

CS-EXECUTIVE

CAF_M

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THEORY QUESTIONS ANSWERS





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On behalf of TEAM YES

CS VIKAS VOHRA
(Founder)

CA CS HARISH A. MATHARIYA
(Founder)

FROM THE AUTHOR

- ✦ This book is for all the students aspiring to make the grade in the Professional Examination.
- ✦ **CORPORATE ACCOUNTING & FINANCIAL MANAGEMENT** subject is both interesting & easy to understand.
- ✦ This subject has utility value in day-to-day commercial activities.
- ✦ Trends shows that, there is a scope for securing high-score in this subject.
- ✦ This book is not a substitute for the Study Material prescribed by the Institute, as I believe,
- ✦ **“There is no short cut to success”**

DEDICATED TO

- ✦ **To my Family:** “Who are Divine Source of Power to me, who always stood beside me in every phase of my Life”
- ✦ **To My Love:** Manisha Soni
- ✦ **Most special regards:** Parents gave me birth, you gave me the identity. I am, who I am is because of all of you, my most lovable STUDENTS.
- ✦ **To My Competitors:** who gave me the ability to sharpen my skills and improve each day
“The only person you are destined to become is the person you decide to be”
I believe these words shall motivate you throughout this journey

HOW TO STUDY?

Step 1

- Develop a liking for the subject, for this you need to be; **Regular in class & Write down all notes neatly.**

Step 2

- For each topic **spend proper time in reading the theory part (concept)**
- Before solving problems **read question very slowly then decide approach to solve it.**
 - Read problem with **high concentration** giving importance to every punctuation
 - **Remembering** contents of question until the solution is completed; for each step you should be able to immediately pick up data without a second reading.
 - **Visualizing** steps for the solution, the layout, tabulation format, number of columns, etc.
 - **Maintain good speed** so that solution is completed within time (5 marks = 8 minutes.)
- **Write down your solutions in a note book. Do not jump to see the solution.**

Step 3

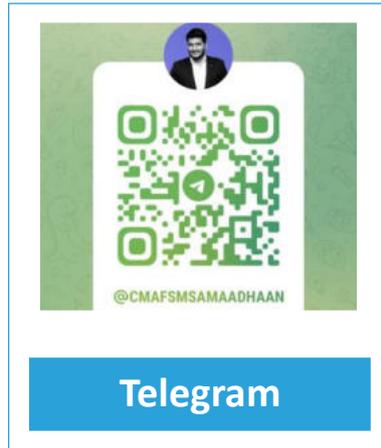
- After you finish a topic, prepare **summary notes (covering all important points)**
- **“Revise” your hand-made summary notes periodically then “Try to Recall”**
- **Solve Topic-wise Test**

Step 4

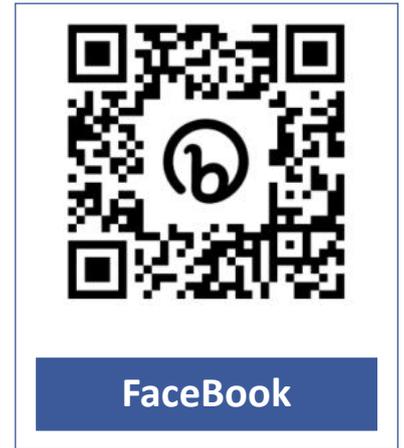
- Before your exams **revisit summary notes & all-important problems as many times as possible.**
- Solve two or three past exam question papers and solve them under simulated exam conditions so that you get smooth, flow of thoughts, hand – mind coordination and most importantly confidence



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CORPORATE ACCOUNTING & FINANCIAL MANAGEMENT

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Topic 1

INTRODUCTION TO ACCOUNTING

Question 1

WHAT ARE THE DIFFERENT FORMS OF ORGANIZATION ?

Answer:

The business activity is carried out by people coming together with a purpose to serve a common cause. This term is often referred to as an organization, which could be in different forms such as sole proprietorship, partnership, corporate body, etc.

- **Sole proprietorship:** A sole proprietorship, also known as a sole trader, is owned by one person and operates for their benefit. All assets of the business belong to a sole proprietor, including, for example, a computer infrastructure, any inventory, manufacturing equipment, or retail fixtures, as well as any real property owned by the sole proprietor.
- **Partnership:** A partnership is a business owned by two or more people. In most forms of partnerships, each partner has unlimited liability for the debts incurred by the business. The three most prevalent types of for-profit partnerships are general partnerships, limited partnerships, and limited liability partnerships.
- **Corporation:** The owners of a corporation have limited liability and the business has a separate legal personality from its owners. Corporations can be either government-owned or privately owned, and they can organize either for profit or as non-profit organizations.
- **Co-operative:** Often referred to as a “co-op”, a co-operative is a limited-liability business that can organize as for-profit or not-for-profit. A cooperative differs from a corporation in that it has members, not shareholders, and they share decision-making authority.
- **Franchises:** A franchise is a system in which entrepreneurs purchase the rights to open and run a business from a larger corporation. Franchising in the United States is widespread and is a major economic powerhouse.
- **A company limited by guarantee:** Commonly used where companies are formed for non-commercial purposes, such as clubs or charities. The members guarantee the payment of certain (usually nominal) amounts if the company goes into insolvent liquidation, but otherwise, they have no economic rights in relation to the company. A company limited by guarantee may be with or without having share capital.
- **A company limited by shares:** The most common form of the company used for business ventures. Specifically, a limited company is a “company in which the liability of each shareholder is limited to the amount individually invested” with corporations being “the most common example of a limited company.”
- **A company limited by guarantee with a share capital:** A hybrid entity, usually used where the company is formed for non-commercial purposes, but the activities of the company are partly funded by investors who expect a return.

- An unlimited company with or without a share capital: A hybrid entity, a company where the liability of members or shareholders for the debts (if any) of the company are not limited. In this case, the doctrine of a veil of incorporation does not apply.

Question 2

What is the position of the resources acquired and used for business purposes? How are these resources financed and where do the funds come from ?

Answer:

The position of resources acquired and used for business purposes refers to the location or state of these resources within the company's operations. It typically includes physical assets such as buildings, machinery, equipment, inventory, and raw materials, as well as intangible assets like patents, trademarks, and software.

The financing of these resources can vary depending on the specific circumstances of the business. Here are some common

Methods of financing resources:

1. **Equity financing:** this involves raising funds by selling ownership shares in the company to investors. Equity financing can come from founders, private individuals, venture capitalists, or through the issuance of stocks in public markets.
2. **Debt financing:** businesses can acquire resources by borrowing money from lenders such as banks, financial institutions, or private lenders. Debt financing requires repayment of the borrowed amount plus interest over a specified period.

Retained earnings: a company can use its internally generated profits, known as retained earnings, to finance its resource acquisitions. By reinvesting a portion of its earnings back into the business, a company can fund its growth and resource needs

3. **Leasing and renting:** Instead of outright purchasing resources, businesses may choose to lease or rent them. This approach allows companies to acquire and use resources without requiring significant upfront capital. Lease payments are typically made on a periodic basis.
4. **Grants and subsidies:** In certain cases, businesses may receive grants or subsidies from government agencies, non-profit organizations, or other sources. These funds can be specifically allocated for acquiring and using certain types of resources, such as research and development grants or energy efficiency subsidies.
5. **Trade credit:** Suppliers sometimes offer trade credit to their customers, allowing them to acquire resources with a deferred payment period. This arrangement provides short-term financing for the resources used in business operations.

It's important to note that the specific mix of financing sources can vary depending on factors such as the nature of the business, its industry, size, growth stage, creditworthiness, and market conditions. Different companies employ different strategies to acquire and finance resources based on their unique circumstances.

Question 3

Difference between book keeping and accounting ?

Answer:

Book-Keeping	Accounting
Output of book-keeping is an input for accounting.	Output of accounting permits informed judgments & decisions by the user (stakeholders) of accounting information.
Purpose of book-keeping is to keep systematic record of Transactions and events of financial character in order of occurrence.	Purpose of accounting is to find results of operating activity of a business and to report its financial strength.
Book-keeping is the foundation of accounting.	Accounting is considered as a language of business.
Book-keeping is carried out by the junior staff.	Accounting is done by the senior staff who have skills of analysis and interpretation.
Objective of book-keeping is to summarize the cumulative effect of all economic transactions of business for a given period by maintaining permanent record of each business transaction with its evidence & financial effects on accounting variable.	Object of accounting is not only book-keeping but also analysing and interpreting reported financial information for informed decisions by the stake-holders or user of financial statement.

Question 4

Explain what is double entry system with advantages and limitations.

Answer:

Double-entry bookkeeping, also known as double-entry accounting, is a method of bookkeeping that relies on a two-sided accounting entry to maintain financial information. Every entry to an account requires a corresponding and opposite entry to a different account. The double-entry system has two equal and corresponding sides known as debit and credit.

Advantages of Double Entry System

- Since personal and impersonal accounts are maintained under the double entry system, both the effects of the transactions are recorded.
- 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.
- It prevents and minimizes error. More over frauds can be detected early.
- Errors can be checked and rectified easily.

- The balances of receivables and payables are determined easily, since the personal accounts are maintained.
- The businessman can compare the financial position of the current year with that of the past years.
- 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.
- Helps in decision-making.
- 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.
- It helps the Government to decide sickness of business units and extend help accordingly.
- The other stakeholders, like suppliers and banks can take a proper decision regarding grant of credit or loans.

Limitations of Double Entry System

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

Question 5

What are the golden rules of accounting? Illustrate rules with example.

Answer:

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 whether the account is to be debited or credited. These rules are shown below:

Personal rule:

Debit the receiver, credit the giver

Real rule:

Debit what comes in , credit what goes out

Nominal rule :

Debit all expenses and losses , credit all income and gain

- (a) debit the receiver, credit the giver

The principle "debit what comes in" implies that asset accounts are debited when they increase. Assets are things of value that a company owns or has a claim to. Conversely, the principle "credit what goes out" means that asset accounts are credited when they decrease. These principles are essential for maintaining the balance in the accounting equation, where assets equal liabilities plus equity.

Illustrations :

- **Debit what comes:**

When a company receives cash from a customer as payment for goods sold, it will debit the cash account. This transaction increases the cash balance, which is considered an asset.

- **Credit what goes out:**

When a company pays cash to a vendor for purchasing supplies, it will credit the cash account. This transaction decreases the cash balance, which is an asset.

(b) Debit all receiver or who owes business Credit the giver or the business owner

The principle "Debit the receiver a/c" suggests that the account receiving the benefit or the asset is debited. Conversely, the principle "Credit the given a/c" indicates that the account giving or providing the benefit is credited.

Illustrations :

- **Debit the receiver a/c:**

When a company receives cash from a customer as payment for services rendered, it will debit the accounts receivable account. This transaction increases the accounts receivable balance, representing the amount owed by the customer.

- **Credit the given a/c:**

When a company pays cash to a supplier for purchasing goods, it will credit the accounts payable account. This transaction decreases the accounts payable balance, representing the amount owed to the supplier.

(c) Debit all expenses and losses , credit all income and gain

The principle "Debit all expenses and loss" indicates that expense and loss accounts are debited to increase their balances, representing the reduction in assets or increase in liabilities. On the other hand, the principle "Credit all income and gains" suggests that income and gain accounts are credited to increase their balances, representing the increase in assets or decrease in liabilities.

Illustration :

- **Debit all expenses and loss:**

When a company pays for rent expense, it will debit the rent expense account. This transaction increases the rent expense balance, representing the cost incurred by the company.

- **Credit all income and gains:**

When a company earns revenue from the sale of products, it will credit the sales revenue account. This transaction increases the sales revenue balance, reflecting the income generated by the company.

Question 6

Illustrate with examples the difference between “Event” and “Transaction

Answer:

Event	Transaction
<p>Events refer to occurrences or happenings that may or may not directly impact the financial records. They are often important from an informational or decision-making perspective.</p>	<p>Transactions specifically involve the exchange of economic resources, resulting in changes to the financial records, such as cash, accounts receivable, accounts payable, and various income and expense accounts. Transactions are the primary focus of accounting as they form the basis for recording and reporting financial information.</p>
<p>Illustration for Event in Accounting:</p> <ul style="list-style-type: none"> An annual general meeting held by a company where shareholders and stakeholders gather to discuss financial statements and vote on important matters. This is an event because it is a significant occurrence related to the company's operations, but it may not directly impact the financial records or result in specific transactions. 	<p>Transaction in Accounting:</p> <ul style="list-style-type: none"> A customer purchases goods on credit from a company. This transaction involves an exchange of goods (inventory) for accounts receivable. The financial records must reflect the increase in sales revenue and the corresponding increase in accounts receivable. A company pays its monthly rent expense. This transaction involves the exchange of cash for the right to use a property for a specific period. The financial records must reflect the decrease in cash and the decrease in the company's rent expense.

Question 7

Even a small amount of the transaction can be considered as material transaction. Explain How?

Answer:

1. Materiality is an accounting principle which states that all items that are reasonably likely to impact investors' decision-making must be recorded or reported in detail in a business's financial statements using GAAP standards. Materiality is a concept that defines why and how certain issues are important for a company or a business sector. A material issue can have a major impact on the financial, economic, reputational, and legal aspects of a company, as well as on the system of internal and external stakeholders of that company. Both nature and volume of a transaction is capable to make it material.
2. In accounting, materiality refers to the concept that transactions or information should be recorded and disclosed if they could influence the decision-making of financial statement users. Materiality is a relative concept and can vary depending on the size, nature, and context of the transaction or information. Here's how even a small amount of a transaction can be considered material:

- **Context and Perspective:**

Materiality is assessed based on the context and perspective of the financial statement users. The same transaction could be material for a small business where every transaction has a greater impact on financial results

- **Cumulative Effect:**

Materiality can also consider the cumulative effect of small transactions. Even if individual transactions seem insignificant, their cumulative impact could become material.

- **Legal and Regulatory Requirements:**

Some legal or regulatory requirements may specify certain thresholds or limits for reporting transactions.

- **Industry Norms and Expectations:**

Materiality is influenced by industry norms and expectations. What may be considered immaterial in one industry could be material in another.

Question 8

Point out the accounts which will be debited and credited for each one of the following transactions

Answer:

• Cash received from X and discount allowed to him.	• Salary paid to clerk by means of cheque.
• Cash paid to Y and discount received from him.	• Payment of cash to landlord for rent.
• Credit Sales to Z.	• Depreciation on furniture.
• Cash Sales to A.	• Interest due but not yet paid.
• Purchases from B on credit.	• Interest provided on capital.

Question 9

What is ledger? what are the types of ledgers under Accounting?

Answer:

In accounting, a ledger is a fundamental and essential component of the double-entry bookkeeping system, which is used to record and manage a company's financial transactions. A ledger serves as a primary repository for financial data and helps in organizing and summarizing the financial information of a business. There are two main types of ledgers:

1. **General Ledger (GL):** The general ledger is the core ledger in accounting. It contains all the accounts necessary to track a company's financial activities. Each account within the general ledger represents a specific financial category, such as cash, accounts receivable, accounts payable, revenues, expenses, and more. For every transaction that occurs, there are at least two entries made in the general ledger: a debit entry and a credit entry. This is known as the double-

entry system, and it ensures that the accounting equation (Assets = Liabilities + Equity) remains in balance.

For example, when a business makes a sale on credit, the general ledger will record an increase in accounts receivable (debit) and an increase in revenue (credit).

2. Subsidiary Ledger: Subsidiary ledgers, also known as sub-ledgers or subsidiary accounts, are used to provide detailed information for specific accounts within the general ledger. They are often used for accounts with many individual transactions or subsidiary accounts like accounts receivable and accounts payable. Subsidiary ledgers help in tracking and managing the details of these accounts, making it easier to analyze specific transactions and account balances.

Further ledger can be divided into two type: personal & impersonal ledger

(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.

There are two type of personal ledger namely

1. Debtor ledger
2. Creditor ledger

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

There are two types of impersonal ledger

1. CASH BOOK
2. GENERAL LEDGER

Question 10

What is trial balance? list out the features of it.

Answer:

- A trial balance is a fundamental financial statement in accounting that lists the balances of all the general ledger accounts of a company at a specific point in time.
- It serves as an internal tool to verify that the double-entry bookkeeping system is in balance and that the total debits equal total credits.
- The final list of balances, totalled and combined, is called Trial Balance”.
- The balance of debit and credit in the total of TB shall be same due to double entry system
Debit Balance - All Assets, Drawings, Debtors, Expenses and Losses.
Credit Balance - All Liabilities, Capital, Creditors, Gains and Incomes.

Features of a Trial Balance

- It is a list of debit and credit balances which are extracted from various ledger accounts.
- It is a statement of debit and credit balances.
- The purpose is to establish arithmetical accuracy of the transactions recorded in the Books of Accounts.
- It is not an account. It is only a statement of account.

- It is not a part of the financial statements.
- 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.

It is a link between the Books of Accounts, Profit and Loss Account and Balance sheet.



Topic 2

INTRODUCTION TO CORPORATE ACCOUNTING

Question 1

Director of Manmaani Ltd. wants to keep its records on cash basis of accounting at its branch office. Explain whether the contention of its director is correct or not with the relevant provisions of companies act. OR

What is proper books of accounts?

Answer:

Applicable Provision: (Proper Books of Accounts)

- As per Section 128 of Companies Act, 2013 **every company** shall prepare & **keep at its registered office**
- **Books of account and other relevant books and papers** and financial statement for every financial year
- Which give a **true & fair view** of the state of the affairs of company, including its branch office, if any
- Such books **must explain the transactions** effected both at the registered office and its branches and
- such books **shall be kept on accrual basis** and **as per double entry system** of accounting
- Company **may keep** such books of account **in electronic mode**

Fact of the case:

Director of given company wants to maintain books on cash basis

Conclusion:

In the light of above discussion we can say that, **contention of director is NOT correct**, given company must maintain its books of accounts **on accrual basis & as per Double entry system**

Question 2

Chief Financial Officer of Sheela Ltd does not maintain its books of accounts manually. What are the other options available related to the same?

Answer:

Applicable Provision:

- Company may keep such books of account **in electronic mode**

Manner of Books of Account to be kept in Electronic Mode:

- Books & papers **maintained in electronic mode shall remain accessible in India, at all times**, so as to be usable for subsequent reference
- **On or after April 01, 2023**, every company shall use only such **accounting software**
- which has a **feature of recording audit trail** of each and every transaction, **creating an edit log of each change made** in books of account **along with the date** when such changes were made and
- Ensuring that the **audit trail cannot be disabled** & Information **shall remain complete & unaltered**
- Such books of account and papers shall be **retained completely in the format** in which they were **originally generated, sent or received**, or in a format which shall **present accurate** information &
- There shall be a proper **system for storage, retrieval, display or printout** of the electronic records
- Also, **back-up** of such books, shall be kept **in servers physically located in India** on a daily basis.

Conclusion:

Thus, CFO of Sheela Ltd **can opt for option to maintain books of accounts in electronic mode** in above mentioned manner

Question 3

Director of the Bambani Ltd wants financial information of its London branch. As a company secretary you are required to provide guidance on above matter.

Answer:

Books of account & other books maintained by company within India

shall be open for inspection at the registered office of the company or at such other place in India by any director during business hours

If books of accounts maintained outside the country:

Copies of such financial information shall be maintained and produced for inspection by any director subject to such conditions as mentioned below:

- **Summarised returns** of the books of account outside India shall **be sent to the registered office at quarterly intervals** & kept open to directors for inspection
- **director shall furnish a request** to the company setting out the full details of required financial information
- company shall produce such financial information **within 15 days of date of the written request**
- Such, information shall be **sought for by the director himself** & not by or through his power of attorney holder or agent or representative

Inspection in respect of any subsidiary:

- Shall be done only by the **person authorised in this behalf by a resolution of the Board** of Directors

Conclusion:

Thus, director of Bambani Ltd may follow the above procedure for getting financial information.

Question 4

Explain the provisions related to “Period for Retention of Books of Accounts”

Answer:

Period for Retention of Books of Accounts

- Books of account shall retain for a **period not less than eight financial years** immediately preceding a financial year, or
- where the company had been in **existence for a period less than eight years**, in respect of **all the preceding years**
- **together with the vouchers** relevant to any entry shall be kept in good order
- where an **investigation** has been ordered Central Government may direct that the books of account **may be kept for such longer period** as it may deem fit.

Penalty:

- If any officer of the company charged by the Board with the duty to maintain books of accounts, **contravenes** provisions of this section,
- such officer shall be punishable with fine which shall not be less than ₹ 50,000/- **which may extend to ₹ 5,00,000.**

Question 5

State the provisions of the Section 129 of the Companies Act, 2013 relating to 'financial statements'.

What are the provisions relating to laying and adoption of financial statements? Explain the law relating to authentication of financial statements.

Answer:

Provisions of section 129:

- Financial statements shall give a **true and fair view** of the state of affairs of a company
- **Financial St & its items** comply with the **accounting standards** notified under **Section 133** and
- shall be in the **form as provided in Schedule III**
- **Provisions of this section not applies to:**
 - **Banking company,**
 - **Insurance company,**
 - **Electricity company &**
 - **Companies governed by special act**
 - financial statements shall **not be treated as not disclosing a true and fair view** merely by reason that, above mentioned company **not disclosed any matters which are not required to be disclosed by the respective governing acts**
- At every AGM of a company, the **BOD shall lay before all members,** financial statements
- Where a company has **one or more subsidiaries,** it shall **prepares a consolidated financial statement (As per AS 21)** of the company in the **same manner** & shall lay before members
- company shall **also attach, a separate statement of salient features** of the financial statement of its **subsidiary** or subsidiaries
- If Financial statements do **not comply with AS,** the company shall **disclose, the deviation** from AS, the reasons & its financial effects
- **Central Government** may, on its own or on an application, by notification, **exempt any class or classes of companies** from complying with any of the requirements of this section or the rules made thereunder, if it is considered necessary to grant such exemption
- **Penalty:** If any person in charged by the board **contravenes this section,** punishable with **imprisonment up to 1 year or with a fine 50,000 to 5,00,000 or with both.** In the absence of any of such person, all the directors are liable for above mentioned punishment

Question 6

Write down the features of SCHEDULE III OF THE COMPANIES ACT, 2013

Answer:

- **Balance Sheet must be in vertical format** with categories of items into **current & non-current**
- Statement of **Profit & Loss also in vertical format** with classification of **expenses based on nature**
- Concept of “Schedules” replaced with “Notes to Accounts”.
- It does **not contain any specific disclosure** for items under the head, “Miscellaneous Expenditure”.
 - As per Accounting Standard-16 **borrowing cost** and discount or premium relating to borrowing could be **amortized over the loan period.**
 - Share **issue expenses, discount on shares, premium** on borrowing, etc. are excluded from AS-26. These items **be amortized over the period of benefit,** i.e., normally 3-5 years
 - **Guidance note** issued by ICAI suggests that **unamortized portion of such expenses** be shown under the head “**Other Current/Non-current Assets**” depending on whether the amount will be amortized in the next 12 months or thereafter.
- **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** (its preparation continues to be as per AS-3)

- It gives prominence to Accounting Standards (AS) over schedules

Question 7

Explain the rules relating to rounding off of figures appearing in the Financial Statements

Answer:

Depending upon the Total income of the company, the figures shall be rounded off as given below:

	Total Income	Rounding off
(a)	less than one hundred crore rupees	To the nearest hundreds, thousands, lakhs or millions, or decimals thereof.
(b)	one hundred crore rupees or more	To the nearest lakhs, millions or crores, or decimals thereof.

Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

Question 8

An auditor of a company signed the balance sheet, profit & loss account and schedules/ notes and furnished the auditor's report on the same date on which the reports were signed by the directors on behalf of the board. On the director raised objection stating that the audit cannot be completed and certified in a day. Do you agree with directors and if not, why?

Answer:

Time gap between authentication of accounts and signing by auditor:

As section 143 gives the auditors access at all times to the books of account and vouchers of the company, which amply suggests that they do not have to remain idle at any time after their appointment as auditors.

Subject to the convenience of the company, he may actually commence the checking up of vouchers, etc., and the company may prepare Trial balances, balance sheets etc, which will save time for the auditors in the preparation of their report in due course.

Thus, if the auditor signs the balance sheet on the same date on which the directors have approved it, it may not be inferred from the circumstances that the auditor has not performed the audit efficiently.

Conclusion: There is no violation of respective section where the audit is completed before approval of the balance sheet by the Board of directors.

Question 9

State how you would present ' Rights, Preferences and Restrictions attaching to shares including restrictions on the distribution of Dividends and the Repayment of Capital' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

- **For Equity Share Capital:** such rights / preferences / restrictions may be with voting rights, or with differential voting rights as to dividend, voting or otherwise as per Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001.
- **For Preference Shares:** the rights include dividend and/ or capital related rights. Further, Preference Shares can be cumulative, non-cumulative, redeemable, convertible, non- convertible, etc.
- All such Rights, Preferences and Restrictions attached to each class of Shares, terms of redemption, etc., should be disclosed separately.

Question 10

State how you would present ' List of Shareholders holding more than 5% shares as on the Balance Sheet Date' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

- Companies should disclose the Shareholding for each class of Shares, both within Equity and Preference Shares. So, such% should be computed separately for each class of Shares.
- Date for computing the 5% limit should be taken as the Balance Sheet date. So, if during the year, any Shareholder held more than 5% Equity Shares but does not hold as much at the Balance Sheet date, disclosure is not required.
- This information should also be given for comparative previous period.

Question 11

State how you would present ' money received against share warrants' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

- Such item to be shown as a separate line item on the face of Balance Sheet
- In case of Listed Companies, share warrants are issued to Promoters & others in terms of the Guidelines for Preferential Issues.
- Effectively, Share Warrants are amounts which would ultimately form a part of the Shareholder's Funds.
- As, Shares are yet to be allotted against the same, these are not reflected as a part of Share Capital, but as a separate line- item

Question 12

State how you would present ' Long Term Borrowings' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

Long-Term Borrowings shall be classified as:

- **Bonds/Debentures**
- **Terms Loans** from Banks, and from Other Parties: Loans with repayment period beyond 36 months are usually known as “Term Loans”.
- **Deferred Payment Liabilities:** include any Liability for which payment is to be made on deferred credit terms, e.g., Deferred Payment for Acquisition of fixed Assets, etc
- **Deposits:** classified under Borrowings would include Deposits accepted from Public and Inter-Corporate Deposits which are in the nature of Borrowings
- **Loans & Advances from Related Parties**
- **Long-Term Maturities of Finance Lease Obligations**
- **Other Loans & Advances (specify nature)**

Question 13

State how you would present ' Other Long Term Borrowings' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

It shall be classified as:

Trade Payables: Sundry Creditors for Goods or Services, and Acceptances should be disclosed as part of Trade Payables

Others: Amounts due under contractual obligations, e.g., payables in respect of statutory obligations, like contribution to Provident Fund, Contractually Reimbursable Expenses, Interest Accrued on Trade Payables, etc., should be classified as “Others” and each such item should be disclosed nature wise

Question 14

State how you would present ' Short Term Borrowings' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

Short-Term Borrowings shall be classified as -

- Loans Repayable on demand-
 1. from Banks, &
 2. Other Parties,
- Loans and Advances from Related Parties,
- Deposits,
- Others Loans and Advances (specify nature)
- Current maturities of Long-Term Borrowing

Note: A 3-Year Loan taken for a business with a 4-year Operating Cycle will be categorized only as Short-Term Borrowings, and not as Long-Term Borrowings

Question 15

State how you would present ' Trade Payables' in the financial statement as per Schedule III of the Companies Act, 2013

Answer

It shall be classified as:

- (a) Total outstanding dues of micro enterprises and small enterprises; and
- (b) Total outstanding dues of creditors other than micro enterprises and small enterprises.”

Question 16

State how you would present ' Reserves & Suplus' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

Reserves & Surplus shall be classified as:

- **Capital Reserves:** which is not available for distribution as Dividend, example: Profit on Re-issue of Forfeited Shares is basically profit of a Capital Nature and, hence, it should be credited to Capital Reserve
- **Capital Redemption Reserve:** is required to be created for redemption of Preference Shares and buyback of Equity Share Capital
- **Securities Premium**
- **Debenture Redemption Reserve**
- **Revaluation Reserve**

- Share Options Outstanding Account
- Other Reserves (specify the nature & purpose)
- Surplus, i.e., balance in Statement of P&L disclosing allocations & appropriations

Note: (Additions & Deductions since last Balance Sheet to be shown under each of specified heads)

Question 17

State how you would present ' Capital Work in progress & Intangible assets under development' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

To be shown as a separate line item on the face of Balance Sheet

(**Note:** Capital Advances should be included under Long- Term Loans and Advances and hence, **cannot** be included under Capital WIP.)

Question 18

State how you would present ' Long Term Loans & Advances' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

- 1. General Classification:** Long-Term Loans and Advances shall be classified as –
 - (a) Capital Advances: are advances given for procurement of Fixed Assets
 - (b) Loans and Advances to Related Parties (giving details thereof),
 - (c) Other Loans and Advances (specify nature)
- 2. Security wise Classification:** The above shall be separately sub-classified as –
 - (a) Secured, considered Good
 - (b) Unsecured, considered Good
 - (c) Doubtful.
- 3. Bad / Doubtful:** Allowance for Bad and Doubtful Loans and Advances shall be disclosed under the relevant heads separately.
- 4. 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 in a Director of a Member should be separately stated.

