cheque after it has been received by the company.
- **Banking processing float:** This is the time from the deposit of the cheque to the crediting of funds in the sellers account.

9. **RTGS (Real Time Gross Settlement)**:- i.e. Online Payment to suppliers and from customers can reduce 'float'.

Distinguish between cash budget and cash forecast:

Cash Budget	Cash Forecast
Cash budget is usually prepared for short periods ranging up to one year.	Cash forecast is for longer terms exceeding one year such as 3 years, 5 years, etc.
Objective is to ensure short term liquidity an avoid default in timely discharge of current liabilities.	Objective is to study sources of funds for various future requirements.
Thrust is on current assets and liabilities and maintaining cash cushion for safety.	Capital receipts and capital expenditure investment dominate this number game.
Usually prepared by junior management team for perusal of senior managers.	Usually prepared by senior management for perusal of directors owners.
It is working capital management activity.	It is more of investment planning activity.

Distinguish between Cash Flow Statement and Cash Budget:

Cash Flow Statement	Cash Budget
Cash flow statement is prepared based on past data of income statement and balance sheet.	Cash budget is prepared based on estimates of collection and outgo of cash.
Is historical in nature.	Is futuristic in nature.
Analytical tool.	Planning tool.
Is based on real data.	Is based on estimates.

Multiple Choice Questions

(1) In which of the following case; the ownership of the goods passes on immediately on making the down payment from the seller to the buyer?
(a) Lease agreement. **(b)** Hire Purchase agreement.
(c) Leave and License agreement. **(d)** Installment System.

(2) Which of the following factors influences the need of Working Capital of a firm?
(a) Type of Technology used. **(b)** Inflation.
(c) Nature of the Business. **(d)** All of the above.

(3) The most important ratio in case of granting of term loan is______.
(a) EPS. **(b)** P/E. **(c)** Current Ratio. **(d)** DSCR.

(4) Debentures is a_______ securities.
(a) Ownership. **(b)** Creditorship. **(c)** Government. **(d)** None of the above.

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CHAPTER : RECEIVABLES MANAGEMENT

The term **'receivables'** is referred as "**debt owed to the firm by customer arising from sale of goods or services on credit in the ordinary course of business**." Receivables Management is, thus, defined as the management of the receivables in the ordinary course of business, in such a manner that the return on proprietors fund is maximized.

Credit Management Process

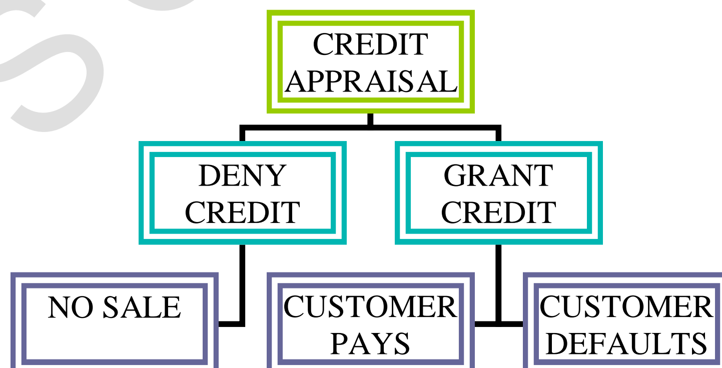
The need of receivables management arises only when company grants credit to its customers. To manage overall condition of receivables, company needs to frame the policy that will govern this process and there are other aspects that are involved in managing receivables. These aspects can be divided in three parts: **(i)** Credit policy, **(ii)** Credit analysis, and **(iii)** Control of receivable.

(i) Credit policy:- It generally involves decision relating to period of credit, discount (if any) and other special items.

- **Period of credit:-** Credit period generally depends on the demand prevailing in the market. It is also dependent on the custom, the practice followed in the industry, credit risk, and availability of funds and possibility of bad debts.
  The credit period is generally stated in term of net days. For example, if the firm's credit terms are "net 50", it is expected that customer will repay credit obligations not later than 50 days.

- **Discount policy:-** Discounts are normally given to speed up the collection of debts. A cash discount is means of improving the liquidity of the seller. In practice, credit terms are written as follows. "3/15 net 60". These means that client will get 3% discount if it pays within 15 days of sale, if he does not avail the offer he must make payment within 60 days. Credit period in this includes three important things i.e. **(a)** rate of cash discount, **(b)** cash discount period and **(c)** net credit period.

(ii) Credit appraisal / analysis:- After determining credit terms, firm should test whether customer will be able to pay debts if it grants credit to him. Here analysis regarding 5 Cs (Character, capacity, capital, conditions and collateral) is done to know his position in the market and depending on the analysis, final decision is taken. The credit granting decision is:



Credit Rating:- An important task for finance manager is to rate the various debtors who seek credit facility. These involves decisions regarding individual parties so as to ascertain how much credit can be extended and for how long. Here finance manager has to look into credit-worthiness of a party and sanction credit limit only after he is convinced that the party is sound. This would involve an analysis of the financial status of the party.

- The credit manager has to employ a number of sources to obtain credit information the following are important sources.
  - **Trade References:-** The firm can ask the customer to give trade reference of people with whom he is doing business or has done it. The trade reference maybe contacted by the firm to get the necessary information.
  - **Bank references:-** A firm can get credit information from the bank were his customer has account in it. Firm can ask bank officials regarding the relationship that its customer has with bank when it comes to exercise the obligation.
  - **Credit Bureau Reports:-** In some cases the associations for specific industries maintain a credit bureau which provides useful and authentic credit information for their members. Credit rating agencies in India which do the same rate CRISIL (Credit Rating Investment Services of India Ltd), IICRA (Investment Information and Credit Rating Agency)
  - **Past Experience:-** In case of existing customers, the past experience of his account would be valuable sources of essential data for security and interpretation.
  - **Published Financial Statements:-** Financial statements are powerful statements itself to determine the creditworthiness of the customers. Using tools like cash flow statement & ratios the financial position of the customer can be determined.

Once the credit-worthiness of a client is ascertained, the next question to resolve is to set a limit on the credit. In all such enquiries, the finance manager must be discreet and should always have the interest of high sales in view.

(iii)Control of receivables:

Another aspect of management of debtors is control of receivables. Merely setting of standards through policy is not sufficient. It is, equally important to control receivables.

Collection policy: Efficient and timely collections of debtors ensure that the bad debts losses are reduced to the minimum and the average collection period is shorter. The collection cell of a firm has to work in a manner that it does not create too much resentment amongst the customers. On the other hand, it has to keep the amount of outstanding on check. Hence, it has to work in a very smooth manner and diplomatically.

It is important that clear-cut procedure regarding credit collection is set up. Such procedure must answer questions like the following:

- How long should a debtor balance be allowed to exist before collection process is started?
- What should be the procedure of follow up with defaulting customer? How reminders are to be send and how should each successive reminder be drafted?
- Should their be collection machinery whereby personal calls by company's representatives are made?

What should be the procedure for dealing with doubtful accounts? Is legal action to be instituted? How should account be handled?

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CHAPTER : NATURE OF FINANCIAL MANAGEMENT

DEFINE AND EXPLAIN FINANCIAL MANAGEMENT

Financial Management is broadly concerned with the mobilization and deployment of funds by a Business organization. For efficient operation of business, it is necessary to obtain and utilize the funds effectively. This job is done by Financial Management.
According to **Pawan Jhabak,** **"**Finance is simply the art & science of managing money.**"** Basically therefore financial management centers around fund raising for Business in the most economical way and investing these funds in optimum way so that maximum returns can be obtained for the share holders. Practically all Business decision have financial implication. Hence, financial management is interlinked with all other functions of business.

ROLE / FUNCTION OF FINANCIAL MANAGEMENT / MANAGER AND HOW HAVE THEY CHANGE IN RECENT YEARS.

Role of financial management / manager	
Sources / Mobilization of funds *(Financial decision)*	Application / deployment of funds *(Investment decisions)*
1. Proprietors Funds Share capital	1. Fixed Assets (Capital Budgeting)
Reserve & surplus	
2. Borrowed Fund	2. Investments
(capital structure)	(Treasury Management)
(cost of capital)	3. Net current Assets
(Dividend policy)	(Working capital management)

The twin aspects procurement & effective utilization of funds are the crucial tasks, which the financial manager faces. The financial manager is required to look into financial implication of any decision in a firm. The finance manager has to manage funds in such a way as to make their optimum utilization & to ensure that their procurement is in a manner so that the risk, cost & control considerations are properly balanced under a given situation.

Functions of Finance Manager

- **Estimating the requirement of fund.**
- **Decision regarding capital structure.**
- **Investment decision.**
- **Dividend decision.**
- **Working capital management / liquidity function.**
- **Maintaining financial procedures & system etc**

1) **Estimating The Requirement Of Funds:** In a business the requirement of funds have to be carefully estimated certain funds are required for long term purpose i.e. investments in fixed assets etc. A careful estimation of such funds & the timing of requirement must be made. Forecasting the requirements of funds involves the use of technique of budgetary control. Estimates of

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requirements of fund can be made only if all physical activities of the organization have been forecasted.

2) **Decisions Regarding Capital Structure:** Once the requirements of funds have been estimated, decisions regarding various sources form where these funds would be raised have to be taken. Finance manager has to carefully look into existing capital structure and see how the various proposals of raising funds will affect it. He has to maintain a proper balance between long-term funds and short-term funds. Long-term funds raised from outsiders have to be in a certain proportion with the funds procured from the owner. He has to see that capitalization of company is such that company is able to procure funds in future All such decisions are 'financing decisions'.

