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Chapter 1: Introduction to Accounting

Q-1 Briefly explain the concept of 'Account', 'Debit' and 'Credit'.

- An account is defined as a summarized record of transactions related to a person or a thing, e.g., when the business deals with customers and suppliers, the customer and supplier will each be a separate account.
- The account is also related to things – both tangible and intangible, like, land, building, equipment, brand value and trademarks are some of the things. When a business transaction happens, one has to identify the account that will be affected by it and then apply the rules to decide its accounting treatment.
- Typically, an account is expressed as a statement in form of English letter 'T'. It has two sides. The left hand side is called as the Debit side, and the right hand side is called as the Credit side. The debit is denoted as 'Dr' and the credit as 'Cr'.

Q-2 Briefly explain various types of Accounts.

(A) **Personal Account:** As the name suggests these are accounts related to persons. These are further divided into three categories:

- (a) These persons could be natural persons, like Suresh's A/c, Anil's A/c and Rani's A/c.
- (b) The persons could also be artificial persons like companies, bodies corporate or association of persons or partnerships. Accordingly, we could have Asian Paints A/c, Infosys Technologies A/c, Charitable Trust A/c, Ali and Sons trading A/c and ABC Bank A/c.
- (c) There could be representative personal accounts as well. Although the individual identity of persons related to these is known, the convention is to reflect them as collective accounts. e.g. when salary is payable to employees, we know how much is payable to each of them, but collectively the account is called as Salary Payable A/c. Similar examples are rent payable, Insurance prepaid, commission pre-received, etc.

(B) **Real Accounts:** These are accounts related to assets or properties or possessions.

Depending on their physical existence or otherwise, they are further classified as follows:

- (a) Tangible Real Account – Assets that have physical existence and can be seen, and touched under this as Machinery A/c, Stock A/c, Cash A/c, Vehicle A/c, and the like.
- (b) Intangible Real Account – These represent possession of properties that have no physical existence but can be measured in terms of money and have value attached to them like Goodwill A/c, Trade mark A/c, Patents & Copy Rights A/c and Intellectual Property Rights A/c.
- (c) Nominal Account: These accounts are related to expenses or losses and incomes or gains e.g. Salary and Wages A/c, Rent of Rates A/c, Travelling Expenses A/c, Commission received A/c and Loss by fire A/c.

Q-3 Briefly describe two approaches for deciding which account is to be debited or credited?

Or

Discuss American Approach or Modern Approach for Accounting.

Or

Discuss British Approach or traditional Approach for Accounting

The two approaches for deciding an account are debited or credited.

(A) American Approach or Modern Approach

(B) British Approach or Traditional Approach

(A) American Approach: According to this approach the rules of debit and credit transactions are divided into the following *five* categories:

- (a) Transactions relating to owner, e.g., Capital – these are personal accounts.
- (b) Transactions relating to other liabilities, e.g., suppliers of goods – these are mostly personal accounts.
- (c) Transactions relating to assets, e.g., land, building, cash, bank, stock-in-trade, bills receivable – these are basically real accounts.
- (d) Transactions relating to expenses, e.g., rent, salary, commission, wages, cartage – These are nominal accounts.
- (e) Transactions relating to revenues, e.g., interest received, dividend received, sale of goods – these are nominal accounts.

B) British Approach or Traditional Approach:

- When one identifies the account that is getting affected by a transaction and type of that account, the next step is to apply the rules to decide whether the accounting treatment is to be debited or credited from that account.
- The Golden Rules will guide us whether the account is to be debited or credited. These rules are shown below :

(a) Personal Account

Debit the receiver

Credit the giver

(b) Real Account

Debit what comes into business

Credit what goes out of business

(c) Nominal Account

Debit all expenses or losses

Credit all income or gains

Q-4 What is Accounting Equation?

The whole Financial Accounting depends on Accounting Equation which is also known as Balance Sheet Equation. The basic Accounting Equation is:

Assets = Liabilities + Owner's equity

or $A = L + P$

or $P = A - L$ Where A = Assets, L = Liabilities, P = Capital

or $L = A - P$

Income or gains will increase owner's equity and expenses or losses will reduce it.

Q-5 What do you mean by Books of prime entry?

- A journal is often referred to the Book of Prime Entry or Book of Original Entry.
- In this book transactions are recorded in their chronological order.
- The process of recording transaction in a journal is called 'Journalization'.
- The entry made in this book is called 'journal entry'.

Q-6 What are the functions of Journal?**Functions of Journal**

(a) **Analytical Function:** Each transaction is analyzed into the debit aspect as well as the credit aspect. This helps to find out how each transaction will financially affect the business.

(b) **Recording Function:** Accountancy is a business language which helps to record the transactions based on the principles. Each such recording entry is supported by a narration, which explain, the transaction in simple language. Narration means to narrate – i.e., to explain. It starts with the word – Being.

(c) **Historical Function:** It contains a chronological record of the transactions for future references.

Q-7 What are the advantages of Journal

The following are the advantages of a journal:

(a) **Chronological Record:** It records transactions as and when it happens. So it is possible to get detailed day-to-day information.

(b) **Minimizing the possibility of errors:** The nature of transaction and its effect on the financial position of the business is determined by recording and analyzing into both debit and credit aspects.

(c) **Narration:** It means explanation of the recorded transactions.

(d) **Helps to finalize the accounts:** Journal is the basis of ledger posting and the ultimate Trial Balance. The Trial Balance helps to prepare the final accounts.

Q-8 What is simple and compound Journal?

- If for a single transaction, only one account is debited and one account is credited, it is known as simple journal.
- If the transaction requires more than one account to be debited or more than one account to be credited, it is known as Compound Journal

Q-9 Briefly explain sub-division of journals

Journal is divided into two types -(i) General Journal and (ii) Special Journal.

(i) General Journal

(a) This is a book of chronological record of transactions.

(b) This book records those transactions which occur so infrequently that they do not warrant the setting up of special journals.

Examples of such entries: (i) opening entries (ii) closing entries (iii) rectification of errors.

(ii) Special Journal

It is subdivided into

- Cash Book,
- Purchase Day Book,

- Sales Day Book,
- Returns Inward Book,
- Returns Outward Book,
- Bills Receivable Book and
- Bills Payable Book.

These books are called subsidiary books.

Q-10 Briefly explain the importance of Sub Division of Journal.

When the number of transactions is large, it is practically not possible to record all the transactions through one journal because of the following limitations of Journal:

(a) The system of recording all transactions in a journal requires (a) writing down the name of the account involved as many times as the transaction occurs; and (b) an individual posting of each account debited and credited and hence, involves the repetitive journalizing and posting labour.

(b) Such a system cannot provide the information on a prompt basis.

(c) Such a system does not facilitate the installation of an internal check system because the journal can be handled by only one person.

(d) The journal becomes huge and voluminous.

To overcome the shortcomings of the use of the journal only as a book of original entry, it is sub-divided into special journal.

The journal is subdivided in such a way that a separate book is used for each category of transactions which are repetitive in nature and are sufficiently large in number.

Q-11 Cash Book is both a journal and a ledger. Comment.

- A Cash Book is a special journal which is used for recording all cash receipts and cash payments.
- Cash Book is a book of original entry since transactions are recorded for the first time from the source documents.
- The Cash Book is larger in the sense that it is designed in the form of a Cash Account and records cash receipts on the debit side and cash payments on the credit side.
- Thus, the Cash Book is both a journal and a ledger.

Q-12 What are the different types of Cash Book?

There are types of Cash Book as follows:

(a) **Single Column Cash Book**- Single Column Cash book has one amount column on each side. All cash receipts are recorded on the debit side and all cash payments on the payment side; this book is nothing but a Cash Account and there is no need to open separate cash account in the ledger.

(b) **Double Column Cash Book**- The Double Column Cash Book has two amounts. Columns on each side are as under:

(i) Cash and discount columns

(ii) Cash and bank columns

(iii) Bank and discount columns

(c) **Triple Column Cash Book**- Triple Column Cash Book has three amount columns, one for cash, one for bank and one for discount on each side. All cash receipts, deposits into book and discounts allowed are recorded on the debit side and all cash payments, withdrawals from bank and discounts received are recorded on the credit side. In fact, a triple-column cash book serves

the purpose of both Cash Account and Bank Account. Thus, there is no need to create these two accounts in the ledger.

(d) **The multicolumn cash book** has multiple columns on both the sides of the cash book.

(e) The petty cash book.

Petty Cash Book is an accounting **book** used for recording expenses which are small and of little value, for **example**, stamps, postage and handling, stationery, carriage, daily wages, etc. These are expenses which are incurred day after day; usually, **petty** expenses are large in quantity but insignificant in value.

Q-13 Write a short note on Ledger Accounts

- The book which contains accounts is known as the ledger.
- Since finding information pertaining to the financial position of a business emerges only from the accounts, the ledger is also called the Principal Book.
- As a result, all the necessary information relating to any account is available from the ledger.
- This is the most important book of the business and hence is rightly called the “King of All Books”. Also Known as Book of Final Entry.
- As and when the transaction takes place, it is recorded in the journal in the form of journal entry. This entry is posted again in the respective ledger accounts under double entry principle from the journal. This is called ledger posting.

Q-14 Write a short note on sub division of ledger

Practically, the Ledger may be divided into two groups -

(A) Personal Ledger

The ledger where the details of all transactions about persons who are related to the accounting unit are recorded is called Personal Ledger.

Personal Ledger may be divided into two groups:

I) **Debtors' Ledger:** The ledger where the details of transactions about the persons to whom goods are sold, cash is received, etc., are recorded is called Debtors' Ledger.

II) **Creditors' Ledger:** The ledger where the details of transactions about the persons from whom use purchase goods on credit, pay to them, etc., are

(B) Impersonal Ledger.

The ledger where details of all transactions about assets, income & expenses, etc., are recorded is called Impersonal Ledger.

Impersonal Ledger may be divided into two groups,

I) **Cash Book:** The Book wherein all cash & bank transactions are recorded is called Cash Book.

II) **General Ledger:** The ledger where all transactions relating to real accounts, nominal accounts, details of Debtors' Ledger and Creditors' Ledger are recorded is called General Ledger.

General Ledger may again be divided into two groups, viz, Nominal Ledger & Private Ledger.

I) **Nominal Ledger:** The ledger where all transactions relating to income and expenses are recorded is called Nominal Ledger.

II) **Private Ledger:** The Ledger where all transactions relating to assets and liabilities are recorded is called Private Ledger.

Q-15 What are the advantages of subdivision of ledger?

The advantages of subdivision of ledger are:

- I) **Easy to divide work** : As a result of subdivision, records can be maintained efficiently by the concerned employee.
- II) **Easy to handle** : As a result of subdivision, the size and volume of ledger is reduced.
- III) **Easy to collect information**: From the different classes of ledger any particular type of transaction can easily be found out.
- IV) **Minimizations of mistakes**: As a result of subdivision chances of mistakes are minimized.
- V) **Easy to compute** : As a result of subdivision, the accounting work may be computed quickly which is very helpful to the management.
- VI) **Fixation of responsibility**: Due to subdivision, allotment of different types of work to different employees is done for which concerned employee will be responsible.

Q-16 Write a short note on Trial Balance

- Trial balance may be defined as a statement or a list of all ledger account balances taken from various ledger books on a particular date to check the arithmetical accuracy.
- Further, it must be understood that Trial Balance does not form part of Books of Account, but it is a report prepared by extracting balances of accounts maintained in the books of accounts.
- When this list with tallied debit and credit balances is drawn up, the arithmetical accuracy of basic entries, ledger posting and balancing is ensured. However, it does not guarantee that the entries are correct in all respect.
- Although it is supposed to be prepared at the end of accounting period, computerized accounting packages are capable of providing instant Trial Balance reports even on a daily basis, as the transactions are recorded almost online.
- It can be seen that the respective total of debit and credit balances is exactly matching. This is the result of double entry book-keeping wherein every debit has equal corresponding credit.

Q-17 What are the features of a Trial Balance

- (I) It is a list of debit and credit balances which are extracted from various ledger accounts.
- (II) It is a statement of debit and credit balances.
- (III) The purpose is to establish arithmetical accuracy of the transactions recorded in the Books of Accounts.
- (IV) It does not prove arithmetical accuracy which can be determined by audit.
- (V) It is not an account. It is only a statement of account.
- (VI) It is not a part of the final statements.
- (VII) It is usually prepared at the end of the accounting year but it can also be prepared anytime as and when required like weekly, monthly, quarterly or half-yearly.
- (VIII) It is a link between the Books of Accounts, Profit and Loss Account and Balance sheet.

Q-18 How Trial Balance is prepared?

- It may be prepared on a loose sheet of paper.
- The ledger accounts are balanced at first. They will have either “debit-balance” or “credit balance” or “nil-balance”.
- The accounts containing debit-balance are written on the debit column, and those with credit-balance are written on the credit column.
- The sum total of both the balances must be equal for “Every debit has its corresponding and equal credit”.

Q-19 What is the purpose of preparing Trial Balance?

It serves the following purposes:

- (I) To check the arithmetical accuracy of the recorded transactions.
- (II) To ascertain the balance of any ledger account.
- (III) To serve as an evidence of the fact that the double entry has been completed in respect of every transaction.
- (IV) To facilitate the preparation of final accounts promptly.

Q-20 Is Trial Balance Indispensable?

- It is a mere statement prepared by the accountants for his their convenience, and if it agrees, it is assumed that at least arithmetical accuracy has been done, although there may be a lot of errors.
- Trial Balance is not a process of accounts, but its preparation helps us to finalize the accounts. Since it is prepared on a particular date, as at / as on is stated.

Q-21 Write a short note on Forms of Trial Balance.

A trial balance may be prepared in two forms, they are –

(A) Journal Form

- This form of a trial balance will have a format of Journal Folio. It will have columns for serial number, name of the account, ledger folio, debit amount and credit amount in the journal form.
- The ledger folio will show the page number on which such account appears in the ledger.

(B) Ledger Form

- This form of a trial balance has two sides, i.e., debit side and credit side. In fact, the ledger form of a trial balance is prepared in the form of an account.
- Each side of the trial balance will have particular like name of the account column, folio column and amount column.

Q-22 Explain different methods of preparing trial balance

- (a) Total Method or Gross Trial Balance.
- (b) Balance Method or Net Trial Balance.
- (c) Compound Method.

Q-23 Explain Total method or Gross Trial Balance of preparing trial balance.

- Under this method, two sides of the accounts are totaled.
- The total of the debit side is called the “debit total”, and the total of the credit side is called the “credit total”.
- Debit totals are entered on the debit side of the trial balance while the credit total is entered on the credit side of the trial balance.
- If a particular account has total in one side, it will be entered either in the debit column or the credit column as the case may be.

Advantages:

- (a) It facilitates arithmetical accuracy of the accounts.
- (b) Extraction of ledger balances is not required at the time of preparation of trial balance.

Disadvantages: Preparation of final accounts is not possible.

Q-24 Explain Balance method or Net Trial balance of preparing trial balance.

- Under this method, all the ledger accounts are balanced. The balances may be either “debit-balance” or “credit balance”.

Advantages:

- (a) It helps in the easy preparation of final accounts.
- (b) It saves time and labour in preparing a trial balance.

Disadvantages:

Errors may remain undisclosed irrespective of the agreement of trial balance.

Q-25 Explain compound method of preparing trial balance

- Under this method, totals of both the sides of the accounts are written in the separate columns. Along with this, the balances are also written in the separate columns.
- Debit balances are written in the debit column and credit balances are written in the credit column of the trial balance.

Advantages: It offers the advantage of both the methods.

Disadvantages: It is a lengthy process and more time is consumed in the preparation of a trial balance.

Q-26 What is the utility of Trial Balance?

The utility of trial balance could be found in the following:

- (a) It forms the basis for the preparation of financial statements, i.e., Profit and Loss Account and Balance Sheet.
- (b) A tallied trial balance ensures the arithmetical accuracy of the entries made. If the trial balance does not tally, the errors can be found out, rectified and then financial statements can be prepared.
- (c) It acts as a quick reference. One can easily find out the balance in any ledger account without actually referring to the ledger.
- (d) If the listing of ledger accounts is systematically done in the trial balance, one can do quick time analysis. Hence, listing is usually done in the sequence of Asset accounts, Liability accounts, Capital accounts, Owner's equity accounts, Income or gain accounts and Expenses or Losses accounts in that order.

One can draw some quick inferences from trial balance by interpreting it. If one plots monthly trial balances side by side, one can analyze the movement of balances in various accounts, e.g., one can see how expenses are increasing or decreasing or showing a trend of movements. By comparing the owner's equity balances as on two dates, one can interpret the business result, e.g., if the equity has gone up, one can interpret that business has earned net profit and vice versa.

Q-27 Write a short note on Double Entry System. Also discuss its features.

- It was in 1494 that Luca Pacioli, the Italian mathematician, first published his comprehensive treatise on the principles of Double Entry System.
- The use of principles of double entry system made it possible to record not only cash but also all sorts of mercantile transactions.
- It had created a profound impact on auditing too, because it enhanced the duties of an auditor to a considerable extent.

Features of Double Entry System

- (a) Every transaction has twofold aspects, i.e., one party giving the benefit and the other receiving the benefit.

- (b) Every transaction is divided into two aspects, debit and credit. One account is to be debited and the other account is to be credited.
- (c) Every debit must have its corresponding and equal credit.

Q-28 What are the advantages of Double Entry System?

- (a) Since personal and impersonal accounts are maintained under the double entry system, both the effects of the transactions are recorded.
- (b) It ensures arithmetical accuracy of the books of accounts, for every debit, there is a corresponding and equal credit. This is ascertained by preparing a trial balance periodically, or at the end of the financial year.
- (c) It prevents and minimizes frauds. Moreover frauds can be detected early.
- (d) Errors can be checked and rectified easily.
- (e) The balances of receivables and payables are determined easily, since the personal accounts are maintained.
- (f) The businessman can compare the financial position of the current year with that of the past years.
- (g) The businessman can justify the standing of his business in comparison with the previous year purchase, sales, and stocks, incomes and expenses with that of the current year figures.
- (h) Helps in decision-making.
- (i) The net operating results can be calculated by preparing the Trading and Profit and Loss A/c for the year ended and the financial position can be ascertained by the preparation of the Balance Sheet.
- (j) It becomes easy for the Government to calculate the tax.
- (k) It helps the Government to decide sickness of business units and extend help accordingly.
- (l) The other stakeholders, like suppliers and banks take a proper decision regarding grant of credit or loans.

Q-29 What are the limitations of Double Entry System?

- (a) The system does not disclose all the errors committed in the books accounts.
- (b) The Trial Balance prepared under this system does not disclose certain types of errors.
- (c) It is costly as it involves maintenance of numbers of books of accounts.

Q-30 What are the functions of Accounting?

The main functions of accounting are as follows:

- **Measurement:** Accounting measures past performance of a business entity and depicts its current financial position.
- **Forecasting:** Accounting helps in forecasting future performance and financial position of an enterprise using past data.
- **Decision-Making:** Accounting provides relevant information to the users of accounts to aid rational decision-making.
- **Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and contingent liabilities which play an important role in predicting, comparing and evaluating financial results.
- **Control:** Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.
- **Government Regulation and Taxation:** Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.

Q-31 What do you mean by Book-Keeping?

As defined by Carter, Book-Keeping is a science as well as art of correctly recording in books of accounts all those business transactions that result in transfer of money or money's worth'.

Book-keeping is an activity concerned with recording and classifying financial data related to business operation in order of its occurrence.

Book-keeping is a mechanical task which involving:

- Collection of basic financial information
- Identification of events and transactions with financial character, i.e., economic transactions
- Measurement of economic transactions in terms of money
- Recording of financial effects of economic transactions in order of its occurrence
- Classifying effects of economic transactions
- Preparing organized statement known as Trial Balance

Q-32 Differentiate between Book Keeping and Accounting

Book-Keeping	Accounting
1. Output of Book keeping is an input for accounting.	1. Output of accounting permit informed judgments and decisions by the user of accounting information.
2. Purpose of book-keeping is to keep systematic record of transactions and events of financial character in order of its occurrence.	2. Purpose of accounting is to find results of operating activity of a business and to report its financial strength.
3. Book-keeping is the foundation of accounting.	3. Accounting is considered as a language of business.
4. Book keeping is carried out by junior staff.	4. Accounting is done by the senior staff who have skills of analysis and interpretation.
5. Objects of book-keeping is to summarize the cumulative effect of all economic transactions of business.	5. Object of accounting is not only book-keeping but also analyzing and interpreting reported financial information for informed decisions.

Q-33 Explain Accounting Cycle.

When complete sequence of accounting procedure is done, which happens frequently, and repeated in same directions during an accounting period, it is called an Accounting Cycle.

Steps/Phases of Accounting Cycle

The steps or phases of accounting cycle can be developed as under:

- **Recording of Transaction:** As soon as a transaction happens it is at first recorded in subsidiary book.
- **Journal:** The transactions are recorded in the journal chronologically.
- **Ledger:** All journals are posted into ledger chronologically in a classified manner.
- **Trial Balance:** After taking all the ledger account closing balances, a Trial Balance is prepared at the end of the period for the preparations of financial statements.
- **Adjustment Entries:** All the adjustments entries are to be recorded properly and adjusted accordingly before preparing financial statements.
- **Adjusted Trial Balance:** An adjusted Trail Balance may also be prepared.
- **Closing Entries:** All the nominal accounts are to be closed by transferring them to Trading Account, and Profit and Loss Account.
- **Financial Statements:** Financial statement can now be easily prepared which will exhibit the true financial position and operating results.

Chapter 2 : Introduction to Corporate Accounting

Q-1 Write a short note on Schedule III of the Companies Act 2013. (Important)

Ans: According to Section 129 of the Companies Act 2013, all the companies registered under this Act will have to present its financial statements in Schedule III of the Act.

The Schedule III of the Companies Act 2013 has been formulated to keep pace with the changes in the economic philosophy leading to privatization and globalization and consequent desired changes/reforms in the corporate financial reporting practices.

It deals with the Form of Balance sheet, Statement of Profit and Loss and disclosures to be made therein and it applies uniformly to all the companies registered under the Companies Act, 2013, for the preparation of financial statements of an accounting year.

It has several new features like:

- A vertical format for presentation of balance sheet with classification of Balance Sheet items into current and non-current categories.
- A vertical format of Statement of Profit and Loss with classification of expenses based on nature.
- Elimination the concept of “Schedules” and such information is now to be furnished in terms of “Notes to Accounts”.
- Debit Balance of Statement of Profit & Loss A/c will be disclosed under the head, Reserves & Surplus as the negative figure.
- No change in the format of cash flow statement as per revised schedule and therefore its preparation continue to be as per AS-3 on cash flow statement.
- It gives prominence to Accounting Standards (AS) i.e. in case of any conflict between the AS and the Schedule, AS shall prevail.

Q-2 Prepare a summarized form of statement of profit and loss account of a company as per the revised Schedule VI of the Companies Act, 1956.

[CS Dec. 2014]

Ans:

PART-II

FORM OF STATEMENT OF PROFIT AND LOSS

Name of the Company

Profit and Loss Statement for the year ended

(Rupees in)

	Particulars	Note. No.	Figures for the current reporting period	Figures for the previous reporting period
I	Revenue from operations		xxx	Xxx
II	Other income		xxx	Xxx
III	Total Revenue (I + II)		xxx	Xxx
IV	Expenses :			
	Cost of materials consumed			
	Purchases of Stock-in-Trade			
	Changes in Inventories of finished goods			
	Work-in –progress and Stock-in-Trade			
	Employee benefits expense			
	Finance Costs			
	Depreciation and amortization expense			

	Other expenses			
	Total expenses		xxx	Xxx
V	Profit before exceptional and extraordinary items and tax (III-IV)			
VI	Exception items		xxx	Xxx
VII	Profit before extraordinary items and tax (V-VI)		xxx	Xxx
VIII	Extraordinary Items		xxx	xxx
IX	Profit before tax (VII-VIII)		xxx	xxx
X	Tax expense : (1) Current tax (2) Deferred tax		xxx	xxx
XI	Profit (Loss) for the period from continuing operations (VII-VIII)		xxx	xxx
XII	Profit/(loss) from discounting operations		xxx	xxx
XIV	Tax expense of discounting operations		xxx	xxx
XV	Profit (Loss) for the period (XI+XIV)		xxx	xxx
XVI	Earnings per equity share: (1) Basic (2) Diluted		xxx	xxx

Q-3 What are the key features of statement of profit and loss as per Schedule III of the Companies Act, 2013? [CS June 2015]

Ans: Key features Statements of Profit and Loss

- (i) The name of 'Profit and Loss Account' has been changed to "Statement of Profit and Loss".
- (ii) This format of Statement of Profit and Loss does not mention any appropriation item on its face. Further, 'below the line' adjustments to be presented under "Reserves and Surplus" in the Balance Sheet.
- (iii) Any item of income or expense which exceeds one percent of the revenue from operations or Rs. 100,000 (earlier 1% of total revenue or Rs. 5,000), whichever is higher, needs to be disclosed separately.
- (iv) In respect of companies other than finance companies, revenue from operations need to be disclosed separately as revenue from (a) sale of products, (b) sale of services and (c) other operating revenues.
- (v) Net exchange gain/loss on foreign currency borrowings to the extent considered as an adjustment to interest cost needs to be disclosed separately as finance cost.
- (vi) Break-up in terms of quantitative disclosures for significant items of Statement of Profit and Loss, such as raw material consumption, stocks, purchases and sales have been simplified and replaced with disclosure of "broad heads" only. The broad heads need to be decided based on materiality and presentation of true and fair view of the financial statements.

Q-4 What are the key features of Balance Sheet?

Ans: Key features of Balance Sheet

- 1) The Schedule III permits only Vertical form of presentation.
- 2) It uses "Equity and Liabilities" and "Assets" as headings.
- 3) All assets and liabilities classified into current and non-current and presented separately on the face of the Balance Sheet.
- 4) Number of shares held by each shareholder holding more than 5% shares now needs to be disclosed.

- 5) Details pertaining to aggregate number and class of shares allotted for consideration other than cash, bonus shares and shares bought back will need to be disclosed only for a period of five years immediately preceding the Balance Sheet date.
- 6) Any debit balance in the Statement of Profit and Loss will be disclosed under the head "Reserves and surplus." Earlier, any debit balance in Profit and Loss Account carried forward after deduction from uncommitted reserves was required to be shown as the last item on the asset side of the Balance Sheet.
- 7) Specific disclosures are prescribed for Share Application money. The application money not exceeding the capital offered for issuance and to the extent not refundable will be shown separately on the face of the Balance Sheet. The amount in excess of subscription or if the requirements of minimum subscription are not met will be shown under "Other current liabilities."
- 8) The term "sundry debtors" has been replaced with the term "trade receivables." 'Trade receivables' are defined as dues arising only from goods sold or services rendered in the normal course of business. Hence, amounts due on account of other contractual obligations can no longer be included in the trade receivables.
- 9) It requires separate disclosure of "trade receivables" outstanding for a period exceeding six months from the date the bill/invoice is due for payment."
- 10) "Capital advances" are specifically required to be presented separately under the head "Loans & advances" rather than including elsewhere.
- 11) Tangible assets under lease are required to be separately specified under each class of asset. In the absence of any further clarification, the term "under lease" should be taken to mean assets given on operating lease in the case of lessor and assets held under finance lease in the case of lessee.
- 12) Under the Schedule III, other commitments also need to be disclosed.

Q-5 State how would you present 'cash and cash equivalents' under the current assets in the balance sheet as per Schedule III of the Companies Act, 2013. (CS June 2016)

'Cash and cash equivalents' under the current assets shall be presented as:

- a) Bank Balances
- b) Cheques, draft in hand
- c) Cash in hand
- d) Cash equivalent (Short term highly liquid investment)
- e) Other (Specify nature)
- f) Earmarked bank balances
- g) Balances with banks to the extent held as security against borrowings, Guarantees or other commitments
- h) Repatriation restrictions
- i) Bank deposits with more than 12 months maturity

Q-6 State how would you present short-term loans and advances under current assets in the balance sheet of a company as per Schedule III of the Companies Act, 2013 ? (CS June 2016)

Short term loans and advances would be shown in the Balance sheet as under:

- (i) Short-term loans and advances shall be classified as:
 - (a) Loans and Advances to Related parties (giving details thereof);
 - (b) Others (specify nature).
- (ii) The above shall also be sub-classified as:
 - (a) To the extent secured, considered good;
 - (b) Others, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and Advances due by directors or other officers of the company or any of them either severally or jointly with any other person debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q-7 Vibgyor Ltd. is unaware of the manner and details of presentation of long-term loans and advances to be given in the balance sheet as per Schedule III of the Companies Act, 2013. Advise the company with the contents and manner of its disclosure. (CS June 2016)

(i) Long-term loans and advances shall be classified as:

- (a) Capital Advances;
- (b) Security Deposits;
- (c) Loans and Advances to related parties (giving details thereof);
- (d) Other Loans and Advances (specify nature).

(ii) The above shall also be separately sub-classified as:

- (a) To the extent secured, considered good;
- (b) Others, considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(ii) Loans and Advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q-8 Board of directors of Mahua Ltd. wants to attach Directors' report to the balance sheet to be presented at the annual general meeting and seeks your help in preparing the same. Enumerate any ten matters on which information is required to be given in such report. (CS June 2016)

The report of the Board of Directors must be attached to every balance sheet presented at the annual general meeting. The report must contain information regarding the following matters

1. The state of affairs of the company, Review of its operating information.
2. The amount, if any, which it proposes to carry to any reserves in such balance sheet
3. The amount of dividend recommended.
4. Details of any material changes and commitments, if any, affecting the financial position of the company.
5. Director's responsibility statement that directors confirms the adoption of applicable accounting standards, use of prudent accounting policies in preparation of financial statement, use of utmost care in preparing financial statement and safeguarding the assets of company and preparation of accounts on a going concern basis.
6. Management discussion and analysis report.
7. Corporate governance report.
8. Details necessary for a proper understanding of the state of the company's affairs and which are not, in the Board's opinion, harmful to the business of the company or of any of its subsidiaries, in respect of changes which have occurred during the financial year in the nature of company's business, in the company's subsidiaries or in the nature of the business carried on by them and generally in the classes of business in which the company has an interest.