Question 19

State how you would present ' Cash & Cash Equivalents' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

Cash and Cash Equivalents shall be classified as:

- (a) Balances with Banks,
- (b) Cheques, Drafts on Hand,
- (c) Cash on Hand,
- (d) Other (Specify nature)

Notes:

- Earmarked Balances with Banks (e.g. for Unpaid Dividend) shall be separately stated.

- Balances with Banks to the extent held as margin Money or Security against the Borrowings, Guarantees, Other Commitments shall be disclosed separately.
- Repatriation restrictions, if any, in respect of Cash and Bank Balances shall be separately stated.
- Bank Deposits with more than 12 months Maturity shall be disclosed separately.

Question 20

State how you would present 'Inventories' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

- (i) Inventories shall be classified as:
 - (a) Raw materials
 - (b) Work-in-progress
 - (c) Finished goods
 - (d) Stock-in-trade (in respect of goods acquired for trading);
 - (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 shall be stated.

Question 21

Explain the treatment of unamortised portion of share issue expenses.

Answer:

1. Schedule III does not contain any specific disclosure requirement for this item.
2. As per AS-16, Ancillary Borrowing Costs and Discount or Premium relating to Borrowings could be amortized over the loan period.
3. Share Issue Expenses, like Discount, Premium on Borrowing, etc., are excluded from the scope of AS- 26 Intangible Assets. But, you can amortize these expenses over the period of benefit, i.e., normally 3 to 5 years
4. Till then, Company can disclose the Unamortized expenses under the head “Other Current/Non- Current Assets”.

Question 22

XBRL

Answer:

XBRL (EXTENSIBLE BUSINESS REPORTING LANGUAGE)

- Is a language for the electronic communication of business and financial data
- Helps in the preparation, analysis & communication of business information
- It offers cost savings, greater efficiency and improved accuracy & reliability
- 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.

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.

The companies preparing their financial statements under the Companies (Accounting Standards) Rules, 2006 shall file the statements using the Taxonomy provided in Annexure-II and companies preparing their financial statements under Companies (Indian Accounting Standards) Rules, 2015, shall file the statements using the Taxonomy provided in Annexure-II A. However, non-banking financial companies, housing finance companies and companies engaged in the business of banking and insurance sector are exempted from filing of financial statements under these rules.

The companies which have filed their financial statements under above rule shall continue to file their financial statements and other documents though they may not fall under the class of companies specified therein in succeeding years

The companies which have filed their financial statements under the erstwhile rules, namely the Companies (Filing of Documents and Forms in Extensible Business Reporting Language) Rules, 2011, shall continue to file their financial statements and other documents though they do not fall under the class of companies specified therein.

Question 23

Explain principles on which basis p&l account drawn

Answer:

- (a) **Materiality:** All significant factors which will have an **impact on the mind of the reader should be disclosed.**

For example,

- Profit / loss on large quantity of raw materials is sold should not be included in the Sales;
- But, the cost of the materials should be deducted from materials consumed and
- the profit or loss on sale of raw materials should be separately disclosed in profit & loss account If, however, only a small quantity was sold, separate disclosure is not necessary

Materiality of a figure should **be judged** from the point of view of both the total amount of item & amount of the profit or loss. In above example, materiality has to be seen from the point of view of :

- (i) the amount of materials consumed and
- (ii) the profit or loss during the year.

- (b) **Prior-Period Items:** The rule in India is that once accounts are adopted at the annual general meeting, they cannot be reopened. If any error is discovered, it can be corrected only in the accounts of the subsequent period. Apart from errors, some of the accounts relating to the previous year may come to knowledge or may be ascertained only in the current year.

For example, rates have been revised with effect from October, 2015, but the decision was made only in March, 2017, The increased wages for 2016-17 can certainly be added to the 2016-2017 wages but the increased wages for six months of 2015-2016 will also have to be taken out into account. Errors and other items relating to the previous year should be shown separately in the profit and loss account, and not clubbed with the item relating to the current year unless the

concerned amounts are not material. Preferably, errors and prior year items should be stated below the line, i.e., in the Profit and Loss Appropriation Account.

- (c) **Extraordinary Items:** If expenses or income that do not arise in the ordinary course and are material they should be stated separately in the profit and loss account.

For example, if a fixed asset is sold, its profit or loss has to be shown separately. Another example would be speculation loss or profit; yet another would be subsidy received from government for operational purposes.

- (d) **Change in Accounting Policies:** It is well known that if there is any change in an accounting policy, say method of valuation of inventories or of change in depreciation, there has to be a disclosure about the fact of change and on profit or loss resulting from such a change.

Question 24

Write short notes on: True and fair view of Financial Statements or Proper Books of Accounts

Answer:

- As per **Section 128** of the Companies Act, 2013,
- every company shall **prepare and keep** at its registered office
- **books** of account & other relevant books and **papers** and **financial statement**
- for **every financial year** which gives a **true and fair view** of the state of the affairs including its branch
- on **accrual basis** and according to the **double entry** system of accounting.
- company **may keep** such books in **electronic mode** in such manner as may be prescribed.

Keeping books of account at place other than registered office:

- Books may be kept at **other place** in India.
- on taking such decision the company shall within **7 days** file with the Registrar
- a **notice** in writing giving the **full address** of that other place:

Accounts of branch office:

Where a company has a branch office then accounts relating branch office are required to **be kept at that office and proper summarized returns periodically** should be sent to the company at its registered office.

Period for which books of account should be kept:

The books of account of every company should be kept for **8 financial years**.

True and fair view: The books and papers and financial statement are said to be give a true and fair view:

- If proper books of account as **required by law**, have been kept by the company
- If books of account are kept on **accrual basis** and according to **double entry** system of accounting
- If the accounts of the company **give the information required by the Act** in the manner so required
- If the balance sheet and profit and loss accounts are **drawn up in a format** and in accordance with the provisions of the Act and in the form provided in Schedule III
- If the **financial position and working results** of the company are stated clearly
- **If any material change in the method** of accounting and the effect thereof on the financial position of the company is clearly indicated
- If there is a **proper and full disclosure** of the financial position of the company
- If the financial statements comply with the **accounting standards** notified under Section 133

- If books of account are **not suppressing any transaction nor contain any fictitious transaction**

Question 25:

State how you would present ' Property Plant & Equipment' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

1. **Classification** shall be given as –
 - (a) Land,
 - (b) Buildings
 - (c) Plant and Equipment
 - (d) Furniture & Fixtures
 - (e) Vehicles
 - (f) Office Equipment
 - (g) Others (Specify Nature).
2. Assets under **Lease shall be separately specified** under **each class** of Asset.
3. **Re-evaluation:**
 - Where asset **written off** on a Reduction of Capital or Re- evaluation of Assets
 - or where **upward** Re-evaluation,
 - every Balance Sheet subsequent to such write off or addition
 - **shall show the Reduced or Increased figures** and
 - also show by way Note for the subsequent **5 years**
4. **Reconciliation:**
 - A Reconciliation of the **Gross and Net** Carrying Amounts
 - at the **Beginning and End** of the Reporting period
 - showing **Additions, Disposals, Acquisitions** through Business Combinations and other Adjustments and the **related Depreciation and Impairment** Losses / Reversals shall be disclosed separately.

Question 26

State how you would present ' Short Term Loans & Advances' in the financial statement as per Schedule III of the Companies Act, 2013

Answer:

- a. **Short-term loans and advances shall be classified as:**
 - i. Loans and advances to related parties (giving details thereof);
 - ii. Others (specify nature).
- b. **The above shall also be sub-classified as:**
 - i. Secured, considered good
 - ii. Unsecured, considered good
 - iii. Doubtful.
- c. **Allowance for bad & doubtful loans & advances** shall be disclosed under relevant heads separately.
- d. Loans and advances **due by directors or other officers** of the company or any of them either severally or jointly with any other person or amounts due by **firms or private companies in which any director is a partner or a director** or a member shall be **separately stated**.

Question 27

Write a short note on Prior-Period Items

Answer:

- **Rule:-** once accounts are adopted at the annual general meeting, they cannot be reopened.
- **If any error is discovered**, it can be **corrected** only in the accounts of the **subsequent** period.
- Apart from errors, some of the **accounts relating to the previous year may come to knowledge only in the current year**
- **Thus, prior period items are the items of income or expenses relating to the previous period but came to the knowledge in the current period**



Topic 3

ACCOUNTING STANDARDS

Question 1

What is the need for Standards?

Answer:

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 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 need of Accounting Standards may be enumerated as under:

- (a) **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.
- (b) **Comparability of financial Statements made easy:** The value of the accounting information is enhanced if the same may 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.
- (c) **Benefits to the accountants and auditors:** The accounting standards provide a basis for the uniform accounting principles. Due to this reason, there is a less possibility of frauds being committed by the accountant. There is more transparency in the accounting information.
- (d) **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.
- (e) **Evaluation of the managerial ability:** Accounting standards are useful in measuring the efficiency of the management regarding profitability, liquidity, solvency and other general areas of progress of the enterprise. In the absence of Accounting Standards, it would be difficult to evaluate the managerial efficiency because there is no basis to compare the financial statements of one enterprise with those of another.
- (f) **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.

Question 2

What is the need for convergence with IFRS?

Answer:

1. Each country has its own set of rules and regulations for accounting and financial reporting.

2. 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.
3. Therefore, translation and re-in statements 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.
4. 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.
5. The harmonization of financial reporting around the world will help to raise the confidence of investors generally in the information they are using to make their decisions and assess their risks.
6. 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. Global Standards facilitate the cross-border flow of money, global listing in different bourses and comparability of financial statements.
7. 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.

Question 3

What are the differences between IGAAP & Ind AS?

Answer:

Points	IGAAP	IND AS
Applicability:	IGAAP was the traditional accounting framework used in India before the adoption of Ind AS	Ind AS is based on the International Financial Reporting Standards (IFRS) and has been gradually implemented in India for certain categories of companies based on their size and listing status.
Scope:	GAAP covers a wide range of accounting standards and practices developed by various regulatory bodies in India, including the	Ind AS, on the other hand, is a converged set of accounting standards aligned with IFRS and covers a broader range of topics,

	Institute of Chartered Accountants of India (ICAI) and the Companies Act, 1956.	including financial instruments, revenue recognition, leasing, and consolidation.
Conceptual Framework	IGAAP is primarily rule-based, with specific accounting treatments prescribed for various transactions	Ind AS, follows a principles-based approach, providing more conceptual guidance and allowing for professional judgment in applying the standards.
Disclosure Requirements	IGAAP doesn't required extensive disclosures as compare to IND AS	Ind AS places greater emphasis on transparency and requires more extensive disclosures compared to IGAAP. The objective is to provide users of financial statements with more relevant and reliable information.
Reporting Format	Under IGAAP, companies prepared their financial statements based on the Schedule VI format prescribed by the Companies Act, 1956	Under IGAAP, companies prepared their financial statements based on the Schedule VI format prescribed by the Companies Act, 1956
Impact on Financial Statements		Adoption of Ind AS has led to significant changes in the presentation and measurement of various financial statement items. It has resulted in increased complexity in areas such as revenue recognition, fair value measurement, and financial instruments.
Regulatory Oversight	IGAAP was regulated by the ICAI and various industry-specific regulatory bodies.	Ind AS is regulated by the National Financial Reporting Authority (NFRA), an independent regulatory body established under the Companies Act, 2013.

Question 4

Describe IFRS? Its features and advantage?

Answer:

- International Accounting Standards Committee (IASC) is responsible for developing International Accounting Standards, was established in June, 1973. It is presently known as International Accounting Standards Board (IASB).
- The IASC comprises the professional accountancy bodies of over 75 countries (including the Institute of Chartered Accountants of India).

- The term IFRS comprises IFRS issued by IASB, IAS issued by International Accounting Standards Committee (IASC), and Interpretations issued by the Standard Interpretations Committee (SIC) and the International Financial Reporting Interpretations Committee (IFRIC) of the IASB. Every major nation is moving towards adopting IFRS to some extent.
- Large number of authorities requires public companies to use IFRS for stock- exchange listing purposes, and in addition, banks, insurance companies and stock exchanges may use them for their statutorily required reports.
- The increased use of IFRS is not limited to public-company listing requirements or statutory reporting. Many lenders and regulatory and government bodies are looking to IFRS to fulfil local financial reporting obligations related to financing or licensing.

The IFRSs are important because of their following features:

Single set of Accounting Standards would enable internationally to standardize and assure better quality on a global screen.

It would also permit international capital to flow more freely, enabling companies to develop consistent global practices on accounting problems.

It would be beneficial to the regulators too, as the complexity associated with needing to understand various reporting regimes would be reduced.

For investors, it gives a better understanding to the financial statements and assess the investment opportunities other than their Home Country. It also benefits the accounting professionals in a way that they will be able to sell their services in the different parts of world.

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.

Question 5

Describe Applicability of Indian Accounting Standards [IND AS]

Answer:

- The Ministry of Corporate Affairs (MCA), in 2015, had notified the Companies (Indian Accounting Standards (IND AS) Rules 2015. The IND AS are applied in the phased manner

- For companies other than Banking companies, Non-banking Financial Companies (NBFCs) and Insurance companies:

(i) For the Accounting period beginning on or after 1st April, 2016: The following companies were Adoption, Convergence and Interpretation of IFRS and Accounting Standards in India required to prepare their financial statements by adopting Indian Accounting Standards (Ind ASs):

- (a) Companies whose equity or debt securities are listed or are in the process of listing on any stock exchange either in India or out of India and having the net worth of ₹ 500 crore or more;
- (b) Unlisted companies having the net worth of ₹ 500 crore or more; and
- (c) Holding companies, subsidiary companies, joint venture or associate companies of the companies mentioned at (a) or (b) above.

Comparatives for the above periods shall be for the period ending on 31st March, 2016 or thereafter.

(ii) For the Accounting period ending on or after 1st April, 2017 : The following companies were required to prepare their financial statements by adopting Indian Accounting Standards (Ind ASs):

- (a) Listed companies having net worth of less than ₹ 500 crores;
- (b) Unlisted companies having net worth of ₹ 250 crore or more but less than ₹ 500 crores; and
- (c) Holding, subsidiary, joint venture and associate companies of the companies mentioned at or (b) above.

Comparatives for the above periods shall be for the period ending on 31st March, 2017 or thereafter.

- It may be noted that the net worth of the company will be considered based on the audited financial statements of the company concerned as at 31st March, 2014 or based on the first audited financial statements of the company concerned as at any date after 31st March, 2014.
- 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.
- Companies whose securities are listed or are in the process of being listed on SME Exchanges will continue to apply the existing Accounting Standards specified under the Companies (Accounting Standards) Rules, 2006.

Companies which are not required to mandatorily follow Indian Accounting Standards (Ind ASs) are required to follow the existing Accounting Standards specified under the Companies (Accounting Standards) Rules, 2006 unless they voluntarily choose to apply Indian Accounting Standards (Ind ASs).

For Non-banking Financial Companies (NBFCs):

(i) For the Accounting period beginning on or after 1st April, 2018: The following NBFCs will be required to adopt Ind ASs:

- NBFCs having net worth of ₹ 500 crore or more; and

- Holding, subsidiary, joint venture and associate companies of the above companies. The comparatives will be for the period ending on 31st March, 2018 or thereafter.
- (ii) For the Accounting period beginning on or after 1st April, 2019: The following NBFCs will be required to follow Ind ASs:
- Listed NBFCs having net worth of less than ₹ 500 crores;
 - Unlisted NBFCs with net worth of ₹250 crore or more but with net worth of less than ₹ 500 crores; and
 - Holding, subsidiary, joint venture and associate companies of the above companies. The comparatives will be for the period ending on 31st march, 2019 or thereafter'

Question 6

Explain valuation principles for inventories under AS 2 of ICAI ?

Answer:

- Accounting Standard 2 (AS 2) is a financial reporting standard that provides guidance on the valuation and measurement of inventories.
- It is issued by the Institute of Chartered Accountants of India (ICAI) and is applicable to all companies in India.
- AS 2 sets out the principles and methods for recognizing, measuring, and presenting inventories in the financial statements.
- It requires inventories to be valued at the lower of cost and net realizable value. Cost includes all costs incurred in bringing the inventories to their present location and condition, including purchase costs, conversion costs, and other directly attributable costs.
- The cost of inventories should comprise-
All costs of purchase
Costs of conversion
Other costs incurred in bringing the inventories to their present location and condition.
- Under AS 2, inventories are classified into different categories such as raw materials, work in progress, and finished goods. Each category may require a different valuation method, such as the specific identification method, first-in, first-out (FIFO) method, or weighted average cost method.
- The ascertained or pre booked or ordered inventory are compulsory to be recorded at cost.
- AS 2 also provides guidance on the treatment of inventory write-downs, recognition of inventory-related expenses, and the disclosure requirements related to inventories in the financial statements.
- It's important to note that AS 2 is specific to India and may differ from the accounting standards issued by other countries or regions, such as International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP) used in the United States.

Question 7

Explain share-based payment under IND AS 102

Answer:

The objective of this Standard is to specify the financial reporting by an entity when it undertakes a share-based payment transaction. In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees.

An entity shall apply this Standard in accounting for all share-based payment transactions, whether or not the entity can identify specifically some or all of the goods or services received, including:

- equity-settled share-based payment transactions,
- cash-settled share-based payment transactions, and
- Transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments.

A share based payment arrangement is an agreement between the entity (or another group entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive:

- (a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including share or share options) of the entity or another group entity, or
- (b) equity instruments (including shares or share options) of the entity or another group entity. Provided that specified vesting conditions, if any, are met.

A share-based payment transaction is a transaction in which the entity:

- (a) receives goods or services from the supplier of those goods or services (including an employee) in a share based payment arrangement, or
- (b) Incurs an obligation to settle the transaction with the supplier in a share based payment arrangement when another group entity receives those goods or services.

Question 8

Difference between IFRS and IGAAP

Answer:

Basis	IFRS	IGAAP
First time adoption	Full retrospective application of IFRS to P&L Account and Balance Sheet. Reconciliation of P&L Account and Balance Sheet with respect of last year’s reported numbers under previous GAAP.	No needs to prepare reconciliation on first time adoption.
Components of Financial Statements	Comprises of Balance Sheet, Profit and Loss A/c. Cash Flow Statement, changes in equity and accounting policy and notes to Accounts.	Comprises of Balance Sheet, Profit and Loss A/c. Cash Flow Statement (if applicable), and Notes to Accounts.

Balance Sheet	No particular format, a current/non-current presentation of assets and liabilities is used.	As per Format Prescribed in Schedule III for Companies, adherence to Banking Regulation for Banks, etc.
Income Statement	No particular format prescribed (IAS-1).	As per Format Prescribed in Schedule III (AS-1).
Cash Flow Statements	Mandatory for all entities (IAS-7).	Level 3 entities are exempted (AS-3).
Dividends	Liability to be recognized in the period when dividend is declared. (IAS- 10).	Recognized as an appropriation against the profit, and recorded as liability at BS date even if declared subsequent to reporting period but before the approval of Financial statements (AS-4).
Cost of major repairs & Overhaul expenditure on fixed assets	Recognized in carrying amount of the assets (IAS-16).	Expensed off. Only expenses which increases the FEB are to be capitalized. (AS-10).
Re-evaluation	Re-evaluation (if done) to be updated periodically so that carrying amount does not differ from fair value at the end period. Re-evaluation to be done for entire class of assets (IAS-16).	No specific requirement for re-evaluation. Re-evaluation can be done on systematic basis like for one location leaving aside the assets of other location. (AS-10).
Earnings Per Share	Disclosure to be made in only consolidated financials of the parent Co. (IAS-33).	Disclosure of EPS in both consolidated and separate financials (AS-20) .
Component Accounting	Required each major part of No such requirement (AS- 10). PPE with a cost that is significant in relation to total cost, should be depreciated separately (IAS-16).	No such requirement (AS-10).
Intangible Assets	Intangible assets can have indefinite useful life and hence such assets are tested for impairment and not amortized.	There is no concept of indefinite useful life. Assets have definite life (usually 10 years).
Reporting Currency	Requires the measurement of profit using functional currency. Entities may, however,	Schedule III to the Companies Act, 2013 specifies Indian Rupees as the reporting currency (AS-11).

	present financial statements in a different currency (IAS- 21).	
Key Management Personnel (KMP)	Includes Executive as well as non-executive directors (IAS- 24).	Excludes non-executive directors (AS- 18).
Compensation to KMP	Disclosure to be made for total compensation such as short term employee benefits & post-employment benefits.	AS-18 does not require the break-up of compensation cost.

Question 9

Explain the disclosure requirements of AS-1

Answer:

- All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.
- The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.
- Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed.
- In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable.

Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

- If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed

Question 10

“One of the characteristics of the financial statements in neutrality” - Do you agree with this statement?

- Neutrality is a key accounting principle that emphasizes the importance of presenting financial information in a fair, unbiased, and objective manner.
- Financial statements are supposed to provide a true and accurate representation of a company's financial position and performance without any intentional bias or manipulation of data.
- Neutrality ensures that financial statements are prepared and presented in a way that is free from any agenda or intent to mislead stakeholders, such as investors, creditors, and regulators.
- This principle helps maintain the credibility and reliability of financial reporting, which is essential for making informed decisions in the business world.

- In summary, neutrality is indeed a fundamental characteristic of financial statements, and it is widely recognized and emphasized in accounting standards and principles.



Topic 4

ACCOUNTING FOR SHARE CAPITAL

Question 1

Distinguish between Equity shares and Preference shares.

Answer:

Basis	Equity Shares	Preference shares
Refund of Capital	On winding up, the equity share capital is paid after the preference share capital or equity shareholder receives residual amount	On winding up, the preference share capital is paid before the equity share capital is paid or preference shareholders have preference to get refund of capital over equity shareholders.
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.
Rate of Dividend	No fixed rate of dividend. It is decided by the board of directors every year and it varies periodically	Fixed rate of dividend is paid as prescribed on the face of preference shares, e.g., Issue at 12%, in that case prefer shares would have 12% rate of dividend.
Right to Vote	Equity shareholders have the right to vote in a meeting of shareholder and they elect the director for managing the company	In normal course of business, preference shareholders do not enjoy the right to vote in the meetings of shareholders. But they may have the right to vote but only in special circumstances.
Redemption	Equity shares are not redeemable; however, a company may buy back its equity shares as conditions prescribed under Companies Act, 2013	Preference shares are always redeemable.

Question 2

Discuss the classes of shares on the basis of participation.

Answer:

• **Equity share:**

equity share are always participating in the terms of voting in the general meeting.

Each share has a single vote unless it is a differential vote share where differential vote can be allotted to a share upto 74 % of the original vote on each of the share .

• **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.

• **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.

Question 3

Describe the important steps in the procedure of share issue

Answer:

• **Issue of Prospectus:**

The Company first issues the prospectus to the public. Prospectus is an invitation to the public that a new company has come into existence and it needs funds for doing business. It contains complete information about the company and the manner in which the money is to be collected from the prospective investors.

• **Receipt of Applications:**

When prospectus is issued to the public, prospective investors intending to subscribe the share capital of the company would make an application along with the application money and deposit the same with a scheduled bank as specified in the prospectus. The company has to get minimum subscription within 120 days from the date of the issue of the prospectus. If the company fails to receive the same within the said period, the company cannot proceed for the allotment of shares and application money should be returned within 130 days of the date of issue of prospectus.

• **Allotment of Shares:**

If minimum subscription has been received, the company may proceed for the allotment of shares after fulfilling certain other legal formalities. Letters of allotment are sent to those whom the shares have been allotted, and letters of regret to those to whom no allotment has been made. When allotment is made, it results in a valid contract between the company and the applicants who now became the shareholders of the company.

Question 4

What is share issue at premium and security premium ? Elaborate the Journal entries for issue at premium ?

Answer:

It is quite common for the shares of financially strong and well-managed companies to be issued at a premium, i.e. at an amount more than the nominal or par value of shares. Thus, when a share of the nominal value of ₹. 100 is issued at ₹. 105, it is said to have been issued at a premium of 5 per cent.

- When the issue of shares is at a premium, the amount of premium may technically be called at any stage of the issue of shares. However, premium is generally called with the amount due on allotment, sometimes with the application money and rarely with the call money.
- The premium amount is credited to a separate account called ‘Securities Premium Account’ and is shown under the title ‘Equity and Liabilities’ of the company’s balance sheet under the head ‘Reserves and Surpluses’.
- The premium on issue of shares is not to be treated as revenue profits. In fact it is considered as capital receipt.
- As per the Companies Act, 2013, when a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium collected on shares must be credited to a separate account called “Securities Premium Account”.
- There are no restrictions in the Companies Act on the issue of shares at a premium, but there are certain restrictions at the time of its disposal. “Securities Premium Account” can be used only for the following five purposes:
 - towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
 - in writing off the preliminary expenses of the company;
 - in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
 - in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
 - for the purchase of its own shares or other securities under section 68.

Accounting treatment of the issue of Shares at Premium

Journal Entry

When allotment money becomes due:

Share Allotment A/c	Dr.	(with the money due on allotment including premium)
	To Securities Premium A/c	(with the premium amount)
	To Share Capital A/c	(with the share allotment amount)

(Being allotment money due on shares issued at premium)

Question 5

What is FORFEITURE OF SHARE ? What are its effects along with Accounting Treatment ?

Answer:

Meaning: In case where a shareholder fails to pay the allotment money and/or calls made on him, his shares are liable to be forfeited.

Forfeitures 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. Articles of Association of the Company provide the authority to forfeit shares to the Board of Directors.

EFFECT OF FORFEITURE

- Defaulting shareholder loses all his rights in the forfeited shares
- Ceases to be a member of the company
- Name of the shareholder is removed from the register of members
- Amount already paid by him is forfeited
- Not entitled in future to dividends and rights of membership

ACCOUNTING TREATMENT FOR FORFEITURE OF SHARE

The forfeiture of shares can be recorded in following two ways:

1. Where the unpaid calls have already been transferred to Calls-in Arrear A/c and the respective call accounts have been closed:

Share Capital A/c	Dr.	(with amount of called up value of shares forfeited i.e. no. of shares forfeited x the called-up value per share.)
To Shares Forfeited A/c		(with the amount already paid-up by the shareholders on the shares forfeited.)
To Calls-in-Arrear A/c		(with the amount of unpaid calls.)

2. Where the unpaid calls have not been transferred to Calls-in-Arrear A/c and the respective call accounts are showing balances representing unpaid amounts:

Share Capital A/c	Dr.	(with amount of called up value of shares forfeited i.e., no. of shares forfeited x the called-up value per share)
To Shares Forfeited A/c		(with the amount already paid up by the shareholders on the shares forfeited.)
To Share Allotment A/c		(with the amount failed on allotment, if any.)
To Share First Call A/c		(with the amount failed on first call, if any.)
To Share Final Call A/c		(with the amount failed on final call, if any.)

Question 6

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

Answer:

- 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 ABC Ltd. has the following options:

Option 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.

The journal entry is as follows:

It is a practice which is prevalent globally with the underlying objectives of increasing Earnings per Share, averting hostile takeovers, improving returns to the stakeholders and realigning the capital structure.

Buy-Back is an alternative way of Reduction of Share Capital. 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.

Free Reserves: ‘Reserves which, as per latest audited Balance Sheet of the company are free for distribution as dividend and shall include balance to the credit of Security Premium A/c but shall not include Share Application Money’.

Advantages of Buy Back:

1. To improve the earnings per share;
2. To improve return on capital, return on net worth and to enhance the long-term value for shareholders; To provide an additional exit route to shareholders when shares are undervalued or thinly traded;
3. It is an alternative mode of reduction in capital without requiring approval of the Court/CLB (NCLT),
4. To enhance consolidation of stake in the company; To prevent unwelcome takeover bids;
5. To return surplus cash to shareholders;
6. To achieve optimum capital structure;
7. To support share price during periods of sluggish market conditions; To serve the equity more efficiently.

Question 8

Explain provisions of Sec 69 for capital redemption reserve under the Companies Act, 2013

Answer:

- Under the provisions of Sec 69 of the Companies Act, a Capital Redemption Reserves Account may be created in the context of a share buyback.
- The Capital Redemption Reserves Account is a reserve that is required to be maintained by a company undertaking a buyback of its own shares.
- When a company buys back its own shares, it needs to fund the purchase. The funds for the buyback cannot come from the company's existing share capital. Instead, the company is required to transfer an amount equal to the nominal value of the shares being bought back, along with any premium paid, to the Capital Redemption Reserves Account.
- The purpose of creating the Capital Redemption Reserves Account in a buyback is to ensure that the company maintains a reserve of funds to support the buyback transaction.
- This reserve acts as a protection for the company's creditors and shareholders, as it prevents the company from reducing its share capital or distributing its reserves without proper justification.

- The specific rules and requirements for the Capital Redemption Reserves Account in a buyback may vary depending on the jurisdiction and the applicable laws and regulations. It is important to consult the relevant provisions of the Companies Act or seek professional advice to ensure compliance with the specific requirements in your jurisdiction.

Question 9

What is Sweat Equity ? Enumerate the procedure for issue of sweat equity shares.