3) **Investment Decision:** Funds procured from different sources have to be invested in various kinds of assets. Investments of funds in a project have to be made after careful assessment of the various projects through capital budgeting. A part of long-term funds is also to be kept for financing working capital requirement. The production manager's &-finance manager keeping in view the requirement of production, future price estimates of raw material & availability of funds would determine inventory policy.

4) **Dividend Decision:** Finance manager is concerned with the decision to pay or declare dividend. He has to assist management in deciding as to what amount of dividend should be retained in business.& this depends on whether the company can make a more profitable use of funds. But in practice trend of earning, share market prices; requirement of funds for future growth, cash flow situation expectation of shareholders has to be kept in mind while deciding dividend.

5) **Working Capital Management / Liquidity Function:** The financial manager has to properly manage current assets such as cash, inventory and Accounts Receivable. He has to ensure a trade off between liquidity and profitability. He has to ensure efficient utilization of every current assets and also overall working capital involved in current assets. Adequate level of current assets is necessary to maintain required level of liquidity of funds. On the other hand if the funds are idle the profitability may be low. Therefore the financial manager has to maintain a proper balance between liquidity and profitability. It includes cash management & collection from debtors.

6) **Maintaining Financial Procedures & Systems:** This includes procedures established for the effective execution of the other functions. Budgeting accounting, record keeping and management information system (MIS) & corporate Goverance are integral part of any organization.

In the last few years, the complexion of the economic and financial environment has altered in many ways. The important changes have been as follows:

Therefore the role of finance manager has changed from Mobilisation and deployment of funds to profit planning, maximizing shareholder wealth, understanding capital markets and good corporate Goverance.

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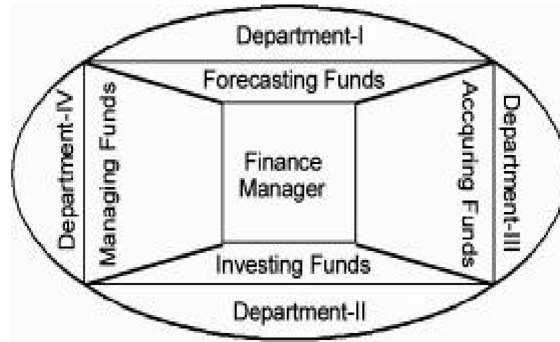
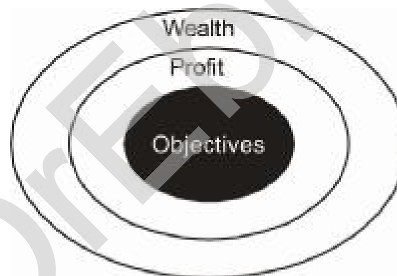
These changes have made the job of the finance manager more important, complex and demanding.



Functions of Financial Manager

DISCUSS WEALTH MAXIMIZATION AND SHAREHOLDER VALUE MAXIMIZATION AS OBJECTIVES OF FINANCIAL MANAGEMENT. OR CORPORATE HOUSES TODAY ARE INCREASINGLY MOVING TOWARDS WEALTH MAXIMIZATION. COMMENT ON THIS MOVEMENT. OR THE OBJECTIVE OF FINANCIAL MANAGEMENT IS WEALTH MAXIMISATION & NOT PROFIT MAXIMISATION. COMMENT



Objectives of Financial Management

Clear objectives are required for wise decision-making. Objectives provide a framework for optimum financial decision-making. Two of the most widely discussed approaches are:

- Profit maximization approach
- Wealth maximization approach

Profit Maximization Decision Criteria:

Under this approach, actions that increase profits should be undertaken and those that decrease profits are to be avoided. In specific operational terms, the profit maximization criterion implies that the investment, financing and dividend policy decisions of a firm should be oriented towards the

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maximization of profits. The rationable behind profit maximization as a guide to financial decision making, is due to following reasons.

- **Profit is a test of economic efficiency.** It provides the yardstick by which economic performance can be judged.
- It leads to **efficient allocation of resources** tend to be directed to uses, which in terms of profitability are the most desirable.
- It ensures **maximum social welfare.** This is so because the quest fro value drives scarce resources to their most productive uses and their most efficient users. The more effectively resources are deployed; the more robust will be the economic growth and the rate of improvement in the standard of living.

The profit maximization criterion however has been questioned and criticized on several grounds. It suffers from the following limitations:

- **Profit in absolute terms is not a proper guide** to decision making. It has no precise connotation. It can be expressed either on a per share basis or in relation to investment. Also, profit can be long term or short term, before tax or after tax, it may be the return on total capital employed or total assets or shareholders equity and so on. If profit maximization is taken to be the objective which of these variants of profit should a firm try to maximize? Therefore, a loose term like profit cannot from the basis of operational criterion for financial management.
- It leaves **considerations of timing and duration undefined.** There is no guide for comparing profit now with profit in future or for comparing profit streams of different durations.
- It **Ignores Risk Factor**. It cannot, for example, discriminate between an investment project, which generates a certain profit of Rs.50,000, and an investment project, which has a variable/uncertain profit outcome of Rs.50,000.

Wealth Maximization Decision Criterion:

This is also known as value maximization or net present worth maximization. The focus of financial management is on the value to the owners or suppliers of equity capital. The wealth of the owners is reflected in the market value of the shares. So **wealth maximization implies the maximization of the market price of shares.** It has been universally accepted as an appropriate operational decision criterion for financial management decisions as it removes the technical limitations, which characterise the earlier profit maximization criterion. Its operational features satisfy all the three requirements of a suitable operational objective of financial courses of action, namely exactness, quality of benefits and the time value of money. Maximization of the wealth of shareholders (as reflected in the market value of equity) appears to be the most appropriate goal for financial decision-making.

Wider than profit maximization is the principle of corporate governance. The fundamental objective of corporate governance is the "the enhancement of the long-term shareholder value while at the same time protecting the interests of other stakeholders." As such, this definition emphasizes the need for a company to strike a balance at all times between the need to enhance shareholders" wealth and

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protecting the interest of other stakeholders in the company such as suppliers, customers, creditors, bankers, employees of the company, government and society at large.

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.

Hence, it is commonly agreed that the objective of a firm is to maximize its value or wealth. Value is represented by the market price of the company's common stock. The market price of a firm's stock represents the judgment of all market participants as to what the value of the particular firm is. The market price serves as a performance index of the firm's progress; it indicates how well management is doing on behalf of shareholders.

An increasingly popular measure of wealth is EVA (Economic Value Added).
Economic Value Added (EVA) can be defined as the net operating profit that a company earns above its cost's of capital. It is a trademark of Stern Stewart & Co.

EVA can be calculated as follows:

EVA = Net operating profit after taxes – {Weighted average cost of capital X cap invested}

Conceptually, EVA is superior as a measure of value creation because it recognizes the cost of capital and, hence, the riskiness of a firm's operations. There is a strong correlation between EVA and the market price of a company's stock. Maximizing any accounting profit or accounting rate of return as a way of increasing shareholder's wealth often leads to an undesired outcome.

Therefore, wealth maximisation should be the objective since it:
- Considers risk.
- Uses Cash flows and not profits.
- Time value of money.
- Implies taking care of both shareholders and other stakeholders (Corporate governance).

DESCRIBE AGENCY PROBLEM IN ACHIEVEMENT OF OBJECTIVES OF FINANCIAL MANAGEMENT

A characteristic feature of corporate enterprise is the separation between ownership and management as a corollary of which the latter enjoys substantial autonomy in regard to the affairs of the firm. With widely diffused ownership, scattered and ill-organised shareholders hardly exercise any control/influence on management, which may be inclined to act in its own interests rather than those of the owners. However shareholders as owners of the enterprise have the right to change the management. Due to the threat of being dislodged for poor performance, the management would have a natural inclination to achieve a minimum acceptable level of performance, the management would have a natural inclination to achieve a minimum acceptable level of performance to satisfy the shareholders requirements/goals, while focussing primarily on their own personal goals. Thus in furtherance of their objective of survival, management would aim at ***satisfying*** instead of ***maximising*** **shareholders'** wealth.

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However, the conflicting goals of management objective of survival and maximizing owners value/wealth can be harmonised by.

1. Incentives To Management: The incentive to management is of various types.
Some of them are follows:

- **Stock options:** Confer on management the right to acquire shares of the enterprise at a special/concessional price.
- Performance shares are given based on the performance of the management as reflected in rates of return.
- Cash bonus-linked to specified performance targets

2. Monitoring of Managers:

- Auditing financial statements and limiting decision making by the management.

The audit and control procedures and limiting managerial decisions are intended to ensure that the actions of management sub serve the interests of shareholders.

- Rotation of Audit Partners.

ACCOUNTING PRINCIPLES

Even though a financial manager is not an accountant, he must be familiar with various accounting principles (GAAPs) to make good decisions:

Monetary Measurement: Accountants do not account for items unless they can be quantified in monetary terms. Items that are not accounted for (unless someone is prepared to pay something for them) include things like market leadership, brand recognition, goodwill etc.

Entity: This convention seeks to ensure that private transactions and matters relating to the owners of a business are segregated from transactions that related to the business. Even transactions of owners with business are recorded in books of company.