Q-9 State how would you present Share Capital in the balance sheet of a company as per Schedule III of the Companies Act, 2013 ?

For each class of share capital (different classes of preference shares to be treated separately) :

- a. the number and amount of shares authorized;
- b. the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
- c. par value per share;
- d. a reconciliation of the number of shares outstanding at the beginning and at the end of the period;
- e. the rights, preferences and restrictions attaching to capital;
- f. shares in the company held by its holding company or by its subsidiaries or associates;
- g. shares in the company held by any shareholder holding more than 5 percent shares;
- h. shares reserved for issue under options;
- i. Separate particulars for a period of five years following the year in which the shares have been allotted/ bought back
- j. Terms of any security issued along with the earliest date of conversion in descending order starting from the farthest such date.

Q-10 State how would you present Reserves and Surplus in the balance sheet of a company as per Schedule III of the Companies Act, 2013 ?

(i) Reserves and Surplus shall be classified as:

- (a) Capital Reserves;
- (b) Capital Redemption Reserves;
- (c) Securities Premium Reserve;
- (d) Debenture Redemption Reserve;
- (e) Revaluation Reserve;
- (f) Share Options Outstanding Account;
- (g) Other Reserves – (specify the nature of each reserve and the amount in respect thereof);
- (h) Surplus i.e. balance in statement of Profit & Loss disclosing allocations and appropriations such as dividend paid, bonus shares and transfer to/from reserves (Additions and deductions since last balance sheet to be shown under each of the specified heads)

(ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

(iii) Debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'Surplus' Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Q-11 State how would you present 'Other current liabilities' in the balance sheet of a company as per Schedule III of the Companies Act, 2013 ?

The amounts shall be classified as:

- (a) Current maturities of long-term debt;
- (b) Current maturities of finance lease obligations;
- (c) Income received in Advance;
- (d) Interest accrued but not due on borrowings;
- (e) Interest accrued and due on borrowings;
- (f) Unpaid Dividends;
- (g) Application money received for allotment of securities and due for refund and interest accrued thereon.

- (h) Unpaid matured deposits and interest accrued thereon;
- (i) Unpaid matured debentures and interest accrued thereon;
- (j) Other payables (specify nature);

Q-12 State how would you present ‘Tangible Assets and Intangible assets’ in the balance sheet of a company as per Schedule III of the Companies Act, 2013 ?

I. Tangible assets

- (i) Classification shall be given as:
 - (a) Land.
 - (b) Buildings.
 - (c) Plant and Equipment.
 - (d) Furniture and Fixtures.
 - (e) Vehicles.
 - (f) Office equipment.
 - (g) Others (specify nature).
- (ii) Assets under lease shall be separately specified under each class of asset.
- (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period.
- (iv) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable.

II Intangible assets

- (i) Classification shall be given as:
 - (a) Goodwill.
 - (b) Brands/trademarks.
 - (c) Computer software.
 - (d) Mastheads and publishing titles.
 - (e) Mining rights.
 - (f) Copyrights, and patents and other intellectual property rights, services and operating rights.
 - (g) Recipes, formulae, models, designs and prototypes.
 - (h) Licences and franchise.
 - (i) Others (specify nature).
- (ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period.
- (iii) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable.

Q-13 State how would you present ‘Non-current Investments’ and ‘Current Investments’ in the balance sheet of a company as per Schedule III of the Companies Act, 2013 ?

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

- (a) Investment property;
- (b) Investments in Equity Instruments;
- (c) Investments in Preference shares;
- (d) Investments in Government or trust securities;
- (e) Investments in units, debentures or bonds;
- (f) Investments in Mutual Funds;

- (g) Investments in partnership firm;
 - (h) Other non-current investments (specify nature)
- Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities)
- (ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.
 - (iii) The following shall also be disclosed:
 - (a) Aggregate amount of quoted investments and market value thereof;
 - (b) Aggregate amount of unquoted investments;
 - (c) Aggregate provision for diminution in value of investments;
 - (d) Aggregate amount of partly paid-up investments;
 - (e) The names of bodies corporate (indicating separately the names of subsidiaries, associates and other business ventures).

Current Investments

- (i) Current investments shall be classified as:
 - (a) Investments in Equity Instruments;
 - (b) Investments in Preference shares;
 - (c) Investments in Government or trust securities;
 - (d) Investments in units, debentures or bonds;
 - (e) Investments in Mutual Funds;
 - (f) Investments in partnership firm;
 - (g) Other investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities)
- (ii) The following shall also be disclosed:
 - (a) The basis of valuation of individual investments;
 - (b) Aggregate amount of quoted investments and market value thereof;
 - (c) Aggregate amount of unquoted investments;
 - (d) Aggregate amount of partly paid-up investments.
 - (e) Aggregate provision for diminution in value of investments.

Q-14 State how would you present 'Other Non Current Assets' in the balance sheet of a company as per Schedule III of the Companies Act, 2013 ?

Other non-current assets

Other non-current assets shall be classified as:

- (i) Long-term Trade Receivables (including trade receivables on deferred credit terms);
- (ii) Others (specify nature)
- (iii) Long-term Trade Receivables, shall be sub-classified as:
 - (i) (a) secured, considered good;
 - (b) unsecured, considered good;
 - (c) Doubtful
 - (ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
 - (iii) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q-15 State how would you present 'Inventories' and 'Trade receivables' in the balance sheet of a company as per Schedule III of the Companies Act, 2013 ?**Inventories**

(i) Inventories shall be classified as :

- (a) Raw material;
- (b) Work-in-progress;
- (c) Finished goods;
- (d) Stock-in-trade;
- (e) Stores and spares;
- (f) Loose tools;
- (g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation should be stated.

Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.

(ii) Trade receivables shall also be classified as:

- (a) To the extent secured, considered good;
- (b) Others, considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q-16 State how would you present 'Contingencies and Commitments' as per Schedule III of the Companies Act, 2013 ?**Contingencies and commitments**

(to the extent not provided for)

(i) Contingent liabilities shall be classified as:

- (a) Claims against the company not acknowledged as debt;
- (b) Guarantees;
- (c) Other money for which the company is contingently liable

(ii) Commitments shall be classified as:

- (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
- (b) Uncalled liability on shares and other investments partly paid;
- (c) Other commitments (specify nature).

Q-17 Briefly Discuss XBRL. How does it work?**XBRL (EXTENSIBLE BUSINESS REPORTING LANGUAGE)**

- XBRL is a language for the electronic communication of business and financial data which is revolutionizing business reporting around the world.
- It provides major benefits in the preparation, analysis and communication of business information.
- It offers cost savings, greater efficiency and improved accuracy and reliability to all those involved in supplying or using financial data.
- XBRL stands for extensible Business Reporting Language. It is already being put to practical use in a number of countries and implementations of XBRL are growing rapidly around the world.

How Does XBRL work?

- XBRL makes the data readable, with the help of two documents – Taxonomy and instance document.
- Taxonomy defines the elements and their relationships based on the regulatory requirements.
- Using the taxonomy prescribed by the regulators, companies need to map their reports, and generate a valid XBRL instance document.
- The process of mapping means matching the concepts as reported by the company to the corresponding element in the taxonomy.
- In addition to assigning XBRL tag from taxonomy, information like unit of measurement, period of data, scale of reporting etc., needs to be included in the instance document.

Q-18 How do companies create statements in XBRL?

There are a number of ways to create financial statements in XBRL:

- XBRL-aware accounting software products are becoming available which will support the export of data in XBRL form. These tools allow users to map charts of accounts and other structures to XBRL tags.
- Statements can be mapped into XBRL using XBRL software tools designed for this purpose.
- Data from accounting databases can be extracted in XBRL format. It is not strictly necessary for an accounting software vendor to use XBRL; third party products can achieve the transformation of the data to XBRL.
- Applications can transform data in particular formats into XBRL. The route which an individual company may take will depend on its requirements and the accounting software and systems it currently uses, among other factors.

Q-19 Which class of companies are required to file financial statements with Registrar as per XBRL Taxonomy?**XBRL filing under the Companies Act, 2013**

The following class of companies shall file their financial statements and other documents under section 137 of the Companies Act with the Registrar in e-form AOC-4 XBRL as per Annexure-I:-

- (i) Companies listed with stock exchanges in India and their Indian subsidiaries;
- (ii) Companies having paid up capital of five crore rupees or above;
- (iii) Companies having turnover of one hundred crore rupees or above;
- (iv) All companies which are required to prepare their financial statements in accordance with Companies (Indian Accounting Standards) Rules, 2015.

Q-20 Discuss the benefits of XBRL.**Benefits of XBRL****i. XBRL increases the usability of financial statement information.**

By presenting its statements in XBRL, a company can benefit investors and all other stakeholders and enhance its profile. It meets the requirements of regulators, lenders and others consumers of financial information, who are increasingly demanding reporting in XBRL. This improves business relations and lead to a range of benefits.

- ii. **All types of organizations can use XBRL to save costs and improve efficiency in handling business and financial information.**
Because XBRL is extensible and flexible, it can be adapted to a wide variety of different requirements. All participants in the financial information supply chain can benefit, whether they are preparers, transmitters or users of business data.

- iii. **XBRL offers major benefits at all stages of business reporting and analysis.** The benefits are seen in automation, cost saving, faster, more reliable and more accurate handling of data, improved analysis and in better quality of information and decision-making.

- iv. **XBRL benefits comparability by helping to identify data which is genuinely alike and distinguishing information which is not comparable.** Computers can process this information and populate both pre defined and customized reports.

- v. **With full adoption of XBRL, companies can automate data collection.** For example, data from different company divisions with different accounting systems can be assembled quickly, cheaply and efficiently. Once data is gathered in XBRL, different types of reports using varying subsets of the data can be produced with minimum effort.

Chapter 3: Underwriting of Issues**Q-1 Write a short note on 'Marked Applications'****Ans:**

- The application forms bearing the stamp of the underwriter are termed as "Marked Applications"
- The benefit of marked applications is given to the concerned underwriters in whose favour application forms have been marked.

Q-2 Write a short note on 'Unmarked Applications'.**Ans:**

- The application forms which do not bear the stamp of the underwriter are termed as "Unmarked Applications".
- The benefit of firm underwriting is given first to the company to the extent of issue not underwritten by underwriters.
- In case there is surplus, the benefit of surplus unmarked applications will be given to the underwriters in the ratio of their gross liability.

Q-3 Write a short note on 'Firm Underwriting'**[CS 2008 Dec; 2001 June]****or****Firm underwriting is a definite commitment by the underwriters. Explain.****[CS Dec 2013]****Ans:**

- Firm underwriting refers to a definite commitment by the underwriter to take up a specified number of securities irrespective of the number of securities subscribed by the public. In other words, the underwriters take up the agreed number of shares or debentures in addition to unsubscribed shares or debentures, if any.
- Even if the issue is over-subscribed, the underwriters are liable to take up the agreed number of shares or debentures.
- The benefit of firm underwriting may be given either
 - i. To an individual underwriter on the basis of his individual firm underwriting. In this case, firm underwriting shares are treated at par with 'Marked Applications'
 - ii. To all the underwriters in the ratio of their gross liability. In this case, firm underwriting shares are treated at par with 'Unmarked Applications'

Q-4 Write a short note on 'Complete or Full Underwriting'**Ans:**

- When the entire issue is underwritten such underwriting is termed as 'Complete underwriting'. For example, X Ltd. decided to make a public issue of 1,00,000 Equity shares of ₹ 10 each which is entirely underwritten by A, B, C and D in the ratio of 2:2:1:1.
- In such a case the benefit of unmarked applications is given to the underwriters in the ratio of their gross liability i.e. 2:2:1:1.

Q-5 Write a short note on 'Partial Underwriting'**Ans:**

- Where only a part of issue is underwritten, such underwriting is termed as 'Partial Underwriting'. For example, X Ltd. decided to make a public issue of 1,00,000 Equity shares of ₹ 10 each out of

which 90,000 shares are underwritten by A, B, C and D in the ratio of 2:2:1:1. It means 10,000 shares are underwritten by the company itself.

- In such a case, the benefit of unmarked applications will first be given to the company.
- In case there is a surplus, such surplus will be distributed among other underwriters in the ratio of their gross liability.

Q-6 Distinguish between the following :

[i] 'Complete underwriting' and 'partial underwriting'.

[CS June 2014]

'Complete or Full Underwriting'

- When the entire issue is underwritten such underwriting is termed as 'Complete underwriting'. For example, X Ltd. decided to make a public issue of 1,00,000 Equity shares of ` 10 each which is entirely underwritten by A, B, C and D in the ratio of 2:2:1:1.
- In such a case the benefit of unmarked applications is given to the underwriters in the ratio of their gross liability i.e. 2:2:1:1.

'Partial Underwriting'

- Where only a part of issue is underwritten, such underwriting is termed as 'Partial Underwriting'. For example, X Ltd. decided to make a public issue of 1,00,000 Equity shares of ` 10 each out of which 90,000 shares are underwritten by A, B, C and D in the ratio of 2:2:1:1. It means 10,000 shares are underwritten by the company itself.
- In such a case, the benefit of unmarked applications will first be given to the company.
- In case there is a surplus, such surplus will be distributed among other underwriters in the ratio of their gross liability.

Q-7 Write a short note on 'Underwriting Agreement'

Ans:

- Underwriting may be defined as a contract entered into by the company with persons or institutions, called underwriters, who undertake to take up the whole or a portion of such of the offered shares or debentures as may not be subscribed for by the public, in consideration of remuneration called underwriting commission.
- In other words, underwriting is an undertaking or guarantee given by the underwriters to the company that the shares or debentures offered to the public will be subscribed for in full.
- In case, the public response is poor, the underwriters will have to take up the balance of the shares or debentures not subscribed for by the public and to pay for them.
- Thus, the underwriters take over the risk of uncertainty of a public issue of shares or debentures of a company and the company is assured of the success of the issue.

Q-8 Distinguish between the following:

[i] 'Underwriters' and 'brokers'.

[CS 2008 Dec]

Underwriters	Brokers
1. An underwriter guarantees the sale of specified number of securities.	1. A broker merely promises and does not guarantee the sale of securities.
2. An underwriter can be held personally liable to take up the shares or debentures.	2. A broker cannot be held personally liable to take up the shares or debentures.
3. Remuneration paid to underwriters is called 'Underwriting Commission'.	3. Remuneration paid to Brokers is called 'Brokerage'.

[ii] 'Marked applications' and 'unmarked applications'**[CS2008 Dec; 2003 June]**

Marked Applications	Unmarked Applications
1. The application forms bearing the stamp of the underwriter are termed as "Marked Applications".	1. The application forms which do not bear the stamp of the underwriter are termed as "Unmarked Applications".
2. The benefit of marked applications is given to the concerned underwriters in whose favour application forms have been marked.	2. The benefit of unmarked applications is first given to company and then to underwriters in the ratio of their gross liability.
3. These applications are received by the company through underwriters.	3. These applications are received directly by the company.

Q-9 Write a short note on 'Underwriting Commission'**[1999 June]**

Ans: The consideration payable to the underwriters for underwriting the issue of shares or debentures of a company is called underwriting commission.

Conditions for payment of Underwriting Commission

Section 40 [6] of the Companies Act 2013, provides that a company may pay commission subject to the following conditions which are prescribed under Companies [Prospectus and Allotment of Securities] Rules, 2014:

- a. The payment of the commission must be authorized by the articles.
 - b. The commission paid must not exceed
 - i. In case of shares: 5% of issue price or rate as per articles whichever is less
 - ii. In case of debentures: 2.5% of the issue price or rate as per articles whichever is less.
 - c. The amount or rate of the commission must be disclosed in the prospectus.
 - d. The number of shares or debentures underwritten by each of the underwriters must be disclosed in the prospectus.
 - e. A copy of the contract for the payment of the commission must be delivered to the Registrar.
 - f. Underwriting commission is payable only on such shares or debentures as are offered to the general public.
- The company is free to negotiate lower rates with underwriters.

Chapter 4: Issue of Shares Capital

Q-1 What is share capital. Briefly explain kinds of share capital.

- A company raises its capital by issuing its **issue of shares to finance** and carry out its business.
- The **Memorandum of association**, which lays down the foundation of the company **contains** the **amount of capital** with which the company decides to register and the number of shares into which it is to be divided.
- It constitutes the basis of the capital structure of a company.
- When total capital of a company is divided into shares, then it is called share capital.

Kinds of share capital

- The share capital of a company limited by shares can constitute of two kinds of share capital under the Companies act, 2013, as follows:
 - (I) **Equity Share Capital:** equity share capital with reference to any company limited by shares means all share capital that does not come under preference share capital. equity share capital can further be divided into the following types:
 - (i) with **voting rights**; or
 - (ii) with **differential rights** regarding dividend or voting or any other such rights.
 - (II) **Preference Share Capital:**
 - Preference, as the name suggests, with reference to any company limited by shares, refers to that share capital of the issued share capital of the company which would carry a **preferential right** with regard to
 - ✓ **Payment of dividend** and
 - ✓ **Repayment**

Q-2 Differentiate between Equity shares and Preference shares.

A-2

Basis	Equity Shares	Preference Shares
1. Refund of capital	On winding up, the equity share capital is paid after the preference share capital.	On winding up, the preference share capital is paid before equity share capital.
2. Right of dividend	Dividend is paid on equity shares after payment of dividend on preference shares.	Dividend is paid on preference shares before payment of dividend on equity shares .
3. Rate of Dividend	No fixed rate of dividend.	Fixed rate of dividend.
4. Right to vote	Equity shareholders have the right to vote in a meeting of shareholders.	Preference shareholders do not enjoy the right to vote in the meetings of shareholders.
5. Redemption	Equity shares are not redeemable . However a company may buy back its shares.	Preference shares are always redeemable .

“Failure will never overtake me if my determination to succeed is strong enough”

Q-3 Explain different Types/Classes of preference shares.

A-3

TYPES/CLASSES OF PREFERENCE SHARES

(a) On basis of Dividend:

- (i) **Cumulative Preference Shares:** Cumulative preference shares are the preference shares whose holders are entitled to **receive arrears of dividend** before any dividend is paid on equity shares.
- (ii) **Non-cumulative Preference Shares:** Non-cumulative preference shares are the preference shares whose holders **do not have the right** to **receive arrears** of dividend. If **no dividend is declared** in any year due to any reason, **they get nothing**, nor can they claim unpaid dividend in any subsequent years.

(b) On basis of Participation

- (i) **Participating Preference Shares:** In addition to the fixed preference dividend, such shares carry a **right to participate in the surplus profit**, if any, after providing dividend at a stipulated rate to equity shareholders.
- (ii) **Non-Participating Preference Shares:** Such shares get **only a fixed rate of dividend** every year and do not have a right to participate in the surplus profit, if any.

(c) On basis of Convertibility

- (i) **Convertible Preference Shares:** They are preference shares with a **right/option to get converted** into equity shares
- (ii) **Non-Convertible Preference Shares:** These are preference shares which **do not have the right/ option to get converted** into equity shares.

Q-4 Write a short note on “Disclosure of Share Capital”

- Capital refers to the amount which is invested in a business with the basic aim of generating revenue.
- Capital is raised from public and people who contribute to the share capital are known as shareholders.
 - **Authorized Capital** is also known as **Nominal or Registered Capital** which means the maximum amount of capital a company can issue. It is **disclosed in the Memorandum of Association**.
 - **Issued Capital** is a **part of Authorized capital** which is **offered to the public** for subscription.
 - **Called Up Capital** is the amount of nominal value of shares that has been **called up by the company** for payment from the shareholder.
 - **Paid Up Capital** is that **part of Called Up Capital** which the members of company or **shareholders have paid for**.
- The following table describes the disclosure of Share Capital, as included in the Liabilities column of the Balance Sheet of a company:

Particulars	Amount
Equity and Liabilities:	
Share Capital:	
Authorized Capital:	

2,00,000 shares of Rs. 10 each	20,00,000
Issued Capital:	
1,50,0000 shares of Rs. 10 each	15,00,000
Subscribed Capital:	
1,00,000 shares of Rs. 10 each	10,00,000
Paid up Capital	
1,00,000 shares of Rs. 10 each, Rs 5 paid up	5,00,000

Q-5 What is the procedure for Issue of shares

- To issue shares, company has to follow a **definite procedure** with prescribed rules and regulations, which is controlled and regulated by the **Companies Act, 2013 and Securities Exchange Board of India (SEBI)**.
- When a public company desires to raise capital by issuing its shares to the public, it must **invite them to subscribe** for the shares.
- The person **who intends** to become a **shareholder** must thus **subscribe** to those shares by **making an application** for the desired number of shares to the company.
- Consequently, the company will **allot shares** to the applicant.
- **Allotment** means **allocating** or apportioning a certain number of shares to an applicant in response to his application.
- The company **cannot allot more than** the number of **shares offered** to the public for subscription through the prospectus.
- Moreover, the company **cannot make allotment unless** the amount stated in the prospectus as the **minimum subscription** has been subscribed and the sum payable on application for the stated amount has been received by the company.
- Shares can be issued either for **cash** or for **consideration other than cash**.
- In general, shares are issued for cash. The company may call the share money either in one instalment or in two or more instalments.

Q-6 Write a short note on 'Issue of Shares at Premium [Sec 52]'.

Ans:

- When Shares are issued at a **price higher than the face value**, they are said to be **issued at premium**.
- The **premium** on issue of shares is regarded as **Capital Receipt**.
- There are **no restrictions** on the issue of shares at premium, but there are restrictions on its disposal.
- U/S 52 of the Companies Act, 2013, the Securities Premium may be used for:-
 - (i) Issuing fully paid **bonus shares**
 - (ii) Writing off **preliminary expenses**
 - (iii) Writing off
 - [a] the **expenses** of or
 - [b] the **commission** paid or
 - [c] **discount allowed** on any issue of shares or debentures of the Company.
 - (iv) Providing for **premium** payable on **redemption** of preference shares or debentures.
 - (v) A Company may **purchase its own shares u/s 68**.
- Securities Premium Account must be shown separately in the liabilities of the balance sheet under the head "Reserves & Surplus".

Q-7 Write a short note on Issues of Shares at Discount.

[CS June 2009]

Ans:

- When shares are issued at a price **lower than the face value**, they are said to be issued at discount. Thus, the excess of the face value over the issue price is the amount of discount. For example, if a share of Rs. 10 is issued at Rs 9 then Rs [10 – 9] = Re. 1 is the discount.
- As per companies Act 2013, a company shall not issue shares at a discount **except as provided in section 54** for issue of sweat equity shares.
- Any **share issued** by a company at a **discounted price** shall be **void**.
- Where a company **contravenes** the provisions of this section,
 - the company shall be punishable with **fine** which shall not be less than **one lakh rupees** but which may extend **to five lakh rupees** AND
 - **every officer** who is in **default** shall be **punishable** with **imprisonment** for a term which may extend to **six months** or with fine which shall not be less than **one lakh** rupees but which may extend to **five lakh** rupees, or with both.
- The **discount** on issue of shares must be treated as a **loss of capital nature**.
- It must be debited to a separate account called **'Discount on Issue of Shares Account'**.

Q-8 ABC Ltd. brought out an issue which was oversubscribed. What option does the company have in case of over subscription?

A

- In case a company receives applications for **more number of shares** than the number of shares offered to the public for subscription, it is a case of **over subscription**.
- A company **cannot allot more** shares **than** what it has **offered**.
- In case of over subscription company has the following options:

Option I

(i) Rejection of Excess Applications and Money Returned

- ✓ The company may **reject the applications** for shares which are received in excess of the shares offered and a **letter of rejection is sent** to such applicants.
- ✓ In this case the application **money** received from these applicants is **refunded** to them in full.

(ii) Excess application money adjusted towards sums due on allotment

- ✓ If the application money received on partially accepted applications is more than the amount required for adjustment towards allotment money, the **excess money is refunded**.
- ✓ However, **if the Articles** of the company so **authorise**, the directors may **retain the excess money as calls in advance** to be adjusted against the call/calls falling due at a later date.

Option II

Partial acceptance of Applications (Pro-rata acceptance):

- ✓ In some cases, the company **accepts the applications** for subscription **partially**. It means that the company does **not allot** the **full** number of **shares** that are applied for. The shares are **accepted in a ratio**, as determined, this is known as **pro-rata** acceptance.
- ✓ In such a case, the company **adjusts the excess share money** received on application **towards** share **allotment** money due on partially accepted applications.

Q-9 Distinguish between ‘Calls-in-arrears’ and ‘calls in advance’

[CS Dec 2008]

Ans:

Calls-in-arrears	Calls in Advance
1) Calls in arrear refers to the amount called up by the company which has not yet been paid by shareholders	1) Call in advance refers to the amount paid by the shareholders in excess of the amount due from them.
2) The amount of calls in arrears is shown by way of deduction from the called-up amount of balance sheet.	2) The amount of calls in advance is shown under separate heading on the Liabilities side of the Balance sheet.
3) Interest is charged on calls-in-arrears	3) Interest is allowed on calls-in-advance
4) The maximum rate of interest as per Table F is 10% p.a.	4) The maximum rate of interest as per Table F is 12% p.a.

Q-10 What do you mean by “Forfeiture of Shares”

A-

Meaning & Procedure:

- In case where a shareholder **fails to pay** the allotment money and/or calls made on him, his shares are **liable to be forfeited**.
- Forfeiture of shares may be said to be the **compulsory termination** of his **membership** by way of penalty for non-payment of allotment and/or any call money.

Effect:

- The effect of forfeiture of shares is that the defaulting shareholder **loses all his rights** in the forfeited shares and **ceases to be a member** of the company.
- The **name** of the shareholder is **removed** from the Register of Members and the bu already paid by him is **forfeited**.
- He is **not entitled** in future **to dividends** and rights of membership.

Q-11 What is the procedure for “Forfeiture of shares”

- **Articles** of Association of the Company **provide the authority** to forfeit shares to the Board of Directors.
- The Board has to give at least **14 days’ notice** to the defaulting members calling upon them to pay outstanding amount, with or without interest as the case may be, before the specified date
- The **notice** must also **state** that if the shareholders **fail to remit** the amount mentioned therein within the stipulated period, their **shares will be forfeited**.
- If they **still fail to pay** the amount within the specified period of time, the Board of **Directors** of the company **may decide to forfeit** such shares by passing a resolution.
- The **decision** regarding the **forfeiture** of shares should be **communicated** to the concerned allottees.
- **Disclosure:** Forfeited shares account is to be shown in the balance sheet by way of **addition to the paid-up share capital** on the ‘Equity & Liabilities’ side, **until** the concerned shares are **reissued**.

Chapter 5: Bonus Issue of shares

Q-1 State the conditions for issue of bonus shares.

[CS Dec 2013]

Ans:[1] A company may issue fully paid-up bonus shares to its members, in any manner out of –

- [i] its free reserves;
- [ii] the securities premium account; or
- [iii] the capital redemption reserve account.

However, **no** issue of **bonus** shares shall be made by capitalising **reserves** created by the **revaluation** of assets.

[2] No company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under [1] above, unless –

- a] it is **authorised** by its **articles**;
- b] it has, on the recommendation of the Board, been **authorised** in the **general meeting** of the company;
- c] it has **not defaulted** in payment of **interest or principal** in respect of fixed deposits or debt securities issued by it;
- d] it has **not defaulted** in respect of the **payment of statutory dues** of the employees, such as, contribution to provident fund, gratuity and bonus;
- e] the partly paid-up shares, if any outstanding on the date of allotment, are made **fully paid-up**;
- f] The company which has **once announced** the decision of its Board recommending a bonus issue, **shall not** subsequently **withdraw** the same.[Rule 14 of Companies [Share Capital and Debentures]Rules, 2014]

[3] The bonus shares shall **not be issued in lieu of dividend**.

Chapter 6: Redemption of Preference Shares

Q-1 Write a short note on Redemption of Preference Shares.

[CS June 2002; June 2011]

Ans: **Section 55** of the Companies Act, 2013 provides for redemption of preference shares.

Section 55 prescribes the following **conditions**:-

- (i) Preference Shares can be redeemed either
 - (a) Out of divisible **profits**/distributable profits or
 - (b) Out of the **proceeds** of a **fresh issue of shares**.
- (ii) The shares must be **fully paid up**.
- (iii) Any **premium** payable on redemption must be provided out of
 - a) The **securities premium** or
 - b) The **profits** of the company
- (iv) The redemption has to take place **within 20 years** from the date of its issue.
- (v) When redemption is made **out of profits**, a **sum** equivalent to the **nominal value** of the shares redeemed must be transferred to **Capital Redemption Reserve Account**.
- (vi) The redemption of preference Share shall **not** be **taken** as **reducing** the amount of its **authorized share capital**.

Chapter 7: Buy Back of Shares

Q-1 Briefly explain Buy Back of shares. What are the advantages of Buy Back.

A-1 When a company has substantial cash resources, it may like to buy its own shares from the market particularly when the prevailing rate of its shares in the market is much lower than the book value or what the company perceives to be its true value. Buy back of shares enables the company to go back to its shareholders and offers to purchase from them the shares they hold. Buy Back of Securities is a very important tool for Companies who wants to reduce their Share Capital.

Advantages of Buy Back:

- It is an alternative mode of reduction in capital without requiring approval of the Court/CLB (NCLT),
- to improve the earnings per share;
- to improve return on capital;
- to provide an additional exit route to shareholders.
- to enhance consolidation of stake in the company;
- to prevent unwelcome takeover bids;
- to return surplus cash to shareholders;

Q-2 What are the conditions to be fulfilled by a Joint Stock Company to buy-back its equity shares as per Companies Act, 2013. Explain in brief.