Answer:

- Sweat equity shares refer to equity shares which are given to the company's employees on favourable terms, in recognition of their work.
- Sweat equity shares are one of the modes of making share-based payments to employees. Sweat equity shares rewards the beneficiaries by giving them incentives in lieu of their contribution towards development of the company.
- Further, sweat equity shares facilitate greater employee stakes as well as interest in company's growth and encourages employees to add more value towards the company.
- Here, "Employee" means-
 - (i) a permanent employee of the company who has been working in India or outside India; or
 - (ii) a director of the company, whether a whole time director or not; or
 - (iii) an employee or a director as defined in sub-clauses (a) or (b) above of a subsidiary, in India or outside India, or of a holding company of the company

Condition for issue of sweat equity share :

- The issue is authorized by a special resolution passed by the company;
- The resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
- The special resolution authorizing the issue of sweat equity shares shall be valid for making the allotment within a period of not more than twelve months from the date of passing of the special resolution.
- The sweat equity shares issued to directors or employees shall be locked in/non-transferable for a period of three years from the date of allotment and the fact that the share certificates are under lock-in and the period of expiry of lock-in shall be stamped in bold or mentioned in any other prominent manner on the share certificate.
- Where the equity shares of the company are listed on a recognized stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with the Companies (Share Capital and Debentures) Rules, 2014

Quantum for issue of sweat equity share

- The company shall not issue sweat equity shares for more than fifteen percent of the existing paid up equity share capital in a year or shares of the issue value of rupees five crores, whichever is higher.
- Provided that the issuance of sweat equity shares in the company shall not exceed twenty five percent, of the paid up equity capital of the company at any time.
- Provided further that a start-up company may issue sweat equity shares not exceeding fifty percent of its paid up capital up to five years from the date of its incorporation or registration.

Question 10

Explain the process of Redemption of Preference share ?

Answer:

- (i) A company which is limited by shares, if the articles so authorize, can issue preference shares liable to be redeemed within a period not exceeding twenty years from the date of their issue under section 55 of the Companies Act, 2013.
- (ii) No company limited by shares shall issue any irredeemable preference shares.
- (iii) A company may issue preference shares for a period exceeding 20 years but not beyond 30 years for infrastructure projects (Specified in Schedule VI). However, the redemption is subject to minimum 10% of such preference shares per year from the twenty-first year onwards or earlier, on proportionate basis, at the option of the preference shareholders.
- (iv) The preference shares can be redeemed only when they are fully paid up
 - out of the profits of the company which would otherwise be available for dividend, or
 - out of the proceeds of a fresh issue of shares made for the purposes of such redemption.
- (v) If preference shares are to be redeemed out of the profits of a company, a sum equal to nominal amount of shares that are to be redeemed, shall be transferred to a reserve called Capital Redemption Reserve Account out of profits of the company and provisions of this Act relating to reduction of share capital of a company shall apply as if the Capital Redemption Reserve Account were paid up share capital of the company.

PREMIUM ON REDEMPTION:

- For the companies whose financial statements comply with the accounting standards as prescribed in section 133, the premium payable on redemption shall be provided out of the profits of the company, before the shares are redeemed.
- For companies whose financial statements need not comply with the accounting standards as under section 133, the premium payable on redemption shall be provided out of the profits of the company, or out of the company's securities premium account, before such shares are redeemed.
 - In case redeemable preference shares are redeemed out of company profits, which are otherwise available for dividend, the “Capital Redemption Reserve Account” is to be created that will represent the redeemable preference shares in the balance sheet after redemption.

This capital redemption reserve should be equivalent to the amount of Preference Shares that are to be redeemed.

- In a case where redeemable preference shares are redeemed out of proceeds received from fresh issue of shares, the Share Capital Account raised by fresh issue shall take the place of Redeemable Preference Share Capital Account after redemption.

Question 11

Elaborate the types of underwriting options available to a company.

Answer:

- Underwriting is a process which refers to a definite and unambiguous assurance by underwriter(s) to take up a fixed number of shares/ debentures of a company irrespective of shares or debentures subscribed for by public
- underwriters are committed to subscribe to pre-agreed number of shares or debentures, along with unsubscribed shares or debentures, if any. Even if issue of shares is over-subscribed, underwriters are liable to take up the decided number of shares of debentures.

Types of Underwriting

Two kinds of underwriting agreement are given below:

- **Complete Underwriting**

In case of complete underwriting, the whole issue of shares or debentures is underwritten. It may be underwritten by a single firm or institution, agreeing to take the complete risk. It can also be done by multiple firms or institutions together, each agreeing to take risk only to a limited extent.

- **Partial Underwriting**

In cases where only a part of shares or debentures issue of a company is underwritten, it is said to be partial underwriting.

- **Firm Underwriting**

In the case of ‘firm underwriting’, the underwriters take up the agreed number of shares or debentures to be ‘firm underwritten’ in addition to unsubscribed shares or debentures, if any. In such an instance an underwriter is not allowed to set off his firm underwriting against his liability otherwise determined, he will then have to subscribe for both shares/ debentures ‘underwritten firm’ and for shares which he has to take under the underwriting contract, ignoring firm underwriting.

Question 12

Describe the purposes for which a company can use the amount of Securities Premium.

Answer:

- As per the Companies Act, 2013, when a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium collected on shares must be credited to a separate account called “Securities Premium Account”.

- There are no restrictions in the Companies Act on the issue of shares at a premium, but there are certain restrictions at the time of its disposal. “Securities Premium Account” can be used only for the following five purposes:
 - towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
 - in writing off the preliminary expenses of the company;
 - in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
 - in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
 - for the purchase of its own shares or other securities under section 68.

Question 13

List out the conditions, framed by SEBI, which a company needs to fulfil in order to issue of bonus shares.

Answer:

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

- (i) As per SEBI, the bonus shares are issued not in lieu of cash dividends.
- (ii) A bonus issue should be authorized by Article of Association (AOA) and not to be declared unless all partly paid-up shares have been converted into fully paid-up shares.
- (iii) The Company should not have defaulted on re-payment of loan, interest, and any statutory dues.

Bonus shares are to be issued only from share premium and free reserves and not from capital reserve on account of fixed assets revaluation.

Topic 5

ACCOUNTING FOR DEBENTURE

Question 1

What are the types of Debenture ?

Answer:

- **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.
- **Unsecured or Naked:** When debentures are issued without any security, they are termed as unsecured or naked debentures.
- **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.
- **Registered Debenture:** 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.
- **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.
- **Non-Convertible:** Such debentures are paid into cash.
- **Redeemable Debenture:** 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.
- **Irredeemable or Perpetual Debenture:** Such debentures are payable either on a happening of the contingency, or when the company winds its business up, or when the company decides to redeem, itself.
- **First Mortgage Debentures:** Such debentures are paid on the basis of priority as compared to other debentures.
- **Second Mortgage Debenture:** Such Debentures are paid after redemption of first mortgage debentures on the

Question 2

Difference between SHARE and DEBENTURE ?

Answer:

Points	Shares	Debentures
Ownership	A 'share' represents ownership of the company. A share is a part of the owned capital	A 'debenture' is only acknowledgement of Debt. A debenture is a part of borrowed capital.
Return	The return on shares is known as dividend. The rate of return	The return on debentures is called interest. The rate of interest on debentures is prefixed.

	on shares may vary from year to year depending upon the profits of the company.	
Repayment	Normally, the amount of shares is not returned during the life of the company.	Generally, the debentures are issued for a specified period and repayable on the expiry of that period.
Voting Rights	Shareholders enjoy voting rights.	Debenture holders do not normally enjoy any voting right.
Security	Shares are not secured by any charge.	Debentures are generally secured and carry a fixed or floating charge over the assets of the company.
Convertibility	Shares cannot be converted into debentures.	Debentures can be converted into shares if the terms of issue so provide, and in that case, these are known as convertible debentures.

Question 3

Define issue of debenture ? Elaborate accounting treatment for issue of debenture ?

Answer:

- The procedure for the issue of debentures is the same as that for the issue of shares. The intending investors apply for debentures on the basis of the prospectus issued by the company.
- The company may either ask for the entire amount to be paid on application or by means of instalments on application, on allotment and on various calls.
- Debentures can be issued at par, at a premium or at a discount. They can also be issued for consideration other than cash or as a collateral security.

Accounting treatment

☐ When the full issue price is payable in lumpsum along with application

- On receipt of application money:

Bank A/c Dr. (with the money received on application)
 To Debentures Application and Allotment A/c

- On allotment:

Debentures Application & Allotment A/c Dr. (with the money received on debentures allotment)
 To Debentures A/c

☐ When the amount is payable in instalments

- On receipt of application money:

Bank A/c Dr. (with the money received on application)
 To Debenture Application A/c

- On Allotment of debentures:

Debenture Application A/c	Dr.	(with the application money on debentures allotted)
To Debentures A/c		
• On allotment money due		
Debenture allotment A/c	Dr.	(with the allotment money due)
To Debenture A/c		
• On receipt of allotment money:		
Bank A/c	Dr.	(with the money received on allotment)
To Debenture Allotment A/c		
• On making calls:		
Debenture Calls A/c	Dr.	(with the money due on respective calls)
To Debenture A/c		
• On receipt of call money:		
Bank A/c	Dr.	(with the money received on respective calls)
To Debenture Calls A/c		

Question 4

What are the Terms of Issue of Debentures ?

Answer:

- When a company issues debenture, it usually mentions the terms on which they will be redeemed on their maturity.
- Redemption of debentures means discharge of liability on account of debentures by repayment made to the debenture holders.
- Debentures can be redeemed either at par or at a premium. Depending upon the terms and conditions of issue and redemption of debentures, the following six situations are commonly found in practice.
 - Issued at par and redeemable at par
 - Issued at discount and redeemable at par
 - Issued at a premium and redeemable at par
 - Issued at par and redeemable at a premium
 - Issued at a discount and redeemable at a premium
 - Issued at a premium and redeemable at a premium
- When debentures are redeemable at a premium, the premium payable on redemption is debited to 'Loss on Issue of Debentures A/c'. It may be noted that when debentures are issued at a discount and are redeemable at a premium, the amount of discount on issue is also debited to 'Loss on Issue of Debentures'. It may be noted that when the debentures are issued at a discount and are redeemable at par, the amount debited to 'Discount on Issue of Debentures A/c' as usual.

- Premium on redemption is a liability of a company payable in future. It is a provision and is shown under the head Non-current liabilities under subhead ‘Long-term Borrowings’ until debentures are redeemed.

Question 5

What is debenture redemption reserve?

Answer:

Redemption of debentures refers to extinguishing or discharging the liability on account of debentures in accordance with the terms of issue. In other words redemption of debentures means repayment of the amount of debentures by the company.

Debenture Redemption Reserve (DRR)

Section 71(4) of the companies Act, 2013 provides that the debentures shall be redeemed out of divisible profits of the company through the creation of Debenture Redemption Reserve in accordance with the conditions given below:

- (i) Debenture Redemption Reserve is created out of profits of the company available for payment of dividend.
- (ii) Every company is required to create DRR shall on or before the 30th day of April in each year invest or deposit, as the case may be, a sum which shall not be less than 15% of the amount of its debentures maturing during the year ending on 31st day of March of next year in any one or more of the following methods, namely;
 - In deposits with any scheduled banks free of any charge or lieu.
 - In unencumbered securities of the Central Government or of any State Government.
 - In unencumbered securities mentioned in sub-clauses (a) to (d) and (e) of Section 20 of Indian Trusts Act, 1882.
 - The amount remaining invested or deposited as the case may be, shall not, at any time, fall below 15% of the number of debentures maturing during the year ending on 31st March of every year.
 - In case of partly convertible debentures, DRR shall be created in respect of non-convertible portion of debentures issue in accordance with sub-rule.
 - The amount credited to DRR shall not be utilized by the company except for the purpose of redemption of debentures.
 - No DRR is required for debentures issued by All India Financial Institutions (AIFIs) regulated by Reserve Bank of India (RBI) and Banking companies for both public as well as privately placed debentures.
 - Further, where a company intends to redeem its debentures prematurely, it may provide for transfer of such amount in Debenture Redemption Reserve as is necessary for redemption of such debentures even if it exceeds the limits specified in this sub-rule.

Method of Redemption of debenture

- (a) Payment in Lumpsum

- (b) Payment in instalment
- (c) Purchase in open market
- (d) Conversion into shares/ new Debenture

Question 6

Explain the term Cum- interest and Ex-interest?

Answer:

- "Cum-interest" and "ex-interest" are terms used in debenture accounting to indicate the status of interest payments for debentures during a specific period.
- 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.
 1. **Cum-Interest:** When a debenture is traded or transferred "cum-interest," it means that the buyer will be entitled to receive the upcoming interest payment associated with the debenture. In other words, the buyer will receive the interest for the period from the last interest payment date until the next interest payment date.
 2. **Ex-Interest:** When a debenture is traded or transferred "ex-interest," it means that the seller retains the right to receive the upcoming interest payment associated with the debenture. The buyer, in this case, will not receive the interest for the current period but will be entitled to receive the subsequent interest payments.
- 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. In any case, the company must pay interest for the expired period and while making entry in its books at the time of purchase of the debentures, the amount paid by way of interest should be treated separately from the price actually paid for the debentures.

Question 7

Difference between Debenture issue at premium and at discount

Answer:

Basis	Deb issue at premium	Deb issue at discount
Issue Price:	Debentures issued at a premium are sold to investors at a price higher than their face value.	Debentures issued at a discount are sold to investors at a price lower than their face value

In case of loss -

Debentures A/c	Dr.	(with the nominal value of debentures cancelled)
Loss on Redemption of Debentures A/c	Dr.	(with the loss, if any)
To Bank A/c		(with the total)



Topic 6

RELATED ASPECT OF COMPANY ACCOUNT

Question 1

WHAT IS AN EMPLOYEE STOCK OPTION PLAN? WHAT IS ITS PURPOSE ?

Answer:

- An Employee Stock Option Plan (ESOP) is an equity compensation companies offer to their employees and executive
- These options are similar to regular call options in which they give the employee the right to purchase the company’s stock at a set price for a set period.
- An exercise price, as well as a vesting and exercise period, are all included in ESOPs
- The vesting period is the period between when you first get the right to buy stock and when you get it.
- The exercise period is a window in which you can purchase them at any time. You lose your right to buy the shares once the exercise period is over.
- Exercise price is the price at which the option is vested to employees.
- PURPOSE :
 1. Source of motivation for the employee to not leave firm.
 2. It aids employers in retaining employees and ensuring better work performance.

Question 2

WHAT ARE THE CONDITIONS NEEDS TO BE SATISFIED BEFORE GIVING ESOP

Answer:

ESOPs are subject to various legal and regulatory requirements.

common conditions and considerations that are typically associated with ESOPs are as follows:

1. Eligibility Criteria: Determine which employees are eligible to participate in the ESOP.
2. ESOP Trust: Establish an ESOP trust that will hold and manage the shares on behalf of the employees.
3. Stock Valuation : Determine the fair market value of the company's stock. This is crucial for allocating shares to employees.
4. Contributions : Decide how shares will be allocated to employees. This can be based on factors like salary, years of service, or a combination of factors. Contributions to the ESOP can be made in the form of cash, stock, or a combination of both.
5. Vesting : Establish a vesting schedule that outlines when employees become fully vested in their ESOP shares. Vesting periods can vary, but it's common for employees to become fully vested over a period of years.
6. Distribution Rules : A company may put a rule of lockin period on such share given under scheme of ESOP
7. Legal Compliance: Ensure that the ESOP complies with all relevant laws and regulations under Companies Act, 2013 read with SEBI (ESOP AND SE) Regulation, 2021. Also

8. **Fiduciary Responsibilities:** Appoint fiduciaries to oversee the ESOP trust and ensure that it is managed in the best interests of the participants.
9. **Annual Reporting:** ESOPs typically require annual reports to participants, including statements of their account balances and other relevant information.
10. **Company Governance:** Consider how the ESOP will affect the company's governance structure, including board representation and decision-making.
11. **Financing:** If the ESOP is being used to finance the purchase of the company by employees, secure the necessary financing arrangements and ensure they comply with legal requirements.
12. **Independent Valuation:** In many cases, an independent appraiser or valuation expert is required to determine the fair market value of the company's stock for ESOP transactions.
13. **Tax Considerations:** ESOPs have tax advantages for both the company and employees. Consult with tax professionals to understand and optimize these tax benefits.
14. **Exit Strategy:** Plan for what happens to the ESOP when employees leave the company or when the company is sold or goes public.

Remember that the specific requirements and conditions for ESOPs can vary by country and region, and they are subject to change over time. Therefore, it's essential to consult with legal and financial advisors who specialize in ESOPs to ensure compliance with current regulations and to tailor the plan to the unique needs of your company and employees.

Question 3

BOARD OF DIRECTORS OF PROGRESSIVE LTD. DECIDES TO ISSUE EQUITY SHARES OF THE COMPANY WITH DIFFERENTIAL VOTING RIGHTS. EXAMINING THE PROVISIONS OF THE COMPANIES ACT, 2013, STATE THE CONDITIONS TO BE COMPLIED WITH BY THE COMPANY IN THIS REGARD.

Answer:

Shares with differential rights means shares issued with differential rights as to dividend, voting or otherwise in accordance with Section 43(a)(ii) of the Companies Act, 2013.

Conditions for issuing shares with differential rights: Rule 4 of the Companies (Share Capital & Debentures) Rules, 2014 provides that no company limited by shares shall issue equity shares with differential rights as to dividend, voting or otherwise, unless it complies with the following conditions:

1. **Authorization from AOA:** The article of association authorizes the issue of shares with differential rights.
2. **Resolution:** The issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders. However, in case of listed company the issue of such shares shall be approved by the shareholders through postal ballot.
3. **Limit on voting power:** Voting power in respect of shares with differential rights of the company shall not exceed 74% of total voting power including voting power in respect of equity shares with differential rights issued at any point of time.

4. **Track record of profits:** The company having consistent track record of distributable profits for the last 3 years.
5. **No default in financial statements & annual returns:** The company has not default- ed in filing financial statements and annual returns for 3 financial years immediately preceding the financial year in which it is decided to issue such shares.
6. **No subsisting default in certain matters:** The company has no subsisting default in following:
 - (a) Payment of a declared dividend to its equity shareholders.
 - (b) Repayment of its matured deposits.
 - (c) Redemption of its preference shares or debentures that have become due for redemption.
 - (d) Payment of interest on deposits or debentures.
 - (e) Payment of preference dividend.
7. **No defaults in respect of dividend, term loans etc.:** The company has not defaulted in following:
 - (a) Dividend on preference shares.
 - (b) Repayment of any term loan from a public financial institution or State level financial institution or scheduled bank that has become repayable or interest payable thereon.
 - (c) Dues with respect to statutory payments relating to its employees to any authority.
 - (d) In crediting the amount in Investor Education & Protection Fund to the Central Government.

However, a company may issue equity shares with differential rights upon expiry of 5 years from the end of the financial Year in which such default was made good. (8) No penalty under certain laws: The company has not been penalized by Court or

Tribunal during the last 3 years of any offence under the following laws:

- (a) RBI Act, 1934
- (b) SEBI Act, 1992
- (c) Securities Contracts (Regulation) Act, 1956
- (d) Foreign Exchange Management Act, 1999
- (d) Any other special Act, under which such companies being regulated by sectoral regulators.

Question 4

STATE THE CONDITIONS WHICH ARE REQUIRED TO BE SATISFIED BY A COMPANY FOR THE PURPOSE OF BUY-BACK OF SHARES.

Answer:

As per the provisions of section 68 of Companies Act, 2013

If co has substantial cash resources, it may buy its own shares in way of either

- tender offer
- open market
- through odd lot

Section 68(1) Purchase can Be Made Out of:

- its free reserves;

- the securities premium account;
- the proceeds of the issue of any shares or other specified securities:

conditions to be satisfied for BB:

- BB shall be Authorized by its AOA;
- A special resolution has been passed at a general meeting of the company authorizing the buy-back where buy-back is above 10% but up to 25% of the aggregate of paid-up capital and free reserves of the company. However, for buy-back up to 10% of paid-up capital and free reserves of the company Board Resolution is sufficient.
- Post BB D/E Ratio, i.e. $(Secured\ Debts + Unsecured\ Debts) / (Paid\ up\ Capital + Free\ Reserve)$ should not be not more than 2:1
- Only Fully paid up share can be purchased from market
- If co is listed, SEBI (buyback of equity share) regulation, 2015 shall be complied with .
- 1-year gap between subsequent Buy-Back from the completion of first.
- BB shall Not be made out of the proceeds same kind of Shares
- Nominal Value of Shares Bought Back out of FR shall be transferred to CRR (use-Bonus Share)

Question 5

BUY-BACK MAY BE MISUSED BY THE CORPORATE ENTITIES AT THE COST OF INNOCENT INVESTORS. GIVE YOUR COMMENTS.

Answer:

As per the provisions of section 68 under companies act, 2013:

BUYBACK is a financial strategy employed by a company to purchase its own outstanding shares of stock from the open market or from its shareholders.

Buy-back programs, when misused, can have negative consequences for innocent investors and the overall market.

1. **Manipulation of price:** a company can buy its own share in order to reduce the supply of share in market to manipulate the price of share
2. **Short term focus:** a co can prioritize the buyback over some important investment that can be beneficial in short term by reducing the dilution of control, but can be loss full in the future of company
3. **Conflict of interest:** buyback of the securities for the sake of reducing dividend liability can create a conflict of interest between SH and Board members
4. **Reduce liquidity:** buyback out of profit can reduce liquidity of securities in the market to manipulate the demand , also it can cause the reduction of cash availability in the company that can harm the goodwill of company.
5. **Opportunity of insider trading:** the board can understand all the insider conditions of company before and after the buyback to make the undisclosed and indirect profit through relative, causing insider trading.

Topic 7

CONSOLIDATION OF ACCOUNTS

Question 1

DIFFERENCE BETWEEN HOLDING CO & SUBSIDIARY COMPANY

Answer:

HOLDING COMPANY	SUBSIDIARY COMPANY
Co who has one or more subsidiaries co. of its own either directly or through another subsidiary up to 2 layers.	A company in which the holding co : - controls the composition of the BOD [power to appoint or fire majority of BOD] or - controls more than one-half (51%) of the total share capital [paid up eq. share or convertible prf. share] either at its own or together with one or more of its subsidiary companies.
Holding company holds either : • Shares in subsidiary co • Controls the BOD appointment • Have voting rights	• No subsidiary directly/indirectly shall hold any shares of its holding co . However: 1. can hold as a legal representative of a member. 2. holding shares before becoming subsidiary.
Has to maintain the consolidated Accounts along with separate FS	No such obligation to keep the consolidated FS alongside separate one

Question 2

DESCRIBE THE ADVANTAGES OF CONSOLIDATION OF FINANCIAL STATEMENTS.

Answer:

Consolidation of account is a financial accounting process used in business to combine the financial statements of multiple subsidiary companies into a single set of consolidated financial statements for the entire group or parent company.

Advantages of consolidation of account are as follows:

- **Facilitates easy comprehension:**
for the clear insight of parent company and subsidiary companies
- **Assists in ascertaining intrinsic value of share:**
For various accounting procedures, intrinsic value of shares serves as an essential tool which can be attained by consolidating accounts
- **Proper assessment of return on investment:**
consolidated FS can provide proper information on share holding on HC
- **Minority interest disclosure:**
In the consolidated balance sheets, the item shown under the head ‘Minority Interest’ discloses the total amount payable to outside shareholders.
- **Helps in the “evaluation” of holding company:**

As consolidated financial statements reflect a true and fair view of the position of the holding company

Question 3

ISSUE OF BONUS SHARES BY THE SUBSIDIARY COMPANY DOES NOT AFFECT THE COST OF CONTROL COMMENT.

Answer:

Bonus Shares: Bonus shares, also known as scrip dividends or capitalization issues, are additional shares given to existing shareholders by a company without any cost to the shareholders. These shares are issued to the existing shareholders in proportion to their current shareholding in the company. The purpose of issuing bonus shares is to capitalize the company's retained earnings or reserves, converting them into share capital.

The issuance of bonus shares by a subsidiary company generally does not affect the cost of control for the parent company, as :

- **No Additional Investment:** When a subsidiary issues bonus shares, it does not involve any new investment or cash outflow. Instead, it merely involves a capitalization of the company's retained earnings or reserves. Shareholders receive additional shares without having to pay for them.
- **Issue of bonus out of pre-acquisition profit:** This will not affect cost of control because share of holding company in pre-acquisition profit is reduced and on the other hand paid up value of the shares held by them is increased.
- **Issue of bonus out of post-acquisition profit:** This will not affect cost of control because share of holding company in post-acquisition profit is reduced and on the other hand paid up value of the shares held by them is increased.
- **No Impact on Investment Value:** The issuance of bonus shares does not change the overall value of the parent company's investment in the subsidiary. The parent company's initial investment remains intact, and the bonus shares represent a reallocation of equity within the subsidiary.

Question 4

WHAT IS THE COST OF CONTROL IN THE CONTEXT OF PREPARING CONSOLIDATED BALANCE SHEET?

Answer:

The cost of control refers to the amount paid by a parent company to acquire or maintain control over a subsidiary. It includes the cost of acquiring shares, assets, or ownership interests in the subsidiary, as well as any additional expenses associated with maintaining control.

Price paid by HC For acquisition of SC shares > intrinsic value of share of SC = Excess treated as **GOODWILL**

- Goodwill = Cost of Investment - Parent’s share in the equity of the subsidiary on date of investment

Price paid by HC for acquisition of SC shares < intrinsic value of share of SC = Treated as CAPITAL RESERVE

- Capital Reserve = Parent’s share in the equity of subsidiary on date of investment - Cost of investment

COST OF CONTROLL	AMOUNT
Cost of investment	XXXX
(-) Face value of share	(XXX)
(-) pre-acquisition dividend	(XXX)
(-) pre-acquisition profit	(XXX)
=Goodwill/Capital Reserve	XXXX

Question 5

DIFFERENCE BETWEEN SC & AC

Answer:

SUBSIDIARY COMPANY	ASSOCIATE COMPANY
Means a company in which the holding company- (i) controls the composition of the Board of Directors; or (ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies.	means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company.
Control over a majority share capital (more than 50%) or control over the composition of BOD	control of at least twenty per cent of total share capital
HC has major control in SC	Parent co has significant influence over the associate company
Headed under section 2(87) of companies act 2013	Headed under section 2(6) of companies act, 2013

Question 6

HOW IS THE DIVIDEND PAYED BY SUBSIDIARY COMPANY EITHER FORM PRE OR POST ACQUISITION PROFIT IS TREATED BY HOLDING COMPANY?

Answer:

- The dividend received from the subsidiary company will be either capital dividend or revenue dividend.
- Capital dividend means the dividend which is received out of the pre-acquisition profits of the subsidiary.

- Revenue dividend means the dividend received out of post- acquisition profits of the subsidiary.
- Depending on the date of acquisition, the dividend shall be assumed to be paid out of pre-acquisition profits and post-acquisition profits.
 - Received out of pre-Acquisition profit : bank account of HC will be debited and is treated as capital receipt. so, it should be credited to investment A/C
 - Received out of post-Acquisition profit : bank account of HC will be debited and is treated as revenue receipt. So, it Is credited to P & L A/C

Question 7

WHAT IS MINORITY INTEREST ? HOW IS IT CALCULATED ?

Answer:

- Minority interest, also known as non-controlling interest (NCI), is an accounting term that refers to the portion of a subsidiary's equity that is not owned by the parent company. In the context of consolidating financial statements.
- When a parent company owns more than 50% of the voting shares or has significant control over another entity, it is required to consolidate the financial statements of that subsidiary into its own financial statements. The purpose of consolidation is to present a comprehensive view of the parent company and its subsidiaries as if they were a single economic entity.
- Minority interest is included in the consolidated financial statements because it represents the equity attributable to the non-controlling shareholders of the subsidiary. In other words, it reflects the portion of the subsidiary's net assets that does not belong to the parent company. It is listed as a separate line item on the consolidated balance sheet within the equity section.
- Calculation of MI :

Particulars	(Rs.)
A. Paid up value of the equity shares (including bonus shares) held by the minority	*****
B. Paid up value of preference shares presently held by the minority	*****
C. Share of minority in the capital profits/(loss) of the subsidiary	*****
D. Share of minority in the revenue profits/(loss) of the subsidiary	*****
E. Share of minority in the revenue reserve of the subsidiary	*****
F. Share of minority in the preference dividend of the subsidiary (on cumulative preference shares whether declared or not and on non-cumulative preference shares when declared)	*****
G. Share of minority in the equity dividend declared by the subsidiary	*****
Minority Interest (A+B+C+D+E+F+G)	

Question 8

WHAT IS PRE ACQUISITION PROFIT AND POST ACQUISITION PROFIT ?

Answer:

In the consolidation of accounts, pre-acquisition and post-acquisition profits are terms used to distinguish the profits of a subsidiary before and after the parent company [HC] acquires control over it. These terms are important for accounting and reporting purposes to ensure that the financial statements accurately reflect the financial performance of the consolidated group.

1. Pre-Acquisition Profits:

- Pre-acquisition profits refer to the profits earned by the subsidiary before it comes under the control of the parent company (HC).
- These are the profits generated by the subsidiary when it was an independent entity or under the control of a different owner.
- When preparing consolidated financial statements, pre-acquisition profits are usually excluded from the income statement while calculating cost of control and minority interest, because they do not belong to the parent company or the group until the acquisition date.

2. Post-Acquisition Profits:

- Post-acquisition profits, on the other hand, refer to the profits earned by the subsidiary after the parent company has gained control over it.
- These are the profits generated by the subsidiary while it is a part of the consolidated group.
- Post-acquisition profits are included in the consolidated income statement because they belong to the parent company and the group.

Question 9

WHAT IS THE TREATMENT OF PRE-ACQUISITION PROFIT AND POST-ACQUISITION PROFIT ?