Materiality: The preparation of accounts involves a high degree of judgement. Where decisions are required about the appropriateness of a particular accounting judgement, the "materiality" convention suggests that this should only be an issue if the judgement is "significant" or "material" to a user of the accounts. The concept of "materiality" is an important issue for auditors of financial accounts.

Going Concern: Accountants assume, unless there is evidence to the contrary, that a company will continue operations in the foreseable future. This has important implications for the valuation of assets and liabilities.

Consistency: Transactions and valuation methods are treated the same way from year to year, or period to period. Users of accounts can, therefore, make more meaningful comparisons of financial performance from year to year. Where accounting policies are changed, companies are required to disclose this fact and explain the impact of any change in notes to Accounts.

Prudence / Conservatism: Profits are not recognised until a sale has been completed. In addition, a cautious view is taken for future problems and cost of business (they are "provided for" in the

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accounts" as soon as their is a reasonable chance that such costs will be incurred in the future. Eg. Depreciation, provision for bad debts)

Matching / Accruals: Income should be properly "matched" with the expenses of a given accounting period, to ascertain profitability. It also implies long term asset should be funded through long term source of finance & short term asset through short term sources of finance.

TYPES OF BUSINESS RISK

Financial management decisions involve risk return trade offs in aspects. Generally the basis for all financial management decisions is higher the risk higher the expected return. The decisions depend on whether the company is conservative or aggressive in its approach.

The different types of risk faced by a business are:

1) **Business Risk:** Uncertainty of doing business in a certain country industry or environment. It could be a result of government policies, economic factors, changes in technology etc. It is born by the owners of a business who may lose ball their investment. It is highest in a sole proprietorship and lowest in a public limited company. (Due to limited liability)
2) **Market Risk:** Uncertainty in returns due to changes in market conditions such as changes in tastes and fashion, fluctuating demand, consumer psychology, natural disasters etc. for eg, Bull & bear stock market.
3) **Inflation Risk:** Uncertainty arising due to changes in purchasing power of money. It affects both sales & cost. It effects real rates of interest.
4) **Interest rate Risk:** Is connecting to inflation risk. Returns/costs are determined by fluctuating interest rates. It effects the financing & investment decisions of financial managers.
5) **Liquidity Risk:** Uncertainty in meeting short term obligations due to the inability to convert an asset into cash.
6) **Financial or Leverages risk:** Risk of using borrowed funds & uncertainty in meeting interest obligations.

Eg:

Company. A		**Company B.**	
10% Loan	10L.	10% Loan	70L.
Eq. Share Cap.	90L.	Eq. Share Cap.	30L.
Capital Employed	100L.	Capital Employed	100L.

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Sales	60L	Sales	60L.
COGS	36L	COGS	36L
Gross. Profit	24L	Op. Profit	24L
Op. Exp	12L	Op. Exp.	12L
PBIT	12L	PBIT	12L
Interest	1L	Interest	7L
PBT	11L	PBT	5L
Tax@40%	4.4L	Tax@40%	2L
PAT	6.6L	PAT	2L

ROE = $\frac{6.6 \times 100}{90}$ = 7.3%

ROE = $\frac{3 \times 100}{30}$ = 10%

7) **Systematic Risk / Undiversifiable Risk:** Systematic risk is the fluctuation in investments returns attributable to changes in the broad social, economic or political factors which influence the returns on investment. Systematic risk is Undiversifiable risk & investor cannot avoid such a risk arising from the factors like inflation, money supply, level of government spending, level of rainfall, etc. which are economy wide factors

8) **Systematic Risk / Undiversifiable Risk:** Unsystematic Risk is also termed as diversified risk. Such a risk is the variation in returns due to factors which are related to the individual firm / security. It arises due to factors which are specific to a particular firm such as labour strikes, plant break down, stoppage of raw materials, etc. It is possible to reduce unsystematic risk hence it is termed as diversifiable risks. In investment management combining securities into diversified portfolios reduces such a risk. It is based on the principle of "Don't put all the eggs in the same basket", diversify it. Since diversification reduces the risk.

SCOPE OF FINANCIAL MANAGEMENT

Scope of Financial Management					
Forecasting	Financing	Coordination & control	Costing	Decision making	Others
Analysis of Economic Trends	Acquiring Funds	Financial Adjustment	Measuring cost of capital	Financial Decision	Tax Management
Analysis of Industries Trends	Allocation of funds	Accounting	Preparing cost sheet	Investment Decision	Fixed Assets management
Forecasting Financial requirement	Investment of funds	Budgeting	Marginal costing	Management of income	Inventory / Receivable management
Profit planning	Ensuring availability of funds	Reporting		Dividend decision	Corporate Governance
Estimating ROI				Meeting contingent liability	Employment Benefits

Financial management is one of the important parts of overall management, which is directly related with various functional departments like personnel, marketing and production. Financial management covers wide area with multidimensional approaches. The following are the important scope of financial management.

1. Financial Management and Economics

Economic concepts like micro and macroeconomics are directly applied with the financial management approaches. Investment decisions, micro and macro environmental factors are closely associated with the functions of financial manager. Financial management also uses the economic equations like money value discount factor, economic order quantity etc. Financial economics is one of the emerging area, which provides immense opportunities to finance, and economical areas.

2. Financial Management and Accounting

Accounting records includes the financial information of the business concern. Hence, we can easily understand the relationship between the financial management and accounting. In the olden periods, both financial management and accounting are treated as a same discipline and then it has been merged as Management Accounting because this part is very much helpful to finance manager to take decisions.

3. Financial Management or Mathematics

Modern approaches of the financial management applied large number of mathematical and statistical tools and techniques. They are also called as econometrics. Economic order quantity, discount factor, time value of money, present value of money, cost of capital, capital structure theories, dividend theories, ratio analysis and working capital analysis are used as mathematical and statistical tools and techniques in the field of financial management.

4. Financial Management and Production Management

Production management is the operational part of the business concern, which helps to multiple the money into profit. Profit of the concern depends upon the production performance. Production performance needs finance, because production department requires raw material, machinery, wages, operating expenses etc.

5. Financial Management and Marketing

Produced goods are sold in the market with innovative and modern approaches. For this, the marketing department needs finance to meet their requirements. The financial manager or finance department is responsible to allocate the adequate finance to the marketing department.

6. Financial Management and Human Resource

Financial management is also related with human resource department, which provides manpower to all the functional areas of the management

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CHAPTER : "Sources of Short Term and Long Term Finance"

Finance is the lifeblood of an organization can exist without it. Finance is required because receipts don't match expenditure, inflows don't match outflows. Sources of finance are categorized in 3 ways:

1. According to the period ie short, medium and long term
2. According to the ownership ie owners fund and borrowed funds
3. According to the generation ie internal and external sources

SHORT TERM SOURCES OF FINANCE:-

Short terms of finance are required primarily to meet working capital requirements. The focus is on maintaining liquidity at a reasonable cost. The various sources of short term finance are:

1. **Trade Credit:-** This is the credit extended by suppliers of material and other resources.

2. **Cash Credits / Overdrafts:-** Under this arrangement the borrower can borrow upto a fixed limit and repay it as and when he desires. Interest is charged only running balance and not on the sanctioned amount. A minimal charge is payable for availing this facility.

3. **Loans repayable in one year:-** They are either credited to the current of the borrower or given to him in cash. A fixed rate of interest is charged and the loan amount is repayable on demand or in periodical installments.

4. **Purchase / Discount of Bills:-** A bill may be discounted with the bank and when it matures on a future date the bank collects the amount from the party who had excepted the bill. When a bank is short of funds it can sell or rediscount the bill on the other hand the bank with surplus funds would invest in bill. However, with discount rate at 10-11 percent for 90-day paper, bill discounting is an expensive sources of short-term funds.

5. **Letter of Credit:-** A letter of credit is an instrument issued by a bank on behalf of an importer, whereby the bank agrees to honour the draft drawn on the importer provided certain condition are satisfied. Through the letter of credit arrangement, the credit of the importer is substituted by the credit of the bank. Hence, it virtually eliminates the risk of the exporter when he sells to an unknown importer in a foreign country. When an L/C is opened by the bank in favour of the customer it takes the responsibility of honoring the obligation in case the customer fails to do so. In this case even though the customer provides the credit the risk is born by the bank.

6. **Inter-Corporate Deposits:-** A deposit made by one company with another, normally for a period of up to 6 months is referred to as an inter-corporate deposit. Such deposit are usually of 3 types:
   a) **Call Deposits:-** In theory, a call deposit is withdrawable by the lender on giving a days notice. In practice however the lender has to wait for at least three days.
   b) **Three Month Deposits:-** More popular in practice, these deposits are taken by borrowers to tide over a short term cash inadequacy that may be caused due to one or more of the following factors: disruption in production, excessive imports of raw material, tax payment delay in collection, dividend payment, and unplanned capital expenditure.

c) **Six Month Deposits**:- Normally, lending companies do not extend deposits beyond this time frame. Such deposits are usually made with first-class borrowers.

As inter-corporate deposits represent unsecured borrowing, the lending company must satisfy itself about the credit worthiness of the borrowing firm.

Characteristics of the Inter-Corporate Deposit Market:

a) **Lack of Regulation**:- The lack of legal hassles and bureaucratic red tape makes an inter-corporate deposit transaction very convenient.
b) **Secrecy:-** Brokers are discreet about their lists of borrowers and lenders.
c) **Importance of Personal Contacts:-** Lending decisions in the inter-corporate deposit markets are based on personal contacts and market information which may sometime lack reliability.