Ans: Section 68 to 70 of the Companies Act, 2013 lays down the provisions for a company to buy-back its own equity shares. The key provisions in this regard are as under:

- [a] A company may purchase its own shares or other specified securities out of:
 - [i] Its free reserves;
 - [ii] The securities premium account;
 - [iii] The proceeds of the issue of any shares or other specified securities [not being the proceeds of an earlier issue of the same kind of shares or other specified securities].
- [b] The buy-back is authorized by its articles.
- [c] A special resolution has been passed in general meeting of the company authorising the buy-back [except where the buy back is of less than 10% of the paid up equity capital and free reserves of the company and the buy back is authorized by the Board by means of a resolution passed at a duly convened Board Meeting]
- [d] The buy-back does not exceed 25% of the total paid up capital and free reserves of the company. Provided that in case of buy back of equity shares in any financial year, the 25% of paid up capital shall be construed as 25% of the total paid up equity capital in that financial year.
- [e] The ratio of the secured and unsecured debt owed by the company after the buy back is not more than twice the paid up capital and its free reserves.
- [f] All the shares and other securities for buy-back are fully paid up.
- [g] The buy-back is completed within 12 months of the passing of the special resolution or a resolution passed by the Board.

- [h] The buy-back of the shares listed on any recognized stock exchange is in accordance with the regulations made by the SEBI in this behalf.
- [i] Before making such buy-back, a listed company has to file with the Registrar and the SEBI a declaration of solvency in the prescribed form.
- [j] Where a company purchases its own shares out of its free reserves or securities premium account it shall transfer an amount equal to the nominal value of such shares to Capital Redemption Reserve Account and details of such transfers should be given in the Balance Sheet.

“A journey of a thousand miles begins with a single step.”

Chapter 8: Employee Stock Option Plan

Q-1 What is Employee Stock Option Plan? Explain the importance of such plans in the modern time.

Ans: Employee Stock Option Plan is a plan under which the company grants employee stock options. Employee Stock Option is a contract that **gives** the **employees** of the enterprise the **right**, but **not the obligation**, for a specified period of time to purchase or subscribe the shares of the company at a fixed or **determinable price** which is generally lower than prevailing market price of its shares.

The **importance** of these plans lies in the following advantages which accrue to both the company and the employees:

- I. Stock options provide an opportunity to employees to **participate and contribute in the growth** of the company
- II. Stock option creates **long term wealth** in the hands of the employees.
- III. They are important means to **attract, retain and motivate** the best available **talent** for the company.
- IV. It creates a **sense of ownership** between the company and its employees.

Chapter 9: Accounting for Debentures**Q-1 What are debentures. Briefly explain various kinds of debentures.**

Debentures are a part of loan capital and the company is liable to pay interest thereon whether it earns profit or not.

Debentures may be of different kinds depending upon the conditions of their issue:

1. Secured or Mortgage

When debentures are secured by a mortgage or charge on the property of the company, they are called secured or mortgage debentures.

2. Unsecured or Naked

When debentures are issued without any security, they are termed as unsecured or naked debentures.

3. Bearer

These debentures are payable to bearer and are transferable by mere delivery. Interest coupons are attached to each individual debenture. The interest and principal amount on such debentures is payable upon presentation and delivery of coupons and debentures.

4. Registered

Interest and principal amount is paid only to the person whose name is registered in the debenture ledger. Such debentures are transferable through a transfer deed.

5. Convertible

Debentures may be convertible into preference or equity shares of the company on certain specified dates on the basis of an agreement between the company and the debenture holders.

6. Non-Convertible

Such debentures are paid into cash.

7. Redeemable

Such debentures are paid either at par or at a premium after the expiry of a particular period or under a system of periodical drawings.

8. Irredeemable or Perpetual

Such debentures are payable either on a happening of the contingency, or when the company winds up its business or when the company decided to redeem itself

9. First Mortgage Debentures

Such debentures are paid on the basis of priority as compared to other debentures.

10. Second Mortgage Debentures

Such debentures are paid after the redemption of first mortgage debentures.

Q-2 What are the conditions for issue of debentures as per Companies Act, 2013.**i. Issue of Debentures by Special Resolution**

A company can issue partly or fully convertible debentures by passing special resolution at a general body meeting.

ii. No Voting Rights

No company can issue any debentures carrying any voting rights.

iii. Terms for the Issue of Secured Debentures

Secured debentures may be issued according to prescribed terms and conditions.

iv. Creation and Utilisation of Debenture Redemption Reserve

The company shall create Debenture Redemption Reserve out of its divisible profits and the amount credited to such an account shall not be utilised for any purpose other than the redemption of debentures.

v. Debenture Trustee(s)

A company cannot issue a prospectus or make an offer or invitation to more than 500 persons for subscribing to debentures unless the company has before issuing such a prospectus, appoint one or more debenture trustees.

A debenture trustee shall take steps to protect the interest of the debenture holders and redress the grievances in accordance with the rules as may be prescribed.

Q-3 Differentiate between 'shares' and 'debentures'.

(CS June 2009)

Points	Debentures	Shares
Capital	Debenture is a part of <u>loan capital</u> or borrowing.	Share capital is an <u>ownership capital</u> .
Status	Debenture holder is <u>creditor</u> of company.	Shareholder is the <u>owner</u> of the company
Income	<u>Interest</u> is the income on the investments in debentures.	<u>Dividend</u> is the income on investment in shares.
Charges/Appropriation	Payment of interest is <u>charge against profits</u> and is payable even if there is no profit.	Payment of dividend is an <u>appropriation of profit</u> and not payable if there is no profit.
Voting rights	Debenture holders do <u>not</u> have any <u>voting</u> rights.	Shareholders generally <u>enjoy</u> the <u>voting</u> right.
Issue at discount	<u>No restriction</u> is imposed on the issue of debentures at <u>discount</u> .	Section 53 <u>prohibits</u> the issue of shares at <u>discount</u> .
Rate	<u>Rate</u> of interest is <u>fixed</u> .	<u>Rate</u> of dividend may <u>vary</u> from year to year for equity shares.
Convertibility	Debentures can be <u>convertible</u> .	Equity shares can <u>never be convertible</u> .

Q-4 Write a short note on 'Loss on issue of debentures'.

(CS Dec 2008)

- ✓ If a company issues debentures at par or at a discount which are redeemable at a premium, the **premium payable** on redemption of the debentures should be treated as **capital loss**.
- ✓ Redemption of debentures at a premium is a **known loss** at the time of issue of debentures as the terms of issue generally contain such provisions for redemption.
- ✓ The loss to be incurred by a company for a particular issue of debentures is ascertained in the following manner: (i) If the debentures are issued at par and redeemable at a premium, the loss will be equal to the amount of premium payable on redemption. (ii) if the debentures are issued at a discount and redeemable at a premium, the loss will be equal to the total of the amount of discount on issue and the amount of premium on redemption. Thus, **total loss = Discount on issue of Debentures + Premium Payable on redemption of debentures**.
- ✓ When debentures are redeemable at a premium the **liability for premium** payable on redemption is **recorded** in the books **at the time of issue** of the debentures although the actual liability will arise only at the time of redemption.
- ✓ It is advisable to **write off** these accounts from the books through the **Profit and Loss A/c** as early as possible particularly within the life time of the debentures. These accounts may also be written off against **Securities premium account** or any **capital reserve**.

Q-5 Write a short note on Debentures issued as Collateral Security.

A-5

- The term 'Collateral Security' may be defined as **additional security** given for a loan.
- Where a company obtains a **secured loan** from a bank or insurance company, it may mortgage some of its **assets as a security** against the said loan.
- But the lending institution may **insist** on some **more** assets **as a collateral security** so that the amount of loan can be realized in full with the help of collateral security, in case the amount realized from the sale of first security falls short of the loan money.
- In such a situation, the company **may issue its own debentures** to the lender as collateral security against the loan in addition to any other security that may be offered.
- Such an issue of debentures is known as "Debentures issued as Collateral Security".
- In such a case, the **lender has the absolute right** over the debentures until and unless the loan is repaid.
- **On repayment** of the loan, however, the **lender is legally bound** to release the debentures forthwith.
- But **in case the loan is not repaid** by the company on the due date or in the event of any other breach of agreement, the **lender has the right to retain these debentures** and to realize them. The holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures.

Q-6 Write a short note on Accounting treatment of Collateral Security.

A-6

✓ **First method**

- **No accounting entry** is required to be shown in the books of account at the time of issue of such debentures because there is no immediate liability created by the company.
- But the existence of such debentures issued as collateral security has to be mentioned by way of a **note** on the Balance Sheet **under** the specific **loan account**.

✓ **Second method**

- If it is desired that such an issue of debentures as collateral security is to be recorded in the books of account, the accounting entries will be as follows:

(i) On issue of debentures as collateral security

Debentures Suspense a/c Dr. (with the nominal value of debentures)
To debentures a/c

- In this case, **debentures Suspense** account will appear on the **asset side** of the balance sheet.
- **Debentures account** will appear as a **liability** on the liabilities side of the Balance Sheet.

(ii) On repayment of the loan and release of debentures

Debentures a/c Dr. (with the nominal value of debentures released)
To debentures Suspense a/c

- Note: the **net effect** of the above two entries is **nil**.
- Both the debentures Suspense account and the debentures account are cancelled on repayment of the loan.
- As such, this method is **rarely followed** in practice.

Q-7 Differentiate between “Interest Accrued and Due” & Interest Accrued but not due”

A-7 (CS December 2015)

Interest accrued and due (outstanding interest)

- Interest on debentures is paid periodically.
- Suppose a company pays interest on 30th September and 31st March on Rs. 5,00,000, 14% debentures.
- The company will pay Rs. 35,000 in every six months.
- The debenture holders cannot demand interest before these specified due dates.
- Assuming that the accounting period ends on 31st March and the interest from 1st October to 31st March remains unpaid.
- In that case the debenture interest is accrued and due and it is technically termed as outstanding interest and will be recorded as under:

Debenture interest A/c Dr	35,000
To outstanding debenture interest A/c	35,000

- The liability of outstanding debenture interest will be shown as “other current liability” in Balance sheet.

Interest accrued but not due (accrued interest)

- While preparing final accounts, interest upto closing date must be taken into account, though the same is simply accrued but not payable.
- For example, if the debenture interest is paid on 30th June and 31st December and the company closes its books on 31st March.
- After the payment of interest on 31st December, the next payment will be made on 30th June in next accounting period.
- But for proper accounting, interest from 1st January to 31st March must be accounted for.
- It is called interest accrued but not due or simply accrued interest and will be recorded as:

Debenture interest A/c Dr	
To accrued debenture interest A/c	

- Accrued debenture interest will be shown as “other current liability” in Balance sheet.

Q-8 What is the treatment of Discount/Loss on the issue of Debentures.

A-8

- The discount/loss on debentures is in the nature of **capital loss** and therefore the same must be written off.
- The following **alternatives** are available to write off discount/loss on issue of debentures.
 1. Discount on issue of debentures being a capital loss can be **written off against capital profits.**
 2. Discount on issue of debentures can be treated as **deferred revenue expenditure** and written off against revenue **over** the period of **life** of the debentures.
- In case there is no capital profit and it is decided to treat discount on the issue of debentures as deferred revenue expenditure, it is desirable to write it off against revenue over the period of life of the debentures on an equitable basis.
- The following are the two methods which are generally adopted for this purpose.
 - i. **Fixed Instalment Method**
 - Where the debentures are **redeemable** at the **end** of specific period, the total amount of discount should be written off by **equal instalments** of fixed amount over that period.
 - ii. **Fluctuating Instalment Method**
 - If the debentures are to be repaid by **annual drawings** or instalments it would be equitable in such a case to **write off** discount **in proportion to unpaid amount of debentures.**

Q-9 Briefly explain the methods of redemption of debentures.

A-9

- Redemption of debentures means **repayment** to the debenture holders. The terms and conditions of redemption are generally given in the prospectus.
- **Methods of Redemption**
 1. **Lumpsum**
 - The redemption is made in **one lumpsum** at the expiry of a specified period promised as the redemption date when the debentures were issued.
 2. **Annual Instalments or Draw by lots**
 - Under this method, a certain amount of debentures is redeemed **at regular intervals**, say yearly, during the life of debentures.
 - The amount of annual drawings may or may not be equal.
 3. **Conversion Into Shares**
 - A company may issue **convertible debentures**, giving **options** to the debenture holders to exchange their debentures for equity shares or preference shares in the company.
 4. **Purchase of Its Own Debentures In Open Market**
 - A company is entitled to purchase its own debentures in **open market**, i.e., through the **stock exchange**.
 - When the company purchases its own debentures for **immediate cancellation**, it leads to automatic redemption.
 - Own debentures may also be purchased by the company for its own **investment**.

Q-10 Comment on the adequacy of Debentures Redemption Reserve (DRR) w.r.t. following: Debenture issued by-

Ans:

S.No	Debentures issued by	Adequacy of Debenture Redemption Reserve (DRR)
(i)	All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures.	No DRR is required
(ii)	Other Financial Institutions (FIs) within the meaning of clause (72) of Section 2 of the Companies Act 2013.	DRR will be as applicable to NBFCs registered with RBI. (i.e. No DRR is required)
(iii)	All listed NBFCs and listed HFCs for both public as well as privately placed debentures	No DRR is required
(iv)	All unlisted NBFCs and unlisted HFCs for privately placed debentures	No DRR is required
(v)	Other listed companies (other than NBFCs and HFCs)	No DRR is required
(vi)	Other unlisted companies (other than NBFCs and HFCs)	DRR shall be 10% of the value of the outstanding debentures issued

Q-11 Explain the liability of the Company to Create Debenture Redemption Reserve**Ans: Liability Of The Company To Create Debenture Redemption Reserve**

Section 71 (4) in the Companies Act 2013 covers the requirement of creating the Debenture Redemption Reserve. The Section 71 states as follows:

- (1) Where a company issues debentures under this section, it shall **create a debenture redemption reserve** account **out of its profits** which are available for distribution of dividend every year until such debentures are redeemed.
- (2) The amounts credited to the debenture redemption reserve **shall not be utilized by the company except for the purpose aforesaid.**
- (3) The company referred to in sub-section (1) shall **pay interest and redeem the debentures** in accordance with the terms and conditions for their issue.
- (4) Where a company fails to redeem the debentures on the date of maturity or fails to pay the interest on debentures when they fall due, the **Tribunal may**, on the application of any or all the holders of debentures or debentures trustee shall, after hearing the parties concerned, **direct by order**, the company **to redeem the debentures** forthwith by the payment of principal and interest due thereon.

Q-12 Explain the requirements of Investment of Debenture Redemption Reserve (DRR) Account.**Ans: Investment of Debenture Redemption Reserve (DRR) Amount**

As per Rule 18(7) of the Companies (Share Capital and Debentures) Amendments Rules, 2019, following companies

- (a) All listed NBFCs
- (b) All listed HFCs
- (c) All other listed companies (other than AIFs, Banking Companies and other FIs); and
- (d) All unlisted companies which are not NBFCs and HFCs

shall on or before the 30th day of April in each year, in respect of debentures issued, deposit or invest, as the case may be, a sum which should not be less than 15% of the amount of its debentures maturing during the year ending on the 31st day of March of next year, in any one more of the following methods, namely:

- (a) in **deposits** with any scheduled **bank**, free from charge or lien;
 - (b) in unencumbered **securities** of the **Central Government** or of any **State Government**;
 - (c) in unencumbered **securities** mentioned in clauses (a) to (d) and (e) of section 20 of the **Indian Trusts Act, 1882**;
 - (d) in unencumbered **bonds** issued by any other company which is notified under clause (f) of section 20 of the **Indian Trusts Act, 1882**;
- The amount deposited or invested, as the case may be, above **shall not be utilized for any purpose other than for the repayment of debentures** maturing during the year referred to above, provided that the amount remaining deposited or invested, as the case may be, **shall not at any time fall below 15 per cent of the amount of debentures** maturing during the 31st day of March of that year.

Q-13 Write a short note on ‘Purchase of Debentures in the market by a company.’(CS June 2011)

OR

Write a short note on Purchase of Debentures in the open market.

- A company, **if authorized** by its Articles of Association, can **buy its own debentures** in the open market.
- The debentures so purchased can be used **either** for immediate **cancellation** or redemption of debentures or for **investment**.
- The debentures so **purchased for investment** can subsequently either **be reissued/sold** when the company requires additional cash **or be cancelled** if the company so desires.
- Debentures when purchased for investment are popularly known as **“Own Debentures”**.
- This can be categorized as follows:
 1. **For immediate cancellation**
 - When the company cancels the debentures so purchased, it amounts to redemption of debentures.
 - it means after cancellation, redemption is automatic and these debentures cannot be reissued.
 2. **For investment in the form of own debentures**
 - If the company purchases its debentures from open market and holds them for sometime before cancellation, such debentures are known as own debentures.
 - Own debentures are held by company as investment and may be resold.
 - After cancellation, the debentures are said to be redeemed and cannot be resold.

Q-14 Write a short note on ‘Conversion of debentures’.

- ✓ According to the terms of issue of the debentures, the debenture holders may be given the right to exercise the **option to convert** their debentures into equity shares or preference shares at a stipulated rate within a specified period.
- ✓ **If** the debenture holders find the **offer is beneficial** to them, they will **exercise their right** and opt for shares, otherwise they may not exercise their right.
- ✓ According to **section 71** of the Companies Act, 2013, a company **may issue debentures** with an **option to convert** debentures into shares either wholly or partly at the time of redemption.
- ✓ In case, the debentures are due for redemption, conversion of debentures into shares, may be made on the basis of terms and conditions mutually agreed upon at the time of redemption.
- ✓ In such a case, even debentures **originally issued at a discount** can be converted into shares on the **basis of the nominal value** of the debentures.
- ✓ At the time of conversion, new shares can be issued at par or at a premium only. As per Companies Act, 2013 issue of shares at discount is prohibited.

Q-15 Explain ‘cum interest’ and ‘ex-interest’ in case of purchase of own debentures. OR Distinguish between ‘cum-interest’ and ‘ex interest’ quotations. (CS Dec 2012; June 2014)

A-15

- ✓ Interest on debentures is **generally paid half-yearly** to the holders on certain specified dates, e.g., 30th September and 31st March every year.
- ✓ If debentures are purchased exactly on these specified dates, it involves no problem. In such a case, interest is payable to the holders of debentures. But, where debentures are **purchased** at a date **before** the specified **date** of payment of **interest** the question which naturally arises is **whether** the price paid for such debentures **includes** the **interest** for the expired period (i.e. from the previous date of payment of interest up to the date of purchase) **or not**.
- ✓ For this purpose it is important to note whether the price paid for the debentures is quoted as “Cum-interest” or “Ex-interest”.

- ✓ If the purchase price for the debentures **includes** interest for the expired period, the quotation is said to be **“Cum-interest”**.
- ✓ If, on the other hand, the purchase price for the debentures **excludes** the interest for the expired period, the quotation is said to be **“Ex-interest”**.
- ✓ In case of Ex-interest quotation, interest has to be paid to the holders for the expired period in addition to the price paid for the debentures.

Chapter 10: Consolidation of Accounts

Q-1 How are pre-acquisition losses of subsidiary companies shared and accounted for?

[CS Dec 2014]

Ans:

- Accumulated losses of the subsidiary company upto the date of acquisition of shares by the holding company are called pre-acquisition losses.
- Both the holding company and the minority shareholders must share such losses in proportion to their respective holdings.
- The minority shareholders' share of such losses should be deducted from the amount of Minority Interest.
- The holding company's share of such losses should be treated as capital loss and debited to Goodwill account.
- While preparing the Consolidated Balance Sheet, this Goodwill Account should be shown as an asset.

Q-2 How are pre-acquisition profits and reserves of subsidiary companies shared and accounted for?

Ans:

- Accumulated profits and reserves which appear in the balance sheet of the subsidiary company up to the date of acquisition of its shares by the holding company are called preacquisition profits and reserves.
- Both the holding company and the minority shareholders will have proportionate share in such profits and reserves.
- The share of the minority shareholders in such profit and reserves will be added to the amount of minority interest.
- But the holding company's proportionate share in such profits and reserve should be treated as capital profits and credited to Capital Reserve since the holding company cannot earn any revenue profits from its subsidiary before the shares are acquired in it.
- While preparing the consolidated balance sheet, this Capital Reserve should be shown on the liabilities side or if there is any Goodwill, it can be shown as a deduction from the Goodwill in the assets side.

Q-3 What is 'cost of control' in the context of preparing consolidated balance sheet?

[CS June 2014]

Ans:

- If the price paid by the holding company for the shares acquired in the subsidiary company is more than the intrinsic value of the shares acquired, the difference should be treated as Cost of Control or Goodwill.
- If on the other hand, the price paid by the holding company for the shares acquired in the subsidiary company is less than the intrinsic value of the shares acquired, the difference should be treated as capital profits and credited to Capital Reserve.
- It should be noted that while computing the intrinsic value of the shares as on the date of acquisition of control, all profits and losses upto that date, have to be taken into account.
- While preparing the consolidated balance sheet, such Goodwill or Capital Reserve, whatever may be the case, must be shown in the Balance Sheet.

“God is not an option, He is a necessity.”

Q-4 How profit on revaluation of assets of subsidiary companies is accounted for?**Ans:**

- If there is any profit resulting from the revaluation of assets of the subsidiary company, the same must be shared both by the holding company and the minority shareholders in proportion to their respective holdings.
- The minority shareholders' share of such profit should be added to the Minority interest.
- But the holding company's share should be treated as capital profits and dealt with like pre-requisitions profit and reserve.
- Further, adjustment for depreciation on the increases or decreases in the value of assets would be made in the profit and loss account of the subsidiary.
- For appreciation in the value of assets, depreciation charge would be increased proportionately and the same would be deducted from the revenue profits of the subsidiary company.
- On the other hand, for revaluation loss due to decrease in the value of assets, excess depreciation provision should be written back.

Q-5 Briefly explain "Inter-company unrealized profits included in unsold goods".

- If goods are sold by one company to the other [i.e., by the holding company to its subsidiary or vice-versa] at a profit and a part of it remains unsold at the end of the year, the unrealised profit and such goods remaining unsold must be provided for.
- But it is important to note here that the minority shareholders will not be affected in any way.
- Such unrealized profit has to be eliminated from the consolidated balance sheet in the following manner:
 - i. The unrealized profits should be deducted from the current revenue profits of the company which sold the goods.
 - ii. Again, the same should be deducted from the value of stock-in-trade of the company concerned.

Q-6 Briefly explain Contingent Liabilities in context of Consolidation.

Ans: If the contingent liabilities relate to the outsiders they must be shown by way of a footnote in the consolidated balance sheet.

But a contingent liability in respect of a transaction between holding and subsidiary companies [internal contingent liability] will disappear from the foot note as they appear as actual liability in the consolidated balance sheet.

Q-7 Write a short note on "Inter Company Transactions"

Ans: The holding company and the subsidiary company may have a number of inter-company transactions in any one or more of the following matters:

- i. Loans advanced by the holding company to the subsidiary company or vice versa. This appears as an asset in the balance sheet of the company which gives loan and as a liability in the balance sheet of the company which takes the loan.
If S Ltd. has taken a loan of Rs. 20,000 from H Ltd. then S Ltd.'s balance sheet shows a liability of Rs. 20,000, while H Ltd.'s balance sheet shows an asset of Rs. 20,000.
- ii. Bills of exchange given by one company and received by another company appears as bills payable in the balance sheet of the accepting company and as bills receivable in the balance sheet of the drawer company.
If H Ltd. draws a bills of Rs. 10,000 on S Ltd. then H Ltd.'s books will show bills receivable Rs. 10,000 while. S Ltd.'s books will show bills payable Rs. 10,000.
- iii. Transactions relating to sale and purchase of goods on credit similarly appears as debtors in the balance sheet of the company selling goods and as creditors in the balance sheet of the company purchasing the goods.

- iv. Debentures issued by one company may be held by the other.
If S Ltd. issues debentures of Rs. 50,000 which are held by H Ltd. then S Ltd.'s books will show a liability of Rs.50,000 while H Ltd. books will show an asset of Rs. 50,000.
All the above inter-company transaction have to be eliminated while preparing the consolidated balance sheet.
This can be done by deducting the intercompany transactions from the respective items on both sides of the balance sheet.

Q-8 Write a short on Minority Interest.

Ans:

- ✓ The claim of outside shareholders in the subsidiary company has to be assessed and shown as a liability in the consolidate balance sheet.
- ✓ Minority interest consists only the face value of the shares held by them. But it may so happen that the subsidiary company may have some accumulated profits and reserves or accumulated losses. Besides, it may have some profits or losses on account of revaluation of its assets on the date of acquisition of shares by the holding company. While calculating the amount of minority interest, all these items have to be taken into account and proportionate share of all such profits and reserves should be added to the amount of minority interest while proportionate share of all such losses should be deducted from the minority interest.
- ✓ Thus, $\text{Minority Interest} = \text{paid-up value of shares held by minority shareholders} + \text{proportionate share of the company's profits and reserves} + \text{proportionate shares of profits on revaluation of assets of the company} - \text{proportionate share of company's losses} - \text{proportionate share of loss on revaluation of assets of the company}$.
- ✓ The company's profit and reserves or loss will include both pre-acquisition and post-acquisition profits and reserves or losses.

Chapter 11: Accounting Standards**Q-1 Explain the meaning of Accounting Standards.**

- The expression 'Accounting Standards', therefore, means generally accepted models or ideals for accounting.
- Accounting standards may be defined as the written policy documents issued by an expert Accounting Body or Government or other regulatory bodies covering the aspects of recognition, measurement, presentation and disclosure of the transactions and other events in the financial statements. Let us understand this definition as under:

a) Accounting standards are the written policy documents: The word 'Policy' means a course of action adopted as advantageous or expedient. These are written documents which are advantageous to be adopted by the enterprises in reflecting the effect of the transactions and other events.

b) Accounting standards are issued by the expert Accounting body, Government or other regulatory bodies: In India, the expert accounting body to issue the accounting standards is the Institute of Chartered Accountants of India (ICAI). Government also issues the accounting standards. For example, the Central Government issues the accounting standards to be adopted by the companies under the Companies Act, 2013 in the preparation and presentation of their financial statements. Similarly, the regulatory body like Insurance and Regulatory Development Authority of India (IRDA) and Reserve Bank of India (RBI) also issue accounting standards.

c) Accounting Standards deal with the **recognition, measurement, presentation and disclosure** of transactions and other events:

- (i) **Recognition** of transactions and other events: Recognition is the process of incorporating an item in the Balance Sheet and statement of Profit and Loss. It involves the depiction of an item in words and by a monetary amount and inclusion of that amount in the totals of the Balance Sheet and Statement of Profit and Loss. The Accounting standards tell us which item to recognize in the Balance sheet and Statement of Profit and Loss.
- (ii) **Measurement** of the transactions and other events: Accounting standards also provide guidance as to what monetary amount should be put to the transaction and events i.e. measurement or quantification of the items of transactions and events. For example, Accounting Standard (AS) 10 'Property, Plant and Equipment' provides that for the initial recognition of an item of PPE, the costs of the items to be considered are (a)Purchase price less trade discount and rebates; (b)Non-refundable purchase taxes; (c) Import duties; (d)Directly attributable cost to bring the asset in the location and condition for operation as intended by the management.
- (iii) **Presentation** of transactions and other events: Accounting Standards also deal with the manner of presentation of transactions and other events in the Balance Sheet and Statement of Profit and Loss. For Example, paragraphs 8 to 17 of Accounting Standard 3 'Cash Flow Statements' deal with the manner of presentation of operating activities, investing and financing activities in the cash flow statement.
- (iv) **Disclosure** of transactions and other events: Accounting standards also deal with the manner of disclosure of transactions and other events. For example, paragraph 37 of the AS 10 provides that in the financial statements, gross and net carrying amounts of the items of PPE at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements should be disclosed.

It may be noted that almost all the Accounting Standards deal with recognition, measurement, presentation and disclosure of transactions and other events.

Q-2 Write a short note on Applicability of Accounting Standards

- Accounting standards are intended to apply to enterprises (whether organized in corporate, co-operative or other forms) engaged in commercial, industrial or business activities irrespective of whether it is profit oriented or it is established for charitable or religious purposes.
- However, the Accounting Standards will not apply to the enterprises which carry on only those activities which are not of commercial, industrial or business nature (e.g. an activity of collecting donations and giving them to flood affected people).
- Exclusion of an enterprise from the applicability of Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature.
- Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.
- Thus, it may be stated that the Accounting Standards apply to:
 - (a) Sole proprietorship concerns/individuals
 - (b) Partnership firms
 - (c) Societies
 - (d) Trusts
 - (e) Hindu Undivided families
 - (f) Association of Persons (AOP)
 - (g) Body of individuals (BOI)
 - (h) Co-operative societies
 - (i) Companies and LLPs

Q-3 Which types of financial statements or reports are the Accounting Standards applicable to?

- Accounting Standards apply to the general-purpose financial Statements and other financial reporting which are subject to attest functions of the members of the ICAI.
- The term 'General purpose Financial Statements' includes 'Balance Sheet', 'Statement of Profit and Loss', 'A Cash Flow Statement' (where applicable), and Statements and explanatory notes which form part thereof issued for the use of various stakeholders, government and their agencies and the public.

Q-4 Explain Accounting Standards Setting process.

Paragraph 5 of the 'Preface to the Statements of Accounting Standards' provides for the procedure of issuing Accounting Standards in India which may be explained as under:

Step 1: Determination of the broad areas: The ASB (*Constituted by ICAI in 1977*) determines the broad areas in which the accounting standards need to be formulated and the priority in regard to the selection thereof.

Step 2: Assistance to the ASB by the study group: In the preparation of the accounting standards, the ASB will be assisted by the study groups constituted to consider the specific subjects. In the formulation of the study group, the provision is made for wide participation by the members of the ICAI and others.

Step 3: Preparation of the preliminary draft of Accounting Standard by the Study group:

The draft of the proposed accounting standard will normally include the following (a) Objective of the standards (b) Scope of the standard (c) Definition of the terms used in the standard (d) Recognition and measurement principles wherever applicable (e) Presentation and disclosure requirements.