Answer:

Pre-Acquisition Profit =

- (a) Holding companies share in Pre A profit is added to paid up value of share of SC held by parent co (HC) While calculating net asset of SC
- (b) Share of minority will be added to the paid up value of share held in SC by the minority SH while calculating minority interest

Post-Acquisition Profit =

- (a) Holding companies share in Pre A profit is added to P&L A/C of parent co (HC) and share in reserve is added to R & S respectively.

Share of minority will be added to the paid up value of share held in SC by the minority SH while calculating minority interest.

Topic 7

FINANCIAL STATEMENT ANALYSIS

Question 1

WRITE DOWN THE CHARACTERISTICS OF GOOD FINANCIAL STATEMENT ?

Answer:

Good financial statements are essential for businesses and investors to assess the financial health and performance of a company accurately. Here are some characteristics of good financial statements:

1. **Accuracy:** Financial statements should be free from errors and omissions. The data presented should reflect the company's financial transactions and position with precision.
2. **Relevance:** The information in financial statements should be relevant to the needs of users, such as investors, creditors, and management. It should help them make informed decisions about the company.
3. **Completeness:** Financial statements should include all relevant financial information necessary for a comprehensive understanding of the company's financial performance and position.
4. **Transparency:** Information should be presented in a clear and transparent manner, making it easy for users to interpret and understand. Avoid jargon and complex language that may confuse readers.
5. **Comparability:** Financial statements should enable users to compare the company's performance and position with previous periods and with other companies in the same industry. Consistency in accounting methods and reporting formats is crucial for comparability.
6. **Timeliness:** Financial statements should be prepared and made available in a timely fashion, typically on a quarterly and annual basis, to ensure that users have access to up-to-date information.
7. **Reliability:** Users should be able to rely on the accuracy and trustworthiness of the information presented. This requires proper accounting methods, internal controls, and adherence to accounting standards.
8. **Understandability:** Financial statements should be presented in a way that is easily understood by users who may not have a background in accounting or finance. Footnotes and explanations should be provided for complex items.
9. **Consistency:** The company should use consistent accounting policies from one reporting period to the next, except when a change is necessary and disclosed properly.
10. **Materiality:** Financial statements should only include information that is material or relevant to decision-making. Immaterial items should not clutter the statements.
11. **Objectivity:** Financial statements should be prepared without bias or the intent to mislead. They should reflect the true economic substance of transactions, even if they are not always easy to measure.

- 12. Compliance with accounting standards:** Financial statements should adhere to generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS), depending on the jurisdiction and reporting requirements.

Question 2

WHAT ARE THE OBJECTIVES OF FINANCIAL STATEMENT ANALYSIS?

Answer:

The primary objective of financial statement analysis is to evaluate and understand a company's financial performance and position by examining its financial statements. This analysis serves several important purposes:

- 1. Assessing Financial Health:** Financial statement analysis helps stakeholders, such as investors, creditors, and management, determine the financial health of a company. It provides insights into the company's ability to meet its financial obligations and sustain operations.
- 2. Evaluating Profitability:** By analyzing income statements, stakeholders can assess a company's profitability, including its ability to generate profits from its core business activities. This information is crucial for investors seeking returns on their investments.
- 3. Measuring Liquidity:** Financial statement analysis helps gauge a company's liquidity, i.e., its ability to meet short-term obligations. This is important for creditors and suppliers to assess the risk of non-payment.
- 4. Assessing Efficiency:** Efficiency ratios, such as inventory turnover and accounts receivable turnover, reveal how effectively a company manages its assets and operations. This can help identify areas for improvement in the utilization of resources.
- 5. Evaluating Solvency:** Solvency ratios, like the debt-to-equity ratio and interest coverage ratio, help assess a company's long-term financial stability. Creditors use these ratios to gauge the risk associated with lending to the company.
- 6. Supporting Investment Decisions:** Investors use financial statement analysis to make informed investment decisions. It helps them identify companies with strong growth potential, stable financial positions, and attractive valuations.
- 7. Detecting Financial Irregularities:** Financial statement analysis can reveal signs of financial fraud or mismanagement. Unusual trends, inconsistencies, or discrepancies in the financial statements may raise red flags.

Question 3

WHAT IS RATIO ANALYSIS? EXPLAIN ADVANTAGES OF RATIO ANALYSIS.

Answer:

- Ratio analysis is a fundamental tool in financial analysis that involves evaluating a company's financial performance and position by examining various financial ratios and relationships between different components of its financial statements.

- These ratios are derived from the data presented in a company's income statement, balance sheet, and cash flow statement.
- Advantages of ratio analysis are as under:
 1. Ratio analysis helps investors, creditors, and management gain insights into a company's financial health, profitability, liquidity, efficiency, and solvency.
 2. One of the advantages of ratio analysis is to compare a company's financial performance to similar firms in the industry to understand the company's position in the market.
 3. Ratio analysis provides a valuable framework for benchmarking a company's performance over time, comparing it to industry peers, and identifying strengths and weaknesses.
 4. It simplifies the Financial statement by comparing different factors there under
 5. It helps analysing the past data to predict the future which helps in better decision making for the policies computation
 6. It plays significant role in cost accounting, financial accounting, budgetary control

Question 4

WHAT IS LIQUIDITY RATIO? ELABORATE DIFFERENT LIQUIDITY RATIOS?

Answer:

Liquidity ratios are financial metrics that assess a company's ability to meet its short-term financial obligations by measuring its ability to convert assets into cash quickly.

These ratios are essential for evaluating a company's liquidity, which is its capacity to cover immediate expenses and liabilities without disrupting its daily operations or resorting to external financing.

There are two primary liquidity ratios:

1. **Current Ratio:** The current ratio is calculated by dividing a company's current assets by its current liabilities. Current assets are assets that are expected to be converted into cash or used up within one year, such as cash, accounts receivable, and inventory. Current liabilities are obligations that are due within one year, such as accounts payable and short-term debt. The formula for the current ratio is:

$$\text{Current ratio} = \text{current asset} / \text{current liability}$$

A current ratio greater than 1 indicates that a company has more current assets than current liabilities, which suggests it has sufficient liquidity to cover its short-term obligations.

2. **Quick Ratio (Acid-Test Ratio):** The quick ratio is a more stringent measure of liquidity that excludes inventory from current assets since inventory may not be as easily convertible into cash in the short term. The formula for the quick ratio is:

$$\text{Quick ratio} = (\text{current asset} - \text{inventories}) / \text{current liability}$$

The quick ratio provides a more conservative estimate of a company's ability to meet its short-term obligations since it excludes inventory.

Liquidity ratios are important for various stakeholders, including creditors, investors, and management:

Question 5

WHAT IS EBITDA MARGIN? HOW IS IT COMPUTED?

Answer:

- EBITDA stands for "Earnings Before Interest, Taxes, Depreciation, and Amortization."
- It is a financial metric that is used to assess the operating performance and profitability of a company.
- EBITDA is often viewed as a measure of a company's core operating profitability because it excludes certain non-operating expenses and non-cash items that can distort a company's bottom-line profit.
- EBITDA margin, also known as EBITDA profitability margin, is a financial ratio that measures a company's profitability as a percentage of its revenue (sales) before accounting for interest, taxes, depreciation, and amortization expenses.
- It is a useful metric for assessing a company's operational efficiency and profitability, independent of its capital structure, tax rates, and non-operating expenses.
- The EBITDA margin is defined as:

$$\text{EBITDA} = \frac{\text{Earnings before interest, taxes, depreciation, and amortisation}}{\text{Net Sales}}$$

Question 6

WRITE SHORT NOTE ON RETURN ON CAPITAL EMPLOYED?

Answer:

Return on Capital Employed (ROCE) is a financial ratio that measures a company's efficiency in generating profits from the capital it has invested in its operations. It is a key financial metric used to assess a company's overall financial performance and the effectiveness of its capital allocation.

The formula for calculating ROCE is as follows:

$$\text{ROCE} = \frac{\text{Profit Before interest and tax (1 - tax rate)}}{\text{Average total assets}}$$

Where:

Capital Employed refers to the total amount of capital invested in the business to generate profits. It is typically calculated as the sum of a company's equity and long-term debt, minus any non-operating assets or excess cash.

ROCE is expressed as a percentage, and it measures how efficiently a company uses its capital to generate returns. A higher ROCE indicates that the company is using its capital effectively to generate profits, while a lower ROCE may suggest that the company is not generating sufficient returns relative to the capital invested.

- **It provides a holistic view:** ROCE offers a broader perspective on financial performance compared to some other financial metrics, such as return on equity (ROE), which only considers the equity portion of the capital structure.

Question 7

ELABORATE THE DUE PONT ANALYSIS?

Answer:

DuPont analysis, also known as the DuPont identity or DuPont model, is a financial analysis framework that breaks down a company's return on equity (ROE) into several components, allowing for a deeper understanding of the factors influencing a company's profitability. The DuPont analysis was developed by the DuPont Corporation in the early 20th century and has since become a widely used tool in financial analysis.

The DuPont analysis decomposes ROE into three key components:

1. **Net Profit Margin (NPM):** This represents the profitability of a company's operations. It is calculated as:

$$\text{NPM} = \text{Net Income} / \text{Total Revenue}$$

Net income is the company's profit after all expenses, including taxes and interest, have been accounted for.

2. **Asset Turnover (AT):** This measure how efficiently a company uses its assets to generate sales. It is calculated as:

$$\text{AT} = \text{Total Revenue} / \text{Average Total Assets}$$

Average Total Assets is the average of the beginning and ending total asset balances over a specific period.

3. **Equity Multiplier (EM) or Leverage:** This reflects the financial leverage or the degree of financial leverage employed by the company. It is calculated as:

$$\text{EM} = \text{Average Total Assets} / \text{Average Shareholders' Equity}$$

Average Shareholders' Equity is the average of the beginning and ending shareholders' equity balances over a specific period.

The formula for ROE, derived from these components, is as follows:

$$\text{ROE} = \text{NPM} \times \text{AT} \times \text{EM}$$

By breaking ROE down into these three components, DuPont analysis helps in identifying the specific drivers of a company's return on equity and provides insights into where improvements can be made. For example:

If a company has a low ROE, the analysis can help determine whether the issue lies with its profitability (NPM), asset efficiency (AT), or leverage (EM).

Question 8

DIFFERENCE BETWEEN: RETURN ON CAPITAL EMPLOYED & RETURN ON NET WORTH

Answer:

RETURN ON CAPITAL EMPLOYED	RETURN IN NET WORTH
This shows how much a company is earning on the capital employed	This ratio expresses the net profit in terms of shareholder funds
$RCE = EBIT / \text{Capital employed} \times 100$	$RNW = PAT / \text{net worth} \times 100$
It reflects the overall efficiency with which capital / assets are used	It indicates the return generated on the net worth of firm

Question 9

WHAT ARE THE PROBLEMS ASSOCIATED WITH FINANCIAL STATEMENT ANALYSIS?

Answer:

Financial statement analysis is a critical process for evaluating a company's financial health and performance.

However, it's important to recognize that there are several challenges and potential problems associated with financial statement analysis:

- 1. Incomplete Information:** Financial statements provide a brief of a company's financial position at a specific point in time. They may not capture all relevant information, especially non-financial factors like changes in market conditions, technological advancements, or changes in consumer preferences.
- 2. Accounting Methods and Assumptions:** Companies use different accounting methods and assumptions, which can affect the way their financial statements are prepared, making it challenging to compare companies accurately.
- 3. Financial Statement Manipulation:** Some companies may engage in financial statement manipulation or creative accounting to make their financial performance appear more favourable than it actually is.
- 4. Seasonality and Cyclical Nature:** Certain industries or companies may experience significant seasonality or cyclical nature in their financial results. An analysis conducted during a particular period may not accurately represent the company's overall performance.
- 5. Quality of Auditors:** The reliability of financial statements also depends on the competence and independence of the auditors who review and certify them. Low-quality audits can result in financial statements that do not provide an accurate representation of a company's financial position.
- 6. Global Accounting Standards:** Different countries may have varying accounting standards (e.g., U.S. GAAP, IFRS), making it challenging to compare financial statements of companies operating in different regions.
- 7. Complex Financial Instruments:** The presence of complex financial instruments and derivatives can make it difficult to assess a company's financial risk and exposure accurately.
- 8. Non-Financial Factors:** Financial statement analysis typically focuses on quantitative data, but qualitative factors, such as management quality, corporate governance, and competitive

positioning, can significantly impact a company's performance and are not always captured in financial statements.

9. **Forward-Looking Information:** Financial statements primarily reflect historical data. Analysts and investors often need to rely on other sources and models to make projections about a company's future performance.
10. **External Economic Factors:** External economic factors, such as changes in interest rates, inflation, or geopolitical events, can influence financial performance and may not be fully accounted for in financial statements.



Topic 9

CASH FLOW STATEMENT

Question 1

DIFFERENCE BETWEEN CASH FLOW & FUND FLOW STATEMENT.

Answer:

BASIS	CASH FLOW STATEMENT	FUND FLOW STATEMENT
Meaning	-A Statement showing flow of cash and cash equivalent position in the firm.	- A statement of sources of funds and change in the working capital
Purpose	-The primary purpose of the cash flow statement is to provide information about the cash inflows and outflows of a business during a specific period.	- it focuses on changes in a company's financial position over a period of time. It provides insights into how funds have been utilized for various activities such as investments, financing, and operations.
Basis	CFS is Prepared on a cash basis, which means it records transactions when cash is received or paid. It does not consider non-cash transactions, such as depreciation, which affects the income statement.	FFS is prepared on an accrual basis, which considers both cash and non-cash transactions. It considers changes in working capital, long-term liabilities, and equity.
Scope	CFS primarily focuses on cash transactions and provides details about operating, investing, and financing activities.	provides a broader view of the company's financial changes, including long-term financial decisions and their impact on the firm's overall financial health.
Balances	CFS covers opening & closing balance of cash and cash equivalent.	FFS does not covers balances of cash and cash equivalent

Question 2

DISTINGUISH BETWEEN CASH & CASH EQUIVALENT?

Answer:

BASIS	CASH	CASH EQUIVALENT
Meaning	Cash refers to physical currency in the form of coins and banknotes that a company holds. It includes demand deposits with banks	This are the short term, highly liquid investment readily convertible into the amount of cash subject to the risk associated with it.
Liquidity	Cash is the most liquid asset a company can hold. It can be used for immediate payments and transactions.	Cash equivalents are also highly liquid but are considered to be slightly less liquid than physical cash.

Purpose	Cash is used for day-to-day transactions, paying bills, making purchases, and covering operational expenses.	Cash equivalents are typically held as a short-term investment to earn a return on temporarily idle funds while maintaining liquidity.
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Question 3

WHAT ARE THE BENEFITS OF CASH FLOW STATEMENT?

Answer:

- The cash flow statement is a financial statement that provides a detailed account of a company's cash inflows and outflows during a specific period of time.
- It is one of the three key financial statements, along with the income statement and the balance sheet. The cash flow statement offers several benefits for businesses, investors, and stakeholders:
- A cash flow statement helps businesses track and manage their cash effectively. It allows them to monitor how cash is generated and used in various operational, investing, and financing activities. This helps in ensuring that there is enough liquidity to meet short-term obligations and invest in growth opportunities.
- By examining trends in cash flows over multiple periods, stakeholders can identify whether a company's cash flow is improving, deteriorating, or remaining stable. This can be valuable information for making investment decisions.
- The cash flow statement can highlight how efficiently a company's core operations are generating cash. Positive operating cash flows indicate that the company's day-to-day operations are self-sustaining.
- Investors can use the cash flow statement to assess the company's investment decisions, such as capital expenditures. It shows whether a company is investing in growth opportunities or if it's overextending itself.
- Lenders and creditors can assess a company's ability to service its debt by analyzing its cash flow from operating activities.
- Cash flow statements can aid in tax planning by highlighting the timing of cash flows. Businesses can optimize their tax strategies by managing when they receive income and when they pay expenses.
- Analysts use cash flow projections to determine the intrinsic value of a company's stock or business. Discounted Cash Flow (DCF) analysis, a common valuation method, relies on cash flow projections.
- The cash flow statement provides transparency and accountability to shareholders, investors, lenders, and other stakeholders. It helps in explaining how a company is managing its cash resources.

Question 4

WRITE DOWN THE NON-CASH TRANSACTION WHICH ARE NOT INCLUDED IN CFS?

Answer:

- The Cash flow statement is the display of all the cash and cash equivalent inflow and outflow transaction in the fin. Year.
- There are many transactions which are neither cash nor cash equivalent that should not be included in the CFS such as :
 1. Issue of Equity Shares or Debentures against the purchase of an Asset
 2. Issue of Equity Shares on conversion of Convertible Debentures
 3. Charging of Depreciation
 4. Amortization of a Fixed Intangible Asset
 5. Written off of an old Fixed Tangible Asset
 6. Declaration of Final Dividend on Shares

Question 5

DEFINE THE ACTIVITIES INCLUDED UNDER CASH FLOW STATEMENT. / OR WHAT ARE THE CATEGORIES OF THE CASH INFLOWS AND OUTFLOWS?

Answer:

1. Cash flow from operating activities:

- Operating activities are the principal revenue producing activities of the enterprise & other activities that are not investing & financing activities.
- Operating activities include cash effects of those transactions and events that enter into the determination of net profit or loss.
- It includes all the activities that are not included in investing or financing activities.
- Example : cash receipts from the sale of goods and the rendering of services

2. Cash flow from investing activities:

- Investing activities are the acquisition & disposal of long term assets & other investments not included in cash equivalents.
- It include transactions & events that involve the purchase & sale of long-term productive assets (e.g. land, building, plant & machinery etc.) not held for resale & other investments.
- Example : Cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self- constructed fixed assets;

3. Cash flow from financing activities:

- Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise
- Example : cash proceeds from issuing shares or other similar instruments;

Question 6

DESCRIBE THE CASH FLOW FROM OPERATING ACTIVITIES BRIEFLY. ALSO DEFINE DIRECT & INDIRECT OF OPERATING ACTIVITIES.

Answer:

- Operating activities are the principal revenue producing activities of the enterprise & other activities that are not investing & financing activities.
- Operating activities are the main source of revenue and expenditure in an enterprise.
- Therefore, the ascertainment of cash flows from operating activities are major priority.
- This operating activities can be computed using 2 methods :

1. Direct method:

- Under direct method, cash receipts from operating revenues and cash payments for operating expenses are arranged and presented in the cash flow statement.
- The difference between cash receipts and cash payments is the net cash flow from operating activities.
- Memorandum for direct method for computation of operating activity:

Cash flows from operating activities

Cash receipt from customers

Cash paid to suppliers & employees

Cash generated from operation

Other/misc. income / Exp

Other/misc. expenses

Income tax/ advance tax paid

Cash before extraordinary item

Extraordinary item

CASH FLOW FROM OPERATING ACTIVITIES

2. Indirect method:

- Indirect method of ascertaining cash flow from operating activities begins with the amount of net profit/loss.
- This is so because statement of profit and loss incorporates the effects of all operating activities of an enterprise.
- It becomes necessary to adjust the amount of net profit/loss as shown by Statement of Profit and Loss for arriving at cash flows from operating activities.
- Memo of indirect method of computing cash flow from operating activities :
 - (A) Cash flows from operating activities
 - Net profit before working capital changes
 - (+) Decrease in CA
 - (-) Increase in CA
 - (+) Increase in CL

- (-) Decrease in CL
- Cash generated from operation
- Other/misc. income
- Other/misc. expenses
- Income tax/ advance tax paid
- Cash before extraordinary item
- Extraordinary item

CASH FLOW FROM OPERATING ACTIVITIES

Question 7

STATE THE LIMITATIONS OF CASH FLOW ANALYSIS?

Answer:

The cash flow statement is a valuable financial statement that provides insights into a company's liquidity, but it also has its limitations and drawbacks. Here are some of the key limitations of the cash flow statement:

1. **Limited Historical Perspective:** The cash flow statement primarily focuses on past transactions and events. It provides information about what has happened in the past, which may not always reflect future cash flows accurately.
2. **Lack of Non-Cash Items:** The cash flow statement does not consider non-cash items such as depreciation and amortization, which are significant in understanding a company's overall financial health. As a result, it may not provide a complete picture of a company's profitability.
3. **Timing Differences:** The timing of cash flows can be misleading. For example, a company may report strong cash flows in a particular period due to the collection of accounts receivable, but this does not necessarily mean that the company is generating sustainable cash flows from its core operations.
4. **Subject to Manipulation:** Like other financial statements, the cash flow statement can be subject to manipulation and creative accounting practices. Companies may use various methods to manipulate their cash flow figures to present a more favourable image to investors and creditors.
5. **Does Not Reflect Economic Events:** The cash flow statement is based on cash transactions, which may not always reflect the economic substance of a transaction. For example, a lease agreement might not result in immediate cash outflows, but it can have a significant impact on a company's long-term financial commitments.
7. **Industry and Seasonal Variations:** Some industries and businesses may have seasonal variations in their cash flows, making it challenging to analyze their financial health accurately based solely on the cash flow statement.
8. **Does Not Account for Investment Quality:** The cash flow statement does not provide information about the quality of investments made by a company. A company might be investing in projects with poor future cash flow prospects, which could impact its long-term financial stability.

9. Limited Predictive Power: While the cash flow statement provides historical data, it may not be a reliable predictor of a company's future performance.

Question 8

DIFFERENCE BETWEEN POSITIVE AND NEGATIVE CASH FLOW ?

Answer:

POSITIVE CASH FLOW	NEGATIVE CASH FLOW
It indicates that a company has more money flowing into the business than out of it over a specified period.	It means cash outflow is higher than cash inflow during a period, but it doesn't necessarily mean profit /Loss
A positive cash flow is generally considered a healthy financial sign. It indicates that the entity is generating more cash than it's spending,	Negative cash flow is typically a cause for concern. It suggests that the entity is spending more money than it's earning
Positive cash flow can result from various factors, including increased sales revenue, effective cost management, profitable investments, or financing arrangements that bring in more cash than they require in payments.	Negative cash flow can occur due to factors like low sales revenue, excessive spending, large debt repayments, or significant investments that haven't yet yielded returns.
Managing positive cash flow involves making strategic decisions on how to allocate excess cash.	Managing negative cash flow requires taking immediate action to address the shortfall.
Positive cash flow, if sustained, contributes to the long-term financial health and growth of a business or individual.	Prolonged negative cash flow without a plan for improvement can jeopardize the financial stability & viability of a business or individual.

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Topic 10

FORECASTING FINANCIAL STATEMENT

Question 1

WRITE A SHORT NOTE ON: IMPORTANCE OF FINANCIAL FORECASTING

Answer:

Financial forecasting is a critical process for individuals, businesses, and organizations of all sizes. It involves making predictions about future financial performance based on historical data and current economic conditions.

Financial forecasts are a crucial part of business planning, budgeting, operations, funding that help leaders and outside stakeholders make better choices.

The importance of financial forecasting can be understood from several perspectives:

- It serves as the basis for budgeting decisions.
- It gives businesses access to cohesive reports, allowing finance departments to establish business goals that are both realistic and feasible.
- It provides management valuable insights into the way the business performed the past and the way it will compare in the future.
- It provides a barometer for those making material financial decisions.
- It facilitates 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.
- It provides customizable approach based on the core set of foundational components. To make accurate budget and facilitates to establish realistic business goals.
- 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.
- Many times, accurate and authenticate financial forecast reflecting higher Return on Investment and that helps to build and enhance the investor's confidence.

Question 2

WRITE A SHORT NOTE ON: ESSENTIALS OF BUDGET

Answer:

Essential elements of a budget are as follows:

- Organizational structure must be clearly defined and responsibility should be assigned to identifiable units within the organization.
- Setting of clear objectives and reasonable targets.
- Objectives should be in consonance with the long-term plan of the organization.
- Objectives and degree of responsibility should be clearly stated and communicated to the management or person responsible for.
- Budgets are prepared for the future periods based on expected course of actions.

- Budgets are updated for the events that were not kept into the mind while establishing budgets. Hence, budgets should be flexible enough for mid-term revision.
- The entire organization must be committed to budgeting.
- Budgets should be quantifiable and master budget should be broken down into various functional budgets.
- Budgets should be monitored periodically. Variances from the set yardsticks (standards) should be analyzed and responsibility should be fixed.
- Budgetary performance needs to be linked effectively to the reward system.

Question 3

DIFFERENCE BETWEEN: FIN FORECASTING AND PROJECTION.

Answer:

FINANCIAL FORECASTING	FINANCIAL PROJECTION
Financial forecasting is the process of making predictions or estimates about future financial performance based on historical data & analysis.	Financial projections are a specific type of financial forecast that represents a more detailed & comprehensive view of a company's financial future.
It typically involves analysing past financial data, trends, & variables such as revenue, expenses, and cash flows to make informed predictions about what may happen in the future.	These projections are typically used for business planning and decision-making, including securing funding from investors or lenders.
Financial forecasts can be short-term (e.g., monthly or quarterly) or long-term (e.g., annual or multi-year) and are used to set targets, make budget decisions, and plan for potential challenges.	Financial projections include various financial statements, such as income statements, balance sheets, and cash flow statements, and often incorporate assumptions about future events and strategies.
Financial forecasting often relies on quantitative data and statistical methods to make predictions.	Financial projections are often used to evaluate the feasibility of a business plan, assess the return on investment, and guide strategic decision-making.

Question 4

DEFINE: FACTORS AND COMPONENTS OF FORECASTING.

Answer:

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

- Define the purpose of financial forecasting
- Collection of historical data and accuracy of data sources
- A forward-looking time horizon (12-18-24 month span)
- Formulas to determine how much weight to give any piece of data

- Consideration of an Internal and Macro-economic risk
- Best/Worst case (Revenue and Expenses) scenarios
- Selection of financial forecast method
- Documentation/Monitoring/ Analysis of data

Question 5

WHAT ARE THE METHODS OF FORECASTING FINANCIAL STATEMENT.

Answer:

Basically, there are two methods of Forecasting namely

1. Quantitative methods: This method used to make assumptions about the future based on historical data
2. Qualitative methods: This relies on experts' knowledge and experience to predict performance rather than historical numerical data.

Other methods of forecasting are as under:

1. Based on Revenue (% of Turnover)

- (a) Costs of goods sold (COGS), Stock and cash are calculated as a percentage of sales.
- (b) To forecast the percent of sales, examine the percentage of each account's historical profits related to sales.
- (c) To calculate this, divide each account by its sales, assuming the numbers will remain steady

2. Moving Average Method:

- (a) The average or Weighted average of previous periods are computed to forecast the future
- (b) It is closely scrutinizing a business's high or low demands
- (c) it is more suitable for short- term forecasting
- (d) For Moving Average:

$$P1+P2+P3.../N$$

Here P = Average for a period

N = Total number of periods

3. Constant Growth Rate:

- (a) It assumes a company's historical growth rate will remain constant
- (b) revenue involves multiplying a company's previous year's revenue by its growth rate.

4. Regression Method

- (a) This method is based on a relationship between two variables: dependent and independent.
- (b) The dependent variable represents the forecasted amount, while the independent variable is the factor that influences the dependent variable.
- (c) Formula $Y = BX + A$
 - (i) Y= Dependent variable (Forecasted number)
 - (ii) B = Slope line
 - (iii) X = Independent variable

(iv) A = Y-intercept

5. Delphi Method

- (a) 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.



Topic 11

INTRODUCTION TO FINANCIAL ACCOUNTING

Question 1

WHAT IS FINANCE?

Answer:

- The word finance is Derived from the Latin word ‘FINIS’ which means end/finish.
- Finance is the procurement of funds and their effective utilization in business concerns.
- Finance act as a medium for business which involves the acquisition and usage of funds in various departments
- As per WEBSTER’S THEORY “FINANCE is ‘Science on study of the management of funds’ and the management of fund as the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities.”
- Finance is a broad term that refers to the management of money and assets. It encompasses a range of activities related to the allocation, acquisition, and utilization of financial resources to achieve specific objectives.
- Finance plays a crucial role in both personal and business contexts and is essential for the functioning of economies at large

Question 2

WHAT ARE THE CATEGORIES OF FINANCE?

Answer:

The KEY CATAGORIES of finance are as follows:

1. PUBLIC FINANCE:

- Public Finance are the funds collected by CG, SG, Local bodies, etc.
- Public finance focuses on the financial activities of governments and public-sector entities.
- It includes budgeting, taxation, public expenditure, and fiscal policy.
- The objectives of Govt. activities are not to earn profit, the objectives are to achieve social and economic upliftment.
- Government financial matters are studied thoroughly and formally

2. CORPORATE FINANCE:

- This deals with how corporations address funding sources, capital structuring, accounting, and investment decisions.
- Objective of corporate finance is to maximize shareholder value through long- and short-term financial planning
- Corporate finance is concerned with monitoring cash flows, preparing FS and taxation.
- It includes areas like capital budgeting, financing decisions (e.g., issuing stocks or bonds), risk management, and mergers and acquisitions.

3. PERSONAL FINANCE:

- The term often refers to the entire industry that provides financial services to individuals and households.
- It emphasis on the personal savings and short term finance goals.

Question 3

WHAT ARE THE OBJECTIVES OF FINANCIAL MANAGEMENT?

Answer:

Finance is an essential and indispensable part of any organization. efficient management of financial resources is essential to be sustainable and viable in the long-run.

Financial management is a critical aspect of running any organization.