7. **Short-Term Loan From Financial Institution:-** The Life Insurance Corporation of India, The General Insurance Corporation of India. and The Unit Trust of India provide short-term loans to manufacturing companies with an excellent track record

. **Features:**

a. They are totally unsecured.
b. The loan is given for the period of 1 year and can be renewed for 2 consecutive years, provided the original eligibility criteria are satisfied.
c. After a loan is repaid, the company has to wait for at least 6 months before availing of a fresh loan.
d. The loans carry a higher interest rate. However, there is a rebate of 1 % for prompt payment.

8. **Commercial Paper:-** Large firms who are financially strong issue commercial paper. It represents a short-term unsecured promissory note issued by firms of high credit rating.

Its important features include:

1. Maturity ranges from 90-180 days.
2. It is sold at a discount from its face value and redeemed at its face value. Thus the implicit interest rate is a function of size of the discount and the period of maturity.
3. CP are either directly placed with investors or sold though dealers / merchant bankers. Usually bought by investors who keep it till the maturity and hence there is no well developed secondary market.

Who can issue CP?

Highly rated listed companies, primary dealers and All-India financial institutions have been permitted to raise short-term resources.

Eligibility of Issuing CP

Minimum tangible net worth as per latest audited balance sheet is Rs.5 crore.

Company has been sanctioned working capital limit by bank(s) or All-India financial institution(s) and

The company is classified as a Standard Asset by the financing bank(s) institution(s)

Minimum Credit Rating required from recognised credit rating agencies

Maturity period of CP
The CP can be issued for maturities between 15 days to 1 year from the date of its issue.

Minimum amount of investment and denomination of CP
The minimum amount required to be invested by a single investor is atleast Rs.5 lakhs. It is issued in denominations of Rs.5 lakh or multiples thereof.

9. **Factoring:-** Factoring is a financial transaction whereby a business sells its accounts receivables at discount to a factor. The three parties directly are: the seller, debtor, and the factor. The seller is owed money (usually for worked performed or goods sold) by the second party, the debtor. The seller than sells the debtor's accounts at a discount to the third party, the factor. The debtor than directly pays the factor the full value of invoice.

Factoring differs from a bank loan in three main ways. First, the emphasis is on the value of the receivables, not the firm's credit worthiness. Secondly, factoring is not a loan- it is the purchased of an asset (the receivable). Finally, a bank loan involves two parties whereas factoring involves three.

Features of Factoring Arrangement:

a) The factor selects the account of the client that would be bought by it.
b) The factor assumes responsibility for collecting the debt of accounts handled by it.
c) The factor advance money to the client against not-yet-collected and not-yet-due debts. Typically the amount advanced is 70-80% of the face value of the debt and carries and interest rate, which may be equal to or marginally higher than the lending rate of commercial banks.
d) Factoring may be on a recourse basis or non-recourse basis (full credit risk). (Presently, in India it is done only on a recourse basis)

Forfaiting is similar to factoring. It is the purchasing of an exporter's receivables (the amount importers owe the exporter) at a discount by paying cash. The forfaiter, the purchaser of the receivables), becomes the entity to whom the importer is obliged to pay its debt. By purchasing these receivables- which are usually guaranteed by the importer's bank- the forfaiter frees the exporter from credit and from the risk of not receiving payment from the importer who purchased the goods on credit.

Sources of Long-term Finance

11.1 Introduction

As you are aware finance is the life blood of business. It is of vital significance for modern business which requires huge capital. Funds required for a business may be classified as long term and short

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term. You have learnt about short term finance in the previous P. Finance is required for a long period also. It is required for purchasing fixed assets like land and building, machinery etc. Even a portion of working capital, which is required to meet day to day expenses, is of a permanent nature. To finance it we require long term capital. The amount of long term capital depends upon the scale of business and nature of business. In this lesson, you will learn about various sources of long term finance and the advantages and disadvantages of each source.

11.2 Objectives

After studying this lesson, you will be able to:

- explain the meaning and purpose of long term finance;
- identify the various sources of long term finance;
- define equity shares and preference shares;
- distinguish between equity shares and preference shares;
- explain the advantages and disadvantages of equity shares from the point of view of (a) shareholders and (b) management;
- define Debentures;
- enumerate the types of debentures;
- explain the merits and demerits of debentures as a source of long term finance;
- compare the relative advantages of issuing equity shares and debentures;
- explain the benefits and limitations of retained earnings;
- explain the merits and demerits of Public Deposits;
- outline the rules and regulations about inviting and accepting public deposits by companies;
- discuss the merits and demerits of long term borrowing from commercial banks.

11.3 Long Term Finance – Its meaning and purpose

A business requires funds to purchase fixed assets like land and building, plant and machinery, furniture etc. These assets may be regarded as the foundation of a business. The capital required for these assets is called **fixed capital**. A part of the working capital is also of a permanent nature. Funds required for this part of the working capital and for fixed capital is called long term finance.

Purpose of long term finance:

Long term finance is required for the following purposes:

1. To Finance fixed assets :

Business requires fixed assets like machines, Building, furniture etc. Finance required to buy these assets is for a long period, because such assets can be used for a long period and are not for resale.

2. To finance the permanent part of working capital:

Business is a continuing activity. It must have a certain amount of working capital which would be needed again and again. This part of working capital is of a fixed or permanent nature. This requirement is also met from long term funds.

3. To finance growth and expansion of business:

Expansion of business requires investment of a huge amount of capital permanently or for a long period.

FACTORS DETERMINING LONG-TERM FINANCIAL REQUIREMENTS :

The amount required to meet the long term capital needs of a company depend upon many factors. These are :

(a) Nature of Business:

The nature and character of a business determines the amount of fixed capital. A manufacturing company requires land, building, machines etc. So it has to invest a large amount of capital for a long period. But a trading concern dealing in, say, washing machines will require a smaller amount of long term fund because it does
not have to buy building or machines.

(b) Nature of goods produced:

If a business is engaged in manufacturing small and simple articles it will require a smaller amount of fixed capital as compared to one manufacturing heavy machines or heavy consumer items like cars, refrigerators etc. which will require more fixed capital.

(c) Technology used:

In heavy industries like steel the fixed capital investment is larger than in the case of a business producing plastic jars using simple technology or producing goods using labour intensive technique.

11.4 SOURCES OF LONG TERM FINANCE

The main sources of long term finance are as follows:

1. Shares: These are issued to the general public. These may be of two types:
(i) Equity and (ii) Preference. The holders of shares are the owners of the business.

2. Debentures: These are also issued to the general public. The holders of debentures are the creditors of the company.

3. Public Deposits : General public also like to deposit their savings with a popular and well established company which can pay interest periodically and pay-back the deposit when due.

4. Retained earnings: The company may not distribute the whole of its profits among its shareholders. It may retain a part of the profits and utilize it as capital.

5. Term loans from banks: Many industrial development banks, cooperative banks and commercial banks grant medium term loans for a period of three to five years.

6. Loan from financial institutions: There are many specialised financial institutions established by the Central and State governments which give long term loans at reasonable rate of interest. Some of these institutions are: Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Unit Trust of India (UTI), State Finance Corporations etc.

7) American Depository Receipts (ADR):- ADR is a stock, which trades in united states but represents a specified number of shares in a foreign corporation. Indian companies having capital demands that are more than the availability of finance at home can issue 'ADR'.

8) Global Depository Receipts (GDR):- GDRs are essentially instrument created by overseas depository bank that are authorised by issuing companies in India to issue instrument outside the country.

9) Lease Financing:- In the recent years, the lease financing has emerged as one of the most important sources of long term financing. Under the leasing arrangement the company acquires the right to use the asset from lessor without holding the title to it.

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10) Hire Purchase:- In case of hire purchase transaction, the asset is delivered by the owner to company on the agreement that company pays the agreed amount in periodical installment.

11) Venture Capital:- Venture capital is money provided by professional institution who invest along side management in young, rapidly growing companies that have potential to develop into significant economic companies.

12) External Commercial Borrowing (ECB):- The guiding principles of ECB policy is government desire of maintaining prudent limits for total external borrowing and at the same time giving flexibility to corporates.

13) Eurobond & Foreign bond:- A company can raise fund by issuing Eurobond and foreign bond to investors in other countries.

14) Government Subsidies:- Government subsidies are the concessions and incentives given by government to lower the commodity price in public interest.

Intext Question 11.1
A. Fill in the blanks with appropriate words given within brackets against each sentence.
1. Long term finance is required for ______________ (Fixed Assets/Current Assets)
2. Long Term sources of finance are also required for______________ of working capital (whole/permanent part)
3. Investment in machines require _________ (Short term finance/long term finance)
4. Fixed capital requirement is more in ___________ business (manufacturing/trading).

B Name the long term source of finance in the following cases:
1. A part of profits of the company that is used as capital.
2. Savings of the public invested in companies for safety and interest earning.
3. Available to a company as ownership capital.
4. Long term loans from the public.

11.5 Shares

Issue of shares is the main source of long term finance. Shares are issued by joint stock companies to the public. A company divides its capital into units of a definite face value, say of Rs. 10 each or Rs. 100 each. Each unit is called a share. A person holding shares is called a shareholder.