Step 4: Consideration of the preliminary draft by the ASB: The ASB will consider the preliminary draft prepared by the Study group and if any revision of the standard is required on the basis of the deliberations, the ASB will make the same or will refer the same to the study group.

Step 5: Circulation of the draft of Accounting Standard by the ASB to the members of ICAI and specified bodies: The ASB will circulate the draft of the standard to the members of the ICAI and to the specified bodies such as MCA, CAG, CBDT, ICAI, ICSI, ASSOCHAM, CII, FICCI, RBI, SEBI, SCOPE, IBA and any other body considered relevant by the ASB keeping in view the nature of the standard.

Step 6: Meeting of the ASB with the representatives of the specified bodies to finalize the exposure draft: The ASB will hold a meeting with the representatives of the specified bodies to ascertain their view and on the basis of the comments received and the views of the representatives of the specified bodies, the ASB will finalize the exposure draft of the proposed accounting standard.

Step 7: Issue of exposure draft for comments by the members of the ICAI and the public and specified bodies: The exposure draft [ED] of the proposed standard will be issued for the comments by the members of the ICAI and the public. The ED will be specifically sent to the specified bodies as listed above and the stock exchanges and the other interest groups as considered appropriate.

Step 8: Submission of the final draft by the ASB to the Council of the ICAI: After taking into consideration the comments received, the ASB will finalize the draft of the standard and the same will be submitted to the council of the ICAI.

Step 9: Consideration of the draft by the council of the ICAI and issue of the Standard by the ICAI: The council of the ICAI will consider the draft of the proposed standard and if found necessary, it will revise the same in consultation with the ASB and then the standard will be issued by the ICAI.

Q-5 What is the duty of an auditor?

- It is the duty of the auditors that while discharging their function they have to ensure that the Accounting Standards issued and made mandatory by the Central Government are complied with.
- Section 143(3)(e) of the Companies Act 2013 requires that the auditor to report whether in his opinion the financial statements comply with the Accounting Standards referred in section 133 of the Companies Act, 2013.

Q-6 What disclosure is required in Board's report in context of accounting standards?

Section 134(5)(a) of the Companies Act, 2013 states that Directors Responsibility statement should include that in the preparation of the annual accounts the applicable Accounting Standards had been followed along with proper explanations relating to material departure.

Q-7 What are the advantages of Accounting Standards?**Advantages of Accounting Standards**

General: The accounting standards seek to describe the accounting principles, valuation techniques and the methods of applying these accounting principles in the preparation and presentation of the financial statements so that they can represent a true and fair view of the financial position and financial performance of the enterprise. The ostensible purpose of the standards setting bodies is to promote the dissemination of the timely and useful financial information to the users.

The various advantages of Accounting Standards may be enumerated as under:

- (i) **Improvement of credibility and reliability of financial statements:** The accounting standards create an environment of confidence among the users of accounting information by providing a uniform structure of uniform guidelines which provide credibility and reliability to the accounting information.
- (ii) **Comparability of financial Statements made easy:** The value of the accounting information is enhanced if the same can be compared in the same line of business activity. But, the comparability is possible only if the same accounting standards are used in the preparation of the financial statements of the different enterprises in the same industry. It is a positive step to protect the interests of the users of the accounting information.
- (iii) **Benefits to the accountants and auditors:** Since the accounting profession follows the accounting standards without any exception, they are helpful not only to the accounting entity but also to the accountants and the auditors. Any type of misinformation can lead to the strict action against the accountants and the auditors.
- (iv) **Additional disclosures:** There are certain areas where the important information is not required to be disclosed by the law. The accounting standards require the disclosure of such matters such as the method of depreciation and the change in the method of depreciation which help the users of the financial statements to take important financial decision.
- (v) **Evaluation of the managerial ability:** Accounting standards are useful in measuring the efficiency of the management regarding profitability, liquidity, solvency and other general progress of the enterprise.
- (vi) **Helpful to the Government:** The Government officials would find the financial information useful for economic planning, market analysis and tax collection if the financial statements are based on the established accounting standards.
- (vii) **Reforms in accounting theory:** The development of accounting standards has been very helpful in the reforms of accounting theory and practice regarding the measurement, treatment, presentation and disclosure of the financial items.

Q-8 What are the disadvantages of Accounting Standards?

The disadvantages of Accounting Standards may be enumerated as under:

- (i) **Difficult choice:** Alternative accounting treatments suggested by the accounting standards may each have arguments to recommend them. In such a case, it becomes difficult to choose one out of them for application by an enterprise.

(ii) **Mechanical choice:** There may be a trend towards rigidity and away from flexibility in applying the Accounting Standards. The reason is that we cannot go beyond the accounting Standards recommendations.

(iii) **Not different from law:** The accounting standards cannot override the statutes and have to be framed within the bounds of the prevailing statutes.

Q-9 How many Accounting Standards?

- The Institute of Chartered Accountants of India has, so far, issued 32 Accounting Standards.
- However, the Accounting Standard 8 “Accounting for Research and Development” was withdrawn subsequent to the issuance of Accounting Standard 26 “Intangible Assets” and the Accounting Standard 6 “Depreciation Accounting” was withdrawn subsequent to the issuance of revised Accounting Standard 10 “Property, Plant and Equipment” including the matters related to depreciation accounting for the old AS 10 “Accounting for Fixed Assets”.
- The Accounting Standards 30,31 and 32 related to “Financial Instruments” have been withdrawn by the ICAI in the year 2016. **Thus, effectively, there are only 27 Accounting Standards at present.**
- The standards are developed by the Accounting Standards Board (ASB) of the Institute and are issued under the authority of its Council. **The institute not being a legislative body can enforce compliance with its standards only by its members.**
- Also, the standards cannot override laws and local regulations.
- The Accounting Standards are nevertheless made mandatory from the dates specified in respective standards and are generally applicable to all enterprises, subject to certain exception. The implication of mandatory status of an Accounting Standard depends on whether the statute governing the enterprise concerned requires compliance with the standard.

Q-10 What is the need for convergence with International Financial Reporting Standards (IFRS)?

- ✓ Each country has its own set of rules and regulations for accounting and financial reporting.
- ✓ Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country apply, and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin.
- ✓ Therefore, translation and re-instatements are of utmost importance in a world that is rapidly globalizing in all ways.
- ✓ In themselves also, the Accounting Standards and principle need to be robust so that the larger society develops degree of confidence in the financial statements, which are put forward by organizations.

- ✓ International analysts and investors would like to compare financial statements based on similar Accounting Standards, and this has led to the growing support for an internationally accepted set of Accounting Standards for cross-border filings.
- ✓ The harmonization of financial reporting around the world will help to raise confidence of investors generally in the information they are using to make their decisions and assess their risks.
- ✓ Also a strong need was felt by legislation to bring about uniformity, rationalization, comparability, transparency and adaptability in financial statements.
- ✓ Having a multiplicity of Accounting Standards around the world is against the public interest. If accounting for the same events and information produces different reported numbers, depending on the system of standards that are being used, it is self-evident that accounting will be increasingly discredited in the eyes of those using the numbers.
- ✓ It creates confusion, encourages error and facilitates fraud. The cure for these ills is to have a single set of global standards, of the highest quality, set in the interest of public. Global Standards facilitate cross-border flow of money, global listing in different bourses and comparability of financial statements.
- ✓ The convergence of financial reporting and Accounting Standards is a valuable process that contributes to the free flow of global investment and achieves substantial benefits for all capital market stakeholders.
- ✓ It improves the ability of investors to compare investments on a global basis and thus lowers their risk of errors of judgment.
- ✓ It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements reinstatement of financial statements.
- ✓ It has the potential to create a new standard of accountability and greater transparency, which are values of great significance to all market participants, including regulators.
- ✓ It reduces operational challenges for accounting firms and focuses their value and expertise around an increasingly unified set of standards.
- ✓ It creates an unprecedented opportunity for standard setters and other stakeholders to improve the reporting model.
- ✓ For the companies with joint listings in both domestic and foreign country, the convergence is very much significant.

Q-11 What are the advantages of International Financial Reporting Standards (IFRS)?

Following are some of the advantages of IFRS:

- It would facilitate increased comparability of financial information among companies operating in different countries.
- The financial reporting process would become more transparent.
- The standardization of accounting methodology provides creditors and investors with the ability to analyze businesses around the world using the same financial methods.
- It would also permit international capital to flow more freely.

- It would give investors a better understanding to the financial statements and assess the investment opportunities in other countries.
- It would also benefit the accounting professionals as they will be able to sell their services in the different parts of the world.

All these benefits of IFRS have prompted many countries to pursue convergence of national Accounting Standards with IFRS. India has also decided to facilitate the convergence of the Indian Accounting Standards with IFRS and in this direction all existing Accounting Standards are being revised and converged with corresponding IAS/ IFRS. Convergence of entire world towards IFRS would benefit the corporate sector, investors, regulators and facilitate economic growth as a whole.

Q-12 Discuss Convergence with IFRS in India

- ✓ Increasingly, Indian accountants and businessmen strangle feel the need for convergence with IFRS.
- ✓ Capital markets provide an important explanation for this change. Some Indian companies are already listed on overseas stock exchanges and many more will list in the future. Internationally acceptable Accounting Standards are becoming the language of communication for Indian companies.
- ✓ Also, the recent stream of overseas acquisitions by Indian companies makes a compelling case for adoption of high quality standards to convince foreign enterprises about the financial standing, as also the disclosure and governance standards of Indian acquirers. Convergence with IFRS would require several changes in Indian laws and decision processes.
- ✓ In India, the Institute of Chartered Accountants of India (ICAI) is on the way towards convergence of its Standards with Global Standards.
- ✓ Divergences have been minimized to the maximum possible extent in the areas wherein full convergence is difficult.
- ✓ Recognizing the growing need of full convergence of Indian Accounting Standards with IFRSs, ICAI constituted a Task Force to examine various issues involved.
- ✓ Full convergence involves adoption of IFRSs in the same form as that issued by the IASB.
- ✓ While formulating the Accounting Standards, ICAI recognizes the legal and other conditions prevailing in India and makes deviations from the corresponding IFRSs.

Q-13 What are the features of IFRS?

Features of IFRS:

- (A) Single set of Accounting Standards would enable internationally to standardize and assure better quality on a global screen.
- (B) It would also permit international capital to flow more freely, enabling companies to develop consistent global practices on accounting problems.
- (C) It would be beneficial to the regulators too, as the complexity associated with needing to understand various reporting regimes would be reduced.
- (D) For investors, it gives a better understanding to the financial statements and assess the investment opportunities other than their Home Country.
- (E) It also benefits the accounting professionals in a way that they will be able to sell their services in the different parts of world.

Q-14 Define Indian GAAP (IGAAP)

- ✓ Indian GAAP is a set of accounting standards that are specifically designed for the Indian context.
- ✓ GAAP stands for Generally Accepted Accounting Principles.
- ✓ Most Indian companies follow Indian GAAP while preparing their accounting records.
- ✓ When a company follows IFRS, it needs to provide a disclosure in the form of a note that it is complying with the IFRS.
- ✓ But for Indian GAAP, the disclosure of the statement isn't mandatory.
- ✓ When a company is said to follow the Indian GAAP, it's assumed that they're complying with the Indian GAAP to portray the true and fair view of their financial affairs.

Q-15 What are the various Accounting Standards issued by ICAI?

AS 1 Disclosure of Accounting Policies

AS 2 Valuation of Inventories

AS 3 Cash Flow Statements

AS 4 Contingencies and Events Occurring After Balance Sheet Date

AS 5 Net profit or Loss for the period, Prior Period Items and Changes in Accounting Policies

AS 7 Construction Contracts

AS 9 Revenue Recognition

AS 10 Property, Plant and Equipment

AS 11 The Effects of Changes in Foreign Exchange Rates

AS 12 Government Grants

AS 13 Accounting for Investments

AS 14 Accounting for Amalgamations

AS 15 Employee Benefits

AS 16 Borrowing Costs

AS 17 Segment Reporting

AS 18 Related Party Disclosures

AS 19 Leases

AS 20 Earnings Per Share

AS 21 Consolidated Financial Statements

AS 22 Accounting for Taxes on Income

AS 23 Accounting for Investments in Associates

AS 24 Discontinuing Operations

AS 25 Interim Financial Reporting

AS 26 Intangible Assets

AS 27 Financial Reporting of Interests in Joint Ventures

AS 28 Impairment of Assets

AS 29 Provisions, Contingent Liabilities and Contingent Assets

Q-16 What are the various Ind AS issued by ICAI?

- ✓ Indian Accounting Standard (abbreviated as Ind-AS) are the Accounting standards adopted by companies in India and issued under the supervision and control of Accounting Standards Board (ASB), which was constituted as a body in the year 1977.
- ✓ ASB is a committee under the Institute of Chartered Accountants of India (ICAI) which consists of representatives from government department, academicians, other professional bodies viz. ICAI, representatives from ASSOCHAM, CII, FICCI, etc., while formulating the accounting standards, ASB will give due consideration to standards issued by IASC and try to integrate them to the extent possible, in the light of the conditions and practices prevailing in India.
- ✓ The Ind-AS are named and numbered in the same way as the corresponding International Financial Reporting Standards (IFRS).
- ✓ MCA has to spell out the accounting standards applicable for companies in India.

Ind AS	IFRS	Title of Ind AS/IFRS	AS
101	1	First time Adoption of Indian Accounting Standards	-
102	2	Share Based Payment	-
103	3	Business Combinations	14
104	4	Insurance Contracts	-
105	5	Non-current Assets Held for Sale And Discontinued Operations	24
106	6	Exploration for and Evaluation of Mineral Resources	-
107	7	Financial Instruments: Disclosures	32
108	8	Operating Segments	17
109	9	Financial Instruments	30
110	10	Consolidated Financial Statements	21
111	11	Joint Arrangements	27
112	12	Disclosure of Interests in other Entities	-
113	13	Fair Value Measurement	-
114	14	Regulatory Deferral Accounts	-
1	1	Presentation of Financial Statements	1
2	2	Inventories	2
7	7	Statement of cash flows	3
8	8	Accounting policies, Changes in	5

10	10	Accounting Estimates and Errors	
		Events after the Reporting period	4
11	11	Construction contracts	7
12	12	Income Taxes	22
16	16	Property, Plant and Equipment	10
17	17	Leases	19
18	18	Revenue	9
19	19	Employee Benefits	15
20	20	Accounting for Government Grants and Disclosure of Government Assistance	12
21	21	The effects of Changes in Foreign Exchange Rates	11
23	23	Borrowing Costs	16
24	24	Related Party Disclosures	18
27	27	Separate Financial Statements	-
28	28	Investment in Associates and Joint Ventures	23
29	29	Financial Reporting in Hyperinflationary Economies	-
32	32	Financial Instruments: Presentation	31
33	33	Earnings per share	20
34	34	Interim Financial Reporting	25
36	36	Impairment of Assets	28
37	37	Provisions, Contingent Liabilities And Contingent Assets	29
38	38	Intangible Assets	26
40	40	Investment Property	13
41	41	Agriculture	-

Applicability of Accounting Standards

Meaning of Small and Medium Sized Company (SMC)

Small and Medium-Sized Company (SMC) as defined in clause 2(e) of the Companies (Accounting Standards) Rules, 2021:

“Small and Medium Sized Company” (SMC) means, a company

- i. whose equity or debt securities are **not listed** or are **not in the process of listing** on any stock exchange, whether in India or outside India;
- ii. which is **not a bank, financial institution or an insurance company**;
- iii. whose **turnover** (excluding other income) does not exceed rupees **two-fifty crores** in the immediately preceding accounting year;
- iv. which does not have **borrowings** (including public deposits) in excess of rupees **fifty crores** at any time during the immediately preceding accounting year; and
- v. which is not **holding or subsidiary company** of a company which is not a small and medium-sized company.

Exemptions or Relaxations for SMCs

(A) Accounting standards not applicable to SMCs in their entirety:

- i. AS 3 : Cash Flow Statements
- ii. AS 17 : Segment Reporting

(B) Accounting Standards in respect of which relaxations from certain requirements have been given to SMCs:

- i. AS 15 : Employee Benefits
- ii. AS 19 : Leases
- iii. AS 20 : Earnings Per Share
- iv. AS 28 : Impairment of Assets
- v. AS 29 : Provisions, Contingent Liabilities and Contingent Assets

(C) There are some accounting standards which are applicable based on regulatory requirement:

- i. AS 21 Consolidated Financial Statements
- ii. AS 23 Accounting for Investments in Associates in Consolidated Financial Statements
- iii. AS 27 Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)
- iv. AS 25 Interim Financial Reporting

Criteria for classification of Non-company entities for applicability of Accounting Standards

For the purpose of applicability of Accounting Standards, Non-company entities are classified into four categories, viz., Level I, Level II, Level III and Level IV

1. Level I entities are **large** size entities
Level II entities are **medium** size entities
Level III entities are **small** size entities
Level IV entities are **micro** entities
Level IV, Level III and Level II entities are referred to as **Micro, Small and Medium Entities (MSMEs)**

2. Level I Entities

Non-company entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

- i. Entities whose securities are **listed or are in the process of listing** on any stock exchange, whether in India or outside India
- ii. **Banks** (including co-operative banks), **financial institutions** or entities carrying on **insurance** business.
- iii. All entities engaged in commercial or industrial or business activities, whose **turnover** (excluding other income) exceeds rupees **two-fifty crores** in the immediately **preceding accounting year**
- iv. All entities engaged in commercial or industrial or business activities having **borrowings** (including public deposits) in excess of **rupees fifty crores** at **any time** during the immediately **preceding accounting year**.
- v. **Holding and subsidiary** entities of any of the above

3. Level II Entities

Non-company entities which are not Level I entities but fall in any one or more of the following categories are classified as Level I entities:

- i. All entities engaged in commercial or industrial or business activities, whose **turnover** (excluding other income) exceeds **rupees fifty crores** but does not exceed rupees two-fifty crores in the immediately preceding accounting year
- ii. All entities engaged in commercial or industrial or business activities having **borrowings** (including public deposits) in excess of **rupees ten crores** but not in excess of rupees of fifty crores at any time during the immediately preceding accounting year.
- iii. **Holding and subsidiary entities** of any of the above

4. Level III Entities

Non-company entities which are not covered under Level I and Level II but fall in any one or more of the following categories are classified as Level III entities:

- i. All entities engaged in commercial or industrial or business activities, whose **turnover** (excluding other income) exceeds **rupees ten crores** but does not exceed rupees fifty crores in the immediately preceding accounting year
- ii. All entities engaged in commercial or industrial or business activities having **borrowings** (including public deposits) in excess of **rupees two crores** but not in excess of rupees of ten crores at any time during the immediately preceding accounting year.
- iii. **Holding and subsidiary entities** of any of the above

5. Level IV Entities

Non-company entities which are not covered under Level I, Level II and Level III are considered as Level IV entities.

6. Applicability of Accounting Standards to Level I Non-company entities

Level I entities are required to comply in full with all the Accounting Standards

Exemptions or Relaxations for MSMEs (Level II/III/IV Entities)

	Level II	Level III	Level IV
Full Exemption	AS – 3 AS – 17 AS - 20	AS – 3 AS – 17 AS – 20 AS – 18 AS – 24	AS – 3 AS – 17 AS – 20 AS – 18 AS – 24 AS – 28
Partial Exemption	AS – 15 AS – 19 AS – 28 AS – 29	AS – 15 AS – 19 AS – 28 AS – 29 AS – 10 AS – 11	AS – 15 AS – 19 AS – 29 AS – 10 AS – 11 AS – 13 AS – 22 AS – 26

There are some accounting standards which are applicable based on regulatory requirement:

- i. AS 21 Consolidated Financial Statements
- ii. AS 23 Accounting for Investments in Associates in Consolidated Financial Statements
- iii. AS 27 Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)
- iv. AS 25 Interim Financial Reporting
- v. AS – 14 (Level IV entities)

General Notes (Relevant for Corporate and Non-Corporate Entities)

- ✓ If an entity/SMC opts **not to avail the exemption/relaxation** in respect of any but not all the of the Accounting Standards, it should **disclose the standards (s) in respect of which it had availed the exemption or relaxation**
- ✓ Where any entity is qualified for exemption or relaxation previously **but no longer qualifies for exemption/relaxation** in current accounting period, the relevant standards **become applicable from the current period** and figures for the corresponding period need not be given.
- ✓ An existing entity/company which was previously not a MSME/SMC and subsequently becomes MSME or SMC, shall **not be qualified for exemption or relaxation** in respect of Accounting Standards available to MSME or SMC **until the entity remains MSME/SMC for two consecutive accounting periods**

ROADMAP FOR IMPLEMENTATION OF INDIAN ACCOUNTING STANDARDS (IND AS)

1. For companies other than banks, NBFCs and Insurance companies.

Phase I

1st April 2015 or thereafter: Voluntary basis for all companies

1st April 2016: Mandatory Basis

- (a) Companies listed / in process of listing on Stock Exchanges in India or Outside India having net worth \geq Rs. 500 crores
- (b) Unlisted companies having net worth \geq Rs. 500 crores
- (c) Holding, Subsidiary, Associate, Joint Venture of above

Phase II

1st April 2017: Mandatory Basis

- (a) All companies which are listed / or in process of listing in or outside India on Stock Exchanges not covered in Phase I
- (b) Unlisted companies having net worth of Rs. 250 crores or more but less than rupees five hundred crores
- (c) Holding, Subsidiary, Associate, Joint Venture of above

Notes

- (a) Companies listed on SME exchange not required to apply Ind AS on mandatory basis
- (b) Once a company starts following Ind AS either voluntarily or mandatorily on the basis of criteria specified, it shall be required to follow the Ind AS for all subsequent financial statements even if any of the criteria specified does not subsequently apply to it.
- (c) Companies not covered by the above roadmap shall continue to apply existing Accounting Standards notified in Companies (Accounting Standard) Rules (**AS 1 to 29**)
- (d) Once the Indian Accounting standards (Ind ASs) are required to be applied in the preparation of the financial statements by a company, the same will apply to both the stand-alone financial statements and consolidated financial statements.

2. Non Banking Financial Companies (NBFCs)

Phase I

1st April 2018: Mandatory Basis

- (a) NBFCs (whether listed or unlisted) having net worth Rs. 500 crores or more
- (b) Holding, Subsidiary, Associate, Joint Venture of above NBFC other than those already covered under corporate roadmap shall also apply from said date

Phase II

1st April 2019: Mandatory Basis

- (a) NBFCs whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having net worth less than Rs. 500 crores
- (b) NBFCs that are unlisted having net worth Rs. 250 crores or more but less than Rs. 500 crores

(c) Holding, Subsidiary, Associate, Joint Venture of above NBFC other than those already covered under corporate roadmap shall also apply from said date

3. **Scheduled Commercial Banks**

Banks were initially required to implement Indian Accounting Standards (Ind AS) from 1st April, 2018. RBI vide press release dated 5th April 2018, deferred the implementation of Ind AS by one year i.e. from 1st April 2019. **However, later on RBI deferred the Ind AS implementation till further notice through a notification dated 22nd March 2019.**

4. **Insurers/Insurance Companies**

The Insurance Regulatory and Development Authority (IRDA) has **deferred** the date of implementation of Indian Accounting Standards (Ind-AS) for the insurance sector **till further notice.**

Chapter 12: Forecasting Financial Statements

Q-1 Write a short note on Financial Statements.

- According to section 2(40) of Companies Act, 2013 defines “financial statement” in relation to a company, includes
 - i. a Balance Sheet as at the end of the financial year,
 - ii. a Profit and Loss account, or (In the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year),
 - iii. Cash Flow Statement for the financial year,
 - iv. a Statement of Changes in Equity, if applicable, and
 - v. any explanatory note annexed to, or forming part of, any document.
- Financial Statements shall be considered as horoscope if one knows how to read and analyze it then probably by addressing the various early warning signal available in statements would have helped to great extent.
- The financial statement analysis investigates past, present and future financial, capital and income situation of entities based on information from various detailed components provided through financial statements.
- It also helps to depict and to interpret the financial situations and developments. The accounting financial statements are considered as an open source of information as per legislation and their composition, disclosure and presentation structure would be unified by basic parameters. In fact, it provides basis for decision making and reflect the cumulative effects of all management’s past decisions for different stakeholders. In nutshell, the purpose of financial statement is to facilitate the possibility of Multiple-Criteria Decision Analysis and to evaluate the effectiveness of the performance of entities.

Q-2 What is financial forecasting? Explain the importance of financial forecasting.

- Financial Forecasting is a process of estimating or predicting a company’s financial future by examining historical performance of data like revenue, cash flow, expenses, or sales.
- It is at the heart of driving business performance and stakeholder’s confidence. Financial projections performed to facilitate any decision-making relevant for determining future business performance.
- It is emphasized on concept of “Today’s Commitment for Tomorrow’s actions”.
- It basically includes the analysis of past business performance, current business trends, and other relevant factors.
- In fact, Business honchos who adopt and maintain financial forecasting best practices are better positioned to grow and to weather unexpected setbacks.
- A thorough forecast includes but is not limited to short and long-term outlooks on conditions that could impact revenues and contingencies for expenditures not currently viewed as necessary.

Importance of Financial Forecasting

- i. It serves as the basis for budgeting decisions.
- ii. It gives businesses access to cohesive reports, allowing finance departments to establish business goals that are both realistic and feasible.
- iii. It provides management valuable insights into the way the business performed in the past and the way it will compare in the future.
- iv. It provides a barometer for those making material financial decisions.
- v. It facilities to build investor relations and Show investors and creditors that your corporate has well and structured plan and is prepared for any unforeseen events impacting revenues and budgets.

- vi. To make accurate budget and facilitates to establish realistic business goals.
- vii. With the help of accurate financial forecasting, problem areas can easily be traced out and company with remedial action plan can reduce the financial risk.
- viii. Many times, accurate and authenticate financial forecast reflecting higher Return on Investment and that helps to build and enhance the investor's confidence.

Q-3 Distinguish between 'Forecast' and 'Budget'.

Basis	Forecast	Budget
Meaning	Mere estimate of what is likely to happen	Shows that policy and program to be followed in future period under planned conditions.
Nature of event	Probable	Proposed
Tool of control	No	Yes
Base	It's a preliminary step or base for budgeting	Forecasts are converted into budget
Hierarchy	It ends with forecast of likely events	It begins when forecasting ends
Scope	Wider	Limited

Q-4 Distinguish between 'Financial Forecasting' and 'Financial Projection'

- **Financial forecast** is a statement of management's expectations which is based on what top management reasonably expects will happen to and in the company and the expected financial impacts. This is the information that is published by publicly traded companies for stakeholders and the general public's review. While on the other hand, a **financial projection** essentially projects the likely outcome of one or more hypothetical scenarios or assumptions. It is a tool used to explore business and market scenarios and predict outcomes before adjusting the company's plans. A financial projection is a snapshot of a possible business outcome that is often weighed in terms of probability.
- In nut shell, both financial forecasts and financial projections are forward-looking statements and predict future outcomes based on specific assumptions. But it is important to understand demarcation line of difference between them:
- Financial forecasts reveal what is likely to happen based on expected events and business conditions (i.e. Financial forecasts are what management expects to happen.) Financial projections are what might happen in any number of hypothetical scenarios.
- For example, keeping in the mind of current market conditions, and seasonal trends, the management of a wholesaler expects sales to increase by 7% over the next quarter. Therefore, a 7% sales increase is his financial forecast for the period. Whereas, company wants to make more profit than that, so he aims for an 10% sales increase. Therefore, his budget calls for an 10% sales increase. The management still expects the company to achieve only 7%, but he hopes for 10%, so he budgets accordingly and aims the sales team at that number. But rather than just crack a whip over the sales team, the Management runs several financial projections to find a way to improve their odds of reaching an 8% or larger sales increase.

Q-5 What are the various components and factors that should be considered and incorporated for financial forecasting?

Following components and factors should be considered and incorporated for financial forecasting

- i. Define the purpose of financial forecasting
- ii. Collection of historical data and accuracy of data sources
- iii. A forward-looking time horizon (12-18-24 months span)
- iv. Formulas to determine how much weight to give any piece of data
- v. Consideration of an Internal and Macro-economic risk
- vi. Best/Worst case (Revenue and Expenses) scenarios
- vii. Selection of Financial forecast method
- viii. Documentation/Monitoring/Analysis of data

Q-6 What are the various forecasting methods?

Basically there are two methods namely Quantitative methods and Qualitative methods. Quantitative forecasting methods are used to make assumptions about the future based on historical data. Whereas, Qualitative forecasting relies on experts' knowledge and experience to predict performance rather than historical numerical data. These forecasting methods are often called into question, as they're more subjective than quantitative methods and they can provide valuable insight into forecasts and account for factors that can't be predicted using historical data.

Various methods are discussed below:

- i. **Based on Revenue (% of Turnover)** As per this method, items like costs of goods sold (COGS), Stock and cash are calculated as a percentage of sales. Those percentages are then applied to future sales estimates to project each line item's future value. For example, COGS is likely to increase proportionally with turnover; therefore, it's to apply the same % estimate to each. To forecast the percent of sales, examine the percentage of each account's historical profits related to sales. To calculate this, divide each account by its sales, assuming the numbers will remain steady. For example, if COGS has historically been 30% of sales, assume that trend will continue.
- ii. **Moving Average Method** It is categorized into two parts namely, The average or Weighted average of previous periods to forecast the future. It is closely scrutinizing a business's high or low demands. Hence, it is more suitable for short-term forecasting. For example, you can use it to forecast next month's sales by averaging the previous quarter.
- iii. **Constant Growth Rate** It assumes a company's historical growth rate will remain constant. Forecasting future revenue involves multiplying a company's previous year's revenue by its growth rate. Say, if Growth rate was 12% in 2021-22 (i.e. P.Y), then, Constant rate @12% forecasting for 2022-23 (Next year) shall be considered as it excludes market fluctuations or supply chain issues.
- iv. **Regression Method** This method is based on a relationship between two variables: dependent and independent. The dependent variable represents the forecasted amount, while the independent variable is the factor that influences the dependent variable. E.g.