The primary objectives of financial management are to ensure the organization's financial health, achieve its financial goals, and maximize shareholder or stakeholder value. Here are some key objectives of financial management

- **Profit Maximization:** One of the primary goals of financial management is to maximize profits or earnings for shareholders in the case of a corporation. This involves increasing revenue while minimizing costs and expenses.
- **Wealth Maximization:** This objective focuses on increasing the wealth of shareholders or stakeholders by increasing the value of their investments. It considers not only current profits but also the long-term growth and sustainability of the organization.
- **Risk Management:** Financial managers aim to manage financial risks effectively. This includes identifying, assessing, and mitigating risks related to investments, financing, and operations to ensure the organization's financial stability.
- **Liquidity Management:** Maintaining an appropriate level of liquidity (cash and near-cash assets) is crucial to meet short-term obligations and take advantage of opportunities. Financial managers aim to strike a balance between liquidity and profitability.
- **Asset Management:** Efficiently managing assets is essential to optimize the use of resources. Financial managers aim to maximize the return on assets while minimizing unnecessary investments or underutilization of assets.
- **Cost Control:** Controlling costs and expenses is vital to improving profitability. Financial managers regularly review and assess costs to identify areas where efficiencies can be achieved.
- **Financial Reporting and Compliance:** Ensuring accurate and transparent financial reporting is a legal and ethical responsibility. Financial managers must adhere to accounting standards and regulatory requirements while providing timely and reliable financial information to stakeholders.
- **Sustainable Growth:** Financial management should consider the long-term sustainability of the organization. This involves making investments in research and development, new markets, and innovation to support future growth.
- **Stakeholder Satisfaction:** Beyond shareholders, financial management should also consider the interests of other stakeholders, such as customers, employees, suppliers, and the broader

community. A focus on stakeholder satisfaction can enhance the organization's reputation and long-term success.

- **Tax Management:** Managing tax liabilities is an important aspect of financial management. Strategies for tax efficiency can help reduce the organization's overall tax burden.

Question 4

WRITE A SHORT NOTE ON: FINANCIAL DISTRESS

Answer:

Financial distress is a condition where a company cannot meet, or has difficulty paying off, its financial obligations to its creditors, typically due to high fixed costs, illiquid sets or revenues sensitive to economic downturns. A company under financial distress can incur costs related to the situation, such as more expensive financing, opportunity costs of projects and less productive employees. Employees of a distressed firm usually have lower morale and higher stress caused by the increased chance of bankruptcy, which would force them out of their jobs.

Generally, the affairs of the firm should be managed in such a way that the total risk of business as well as financial borne by equity shareholders is minimized and is manageable. otherwise the firm will obviously face difficulties. If cash inflow is inadequate, the firm will face difficulties in payment of interest and repayment of principal. If the situation continues long enough, a time will come when the firm would face pressure from creditors. Failures of sales can also cause difficulties in carrying out production operations. The firm would find itself in a tight spot. Investors would not invest further Creditors would recall their loans. Capital market would heavily discount its securities Thus, the firm would find itself in a situation called distress.

Signs of Financial Distress: Poor profits indicate a company is not experiencing financial health. Struggling to break even indicates a business cannot sustain itself from internal funds and needs to raise capital externally. This raises the company's business risk and lowers its creditworthiness with lenders, suppliers, investors and banks. Limiting access to funds typically results in a company failing.

Pour sales growth or decline indicates the market is not positively receiving a company's products or services based on its business model. When extreme marketing activities result in no growth, the market may not be satisfied with the offerings, and the company nay close down. Likewise, if a company offers poor quality in its products or services, consumers start buying from competitors, eventually forcing a business to close its doors When debtors take too much time paying their debts to the company, cash flow may be severely stretched. The business may be unable to pay its own liabilities. The risk is especially enhanced when a company has one or two major customers.

Question 5

WRITE SHORT NOTE ON FINANCIAL DECISIONS:

Answer:

- Investment ordinarily means utilisation of money for profits or returns.
- This could be done by creating physical assets with the money and carrying on business or purchasing shares or debentures of a company.
- Investments necessarily involve uncertainty and are therefore quite risky.
- Investment decisions relate to capital budgeting as well as working capital management.
- Investment decisions are concerned with the question whether adding to capital assets today will increase the revenues of tomorrow to cover costs.

CATEGORIES of investment decision are as under

- **Inventory Management:** Holding of stocks of materials is unavoidable for smooth running of a business.
- **Strategic Investment:** In this case, the firm makes investment decisions in order to strengthen its market power.
- **Investment on Modernization:** In this case, the firm decides to adopt a new and better technology in place of the old one for the sake of cost reduction.
- **Investment in New Business:** Where a new set of machines are to be purchased For the diversification of business.
- **Investment in New Business:** The firm takes decisions about the replacement of worn out & obsolete assets by new ones.
- **Expansion Investment:** The firm decides to expand the productive capacity for existing products and thus grows further unidirectional.

FACTORS DETERMINING investment decision:

- Estimation of capital outlays and the future earnings of the proposed project
- Availability of capital and considerations of cost of capital
- A set of standards by which to select a project for implementation and maximizing returns

THE INVESTMENT DECISION PROCESS:

- Generate cash flow forecasts for the projects,
- Determine the appropriate opportunity cost of capital,
- Use the cash flows and the cost of capital to compute the relevant investment criteria.

Question 6

FINANCING DECISION:

Answer:

- Determining the best capital structure or financing decision is the next step in financial management for executing the investment decision once taken.
- Financing decisions are to determine how much funds to procure from the various avenues available or the financing mix or capital structure

- Capital structure refers to the amount of debt and/or equity employed by a firm to fund its operations and finance its assets. A firm’s capital structure is typically expressed as a debt-to-equity or debt-to-capital ratio.
- Capital Structure is the mix between owner’s funds and borrowed funds.

Funds = Owner’s funds + Borrowed funds

Owner’s funds (Equity) = Equity share capital + Preference share capital + Reserves and Surplus + Retained Earnings

Borrowed funds = Loans + Debentures + Public Deposits

FACTORS affecting financing decision:

- Cost:
- Risk:
- Cash flow position:
- Control consideration:
- Floating cost:

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Question 7

DIVIDEND DECISION:

Answer:

- The financial manager must decide whether the firm should distribute all profits or retain them or distribute a portion and retain the balance. Such decision is called as Dividend decision
- Such decision should depend on whether the company or its shareholders are in position to better utilize funds.
- both the dividends and retention of profits are important financial signals to the market as financing and dividend decision are inter-related to each other.
- Management needs to ensure that enough funds is available at right time to meet the needs of the business.

MAJOR FACTORS that influence the dividend decision:

• **Legal requirements:**

There is no legal compulsion on the part of a company to distribute dividend. However, there certain conditions imposed by law regarding the way dividend is distributed.

• **Firm’s liquidity position**

Liquidity of the profit is so important as, In spite of sufficient retained earnings, the firm may not be able to pay cash dividend if the earnings are not held in cash.

• **Repayment needs:**

The debts taken to meet the financing needs must be repaid at the maturity. If the firm has to retain its profits for purpose of repaying debt, the dividend payment capacity reduces.

• **Expected rate of return**

If a firm has relatively higher expected rate of return on the new investment, the firm prefers to retain the earnings for reinvestment rather than distributing cash dividend.

• **Stability of earning**

If a firm has relatively stable earnings, it is more likely to pay relatively larger dividend than a firm with relatively fluctuating earnings.

Question 8

INVESTMENT, FINANCING & DIVIDEND DECISIONS ARE INTERRELATED. COMMENT.

Answer:

- When a company takes on profitable investment projects, it can generate higher cash flows.
- These cash flows can then be used to repay debt or fund future projects, reducing the need to issue additional equity.
- Profitable investments can also enhance the company's credit worthiness, potentially leading to lower financing costs.
- On the other hand, if a company lacks internal funds to finance its investments and must rely heavily on external debt or equity financing, it may face higher financing costs and increased financial risk.
- This can negatively impact the attractiveness of investment opportunities.
- Paying dividends reduces the amount of cash available for financing and investment.
- Companies that pay substantial dividends may need to raise capital externally, potentially leading to higher financing costs.
- Alternatively, companies that retain earnings instead of paying dividends can reduce their reliance on external financing.
- In summary, investment, financing, and dividend decisions are closely intertwined in corporate finance. A well-balanced approach to these decisions is crucial for optimizing a company's financial performance, managing risk, and creating value for shareholders.

Question 9

DISTINGUISH BETWEEN: FINANCIAL DISTRESS & FINANCIAL INSOLVENCY

Answer:

Financial Distress	Financial Insolvency
Financial distress refers to a condition where a company or individual is experiencing financial difficulties or challenges, but they have not yet reached a point where they are unable to meet their financial obligations.	Financial insolvency is an advanced situation that occurs when a company or individual is unable to meet their financial obligations as they come due & cannot pay their debts or fulfil their financial commitments.
It is a preliminary stage of financial trouble, indicating that there are problems with cash flow, profitability, or debt management, but are able to run affairs of firm	This involves a situation where assets are insufficient to cover the liabilities, and it often leads to bankruptcy proceedings or legal actions by creditors to recover their debts.
During financial distress, the entity may take various measures to improve its financial situation, such as cutting costs, renegotiating contracts, or seeking additional financing to bridge the gap.	Insolvency can result in the liquidation of assets to repay creditors or a formal restructuring process, such as bankruptcy or a proposal under bankruptcy laws, to reorganize and manage the debts.

Financial distress is often a warning sign that action needs to be taken to prevent the situation from deteriorating further into insolvency.	It is a critical point where the financial entity's ability to continue operating or managing their financial affairs in the normal course is seriously compromised.
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Question 10

AN INVESTOR SUFFERS DILUTION OF FINANCIAL INTEREST WHEN HE DOES NOT EXERCISE HIS PRE-EMPTIVE RIGHTS. COMMENT.

Answer:

- To preserve the shareholders proportionate dividend, liquidation and voting rights, pre-emptive rights are often recognized,
- But their existence and scope can be affected by provisions in the articles.
- However, Section 62 of the Companies Act, 2013 secures shareholders pre-emptive rights with regard to the further issue of share capital by the company.
- As per Section 62, where at any time, a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares shall be offered to existing shareholders in proportion to the paid-up share capital on those shares by sending a letter of offer.
- Thus, existing shareholders are given option to subscribe new shares. If shareholder does not exercise his pre-emptive rights his financial interest dilutes.

Question 11

FAILURE OF A FIRM IS TECHNICAL IF IT IS UNABLE TO MEET ITS CURRENT OBLIGATIONS. COMMENT.

Answer:

- Failure of a firm is technical if it is unable to meet its current obligations. The failure could be temporary and might be remediable.
- When liabilities exceed assets ie. the net worth becomes negative, bankruptcy, as commonly understood, arises.
- Bankruptcy can be ascertained by comparing current assets and current liabilities Le. working out current ratio or quick ratio.
- On the other hand, solvency ratios indicate long term liquidity i.e. the ability of the firm to discharge its term-liabilities. Examples of solvency ratios are Debt to Equity ratio, Debt to total Funds Ratios, and Interest coverage ratio.
- Trend analysis should be made for the past three to five years to pick up signals of bankruptcy, if any

Question 12

TRADITIONAL APPROACH OF BUSINESS FINANCE CONSIDERS EFFICIENT UTILIZATION OF RESOURCES. COMMENT. (OLD SYLLABUS QUESTION)

Answer:

- Financial management approach measures the scope of the financial management in various fields, which include the essential part of the finance.
- Financial management is not a revolutionary concept but an evolutionary. The definition and scope of financial management has been changed from one period to another period and applied various innovations.
- Traditional Approach: Traditional approach is the initial stage of financial management which was followed, in the early part of during the year 1920 to 1950.
- This approach is based on the past experience and the traditionally accepted methods. Main part of the traditional approach is rising of funds for the business concern.
- Traditional approach consists of the following important area:
 - Arrangement of funds from lending body.
 - Arrangement of funds through various financial instruments.
 - Finding out the various sources of funds.
 - Effective utilization of own resources.

Question 13

LIQUIDITY & PROFITABILITY ARE COMPETING GOALS FOR THE FINANCIAL EXECUTIVES.

Answer:

- Liquidity is an important concept in financial management and is defined as ability of the business to meet its 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.
- Profitability as a decision criterion is another important tool in financial management for taking decisions from different angles after evaluating the performance of the company in different spheres.
- There is an inverse relationship between liquidity and profitability.
- While the immediate survival of a business depends on its liquidity, its long term survival and growth depend on profitability.
- Thus, liquidity ensures short term survival and profitability ensures long term survival. Both are, therefore important for any firm to survive.
- A firm should maintain a trade-off situation where the firm maintains its optimum liquidity for greater profitability and the finance executive has to strike a balance between the two conflicting objectives.
- Therefore we can say that Liquidity and Profitability are competing goals for the finance manager.

Question 14

FINANCIAL MANAGEMENT MEANS THE MANAGEMENT OF FINANCES OF A BUSINESS ORGANIZATION IN ORDER TO ACHIEVE FINANCIAL OBJECTIVES. ELABORATE THE FINANCIAL OBJECTIVES OF A FIRM.

Answer:

Financial management of any business firm has to set goals for itself and to interpret them in relation to the objective of the firm. Broadly, there are only two alternative objectives a business firm can pursue viz.

(a) Profit Maximization:

- Profit maximization is considered as an important goal in financial decision-making in an organization.
- It ensures that firm utilizes its available resources most efficiently under conditions of competitive markets.
- Now a days, profit maximization is regarded as unrealistic, difficult, inappropriate and socially not much preferred goal for business organization.
- Profit maximization as corporate goal is criticized by scholars mainly on the following grounds:
 - (a) It is vague conceptually.
 - (b) It ignores timing of returns.
 - (c) It ignores the risk factor.
 - (d) It may tempt to make such decisions which may in the long run prove disastrous
 - (e) Its emphasis is generally on short run projects.
 - (f) It may cause decreasing share prices.
- The profit is only one of the many objectives and variables that a firm considers.

(b) Wealth maximization:

- It is the duty of the finance manager to see that the share- holders get good returns on the shares. Hence, the value of the share should increase in the share market.
- The share value is affected by many things. If a company is able to make good sales and build a good name for itself, in the industry, the company's share value goes up.
- If the company makes a risky investment, people may lose confidence in the company and the share value will come down.
- So, this means that the finance manager has the power to influence decisions regarding finances of the company.
- The decisions should be such that the share value does not decrease. Thus, wealth or value maximization is the most important goal of financial management.
- The management of an organization maximizes the present value not only for share- holders but for all including employees, customers, suppliers and community at large.
- This goal for the maximum present value is generally justified on the following grounds:
 - (a) It is consistent with the object of maximizing owners economic welfare. It focuses on the long run picture.

- (b) It considers risk.
- (c) It recognizes the value of regular dividend payments. It takes into account time value of money.
- (d) It maintains market price of its shares. It seeks growth in sales and earnings.
- (e) However, profit maximization can be part of a wealth maximization strategy.

Quite often two objectives can be pursued simultaneously but the maximization of profit should never be permitted to overshadow the objectives of wealth maximization.

Question 15

FINANCIAL MANAGEMENT IS SCIENCE AS WELL AS ART. COMMENT.

Answer:

- The financial management is neither a pure science nor an art. It deals with various methods and techniques, which can be adopted, depending on the situation of business and the purpose of the decision.
- As a science it uses various statistical and mathematical models and computer applications for solving the financial problems relating to the firm for example, capital investment appraisal, capital allocation and rationing, optimizing capital structure mix, portfolio management etc.
- Along with the above, a finance manager required to apply his analytical skills in decision making.

Hence, financial management is both a science as well as an art.

Question 16

FINANCIAL SECTOR PERFORMS BASIC ECONOMIC FUNCTION OF INTERMEDIATION THROUGH TRANSFORMATION MECHANISMS. COMMENT.

Answer:

- In any economy, the financial sector plays a major role in the mobilization and allocation of savings.
- Financial institutions, instruments and markets which constitute the financial sector act as conduit for the transfer of financial resources from net savers to net borrowers, i.e, from those who spend less than they earn to those who spend more than they earn.
- The financial sector performs this basic economic function of intermediation essentially through four transformation mechanisms:
 - (a) **Liability-asset transformation:** Accepting deposits as a liability and converting them into assets such as loans.
 - (b) **Size transformation:** Providing large loans on the basis of numerous small deposits
 - (c) **Maturity transformation:** Offering savers alternate forms of deposits according to their liquidity preferences while providing borrowers with loans of desired maturities
 - (d) **Risk transformation:** Distributing risks through diversification which substantially reduces risks for savers which would prevail while directly in the absence of financial intermediation.

- The process of financial intermediation supports increasing capital accumulation through the institutionalization of savings and investments and as such, fosters economic growth.
- The gains to the real sector of the economy, therefore, depend on how efficiently the financial sector performs this basic function of financial intermediation.

Question 17

FINANCIAL MANAGEMENT HAS CHANGED SIGNIFICANTLY IN ITS SCOPE AND COMPLEXITY IN RECENT TIMES. COMMENT.

Answer:

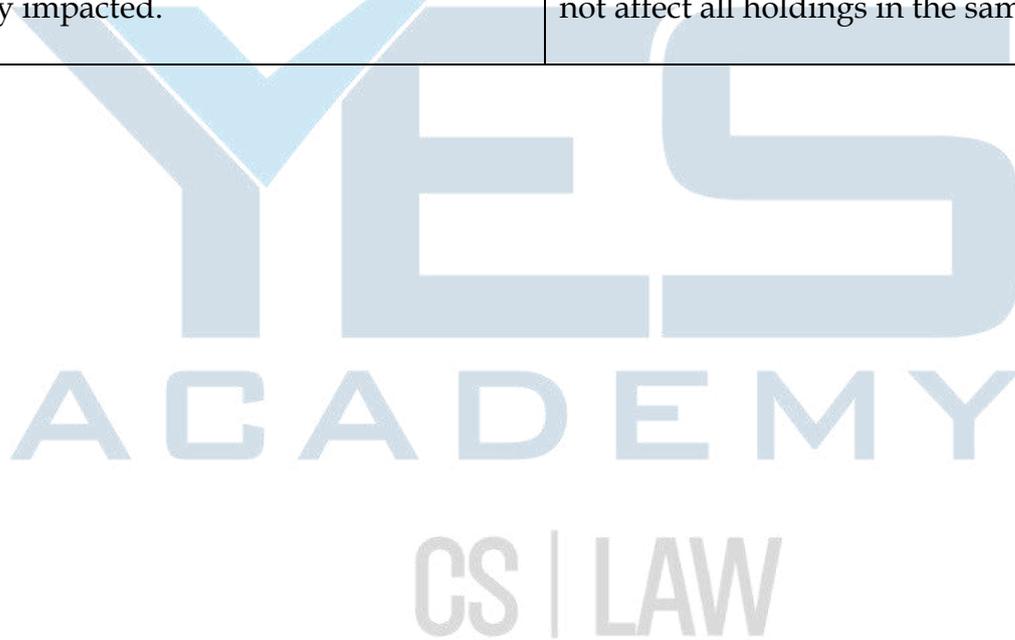
- Financial management in India has also changed substantially in scope and complexity in view of recent government policy.
- Some of the changes include introduction of new financial instruments and transactions like options and future contracts, foreign currency swaps, and interest rate swaps, GDR, Euro Issues, globalization of capital markets, finance mix, liberalization measures taken by government etc. All these have emphasized the need for effective and efficient use of corporate financial resources.
- Under the changed circumstances, financial management covers the following:
 - (a) Raising the funds:** Apart from Indian Public and Financial Institutions, companies have started raising funds etc. in the international markets by way of Euro Issues and from International Financial Institutions etc. Foreign currency loans are availed from foreign banks due to globalization. FII has also started participation in India's equity market due to liberalization of the economy.
 - (b) Investment Decisions:** Presently, investment decisions of firms are not confined to India but spread over globally. Foreign investors are encouraged. Hence, the competitions in India as well as from abroad have made the financial management more complex and foreign exchange management has become highly specialized area in financial management. The time value of money coupled with exchange rate fluctuations make the decision making exercise more complex and compelled the decision makers to make the use of various sophisticated management techniques like probability theory, capital rationing, linear programming, goal programming and sensitivity analysis to overcome the problems.
 - (c) Dividend Decisions:** In view of wealth maximization of firm, the internal generations of funds are not paid out by way of dividend or issue of bonus shares. They are utilized by companies in portfolio management by floating mutual funds etc. In order to avoid scams, the Government has established new institutions like SEBI, NSE. Stock Holding Corporation of India etc. It further increases the scope of financial management and makes it more complex.
- However, in true sense, as such there is no change in scope of financial management in India because it still aims at maximizing value of shares. Basically, it is extension in earlier coverage.

Question 18

DIFFERENCE BETWEEN SYSTEMATIC AND UNSYSTEMATIC RISK.

Answer:

Systematic risk	Unsystematic risk
Systematic risk, also known as market risk or non-diversifiable risk, is the type of risk that affects the entire market or a specific segment of the market.	Unsystematic risk, also known as specific risk or idiosyncratic risk, is the type of risk that is specific to a particular company or industry.
It is caused by external factors that are beyond the control of an individual investor or company. These factors include economic events, political events, interest rate changes, inflation, and market sentiment.	It arises from factors that are unique to a specific investment or a small group of investments, such as company-specific events, management decisions, competition, labour strikes, or supply chain disruptions.
Systematic risk cannot be eliminated through diversification because it affects all investments in the market. When a major economic event occurs, such as a recession or a financial crisis, most assets tend to be negatively impacted.	Unsystematic risk can be mitigated through diversification. By holding a diversified portfolio of assets, investors can reduce the impact of unsystematic risk because negative events affecting one company or industry may not affect all holdings in the same way.



Topic 12

TIME VALUE OF MONEY

Question 1

THE TIME VALUE OF MONEY CONCEPT IS NEEDED TO MAXIMIZE WEALTH.

Answer:

The time value of money (TVM) is a fundamental financial concept that is indeed essential for maximizing wealth and making informed financial decisions. It recognizes that the value of money changes over time due to various factors such as inflation, interest rates, and opportunity costs. Here's why TVM is crucial for wealth maximization:

1. **Inflation:** Inflation erodes the purchasing power of money over time. By understanding TVM, individuals and investors can account for the impact of inflation on the future value of their money. This knowledge is essential to ensure that the returns on investments or savings outpace inflation, thereby protecting and increasing real wealth.
2. **Opportunity Costs:** TVM helps individuals and businesses make choices about how to allocate their resources. By considering the time value of money, they can make decisions that maximize their returns and minimize opportunity costs, leading to the efficient use of capital.
3. **Investment Decisions:** TVM is critical for evaluating investment opportunities. It helps in comparing the present value of investments (initial outlays) with the expected future cash flows. By discounting these cash flows to their present value using an appropriate discount rate, investors can assess the profitability and risk of various investment options, allowing them to make informed choices that maximize wealth.
4. **Borrowing and Debt Management:** TVM is equally important for those who borrow money. It enables them to understand the cost of borrowing, including interest payments, and make informed decisions about taking on debt. Managing debt wisely can reduce interest expenses and free up capital for wealth-building investments.
5. **Retirement Planning:** TVM plays a crucial role in retirement planning. By considering the time value of money, individuals can determine how much they need to save and invest to achieve their retirement goals. They can calculate the future value of their savings and assess whether they are on track to meet their financial objectives.
6. **Budgeting and Cash Flow Management:** ** TVM can also help with budgeting and cash flow management. By understanding the TVM concept, individuals can prioritize spending and saving, ensuring that they allocate their resources in a way that maximizes their wealth over time.

Question 2

WRITE A SHORT NOTE ON: PRESENT VALUE OF AN ANNUITY

Answer:

The present value of an annuity is the current value of future payments from an annuity, given a specified rate of return, or discount rate.

The higher the discount rate, the lower the present value of the annuity.

Key points:

- The present value of an annuity refers to how much money would be needed today to fund a series of future annuity payments.
- Because of the time value of money, a sum of money received today is worth more than the same sum at a future date.
- One can use a present value calculation to determine whether he will receive more money by taking a lump sum now or an annuity spread out over a number of years.
- The formula to compute Present Value of an Annuity is :

$$P = PMT \times \{ [1 - 1/(1+r)^n] / r \}$$

Where,

P = Present value of an annuity stream. PMT Monetary value of each annuity payment.

r = Interest rate (also known as discount rate).

n = Number of periods in which payments will be made.

TM

Question 3

WRITE A SHORT NOTE ON: USE OF PRESENT VALUE OF PERPETUITY

Answer:

- Perpetuity is normally utilized in preferred stocks.
- The preferred stocks tend to provide fixed dividends throughout the company life cycle.
- Since the perpetuity is an infinite amount, its present value helps in arriving at a value that has a limited amount. The perpetuity has its applications in real estate as well.
- If the real estate provides a sustainable income stream, then its present value is derived using the relationship of the present value of perpetuity.
- Additionally, the PV of the perpetuity forms the basis for several endowment schemes and retirement planning.
- Endowment schemes are financial protection plans that provide financial protections as well as cater to a comprehensive saving plan.
- Formula: $ICF / (r - g)$

Here, ICF = identical cash flows

R = interest rate

G = growth rate

Question 4

DIFFERENCE BETWEEN COMPOUNDING AND DISCOUNTING.

Answer:

COMPOUNDING	DISCOUNTING
Compounding is the process of calculating the future value of a sum of money by adding	Discounting is the process of calculating the present value of a future sum of money,

interest or returns to the initial principal (the original amount) over a series of time periods.	considering the time value of money and a specified discount rate. It involves reducing the value of a future cash flow to its equivalent value in today's dollars.
It is used to determine how an investment or savings account grows over time, considering interest or returns earned on the initial investment.	It is used for evaluating investments, loans, or any cash flow that will occur in the future, allowing individuals and businesses to assess the current worth of those future cash flows
Formula: $FV = PV \times (1 + r)^n$	Formula: $PV = FV / (1 + r)^n$
compounding focuses on determining the future value of money,	discounting focuses on finding the present value of money.

Question 5

DIFFERENCE BETWEEN: ANNUITY DUE VS. ORDINARY ANNUITY:

Answer:

Ordinary Annuity [at end]	Annuity Due [at beginning]
Payments for an ordinary annuity are made at the end of the period	payments made for annuity due at the start of each period/interval.
Ordinary annuity payments include loan repayments, mortgage payments, bond interest payments, and dividend payments.	Many monthly bills, such as rent, car payments, and cell phone payments, are annuities due because the beneficiary must pay at the beginning of the billing period.
present value of an Ordinary annuity is lower	present value of an annuity due is higher
When calculating the future value or present value of an ordinary annuity, you use the end-of-period cash flow as the basis for your calculations	When calculating the future value or present value of an annuity due, you use the beginning-of-period cash flow as the basis for your calculations.

Topic 13

CAPITAL BUDGETING

Question 1

WRITE SHORT NOTE ON: CAPITAL BUDGETING.

Answer:

- Capital budgeting is the process of evaluating and selecting long-term investment projects or expenditures that will generate future cash flows.
- This financial management technique is used by businesses and organizations to determine which investment opportunities are worth pursuing and which ones should be rejected.
- Capital budgeting involves analyzing the costs and benefits of potential projects to make informed investment decisions.
- Capital budgeting is important not only because of high investment cost of capital projects, their irreversible nature and permanent commitment and their long-run effects on the profitability of the concern.
- It may involve a number of steps depending upon the size of the concern, nature of projects, complexities and diversities such as :
 - Project Generation:
 - Project Evaluation:
 - Project Selection:
 - Project Execution:
 - Follow-Up:

Question 2

WRITE A SHORT NOTE ON: LEVERAGED LEASE.

Answer:

- A leveraged lease or leased lender is a lease in which the lessor puts up some of the money required to purchase the asset and borrows the rest from a lender.
- Leveraged lease involves lessor, lessee and financier. In leveraged lease, the lessor makes a substantial borrowing, even up to 80% of the assets purchase price.
- He provides remaining amount-about 20% or so-as equity to become the owner. The lessor claims all tax benefits related to the ownership of the assets.
- Lenders, generally large financial institutions, provide loans on a non-recourse basis to the lessor.
- Their debt is served exclusively out of the lease proceeds. To secure the loan provided by the lenders, the lessor also agrees to give them a mortgage on the asset. Leveraged lease is called so because the high non-recourse debt creates a high degree of leverage.

Question 3

THE DEVICE OF CAPITAL RATIONING IS ADOPTED TO CONTROL CAPITAL EXPENDITURE. COMMENT.

Answer:

- Capital rationing refers to a situation where a company cannot undertake all positive NPV projects, it has identified because of shortage of capital.
- Under this situation, a decision maker is compelled to reject some of the viable projects having positive net present value because of shortage of funds. It is known as a situation involving capital rationing.
- Capital rationing may be affected through budget ceiling. A firm may resort to capital rationing when it follows the policy of financing investment proposals only by ploughing back its retained earnings.
- In that case, capital expenditure in a given period cannot exceed the amount of retained earnings available for reinvestment.
- Management may also introduce capital rationing when a department is authorized to make investments up to a limit beyond which investment decisions will be made by higher level management.
- Capital rationing may result in accepting several small investment proposals then accepting a few large investment proposals so that there may be full utilization of budget ceiling.
- This may result in accepting relatively less profitable investment proposals if full utilization of budget is a primary consideration.
- Similarly, capital rationing also means that the firm foregoes the next most profitable investment falling after the budget ceiling even though it is estimated to yield a rate of return much higher than the required rate of return. Thus, capital rationing does not lead optimum results.
- There are few advantages of practicing capital rationing:
 - (1) **Budgeting:** The first and an important advantage is that capital rationing introduces a sense of strict budgeting of corporate resources of a company. Whenever there is an injunction of capital in the form of more borrowings or stock issuance capital. the resources are properly handled and invested in profitable projects.
 - (2) **Less wastage:** Capital rationing prevents wastage of resources by not investing in each and every new project available for investment.
 - (3) **Fewer projects:** Capital rationing ensures that limited numbers of projects are elected by imposing capital restrictions. This helps in keeping the number of active projects to minimum and thus manages them well.
 - (4) **Higher returns on investments:** Through capital rationing, companies invest only in projects where the expected return is high, thus eliminating projects with lower returns on capital.
 - (5) **Stability:** As the company is not investing in every project, the finances are not overextended. This helps in having adequate finances for tough times and ensures more stability and increase in the stock price of the company

Question 4

UNDER CAPITAL RATIONING, THE STANDARD NET PRESENT VALUE (NPV) DECISION RULE NO LONGER HOLDS TRUE. COMMENT.