Characteristics of shares:
The main characteristics of shares are following:
1. It is a unit of capital of the company.
2. Each share is of a definite face value.
3. A share certificate is issued to a shareholder indicating the number of shares and the Face value amount.
4. Each share has a distinct number.

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5. The face value of a share indicates the interest of a person in the company and the extent of his liability.
6. Shares are transferable units.

Investors are of different habits and temperaments. Some want to take lesser risk and are interested in a regular income. There are others who may take greater risk in anticipation of huge profits in future. In order to tap the savings of different types of people, a company may issue different types of shares. These are:

1. Preference shares, and
2. Equity Shares.

Preference Shares : Preference Shares are the shares which carry preferential rights over the equity shares. These rights are (a) receiving dividends at a fixed rate, (b) Priority in getting back the capital in case the company is wound-up or after fixed period. Investments in these shares are relatively safe, and a preference shareholder also gets dividend regularly.

Equity Shares: Equity shares are shares which do not enjoy any preferential right in the matter of payment of dividend or repayment of capital. The equity shareholder gets dividend only after the payment of dividends to the preference shares. There is no fixed rate of dividend for equity shareholders. The rate of dividend depends upon the surplus profits. In case of winding up of a company, the equity share capital is refunded only after refunding the preference share capital. Equity shareholders have the right to take part in the management of the company. However, equity shares also carry more risk. They have potential of high returns.
Following are the merits and demerits of equity shares:

(a) Merits

(A) To the shareholders:

1. In case there are good profits, the company pays dividend to the equity shareholders at a higher rate.
2. The value of equity shares i.e price goes up in the stock market with the increase in profits of the concern.
3. Equity shares can be easily sold in the stock market.
4. Equity shareholders have greater say in the management of a company as they are conferred voting rights by the Articles of Association.

(B) To the Management:

1. A company can raise fixed capital by issuing equity shares without creating any charge on its fixed assets.
2. The capital raised by issuing equity shares is not required to be paid back during the life time of the company. It will be paid back only if the company is wound up.
3. There is no liability on the company regarding payment of dividend on equity shares. The company may declare dividends only if there are enough profits.
4. If a company raises more capital by issuing equity shares, it leads to greater confidence among the investors, lenders and creditors.

Demerits :

(A) To the shareholders

1. Uncertainly about payment of dividend: Equity share-holders get dividend only when the company is earning sufficient profits and the Board of Directors declare dividend. If there are preference shareholders, equity shareholders get dividend only after payment of dividend to the preference shareholders.

2. Speculative: Often there is speculation on the prices of equity shares. This is particularly so in times of boom and doom. In bull market price of equity shares generally rise more than the fundamentals of the company deserve & vice verse

3. Danger of over–capitalisation: In case the management miscalculates the long term financial requirements, it may raise more funds than required by issuing shares. This may amount to over-capitalization which in turn leads to low value of shares in the stock market.

4. Ownership in name only : Holding of equity shares in a company makes the holder one of the owners of the company. Such shareholders enjoy voting rights. They manage and control the company. But then it is all in theory. In practice, a handful of persons (i.e. promoters) control the votes and manage the company. Moreover, the decision to declare dividend rests with the Board of Directors.

5. Higher Risk : Equity shareholders bear a very high degree of risk. In case of losses they do not get dividend. In case of winding up of a company, they are the very last to get refund of the money invested. Equity shares actually swim and sink with the company.

B) To the Management

1. No trading on equity : Trading on equity means ability of a company to raise funds through preference shares, debentures and bank loans etc. On such funds the company has to pay at a fixed rate. This enables equity shareholders to enjoy a higher rate of return when profits are large. The major part of the profit earned is paid to the equity shareholders because borrowed funds carry only a fixed rate of interest. But if a company has only equity shares and does not have either preference shares, debentures or loans, it cannot have the advantage of trading on equity.

2. Conflict of interests : As the equity shareholders carry voting rights, groups are formed to corner the votes and grab the control of the company. There develops conflict of interests which is harmful for the smooth functioning of a company. (eg. Ranbaxy Ltd.)

Difference between preference shares and equity shares : We have learnt the meaning and the feature of preference and equity shares. Now we can differentiate between the two.

Basic of Difference	Preference Shares	Equity Shares
1. Choice	It is not compulsory to issue these shares	It is compulsory to issue the shares.
2. Payment of dividend	Dividend is Paid on these shares in preference to the equity shares.	Dividend is paid on these shares only after paying dividend on preference shares.
3. Return of Capital.	In case of winding up of a company the capital is refunded in preference over the equity shares	Capital of these shares is refunded in case of winding up of the company after refund of preference share capital.
4. Risk/return potential	Generally Low	Generally high

Intext Questions 11.2

A) Following are the characteristics either of equity shares or of preference shares. Put the appropriate characteristics against

(a) Equity shares and **(b)** preference shares:
i) No fixed rate of dividend.
ii) Carry maximum risk.
iii) Priority regarding payment of dividend and repayment of capital.
iv) Provides scope for trading on equity.
B) Following are the merits and demerits of equity shares classify them as
(a) Merits to share holders, (b) Demerits to shareholders, (c) Merits to Management,
(d) Demerits to Management. i) In case of good profits, company pays higher dividend
ii) Benefit of trading on equity will not be available. iii) It helps in creating more confidence among the investors and creditors
iv) No certainty of payment of dividends.

11.6 Debentures

Whenever a company wants to borrow a large amount of fund for a long but fixed period, it can borrow from the general public by issuing loan certificates called Debentures. The total amount to be borrowed is divided into units of fixed amount say of Rs.100 each. These units are called Debentures. These are offered to the public to subscribe in the same manner as is done in the case of shares. A debenture is issued under the common seal of the company. It is a written acknowledgement of money borrowed. It specifies the terms and conditions, such as rate of interest, time repayment, security offered, etc.

Characteristics of Debenture

Following are the characteristics of Debentures:
i) Debentureholders are the creditors of the company. They are entitled to periodic payment of interest at a fixed rate.
ii) Debentures are repayable after a fixed period of time, say five years or seven years as per agreed terms.
iii) Debentureholders do not carry voting rights.
iv) Ordinarily, debentures are secured. In case the company fails to pay interest on debentures or repay the principal amount, the debentureholders can recover it from the sale of the assets of the company.

Types of Debentures :

Debentures may be classified as:
a) Redeemable Debentures and Irredeemable Debentures
b) Convertible Debentures and Non-convertible Debentures.

Redeemable Debentures :

These are debentures repayable on a pre-determined date or at any time prior to their maturity, provided the company so desires and gives a notice to that effect.

Irredeemable Debentures :

These are also called perpetual debentures. A company is not bound to repay the amount during its life time. If the issuing company fails to pay the interest, it has to redeem such debentures.

Convertible Debentures :

The holders of these debentures are given the option to convert their debentures into equity shares at a time and in a ratio as decided by the company.

Non-convertible Debentures:

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These debentures cannot be converted into shares.

Merits of debentures :

Following are some of the advantages of debentures:

1) Raising funds without allowing control over the company:

Debenture holders have no right either to vote or take part in the management of the company.

2) Reliable source of long term finance :

Since debentures are ordinarily issued for a fixed period, the company can make the best use of the money. It helps long term planning.

3) Tax Benefits :

Interest paid on debentures is treated as an expense and is charged to the profits of the company. The company thus saves incometax.

4) Investors' Safety :

Debentures are mostly secured. On winding up of the company, they are repayable before any payment is made to the shareholders. Interest on debentures is payable irrespective of profit or loss.

Demerits :

Following are the demerits of debentures:

1. As the interest on debentures have to be paid every year whether there are profits or not, it becomes burdensome in case the company incurs losses.

2. Usually the debentures are secured. The company creates a charge on its assets in favour of debentureholders. So a company which does not own enough fixed assets cannot borrow money by issuing debentures. Moreover, the assets of the company once mortgaged cannot be used for further borrowing.

3. Debenture-finance enables a company to trade on equity. But too much of such finance leaves little for shareholders, as most of the profits may be required to pay interest on debentures. This brings frustration in the minds of shareholders and the value of shares
may fall in the securities markets.

4. Burdensome in times of depression : During depression the profits of the company decline. It may be difficult to pay interest on debentures. As interest goes on accumulating, it may lead to the closure of the company. Until now you have learnt about issue of shares and debentures as two main sources of raising long term finance. You have also learnt about the merits and demerits of the two. Now let us make a comparative study of shares and debentures for raising long term capital.

Basis	Shares	Debentures
1. Status	Shareholders are the owners of the company. They provide ownership capital which is not refundable.	Debentureholders are the creditors of the company. They provide loans generally for a fixed period. Such loans are to be paid back.
2. Nature of return on investment	Shareholders get dividends. The amount is not fixed. It depends on the profit of the company. Hence only those persons invest in shares who are ready to take risk.	Interest is paid on debentures on fixed rate. Interest is payable even if the company is running at a loss. So It is good investment for those who do not want to take high risk.