Advertisement expense (Independent Variable) and Sales (Dependent). It means change in advertisement expense would lead to change in sales. It is based on equation: $Y = BX + A$

Y = Dependent variable (Forecasted number) B = Slope line X = Independent variable A = Y-intercept

- v. **Delphi Method** The Delphi method i.e. Estimate-Talk-Estimate Technique (ETE) is a systematic and qualitative method of forecasting by collecting opinions from a group of financial experts through several rounds of questions. The Delphi method relies on experts who are knowledgeable about a specific area so they can forecast the outcome of future scenarios, predict the likelihood of an event, or reach consensus about a particular topic. The financial experts then fill out another questionnaire that gives them the opportunity to provide updated opinions based on what they understand from the summary report. It is one of most important qualitative method

Chapter 13: Nature, Significance and Scope of Financial Management**Q-1 What do you mean by Financial management. Explain its basic aspects.**

Financial Management is a managerial activity that deals with planning and controlling of a firm's financial resources. Financial management deals with **procurement of funds** and **effective utilization of funds** in business. The two basic aspects/functions of Financial Management are explained below-

Procurement of funds:

- As funds can be obtained from different sources so procurement of funds is considered as an important problem of business concerns.
- Funds procured from different sources have different characteristics in terms of risk, cost and control.
- Funds issued by the issue of equity shares are the best from risk point of view for the company as there is no question of repayment of equity capital except when the company is under liquidation.
- From the cost point of view equity capital is most expensive source of funds as dividend expectations of shareholders are normally higher than prevalent interest rates.
- Financial management constitutes risk, cost and control. The cost of funds should be at minimum for a proper balancing of risk and control.
- In the Globalised competitive scenario mobilization of funds plays a very significant role.

Utilization of Funds:

- Effective utilization of funds as an important aspect of financial management avoids the situations where funds are either kept idle or proper uses are not being made.
- Funds procured involve a certain cost and risk.
- If the funds are not used properly then running business will be too difficult.
- In case of dividend decisions we also consider this. So it is crucial to employ the funds properly and profitably.

Q-2 What are the functions of Financial Manager?

- ✓ To achieve the objective of the financial management i.e. to maximize the owner's wealth, the financial executives have to perform variety of tasks to discharge their responsibilities.
- ✓ In the light of different responsibilities of the financial manager, he performs mainly the following duties:
 - ◆ Forecasting of cash flow
 - ◆ Raising funds
 - ◆ Managing the flow of internal funds
 - ◆ To facilitate cost control
 - ◆ To facilitate pricing of product lines and services
 - ◆ Forecasting profits
 - ◆ Measuring required return
 - ◆ Managing assets
 - ◆ Managing funds

Q-3 Write a short note on 'Scope of Financial Management'

- A sound financial management is essential in all types of organizations whether it may be profit or non-profit.
- Financial management is essential in a planned Economy as well as in a capitalist set-up as it involves efficient use of the resources.

- From time to time it is seen that many firms have been liquidated not because their technology was obsolete or because their products were not in demand or their Labour was not skilled and motivated but there was a complete mismanagement of financial affairs.
- Even in a boom period, when a company make high profits there is also a fear of liquidation because of bad financial management.
- Financial management optimizes the output from the given input of funds.
- In the country like India where resources are scarce and the demand for funds are many, the need of proper financial management is required.
- In case of newly started companies with a high growth rate it is more important to have sound financial anagement since finance alone guarantees their survival.
- Financial management is very important in case of non-profit organizations, which do not pay adequate attentions to financial management.
- However a sound system of financial management has to be cultivated among bureaucrats, administrators, engineers, educationalists and public at a large.

Q-4 Investment, financing and dividend decisions are inter-related.**(CS Dec 2008)****1. Objective:**

- The underlying objective of all the three decisions viz. – Investment, Financing and Dividend decisions, is “maximization of Shareholders’ wealth”.
- The Finance Manager has to consider the joint impact of these three decisions on the market price of the Company’s Shares.

2. Linkage:

- A new project (investment) needs finance. Also, a Company may have to expand/develop its operations, which require funds. Hence Investment Decisions is based on the Financing Decision.
- The Financing decision is influenced by, and influences the Dividend decision, since Retained Earnings used in internal financing means reduction in dividends paid to Shareholders.
- So, the inter-relationship between the three types of decisions should be analyzed jointly, in order to maximize the Shareholders’ wealth.

3. Decision-Making: The three decisions can be linked to maximize Shareholders’ Wealth, in the following manner –**a) Investment Decisions:**

- Investment in Long Term Projects should be made after Capital Budgeting and uncertainty analysis.
- Projects which give reasonable returns (higher than cost) in order to add to the surplus of the Shareholders’, should be selected.
- The returns should be high enough as to distribute reasonable dividends and also retain adequate resources for the Company’s growth prospects.

b) Financing Decisions:

- Proper balancing between long-term and short-term funds, as well as own funds and loan funds, will help the Firm to minimize its overall cost of capital and increase its wealth/value.
- Low cost of funds will mean higher profit margins, which can be used for dividend distribution as well as internal financing of new projects/growth plans.

c) Dividend Decisions:

- The optimum dividend pay-out ratio ensures that shareholders’ wealth is optimized.

- Where the funds at the disposal of the Company earn a higher return than if distributed to shareholders, wealth maximization can be achieved by retaining the funds, rather than declaration of dividend.

Q-5 Write a short note on 'Profit Maximization'.

- ◆ Profit maximization is considered as an important goal in financial decisions making in an organization.
- ◆ It ensures that firm utilizes its available resources most efficiently under conditions of competitive markets.
- ◆ Profit maximization as corporate goal is criticized by scholars mainly on the following grounds:
 - i. It is vague conceptually.
 - ii. It ignores timing of returns.
 - iii. It ignores the risk factor.
 - iv. It may tempt to make such decisions which may in the long run prove disastrous.
 - v. It emphasis is generally on short run projects.
 - vi. It may cause decreasing share prices.
 - vii. The profit is only one of the many objectives and variables that a firm considers.

Q-6 Write a short note on 'Wealth Maximization'.

- ◆ Presently, maximization of present value (or wealth) of a course of action is considered appropriate operationally flexible goal for financial decision-making in an organization.
- ◆ This goal for the maximum present value is generally justified on the following grounds:
 - i. It is consistent with the object of maximizing owners economic welfare.
 - ii. It focuses on the long run picture.
 - iii. It considers risk.
 - iv. It recognizes the value of regular dividend payments.
 - v. It takes into account time value of money.
 - vi. It maintains market price of its shares.
 - vii. It seeks growth in sales and earnings.

Q-7 Write a short note on 'Profit maximization' Vs 'Wealth maximization' (CS June 2003)

Goal	Objective	Advantages	Disadvantages
Profit maximization	Large amount of profits	1. Easy to calculate profits. 2. Easy to determine the link between financial decisions and profits	1. Emphasizes the short term. 2. Ignores risk or uncertainty 3. Ignores the timing of returns 4. Requires immediate resources
Shareholder wealth Maximization	Highest market value of Common stock	1. Emphasizes the long term 2. Recognizes risk or uncertainty 3. Recognizes the timing of	1. Offers no clear relationship between financial decisions and stock price

		returns 4. Considers return	2. Can lead to management anxiety and frustration
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Q-8 Liquidity and profitability are competing goals for the finance manager. Comment. (CS Dec 2003)

- ◆ Liquidity ensures the ability of the firm to honour its short term commitments, that means, the firm has adequate cash, to pay for its bills, to make unexpected large purchases and to meet contingencies, at all times.
- ◆ It also reflects the ability of the firm to convert its assets into cash and pay off liabilities quickly.
- ◆ Under liquidity management, the finance manager is expected to manage all its current assets including near cash assets in such a way as to ensure its effectively with the view to minimize its costs.
- ◆ Under profitability objective, the finance manager is expected to utilize the funds of the firm in such a manner as to ensure the highest return.
- ◆ However, the two objectives of the liquidity and profitability have inverse relationship
- ◆ If liquidity increases profitability decreases and vice-a-versa.

Q-9 Write a short note on 'Liquidity' and 'Profitability'.**Liquidity**

- ◆ Is defined as ability of the business to meet short-term obligations.
- ◆ It shows the quickness with which a business/company can convert its assets into cash to pay what it owes in the near future.
- ◆ It measures a company's ability to meet expected as well as unexpected requirements of cash to expand its assets, reduce its liabilities and cover up any operating losses.
- ◆ Liquidity is assessed through the use of ratio analysis. liquidity ratio provides an insight into the present cash solvency of a firm and its ability to remain solvent in the event of calamities.
- ◆ Liquidity of receivables is assessed through Average collection period (ACP) it tells us the average number of days receivables are outstanding i.e., the average time a bill takes to convert into cash.
- ◆ The ratio, reveals the following:
 - Too low an ACP may suggest excessively restricted credit policy of a company.
 - Too high an ACP may indicate too liberal a credit policy. A large number of receivables may remain due and outstanding, resulting in less profits and more chances of bad debts.

PROFITABILITY:

- ◆ It becomes essential for a company to examine profit per unit of sale then it is done by estimating profitability per rupee sales. It is used to measure of comparison and standard of performance.
- ◆ Profitability to sales ratio reflects the company's ability to generate profits per unit of sales.

Chapter 14: Capital Structure

Q-1 Define Capital Structure.

The following definitions clearly initiate, the meaning and objective of the capital structure.

According to the definition of Gerstenberg, “Capital Structure of a company refers to the composition or make up of its capitalization and it includes all long-term capital resources”.

According to the definition of James C. Van Horne, Capital Structure is “The mix of a firm’s permanent long term financing represented by debt, preferred stock and common stock equity”.

Q-2 Describe various kinds of capital structure.

Capital structure can be of various kinds as described below:

Horizontal Capital Structure

- In a Horizontal capital structure, the firm has zero debt component in the structure mix.
- The structure is quite stable.
- Expansion of the firm takes in a lateral manner, i.e. through equity or retained earning only.
- The absence of debt results in the lack of finance leverage.
- Probability of disturbance is remote.

Vertical Capital Structure

(CS Dec 2008)

- In a vertical structure, the base of the structure is formed by a small amount of equity share capital.
- This base serves as the foundation on which the super structure of preference share capital and debt is built.
- The incremental addition in the capital structure is almost entirely in the form of debt.
- Quantum of retained earnings is low and the dividend pay-out ratio is quite high.
- In such a structure, the cost of equity capital is usually higher than the cost of debt.
- The high component of debt in the capital structure increases the financial risk of the firm and renders the structure unstable.
- The firm, because of the relatively lesser component of equity capital, is vulnerable to hostile takeovers.

Pyramid shaped Capital structure

- A pyramid shaped capital structure has a large proportion consisting of equity capital and retained earnings which have been ploughed back into the firm over a considerably large period of time.
- The cost of share capital and the retained earnings of the firm is usually lower than the cost of debt.
- This structure is indicative of risk averse conservative firms.

Inverted Pyramid shaped Capital Structure

- Such a capital structure has a small component of equity capital, reasonable level of retained earnings but an ever increasing component of debt.
- All the increases in the capital structure in the recent past have been made through debt only.
- Chances are that the retained earnings of the firm are shrinking due to accumulating losses.
- Such a capital structure is highly vulnerable to collapse.

Q-3 What is the significance of capital structure.

- i. **Reflects the firm's strategy:-**
 - The capital structure reflects the overall strategy of the firm.
 - In case the firm want to grow at a faster pace, it would be required to incorporate debt in its capital structure to a greater extent.
- ii. **Indicator of the risk profile of the firm**
 - If the debt component in the capital structure is predominant, the fixed interest cost of the firm increased thereby increasing its risk.
- iii. **Acts as a tax management tool**
 - The interest on borrowings is tax deductible, a firm having healthy growth in operating profits would find it worthwhile to incorporate debt in the capital structure in a greater measure.
- iv. **Helps to brighten the image of the firm: -**
 - A firm can build on the retained earnings.
 - Such an act has two benefits. On the one hand, it helps the firm to improve its image in the eyes of the investors. At the same time, it reduces chances of hostile take-over of the firm.

Q-4 Differentiate between capital structure and financial structure?

Following are the differences between financial structure and capital structure:

- (A) Capital structure relates to long term capital deployment for creation of long term assets. Financial structure involves creation of both long term and short term assets.
- (B) Capital structure is the core element of the financial structure. Capital structure can exist without the current liabilities and in such cases. Capital structure shall be equal to the financial structure. But we cannot have a situation where the firm has only current liabilities and no long term capital.
- (C) Components of the capital structure may be used to build up the level of current assets but the current liabilities should not be used to finance acquisition of fixed assets. This would result in an asset liability mismatch.

Q-5 What are the attributes of well planned capital structure?

A sound or appropriate capital structure should have the following features:

Return: The capital structure of the company should be most advantageous. Subject to other considerations, it should generate maximum returns to the shareholders without adding additional cost to them.

Risk: The use of excessive debt threatens the solvency of the company. To the point debt does not add significant risk. It should be sued, otherwise its use should be avoided.

Flexibility: The capital structure should be flexible. It should be possible for a company to adapt its capital structure with a minimum cost and delay if warranted by a changed situation. It should also be possible for the company to provide funds whenever needed to finance its profitable activities.

Capacity: The capital structure should be determined within the debt capacity of the company and this capacity should not be exceeded. The debt capacity of a company depends on its ability to generate future cash flows. It should have enough cash to pay creditors' fixed charges and principal sum.

Control: The capital structure should involve minimum risk of loss of control of the company. The owners of closely-held companies are particularly concerned about dilution of control.

Q-6 What are the points to be considered while designing a capital structure?

After planning the capital structure, we are faced with the issue of its design. Design takes off from where the plan ends. Planning establishes the broad parameters of the structure. It is left for the design to fill in the minor details. While designing a capital structure, following points need to be kept in view:

1. Design should be functional: The design should create synergy with the long term strategy of the firm and should not be dysfunctional. It should facilitate the day to day working of the firm rather than create systematic bottlenecks.

2. Design should be flexible: The capital structure should be designed to incorporate a reasonable amount of flexibility in order to allow for temporary expansion or contraction of the share of each component.

3. Design should be conforming statutory guidelines: The design should conform to the statutory guidelines, if any, regarding the proportion and amount of each component. The limits imposed by lenders regarding the minimum level of owners' equity required in the firm should be complied with.

Q-7 What are the factors influencing capital structure?

1. Cash Flow Position
2. Interest Coverage Ratio-ICR
3. Debt Service Coverage Ratio-DSCR
4. Return on Investment-ROI
5. Cost of Debt
6. Tax Rate
7. Cost of Equity Capital
8. Floatation Costs
9. Risk Consideration: There are two types of risks in business –
10. Operating Risk or Business Risk
11. Financial Risk
12. Flexibility
13. Control
14. Regulatory Framework
15. Stock Market Conditions
16. Capital Structure of Other Companies

Q-8 Write a short note on Pecking Order Theory

- The Pecking order theory is based on the assertion that managers have more information about their firm than investors. This disparity of information is referred to as asymmetrical information. Other things being equal, because of asymmetrical information, managers will issue debt when they are positive about their firm's future prospects and will issue equity when they are unsure.
- The cost of equity includes the cost of new issue of shares and the cost of retained earnings. The cost of debt is cheaper than the cost of both these sources of equity funds. Amongst the cost of new issue and retained earnings, the latter is cheaper because personal taxes have to be paid by shareholders on distributed earnings while no taxes are paid on retained earnings and also no floatation costs are incurred when the earnings are retained.
- As a result, between the two sources of equity funds, retained earnings are preferred. It has been found in practice that firms prefer internal finance. If the internal funds are not sufficient to meet the investment outlays, firms go for external finance, issuing the safest security first. They start with debt, then possibly hybrid securities such as convertible debentures, then perhaps equity as a last resort. It is called Pecking order theory since there is not a well defined debt equity target and there are two kinds of equity, internal and external, one at the top of pecking order and one at the bottom.

Q-9 Explain EBITDA Analysis.**EBITDA ANALYSIS (EARNINGS BEFORE INTEREST, TAX, DEPRECIATION AND AMORTIZATION),**

- EBITDA, an acronym for “earnings before interest, taxes, depreciation and amortization,” is an often-used measure of the value of a business.
- EBITDA is calculated by taking net income and adding interest, taxes, depreciation and amortization expenses back to it.
- EBITDA is used to analyze a company’s operating profitability before non- operating expenses (such as interest and “other” non-core expenses) and non-cash charges (depreciation and amortization).

Analysis with EBITDA

- EBITDA enables analysts to exclude the impacts of non-operating activities and focus on the outcome of operating decisions.
- Non-operating activities include interest expenses, tax rates, and large non-cash items such as depreciation and amortization.
- By removing the non-operating effects, EBITDA gives investors the ability to focus on the profitability of their operations. This type of analysis is particularly important when comparing similar companies across a single industry.

Limitations of EBITDA

- Factoring out interest, taxes, depreciation and amortization can make even completely unprofitable firms appear to be fiscally healthy. The use of EBITDA as measure of financial health made these firms look attractive.
- EBITDA numbers are easy to manipulate.
- If fraudulent accounting techniques are used to inflate revenues and interest, taxes, depreciation and amortization are factored out of the equation, almost any company may appear to be profitable and great.
- Operating cash flow is a better measure of how much cash a company is generating because it adds non-cash charges (depreciation and amortization) back to net income and includes the changes in working capital that also use or provide cash (such as changes in receivables, payables and inventories).
- These working capital factors are the key to determining how much cash a company is generating. If investors do not include changes in working capital in their analysis and rely solely on EBITDA, they will miss clues that indicate whether a company is losing money because it isn’t making any sales.

Despite various shortcomings, there are some good reasons for using EBITDA.

- The first factor to consider is that EBITDA can be used as a shortcut to estimate the cash flow available to pay debt on long-term assets.
- Another factor is that EBITDA estimate to be reasonably accurate, the company under evaluation must have legitimate profitability.
- EBITDA can also be used to compare companies against each other and against industry averages.
- EBITDA is a good measure of core profit trends.
- Ultimately, EBITDA should not replace the measure of cash flow, which includes the significant factor of changes Capital in working capital. Remember “cash is king” because it shows “true” profitability and a company’s ability to continue operations.

Chapter 15: Capital Structure Theories

Q-1 What are the assumptions of Net Income Approach?

According to this approach there is a relationship between capital structure and the value of the firm and therefore, the firm can affect its value by increasing or decreasing the debt proportion in the overall financial mix. The Net Income Approach makes the following assumptions:

- i. Cost of debt (K_d) is less than cost of equity (K_e) ($K_d < K_e$)
- ii. Both K_d and K_e remain constant and increase in financial leverage i.e., use of more and more debt financing in the capital structure does not affect the risk perception of the investors.
- iii. There are no taxes.

Q-2 What are the assumptions of Net Operating Income Approach?

Net operating income approach is opposite to the Net income approach. According to NOI Approach, the market value of the firm depends upon the net operating profit or EBIT and the overall cost of capital. The financing mix or the capital structure is irrelevant and does not affect the value of the firm. The NOI Approach makes the following assumptions:

- i. The investors see the firm as a whole and thus capitalize the total earnings of the firm to find the value of the firm as a whole.
- ii. The overall cost of capital K_0 , of the firm is constant and depends upon the business risk which also is assumed to be unchanged.
- iii. The cost of debt, K_d , is also taken as constant.
- iv. The use of more and more debt in the capital structure increases the risk of the shareholders and thus results in the increase in the cost of equity capital i.e, K_e . The increase in K_e is such as to completely offset the benefits of employing cheaper debt, and
- v. There are no taxes.

Q-3 What are the assumptions under traditional approach?

- i. The rate of interest on debt remains constant for a certain period and thereafter with an increase in leverage, it increases.
- ii. The expected rate by equity shareholders remains constant or increase gradually. After that, the equity shareholders starts perceiving a financial risk and then from the optimal point and the expected rate increases speedily.
- iii. As a result of the activity of rate of interest and expected rate of return, the WACC first decreases and then increases. The lowest point on the curve is optimal capital structure.

Q-4 What are the different propositions given by Modigliani and Miller?

Modigliani and Miller have restated the net operating income position in terms of three basic propositions:

Proposition I – The total value of a firm is equal to its expected operating income divided by the discount rate appropriate to its risk class.

Proposition II – The expected yield on equity, K_e is equal to K_0 plus a premium.

Proposition III – The cut off rate for investment decision making for a firm in a given risk class is not affected by the manner in which the investment is financed.

Chapter 16 Cost of Capital

Q-1 Explain the concept of Cost of Capital.

- The cost of capital is the rate of return a firm must earn on its investments so that the market value of the firm remains unchanged. Thus, it is a yardstick or basis of approval or rejection of an investment.
- In this way it becomes a target rate of return, cut off rate or hurdle rate or the financial standard of assessment of performance of a project.
- Cost of capital is the required rate of return on its investments which belongs to equity, debt and retained earnings. If a firm fails to earn return at the expected rate, the market value of the shares will fall and it will result in the reduction of overall wealth of the shareholders.
- The choice of financing makes the cost of capital a crucial variable for every company, as it will determine its capital structure. Companies look for the optimal mix of financing that provides adequate funding and minimizes the cost of capital.

“The cost of capital is the minimum rate of return which a firm requires as a condition for undertaking an investment.” - Milton H. Spencer

“Cost of capital is the minimum required rate of earnings or the cut off rate for capital expenditures.” - Solomon Ezra

Q-2 Explain the importance of the concept of Cost of Capital.

The importance of this concept to modern management is summarized as follows:

- Designing the Optimal Capital Structure:** This concept is very helpful in designing a sound, optimal and economical capital structure of the firm. Each source of capital involves different cost and different risk. By comparing various specific costs of different sources, the financial manager can select the best and the most economical source of finance.
- Helpful in Evaluation of Expansion Projects:** It helps in the evaluation of financial soundness of a given expansion project. An expansion project will be accepted by the management only when the marginal return on investment exceeds the cost of its financing.
- Rational Allocation of National Resources:** The concept of cost of capital is important for national economy as well since it provides the basis of optimum allocation of financial resources.
- Evaluation of Financial Performance of Top Management:** The cost of capital framework can be used to evaluate the financial performance of top executives. Such an evaluation can be done by comparing the actual profitability of the projects undertaken with the projected overall cost of capital, and an appraisal of the actual costs incurred in raising the required funds.
- Financing and Dividend Decisions:** This concept is useful in other areas of financial decision making, such as dividend decisions, decisions on capitalization of profits and rights issue, working capital management and capital expenditure control etc.

Q-3 Explain the factors determining the firm's cost of capital

Cost of capital, like all other costs, is a variable term, subject to changes in a number of factors. There are four main factors which mainly determine the cost of Capital of a firm.

- General Economic Conditions**

General economic conditions determine the demand for and supply of capital within the economy, as well as the level of expected inflation. In principle, as the demand for money in the economy changes relative to the supply, investors alter their required rate of return. For example, if the demand for money increases without an equivalent increase in the supply, lenders will raise their required interest rate. At the same time, if inflation is expected to deteriorate the purchasing power of money, investors require a higher rate of return to compensate for this anticipated loss.

ii. Market Conditions

When an investor purchases a security with significant risk, an opportunity for additional returns is necessary to make the investment attractive. Essentially, as risk increases, the investor requires a higher rate of return. This increase is called a risk premium. When investors increase their required rate of return, the cost of capital rises simultaneously.

iii. Operating and Financing Decisions

Risk also results from decisions made within the company. Risk resulting from these decisions is generally divided into two types: business risk and financial risk. As business risk and financial risk increase or decrease, the investor's required rate of return (and the cost of capital) will move in the same direction.

iv. Amount of Financing

The last factor determining the corporation's cost of funds is the level of financing that the firm requires. As the financing requirements of the firm become larger, the weighted cost of capital increases for several reasons. Suppliers of capital become hesitant to grant relatively large sums without evidence of management's capability to absorb this capital into the business.

Q-4 What are the assumptions of Cost of Capital

While computing the cost of capital, the following assumptions are made:

- a. The financial and business risks are not affected by investing in new investment in new investment proposals.
- b. The firm's capital structure remains unchanged.
- c. Cost of each source of capital is determined on an after-tax basis.
- d. Cost of previously obtained capital is not relevant for computing the cost of capital to be raised from a specific source.

Q-5 What are the steps for computation of Weighted Average Cost of Capital

It involves the following four steps:

- 1) The computation of specific costs of various sources. It has already been explained in the preceding pages in this chapter.
- 2) Assignment of weights to each type of funds.
- 3) Each specific cost is multiplied by the corresponding weight and in this way weighted cost of each source is determined.
- 4) Finally, weighted cost of all sources of capital as calculated in (3) are added together to get an overall weighted average cost of capital.

Q-6 What are the various approaches for assigning weights for computation of Cost of Capital?

This involves the determination of share of each source of capital in the total capital structure of the company. There are three approaches of assigning weights:

(i) Historical Weights Approach: According to this approach, the relative proportions of various sources of capital to the existing capital structure are used to assign weights. Historical weights can be given on the basis of face or book value of securities or on the basis of their market value.

Book Value Weights: This is most convenient to be used. In this method proportion of each source in total capital structure is determined on the basis of the book value of securities.

Market Value Weights: In this method, market value of invested capital funds of each type of security is calculated on the basis of their prevailing market values and proportion of each type of security to the total of market values of all securities is used as weight. However, it is more difficult to calculate the market values of a firm's sources of equity financing (i.e., preference shares, equity shares and retained earning) than to use book values

(ii) Target Weights Approach: If a firm has determined the capital structure which it believes most consistent with its goal of owner's wealth maximization and it is directing its financing policies toward achievement of this "optimal" capital structure, then the use of these target capital structure weights may be appropriate

(iii) Marginal Weights Approach: According to this approach, specific costs are assigned weights in proportion of funds to be raised from each source to the total funds to be raised. This approach presumes that new project is to be financed wholly by raising fresh capital.

Q-7 "Retained earning is not a cost free source of capital", Explain.

As there is no explicit cost of retained earnings, these funds are free of cost. Comment.

(CS June 2015)

- That part of earnings of a company which remains with it after distribution on dividend among the shareholders is called as 'retained earnings'. They are commonly known as internal equity of the concern.
- There is no explicit cost of this type of profits because there is no formal or implied obligation on the company to pay any return on this amount. But it is not correct to treat them as cost free. In fact, cost of this source of finance is its opportunity cost.
- If retained earnings were not retained, they would have been paid out to the shareholders as dividend and the shareholders should have invested it in some alternative investments and should have earned return. When earnings are retained, the shareholders are forced to forego such return. Hence, the expected return foregone by the shareholders on forgone dividends may be treated as the cost of retained earnings.

Q-8 Distinguish between 'explicit cost' and 'implicit cost'

(CS June 2015)

Explicit Cost	Implicit Cost
1. This cost is attached with the source of capital apparently.	1. Implicit cost is the hidden cost which is not incurred directly.
2. Example: Cost of Debt (Interest)	2. Example: Cost of Retained Earnings
3. This cost is reported in financial statements.	3. This cost is not reported in financial statements.
4. It results in cash outflow.	4. It is the opportunity cost and does not involve cash outflow.
5. It reduces bottom line profitability.	5 Bottomline profitability is not affected.

Q-9 Discuss the assumptions of capital asset pricing model (CAPM) along with limitations.

(CS June 2015)

Capital asset pricing model (CAPM) helps to work out the required rate of return required by investor in the form of equity investment. It establishes a linear relationship between the required rate of return of a security and its beta (β).

CAPM model is based on certain assumptions:

1. Capital market is efficient means share price reflects all available information.
2. Investors are risk averse. They evaluate security return and risk.
3. All investors can lend and borrow at risk free rate.
4. All investors' decisions are based on a single time period.
5. There exist no taxes whether personal or corporate.
6. Transaction in securities is without any transaction cost.

CAPM suffers from following limitations:

- 1) It is based on unrealistic assumptions: CAPM is based on a number of assumptions that are far from reality. Therefore CAPM may not accurately explain the investment behavior of investors and beta may fail to capture the risk of investment.
- 2) It is difficult to test the validity of CAPM
- 3) Betas do not remain stable over time

***God is all knowing. Without even saying a word our condition is known to God
- Sant Rajinder Singh Ji***

Chapter 17: Inventory Management

Q-1 Briefly explain inventory management?

- Inventory is the second step in the operating cycle wherein cash is converted into various items of the inventory.
- Inventory has the following major components:
 - a) Raw Material
 - b) Work in Process
 - c) Finished Goods.
- Inventories form a link between production and sale of a product.
- A manufacturing company must maintain a certain amount of inventory during production, the inventory known as work in process (WIP).
- Raw materials inventory gives the firm flexibility in its purchasing.
- Finished goods inventory allows the firm flexibility in its production scheduling and in its marketing.

Q-2 What are the assumptions of the EOQ model?

- The total usage of that particular item for a given period is known with certainty and the usage rate is even throughout the period.
- There is no time gap between placing an order and receiving supply.
- The cost per order of an item is constant and the cost of carrying inventory is also fixed and is given as a percentage of the average value of inventory.
- There are only two costs associated with the inventory and these are the cost of ordering and the cost of carrying the inventory.

Q-3 What are the main objectives of Inventory Management?

The following are the objectives of inventory management:

- i. To ensure continuous supply of materials, spares and finished goods so that production should not suffer at any time and the customer's demand should also be met.
- ii. To avoid both over-stocking and under-stocking of inventory.
- iii. To maintain investments in inventories at the optimum level as required by the operational and sales activities.
- iv. To keep material cost under control so that they contribute in reducing cost of production and overall costs.
- v. To eliminate duplication in ordering or replenishing stocks. This is possible with the help of centralizing purchases.
- vi. To minimize losses through deterioration, pilferage, wastages and damages.
- vii. To design proper organization for inventory management. A clear cut accountability should be fixed at various levels of the organization.
- viii. To ensure perpetual inventory control so that materials shown in stock ledgers should be actually lying in the stores.
- ix. To ensure right quality goods at reasonable prices. Suitable quality standards will ensure proper quality of stocks. The price-analysis, the cost-analysis and value-analysis will ensure payment of proper prices.
- x. To facilitate furnishing of data for short-term and long-term planning and control of inventory.