Answer:

- The term capital rationing refers to the situation where the funds available to a firm are limited. The implicit assumption within the NPV decision rule does not hold true i.e. a firm cannot accept all positive NPV projects because of shortage of capital.
- Capital rationing is of two types - Hard and Soft, characterized by sources of capital expenditure constraints. Hard capital rationing occurs when constraints are externally imposed while soft rationing occurs, when constraints are imposed internally by management.
- In capital rationing, NPV decision rule does not hold true, so it has to be modified. In single period rationing condition, the simple NPV decision rule is replaced by feasibility set approach or benefit cost ratio analysis and in multi-period capital rationing the optimal solution is obtained through linear programming.

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Question 5

WHAT ARE THE SCOPE OF CAPITAL BUDGETING ?

Answer:

- Capital budgeting are the long-term investment decisions
- The scope of capital budgeting is broad and encompasses various aspects of financial decision-making related to long-term investments.
- It plays a critical role in the strategic planning and financial management of businesses and organizations.
- The scope of capital budgeting can include:

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) A company may have to replace its existing old or obsolete machinery by new and latest model machinery.
- (b) 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.

Question 6

RISK AND UNCERTAINTY IS QUITE INHERENT IN CAPITAL BUDGETING. COMMENT

Answer:

- Risk analysis gives management better information about the possible outcomes that may occur so that management can use their judgement and experience to accept an investment or reject it. Since risk analysis is costly, it should be used relatively in costly and important projects.
- Risk and uncertainty are quite inherent in capital budgeting decisions.
- This is so because investment decisions and capital budgeting are actions of today which bear fruits in future which is unforeseen. Future is uncertain and involves risk.
- The projection of probability of cash inflows made today is not certain to be achieved in the course of future. Seasonal fluctuations and business cycles both deliver heavy impact upon the cash inflows and outflows projected for different project proposals.
- The cost of capital which offers cut-off Rates may also be inflated or deflated under business cycle conditions.
- Inflation and deflation are bound to affect the investment decision in future period rendering the degree of uncertainty more severe and enhancing the scope of risk.
- Technological developments are other factors that enhance the degree of risk and uncertainty by rendering the plants or equipment's obsolete and the product out of date.
- Tie up in the procurement in quantity and/or the marketing of products may at times fail and frustrate a business unless possible alternative strategies are kept in view.
- All these circumstances combined together affect capital budgeting decisions.
- It is therefore necessary to allow discounting factor to cover risk. One way to compare risk in alternative proposals is the use of Standard Deviation.
- Lower standard deviation indicates lower risk. However, wherever returns are expressed in revenue terms the coefficient of variation gives better measurement for risk evaluation.

Question 7

CAPITAL RATIONING DOES NOT ALWAYS LEAD TO OPTIMUM RESULTS. COMMENT.

Answer:

- A Firm may fix the maximum amount that can be invested in capital projects, during a given period of time.
- The firm then attempts to select a combination of investment proposals that will be within the specific limits providing maximum profitability and put them in descending order according to their rate of return.
- Capital rationing may result in accepting several small investment proposals than a few large investment proposals so that there may be full utilization of budgeted amount. This by result in accepting relatively less profitable investment proposals if full utilization of budget is a primary consideration.
- Similarly, capital rationing may also mean that the firm foregoes the next most profitable investment following after the budget ceiling even though it is estimated to yield a rate of return much higher than the required rate of return. Thus, capital rationing does always lead to optimum results.

Question 8

INTERNAL RATE OF RETURN (IRR) OF A PROJECT IS THAT RATE WHERE NET PRESENT VALUE (NPV) IS ZERO. COMMENT.

Answer:

- The Internal Rate of Return (IRR) of a capital budgeting project is the discount rate at which the Net Present Value (NPV) of a project equals zero.
- The IRR decision rule specifies that all independent projects with an IRR greater than the cost of capital should be accepted. When choosing among mutually exclusive projects, the project with the highest IRR should be selected (as long as the IRR is greater than the cost of capital).
- Acceptance rule: The use of IRR, as a criterion to accept capital investment decision involves a comparison of IRR with the required rate of return known as cut-off-rate.
- If IRR is greater than cut-off-rate, the project should be accepted. If IRR is less than the cut-off rate, the project is rejected. In case, the IRR is equal to the cut-off-rate, the firm is indifferent.

Merits:

1. It considers the time value of money.
2. It considers the total cash inflows and cash outflows.
3. It is easier to understand

Demerits:

1. It does not use the concept of desired rate of return, whereas it provides the rate of return, which is indicative of the profitability of investment proposal.
2. It involves tedious calculations, based on trial and error method.
3. It produces multiple rates, which can be confusing.
4. Projects selected based on higher IRR may not be profitable.
5. Unless the life of the project can be accurately estimated, assessment of cash flows cannot be correctly made.

6. Single discount rate ignores the varying future interest rates.

Question 9

WRITE A SHORT NOTE ON: SENSITIVITY ANALYSIS IN CAPITAL BUDGETING.

Answer:

A sensitivity analysis is a technique used to determine how different values of an independent variable impact a particular dependent variable under a given set of assumptions.

This technique is used within specific boundaries that depend on one or more input variables.

In relation to capital budgeting, sensitivity analysis deals with the consideration of sensitivity of the NPV to different variables contributing to the NPV Steps to find out sensitivity of NPV to different variables:

1. Cash flows for project are identified. NPV is calculated on the basis of these cash flows.
2. Variables which have a bearing on cash flows of project are identified. Some of these variables may be selling price, operating costs, discounting factor, initial cash outflows etc.
3. Perform the calculation for variables to find out how much change is required.

For example, if one has to calculate sensitivity of NPV to selling price, then calculation has to be done to see that how much change in selling price will make the NPV of the project zero.

Advantages of sensitivity analysis:

- (a) It compels the decision maker to identify the variables which affect the cash flow forecasts. This helps him in understanding the investment project in totality.
- (b) It indicates the critical variables for which additional information may be obtained. The decision maker can consider actions which may help in strengthening the "weak spots" in the project.
- (c) It helps to expose inappropriate forecasts and thus guides the decision maker to concentrate on relevant variables.

Disadvantages of sensitivity analysis:

- (a) It does not provide clear cut results. The terms 'optimistic' and 'pessimistic' could mean different things to different people.
- (b) It fails to focus on the interrelationship between underlying variables. For example sales volume may be related to price and cost but we analyze each variable differently.
- (c) Sensitivity analysis does not eliminate risk. It merely measures the resilience level of identified variables to change in assumption.

Question 10

THERE ARE NUMBER OF STATISTICAL/MATHEMATICAL TECHNIQUES OF RISK EVALUATION IN CAPITAL BUDGETING. COMMENT.

Answer:

Following statistical/mathematical techniques of risk evaluation are used in capital Budgeting

1. Certainty Equivalent Approach
2. Probability Assignment

3. Expected Net Present Value
4. Standard Deviation
5. Coefficient of Variation
6. Sensitivity Analysis
7. Simulation
8. Probability Distribution Approach
9. Normal Probability Distribution.
10. linear Programming

Question 11

WRITE A SHORT NOTE ON: SALE AND LEASE BACK.

Answer:

- A sale and leaseback constitute an arrangement where the seller of an asset leases back the same asset from the purchaser.
- The lease arrangement is made immediately after the sale of the asset with the amount of the payments and the time period specified.
- Essentially, the seller of the asset becomes the lessee and the purchaser becomes the lessor in this arrangement.
- A leaseback arrangement is useful when companies need to untie the cash invested in an asset for other investments, but the asset is still needed in order to operate. Leaseback deals can also provide the seller with additional tax deductions. The lessor benefits in that they will receive stable payments for a specified period of time.

Question 12

DESPITE OF SEVERAL OBJECTIONS, COST OF CAPITAL IS USED AS THE BASIS TO EVALUATE INVESTMENTS.

Answer:

- Despite several objections, cost of capital is used as the basis to evaluate investments whose cash flows are perfectly correlated with the cash flows from the company's present assets.
- With perfect co-relation between the two sets of cash flows, risk is the same.
- But if the timing of the cash flows is not same, the same discount rate cannot be used for both investments. But weighted average cost of capital represents averaging of all the risks of the company and can be used to evaluate investments in as much as the same manner as that of the pay-back method.
- It gives some insights and guidance and to that extent it is good to be used.
- Present value of an investment can be computed using a weighted average cost of capital and this can be compared with present values calculated using the other discount rates.

- It may be that an investment with a positive present value should be rejected because of its risk characteristics or that an investment with a negative present value using the weighted average cost of capital should be accepted.
- All this will differ from situation to situation and case to case. Nevertheless, evaluation of projects involving capital investments requires some basis which could serve as the minimum rate of return which a project should generate.
- In such cases, weighted cost of capital could serve as an accepted discounting rate for evaluating investment decisions as no project will be acceptable which does not generate funds equal or greater to the cut-off rate represented by weighted cost.

Question 13

DISTINGUISH BETWEEN: SENSITIVITY ANALYSIS AND RISK ANALYSIS.

Answer:

Basis	Sensitivity Analysis	Risk Analysis.
Meaning	A sensitivity analysis is a technique used to determine how different values of an independent variable impact a particular dependent variable under a given set of assumptions.	Risk analysis is a systematic process of identifying, assessing, and managing potential risks or uncertainties associated with a particular action, decision, project, or system
Purpose	Sensitivity analysis is primarily used to assess how changes in input variables or parameters impact the output of a model or system. It helps identify which variables have the most significant influence on the outcome and how the outcome changes when those variables are adjusted.	Risk analysis explicitly deals with uncertainty by considering probabilistic distributions of input variables. It evaluates the range of possible outcomes and the likelihood of each outcome occurring, allowing for a more comprehensive understanding of the potential risks involved.
	Sensitivity analysis typically assumes that input variables are known with certainty and examines the effect of changes in those variables. It does not explicitly address uncertainty.	Risk analysis explicitly deals with uncertainty by considering probabilistic distributions of input variables. It evaluates the range of possible outcomes and the likelihood of each outcome occurring.
output	The output of sensitivity analysis is usually a set of sensitivity measures or charts that show how changes in input variables impact the output, often in a deterministic or one-dimensional manner.	The output of risk analysis includes probability distributions, risk assessments, and metrics such as expected values, standard deviations, and confidence intervals. It provides a

		more comprehensive view of potential outcomes under various scenarios.
Application	Sensitivity Analysis: Sensitivity analysis is commonly used in financial modelling, engineering design, and optimization to understand how changes in specific variables affect project or system performance.	It helps organizations assess the likelihood and impact of adverse events and make informed decisions to mitigate or manage risks.

Question 14

DISTINGUISH BETWEEN: SENSITIVITY ANALYSIS & SCENARIO ANALYSIS.

Answer:

basis	Sensitivity Analysis	Scenario Analysis
Meaning	Sensitivity analysis is a quantitative technique used to examine how changes in one or more input variables (parameters) affect the output of a model or a particular result.	Scenario analysis is a broader and more qualitative technique used to explore a range of potential future situations or scenarios and assess their impact on a decision or outcome.
Purpose	It is typically used to assess the sensitivity of a specific output or outcome to changes in individual input variables, holding all other factors constant.	It involves the creation of multiple hypothetical scenarios that encompass various combinations of input variables or factors.
Use	sensitivity analysis deals with the consideration of sensitivity of the NPV to different variables contributing to the NPV.	This limitation is partially overcome by what is known as scenario analysis, where scenario of certain prices, cost and other variables are created and the financial parameter are computed

Question 15

DIFFERENCE BETWEEN: NPV & IRR

Answer:

BASIS	NET PRESENT VALUE	INTERNAL RATE OF RETURN
Meaning	NPV measures the absolute Rupee value of an investment or project by discounting all future cash flows (both inflows and outflows) to their	IRR is the discount rate at which the NPV of a series of cash flows becomes zero. In other words, it is the rate at which the present value of the project's

	present value using a chosen discount rate.	inflows equals the present value of the project's outflows.
Calculating method	NPV calculates absolute dollar value of a project's net benefit or loss.	IRR calculates the discount rate at which the project breaks even, making the NPV zero.
measure	NPV is an absolute measure and helps in comparing projects in terms of their contribution to the overall value of company or organization.	IRR is a relative measure, making it useful for comparing different projects or investments to determine which one offers the highest return for a given level of risk.
Units of Measurement:	NPV is expressed in monetary terms (dollars or any other currency).	IRR is expressed as a percentage (rate of return).
Decision Criteria:	NPV is used to determine whether an investment or project is financially viable. A positive NPV indicates that project is expected to be profitable.	IRR is used to assess the relative attractiveness of different projects. The project with the highest IRR is often considered the most appealing.

Question 16

DIFFERENCE BETWEEN: NPV & IRR

Answer:

BASIS	NP VALUE	PROFITABILITY INDEX
Meaning	NPV measures the absolute Rupee value of an investment or project by discounting all future cash flows (both inflows and outflows) to their present value using a chosen discount rate.	PI is a relative measure that assesses the desirability of an investment by comparing the present value of the benefits (cash inflows) to the present value of the costs (initial investment and operating costs).
Measurement	NPV provides the absolute dollar value of the project's profitability in today's currency.	PI provides a ratio that shows the relative efficiency of the project in generating benefits compared to its costs.
Decision Criteria	NPV helps in making investment decisions by directly indicating whether the project will increase the company's value. A positive NPV is generally considered a favourable outcome.	PI is used to rank projects based on their cost-effectiveness. A higher PI indicates a more favorable benefit-to-cost relationship, but it doesn't provide the exact dollar value of the project's contribution to the company's value.
Units	NPV is expressed in monetary units (dollars or any other currency).	PI is a unitless ratio.

Question 17

DIFFERENCE BETWEEN: RISK EVALUATION & SENSITIVITY ANALYSIS

Answer:

BASIS	RISK EVALUATION	SENSITIVITY ANALYSIS
Meaning	Risk evaluation gives management better information about the possible outcomes that may occur so that the management can use their judgement and experience to accept an investment or reject it	In relation to capital budgeting, sensitivity analysis deals with the consideration of sensitivity of the NPV to different variable contributing to the NPV
Purpose	Risk evaluation, also known as risk assessment, is primarily focused on identifying, assessing, and prioritizing risks that may impact a project, organization, or decision.	Sensitivity analysis, on the other hand, is a specific analytical technique used to assess how variations or changes in specific input parameters or assumptions can impact the output or outcomes of a model, project, or decision.
Scope	Risk evaluation encompasses a broader perspective on risks, looking at various types of risks, their likelihood, and their potential consequences on the overall objectives and operations of an entity.	Sensitivity analysis is more focused and narrow in scope compared to risk evaluation. It specifically targets a limited set of variables or assumptions to examine how changes in those variables might affect the results.
Output	The primary outputs of risk evaluation include risk registers, risk matrices, and risk management plans	The primary output of sensitivity analysis is typically a sensitivity report, which illustrates the degree to which changes in input parameters or assumptions impact the final outcomes

Question 18

DIFFERENCE BETWEEN: CAPITAL BUDGETING & CAPITAL RATIONING

Answer:

BASIS	CAPITAL BUDGETING	CAPITAL RATIONING
Meaning	Capital budgeting is the process by which the firm decide which long-term investments to make	Capital rationing refers to a situation where a company cannot undertake all positive NPV projects, it has identified because of shortage of capital

purpose	Capital budgeting, also known as investment appraisal or capital expenditure decision-making, is a financial process that involves evaluating and selecting long-term investment projects or capital expenditures	Capital rationing is a financial constraint or a deliberate strategy that an organization uses to limit its capital expenditures or investment projects. This may occur when a company faces limited availability of funds or wants to control its debt levels.
scope	Capital budgeting focuses on evaluating individual investment projects or capital expenditures to assess their financial feasibility, profitability, and alignment with the company's long-term goals	Capital rationing deals with the allocation of a fixed or constrained budget among various potential investment projects. It is about making choices within budget constraints and deciding which projects to undertake or reject based on the available capital resources.
outcome	The outcome of capital budgeting is a set of recommended investment projects that are expected to yield a positive net present value (NPV) or a favourable return on investment (ROI)	The outcome of capital rationing is a prioritized list of projects or investments that can be funded within the budget constraints.

Question 19

DIFFERENCE BETWEEN IRR AND ARR

Answer:

BASIS	Internal rate of return [IRR]	Accounting Rate of Return [ARR]
Meaning	Internal rate of return is a percentage discount rate used in capital investment appraisals, which brings the cost of a project and its future cash inflows into equality. It is the rate of return, which equates the present value of anticipated net cash flows with the initial outlay. The IRR is also defined as the rate at which the net present value is zero.	The Accounting rate of return method employ the normal accounting technique to measure the increase in profit expected to result from an investment by expressing the net accounting profit arising from the investment as a percent- age of that capital investment-
purpose	IRR is a financial metric used to assess the profitability and attractiveness of an investment project or capital expenditure.	ARR is a non-discounted financial metric used to assess the accounting profitability of an investment project
Calculation	IRR is determined by finding the discount rate that makes the sum of the present	ARR is calculated by dividing the average annual accounting profit (often

	values of all cash flows from the investment project equal to zero.	based on accounting measures like net income or operating profit) by the average investment in the project
Decision criteria	In capital budgeting, a project is considered acceptable if its IRR is greater than the required rate of return or the organization's cost of capital.	In capital budgeting, a project is considered acceptable if its ARR exceeds a predetermined benchmark or a required rate of return set by the organization.

Question 20

WHAT IS CASH FLOW UNDER CAPITAL BUDGETING?

Answer:

- Cash flow is a critical concept in capital budgeting, which is the process of evaluating and selecting long-term investment projects for a business.
- Capital budgeting involves assessing the financial viability of projects or investments to determine whether they should be undertaken
- In capital budgeting, CFAT stands for "Cash Flow After Tax." CFAT is a crucial financial metric used to evaluate the profitability and financial viability of a capital project or investment.
- It represents the net cash flows generated by the project after accounting for taxes. Here's how CFAT is calculated and why it is important:

CALCULATION OF CASH INFLOWS:

Annual Sale Income (revenue)	****
(-)Operating Expenses (with dep.)	****
Income before Tax	****
(-) Income Tax	****
Net income after Tax	****
(+) Depreciation	****
Net cash Inflows	****

CALCULATION OF CASH OUTFLOW:

Cost of Fixed Asset (purchasing Price)	****
(+) Installation Cost	****
(+) Insurance, Freight	****
(+) Increase in Working Capital	****
(-) Salvage Value of scrap or wastage	****
(-) Decrease in Working Capital	****
Initial Investment	****

Topic 14

COST OF CAPITAL

Question 1

RETAINED EARNINGS HAVE NO COST. DO YOU AGREE? GIVE REASONS TO YOUR ANSWER.

Answer:

- I must respectfully disagree with the assertion that retained earnings have no cost.
- Retained earnings do have a cost, which is typically referred to as the opportunity cost.
- When a company retains its earnings rather than distributing them to shareholders in the form of dividends or using them for other income-generating investments, shareholders forgo the opportunity to earn a return on those funds.
- The opportunity cost of retained earnings represents the income that shareholders could have received if the company had chosen to distribute those earnings or invest them in alternative opportunities.
- Shareholders could have used those funds for other investments, such as stocks, bonds, or other income-generating assets, and earned a return on their investments.
- While retaining earnings can have strategic benefits for a company, such as funding growth, debt reduction, or research and development, it does come at the cost of forgoing the immediate income shareholders could have received.
- Therefore, it is inaccurate to claim that retained earnings have no cost; they indeed have an associated opportunity cost for shareholders.

Question 2

WRITE SHORT NOTE ON: EVA OR ECONOMIC VALUE ADDED (EVA) REPRESENTS THE REAL PROFIT OF AN ENTITY. COMMENT

Answer:

- Economic Value Added (EVA) is a financial performance measure that aims to assess the economic profit of an entity by considering both the operating profits generated and the cost of capital used to generate those profits.
- It is a way of determining whether a company has created value for its shareholders after considering the cost of capital, and it is often considered a more accurate indicator of a company's financial performance compared to traditional accounting measures like net profit or earnings per share.
- Calculation of EVA:

EBIT	xxxx
(-) Interest	(xxx)
= EBT	xxx
(-) TAX	(xxx)

= PAT	xxxx
(+) Interest (1- t)	xxx
= NOPAT (net operating profit after tax)	xxxx
(-) Cost of Capital	(xxx)
= EVA (economic value added)	xxxx

- In short EVA = NOPAT - Cost of Capital
- EVA does aim to represent the real profit of an entity in the sense that it accounts for the cost of capital, making it a more comprehensive measure of financial performance. It provides insight into whether a company is generating returns that are above and beyond the costs associated with the capital employed to generate those returns.

Question 3

WRITE SHORT ON: RETAINED EARNINGS

Answer:

- The cost of retained earnings refers to the opportunity cost associated with not distributing earnings as dividends to shareholders.
- When a company retains its earnings and reinvests them in the business or holds them as reserves, shareholders miss out on the potential income they could have earned had those earnings been distributed to them.
- Formula to calculate cost of retained earnings:

$$k_{r.e} = \frac{DPS(1-t_i)(1-B)}{MPS(1-t_e)} \times 100$$

Here,

Cr = Cost of Retained Earnings

DPS = Dividend Per Share

Ti = Marginal tax rate

B = Brokerage Cost

MP = Market Price per share

Te = Capital Gains Tax

G = Growth rate of dividends

- This cost can be understood as the income that shareholders forgo by not receiving dividends or not being able to invest those earnings in alternative income-generating opportunities.
- Shareholders could have taken those funds and invested them in stocks, bonds, or other assets to generate returns.

Question 4

WHAT ARE THE COMPONENTS OF COST OF CAPITAL?

Answer:

- The cost of capital is the required rate of return that a company needs to generate in order to attract investors and raise funds for its operations and investments.
- It is composed of various components, each representing a different source of capital.
- The primary components of the cost of capital include:

(a) Cost of Debt (R_d): This is the cost associated with raising funds through debt, such as bonds or loans. It is typically represented by the interest rate on the debt.

FORMULA:

irredeemable debt: $C_d \text{ (or } K_d) = \frac{I}{NP} \times 100$

Redeemable debt: $C_d = \frac{i + \frac{MV - NV}{n}}{\frac{MV + NP}{2}} \times 100$

where,

C_d = cost of debt capital

i = annual interest payment MV = maturity value

NP = net proceeds

n = number of years to maturity

TM

(b) Cost of Equity (R_e): The cost of equity is the return that shareholders expect for their investment. It can be estimated using various models, such as the Dividend Discount Model (DDM) or the Capital Asset Pricing Model (CAPM).

FORMULA :

(i) CAPM:

$$K_e = R_f + (R_m - R_f) \beta$$

Where:

K_e = Cost of equity

R_f = Risk-free rate

R_m = Equity market required return (expected return on the market portfolio)

β = beta is Systematic Risk Coefficient.

(ii) DIVIDEND YIELD METHOD

$$C_e \text{ (After tax)} = \frac{DPS}{MP} \times 100$$

Where, = Cost of Equity Share Capital

DPS = Current Cash Dividend per Share

MP = Market Price per Share.

(iii) EARNING YIELD METHOD

$$C_e \text{ (After tax)} = \frac{EPS}{MP} \times 100$$

(iv) DIVIDEND GROWTH METHOD

$$C_e \text{ (after tax)} = \left(\frac{DPS}{MP \text{ (or)} NP} \times 100 \right) + G$$

(c) Cost of Preferred Stock (Rp): If a company has preferred stock, the cost of preferred stock represents the required rate of return for those investors who hold preferred shares.

Cost of Irredeemable Preference Share Capital:

$$C_p \text{ (or } K_p) = \frac{PD}{NP} \times 100$$

$$C_d = \frac{i + \frac{MV - NV}{n}}{\frac{MV + NP}{2}}$$

Where,

PD = amount of annual preference dividend

MV = amount to be paid on maturity

NP = net proceeds

n = number of years after which the preference shares will be repaid

(d) Cost of Retained Earnings (Rr): Retained earnings are the profits that a company has reinvested in its operations. While there is no explicit cost associated with retained earnings, it's important to consider the opportunity cost of not distributing those earnings as dividends.

Formula:

$$C_r \text{ (or } K_r) = \frac{DPS(1-T_i)(1-B)}{MP(1-T_e)} \times 100$$

$$C_r \text{ (or } K_r) = \frac{(DPS + G)(1-T_i)(1-B)}{MP(1-T_e)} \times 100$$

Where,

Cr = Cost of Retained Earnings

DPS = Dividend Per Share

Ti = Marginal tax rate applicable to individual shareholder

B = Brokerage Cost

MP = Present Market Price per share

Te = Capital Gains Tax

G = Growth rate of dividends

Question 5

COST OF CAPITAL IS USED BY A COMPANY AS A MINIMUM BENCHMARK FOR ITS YIELD. COMMENT.

Answer:

- Cost of capital refers to cost of raising funds, which includes both debt and equity
- Thus, it is minimum return that investors seek from the company in return of funds invested by them.
- Hence, it sets a benchmark/threshold for the company to earn that minimum return to satisfy its inventors.

- To conclude, cost of capital is the minimum benchmark for yield and company should try to maximize its yield over and above the cost of capital to increase market value and enable wealth maximization which is the ultimate object of the business

Question 6

CAPITAL ASSET PRICING MODEL (CAPM) IS A TOOL TO WORK OUT COST OF EQUITY.

Answer:

- Capital Assets Pricing Method: This model describes the relationship between non-diversifiable and return for securities.
- Cost of equity capital under CAPM model calculated by following formula:

$$K_e = R_f + B (R_m - R_f)$$

Where,

K_e = Cost of equity capital

R_f (Rate of return on security) = CAPM starts with a risk-free rate of return, typically based on government bonds, as a starting point. This represents the return an investor could earn with zero risk.

B (Beta coefficient) = Beta measures an asset's sensitivity to market movements. A beta of 1 means the asset moves in line with the market. A beta less than 1 suggests less risk than the market, while a beta greater than 1 indicates more risk

R_m (Rate of return on market portfolio) = CAPM calculates the expected return on an investment, such as a stock or a portfolio, based on the relationship between the asset's risk and the overall market's risk.

Here,

Market Risk Premium ($R_m - R_f$) = The market risk premium is the excess return that investors demand for taking on the risk of investing in the overall market compared to a risk-free investment.

Question 7

IN REAL LIFE, THE COMPONENT COSTS OF DEBT AND EQUITY ARE JOINTLY OPERATIONAL RATHER THAN INDEPENDENTLY DETERMINED. ELUCIDATE.

Answer:

- In most of the companies the capital structure consists of debt and equity.
- Cost of availing debt funds is known as 'cost of debt' and cost of availing equity funds is known as 'cost of equity'.
- High component of debt funds increases the earning for its shareholders but at the same time increase the business/operating risk for the company.
- Thus, companies try to keep optimum combination of debt funds and equity funds in their capital structure.

- As both type of funds normally exist in capital structure cost of debt and cost of equity are jointly operational.

Question 8

DISTINGUISH BETWEEN: EXPLICIT COST & IMPLICIT COST.

Answer:

EXPLICIT COST	IMPLICIT COST
Explicit costs are also known as out-of-pocket costs or accounting costs.	Implicit costs are sometimes referred to as opportunity costs.
These costs are tangible, actual, and easily quantifiable expenses that a business or individual incurs and must pay for.	These costs represent the foregone opportunities or the value of resources used in a particular endeavor when they could have been used elsewhere.
Explicit costs include expenses such as wages, rent, utilities, raw materials, interest on loans, and other bills that are paid with real money.	implicit costs can include the value of their time and skills, as well as the return they could have earned on their invested capital if it were used in an alternative investment or business venture.
These costs are recorded on a firm's income statement and are used to calculate profit and loss.	Implicit costs are not recorded in financial statements but are essential to consider when evaluating economic decisions.

Question 9

STATE THE DRAWBACKS OF ADOPTING SHAREHOLDER VALUE ADDED (SVA) APPROACH.

Answer:

Drawbacks of adopting Shareholder Value Added (SVA):

- A limitation in the use of SVA as a performance measure is that, by nature, it is an aggregate measure. In order to analyze the underlying causes of any changes in calculated value between years, it is necessary to fully comprehend the value drivers and activities specific to a given firm.
- There may be certain enterprises which are subject to any degree of price regulation then it may not be possible for management to adjust output prices to achieve a commercial return in response to upward movements in input prices. Such a situation may result in SVA being reduced even though there may have been no decrease in overall efficiency.
- Similarly, a reduction in direct Government funding would result in a decrease in SVA.
- Combined with the use of traditional accounting measures, a thorough knowledge of the value drivers of the business will assist in determining the underlying causes of fluctuations in the value-added measure.
- Again, the use of SVA is not a substitute for detailed analysis of business drivers. rather it is an additional measurement tool with an economic foundation.