3. Rights.	Shareholders are the real owners of the company. They have the right to vote & frame the objectives & policies of the company.	Debentures holders do not have the right to attend meetings of the company. So they have no say in the management of the company.
4. Security.	No security is required to issue shares.	Generally debentures are secured. Therefore sufficient fixed asset are required when debentures are to be issued.
5. Order of repayment	Shareholders take the maximum risk because their capital will be paid back only after repaying the loan of debentureholders	Debentureholders have the priority of repayment over shareholders

Intext Questions 11.3

A) Write true or false in the space provided against each sentence:

1. Debentureholders are the creditors of the company.
2. Debentureholders have the right to vote in the meetings of the company.
3. Interest at a fixed rate is paid on debentures.
4. Debentures carry more risk than shares.
5. Debentures are generally redeemable after a fixed period.

B. Match the following.

1. Convertible debenture.	(i) Holders have the right to recover their money from the sale of assets of the company
2. Secured debentures	(ii) Deducted from the profits of the company.
3. Interest on debentures	(iii) Permanent liability on the company.
4. Irredeemable Debentures	(iv) The holders of such debentures are given the option to exchange them for shares.

(C) Following sentences relate to either shares or debentures. Put tick (Ö) mark in the correct box given in the table below:

i) They provide ownership capital.
ii) Return on these is called interest.
iii) Return on these is called dividend.
iv) Holders enjoy voting rights.
v) Holders are the creditors of the company.

	(i)	(ii)	(iii)	(iv)	(v)
1. Shares					
2. Debentures					

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11.7 Retained Earnings

Like an individual, companies also set aside a part of their profits to meet future requirements of capital. Companies keep these savings in various accounts such as General Reserve, Debenture Redemption Reserve and Dividend Equalisation Reserve etc. These reserves can be used to meet long term financial requirements. The portion of the profits which is not distributed among the shareholders but is retained and is used in business is called retained earnings or ploughing back of profits. As per Indian Companies Act., companies are required to transfer a part of their profits in reserves. The amount so kept in reserve may be used to buy fixed assets. This is called internal financing.

Merits :

Following are the benefits of retained earnings:

1. Cheap Source of Capital :

No expenses are incurred when capital is available from this source. There is no obligation on the part of the company either to pay interest or pay back the money. It can safely be used for expansion and modernization of business.

2. Financial stability :

A company which has enough reserves can face ups and downs in business. Such companies can continue with their business even in depression, thus building up its goodwill.

3. Benefits to the shareholders:

Shareholders may get dividend out of reserves even if the company does not earn enough profit. Due to reserves, there is capital appreciation, i.e. the value of shares go up in the share market .

Limitation :

Following are the limitations of Retained Earnings:

1. Huge Profit :

This method of financing is possible only when there are huge profits and that too for many years.

2. Dissatisfaction among shareholders :

When funds accumulate in reserves, bonus shares are issued to the shareholders to capitalise such funds. Hence the company has to pay more dividends. By retained earnings the real capital does not increase while the liability increases. In case bonus shares are not issued, it may create a situation of under–capitalisation because the rate of dividend will be much higher as compared to other companies.

3. Fear of monopoly :

Through ploughing back of profits, companies increase their financial strength. Companies may throw out their competitors from the market and monopolize their position.

4. Mis-management of funds :

Capital accumulated through retained earnings encourages management to spend carelessly.

Intext Question 11.4

Which of the following statements are right and which are wrong?

1. Retained earning is the portion of profit which is not distributed among shareholders as dividend.
2. A company can create reserves even if it is running at a loss.
3. Heavy expenses are incurred to raise capital through retained earnings.
4. Retained earnings are useful for shareholders because it brings stability in the rate of dividend and leads to capital appreciation.
5. Retained earning means ploughing back of profits.

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11.7 Public Deposits

It is a very old source of finance in India. When modern banks were not there, people used to deposit their savings with business concerns of good repute. Even today it is a very popular and convenient method of raising medium term finance. The period for which business undertakings accept public deposits ranges between six months to three years.

Procedure to raise funds through public deposits:

An undertaking which wants to raise funds through public deposits advertises in the newspapers. The advertisement highlights the achievements and future prospects of the undertaking and invites the investors to deposit their savings with it. It declares the rate of interest which may vary depending upon the period for which money is deposited. It also declares the time and mode of payment of interest and the repayment of deposits. A depositor may get his money back before the date of repayment of deposits for which he will have to give notice in advance.

Features :

1. These deposits are not secured.
2. They are available for a period ranging between 6 months and 3 years.
3. They carry fixed rate of interest.
4. They do not require complicated legal formalities as are required in the case of shares or debentures.

Keeping in view the malpractices of certain companies, such as not paying
interest for years together and not refunding the money, the Government has framed certain rules and regulations regarding inviting public to deposit their savings and accepting them.

Rules governing Public Deposits

Following are the main rules governing public deposits:

1. Deposits should not be made for less than six months or more than three years.
2. Public is invited to deposit their savings through an advertisement in the press. This advertisement should contain all relevant information about the company.
3. Maximum rate of interest is fixed by the Reserve Bank of India.
4. Maximum rate of brokerage is also fixed by the Reserve Bank of India.
5. The amount of deposit should not exceed 25% of the paid up capital and general reserves.
6. The company is required to maintain Register of Depositors containing all particulars as to public deposits.
7. In case the interest payable to any depositor exceeds Rs. 10,000 p.a., the company is required to deduct income-tax at source.

Advantages :

Following are the advantages of public deposits:

1. Simple and easy:

The method of borrowing money through public deposit is very simple. It does not require many legal formalities. It has to be advertised in the newspapers and a receipt is to be issued.

2. No charge on assets :

Public deposits are not secured. They do not have any charge on the fixed assets of the company.

3. Economical :

Expenses incurred on borrowing through public deposits is much less than expenses of other sources like shares and debentures.

4. Flexibility :

Public deposits bring flexibility in the structure of the capital of the company. These can be raised when needed and refunded when not required.

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Disadvantages :

Following are the disadvantages of public deposits:

1. Uncertainty :

A concern should be of high repute and have a high credit rating to attract public to deposit their savings. There may be sudden withdrawals of deposits which may create financial problems.

2. Insecurity :

Public deposits do not have any charge on the assets of the concern. It may not always be safe to deposit savings with companies particularly those which are not very sound.

3. Lack of attraction for professional investors :

As the rate of return is low and there is no capital appreciation, the professional investors do not appreciate this mode of investment.

4. Uneconomical :

The rate of interest paid on public deposits may be low but then there are other expenses like commission and brokerage which make it uneconomical.

5. Hindrance to growth of capital-market :

If more and more money is deposited with the companies in this form there will be less investment in securities. Hence the capital market will not grow. This will deprive both the companies and the investors of the benefits of good securities.

6. Over–capitalisation :

As it is an easy, convenient and cheaper source of raising money, companies may raise more money than is required. In that case it may not be able to make the best use of the funds or may indulge in speculative activities.

Intext Questions 11.5

A) Tick the correct part of the statements:

1. Public deposits are secured/unsecured.
2. Public deposits involve/do not involve any charge on the assets of the company.
3. Advertisement is required/not required for inviting public deposit.
4. Public deposits can be/cannot be for more than three years.

B) Write yes or no against the following statements:

i) The system of public deposits is economical.
ii) Public deposits are secured.
iii) Rate of interest on public deposits is not fixed.
iv) Public deposits help in the growth of a sound capital market in the country.
v) Public deposit is a method which has become popular only recently.

19.8 Borrowing From Commercial Banks :

Traditionally, commercial banks in India do not grant long term loans. They grant loans only for short period not extending one year. But recently they have started giving loans for a long period. Commercial banks give term loans i.e. for more than one year. The period of repayment of short term loan is extended at intervals and in some cases loan is given directly for a long period. Commercial banks provide long term finance to small
scale units in the priority sector.

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Merits of long term borrowings from Commercial Banks:
The merits of long-term borrowing from banks are as follows:
1. It is a flexible source of finance as loans can be repaid when the need is met.
2. Finance is available for a definite period, hence it is not a permanent burden.
3. Banks keep the financial operations of their clients secret.
4. Less time and cost is involved as compared to issue of shares, debentures etc.
5. Banks do not interfere in the internal affairs of the borrowing concern, hence the management retains the control of the company.
6. Loans can be paid-back in easy installments.
7. In case of small-scale industries and industries in villages and backward areas, the interest charged is low.

Demerits:
Following are the demerits of borrowing from commercial banks:
1. Banks require personal guarantee or pledge of assets and business cannot raise further loans on these assets.
2. In case the short term loans are extended again and again, there is always uncertainty about this continuity.
3. Too many formalities are to be fulfilled for getting term loans from banks. These formalities make the borrowings from banks time consuming and inconvenient.

Intext Question 11.6
Write 'True' if the statement is correct and 'False' if the statement is incorrect:
(a) Commercial banks do not grant long-term loans.
(b) Short term loans grant by commercial banks can become long term loans.
(c) Commercial banks charge high rate of interest while giving loans to small scale industries and industrial units set up in villages.
(d) No guarantee or pledge of assets are to be made while borrowing from commercial banks.

11.9. What You Have Learnt
Capital is the life blood of business. A business requires capital to purchase its fixed assets, which is called long term finance. The factors that determine the long term requirements of capital are: (i) Nature of business, (ii) Size of business, (iii) Kinds of goods produced, and (iv)Technology used. The main sources of raising long term finance are: (i) Shares, (ii) Debentures (iii) Public deposits, (iv) Retained earnings, (v) loans from
financial institutions, and (vi) term loans from banks.
Share is an unit of capital of a company of a definite face value. Share indicates certain rights of its holder and the extent of his liability. Shares are mainly of two types : (i) Equity shares (ii) Preference shares. Preference shares are the shares which carry preferential rights of receiving dividend and repayment of capital (in case the company is wound up) over other shares.