Q-4 What are the purposes or motives of holding Inventories?

There are three main purposes or motives of holding inventories:

- i. The Transaction Motive which facilitates continuous production and timely execution of sales orders.
- ii. The Precautionary Motive which necessitates the holding of inventories for meeting the unpredictable changes in demand and supplies of materials.
- iii. The Speculative Motive which induces to keep inventories for taking advantage of price fluctuations, saving in re-ordering costs and quantity discounts, etc.

Q-5 What are the risks associated with Inventory Management

Risk associated with inventory

The risk in inventory management signifies the chance that inventories cannot be turned over into cash through normal sale without a loss. These risks are due to following three factors:

- i. **Price decline:**
It may result from an increase in the market supply of products, introduction of a new competitive product and price reduction by competitors.
- ii. **Product deterioration:**
It may result due to holding a product too long or it may occur when inventories are held under improper conditions of light, heat, humidity and pressure.
- iii. **Obsolescence:**
It is due to changes in customer taste, new production techniques, improvement in the product design, specifications etc.

Q-7 Explain the concept of 'ABC Analysis' as a technique of inventory control.

ABC Analysis is a system of selective inventory control whereby the measure of control over an item of inventory varies with its usage value. It exercises discriminatory control over different items of stores grouped on the basis of the investment involved. Usually the items of material are grouped into three categories viz; A, B and C according to their use value during a period. In other words, the high use value items are controlled more closely than the items of low use value.

- i. 'A' Category of items consists of only a small percentage i. e., about 10% of the total items of material handled by the stores but require heavy investment i. e., about 70% of inventory value, because of their high prices and heavy requirement.
- ii. 'B' Category of items comprises of about 20% of the total items of material handled by stores. The percentage of investment required is about 20% of the total investment in inventories.
- iii. 'C' Category of items does not require much investment. It may be about 10% of total inventory value but they are nearly 70% of the total items handled by stores.

Chapter 18: Cash Management

Q-1 What are the motives for holding cash?

Transaction Motive: A firm needs cash for making transactions in the day to day operations. The cash is needed to make purchases, pay expenses, taxes, dividends, etc. The need to hold cash would not arise if there were perfect synchronization between cash receipts and cash payment, i.e., enough cash is received when the payment has to be made.

2) Precautionary Motive: A firm is required to keep cash for meeting various contingencies. Though cash inflows and cash outflows are anticipated, there may be variations in these estimates. For example, a debtor who was to pay after 7 days may inform of his inability to pay; on the other hand a supplier who used to give credit for 15 days may not have the stock to supply or he may not be in a position to give credit at present. In these situations cash receipts will be less than expected and cash payments will be more as purchases may have to be made for cash instead of credit. Such contingencies often arise in a business. A firm should keep some cash for such contingencies or it should be in position to raise finances at a short period. The cash maintained for contingency needs is not productive or it remains idle. However, such cash may be invested in short-period or low-risk marketable securities which may provide cash as and when necessary.

3) Speculative Motive: The speculative motive relates to holding of cash for investing in profitable opportunities as and when they arise. Such opportunities do not come in a regular manner. These opportunities cannot be scientifically predicted but only conjectures can be made about their occurrence. For example, the prices of shares and securities may be low at a time with an expectation that these will go up shortly. The prices of raw materials may fall temporarily and a firm may like to make purchases at these prices. Such opportunities can be availed of if a firm has cash balance with it. These transactions are speculative because prices may not move in a direction; in which we suppose them to move. The primary motive of a firm is not to indulge in speculative transactions but such investment may be made at times.

Q-2 What are the factors which determine the level of cash in any organization?

FACTORS DETERMINING LEVEL OF CASH

Maintenance of optimum level of cash is the main problem around which the financial managers do the exercise of cash managements. Level of cash holding differs from industry to industry, organization to organization but the factors determining its level are common to all which can be summarized as follows:

- i. **Credit Policy:** Credit policy refers to the management policy in regard to allowing credit sales. It affects productivity and liquidity of the business considerably. If credit policy is liberal cash level will be higher and vice-versa.
- ii. **Nature of the Product:** Nature of goods produced by the organization to a great extent exercises influence on cash reserves.
- iii. **Size and Area of Operation:** Area of operation refers to the geographical area in which the organization is operating. If the organization is working on a large scale, it is quite possible that organization would have to keep higher cash balance. On the contrary, limited area of operations will require less cash balance.
- iv. **Duration of Production Cycle:** It refers to the time period taken by the raw material to become finished product/marketable produce. In case of long production cycle, the level of cash holding is likely to be high and vice-versa.
- v. **Policy followed by the Organization as to Disbursement of Salaries, Bonus, Dividend etc.:** If salaries are being distributed after 15 days the organization would have to manage a high level of cash reserve, while the weekly payment of wages and salaries will require still more funds. On the contrary, monthly payments will reduce the need of funds.

- vi. **Relations with Banks and Credit Standing of the Firm:** A firm managing proper relations with banks needs to carry less cash reserves to meet unpredicted cash outflow. Similarly, a firm whose credit standing is high can secure its supplies of materials on most suitable terms and finance a considerable part of its inventory through trade credit.

Q-3 What are the advantages of having ample cash?

ADVANTAGES OF AMPLE CASH The planning of cash is one of the primary responsibilities of financial management. In fact, cash is hub around which all financial matters cluster. A firm having sufficient cash balance can drive the following advantages from it:

- i. **Maintenance of Goodwill:** The goodwill and reputation of a business firm depends to a large extent on this fact that the firm retires all the obligations and meets the payments as and when they mature. It can be possible only when the firm maintains a good cash balance.
- ii. **Cash Discount can be Availed:** If a firm has sufficient cash, it can avail cash discounts offered by the suppliers. It will lower down the raw material cost and finally the cost of production.
- iii. **Good Bank Relations:** Commercial banks like to maintain good relations with such firms having high liquidity in funds. Such firms can avail credit facility from the banks at reasonable rate of interest.
- iv. **Exploitation of Business Opportunities:** Firms having good cash position can exploit the business opportunities very well. They can take risk of entering into new ventures.
- v. **Encouragement to New Investments:** Firm having good cash position can maintain a sound cash dividend policy. This encourages the new investment in the shares of such firm because shareholders like cash dividend the most.
- vi. **Increase in Efficiency:** Unless there is an adequate supply of cash, production cannot be carried out smoothly. Uninterrupted production process increases labour efficiency.

Chapter 19 Receivables Management

Q-1 Explain the concept of Receivables management.

- Receivables management is the process of making decisions relating to investment in trade debtors. Certain investment in receivables is necessary to increase the sales and the profits of a firm. But at the same time investment in this asset involves cost considerations also. Further, there is always a risk of bad debts too.
- Thus, the objective of receivable management is to take sound decision as regards investment in debtors. In the words of Bolton, S.E., the objective of receivables management is “to promote sales and profits until that point is reached where the return on investment in further funding of receivables is less than the cost of funds raised to finance that additional credit”.

Q-2 What are the costs incurred on maintaining receivables?

Costs of maintaining receivables: A firm incurs the following costs on maintaining receivables:

- Cost of Financing Receivables:** ‘Selling goods or services on credit’ means allowing the customers to use concern’s funds. The concern incurs some cost for collecting funds which finance receivables.
- Administrative Costs:** This relates to costs for maintaining accounts of debtors and cost of conducting investigation regarding potential credit customers to determine their credit worthiness.
- Cost of Collection:** This includes cost of reminders to the customers, cost of persons sent for collection and cost of legal recourse to recover money from the defaulting customers.
- Defaulting Costs or Bad Debts:** The amount which the firm is unable to realize from the customers is known as bad debts.

Q-3 Explain the scope of receivables management

The scope of receivable management is very wide. It includes the following aspects:

- Determining Credit Policy:** The term ‘credit policy’ refers to those decision variables that influence the amount of trade credit, i.e., the investment in receivables. The credit policy may be lenient (loose or expensive) or tight (or restrictive). In developing an optimum credit policy, the financial executives will have to compare the benefits of credit extension with the costs of credit.
- Determining Credit Terms:** The second aspect of receivables management is concerned with determining credit terms. The ‘credit terms’ include the decisions like credit period, the quantum of cash discount, period of cash discount and fixing the credit standards.
- Evaluating the Credit Applicants:** The third important aspect of receivables management is to lay down clear-cut guidelines and procedures for granting credit to individual customers. A firm can not follow the policy of treating all customers equal for the purpose of extending credit. Each case is to be decided on its own merits.
- Determining Collection Policies and Methods:** Next aspect is collection policy and setting collection methods. A well-conceived collection policy is needed because all customers do not pay the firm’s bills in time. There are certain customers who are slow payers and some are non-payers. Therefore, the collection policy should aim at accelerating collections from slow prayers and reducing bad debt losses.

Q-4 Explain the factors affecting the investment in receivables.**FACTORS AFFECTING THE SIZE OF RECEIVABLES**

- a) **General Factors:** These are those factors which are common to all firms and all types of assets. They include the type and nature of business, anticipated volume of sales operations, price-level variations, availability of funds, interest rate, pace of technological development, industry norms, etc.
- b) **The Volume of Credit Sales:** The most important variable affecting the level of the receivables is the volume of credit sales. As sales increases, receivables expand. As sales fall down, the receivables also decline.
- c) **Terms of Sale:** If the firm sells goods only for cash on delivery in order to avoid tying its funds in receivables and risking bad debts losses this item will altogether not appear in the balance sheet of the firm. But credit is the soul of business. Hence, if the firm sells on credit and credit period allowed is more, then receivables will also be more.
- d) **Stability of Sales:** If the business is of seasonal character, its credit sale in the season will be large, simultaneously; a large volume of receivables will be there. If a firm supplies goods on installment basis its investment in receivables will be high.
- e) **Credit and Collection Policy:** If a firm has a lenient or relatively liberal credit policy, it will experience a high level of receivables as compared to a firm with a more rigid or stringent credit policy.
- f) **Bills Discounting or Endorsement:** If bills are got discounted with banks or endorsed to third parties the level of investment in this asset will be automatically low.
- g) **Credit Period Allowed:** Longer the period of credit allowed, higher will be the volume of receivables.

*God is all knowing. Without even saying a word our condition is known to God
- Sant Rajinder Singh Ji*

Chapter 20: Factoring

Q-1 Write a short note on factoring services.

- As the accounts receivable amount to the blocking of the firm's funds, the need for an outlet to impart these liquidity is obvious.
- Other than the lag between the date of sale and the date of receipt of dues, collection of receivables involves a cost of inconvenience associated with tapping every individual debtor.
- Thus, if the firm could contract out the collection of accounts receivable it would be saved from many things such as administration of sales ledger, collection of debt and the management of associated risk of bad-debts etc.
- Factoring is a type of financial service which involves an outright sale of the receivables of a firm to a financial institution called the factor which specialises in the management of trade credit.
- Under a typical factoring arrangement, a factor collects the accounts on the due dates, effects payments to the firm on these dates (irrespective of whether the customers have paid or not) and also assumes the credit risks associated with the collection of the accounts.
- As such factoring is nothing but a substitute for in-house management of receivables.
- A factor not only enables a firm to get rid of the work involved in handling the credit and collection of receivables, but also in placing its sales *in effect* on cash basis.

Q-2 Briefly explain the functions of factoring

Purchase of book debts is fundamental to the functioning of factoring, there are a number of functions associated with this unique financial services. A proper appreciation of these functions would enable one to distinguish it from the other sources of finance against receivables. They are:

- assumption of credit and collection function;
- credit protection;
- encashing of receivables;
- collateral functions such as:
 - (a) loans on inventory,
 - (b) loans on fixed assets, other security and on open credit,
 - (c) advisory services to clients.

Q-3 Briefly explain the mechanics of factoring

A- Factoring offers a very flexible mode of cash generation against receivables. The dynamics of factoring comprises of the sequence of events outlined as under:

- (i) Seller negotiates with the factor for establishing factoring relationship
- (ii) Seller requests credit check on buyer
- (iii) Factor check credit credentials and approves buyer
- (iv) Seller sells goods to buyer
- (v) Seller sends invoice to factor
- (vi) Factor sends copy of the invoice to buyer
- (vii) Factor advises the amount to which seller is entitles after retaining a margin
- (viii) On expiry of agreed credit period, buyer makes payment of invoice to the factor
- (ix) Factor pays the residual amount to seller.

Q-4 Differentiate between factoring and Accounts receivable loans

- Accounts receivable loan is simply a loan secured by a firm's accounts receivable by way of hypothecation or assignment of such receivables with the power to collect the debts under a power of attorney. In case of factoring however, there is an outright sale of receivables.
- Thus, in case of the former, the bank may debit client's account for 'handling charges' if the debt turns out to be bad as against non-recourse factoring.

Q-5 Differentiate between Factoring and Bill Discounting

- Under a bill discounting arrangement, the drawer undertakes the responsibility of collecting the bills and remitting the proceeds to the financing agency, whereas under factoring agreement, the factor collects client's bills.
- Moreover, bill discounting is always with recourse whereas factoring can be either with recourse or without recourse.
- The finance house discounting bills does not offer any non-financial services unlike a factor which finances and manages the receivables of a client.

Q-6 Explain the concept of 'Forfeiting'

Forfeiting is a form of financing of receivables pertaining to international trade. It denotes the purchase of trade bills/ promissory notes by a bank/financial institution without recourse to the seller. The purchase is in the form of discounting the documents covering entire risk of non-payment in collection. All risks and collection problems are fully the responsibility of the purchaser (forfeiter) who pays cash to seller after discounting the bills/notes. The salient features of forfeiting as a form of export relating financing are as under:

- i. The exporter sells and delivers goods to the importer on deferred payment basis.
- ii. The importer draws a series of promissory notes in favour of the exporter for payment including interest charge. Alternatively the exporter draws a series of bill which are accepted by the importer.
- iii. The bills/notes are sent to the exporter. The promissory notes/bills are guaranteed by a bank which may not necessarily be the importer's bank.
- iv. The exporter enters into a forfeiting agreement with a forfeiter which is usually a reputed bank. The exporter sells the availed notes/bills to the bank at a discount without recourse and receives the payment.
- v. The forfeiter may hold these notes/bills till maturity for payment by the importers bank.

Q-7 Differentiate between Forfeiting vs. Export Factoring

Forfeiting vs. Export Factoring

Forfeiting is similar to cross border factoring to the extent both have common features of non recourse and advance payment. But they differ in several important respects:

- (a) A forfeiter discounts the entire value of the note/bill but the factor finances between 75-85% and retains a factor reserve which is paid after maturity.
- (b) The availing bank which provides an unconditional and irrevocable guarantee is a critical element in the forfeiting arrangement whereas in a factoring deal, particularly non-recourse type, the export factor bases his credit decision on the credit standards of the exporter.
- (c) Forfeiting is a pure financing arrangement while factoring also includes ledger administration, collection and so on.
- (d) Factoring is essentially a short term financing deal. Forfeiting finances notes/bills arising out of deferred credit transaction spread over three to five years.
- (e) A factor does not guard against exchange rate fluctuations; a forfeiter charges a premium for such risk

Chapter 21: Working Capital Estimation

Q-1 Explain the kinds of working capital.

Working capital can be classified either on the basis of Balance Sheet concept or on the basis of periodicity (Time) of its requirements.

1) On the Basis of Balance Sheet Concept: On the basis of B/S concept, it may be either gross working capital or net working capital. Gross working capital is represented by the total current assets. The net working capital is the excess of current assets over current liabilities.

- a) Gross Working Capital = Total Currents Assets (CA)
- b) Net Working Capital = Current Assets – Current Liabilities

2) On the basis of Requirement: The working capital can be classified into two categories on the basis of time and requirement:

a) Permanent Working Capital: It refers to the minimum amount of investment which should always be there in fixed or minimum current assets like inventory, accounts receivable, or cash balance etc., in order to carry out business smoothly. This investment is of a regular or permanent type and as the size of the firm expands, the requirement of permanent working capital also increases. Tondon Committee has referred to this type of working capital as “hard core working capital”.

b) Variable Working Capital: The excess of the amount of working capital over permanent working capital is known as variable working capital. The amount of such working capital keeps on fluctuating from time to time on variations in business activities. It may again be sub-divided into seasonal and special working capital. Seasonal working capital is required to meet the seasonal demands of busy periods occurring at stated intervals. On the other hand, special working capital is required to meet extraordinary needs for contingencies. Events like strike, fire, unexpected competition, rising price tendencies or initiating a big advertisement campaign require such capital.

Q-2 Explain the importance or advantages of Working Capital.

IMPORTANCE OR ADVANTAGES OF WORKING CAPITAL

Working capital is the lifeblood and nerve center of a business. Just as circulation of blood is essential in the human body for maintaining life, working capital is very essential to maintain the smooth running of a business. No business can run successfully without an adequate amount of working capital. The main advantages of maintaining adequate amount of working capital are as follows:

1. **Solvency of the Business:** Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.
2. **Goodwill:** Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.
3. **Easy Loan:** A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and others on easy and favorable terms.
4. **Cash Discounts:** Adequate working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.
5. **Regular Supply of Raw Material:** Sufficient working capital ensures regular supply of raw materials and continuous production.
6. **Regular Payment of Salaries, Wages and Day to Day Commitments:** A company which has ample working capital can make regular payment of salaries, wages and other day-to-day commitments which raises the morale of its employees, increases their efficiency, reduces wastages and costs and enhances production and profits.

7. **Exploitation of Favorable Market Conditions:** Only concerns with adequate working capital can exploit favorable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.
8. **Ability to Face Crisis:** Adequate working capital enables a concern to face business crisis in emergencies such as depression because during such periods, generally, there is much pressure on working capital.
9. **Quick and Regular Return on Investments:** Every investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to its investors, as there may not be much pressure to plough back profits. This gains the confidence of its investors and creates a favorable market to raise additional funds in the future.
10. **High Morale:** Adequacy of working capital creates an environment of security, confidence, high morale and creates overall efficiency in a business.

Q-3 What are the factors which affect the quantum of working Capital?

Factors Determining the Working Capital The working capital requirement may be calculated with following determinants:

1. **Nature of Business:** The working capital requirements of a firm basically depend upon the nature of its business. Public utility undertakings like Electricity, Water Supply and Railways need very limited working capital because they offer cash sales only and supply services, not products, and as such no funds are tied up in inventories and receivables. On the other hand trading and financial firms require less investment in fixed assets but have to invest large amounts in current assets like inventories, receivables and cash; as such they need large amount of working capital.
2. **Size of Business/Scale of Operations:** The working capital requirements of a concern are directly influenced by the size of its business which may be measured in terms of scale of operations.
3. **Manufacturing Process/Length of Production Cycle:** In manufacturing business, the requirements of working capital increase in direct proportion to length of manufacturing process. Longer the process period of manufacturing, larger is the amount of working capital required.
4. **Seasonal Variations:** In certain industries raw material is not available throughout the year. They have to buy raw materials in bulk during the season to ensure an uninterrupted flow and process during the entire year.
5. **Working Capital Cycle or Operating Cycle:** In a manufacturing concern, the working capital cycle starts with the purchase of raw material and ends with the realization of cash from the sale of finished products. The speed with which the working capital completes one cycle determines the requirement of working capital-longer the period of the cycle larger is the requirement of working capital.
6. **Rate of Stock Turnover:** There is a high degree of inverse co-relationship between the quantum of working capital and the velocity or speed with which the sales are effected. A firm having a high rate of stock turnover will need lower amount of working capital as compared to a firm having a low rate of turnover.
7. **Firm's Credit Policy:** The credit policy of a concern in its dealings with debtors and creditors influences considerably the requirements of working capital. A concern that purchases its requirements on credit and sells its products/services on cash requires lesser amount of working capital. On the other hand a concern buying its requirements for cash and allowing credit to its customers, shall need larger amount of working capital as very huge amounts of funds are bound to be blocked up in debtors or bills receivables.
8. **Business Cycles:** Business cycle refers to alternate expansion and contraction in general business activity. In a period of boom i.e., when the business is prosperous, there is a need for larger amount of working capital due to increase in sales, rise in prices, optimistic expansion of business, etc. On the contrary, in the times of depression i.e. when there is a downswing of the

cycle, the business contracts sales decline, difficulties are faced in collections from debtors, and firms may have a large amount of working capital lying idle.

9. **Rate of Growth of Business:** The working capital requirements of a concern increase with the growth and expansion of its business activities. In fast growing concerns, we shall require larger amount of working capital.
10. **Earning Capacity and Dividend Policy:** Some firms have more earning capacity than others due to quality of their products, monopoly conditions, etc. Such firms with high earning capacity may generate cash profits from operations and contribute to their working capital. The dividend policy of a concern also influences the requirements of its working capital.
11. **Other Factors:** In addition to the above considerations, there are a number of other factors which affect the requirements of working capital. Such as operating efficiency, management ability, irregularities to supply, import policy, asset structure, political stability, importance of labour banking facilities, etc., also influence the requirements of working capital.

Q-4 Explain the concept of negative working capital.

- Negative Working capital is a situation in which current liabilities of the company are higher than current assets. Generally negative working capital is a sign that the company may be facing bankruptcy or a serious financial trouble.
- Poor working capital leads to financial pressure on a company, increased borrowing, and late payments to creditor - all of which result in a lower credit rating.
- A lower credit rating means banks charge a higher interest rate, which can cost a corporation a lot of money over time.
- Companies with negative working capital may lack the funds necessary for growth.
- Another situation is where companies can sell their inventory and generate cash so quickly that they actually have a negative working capital. These are companies which takes advance first against supply of goods or services. McDonald's had a negative working capital of \$698.5 million between 1999 and 2000). Amazon.com is another example. This happens because customers pay upfront and so rapidly that the business has no problems raising cash. In these companies, products are delivered and sold to the customer before the company even pays for them. In order to understand how a company can have a negative working capital, let us take an example of Wal-Mart. Suppose Wal-Mart orders 500,000 copies of a DVD to Warner Brothers and they were supposed to pay within 30 days. What if by the sixth or seventh day, Wal-Mart had already put the DVDs on the shelves of its stores across the country? By the twentieth day, they may have sold all of the DVDs. Here, Wal-Mart received the DVDs, shipped them to its stores, and sold them to the customer (making a profit in the process), all before they had paid Warner Brothers! If Wal-Mart can continue to do this with all of its suppliers, it doesn't really need to have enough cash on hand to pay all of its accounts payable. As long as the transactions are timed right, they can pay each bill as it comes due, maximizing their efficiency. **The bottom line is that a negative working capital can also be a sign of managerial efficiency** in a business with low inventory and accounts receivable (which means they operate on an almost strictly cash basis).

Q-5 What are the various policies for financing current assets?

A firm can adopt different financing policies vis-a-vis current assets.

1. Matching Approach
2. Conservative Approach
3. Aggressive Approach

Matching Approach

The firm can adopt a financial plan which matches the expected life of assets with the expected life of the source of funds raised to finance assets. Thus, a ten-year loan may be raised to finance a plant with an expected life of ten years; stock of goods to be sold in thirty days may be financed with a thirty day

commercial paper or a bank loan. Using long-term financing for short-term assets is expensive as funds will not be utilized for the full period. Similarly, financing long-term assets with short-term financing is costly as well as inconvenient as arrangement for the new short-term financing will have to be made on a continuing basis. When the firm follows matching approach (also known as holding approach), long-term financing will be used to finance fixed assets and permanent current assets and short-term financing to finance temporary or variable current assets. However, it should be realized that exact matching is not possible because of the uncertainty about the expected lives of assets.

Conservative Approach The financing policy of the firm is said to be conservative when it depends more on long-term funds for financing needs. Under a conservative plan, the firm finances its permanent assets and also a part of temporary current assets with long-term financing. In the periods when the firm has no need for temporary current assets, the idle long term funds can be invested in the tradable securities to conserve liquidity. The conservative plan relies heavily on long-term financing and, therefore, the firm has less risk of facing the problem of shortage of funds.

Aggressive Approach A firm may be aggressive in financing its assets. An aggressive policy is said to be followed by the firm when it uses more short-term financing than warranted by the matching plan. Under an aggressive policy, the firm finances a part of its permanent current assets with short-term financing. Some extremely aggressive firms may even finance a part of their fixed assets with short-term financing. The relatively more use of short-term financing makes the firm more risky.

Q-6 What are the sources of permanent working capital?

Permanent working capital should be financed in such a manner that the enterprise may have its uninterrupted use for a sufficiently long period. There are five important sources of permanent or long-term working capital.

1. **Shares:** Issue of shares is the most important source for raising the permanent or long-term capital. A Company can issue equity shares or preference shares. As far as possible, a company should raise the maximum amount of permanent capital by the issue of shares.
2. **Debentures:** A debenture is an instrument issued by the company acknowledging its debt to its holder. It is also an important method of raising long-term or permanent working capital. The debenture-holders are the creditor of the company; fixed rate of interest is paid on debentures.
3. **Public Deposits:** Public deposits are the fixed deposits accepted by a business enterprise directly from the public. This source of raising short term and medium-term finance was very popular in the absence of banking facilities.
4. **Ploughing Back of Profits:** It means the reinvestments by concern of its surplus earnings in its business. It is an internal source of finance and is most suitable for an established firm for its expansion, modernization, replacement etc.
5. **Loans from Financial Institutions:** Financial institutions such as Commercial Banks, Life Insurance Corporation, Industrial Finance Corporation of India, Industrial Development Bank of India, etc. also provide short-term, medium term and long-term loans.

Q-7 What are the sources of variable working capital?

Working capital required for limited period of time may be secured from temporary sources as discussed below:

- (a) Trade Creditors
- (b) Short term Bank loan:
- (c) Commercial Paper:
- (d) Depreciation as a source of working capita
- (e) Tax liabilities:
- (f) Other miscellaneous sources are Dealer Deposits, Customer advances etc.

Chapter 22 Capital Budgeting

Q-1 Explain the importance of Capital Budgeting.

Capital budgeting decisions are of paramount importance in financial decision. So it needs special care on account of the following reasons:

(1) **Long-term Implications:** A capital budgeting decision has its effect over a long time span and inevitably affects the company's future cost structure and growth. A wrong decision can prove disastrous for the long-term survival of firm.

(2) **Involvement of large amount of funds:** Capital budgeting decisions need substantial amount of capital outlay.

(3) **Irreversible decisions:** Capital budgeting decisions in most of the cases are irreversible because it is difficult to find a market for such assets. The only way out will be to scrap the capital assets so acquired and incur heavy losses.

(4) **Risk and uncertainty:** Capital budgeting decision is surrounded by great number of uncertainties. Longer the period of project, greater may be the risk and uncertainty. The estimates about cost, revenues and profits may not come true.

(5) **Difficult to make:** Capital budgeting decision making is a difficult and complicated exercise for the management.

Q-2 Discuss the process of Capital Budgeting

A capital budgeting process may involve a number of steps depending upon the size of the concern, nature of projects, complexities and diversities. Following steps are necessary for a comprehensive capital budgeting process:

- i. **Project Generation:** First of all capital expenditure requirements should be forecasted. Capital expenditure proposals may originate at any level, i.e., from top management's level to operative's level.
- ii. **Project Evaluation:** This step involves:
 - a) Estimating the costs and benefits in terms of cash flows, and
 - b) Selecting an appropriate criterion for judging the desirability of the projects.
 - c) Project evaluation based on selected techniques.
- iii. **Project Selection:** This step relates to the screening and selecting of the projects according to the criterion of the firm. This is done either by the financial manager or by a capital expenditure planning committee. The selected projects with details are submitted to top management for final approval.
- iv. **Project Execution:** After selecting the best proposals and taking final approval of top management, funds are allocated for them. It is the duty of the executive committee to ensure that funds are spent in accordance with allocation made in the capital budgets. Periodical reports should be prepared and submitted to the controller to exercise control over such expenditures.
- v. **Follow-Up:** This step involves evaluation of the programme after its implementation. This involves comparison of actual performance with the budgeted data.

Q-3 Explain the scope of Capital Budgeting Decisions.

Broadly speaking, capital budgeting decisions are long-term investment decisions. They include the following:

1. **Expansion Decisions:** Decisions on the matters such as acquisition of new machinery of building, addition of building and machinery etc. are taken on the basis of cost of investment and expected profits from goods produced.

2. **Replacement Decisions:** A company may have to replace its existing old or obsolete machinery by new and latest model machinery. The use of new machinery may bring down operating costs and increase the volume of output. Decisions on such matters are taken on the basis of saving on account of decrease in operating costs and profits from additional volume produced by new plant.
3. **Buy or Lease Decisions:** The management may have to take decision on acquiring a fixed asset by purchase it from the market or by arranging it on lease basis. Such decisions are taken by comparing the cost of funds required for the purchase of asset with the amount payable on lease.
4. **Choice of Equipment:** The management may have to select the best machine out of available several alternative machines. Decisions on such matters are taken by comparing the cost of different assets with their respective profitability.
5. **Product of Process Improvement:** This concern with decision on matters related to cost reduction or improvement in the quality of product by change in production processes. Decision on such matters is taken on the basis of a comparative study of cost of change and possible additional income or saving as a result of change.

Q-4 What is pay back period. Also discuss its advantages and limitations.

Payback period is that time period in which net cash inflow from investment recovers the cost of investment.

Advantages or Merits of Payback Method

- i. It is simple to calculate and easy to understand, apply and interpret.
- ii. It is realistic in approach as businessmen want speedy recovery of their money in capital assets.
- iii. It weights early returns heavily and ignores distant returns and thus short payback period acts as a hedge.
- iv. It is safe since it avoids incalculable risk and uncertainty in the long run.

Limitations or Demerits of Payback Method Major shortcomings of this method are as follows:

- i. It concentrates only on the 'recovering of the cost of investment' and does not consider the earnings after the payback period.
- ii. It considers only the payback period of the project and not its whole life.
- iii. This method ignores the risk factor in investments. Hence, projects with higher risk but lower payback period will be accepted as compared to a project with lower risk and higher payback period.
- iv. This method ignores the time value of money. It fails to consider varying cash flow patterns. All cash flows are treated and weighted equally, regardless of the time period of their occurrence.
- v. This method ignores the salvage value of the asset.
- vi. It is not possible to calculate rate of return by this method.