Question 10

DISCUSS THE CONTROLLABLE FACTORS THAT SUPPORT TO OPTIMIZE THE COST OF CAPITAL OF A FIRM.

Answer:

Cost of capital is the required rate of return that a firm must achieve to cover the cost of generating funds in the market place. It is the rate of return that a firm must earn on its project investments to maintain its market value and attract funds. Cost of capital is affected by both controllable and uncontrollable factors. The same are discussed below:

Controllable factors affecting cost of capital: These are the factors that affect the co of capital and the company has control over them. These factors are as follows:

- (1) Capital Structure Policy:** A firm has control over its capital structure, and it targets an optimal capital structure. As more debt is issued, the cost of debt increases, and as more equity is issued, the cost of equity increases.
 - (2) Dividend Policy:** Given that the firm has control over its payout ratio, the breakpoint of the marginal cost of capital schedule can be changed. The internally generated equity has a lower cost as compared to newly issued equity. As the payout ratio of the company increases, the breakpoint between lower-cost internally generated equity and newly issued equity is lowered.
 - (3) Investment Policy:** It is assumed that, when making investment decisions, the company is making investments with similar degrees of risk. If a company changes its investment policy relative to its risk, both the cost of debt and cost of equity changes
- Uncontrollable factors affecting the cost of capital:

These are the factors affecting the cost of capital on which the company has no control:

- (1) Level of Interest Rates:** The level of interest rates in the economy affects the cost of debt and, potentially, the cost of equity. For example, when interest rates increase the cost of debt increases, which in turn increases the cost of capital.
- (2) Tax Rates:** Tax rates affect thereby after-tax cost of debt. As tax rates increase, the cost of debt decreases, thereby decreasing the cost of capital.

Question 11

WHAT IS DIVIDEND GROWTH METHOD OF CALCULATING COST OF EQUITY ? ELABORATE WITH EXAMPLE.

Answer:

- The Dividend Growth Model, also known as the Gordon Growth Model or the Dividend Discount Model (DDM),
- Dividend Growth method is based on the thinking that each equity shareholder is not satisfied with the present rate of dividend only, he wants an increased in it each year based on his expectations of increase in future earnings of the company.

- In this method, cost of equity share capital is found by making appropriate adjustment in current rate of dividend on the basis of probable rate of increase in future earnings of the company. This rate of increase is termed as growth rate.
- **When dividends are expected to grow at a uniform rate perpetually:**

$$C_e \text{ (after tax)} = \left(\frac{DPS}{MP(Or) NP} \times 100 \right) + G$$

Where, C_e = Cost of Equity Share Capital

DPS = Expected Dividend Per Share

MP = Current Market Price Per Share

NP = Net Proceeds per share

G = Growth Rate in expected Dividend

- **When dividends grow at different rates:**

$$\left(\frac{DPS}{MP} \times 100 \right) + G$$

$$MP = \sum_{t=1}^n \frac{D_0(1+g_n)^{t-1}}{(1+K_e)^t} + \sum_{t=n+1}^{\infty} \frac{D_n(1+g_n)^{t-1}}{(1+K_e)^t}$$

TM

EXAMPLE for Dividend Growth method :

Dividend paid= 21 %

Growth rate = 3%

MPS = ₹ 105

$$\begin{aligned} \text{Solution - } C_e \text{ (after tax)} &= \left(\frac{DPS}{MP(Or) NP} \times 100 \right) + G \\ &= \left(\frac{21}{105} \times 100 \right) + 3 \\ &= 23\% \end{aligned}$$

Question 12

EXPLAIN THE CONCEPT OF WEIGHTED AVERAGE COST OF CAPITAL (WACC). HOW IS IT CALCULATED, AND WHAT DOES IT REPRESENT FOR A COMPANY?

Answer:

- A company finances its projects by different sources, although the specific cost of each source of finance is different. Some are cheaper and some are dearer.
- There are two objectives of this policy - firstly, to balance the capital structure, and secondly to increase the return of equity shareholders.
- These objectives can be achieved only when firm's average cost of financing is lower than its return on investment. This requires the computation of overall or average cost of capital.
- Overall cost of capital may be defined as the average cost of the specific costs of different sources of financing. This is used as acceptance/ rejection criterion in capital expenditure decisions.

- The average can be a simple average or weighted average. However, weighted average is more reasonable and appropriate as it gives due emphasis to different sources of capital in the capital structure of a firm.
- The Weighted Average Cost of Capital (WACC) is a financial metric used to determine the cost of financing for a company. It represents the average rate of return a company is expected to pay to its investors (both equity and debt holders) to maintain and grow its operations. WACC considers the cost of different sources of capital and their respective weights in the company's capital structure
- **COMPUTATION OF WEIGHTED AVERAGE COST OF CAPITAL:**
 - The computation of specific costs of various sources.
 - Assignment of weights to each type of funds.
 - Multiply each cost by the corresponding weight
 - Add all weighted cost together to get overall cost of capital
- In summary, the WACC is a critical financial metric that helps a company evaluate the cost of financing and make strategic financial decisions. It provides a benchmark for comparing investment opportunities and plays a key role in determining a company's capital structure and stock valuation.

Question 13

HOW DOES A COMPANY'S CAPITAL STRUCTURE AFFECT ITS OVERALL COST OF CAPITAL? PROVIDE EXAMPLES OF HOW CHANGES IN THE CAPITAL STRUCTURE CAN IMPACT THE WACC.

Answer:

A company's capital structure, which represents the mix of debt and equity used to finance its operations and investments, has a significant impact on its overall cost of capital, as measured by the Weighted Average Cost of Capital (WACC).

Changes in the capital structure can influence the WACC in several ways. Here are some examples of how these changes can affect the company's WACC:

1. Increase in Debt (Leverage):

- (a) Example: If a company decides to take on additional debt to finance its projects, its debt component in the capital structure increases.
- (b) Impact on WACC: Adding more debt, assuming it has a lower cost than equity, reduces the weighted average cost of capital. The WACC decreases because the interest on debt is tax-deductible, making it a cheaper source of financing compared to equity.

2. Decrease in Debt (Deleveraging):

- (a) Example: A company pays off a significant portion of its outstanding debt, resulting in a lower level of debt in its capital structure.

(b) Impact on WACC: Reducing debt levels will increase the cost of capital, as the proportion of more expensive equity in the capital structure becomes higher. WACC increases because the tax benefit of debt is reduced.

3. Change in the Mix of Debt and Equity:

(a) Example: A company shifts its capital structure by changing the ratio of debt to equity, e.g., moving from 60% equity and 40% debt to 40% equity and 60% debt.

Impact on WACC: The WACC will change in accordance with the new debt-equity mix. If the company increases its reliance on debt, WACC will decrease; if it increases equity, WACC will increase.



Topic 15

CAPITAL STRUCTURE

Question 1

THE CHOICE OF AN APPROPRIATE DEBT POLICY INVOLVES A BENEFIT AND THE COST OF FINANCIAL DISTRESS TRADE-OFF BETWEEN TAX." COMMENT.

Answer:

- Capital structure is significant for a firm because the long term profitability and solvency of the firm is sustained by an optimal capital structure consisting of an appropriate mix of debt and equity, While deciding about capital structure, the debt proportion needs to be appropriate.
- High proportion of debt in capital structure leads to high interest burden on the company, it reduces the taxable income and thus reduces taxable income but at the same time due high debt funds equity funds will be less and hence also increases the EPS of the company.
- Though high debt funds in capital structure increases EPS but one cannot ignore the risk involved on it.
- High debt funds also increase the operating or business risk of the company and may lead to financial distress and bankruptcy. Thus, management has to strike a proper balance between owned funds and debt funds.

Question 2

WRITE A SHORT NOTE ON: VERTICAL CAPITAL STRUCTURE.

Answer:

- Capital Structure of a firm reflects the overall investment and financing strategy of the firm.
- It shows how much reliance is being placed by the firm on external sources of finance and how much internal accruals are being used to finance expansions
- In a vertical capital 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.

Question 3

DISCUSS THE CONCEPT OF "OPTIMUM CAPITAL STRUCTURE".

Answer:

- The optimal capital structure is the ideal mix of debt and equity financing that a company should use to maximize its overall value and minimize its cost of capital.
- It represents the balance between the various sources of funding that a company can employ to finance its operations and growth.
- Achieving the optimal capital structure is important because it can have a significant impact on a company's financial performance and shareholder value.
- It's important to note that the optimal capital structure is not a one-size-fits-all concept. What's considered optimal can vary from one company to another, depending on its unique circumstances, goals, and market conditions.
- Companies may adjust their capital structure over time as they evolve and as external factors change.
- The goal is to find the mix that maximizes shareholder value and profitability while maintaining financial stability.

Question 4

WHAT ARE THE SIGNIFICANCE OF CAPITAL STRUCTURE?

Answer:

The capital structure of a company refers to the mix of debt and equity it uses to finance its operations and growth.

It plays a significant role in a company's financial management and has several important implications and significance

1. It reflects the firm's strategy

The capital structure reflects the overall strategy of the firm. The strategy includes the pace of growth of the firm. In case the firm wants to grow at a faster pace, it would be required to incorporate debt in its capital structure to a greater extent.

2. It is an indicator of the risk profile of the firm

One can get a reasonably accurate broad idea about the risk profile of the firm from its capital structure. If the firm has no long-term debt in its capital structure, it means that either it is risk averse or it has cost of equity capital or cost of retained earnings less than the cost of debt.

3. It acts as a tax management tool

The capital structure acts as a tax management tool also. Since 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.

4. It helps to brighten the image of the firm

A firm can build on the retained earnings component of the capital structure by issuing equity capital at a premium to a spread out base of small investors. 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.

Question 5

DIFFERENCE BETWEEN VERTICAL STRUCTURE AND HORIZONTAL STRUCTURE.

Answer:

VERTICAL STRUCTURE	HORIZONTAL STRUCTURE
The base of the structure is formed by a small amount of equity share capital.	The firm has zero debt components in the structure mix.
super structure of preference share capital and debt can be built.	Equity and retained earning based structure can be built
This are Very risky firm	This are the most Stable firm
This are Highly levered firm	No leverage used in such firms
Such firms are Vulnerable to hostile takeover	No such risk of hostile takeover here

Question 6

WHAT ARE THE ATTRIBUTES OF CAPITAL STRUCTURE?

Answer:

An appropriate capital structure should have the following attributes:

- **Return:** The capital structure of the company should be most advantageous. Subject to other considerations, it should generate maximum returns to the shareholders.
- **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.
- **Capacity:** 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.

Question 7

WHILE DECIDING UPON THE CAPITAL STRUCTURE, THE FIRM HAS TO CONSIDER THE DIFFERENT LIFE CYCLE STAGES. COMMENT

Answer:

The capital structure of a firm, which refers to the mix of debt and equity used to finance its operations and growth, should indeed be considered in the context of the firm's life cycle stages.

A firm typically goes through various stages in its life cycle. Here's how the firm's capital structure considerations may vary across these life cycle stages:

- (a) **Pioneering Stage:** It is the starting stage when there is rapid increase in demand for the product/services of company. At this stage only efficient companies survive. Due to risk

perception about the company the cost of borrowing is high. To survive in this stage, capital structure is more oriented towards equity and avail more soft loans capital structure

- (b) **Expansion Stage:** In this stage strong companies having survived the competition struggle successfully expand their market share and volumes. For this requirement of funds is high. Therefore, the company in this stage resorts to financial leverage.
- (c) **Stabilization/Stagnation Stage:** In this stage, management looks out for expansion and diversification into new projects. Takeovers, mergers, acquisition and strategic alliances are main activities. In this stage, capital structure depends on these activities.

Question 8

A FIRM'S STOCK PRICE IS NOT RELATED TO ITS MIX OF DEBT AND EQUITY FINANCING COMMENT.

Answer:

- The statement that "a firm's stock price is not related to its mix of debt and equity financing" is not entirely accurate. The capital structure of a firm, which refers to the mix of debt and equity used to finance its operations, can indeed have an impact on its stock price, although it is just one of many factors that influence a company's stock price.
- Theory of modern financial management - by Franco Modigliani and Merton Miller concluded that the value of a firm depends solely on its future earnings stream, and hence its value is unaffected by its debt/equity mix They concluded that a firm's value stems from its assets, regardless of how those assets are financed.
- The theory was based on restrictive set of assumptions, including perfect capital market (which implies zero taxes).
- They used an arbitrage proof to demonstrate that capital structure is irrelevant. If debt financing resulted in a higher value for the firm than equity financing, then investors who owned shares in a leveraged (debt-financed) firm could increase their income by selling those shares and using the proceeds, plus borrowed funds, to buy shares in an unleveraged (all equity-financed) firm.
- The simultaneous selling of shares in the leveraged firm and buying of shares in the unleveraged firm would drive the prices of the stocks to the point where the values of the two firms would be identical Thus, according to MM Hypothesis, a firm's stock price is not related to its mix of debt and equity financing.

Question 9

**WHAT IS THE BASIS OF DIFFERENCE IN THE THEORIES UNDER CAPITAL STRUCTURE?
WHAT ARE THE GENERAL ASSUMPTIONS OF CAPITAL STRUCTURE?**

Answer:

Capital structure theories are divided into two categories on the basis of influence of debt presence on value of firm:

1. Capital structure influence value of firm i.e. cost of capital = (WACC)

- The capital structure of a firm can indeed influence the value of the firm.
 - This relationship is a fundamental concept in corporate finance, and it is often associated with the
 - (i) Net Income Approach (N.I) &
 - (ii) Traditional Theory
2. Capital structure does not influence value of firm
- Theories where Capital structure does not influence value of firm are:
 - (i) Net Operating Income (NOI)
 - (ii) Modigliani & Milter (MM) Approach

General assumptions for the capital structure theories are:

1. There are only 2 sources of funds < Debts & Equity
2. Total capital of firm will remain constant on any ratio of mix
3. EBIT shall remain Constant
∴ Sales shall also remain Constant
4. Zero retention of earning. i.e 100% payout ratio
5. EBIT or operating profit shall always be positive
6. Business risk shall remain constant
7. No Taxation for the sack of simplify theory
8. No difference in investors expectation
9. Capital structure can be altered without any transfer cost

Question 10

WRITE SHORT NOTE ON: NET INCOME APPROCH

Answer:

- According to NET INCOME approach there is a relationship between capital structure and the value of the firm.
- 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:
 1. Cost of debt (K_d) is less than cost of equity (K_e) i.e. ($K_d < K_e$)
 2. Both K_d and K_e . remain constant and increase i.e., 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.
 3. There are no taxes.
- Under this approach, the cost of debt capital, K_d and the cost of equity capital K_e remains unchanged when D/S , the degree of leverage, varies.
- Here S stands for total capital employed ($S = D + E$). The constancy of K_d and K_e with respect to the degree of leverage means that K_o the average cost of capital, measured by the following formula declines as the degree of leverage increases.

$$K_0 = K_d \times \frac{D}{(D+E)} + K_e \times \frac{E}{(D+E)}$$

Question 11

THE NATURE OF THE INDUSTRY PLAYS AN IMPORTANT ROLE IN CAPITAL STRUCTURE DECISIONS. COMMENT.

Answer:

- The nature of the industry indeed plays a crucial role in shaping a company's capital structure decisions.
- Various industry-specific factors can significantly influence the choice between debt and equity financing, the level of leverage a company employs, and the overall financial strategy.
- The nature of the industry exerts a significant influence on capital structure decisions. Companies must consider the unique financial needs, risk profiles, regulatory constraints, and competitive landscapes of their respective industries when determining the optimal mix of debt and equity financing.
- The choice of capital structure should align with a company's strategic objectives, risk tolerance, and industry-specific conditions.

Question 12

EXPLAIN 'PECKING ORDER HYPOTHESIS' RELEVANT TO CAPITAL STRUCTURE PLANNING.

Answer:

- The Pecking Order Hypothesis, proposed by Myers and Majluf in 1984, is a theory in finance that provides insights into capital structure planning for companies.
- This theory suggests that companies have a preferred "pecking order" when it comes to financing their operations and growth, and this order is based on the cost of capital and the information asymmetry between the firm and external investors.
- The hypothesis outlines the following principles:
 1. **Internal Financing (Retained Earnings):** According to the Pecking Order Hypothesis, the first source of financing preferred by firms is internal funds, such as retained earnings. Internal funds are the most desirable because they do not send any negative signals to the market and do not create information asymmetry issues.
 2. **Debt Financing (if necessary):** If internal funds are insufficient to cover the company's capital needs, firms will turn to debt as the next choice. Debt is preferred over equity because it is generally less costly, and it does not dilute ownership or signal negative information. However, firms aim to use debt conservatively to avoid taking on too much financial risk.
 3. **Equity Financing (as a last resort):** Equity issuance is considered the least favourable option for financing, as it can signal that a company's internal funds and debt capacity are exhausted. Equity issuance can dilute ownership and may lead to negative market reactions. Therefore,

companies prefer to use equity financing only when internal funds and debt financing are insufficient to meet their capital requirements.

- Key features and implications of the Pecking Order Hypothesis:
 - It assumes that firms have better information about their financial condition and prospects than external investors. As a result, firms try to avoid actions that might signal adverse information, like issuing equity when they have better financing options.
 - The hypothesis emphasizes that capital structure decisions are influenced by considerations of information asymmetry and market reactions.
 - Firms may follow a reactive approach to financing, where they adjust their capital structure based on their financing needs as they arise.

Question 13

MODIGLIANI-MILLER THEORY AMPLIFIES THAT VALUE OF THE LEVERED FIRM IS SAME AS VALUE OF THE UNLEVERED FIRM." UNDER WHICH CIRCUMSTANCES THIS PROPOSITION CAN BE PROVED.

Answer:

- The Modigliani-Miller theorem is a fundamental proposition in corporate finance. It makes the assertion that, under certain idealized assumptions and conditions, the value of a levered firm (a firm with debt) is the same as the value of an unlevered firm (a firm without debt).
- Circumstances that supports the same are as follows:
 - (a) The Modigliani-Miller theorem assumes that capital markets are perfectly efficient. In a world with perfect capital markets, investors have access to all relevant information, and there are no transaction costs, taxes, or other market imperfections.
 - (b) It is assumed that all investors have homogeneous expectations regarding the future cash flows and risks associated with the firm. In other words, everyone in the market has the same information and views about the company.
 - (c) Financial distress costs, such as bankruptcy costs and agency costs, are absent in this idealized world. In reality, the financial distress of a levered firm can result in significant costs, including legal fees, bankruptcy-related costs, and disruptions in business operations.
 - (d) The theorem assumes that debt and equity are perfect substitutes, meaning that investors are indifferent between holding debt or equity. In the real world, investors often have preferences for one type of security over the other.
- Under these idealized conditions, the Modigliani-Miller theorem demonstrates that the capital structure of a firm (the mix of debt and equity) does not affect its overall value. This proposition is sometimes referred to as "capital structure irrelevance."

Question 14

WHAT IS EBITDA ANALYSIS ? WHAT ARE ITS LIMITATIONS ?

Answer:

- EBITDA, which stands for Earnings Before Interest, Taxes, Depreciation, and Amortization, is a financial metric used in financial analysis to evaluate the profitability and operational performance of a company.
- It is calculated by taking a company's net income and adding back interest, taxes, depreciation, and amortization. The formula for EBITDA is:

$$\text{EBITDA} = \text{Net Income} + \text{Interest} + \text{Taxes} + \text{Depreciation} + \text{Amortization}$$
- EBITDA analysis is used for several purposes:
 - a. Comparing Companies: EBITDA allows for the comparison of the operating performance of different companies, as it eliminates the effects of financing decisions (interest and taxes) and non-cash expenses (depreciation and amortization).
 - b. Assessing Operational Efficiency: It provides insight into a company's core operating profitability by excluding non-operating items.
 - c. Evaluating Acquisition Targets: EBITDA is often used to assess the profitability of potential acquisition targets because it provides a picture of the target company's earnings potential before accounting for the acquirer's financing structure and tax considerations.
- However, EBITDA has several limitations:
 - (a) **Excludes Capital Expenditures:** EBITDA does not account for capital expenditures, which are essential for a company's long-term growth and maintenance of assets. It provides no information about a company's ability to invest in its own future.
 - (b) **Ignores Changes in Working Capital:** EBITDA does not consider changes in a company's working capital, which is important for assessing a company's liquidity and cash flow.
 - (c) **Can Be Manipulated:** EBITDA can be manipulated by management through accounting practices, like capitalizing operating expenses or changing depreciation methods. This can make it less reliable as a standalone metric.
 - (d) **No Consideration for Differences in Capital Structure:** EBITDA ignores the impact of a company's capital structure and the cost of debt, which can be significant in assessing the financial health of a company.

Question 15

WRITE SHORT NOTE ON: LEVERAGE AND ITS TYPES

Answer:

- Leverage refers to the use of borrowed funds to increase the potential return on an investment.
 - It allows individuals or businesses to amplify their investment exposure and potentially magnify profits if the investment performs well.
 - However, it also comes with increased risk because losses can be magnified as well.
 - Leverage can be classified into three major headings according to the nature of the finance mix of the company.
1. **Operational leverage** is defined as the company's ability to use fixed operating costs to magnify the effects of changes in sales on its earnings before interest and taxes.

- It measures how sensitive a company's profits are to changes in its sales or revenue.
- Operating leverage consists of two important costs viz., fixed cost and variable cost.
- If A company employs a great amount of fixed cost and smaller amount of variable cost it is more likely to enjoy the operational leverage.
- Thus, the degree of operating leverage depends upon the amount of various cost structure.
- Operating leverage can be determined with the help of a break even analysis.
- Operating leverage can be calculated with the help of the following formula:

$$\text{Operating Leverage} = \frac{\text{Contribution}}{\text{Operating Profit (EBIT)}}$$

- High operating leverage shows higher burden of fixed cost and low EBIT. Hence Operational leverage is Directly proportion to business risk

2. **Financial leverage** represents the relationship between the company’s earnings before interest and taxes (EBIT) or operating profit and the earning available to equity shareholders.

- It is the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on the earnings per share”.
- The use of long-term fixed interest-bearing debt and preference share capital along with share capital is called financial leverage or trading on equity”.
- Financial leverage can be calculated with the help of the following formula:

$$\text{Financial Leverage} = \frac{\text{Operating Profit (EBIT)}}{\text{Profit Before Tax}}$$

3. **Combined leverage** is When the company uses both financial and operating leverage to magnification of any change in sales into a larger relative change in earning per share.

- Combined leverage expresses the relationship between the revenue in the account of sales and the taxable income.
- Combined leverage can be calculated with the help of the following formulas:

$$\text{DCL} = \text{DOL} \times \text{DFL} = \frac{\text{Contribution}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{PBT}} \times \frac{\text{Contribution}}{\text{PBT}}$$

Question 16

DIFFERENCE BETWEEN: OL AND FL

Answer:

OPERATING LEVERAGE	FINANCIAL LEVERAGE
associated with investment activities	associated with financing activities
consists of fixed operating expenses	consists of Fixed Financial Exp
ability to use fixed operating cost.	ability to use fixed financial cost.
OL = Contribution/ EBIT	FL = EBIT/EBT
Degree of OL = $\frac{\% \text{ change in EBIT}}{\% \text{ change in SALES}}$	Degree of FL = $\frac{\% \text{ Change in EPS}}{\% \text{ Change in sales}}$
Trading on equity is not possible by using operating leverage	Trading on equity is possible while using FL

Operating leverage depends upon fixed cost and variable cost.	Financial leverage depends upon the operating profits & fixed financial costs.
Tax rate and interest rate will not affect the operating leverage.	Financial leverage will change due to tax rate and interest rate.

Question 17

WHAT IS WORKING CAPITAL LEVERAGE? ELABORATE WITH EXAMPLE.

Answer:

- Working capital leverage is a financial metric that assesses the impact of changes in a company's working capital on its overall financial performance, especially in terms of profitability and risk.
- Working capital refers to the capital a company uses to fund its day-to-day operations, such as paying for short-term liabilities, purchasing inventory, and covering operational expenses
- Working capital leverage measures the sensitivity of return in investment of charges in the level of current assets.

$$\text{Working Capital Leverage} = \frac{\% \text{ change in ROI}}{\% \text{ change in working capital}}$$

- If the earnings are not affected by the changes in current assets, the working capital leverage can be calculated with the help of the following formula.

$$\text{Working Capital Leverage} = \frac{CA}{(TA + \Delta CA)}$$

- Example: The following information is available

	X Ltd.
Fixed Assets	₹ 4,00,000
Current Assets	₹ 10,00,000
Total Assets	₹ 14,00,000
Earnings before interest and taxes	₹ 1,50,000

Solution -

$$\begin{aligned} \text{Working Capital Leverage} &= \frac{CA}{(TA + \Delta CA)} \\ &= \frac{10,00,000}{14,00,000 - 1,20,000} \\ &= \frac{10,00,000}{11,00,000} \\ &= 0.90 \end{aligned}$$

Question 18

WHAT IS DEGREE OF LEVERAGE ?

Answer:

- The term "degree of leverage" typically refers to a measure of how sensitive or responsive a company's one factor are to changes in its level of another.

- The degree of operating leverage may be defined as percentage change in the operating income (EBIT) resulting from a percentage change in the sales. It can be calculated with the help of the following formula

$$DOL = \frac{\% \text{ change in EBIT}}{\% \text{ change in SALES}}$$

- Degree of financial leverage may be defined as the percentage change in taxable profit as a result of percentage change in earnings before interest and tax (EBIT). This can be calculated by the following formula :-

$$DFL = \frac{\% \text{ change in taxable income}}{\% \text{ change in operating income}}$$

- The percentage change in a firm's earning per share (EPS) results from one percent change in sales. This is also equal to the firm's degree of operating leverage (DOL) times its degree of financial leverage (DFL) at a particular level of sales.

$$\text{Degree of combined leverage} = \frac{\% \text{ change in EPS}}{\% \text{ change in Sales}}$$

TM

Question 19

WHAT IS RISK UNDER BUSINESS FINANCING?

Answer:

- Risk is the probability that the future revenue streams of a firm shall show a variation from the expected figures
- It refers to the potential for financial losses or unfavourable outcomes that a business may encounter in its operations and financial activities.
- Risk can manifest in various forms, and it's an integral consideration in making financial decisions and managing the financial health of a company.
- In the context of leverage, we can divide risk into two broad categories, i.e. business risk and financial risk.

1. Business Risk

Refers to the risk associated with the firm's day to day operations.

It is represented by the variability earnings before interest and tax (EBIT).

The operating leverage concept can be used to evaluate business risk

2. Financial risk

It is associated with introduction of fixed interest-bearing debt obligations in the capital structure of the firm.

These obligations create a prior charge on EBIT before distribution of post tax profits among the owners.

More the debt would have higher the financial risk

Topic 16

DIVIDEND DECISIONS

Question 1

What is Dividend & Dividend Policy?

Answer:

Dividend:

- Distributed profits of a company among its shareholders.
- It is the reward of the shareholders for investments made by them in the company.
- Institute of Chartered Accountant of India: “A dividend is a distribution to shareholders out of profit or reserves available for this purpose.”

Dividend Policy:

- Refers to the policy concerning quantum of profit to be distributed as dividend.
- “Dividend policy determines the division of earnings between payments to shareholders and retained earnings.”

TM

Question 2

Kinds (Forms) of Dividend

Answers:

❖ Types of security

- Equity Dividend
 - Is the dividend paid on equity shares. Its rate is recommended by the BOD & approved by their shareholders
- Preference dividend
 - Is the dividend paid on Preference Shares, its rate fixed in nature & paid before equity dividend

❖ Based on time

- Interim Dividend
 - paid by a company for the current year before the accounts have been closed. Is paid when the company has heavy earning during the year
- Regular Dividend
 - Payment of dividend at the usual rate. The investors such as retired persons, widows and other economically weaker person prefer to get regular dividends.

❖ Mode of payment

- Cash Dividend
 - Is a usual method of paying dividends. Payment of dividend in cash results in outflow of funds and reduces the company's net worth
- 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. Stock dividend amounts to capitalization of earnings
- Scrip/Bond Dividend
 - A scrip dividend promises to pay the shareholders at a future specific date. In case a company does not have sufficient funds to pay dividends in cash, it may issue notes or bonds for amounts

- Property Dividend
 - are paid in the form of some assets other than cash, issue under exceptional circumstances
- Composite Dividend
 - is paid partly in cash and partly in the form of property
- Optional Dividend
 - company gives option to its shareholders either for cash dividend or for property
- Special or Extra Dividend
 - 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 such dividend

Question 3

What is Stock Split? Explain with Example.

Answer:

STOCK SPLITS

- Is the decision by a BOD to increase the number of shares by issuing more shares to current shareholders.
- For example, in a 2-for-1 stock split, a shareholder receives 1 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.
- 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.

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.

Question 4

Reason Behind Stocks Split

Answer:

1. Basic reason 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
2. Once the number of shares increases, it leads to greater liquidity in stocks. Due to this companies can repurchase their shares at a lower cost
3. Number of shares owned by investors' increases. Now, after some time, when share prices reach a high, the investor will enjoy more profit.

4. 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.