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Equity shares are shares which do not carry any preferential right. Holders of these shares are the real owners of the company. They get dividends only when dividend on preference shares has been paid.
Issue of debenture is a source of borrowed capital. A debenture is a written acknowledgement of debt by a company. Debentureholders are the creditors of the company. They do not enjoy any voting rights. They are secured. Debentures may be (a) redeemable or irredeemable, and (b) convertible or non-convertible.
Public deposits channelise savings into business. They are unsecured. They bear fixed rate of interest. Deposits generally are for one year to three years. An advertisement is required for inviting public deposits.
Retained earning is a portion of profit, earned by an enterprise, set aside to finance its activities. It is also called ploughing back of profit or internal financing.
Commercial banks traditionally give loans for a short period. But recently they have started giving term loans both by extending the short-termloans and also directly for a long period.

11.11 Terminal Question

1. Why does business need long term finance? Explain in brief.
2. Give the advantages of equity shares to (a) the management and to(b) the shareholders.
3. Differentiate between :
(a) Equity shares and preference shares (b) Shares and Debentures
4. State the meaning of Debenture. Give the merits and demerits of debentures as a source of long term finance.
5. Define Retained Earnings. What are limitations of Retained Earning as a source of finance?
6. Briefly explain the meaning of Public Deposits. State the government rules and regulations regarding Public Deposits.
7. List out the various advantages and disadvantages of long term loans from commercial banks.
8. The management of an engineering company has decided to double its manufacturing capacity. Suggest, giving arguments, whether it should issue shares or debentures?

11.11 Answers to intext Questions

A.. 1. Fixed Assets **2.** Permanent **3.** long term finance **4.** Manufacturing
B. 1. Retained earning **2.** Public Deposits **3.** Shares **4.** Debentures
11.2 A a) Equity Shares **(i), (ii)**
b) Preference Shares **(iii), (iv)**
B (i) (a), (ii) (d), (iii) (c), (iv) (b)
11.3 (A) 1. True 2. False 3. True 4. False 5. True
(B) (1) (iv), (2) (i), (3) (ii), (4) (iii)
11.4 1. Right 2. Wrong 3. Wrong 4. Right 5. Right
11.5 A) 1. Unsecured 2. Do not involve 3. Required 4. Cannot be
B) (i) Yes, (ii) No, (iii) No, (iv) No, (v) No.
11.6 a) False b) True c) False d) False

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7. American Depository Receipts (ADRs):

Definition: An ADR is a certificate issued by an American bank, which represents a foreign stock share, held on deposit. Since the bank holds the stock, it is equivalent to trading the foreign stock.

Origin and Nature: - Introduced to the financial markets in 1927, an American Depository Receipt (ADR) is a stock, which trades in the United States but represents a specified number of shares in a foreign corporation. ADRs are bought and sold on American markets just like regular shares, and are issues/sponsored in the US by a bank or brokerage house. ADRs were introduced as a result of the difficulty buying shares in other countries, which trade at different prices and currency values. For this reason US banks simply purchase a large lot of shares from the company, bundles the shares into groups and reissue them on the NYSE, AMEX, or NASDAQ.

Why do companies use ADRs?

1. Companies may have capital demands that are more than the availability of financing at home. It gives more US exposure and allows them to enter the US equity markets.
2. Increasing the size of the market for its shares that may increase or stabilize the share price.
3. They also enhance the image of the company's products or services.
4. For those companies who are truly global, it allows buyers of the company's products and services to also invest in the company.

The following are a few Indian companies whose ADRs are being traded on the American Exchanges: Infosys, Reliance, Dr. Reddy's Laboratories etc

Foreign company
↓ Issues shares to the
U.S. Depository Bank
↓ Which in turn issues ADRs to the
American Investor

Benefits of ADRs to investors:

- Abundant Selection.
- Easier than buying foreign shares
- Entitled to the same information disclosure as holders of the underlying security.
- All notices and reports are issued in English language.
- All issuers must report by U.S. standards.
- Denominated in U.S. dollars.

8. Global Depository Receipts (GDRs)

Nature and Definition: Global depository receipts (GDRs) are essentially instruments created by overseas depository bank that are authorized by issuing companies in India to issue outside the

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country. GDRs are issued to non-resident investor against the shares of the issuing companies held with the nominated domestic custodian banks. They are negotiable certificates that usually represent a company's publicly trade equity and are denominated in US dollars. They are listed on a European Stock Exchange-often Luxembourg, but London is also used. For all good purposes, GDRs can be treated as direct investment in the issuing companies.

Advantages of GDR for the Issuer:- The share price of the company may stabilize because of the widening of the market. The image of the issuer is also enhanced in the global market. Euro issues cost less than domestic rights issue. Companies making Euro issue may have understanding with depository bank resulting in certain voting pattern. The Indian Company does not bear any foreign exchange risk since the securities are denominated in the rupees. On the other hand, it receives the proceeds of Euro-issue in foreign currency. Euro-issues are easier to administer since dealings are with a single shareholder, the custodian depository bank.

Advantages to the Investor:- In regard to the investor, they enjoy the benefits of international diversification while avoiding long delays in settlement and transfer of shares, confusing trade and tax practices. GDRs are quoted in dollars and dividends are paid in dollar, free of foreign exchange risk. They enable the foreign investor to avoid restriction on purchase and holding of individual company's shares. GDRs are quite as liquid as the underlying shares and they can be exchanged for shares. A GDR is tradable both in Europe and America.

9. Lease Financing:

1) Lease: A contract of lease may be defined as "A contract whereby the owner of an asset (lessor) grants to the another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent."

Important features here are:

- **a)** Owner and User are different
- **b)** Depreciation claim is not with the user (lessee) as he is not the owner. Lessor (owner) claim the depreciation.
- **c)** Lease (rent) payment is a tax-deductible expense.
- **d)** In most transactions, asset is delivered directly to the lessee by the manufacturer/ supplier. Lessor makes payment to the supplier and receives rent from lessee in future periods.
- **e)** Lease funded assets do not alter Debt Equity ratio.

2) Types of Leases:

Distinction between: Operating Lease and Finance Lease:

Operating Lease	Finance Lease
1) In an operating lease all the risks and rewards incidental to ownership are not transferred by the lessee to the lessor.	**1)** In a finance lease the lessor transfers to all the risks and rewards incidental to the ownership of the asset to the lessee.
2) Operating lease is cancelable by either party during the lease period.	**2)** Finance lease is non- cancellable and it involves payment of lease rentals over an obligatory non-cancellable lease period.

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3) In an operating lease the lessor does not relay on only a single lessee for recovery of his investment since the lease period are shorter such as even an hour, a day, a week, or a month and so on. The lessor is ultimately interested in the residual value of the asset.	**3)** In a finance lease the lessor is only a financer and usually not interested in the asset.
4) An operating lease is termed as a 'Service Lease'	**4)** Finance lease is also termed as 'full-payout leases.'
5) In an operating lease the cost of asset is not fully amortised during the primary lease (non-cancellable) period.	**5)** The finance lease enable the lessor to recover his investment in the asset lease plus to derive a profit.
6) Operating lease being shorter than the expected economic life of the asset no such option of purchase of the asset by the lessee exists there.	**6)** In a finance lease the lessee has the option to purchase the asset at a price on a date the option becomes exercisable or at the end of the lease agreement period.
7) An operating lease is generally for a period shorter than the economic life of the leased asset.	**7)** In a finance lease the lease term is for the major part of the economic life of the asset.
8) In an operating lease the lessor other than financing the cost of leased asset, also provides such as repairs, maintenance and technical advice.	**8)** In a finance lease the lessee is responsible for the repairs and maintenance, insurance and risk of obsolescence of the asset leased.
9) In an operating lease the lessor bears the risk of obsolescence of the asset leased.	**9)** In a finance lease the lessee has to bear the risk of obsolescence of the asset leased.
10) Examples: Aircrafts, Buildings, Heavy machinery, railway, wagons, Buses etc.	**10)** Examples: Hiring a taxi, chartering of Air crafts, Hiring of mobile cranes etc.

3) **Leveraged Lease:-** Under leveraged leses there are three parties. The lessor, the lessee and the financial institution / Bank who lends a major cost of the asset leased. The lessor contributes 20% to 50% of the cost and the lender contributes 50% to 80% of the cost of the asset. The periodic lease rental is being appropriately divided between the lender and the lessor.
4) **Sale and Lease Back:-** In case of sale and lease back as the name suggest, the firm sells an asset that it already owns to another firm / party and (hires) gets it on lease back from the buyer which is usually a financial institution or a leasing company.
5) **Direct Lease:-** In case of direct lease the lessee acquires the equipment directly from the manufacturer or arrange the desired equipment to be purchased by the leasing company.
6) **Cross Border Lease / International Lease:-** A cross border lease is also known as an international lease or a trans-national lease. In this case lessee and the lessor are domiciled in different countries. It is an agreement between the nationals of two countries.
7) **Triple Net Lease:-** IN case of triple net lease is obligated to pay the following typical executory costs in addition to and separate from the basic lease rental payments. Such additional executory costs are**..**

(ii) Sales Tax
(iii) Property Tax
(iv) Repairs

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(v) Parts and Accessories
(vi) Insurance
(vii) Maintenance and Servicing
(viii) Licenses and Registration

8) **Master Lease:-** Master leases are structure for lessees who either will be leasing several pieces of equipment to be received over a period of time or leasing equipment that will require frequent substitution.