Q-5 What is Accounting Rate of Return (ARR). Also discuss its advantages and limitations.

This method is also known as unadjusted rate of return method or Financial Statement Method because the main figures used in the calculation are derived from accounting statements.

Advantages or Merits of Unadjusted Rate of Return Method

- i. It is simple to compute and easy to understand and interpret.
- ii. It takes into consideration the total earnings from the project during the its entire economic life.
- iii. This method gives due weight to the profitability of the project.
- iv. This method duly recognizes the concept of net earnings, i.e., earnings after providing for depreciation on capital asset. In fact, this is the correct way of income determination.

Limitations or Demerits of Unadjusted Rate of Return Method

- i. It is simply an averaging technique, which does not take into account the impact of various external factors on overall profits of the firm.
- ii. It ignores the time value of earnings. In other words, this method does not discount the future earnings to present value.
- iii. The method does not determine the fair rate of return on investments. It is left at the discretion of management.
- iv. This method does not give consideration to the risk factor in respect of each project.

Q-6 Briefly explain the merits and demerits of Net Present Value method?**Merits of NPV Method**

- i. The NPV method recognizes the time value of money and takes into consideration the cost of capital.
- ii. It is very easy to calculate and simple to understand and interpret.
- iii. It takes care of the entire life of the project and its entire earnings including salvage of asset.
- iv. It can be applied to both types of cash inflow patterns – even and uneven cash inflows.
- v. The economists generally prefer this method as it is consistent with the objective of maximizing owners' wealth.

Limitation or Demerits of NPV Method

- i. Compared to payback or accounting rate of return methods, NPV method is difficult and complicated.
- ii. The greatest problem of this method is determination of desired rate of return. Due to difference in the state of risk and uncertainty of different business, no uniform rate can be used.
- iii. Keeping in view time-span of different projects and difference of risk inherent in them, use of a common discounting rate is not correct.
- iv. It may also not give satisfactory results where the projects under competition have different lives.
- v. It assumes that intermediate cash inflows are reinvested at the firm's cost of capital, which is always not true.
- vi. The results from this method may contradict those under internal rate of return method, even in the case of alternative proposals, which are mutually exclusive.
- vii. Net present value is sensitive to discount rates. With a change in rate, a desirable project may turn into an undesirable one and vice-versa.

Q-7 Briefly explain the merits and demerits of Internal Rate of Return?**Merits of IRR Method**

- i. Like NPV, IRR method takes into consideration time value of money and also the total cash inflows and outflows over the entire life of the project.
- ii. The pre-determination of earnings rate is not a pre-condition for the use of this method.
- iii. For a manager, it is easier to understand and interpret the 'rate' than an absolute amount.

Demerits of TAR or IRR Method

- a. Its computation is difficult. IRR requires tedious calculations based on trial and error procedure or interpolation.
- b. The assumption that cash flows are reinvested for the remaining life of the project at the IRR is unrealistic. In some cases, it remains idle in the business.
- c. This method requires the determination of minimum required rate of return to know the acceptability of IRR, which is a difficult task.

Q-8 Distinguish between 'Net Present Value' and 'Internal Rate of Return' (CS June 2016; Dec 2017)

The net present value (NPV) and internal rate of return (IRR), two widely used method for making capital budgeting decisions are the species of the same genre i.e. Discounted cash flow method, yet they are different from each other on various points.

The broad points of difference between the two are as follows:

1. **Computation:** In the NPV method the difference between the present value of cash inflows and present value of cash outflows is computed as the net benefit by the project. IRR is defined as the discount rate that makes NPV= 0.
2. **Interest rate:** Under the net present value method rate of interest is assumed as the known factor whereas it is unknown in case of internal rate of return method.
3. **Reinvestment Axiom:** The conflict between NPV and IRR rule in the case of mutually exclusive project situation arises due to re-investment rate assumption. NPV rule assumes that intermediate cash flows are reinvested at discount rate and IRR assumes that they are reinvested at rate equal to the proposal's IRR itself. The assumption of NPV rule is more realistic than the IRR method.
4. **Objective:** The net present value method looks to ascertain the amount which can be invested in a project so that its expected yield will exactly match to repay this amount with interest at the market rate. On the other hand, internal rate of return method attempts to find out the rate of interest which is maximum to repay the invested fund out of the cash inflows.

Q-9 Distinguish between 'Accounting Rate of Return' and 'Internal Rate of Return' (CS June 2018)

Internal Rate of Return	Accounting Rate of Return
1. IRR is a discounted cash flow technique 2. It is based on cash flows 3. IRR takes into account time value of money. 4. Cash flows are matched with original investment under IRR 5. Under IRR cash inflows are assumed to be reinvested at internal rate of return. 6. IRR is a scientific method and a good measure of return	1. ARR is non discounted technique of evaluation 2. It is based on accounting profits. 3. It does not consider time value of money 4. Average investment is taken into account 5. No such reinvestment assumption applies in ARR 6. It is not a scientific method and is inferior to IRR.

Q-10 Write a short note on Capital Rationing

The firm may put a limit to the maximum amount that can be invested during a given period of time, such as a year. Such a firm is then said to be resorting to capital rationing. A firm with capital rationing constraint attempts to select the combination of investment projects that will be within the specified limits of investments to be made during a given period of time and at the same time provide greatest profitability.

Types of Capital Rationing

1. "hard" or external
2. "soft" or internal

Hard capital rationing occurs when external factors force a company to cut expenses, including capital expenditures. For example, creditors may include provisions in an agreement limiting borrowers' spending to reduce the risk of default. Many companies are also forced to reduce spending when they are going to raise additional capital by issuing new debt or equity. The objective of such a strategy is to increase the free cash flow and therefore make a company more attractive to investors. As we can see, external factors may cause severe constraints on the capital budget.

Soft capital rationing is caused by internal factors. For example, to reduce overall risk, the board of directors may set a minimum internal rate (IRR) of return for capital projects. All projects having a lower IRR will be rejected even though they have a positive net present value. Dividend policy can also cause soft rationing. For example, if a company declares paying a fixed dividend per share, any failure will be negatively perceived by the market and will most likely result in a decrease in the stock price. That is why company management would prefer to cut capital expenditures than dividends.

Q-11 What considerations other than profitability are made in managerial decisions about investment proposal?

Managerial decision on capital projects is very difficult and complicated problem. Though profitability of the proposal is the crucial factor that influences the capital expenditure decisions this cannot be the sole determinant for these decisions. In practice there are many other factors which make the profitability base subsidiary or less important. These factors are as follows:

- 1. Urgency of the Project:** Sometimes an investment is made due to urgency to avoid heavy losses. For example, on breakdown of machinery, management may decide to replace it by any available machine suitable for the work without proper evaluation of its cost and benefits so as to avoid heavy losses due to stoppage of production process. In such a case, the basis of managerial decision is urgency and not the profitability.
- 2. Funds Available:** The availability of funds is an important factor that influences the capital budgeting decisions. Sometimes, a more profitable project is not taken up for want of sufficient funds and a lesser profitable project of lower payback period is approved, if the firm is short of funds.
- 3. Available Technical Know-how and Managerial Capability:** Before approving a project, the management will have to consider whether their firm has got the necessary technical know-how and managerial capability to implement that project and if not, whether it could be acquired.
- 4. Availability of Additional Funds:** If the management is capable of arranging additional funds in future, then all the funds available at present may be utilized for the capital projects; if not, working capital needs will have to be arranged out of the funds available with the firm.
- 5. Future Expectations of Earnings:** Expected earnings on future investments may also influence current capital investment decisions. If more profitable investments are possible in future, then at present management would select the project of lower useful life so that the funds invested may be taken back early and could be invested in future in more profitable projects.
- 6. Degree of Certainty of Net Income:** Certainty of income on project also influences the selection of the project. Although future business operations are uncertain, even then the management may select a lower income project in place of a higher but uncertain income project.
- 7. Risk of Obsolescence:** In case of rapid technological development, the project with a lesser payback period may be preferred in comparison to one which may have higher profitability but still longer payback period.
- 8. Maintaining Market Share:** Sometimes, the management may take a decision in favor of a project though yielding a lower return but necessary to maintain earning capacity and existing market share of the firm.

*God is all knowing. Without even saying a word our condition is known to God
- Sant Rajinder Singh Ji*

Chapter 23 Dividend Policy

Q-1 What are the various kinds (forms) of Dividend?

1. **Equity Dividend:** The dividend paid on equity shares is called Equity Dividend. The rate of equity dividend is set (recommended) by the board of directors of a business firm and approved by their shareholders.
2. **Preference Dividend:** Preference dividend is paid on Preference Shares. At the time of issue of such shares, the rate of dividend is mentioned which remains fixed in nature. This dividend on preference shares is paid before equity dividend.
3. **Interim Dividend:** Interim dividend is paid by a company for the current year before the accounts for that period have been closed.
4. **Regular Dividend:** Payment of dividend at the usual rate is termed as regular dividend. The investors such as retired persons, widows and other economically weaker person prefer to get regular dividends.
5. **Cash Dividend:** A cash dividend is a usual method of paying dividends.
6. **Stock Dividend:** Stock dividend means the issue of bonus shares to the existing shareholders. If a company does not have liquid resources it is better to declare stock dividend.
7. **Scrip or Bond Dividend:** A scrip dividend promises to pay the shareholders at a future specific date.
8. **Property Dividend:** Property dividends are paid in the form of some assets other than cash. They are distributed under exceptional circumstances and are not popular in India.
9. **Composite Dividend:** When dividend is paid partly in cash and partly in the form of property then it is known as composite dividend.
10. **Optional Dividend:** Instead of paying composite dividend, if the company gives option to its shareholders either for cash dividend or for property dividend then it is called option dividend.
11. **Extra or Special Dividend:** Special dividend is an abnormal and non-recurring form of dividend, when the management of company does not want to make frequent changes in the regular rate of dividend but company is having good amount of profits or undistributed reserves then they can declare extra or special dividend.

Q-2 What are the determinants/constraints of dividend policy?

In the company/organisation, dividend policy is determined by the Board of directors having taken into consideration a number of factors.

The main considerations are as follows:

- (1) **Legal Restrictions:** The purpose of legal restriction is to ensure that the payment of dividend may not cause insolvency.
- (2) **Financial:** A firm can pay dividend only to the extent that it has sufficient cash to disburse.
- (3) **Stage of Business Cycle:** The demand for capital expenditure, money, supply etc. changes during the different stages of a business cycle, as a result, dividend policy may fluctuate from time to time.
- (4) **Nature of Business Conducted by a Company:** A company having a business of the nature which gives regular earnings may like to have a stable and consistent dividend policy. Industries manufacturing consumer/consumer durable items have a stable dividend policy.
- (5) **Age of the Company:** The age of the company also influences the dividend decision of a company. A newly established concern has to limit payment of dividend and retain substantial part of earnings for financing its future growth, while older companies which have established sufficient reserves can afford to pay liberal dividends.
- (6) **Taxation Policy:** High taxation reduces the earnings of the companies and consequently the rate of dividend is lowered down. Sometimes Government levies dividend tax on distribution of dividend.

(7) **Future Financial Requirements:** Needs of the Company for additional capital affects the dividend policy. The extent to which the profits are required to be invested in the company for business growth is the main consideration in dividend decisions.

(8) **Cost of Capital:** If the cost of capital involved in external financing is greater than the cost of internally generated funds, a corporation adopts a conservative dividend policy.

(9) **Financial Arrangement:** In case of financial arrangements being entered into or being planned like merger or amalgamation with another company, liberal policy of dividend distribution is followed to make the share stock more attractive.

(10) **Regularity:** Some companies consider that regularity in payment of dividend is more important than anything else. They may use past earnings to pay dividends regularly irrespective of whether they have current profits or not.

Q-3 What are the various types of dividend policies?

There are basically four types of dividend policy-

- (a) Regular dividend policy
- (b) Stable dividend policy
- (c) Irregular dividend policy
- (d) No dividend policy

Q-4 Write a short note on regular dividend policy.

Regular dividend policy: Payment of dividend at the usual rate is termed as regular dividend. The investors such as retired persons, widows and other economically weaker person prefer to get regular dividends

Merits/Advantages of Regular Dividend Policy:

- It helps in creating confidence among the shareholders.
- It stabilizes the market value of shares.
- It helps in maintaining the goodwill of the company.
- It helps in giving regular income to the shareholders.
- If profits are not distributed regularly and are retained, the shareholders may have to pay a higher rate of tax in the year when accumulated profits are distributed.

However it must be remembered that regular dividends can be maintained only by companies of long standing and stable earnings. A company should establish the regular dividend at a lower rate as compared to the average earnings of the company.

Q-5 Write a short note on Stable dividend policy. Also state advantages of Stable Dividend Policy.

Stable dividend policy:

The term 'Stability of dividend' means consistency or lack of variability in the stream of dividend payments. Here the payment of certain sum of money is regularly made to the shareholders.

It is of three types:

(a) Constant dividend per share:

Some companies follow a policy of paying fixed dividend per share irrespective of the level of earnings year after year. Such, firms, usually, create a 'Reserve for Dividend Equalization' to enable them to pay the fixed dividend even in the year when the earnings are not sufficient or when there are losses. A policy of constant dividend per share is most suitable to concerns whose earning is expected to remain stable over a number of years.

(b) Constant payout ratio:

Constant pay-out ratio means payment of a fixed percentage of net earnings as dividends every year. The amount of dividend in such a policy fluctuates in direct proportion to the earnings of the company.

The policy of constant pay-out is preferred by the firms because it is related to their ability to pay dividends.

(c) Stable rupee dividend + extra dividend: Under this type, there is payment of low dividend per share constantly + extra dividend in the year when the company earns high profit. Such a policy is most suitable to the firm having fluctuating earnings from year to year.

Advantages of Stable Dividend Policy:

A stable dividend policy is advantageous to both the investors and the company on account of the following:

- i) It is sign of continued normal operations of the company.
- ii) It stabilizes the market value of shares.
- iii) It creates confidence among the investors.
- iv) It provides a source of livelihood to those investors who view dividends as a source of funds to meet day-to-day expenses.
- v) It meets the requirements of institutional investors who prefer companies with stable dividends.
- vi) It improves the credit standing and makes financing easier.
- vii) It results in a continuous flow to the national income stream and thus helps in the stabilization of national economy.

Q-6 Write a short note on Irregular dividend policy

Irregular dividend: as the name suggests here the company does not pay regular dividend to the shareholders.

The company uses this practice due to following reasons:

- Due to uncertain earning of the company.
- Due to lack of liquid resources.
- The company is sometime afraid of giving regular dividend.
- Due to uncertainty of business.

Q-7 Discuss no dividend policy

The company may use this type of dividend policy due to requirement of funds for the growth of the company or for the working capital requirement.

Q-8 What are the essentials of a Sound Dividend Policy

Following are the essentials of a sound dividend policy of a company:

1. **Stability:** Stability in dividend distribution implies regularity in payment of dividend. If a company pays high dividend in a year but fails to pay any dividend next year, then it can not be said as good. On the other hand, if a company pays dividend each year even though at a medium rate, its shareholders will remain satisfied and its shares will not be subjected to high speculation.
2. **Gradually Rising Dividends:** The management of the company should always try to make some increase in dividend rate each year, though this increase will depend on increase in income of the company. If there are huge profits in any year then in that year the company should distribute additional or special dividend.
3. **Distribution of Cash Dividend:** Dividend should be paid in cash. But, if the amounts of reserves and funds in the company become very high, then stock dividend may also be declared. But the distribution of stock dividend should remain within reasonable limits otherwise the company may become victim of over-capitalization.
4. **Moderate Start:** In the beginning years of company's incorporation, dividend should be declared at lower rates for some years so that company's financial position may become sound.

Afterwards with the growth and progress of the company, dividend rates may be increased gradually.

5. **Other factors:** Dividend should be paid out of earned profits only. If there is carry forward of past losses, then dividend should not be declared till these are set off. Though, the dividend is usually paid only once in a year in order to keep the shareholders in high spirits, interim dividends should also be declared.

Q-9 Explain theory of irrelevance of Dividend

Or

Explain Modigliani and Miller Approach with respect to dividend Policy. What are the assumptions of this policy.

- According to Modigliani and Miller (M-M), dividend policy of a firm is irrelevant as it does not affect the wealth of the shareholders.
- They argued that the value of the firm depends on its earning potentiality and investment policy and not on the pattern of income distribution. Thus, when investment decision of the firm is given, dividend decision, i.e., the split of earnings between dividends and retained earnings, is of no significance in determining the value of the firm.

Assumptions of M-M Hypothesis

This hypothesis is based on the following assumptions:

1. The capital markets are perfect. Perfect capital markets imply that
 - a) Information is freely available to all,
 - b) Transaction and floatation costs do not exist and
 - c) No investor is large enough to affect the market price of a share.
2. Investors behave rationally.
3. There are either no taxes or there are no differences in the tax rates applicable to dividends and capital gains. This means that investors value a rupee of dividend as much as a rupee of capital gains.
4. The firm has a fixed investment policy.
5. Risk or uncertainty does not exist, i.e., investors are able to forecast future prices and dividends with certainty and one discount rate is appropriate for all securities at time periods.

Q-10 What are the Criticisms of MM Hypothesis?

M-M hypothesis of dividend irrelevance is based on unrealistic assumptions, the most critical of which are as follows:

1. **Perfect Capital Market:** Perfect capital market does not exist in reality. Information about the company is not available to all persons.
2. **Tax Differential:** Taxes do exist and there are different rates of tax for capital gains and dividends. Capital gains are subject to lower tax rate compared to dividends. Hence, cost of internal financing will be cheaper than external financing. So, the shareholders would favor retention of earnings on account of tax differential.
3. **Floatation Cost:** The firms have to incur floatation costs while raising funds from outside. Hence, external financing will be costlier than internal financing.
4. **Transaction Costs:** The shareholders have to pay brokerage fee etc. on selling their shares. Moreover, it is inconvenient also to sell shares. Hence, shareholders would prefer to have dividend as compared to capital gains.
5. **Uncertainty:** There is always uncertainty in the capital market. Hence, shareholders prefer present dividends to future dividends. Hence, the value of shares of that company would be higher than that of company which is following the policy of retention of earnings.

6. **Rigid Investment Policy:** The firms do not follow a rigid investment policy. All the above discussion proves that dividend decision is very relevant in affecting the value of firm and shares.

Q-11 What are the assumption of Walter's model?

Walter's model is based on the following assumptions:

- Internal financing:** The firm finances all investment through retained earnings; that is debt or new equity is not issued.
- Constant return and cost of capital:** The firm's rate of return, r , and its cost of capital, k is constant.
- 100 percent payout or retention:** All earnings are either distributed as dividends or reinvested internally immediately.
- Constant EPS and DPS:** Beginning earnings and dividends never change. The value of the earnings per share, EPS, and the dividend per share, DPS, may be changed in the model to determine results, but any given values of EPS or DPS are assumed to remain constant forever in determining a given value.
- Infinite time:** The firm has a very long or infinite life.

Q-12 What are the Criticisms of Walter's Model?

Walter's model has been criticized on account of various assumptions made by Prof. Walter in formulating his hypothesis:

- The basic assumption that investments are financed through retained earnings only is seldom true in real world. Firms do raise funds by external financing.
- The internal rate of return, i.e., r , also does not remain constant. As a matter of fact, with increased investment the rate of return also changes.
- The assumption that cost of capital (k) will remain constant also does not hold good. As a firm's risk pattern does not remain constant, it is not proper to assume that k will always remain constant.
- The formula does not consider all the factors affecting dividend policy and share price. It ignores such factors as taxation, various legal obligations etc., Moreover, determination of market capitalization rate is difficult

Q-13 Explain the concept of Stock Split. What are the main reasons behind Stocks Split?

- A stock split is a decision by a company's board of directors to increase the number of shares outstanding by issuing more shares to current shareholders.
- For example, in a 2-for-1 stock split, a shareholder receives an additional share for each share held. So, if a company had 10 million shares outstanding before the split, it will have 20 million shares outstanding after a 2-for-1 split.
- Generally a company announces a stock split when the price of the shares has risen to the point that it might be unappealing to investors who are more comfortable with lower-priced securities.
- While a split doesn't actually make your investment any more valuable in and of itself, a lower share price and the resulting increase in trading liquidity can certainly attract additional investors.
- Stock Split Example** Suppose, a company has 2000 stocks each stock is worth 20 rupees. Now, if the company wants to increase the number of stocks, then it will split them. This means that the total number of stocks increases but there will be no impact on the cost of these stocks. Suppose, the company has split it in the ratio of 2:1, then:
Earlier, 1 stock = 20 rupees
After a 2:1 split, 1 stock = 10 rupees (per share price/number of parts in which split has occurred i.e. $20/2$ here)

This means that the number of stocks will now be 4,000 but the total cost of stocks remains at 40,000.

Reason Behind Stocks Split

The following reasons facilitate this split:

- i. One of the basic reasons behind the stock split is the inability of investors to afford the share. Once the share prices hit a specific high price, companies decide to go for a stock split since it will allow more investors to own stocks at a lower price.
- ii. Once the number of shares increases, it leads to greater liquidity in stocks. The increased liquidity eases trading for buyers and sellers without any major impact on share prices.
- iii. The number of shares owned by investors' increases. Now, after some time, when share prices reach a high, the investor will enjoy more profit.
- iv. Sometimes, the split is executed to meet the minimum criteria to stay listed on the exchange. This usually happens in the case of a reversed stock split.

Q-14 Explain the concept of Share Repurchase (Buy Back of Shares). What are reason for share repurchase.

- A stock buyback occurs when a company buys back its shares from the marketplace with its accumulated cash. Also known as a share repurchase, a stock buyback allows a company to re-invest in itself.
- The repurchased shares are absorbed by the company, reducing the number of outstanding shares on the market. Because there are fewer shares on the market, the relative ownership stake of each investor increases.
- **Reasons of share repurchase:**
 - a. The board might feel that the company's stock is undervalued, making it a good investment.
 - b. Investors often perceive a buyback as an expression of confidence by the company.
 - c. If the excess cash is a windfall, the company may not want to commit to paying a dividend (if it doesn't already) or to increasing its existing dividend on an ongoing basis (if it already pays a dividend). An ongoing dividend can burden a company during lean times if it's maintained, and leave investors upset if it's cut.
 - d. The company's large shareholders may not want the extra tax burden of an increased dividend. Unlike dividends, share-repurchase programs don't have immediate tax implications for shareholders, as there's no payment to investors.
 - e. The company may wish to offset the dilution caused by generous employee stock-option plans.
- **Impact of a Share Repurchase**
 - When a company buys back shares, the total number of shares outstanding diminishes.
 - Earnings per share (EPS) or cash flow per share (CFPS) will increase due to a decrease in the denominator used to produce the figures. Thus, investors must be wary of the situation, as EPS and CFPS will become artificially inflated – meaning that the increase cannot be attributed to economic value creation activities such as boosting earnings or cutting costs.
 - Following the concept of supply and demand, we can predict an increase in the stock price. Assuming that the demand for the stock remains constant in the face of a reduction in supply, we can project that the price of the stock will increase. Once again, investors must be wary of the phenomenon as it may not result from legitimate improvements in the business' financial health.

***God is all knowing. Without even saying a word our condition is known to God
- Sant Rajinder Singh Ji***

Chapter 24: Security Analysis

Q-1 Any investment decision will be influenced by three objectives. What are those objectives?

Any investment decision will be influenced by three objectives – security, liquidity and yield. A best investment decision will be one, which has the best possible compromise between these three objectives.

When selecting where to invest our funds, we have to analyze and manage following three objectives.

- I. **Security:** Central to any investment objective is the certainty in recovery of the principal. One can afford to lose the returns at any given point of time, but s/he can ill afford to lose the very principal itself. By identifying the importance of security, we will be able to identify and select the instrument that meets this criterion. For example, when compared with corporate bonds, we can vouch the safety of return of investment in treasury bonds as we have more faith in governments than in corporations. Hence, treasury bonds are highly secured instruments. The safest investments are usually found in the money market and include such securities as Treasury bills (T-bills), certificates of deposit (CD), commercial paper or bankers' acceptance slips; or in the fixed income (bond) market in the form of municipal and other government bonds, and in corporate bonds.
- II. **Liquidity:** To meet our unexpected demands and needs, our investment should be highly liquid. They should be encashable at short notice, without loss and without any difficulty. If they cannot come to our rescue, we may have to borrow or raise funds externally at high cost and at unfavorable terms and conditions. Such liquidity can be possible only in the case of investment, which has always-ready market and willing buyers and sellers. Such instruments of investment are called highly liquid investment. Common stock is often considered the most liquid of investments, since it can usually be sold within a day or two of the decision to sell.
- III. **Yield:** Yield is best described as the net return out of any investment. Hence given the level or kind of security and liquidity of the investment, the appropriate yield should encourage the investor to go for the investment. If the yield is low compared to the expectation of the investor, s/he may prefer to avoid such investment and keep the funds in the bank account or in worst case, in cash form in lockers. Hence yield is the attraction for any investment and normally deciding the right yield is the key to any investment.

Q-2 Differentiate between Investment and Speculation

- According to Benjamin Graham "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."
- Thus investment differs from speculation. Speculation also involves deployment of funds but it is not backed by a conscious analysis of pros and cons.
- Mostly it is a spur of the moment activity that is promoted and supported by half-baked information and rumours.
- Speculative deployment of funds is generally prevalent in the secondary equity market. What attracts people to speculation is a rate of return that is abnormally higher than the prevailing market rates.

Basis for comparison	Investment	Speculation
Meaning	The purchase of an asset with the hope of getting returns is called investment.	Speculation is an act of conducting a risky financial transaction in the hope of substantial profit.
Basis for decision	Fundamental factors i.e. performance of the company	Hearsay, technical charts and market psychology

Time horizon	Long term	Short term
Risk involved	Moderate risk	High risk
Intent to profit	Changes in value	Changes in price
Expected rate of return	Modest rate of return	High rate of return
Funds	An investor uses his own funds	A speculator uses borrowed funds
Income	Stable	Uncertain and erratic
Behavior of participants	Conservative and cautious	Daring and careless

Q-3 Differentiate between Investment and Gambling

- Investment differs from gambling and betting also. Both gambling and betting are games of chance in which return is dependent upon a particular event happening. Here also, there is no place for research-based activity.
- The returns in gambling are high and known to the parties in advance.

Basis for comparison	Investment	Gambling
Planning Horizon	Longer Planning Horizon	Short Planning Horizon
Basis for decision	Scientific Analysis of Intrinsic worth of the security	Based on tips and rumours
Nature	Planned activity	Unplanned activity
Risk involved	Commercial risk	Artificial risk
Return expectation	Risk-return trade-off determine return	Negative returns are expected.
Motive	Safety of principal and stability of returns	Entertainment while earning.

Q-4 What is Security Analysis? Why do we need to carry it out?

- Security analysis is the first part of investment decision process involving the valuation and analysis of individual securities.
- Security Analysis is primarily concerned with the analysis of a security with a view to determine the value of the security, so that appropriate decisions may be made based on such valuation as compared with the value placed on the security in the market.
- Two basic approaches of security analysis are fundamental analysis and technical analysis

Q-5 Explain Fundamental Analysis

Fundamental analysis is a three level systematic process that analyse the overall external and internal environment of the company before placing a value on its shares. The three levels at which the analysis is carried out are the following:

(a) Analysis of the economy

- Performance of a company is intimately related to the overall economic environment of the country because demand for products and services of the company would under normal circumstances be directly related to growth of the country's economy.
- If the country has an improving GDP growth rate, controlled inflation and increasing investment activity then chances are that the valuation of securities shall be liberal. The capital market is said to be in a bullish phase with share values shooting up across the board. As the economy is growing, the analyst expects almost every industry to do well.
- On the other hand, if the GDP growth rate slackens, inflation is out of control and investment activity is stagnant or declining, the investor or the analyst will expect the performance of

industries to slow down. Under such circumstances, valuation of securities tends to be conservative. The capital market enters a bearish phase and share values decline across to board.

- While undertaking the analysis of the economy, the following macro-economic factors are commonly used.
 - i. **Gross Domestic Product:** Gross Domestic Product (GDP) indicates the rate of growth of the economy. Whenever the GDP grows, it indicates economic growth and higher return for investors.
 - ii. **Savings and Investment:** It is obvious that growth demands investment which in turn needs substantial amount of domestic savings. Stock market is a channel through which the savings of the investors are made available to corporate houses.
 - iii. **Inflation:** Along with the growth rate of GDP, if the inflation rate also increases, then the real rate of growth of would be very less. The demand in the consumer product industry is significantly affected. The industries which come under the government price control policy may lose the market.
 - iv. **Interest rates:** The interest rate affects the cost of financing to the firms. A decrease in interest rate implies lower cost of finance for firms and more profitability.
 - v. **Budget:** The Union Budget provides a detailed account of the government revenues and expenditures. A deficit budget may lead to high rate of inflation and adversely impact the cost of production.
 - vi. **Tax structure:** Tax concessions and incentives given to certain industries encourages investment in that particular industry. Tax reliefs provided to savings encourage savings.
 - vii. **Other factors:** Other factors include the balance of payment, monsoon and agriculture, infrastructure facilities and demographic factors.

(b) Industry Level Analysis

- Industry level analysis focuses on a particular industry rather than on the broader economy. In this analysis, the analyst has to look for the composition of the industry, its criticality vis-à-vis the national economy, its position along the industrial life cycle, entry and exit barriers. All these factors have a bearing upon the performance of the company.
- Industry is a combination or group of units whose end products and services are similar. Having a common market, the participants in the industry group face similar problems and opportunities. To the extent that an industry loses or gains from certain happenings, the performance of the participants is sure to be similarly impacted. These happenings may be technological changes, shifts in consumer preferences, availability of substitutes etc. These changes also drive the life cycle of the industry.
- The industry life cycle or the industry growth cycle can be divided into three major stages-pioneering stage, expansion stage and stagnation stage. The pioneering stage is related to sunrise status of the industry. It is the stage when technological development takes places. The products have been newly introduced in the market and they gain ready acceptance. The pioneering units in the industry make extraordinary profits and thus attract competition. As competition increases profitability in the industry comes under strain and less efficient firms are forced out of the market. At the end of the pioneering stage, selected leading companies remain in the industry.
- In the expansion stage of the growth cycle the demand for the products increases but at a lower rate. There is less volatility in prices and production. Capital is easily available in plenty for these units. Due to retention of profits, internal accruals increase.
- At the stagnation stage, the growth rate initially slows down, then stagnates and ultimately turns negative. There is no product innovation. External capital is hard to come by. Even the internal capital takes flight. This stage of the industry is most valuable during times of slow down in national economy.

(c) Company Analysis

- Armed with the economic and industry forecasts, the analyst looks at the company specific information. Company information is generated internally and externally. The principle source of internal information about a company is its financial statements. Quarterly and annual reports including the income statement, the balance sheet and cash flows must be screened to assure that the statements are correct, complete, consistent, and comparable.
- Many popular and widely circulated sources of information about the companies emanate from outside, or external sources. These sources provide supplements to company-generated information by overcoming some of its bias, such as public pronouncements by its officers. External information sources also provide certain kinds of information not found in the materials made available by companies themselves. There are traditional and modern techniques of company analysis.
- Among the traditional techniques are forecasting expected dividends and earnings using price-earning ratios which help us to determine whether a stock is fairly valued at a point in time. Such approaches allow us to evaluate an equity share for a short term horizon.

Q-6 Write a short note on Technical Analysis

- In the fundamental analysis, share prices are predicted on the basis of a **three stage analysis**. However, in actual practice, it often happens that a share having sound fundamentals **refuses to rise** in value and vice versa. Technical analysis is an **alternative approach** to predict share price behavior.
- It is used in **conjunction with fundamental analysis** and **not as its substitute**.
- Technical analysis assumes that market prices of securities are determined by the **demand-supply equilibrium**. The **shifts** in this **equilibrium** give rise to **certain patterns** of price and volume of trading which have a tendency to repeat themselves over a period of time.
- An analyst who is familiar with these patterns can **predict** the future behaviour of stock **prices** by **noticing** the formation of these **patterns**.
- It is a **science of predicting the share price movements** from the past data about share price movements. These predictions are **indicative** and do not provide irrefutable declarations about future trends.
- Technical analysis is based on the following assumptions:
 - The inter-play of **demand and supply** determines the market value of shares.
 - Supply and demand are governed by various factors – both rational and irrational.
 - Stock values tend to **move in trends** that persist for a reasonable time.
 - These **trends change** as a result of **change in demand-supply** equilibrium.
 - Shifts in demand and supply can be **detected in charts** of market action.
 - **Chart patterns tend to repeat** themselves and this repetition can be used to forecast future price movements.
 - Markets behave in a random style.
 - Markets discount every future event that has a bearing upon share values.

Q-7 Write a short note on Dow Jones Theory

It is one of the earliest theories of technical analysis. The theory was formulated by **Charles H. Dow** of Dow Jones & Co. who was the first editor of Wall street Journal of USA. According to this theory, share prices demonstrate a pattern over four to five years.

These patterns can be divided into **three distinct cyclical trends**- primary, secondary or intermediate and minor trends.

Primary Trends

- The primary trend lasts from **one to three years**. Over this period, the markets exhibit definite upward or downward movement which is punctuated by shorter spans of trend reversal in the opposite directions. The trend reversal is called the secondary trend.
- **Primary trend is indicative of the overall pattern of movement.**
- In Dow theory, the primary trend is the major trend of the market, which makes it the most important one to determine. This is because the overriding trend is the one that affects the movements in stock prices. The primary trend will also impact the secondary and minor trends within the market.
- If the primary trend is upward, it is called a bullish phase of the market. If the primary trend is downwards, it is called a bearish phase.
- In a bullish phase, after each peak, there is a fall but the subsequent rise is higher than the previous one. The prices reach higher level with each rise. After the peak has been reached, the primary trend now turns to a bearish phase.
- In a bearish phase, the overall trend is that of decline in share values. After each fall, there is slight rise but the subsequent fall is even sharper.

Secondary Trends

- In Dow theory, a primary trend is the main direction in which the market is moving.
- Conversely, a secondary trend moves in the opposite direction of the primary trend, or as a correction to the primary trend. For example, an upward primary trend will be composed of secondary downward trends.
- In a primary downward trend the secondary trend will be an upward move, or a rally.
- In general, a secondary, or intermediate, trend typically lasts between three weeks and three months, while the retracement of the secondary trend generally ranges between one-third to two-thirds of the primary trend's movement.

Minor Trend

- Minor trends are changes occurring every day within a narrow range.
- These trends are not decisive of any major movement.
- The minor trend is generally the corrective moves within a secondary move, or those moves that go against the direction of the secondary trend.

Q-8 What are the tools of Technical Analysis?

Technical analysts use two major types of tools for their analysis:

- (A) Technical Charts
- (B) Technical Indicators

Q-9 Write a short note on Technical Charts

- These are the plottings of prices and trading volumes on charts.
- The purpose of reading and analysing these charts is to determine the demand-supply equation at various levels and thus to predict the direction and extent of future movement of the prices.
- The charts are not infallible but because of their repeated accuracy, they have come to be accepted.
- In all the charts, a correlation exists between market price action and the volume of trading when the price increase is accompanied by a surge in trading volumes, it is a sure sign of strength.
- On the other hand, when the decline in share prices is accompanied by increased volumes, it is indicative of beginning of bearish trend.

Q-10 What are the four ways to construct a chart?

There are four ways to construct a chart. These are the Line chart, Bar Chart, Candle Stick Chart and Point & Figure Chart.

1. Line Chart

- A Line chart is a style of chart that is created by connecting a series of data points together with a line.
- This is the most basic type of chart used in finance and it is generally created by connecting a series of past prices together with a line.
- Line charts are the most basic type of chart because it represents only the closing prices over a set period.
- The line is formed by connecting the closing prices for each period over the timeframe and the intra period highs and lows of stock prices are ignored.
- This type of chart is useful for making broad analysis over a longer period of time.

2. Bar Chart

- Bar charts expand upon the line chart by adding the open, high, low, and close – or the daily price range, in other words – to the mix.
- The chart is made up of a series of vertical lines that represent the price range for a given period with a horizontal dash on each side that represents the open and closing prices.
- The opening price is the horizontal dash on the left side of the horizontal line and the closing price is located on the right side of the line.
- If the opening price is lower than the closing price, the line is often shaded black to represent a rising period. The opposite is true for a falling period, which is represented by a red shade.

3. Candlestick Charts

- Like a bar chart, candlestick charts have a thin vertical line showing the price range for a given period that is shaded different colors based on whether the stock ended higher or lower.
- The difference is a wider bar or rectangle that represents the difference between the opening and closing prices.
- Falling periods will typically have a red or black candlestick body, while rising periods will have a white or clear candlestick body.
- Days where the open and closing prices are the same will not have any wide body or rectangle at all.

4. Point and Figures Charts

- In this type of charts, emphasis is laid on charting price changes only and time and volume elements are ignored.
- The first step in drawing a figure and point chart is to put a X in the appropriate price column of a graph.
- Successive price increases are added vertically upwards in the same column as long as the uptrend continues.
- Once the price drops, the figures are moved to another column and Os are entered in downward series till the downward trend is reversed.

Q-11 Briefly explain the patterns created by charts

The common patterns are being described below:

1. Support and resistance levels

- A support level indicates the bottom which the share values are unable to pierce.
- After rising time and again, the share price dips to a particular level and then starts rising again. At this level, the share gets buying support.

- A resistance level is that level after which the share price refuses to move up in repeated efforts. At this level, selling emerges.
- Support and resistance levels are valid for a particular time period. Once these levels are breached, beginning of a new bull or bear phase is signaled.

2. **Heads and Shoulders configuration**

- In this type of chart configuration, a formation similar to heads and shoulders is created wherein the neckline acts as the resistance or support line.
- As the head and shoulder top is formed, a resistance level appears at the top of the head.
- The volumes start declining near the head top and reversal sets in.
- The volumes become heavy again and shrink near the neckline where another reversal of trend begins.

3. **Triangle or coil formation**

- This pattern represents a pattern of uncertainty. Hence it is difficult to predict which way the price will break out.

4. **Double Top Formation**

- It represents a bearish development, signaling that the price is expected to fall.

5. **Double Bottom Formation**

- It represents a bullish development, signaling that the price is expected to rise.

Q-12 **What are limitations of charts**

- Interpretation of charts is prone to subjective analysis. This factor is a major cause of often contradictory analysis being derived from the same charts.
- Also the changes in charts are quite frequent in the short term perspective leading to a host of buy and sell recommendations which are not in the best interest of the investor.
- Another disadvantage is that decisions are made on the basis of chart alone and other factors are ignored.

Q-13 **What are the technical indicators?**

Apart from the charts, technical analysts use a number of indicators generated from prices of stocks to finalise their recommendations. These indicators are often used in conjunction with charts. Some of the important indicators are the Advance Decline Ratio, the Market Breadth Index and Moving Averages.

(a) Advance-Decline Ratio

It is the ratio of the number of stocks that increase to the number of stocks that have declined. If the ratio is more than one, the trend is assumed to be bullish. If the ratio starts declining, a change of trend is signaled.

(b) Market Breadth Index

This index is a variation of the Advance-Decline Ratio. This index is computed by taking the difference between the number of stocks rising and the number of stocks falling. If during a month, 400 out of 1000 stocks in the market have risen and 300 have declined while 300 have remained unchanged, then market breadth would be calculated as $= 2(400-300)/300$. The figure of each time period is added to the previous period. If market breadth is increasing along with rise in stock indices, it confirms the bullish trend and vice versa.

(c) Moving Averages

A moving average is the average of share values of a set of consecutive number of days. If we have to calculate 50 days moving average, we calculate the average for days 1–50. Then on day 51, we add the value of day 51 and deduct the value of day 1 and so on. Similarly, moving averages for 100 days, 200 days and 300 days can be calculated. Moving averages provide a benchmark for future valuation. If share value is below the moving average, it has scope for appreciation. If the value is above the moving average, the upside is limited in the near term.

(d) Relative Strength Index

- The relative strength index (RSI) is a momentum indicator used in technical analysis. RSI measures the speed and magnitude of a security's recent price changes to evaluate overvalued or undervalued conditions in the price of that security.
- The RSI is displayed as an oscillator (a line graph) on a scale of zero to 100. The indicator was developed by J. Welles Wilder Jr. and introduced in his seminal 1978 book, *New Concepts in Technical Trading Systems*.
- The RSI can do more than point to overbought and oversold securities. It can also indicate securities that may be primed for a trend reversal or corrective pullback in price. It can signal when to buy and sell. Traditionally, an RSI reading of 70 or above indicates an overbought situation. A reading of 30 or below indicates an oversold condition.
- As a momentum indicator, the relative strength index compares a security's strength on days when prices go up to its strength on days when prices go down. Relating the result of this comparison to price action can give traders an idea of how a security may perform. The RSI, used in conjunction with other technical indicators, can help traders make better-informed trading decisions.

(e) Aroon Indicator

The Aroon indicator is a technical indicator that is used to identify trend changes in the price of an asset, as well as the strength of that trend. In essence, the indicator measures the time between highs and the time between lows over a time period. The idea is that strong uptrends will regularly see new highs, and strong downtrends will regularly see new lows. The indicator signals when this is happening, and when it isn't. The indicator consists of the "Aroon up" line, which measures the strength of the uptrend, and the "Aroon down" line, which measures the strength of the downtrend. The Aroon indicator was developed by Tushar Chande in 1995.

(f) The price rate of Change

The Price Rate of Change (ROC) is a momentum-based technical indicator that measures the percentage change in price between the current price and the price a certain number of periods ago. The ROC indicator is plotted against zero, with the indicator moving upwards into positive territory if price changes are to the upside, and moving into negative territory if price changes are to the downside. Thus, The Price Rate of Change (ROC) oscillator is an unbounded momentum indicator used in technical analysis set against a zero-level midpoint. A rising ROC above zero typically confirms an uptrend while a falling ROC below zero indicates a downtrend. When the price is consolidating, the ROC will hover near zero. In this case, it is important traders watch the overall price trend since the ROC will provide little insight except for confirming the consolidation.

Q-14 Briefly explain 'Risk' in Security Analysis. What are the various kinds of risks?

Risk in security analysis is generally associated with the possibility that the realized returns will be less than the returns that were expected. In finance, different types of risk can be classified under two main groups, viz., systematic risk and unsystematic risk

A. Systematic Risk

- Those forces that are uncontrollable, external and broad in their effect are called sources of systematic risk. Systematic risk is due to the influence of external factors on an organization.
- Such factors are normally uncontrollable from an organization's point of view.
- Systematic risk is a macro in nature as it affects a large number of organizations operating under a similar stream or same domain. It cannot be planned by the organization.
- In this way economic, political and sociological changes are sources of systematic risk.

- For example, if an economy moves into recession or if there is a political upheaval, it will cause the prices of nearly all the securities, whether bond or equity to decline.
- The type of Systematic risk are as follows
 - i. **Interest rate risk** Interest-rate risk is the variation in the single period rates of return caused by the fluctuations in the market interest rate. It particularly affects debt securities as they carry the fixed rate of interest.
 - ii. **Market risk:** Market risk is associated with consistent fluctuations seen in the trading price of any particular shares or securities. That is, it arises due to rise or fall in the trading price of listed shares or securities in the stock market.
 - iii. **Purchasing power or inflationary risk:** Purchasing power risk is also known as inflation risk. It is so, since it emanates (originates) from the fact that it affects a purchasing power adversely. It is not desirable to invest in securities during an inflationary period.

B. Unsystematic Risk

- Unsystematic risk is due to the influence of internal factors prevailing within an organization.
- Such factors are controllable, internal factors which are peculiar to a particular industry or firm/(s). It may be because of change in management, labour strikes which will impact the returns of only specific firms which are facing the problem.
- It is a micro in nature as it affects only a particular organization. It can be planned, so that necessary actions can be taken by the organization to mitigate (reduce the effect of) the risk.
- The type of Systematic risk are as follows
 - i. Business risk
 - ii. Financial risk

Q-15 What are the approaches to valuation of security?

There are three main schools of thought on the matter of security price evaluation. Advocates of different schools can be classified as

(1) Fundamentalists; (2) Technicians; and (3) efficient market advocates.

(1) The Fundamental Approach: The Fundamental approach suggests that every stock has an intrinsic value. Estimate of intrinsic worth of a stock is made by considering the earnings potential of firm which depends upon investment environment and factors relating to specific industry, competitiveness, quality of management, operational efficiency, profitability, capital structure and dividend policy. If the intrinsic value is more than the market value, the fundamentalists recommend buying of the security and vice versa.

(2) Technical Approach: The technical analyst endeavours to predict future price levels of stocks by examining one or many series of past data from the market itself. The basic assumption of this approach is that history tends to repeat itself and the price of a stock depends on supply and demand in the market place and has little relationship with its intrinsic value.

(3) Efficient Capital Market Theory : The theory is popularly known as “Efficient Capital Market Hypothesis: (ECMH). The advocates of this theory contend that securities markets are perfect, or at least not too imperfect. The theory states that it is impossible to beat the market because stock market efficiency causes existing share prices to always incorporate and reflect all relevant information. It is based on the assumption that in efficient capital markets prices of traded securities always fully reflect all publicly available information concerning those securities. Market efficiency was development in 1970 by the economist Eugene Fama, whose theory of efficient market hypothesis stated that it is not possible for an investor to outperform the market because all available information built in to all stock prices.

Q-16 Discuss Random walk theory

- There is another approach which negates both Fundamental and Technical analysis.
- According to the theory, share prices will rise and fall on the whims and fancies of manipulative individuals.
- As such, the movement in share values is absolutely random and there is no need to study the trends and movements prior to making investment decisions.
- No sure prediction can be made for further movement or trend of share prices based on the given prices as at a particular moment.
- The Random Walk Theory is inconsistent with technical analysis. It states that successive price changes are independent, the technicians claim that they are dependent.
- The random walk hypothesis is entirely consistent with an upward and downward movement in price, as the hypothesis supports fundamental analysis and certainly does not attack it.
- One of the advantages of this theory is that one is not bothered about good or bad judgement as shares are picked up without preference or evaluation.
- It is easier for believers in this theory to invest with confidence.
- The second advantage is that there is no risk of being ill informed while making a choice as no information is sought or concealed.
- Random walk theory implies that short term price changes i.e day to day or week to week changes are random but it does not say anything about trends in the long run or how price levels are determined.

Q-17 Discuss efficient market theory

- Efficient Market Hypothesis accords supremacy to market forces. A market is treated as efficient when all known information is immediately discounted by all investors and reflected in share prices.
- In such a situation, the only price changes that occur are those resulting from new information. Since new information is generated on a random basis, the subsequent price changes also happen on a random basis.
- Major requirements for an efficient securities market are:
 - i. Prices must be efficient so that new inventions and better products will cause a firms' securities prices to rise and motivate investors to buy the stocks.
 - ii. Information must be discussed freely and quickly across the nations so that all investors can react to the new information.
 - iii. Transaction costs such as brokerage on sale and purchase of securities are ignored.
 - iv. Taxes are assumed to have no noticeable effect on investment policy.
 - v. Every investor has similar access to investible funds at the same terms and conditions.
 - vi. Investors are rational and make investments in the securities providing maximum yield.
- Research studies devoted to test the random walk theory on Efficient Capital Market Hypothesis (ECMH) are put into three categories i.e.
 - (a) the strong form,
 - (b) the semi-strong form, and
 - (c) the weak form theory.

(a) The Strong Form of Efficiency: This test is concerned with whether two sets of individuals – one having inside information about the company and the other uninformed could generate random effect in price movement. The strong form holds that the prices reflect all information that is known. It contemplates that even the corporate officials cannot benefit from the inside information of the company. The market is not only efficient but also perfect. The findings are that very few and negligible people are in such a privileged position to have inside information and may make above-average gains but they do not affect the normal functioning of the market.

(b) Semi-strong form of Efficiency: This hypothesis holds that security prices adjust rapidly to all publicly available information such as functional statements and reports and investment advisory reports, etc. All publicly available information, whether good or bad is fully reflected in security prices. The buyers and sellers will raise the price as soon as a favourable price of information is made available to the public; opposite will happen in case of unfavourable piece of information. The reaction is almost instantaneous, thus, printing to the greater efficiency of securities market.

(c) The Weak Form theory: This theory is an extension of the random walk theory. According to it, the current stock values fully reflect all the historical information. If this form is assumed to be correct, then both Fundamental and Technical Analysis lose their relevance. Study of the historical sequence of prices, can neither assist the investment analysts or investors to abnormally enhance their investment return nor improve their ability to select stocks. It means that knowledge of past patterns of stock prices does not aid investors to make a better choice. The theory states that stock prices exhibit a random behaviour. In this way, if the markets are truly efficient, then the fundamentalist would be successful only when (1) he has inside information, or (2) he has superior ability to analyse publicly available information and gain insight into the future of the company. The empirical evidence of the random walk hypothesis rests primarily on statistical tests, such as runs test, correlation analysis and filter test. The results have been almost unanimously in support of the random walk hypothesis, the weak form of efficient market hypothesis.

Practical Questions

- Q-1** Mr. A invested Rs. 10,000 in shares of XYZ Company 10 years ago, and that your shares (including reinvested dividends) are currently worth Rs. 23,800. Using this information, calculate total investment return of Mr. A.
- Q-2** Three years ago, Fred invested \$10,000 in the shares of ABC Corp. Each year, the company distributed dividends to its shareholders. Each year, Fred received \$100 in dividends. Note that since Fred received \$100 in dividends each year, his total income is \$300. Today, Fred sold his shares for \$12,000, and he wants to determine the HPR of his investment.
- Q-3** What is the HPR for an investor, who bought a stock a year ago at \$50 and received \$5 in dividends over the year, if the stock is now trading at \$60?
- Q-4** Which investment performed better: Mutual Fund X, which was held for three years and appreciated from \$100 to \$150, providing \$5 in distributions, or Mutual Fund B, which went from \$200 to \$320 and generated \$10 in distributions over four years?
- Q-5** An investor is holding 1000 shares of Right Choice Ltd. The current rate of dividend paid by the company is ₹ 5/- per share. The long term growth rate is expected to be 10% and the expected rate of return is 19.62%. Find out the current market price of the share.
- Q-6** Using the following information calculate expected return: Current yield on a U.S. 10-year treasury is 2.5% The average excess historical annual return for U.S. stocks is 7.5% The beta of the stock is 1.25.
- Q-7** Winner Corporation stock will pay a dividend of \$1.32 next year. Its current price is \$24.625 per share. The beta for the stock is 1.35 and the expected return on the market is 13.5%. If the riskless rate is 8.2%, what is the expected growth rate of Winner Corporation?
- Q-8** Peak Services Ltd. common stock has a $\beta = 1.15$ and it expects to pay a dividend of \$1.00 after one year. Its expected dividend growth rate is 6%. The riskless rate is currently 12%, and the expected return on the market is 18%. What should be a fair price of this stock?
- Q-9** Wonderful Oil stock currently sells at \$120 a share. The stockholders expect to get a dividend of \$6 next year, and they expect that the dividend will grow at the rate of 5% per annum. The expected return on the market is 12% and the riskless rate is 6%. Wonderful Oil announced that it has won the multimillion dollar navy contract, and in response to the news, the stock jumped to \$125 a share. Find the beta of the stock before and after the announcement.
- Q-10** A Ltd has just declared a dividend of Rs. 10 per share. (Dividend ratio 100%) The ROE of the company is 20%, while EPS has been Rs. 40 per share. If the Investor required rate of return is 20%, then what should be the price per share?

Chapter 25: Operational Approach to Financing Decision

Q-1 Define cost

- ✓ Cost is the amount of resource given in exchange for some goods or services.
- ✓ The Chartered Institute of Management Accountants (CIMA), London defines cost as “the amount of expenditure (actual or notional) incurred on or attributable to a specified thing or activity”.
- ✓ Cost is the amount of expenditure (actual or notional) incurred on, or attributable to a specified thing or activity.

Q-2 Explain the nature of Costing

1. **Cost Accounting is a Branch of Knowledge**-Though cost accounting is considered as a branch of financial accounting, it is one of the important branches of knowledge. It is an organized body of knowledge consisting of its own principles, concepts and conventions. These principles and rules vary from industry to industry.
2. **Cost Accounting is a Science**- Cost accounting is considered as a science because it is a body of systematic knowledge relating to not only cost accounting but relating to a wide variety of subjects such as law, office practice and procedure, data processing, production and material control, etc. It is necessary for a cost accountant to have intimate knowledge of all these field of study in order to carry on day-to-day activities. But it is to be admitted that it is not a perfect science as in the case of natural science.
3. **Cost Accounting is an Art**. Cost accounting is an art in that it calls on the ability and expertise of a cost accountant to apply the concepts, procedures, and methods of cost accountancy to specific management issues. These issues include determining cost control, determining profitability, and other issues.
4. **Cost accounting is a profession**. In recent years, cost accounting has emerged as one of the crucial and most difficult occupations. These two facts make this opinion clear. First, the establishment of numerous professional organisations, including the National Association of Accountants (NAA), the Institute of Cost and Management Accountants in the United Kingdom, the Institute of Cost and Works Accounts in India, and similar organizations in developed and developing nations, has increased public awareness of the costing profession. Second, many students have enrolled in these institutions in order to gain expensive degrees and membership necessary for supporting themselves.

Q-3 Explain important objectives of Costing.

1. Ascertainment of Cost

The first and most significant goal of costing is cost determination. In order to ensure that all costs are included in the price of the products, techniques, and costing process employed, it is important to ascertain the cost of each product, process, or operation. It is beneficial to do preliminary research and implement a system for recording costs in order to determine the cost of management with the assistance of the costing department.

- Materials, labour, and other expenses are maintained in a correct and thorough manner (referred to as covered heads). As a result, the management gathers cost information on a regular basis, which is then used to establish the selling price. Therefore, the costs and sales are equal. This matching procedure assists in determining and raising the product's profitability. Importantly, costing gives managers a way to determine costs as well as a foundation for determining the profitability of any services or products being provided.
2. **Cost Control** Cost estimation alone is insufficient. Naturally, it is insufficient because the cost dictates the selling price, which in turn decides the profitability. As a result, "the lower the cost, the larger to profit" is the standard that everyone tries to adhere to. It's crucial to keep costs under control in order to bring about this norm's fundamental goal of lower prices for goods and services. A comparison is conducted after budgets have been created, standards have been established, and actual have been determined. Corrective action is conducted if any discrepancy between the actual, the budget, and the standards is found. As a result, managers can increase their income or lower the selling price while also helping to control costs. As a result, the customer can gain from higher quality, which can increase consumer loyalty to the brand and business.
 3. **Guidelines for Management** The devoted servant of managers in a company is costing. In all practical respects, it supports managerial decision-making. Managers can work toward efficiency for the entire organisation with the use of cost data that comes from costing. Cost information offers organisational recommendations for different managerial choices. For instance, the utilisation of cost data might direct the launch of a new product line, reveal areas of untapped capacity, or draw attention to growth prospects.

Q-4 What are the advantages of Costing.

Advantages of Costing

Costing gives useful cost information. As a result, it is crucial in managerial decision-making. A sound costing system is also important in order to provide high-quality services. The costing department has a significant impact on the benefits managers gain from costing, notably in the following dimensions:

- i. **Measurement and Improvement of Efficiency:** The chief advantage to be gained is that Cost Accounting will enable a concern to, first of all, measure its efficiency and then to maintain and improve it. This is done by suitable comparisons and analysis of the differences that may be observed. Example- if materials spent upon a pair of shoes in 2022 comes to Rs. 100 and for a similar pair of shoe the amount is Rs. 120 in 2023. It is an indication of decline in efficiency. Of course, the increase may only be due to increase in price of materials; it may also be due to greater wastage in use of materials or inefficiency at the time of buying so that unnecessary high prices were paid.
- ii. **Profitable and Unprofitable Activities:** It will throw light upon those activities which bring profits and those activities which result in losses. This will be done only if the cost of each product or each job is ascertained and compared with the price obtained.
- iii. **Fixation of Prices:** In many cases a firm is able to fix a price for its products on the basis of the cost of production.

- iv. **Guide in Reducing Prices:** In certain periods it becomes necessary to reduce the price even below the total cost. This will be so when there is a depression or slump. Costs, properly ascertained, will guide management in this direction.
- v. **Information for Proper Planning:** For a proper system of Costing, it is necessary to have detailed information about the facilities available about machine and labour capacity. This helps in proper planning of work so that no section is overworked and no section remains idle.
- vi. **Control over Materials etc.:** Information about availability of stocks of various materials and stores must be constantly available if there is a good system of Cost Accounting.
- vii. **Expansion in Production:** Sometimes it is necessary to decide whether production of one product or the other is to be increased. This problem can also be solved only if proper information about costs is available.
- viii. **Reasons for Losses Detected:** Exact causes of existence of profits or losses will be revealed by a system of Cost Accounting.
- ix. **Helps in Taking Decisions:** Cost Accounting inculcates the habit of making calculations with pencil and paper before taking a decision. It will certainly check recklessness. Also some of the silly mistakes that sometimes occur can be avoided if there is a good Cost Accounting system.

Q-5 What are the limitations of cost accounting?

Like other branches of accounting, cost accounting is also having certain limitations. The limitations of cost accounting are as follows:

1. **Expensive:** It is expensive because analysis, allocation and absorption of overheads require considerable amount of additional work, and hence additional money.
2. **Requirement of Reconciliation:** The results shown by cost accounts differ from those shown by financial accounts. Thus preparation of reconciliation statements is necessary to verify their accuracy.
3. **Duplication Work:** it involves duplication of work as organization has to maintain two sets of accounts i.e. Financial Accounts and Cost Accounts.
4. **Inefficiency:** Costing system itself does not control costs but its usage does.

Q-6 What are the basic principles of Costing

Basic Principles of Costing

- i. **Cause-and-effect relationships:** For each expense component, a cause-and-effect link needs to be defined. Each cost should be as closely tied to its root cause as feasible, and its impact on the various departments should be determined. Only units that travel through the departments at which a cost has been incurred should share that cost.
- ii. **Previous Costs That Could Not Be Collected in the Past Should Not Be Included in Future Costs:** Recovering past costs that could not be recovered in the past should not be done since it will not only skew the results of the future period's actual operations but also other statements.
- iii. **Charge of Cost Only Upon Incurrence:** Only costs that have been legitimately incurred should be included in unit costs. For instance, unit costs shouldn't be included in selling costs while an item is still being produced.

- iv. **Abnormal Costs Are Excluded from Cost Accounts:** When calculating the unit cost, all expenses incurred for unusual causes (such as theft or negligence) shouldn't be taken into account. If done thus, it will skew expense estimates and mislead management, leading to poor choices.
- v. **Double Entry Principles Preferably Should Be Obeyed:** Cost ledgers and cost control accounts should, to the greatest extent possible, be maintained using double entry methods to reduce the likelihood of any error or mistake. By doing this, the accuracy of cost sheets and cost statements that are created for cost estimation and cost control would be guaranteed.

Q-7 What are elements of cost?

- ✓ The elements that constitute the cost of manufacturing are known as the elements of cost. Such elements of cost are divided into three categories. In a manufacturing concern raw materials are converted into a finished product with the help of labour and other service units.
- ✓ There are three broad elements of costs:
 - (1) Material
 - (2) Labour
 - (3) Expenses
- ✓ Material, Labour, Expenses can be divided into direct and indirect cost.
- ✓ Direct Material, Direct Labour and Direct Expenses when combined together are known as Prime Cost.
- ✓ Indirect Material, Labour and Expenses when combined together are termed as Overheads.