10) Hire Purchase: In case of hire purchase transaction, the goods are delivered by the owner to another person on the agreement that such person pays the agreed amount in the periodical installment.

Important features here are:
(a) Ownership of the asset is transferred to the buyer only on payment of last installment.
(b) Buyer claims depreciation on the asset.

Lease	Hire Purchase
Lessor claims depreciation	Buyer claim depreciation
On completion of contract residual (salvage) value goes to Lessor.	On completion of contract residual (salvage) value goes to Buyer.
In absence of specific agreement otherwise, asset is to be returned to the lessor after the lease period.	Asset is conclusively purchased by the buyer at the end of the agreement period.
Lease payment is fully deductible for tax.	Only interest portion of EMI/ Hire value is tax deductible.

11. Venture Capital

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have a potential to develop into significant economic contributors. Venture capital is an important sources of equity for start-up companies.

Venture capitalists generally:

- Finance new and rapidly growing companies.
- Purchase equity securities
- Assist in the development of new product or services
- Add value to the company through active participation
- Take higher risk with the expectation of higher rewards
- Have a long term orientation

When considering an investment, venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. They also actively work with the company's management, especially with contact and strategy formulation. Companies such as Digital Equipment Corporation,

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Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech are famous examples of companies that received venture capital early in their development period.

In India, these funds are governed by the Securities and Exchanged Board of India (SEBI) guidelines. According to this, venture capital fund means a fund established in the form of the company or trust, which raises monies through loans, donations, and issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations.

The basic principal underlying venture capital-invest in high –risk projects with the anticipation of high returns. These funds are then invested in several fledging enterprises, which require funding, but unable to access it through the conventional sources such as bank and financial institutions. Typically first generation entrepreneurs start such enterprises. Such enterprises generally do not have any major collateral to offer as security, hence banks and financial institution are averse to funding them. Venture capital funding may be by way of investment in the equity of the new enterprises or a combination of debt and equity, though equity is the most preferred route.

Since most of the venture finance is through this route are in new areas (worldwide venture capital follows "hot industries" like infotech, electronic and biotechnology), the probability of success in very low. All project financed have a potentially high return. Some projects fail and some give moderate returns. The investment, however, is a long- term risk capital as such projects normally take 3 to 7 years to generate substantial returns. Venture capitalists give "more than money" to the venture and seek to add value to the investee unit by active participation in its management. They monitor and evaluate project on a continuous basis.

To conclude, a venture financier is one who funds a start up company, in most cases promoted by a first generation technocrat promoter with equity. A venture capitalist is not a lender, but an equity partner. He is driven by maximization: wealth maximization. Venture capitalists are sources of expertise for the companies they finance. Exit is preferably through listing on stock exchanges. This method has been extremely successful in USA, and venture funds have been credited with the success of technology companies in Silicon valley.

12) External Commercial Borrowings (ECB)

External Commercial borrowings are one of the modes for sourcing of funds for corporates. The Government of India has come out with guidelines for approval of external commercial borrowings. These guidelines reflect the government's desire of maintaining prudent limits for total external borrowings and at the same time give flexibility to corporates. The guiding principles of ECB policy are keep borrowing maturities long, costs low, and encourage infrastructure and export sector financing which are crucial for overall growth of the economy.

Applicants will be free to raise ECB from any internationally recognised source like banks, export credit agencies, suppliers of equipment, foreign collaborations, foreign equity-holders, international capital markets etc.

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13) Eurobonds & Foreign Bonds:-

A company can raise funds by issuing Eurobonds and foreign bonds to investors in other countries. Eurobonds are bonds sols outside the country in whose currency they are denominated. They are issued directly by the borrowers to the investors. Eurobond market is a free market without any regulation. It is a self-regulated market. Both fixed rate and floating rate Eurobonds are issued by the borrowers. A foreign bond is different from Eurobond. It is issued by a company in a domestic market of a foreign market. It is denominated by the currency of the country where it is issued and is subject to the laws and regulations of that country.

14) Government Subsidies:

Government subsidies are the concessions and incentives given by central or state government or both. A subsidy is the converse of an indirect tax, while indirect tax raises the price of the taxed commodity a subsidy is expected to lower the commodity price.

Forms of subsidies:

1) Cash subsidies e.g. Export, fertilizer, food etc.
2) Interest or credit subsidies
3) Tax subsidies
4) Equity subsidies e.g. investment in equity share

Viability Gap Funding (VGF) e.g. Mumbai Metro Project.

Nooyi among highest-paid women in the world: Fortune.
New York: With a pay package of $14.9 million, Indian origin chief of pepsico Indra Nooyi has made it to the list of world's 25 highest-paid woman executive with a pay package of $42.4 million in the list published by fortune & compiled by executive compensation research firm Equilar Inc for the US magazine. Nooyi, who has been named as the world's most powerful women in the US business recently, is ranked at the 10th Place in the list of 25 highest-paid women with a total compensation of $ 14.9 million (around Rs.72.44 crore) in 2008.

Multiple Choice Questions:

(1) **A** type of preference shares which can be converted into Equity Shares.
(a) Participating Preference Shares. (b) Cumulative Preference Shares.
(c) Secured Preference Shares. (d) Convertible Preference Shares.

(2) Which of the following is a tax- deductible expenditure?
(a) Interest on Debt. (b) Preference Dividend.
(c) Equity Dividend. (d) All of the above.

(3) Dividend declared between two Annual General Meeting (AGMs) is termed as _______.
(a) Stock Dividend. (b) Cash Dividend.
(c) Interim Dividend. (d) Liquidation Dividend.

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(4) Capitalisation of reserves is also termed as:
(a) Bonus Issue. (b) Stock Dividend.
(c) Both (a) and (b). (d) None of the above.

(5) A Balance-Sheet tallies: because:
(a) It is based on Double Entry System of Accounting
. (b) . It is based on Single Entry System of Accounting.
(c) All accounts are Computerised.
(d) Total of Assets equals to the total of Liabilities.

(6) Which of the following is a security on a moveable property?
(a) Pledge. (b) Mortgage.
(c) Hypothecation. (d) Lien.

(7) Time Value of Money is based on the principle of:
(a) A stich in time; saves nine.
(b) A bird in hand; is worth two in a bush.
(c) As you sow; so shall you reap.
(d) Hard Work pays in the long run.

(8) Mutual Funds Works on the principle of:
(a) Don't put all the eggs in the same basket.
(b) Diversification reduces risks.
(c) Small drops can make an ocean.
(d) All of the above.

(9) Present Value of a Rupee is always:
(a) Equal to its Future Value. (b) Greater than its Future Value.
(c) Less than its Future Value. (d) Is not related to its Future Value.

(10) **_______** is a regulatory authority over the entire Capital Markets in India.
(a) RBI. (b) SEBI (c) Stock Exchanges. (d) IRDA.

(11) An ideal liquid ratio must be **______**.
(a) 1 : 1. (b) 1 : 2. (c) 2 : 1. (d) 1.33 : 1.

(12) In the Balance-Sheet **________** stock is indicated.
(a) Opening. (b) Closing.
(c) Average. (d) Finished Goods.

(13) The abbreviation "NAV" in a mutual fund stand for**________**.
(a) New Asset Value. (b) Non- Achievable Value.
(c) Net Asset Value. (d) Net Annual Value.

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(14) The abbreviation "SIP" in a Mutual Funds stands for _________.
(a) Simple Investment Plan.
(b) Systematic Investment Plan.
(c) Small Investment Plan.
(d) Social Investment Programme.

(15) Internal funds is also termed as _________.
(a) Ploughing back of Profits. (b) Self-Financing.
(c) Internal Financing. (d) All of the above.

(16) Rights issue is also called as _______.
(a) Privileged Subscription. (b) Equity Shares.
(c) Stock Dividend. (d) Bonus Shares.

(17) _______ shares are issued free of cost.
(a) Equity. (b) Rights. (c) Preference. (d) Bonus.

(18) ________ Increase the number of shares without actually increasing the paid- up value of the share capital.
(a) Consolidation of Shares. (b) Stock Split- ups. (c) Bonus Issue. (d) Rights Issue.

(19) A stock exchange is a _______ market.
(a) Primary. (b) Secondary. (c) Tertiary.

(20) Dividend payout ratio is ________.
(a) DPS dividend by MPS. (b) DPS dividend by EPS.
(c) DPS dividend by Face Value. (d) EPS dividend by DPS.

(21) The cost of ________ capital is the highest.
(a) Equity. (b) Preference. (c) Debt. (d) International.

(22) The abbreviation "NRI" stands for ________.
(a) Not Required Indians.
(b) Non-Resident Indians
(c) Newly Resident Indians.
(d) Newly Recognised Individuals.

(23) In the word "B-Schools"; the letter "B" stands for ________.
(a) Boys. (b) Bombay. (c) Businesses. (d) Bajaj.

(24) ________ involves selling securities privately to a group of investors.
(a) Public Issue. (b) Rights Issue.
(c) Buy Back of Shares. (d) Private Placement.

(25) Members of recognised stock exchanges are termed as _________.
(a) Brokers. (b) Underwriters. (c) Shareholders. (d) Lead Managers.

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