Question 5

Derminants of Dividend Policy

Answer:

1. Legal Restrictions:
Contract/ Agreements for bonds/loans may restrict dividend payments. The purpose of legal restriction is to ensure that the payment of dividend may not cause insolvency.
2. Magnitude and Trend of Earnings:
Past trends of dividend payment shall be kept in mind while paying dividend
3. Desire and Type of Shareholders:
Desire of SH has to be kept in mind while paying dividend
4. Nature of Industry:
Nature of co also affect divided policy of co
5. Age of the Company:
A new co may pay more dividend to attract the SH while old not
6. Future Financial Requirements:
If co need cash in future it may not pay dividend or interim dividend respectively
7. Taxation Policy:
High DDT may prone co to not pay excessive dividend
8. Policy of Control:
Co need to consider that More dividend payed to attract new SH may dilute the control of co
9. Stage of business Cycle:
Demand and supply position of co may affect DP
10. Cost of Capital:
Where external financing > internal financing,
Co may pay less dividend to save the cost
11. Regularity:
Some co may consider regularity in payment of dividend
12. Requirements of Institutional Investors:
Where co need permission from some institution to bay dividend it may affect payment of dividend

Question 6

TYPES OF DIVIDEND POLICY

Answer:

DIVIDEND POLICY

1. Regular Dividend – Reasons:-
 - Annual payment of dividend at regular interval
 - Investment get regular dividend
 - Investment from Weaker section of society
 - Can be maintained only if co. have regular earning

2. Stable Dividend – Reasons:-
 - Certain sum of money is regular paid
 - Constant dividend per share
 - Constant payout ratio
 - Stable dividend + extra dividend
 - Divided in three forms:
 - Constant Dividend Policy
 - Constant pay-out Ratio
 - Stable Rupee Dividend Plus Extra Dividend

3. Irregular Dividend: Reasons:-
 - Uncertainty of earnings
 - Unsuccessful business operations
 - Lack of liquid resources
 - Fear of adverse effects of regular dividends

4. No Dividend
 - No dividend paid to SH in order to retain the earnings for the growth of co.

Question 7

ESSENTIALS OF A SOUND DIVIDEND POLICY

Answer:

1. Stability:

Means 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 & vice versa.
2. Gradually Rising Dividends:

Implies that company should always try to make some increase in dividend rate each year
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, Risk - over-capitalization)
4. Moderate Start:

In the beginning years, dividend should be declared at lower rates. 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.

Question 8

IRRELEVANT CONCEPT OF DIVIDEND OR MODIGLIANI AND MILLER'S APPROACH (M-M MODEL)

Answer:

Modigliani and Miller’s Approach (M-M Model)

- Dividend decision is Irrelevant with the valuation of firm “(MM theory)
- Also Says, Dividend has no impact on wealth of S.H
- This model says, Value of firm determined by earnings power of firm.
- Manner in which earning divided into – Retained Earning dividend or Dividend does not affect value of the firm

$$\therefore P_o = \frac{D_1 + P_1}{1 + K_e}$$

Po = Mkt price now, P1=price @period end

D1 = Dividend @ end of yr. 1

Ke = Cost equity (Expected return by SH)

Assumptions of M-M HYPOTHESIS

- Existence of perfect Market with rational Investors
- NO taxes
- No floatation Cost
- Fixed Investment policy of firm

CRITICISM OF M-M HYPOTHESIS

- Assumptions of perfect cap market is not realistic
- There are different taxes in the capital market ignored by theory
- External financing will be costlier than internal financing due to floating cost.
- Transation cost is ignored
- capital market is uncertain.
- A firm cant follow rigid investment policy as suggested by the policy

Question 9

RELEVANCE CONCEPT OF DIVIDEND - WALTER’S APPROACH:

Answer:

RELEVANCE CONCEPT OF DIVIDEND - WALTER’S APPROACH:

- By Prof. James E Walter
- Says:- Dividend policy can influence value of firm
- Says:- Use appropriate dividend policy to increase value of firm, which is depends on type of firm

FORMULA :

$$\text{Price of Share (P)} = \frac{D + \frac{R(E-D)}{K_e}}{K_e}$$

Here ,

D = Dividend Per. Share

E = EPS

Ke = Cost of Equity

R = ROI

According to Prof Walter, there are three types of firms as given below:

❖ Growth firm

- $R > K_e$
- Optimum Payout ratio - zero

❖ Normal firm (Stable)

- $R = K_e$
- Payout ratio is irrelevant (any ratio is optimum)

❖ Declining firm

- $R < K_e$
- Optimum payout ratio is 100%

❖ ASSUMPTIONS OF WALTER'S MODEL :-

- Firm is all equity
- Firm will use only retained earning for financial needs
- R is constant
- K_e is constant
- All earnings are distributed / Immediately
- Firm has infinite life
- Earning and dividend not change

❖ CRITICISMS:-

- Assumptions are not realistic (like, firms will use only retained earnings)
- Constant ROI is not acceptable
- Constant K_e also not realistic
- The formula does not consider all the factors affecting dividend policy and share price. It ignores such factors as taxation, various legal obligations etc.

Question 10

RELEVANCE CONCEPT OF DIVIDEND- GORDON'S APPROACH

Answer:

According to Gordon:-

- Dividend policy affects the value of firm
- Market value of a share is equal to the present value of an infinite stream of dividends to be received by the shareholders on that share.

Assumptions:

1. The firm is an all equity firm.
2. No external financing is available. Only retained earnings will be used to financing expansion.
3. The internal rate of return is constant.
4. The cost of capital (or discount rate) for the firm remains constant and it is greater than the grow rate, i.e., $CR > br$ (or g).
5. The retention ratio, b , once decided upon, is constant.
6. The firm and its stream of earnings are perpetual. Thus, the growth rate, $g = br$, is constant for ever.
7. The corporate taxes do not exist.

Formula:

$$P_0 = \frac{E(1-b)}{Ke-g} \text{ OR } \frac{D}{Ke-g}$$

Note :- $E(1-b) = \text{Dividend}$

$P_0 = \text{Mkt price at year 'o'}$

$b = \text{retention ratio}$

$G = \text{growth rate}$

REVISED GORDON MODEL

$$\text{Says, } P_0 = \frac{D_1}{Ke-g}$$

Here, $D_1 = D_0(1+g)$

For finding out cost of equity share, the following formula is applied:

$$K_e = \frac{D_0(1+g)}{P_0} + g = \frac{D_1}{P_0} + g$$

P_0 - Mkt Price of share @year 0 (Zero)

D_1 - Dividend @ end of year 1

K_e - Cost of Equity / capitalization rate

g - Growth rate

Implication of Gordon's model,:

❖ Growth firm

- $R > K_e$
- such firms should retain maximum earnings
- Optimum payout ratio is 0%

❖ Normal firm (Stable)

- $R = K_e$
- For such firm, dividend policy is irrelevant and hence there is no optimum dividend payout
- Any payout ratio is Optimum

❖ Declining firm

- $R < K_e$
- such firms should distribute maximum earnings
- Optimum payout ratio is 100%

Topic 17

WORKING CAPITAL

Question 1

WHAT IS THE CONCEPT OF 'OPERATING CYCLE'? WHY IT IS IMPORTANT IN WORKING CAPITAL MANAGEMENT? GIVE A SUITABLE EXAMPLE TO ILLUSTRATE THE OPERATING CYCLE CONCEPT.

Answer:

- The operating cycle approach is a financial management concept that helps businesses understand and manage the time it takes to convert their resources into cash through their operational activities.
- This approach is particularly useful for assessing a company's working capital needs and optimizing cash flow.
- The operating cycle analyzes the accounts receivable, inventory and accounts payable cycles in terms of number of days.
- Working capital cycle indicates the length of time between the companies pays for materials, entering into stock and receiving the cash from sales of finished goods. It can be determined by adding the number of days required for each stage in the cycle.
- For example, a company holds raw materials on an average for 60 days, production process needs 15 days, finished goods are held for 30 days, 30 days credit is extended to debtors and it gets credit from the supplier for 15 days. The total of all these, 120 days (60 15+30 30-15) is the total working capital cycle.

• Computation of working capital with help of operating cycle concept:

In the form of an equation, the operating cycle process can be expressed as follows:

$$\text{Operating Cycle} = R+W+F+D-C$$

Where,

$$R = \text{RM conversion period} = \frac{\text{Average inventory of raw materials and stores}}{\text{Average per day consumption of raw materials and stores}} \times 360$$

$$W = \text{Work in progress conversion period} = \frac{\text{Average work in progress}}{\text{Average cost of production per day}} \times 360$$

$$F = \text{Finished goods conversion period} = \frac{\text{Average inventory of finished goods}}{\text{Average cost of sale per day}} \times 360$$

$$D = \text{Debtors collection period} = \frac{\text{Average Debtors}}{\text{Daily Average sales}} \times 360$$

$$C = \text{Creditors payment period} = \frac{\text{Average trade crediturs}}{\text{Average credit purchases per day}} \times 360$$

Question 2

WHAT IS WORKING CAPITAL? WHAT ARE THE TYPES AND BASIS OF CLASSIFICATION OF WORKING CAPITAL?

Answer:

- Working capital is a fundamental concept in finance and accounting that represents the operational liquidity or short-term financial health of a business.

- It is defined as the difference between a company's current assets and its current liabilities.
- Current assets are assets that are expected to be converted into cash or used up within one year, while current liabilities are obligations that are expected to be settled within one year.

- The formula for working capital is as follows:

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

- 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 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. The working capital can be classified into two categories on the basis of time and requirement:

(a) **Permanent Working Capital:**

To carry on a business a certain minimum level of working capital is necessary on a continuous and uninterrupted basis

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.

(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

The variable WC can further divided into two types namely:

(i) **Seasonal working capital** is required to meet the seasonal demands of busy periods occurring at stated intervals.

(ii) **Special working capital** is required to meet extraordinary needs for contingencies

Question 3

WHAT ARE THE ADVANTAGES OF WORKING CAPITAL?

Answer:

- Working capital is the capital a business uses in its day-to-day trading operations.
- It represents the difference between a company's current assets and current liabilities.
- There are several advantages to having sufficient working capital in a business:

a) **Solvency of the Business:**

Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

b) Goodwill:

Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.

c) Easy Loan:

A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and others on easy and favourable terms.

d) Cash Discounts:

Adequate working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.

e) Regular Supply of Raw Material:

Sufficient working capital ensures regular supply of raw materials and continuous production.

f) 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.

g) Exploitation of Favourable Market Conditions:

Undertaking of any opportunity in the manner of time is only possible with adequate working capital

h) Ability to Face Crisis:

Adequate working capital enables a concern to face business crisis in emergencies such as depression.

i) Quick and Regular Return on 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.

j) High Morale:

Adequacy of working capital creates an environment of security, confidence, high morale and creates overall efficiency in a business.

Question 4

WRITE A SHORT NOTE ON: DETERMINANTS OF WORKING CAPITAL ?

Answer:

- Working capital is influenced by a variety of factors and determinants that impact a company's operational liquidity and financial health.
- Understanding these determinants is crucial for effective working capital management.
- Determinants of working capital: Following factors determine the working capital requirement:
 - Nature and size of business
 - Manufacturing cycle
 - Credit policy both for customers and from suppliers
 - Business fluctuations and seasonal fluctuations
 - Production policy

- Growth and expansion activities
- Profit margin and profit appropriation i.e. profit, tax, dividends and retained earnings
- Volume of sales and price level changes.
- Operating efficiency Inventory turnover
- Liquidity and profitability
- Inflation factor
- Attitude to risk
- Profit planning and control Changes in technology
- Degree of mechanization
- Government policy.

Question 5

WHAT IS THE NEGATIVE WORKING CAPITAL? WHAT ARE ITS DISADVANTAGES?

Answer:

- Negative working capital, also known as a "working capital deficit," occurs when a company's current liabilities exceed its current assets.
- In other words, a business has more short-term obligations to meet than it has readily available assets to cover those obligations.
- 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.
- This situation can have both advantages and disadvantages, depending on the specific circumstances of the company.
- Disadvantages of Negative Working Capital:
 - (a) **Financial Risk:** Negative working capital can indicate financial risk because it means the company may struggle to meet its short-term obligations when they come due.
 - (b) **Limited Financial Flexibility:** In times of economic downturns, negative working capital can be a disadvantage because the company may not have sufficient liquidity to handle unexpected expenses or take advantage of opportunities.
 - (c) **Strained Supplier Relationships:** Suppliers may become concerned or less willing to extend credit terms if they see a company consistently operating with negative working capital. This can strain the relationships between the business and its suppliers.
 - (d) **Limited Growth Potential:** A company with consistently negative working capital may face limitations when it comes to expanding, as it may struggle to secure necessary financing for growth initiatives.
 - (e) **Credit Rating Impact:** A pattern of negative working capital could negatively impact the company's credit rating, making it more expensive and difficult to secure financing.

Question 6

FAILURE OF A FIRM IS TECHNICAL IF IT IS UNABLE TO MEET ITS CURRENT OBLIGATIONS. COMMENT.

Answer:

- The statement that the failure of a firm is technical if it is unable to meet its current obligations suggests that technical insolvency, also known as cash flow insolvency, occurs when a company cannot meet its short-term financial obligations, such as paying bills, meeting payroll, or servicing its debts when they become due.
- This is an essential aspect of a firm's financial health and can be a strong indicator of financial distress.
- The failure could be temporary and might be remediable. When liabilities exceed assets i.e. the net worth becomes negative, bankruptcy as commonly understood, arises.
- The technical bankruptcy can be ascertained by comparing current assets and current liabilities i.e. working out current or/and quick ratios.
- If the amount of current assets is not sufficient to meet the current liabilities, it is known as technical failure of firm. However, this type of failure is related to short term only and firm can recover from such situation in long-term.

Question 7

THE RISK OF BECOMING TECHNICALLY INSOLVENT IS MEASURED BY USING THE TOOL OF NET WORKING CAPITAL BY THE FINANCE MANAGERS. COMMENT.

Answer:

- Net working capital is a useful financial metric that finance managers often use to assess a company's liquidity and its risk of becoming technically insolvent.
- Net working capital represents the difference between a company's current assets and its current liabilities, and it is a valuable tool for evaluating short-term financial health.
- In formulating a firm's working capital policy, an important consideration is the trade-off between profitability and risk.. The term profitability here means profits after expenses.
- The term risk is defined as the probability that a firm will become technically insolvent so that it will not be able to meet its obligations on due for payment.
- The risk of becoming technically insolvent is measured using net working capital. It is assumed that the greater the amount of Net Working Capital, the less risky the firm is, and vice versa.
- The relationship between liquidity, Net Working Capital and risk is such that if either net working capital or liquidity increases, the firm's risk decreases.
- What proportion of current assets should be financed by current liabilities and how much by long term sources will depend on the risk perception of the management.
- Two broad policy alternatives, in this respect, are:

- (a) **A conservative current asset financing policy:** It relies less on short term bank financing and more on long term sources. No doubt it reduces the risk that the firm will be unable to repay its short-term debt periodically, but enhances the cost of financing.
- (b) **An aggressive current Asset Financing Policy:** It relies heavily on short term bank finance and seeks to reduce dependence on long term financing. It exposes the firm to a higher degree of risk, but reduces the average cost of financing thereby resulting in higher profits.

Question 8

THE BALANCE SHEET FAILS TO DEPICT AN EXACT PICTURE OF THE CURRENT ASSETS. ELUCIDATE.

Answer:

- The balance sheet, while a crucial financial statement for assessing a company's financial position, may not provide an exact or real-time picture of the current assets of a company.
- Several factors contribute to this limitation:
 - (a) The balance sheet typically reports assets at their historical cost, which is the original purchase price adjusted for depreciation, amortization, and impairments. This accounting method does not reflect the current market value of assets, which can fluctuate significantly.
 - (b) Certain assets, like land, buildings, and equipment, are reported at historical cost, even if their market values have appreciated significantly. This means that the balance sheet may understate the true economic value of these assets.
 - (c) Provisions in the balance sheet always varies the values of assets and accounts receivable and payable that is reflected in the true view of balance sheet
 - (d) Current assets, particularly inventory, are reported at the lower of cost or market value, that can lead to an understatement of the value of current assets on the balance sheet.
 - (e) The balance sheet provides a snapshot of a company's financial position at a specific point in time, typically at the end of a reporting period. Therefore, it may not capture daily or intra-period fluctuations in the company's current assets.
 - (f) Some current assets and liabilities, such as contingent liabilities or off-balance sheet financing arrangements, may not be reported on the balance sheet but can have a material impact on the company's financial condition.
- Hence, while the balance sheet is a valuable financial statement, it has limitations in accurately depicting the current value of certain assets due to historical cost accounting, timing differences, and other factors.

Question 9

DEFERRED PAYMENT OF TAXES IS A SOURCE OF WORKING CAPITAL. COMMENT.

Answer:

Not Available

Question 10

WORKING CAPITAL LEVERAGE MEASURES THE SENSITIVITY OF THE RETURN ON INVESTMENT IN WORKING CAPITAL. COMMENT WITH EXAMPLE.

Answer:

- Working capital leverage is a financial metric that assesses the impact of changes in a company's working capital on its overall financial performance, especially in terms of profitability and risk.
- Working capital refers to the capital a company uses to fund its day-to-day operations, such as paying for short-term liabilities, purchasing inventory, and covering operational expenses
- Working capital leverage measures the sensitivity of return in investment of charges in the level of current assets.

$$\text{Working Capital Leverage} = \frac{\% \text{ change in ROI}}{\% \text{ change in working capital}}$$

- If the earnings are not affected by the changes in current assets, the working capital leverage can be calculated with the help of the following formula.

$$\text{Working Capital Leverage} = \frac{CA}{(TA - \Delta CA)}$$

Here ROCE = $\frac{\text{Earning before interest and tax [EBIT]}}{\text{Total assets or Capital employed}}$

- Example: The following information is available

	X Ltd.
Fixed Assets	₹ 4,00,000
Current Assets	₹ 10,00,000
Total Assets	₹ 14,00,000
Earnings before interest and taxes	₹ 1,50,000

$$\text{Working Capital Leverage} = \frac{CA}{(TA + \Delta CA)} = \frac{10,00,000}{14,00,000 - 1,20,000} = \frac{10,00,000}{11,00,000} = 0.90$$

Question 11

DIFFERENCE BETWEEN: PERCENTAGE OF SALE METHOD & REGRESSION ANALYSIS METHOD

Answer:

Percentage of sale method	Regression analysis method
It is a traditional and simple method of determining the level of working capital and its components	This is statistical method or technique which is applied to forecast working capital requirement
It's often employed in financial planning and budgeting to project income statement items based on the company's historical relationships between sales and expenses.	It can be applied to various scenarios, including financial analysis, to model complex relationships between variables.

It assumes a constant or fixed percentage relationship between sales and certain expenses or financial variables.	It allows for the identification of statistical patterns and trends that may not be evident through simple percentage relationships.
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Question 12

MOST BUSINESSES NEED CASH FUNDS TO MEET CONTINGENCIES. COMMENT.

Answer:

- It is essential for businesses to maintain cash reserves to meet contingencies. Contingencies in business refer to unexpected events, emergencies, or unplanned expenses that can arise at any time.
- It is possible that cost of raw materials or components might go up or the time taken for conversion of raw materials into finished goods might increase. For such contingencies, some amount of cash is kept by every firm.
- The motive of holding cash for contingencies is based on the need to maintain sufficient cash to act as a cushion to buffer against unexpected events. One never knows about the happening of natural calamities or sudden increase in cost of raw materials or any other factor such as strike, lock-out etc.
- Such events may seriously interrupt even the best planned financial plans and thus temporarily make the cash budget ineffective and non-existent.
- Therefore, the business should maintain larger cash balance than required for day to day transactions in order to avoid unforeseen situation arising because of insufficient cash.
- However, maintaining too much cash can also be detrimental, as it can result in missed investment opportunities and decreased returns. Striking the right balance between having enough cash for contingencies and allocating capital for growth and profitability is a key financial management challenge for businesses.

Question 13

WHAT ARE THE MOTIVE OF HOLDING CASH?

Answer:

- The motive for holding cash in a business or personal context is based on several key financial and operational objectives.
- Businesses and individuals hold cash for various reasons, often referred to as "motives for holding cash." The main motives for holding cash include:
 - (a) Transaction Motive:** This motive involves holding cash to facilitate everyday financial transactions. Businesses and individuals need cash on hand to cover routine expenses, such as paying bills, buying groceries, or making small, everyday purchases. Cash on hand ensures that day-to-day financial transactions can be carried out smoothly without relying solely on credit or electronic payment methods.

- (b) **Precautionary Motive:** This motive for holding cash is about being prepared for unexpected events and emergencies. Holding cash as a precautionary measure provides a financial safety net to cover unexpected expenses, such as medical emergencies, urgent home repairs, or sudden changes in business conditions. It helps mitigate financial risk and provides peace of mind.
 - (c) **Speculative Motive:** Businesses and individuals may hold cash for speculative purposes. This means keeping cash available to take advantage of investment or business opportunities that may arise. For businesses, this could involve acquiring assets, expanding operations, or making strategic investments when favorable opportunities present themselves. For individuals, it might involve investments in stocks, real estate, or other assets when prices are attractive.
 - (d) **Compensating Motive:** The compensating motive is related to managing discrepancies between cash inflows and cash outflows. It involves holding cash to compensate for timing differences between when money is received and when it needs to be spent. This helps avoid potential liquidity problems. For businesses, this motive is particularly relevant in managing cash flow, as they need to ensure they have enough cash available when bills are due, even if income is irregular.
 - (e) **Operational Motive:** Businesses also hold cash to support their day-to-day operations. This can include maintaining cash reserves for paying employees, purchasing inventory, and covering operational expenses. Having cash readily available ensures the smooth functioning of the business.
- The specific mix of these motives for holding cash varies depending on individual circumstances, business objectives, and risk tolerance. Effective cash management involves striking a balance between the motives for holding cash, ensuring there is enough liquidity to meet financial obligations and take advantage of opportunities while not holding excessive cash that could otherwise be invested for better returns.

Question 14

WRITE SHORT NOTE ON: BAUMOL'S MATHEMATICAL MODEL

Answer:

- The Baumol Model, developed by economist William J. Baumol, is a mathematical model used to determine the optimal cash balance a firm should maintain to minimize the costs associated with managing its cash.
- The model is often used in cash management and finance to strike a balance between holding too much cash, which incurs opportunity cost, and holding too little cash, which may lead to costs related to shortages and transaction expenses.

- It is assumed that the size and timing of cash inflows are fully controllable to which transaction cost (cost of converting the securities into cash) and a variable carrying cost per rupee (in the form of opportunity cost of holding cash, i.e., the return on marketable securities) are attached.
- There is inverse relationship between the two costs as when one increases, the other decreases. Hence, the optimal cash balance is the trade off between opportunity cost and transaction cost and it is reached at a point where total cost is least.
- The Formula to calculate economic lot size by Baumol’s model:

$$C = \sqrt{\frac{2A \times F}{O}}$$

Where

C = Optimum cash balance

A = Annual (or monthly) cash disbursements

F = Fixed cost per transaction

O = Opportunity cost of holding cash

TM

Question 15

THE STRATEGY FOR EFFECTIVE CASH MANAGEMENT IN ANY FIRM HAS A CORE COMPONENT OF OPERATING CYCLE. COMMENT.

Answer:

- The strategy for effective cash management in any firm has a core component of ensuring uninterrupted supply of cash to the operating cycle.
- This cash is ideally generated from the cycle itself but under certain circumstances infusion of cash from outside the cycle also takes place. Examples of such circumstances are:
 - when the firm has been newly set up and the cycle has yet to commence;
 - when due to disruption in the cycle, cash gets stuck in other current assets and outside cash infusion in the form of promoters lenders' contribution is done.
- Essential elements of a successful cash management strategy:
 - (a) Realistic cash forecasting:**
 - Realistic cash forecasting mean that a cash forecast for the entire next year should be prepared at its commencement.
 - The cash forecast has two parts-one is the forecast of cash flows from the operating cycle and the second part is the capital flows.
 - The first part originates from the sales forecast for the year while the second part originates from the capital budget.
 - For realistic cash forecast, the sales projections and capital budget have to be drawn up after extensive deliberations in the management committee of the firm.
 - Involvement of operational level people, both from production and sales areas, is essential for realistic cash forecast.

(b) Speeding up Collections:

- After the cash forecast has been prepared, the firm should ensure that in day to day operations cash (including cheques) should be collected speedily.
- A schedule of receivables should be prepared and kept updated. Before due date of each payment, the debtor should be reminded for it. When the cheques are received on due dates, these should be credited to the bank account expeditiously.
- Similarly, facilities like drop boxes can be provided by firms having a large user base whereby customers can drop their payments in boxes placed at vantage locations.

(c) Spreading out Payments:

- Simultaneously with speeding up collection, the firm should spread out payments as far as possible.
- It means that if credit period is available in some payments, it should be utilized fully.
- Bunching of payments should be avoided.
- For outstation customers, arrangement can be made with the bank for making at par payment.

Question 16

WHAT ARE THE OBJECTIVES OF INVENTORY MANAGEMENT?

Answer:

- Inventory management is a critical function in supply chain and operations management. The objectives of inventory management are multifaceted and involve balancing the costs and benefits associated with holding inventory.
- The primary objectives of inventory management include:
- To ensure continuous supply of materials, spares and finished goods so that production should not suffer at any time and the customers demand should also be met.
- To avoid both over-stocking and under-stocking of inventory.
- To maintain inventories at the optimum level as required by the operational activities.
- To keep material cost under control so that they contribute in reducing cost of production and overall costs.
- To eliminate duplication in ordering stocks. This is possible with the help of centralizing purchases.
- To minimize losses through deterioration, pilferage, wastages and damages.
- To design proper organization for inventory management.
- To ensure perpetual inventory control Audit so that materials shown in stock ledgers should be actually lying in the stores.
- To ensure right quality goods at reasonable prices. The price-analysis, the cost-analysis and value-analysis will ensure payment of proper prices.
- To facilitate furnishing of data for short and long-term planning and control of inventory.

Question 17

IN ADDITION TO TRANSACTION MOTIVE, MORE MOTIVES FORCE CORPORATE TO HOLD INVENTORY. COMMENT

Answer:

- There are three possible motives for holding inventory, such as transaction motive precautionary motives and speculative motive.
 - (a) **Transaction motive:** Transaction motive of holding inventory takes into consideration the view that inventory level needs to be maintained in the right quantum to ensure proper functioning of business
 - (b) **Precautionary motive:** Precautionary motive provides that the level of inventory should also consider the aspect of that purchases which may prove to be time consuming in some cases and hence ample inventory should be maintained to avoid stock-out situation
 - (c) **Speculative motive:** Speculative motive talks about availment of discount and concessions associated with bulk purchases.
- Thus, in addition to transaction motive, corporate are influenced by precautionary motive and speculative motives to hold inventory

Question 18

DISCUSS THE ABC ANALYSIS AS A TECHNIQUE OF INVENTORY CONTROL.

Answer:

- ABC analysis, also known as Pareto analysis or the 80/20 rule, is a popular technique in inventory management used to categorize and prioritize items within an inventory.
- It helps businesses determine which items require the most attention and resources based on their importance or value to the organization.
- ABC analysis classifies inventory items into three categories: A, B, and C, each with a different level of priority and management focus.
 1. **Category A (High-Priority Items):** Category A items represent a relatively small percentage of the total items in the inventory but account for a significant portion of the total inventory value. These are typically high-value or high-demand items that need close monitoring and control. Effective management of Category A items is crucial for overall inventory management.
 2. **Category B (Medium-Priority Items):** Category B items are moderately important. They make up a moderate percentage of the inventory items and value. Managing these items involves a moderate level of attention and resources. It's essential to strike a balance between effective control and the cost of management.

3. Category C (Low-Priority Items): Category C items comprise a large portion of the inventory in terms of the number of items but represent a relatively small portion of the inventory value. These are often low-value or slow-moving items. While they don't require extensive management efforts, it's still important to monitor and review these items periodically to prevent overstocking or obsolescence.

- ABC Analysis of inventory items are represented in the table :

Category	% Of Items	% Of Value
A	15 %	80 %
B	35 %	15 %
C	50 %	5 %
-	100 %	100 %

Question 19

IT IS NOT ALWAYS NECESSARY THAT INVENTORY IS HELD FOR SMOOTH MANUFACTURING AND SALES OPERATIONS. COMMENT.

Answer:

- Inventory management is a critical aspect of many businesses, but it is not always necessary to hold a significant amount of inventory for smooth manufacturing and sales operations.
- The extent to which inventory is needed can vary based on several factors, including the nature of the business, the industry it operates in, and the specific business model.
- Here are some considerations and scenarios in which limited or no inventory may be required:
- Just-In-Time (JIT) Manufacturing: JIT is a production strategy that aims to minimize inventory levels by producing goods only when they are needed. It reduces holding costs, minimizes waste, and ensures that products are made to meet current demand.
- Seasonal Businesses: Some businesses may operate seasonally and can adjust their inventory levels based on peak demand periods. For example, a business that sells holiday decorations may only need inventory in the months leading up to the holiday season.
- Custom or Made-to-Order Products: Manufacturers that produce customized or made-to-order products may not need to hold excess inventory. They procure materials and produce goods only when orders are received, reducing the risk of overstocking.
- The choice to minimize inventory should be based on factors such as the type of industry, customer demand patterns, supplier reliability, and the cost of storage.
- It is highly uneconomical to keep men and machines waiting. Hence firms must carry inventories. Without proper control, inventories tend to grow beyond economic limits. Funds are tied up unnecessarily in surplus stores and stocks, productive operations are stalled, and finances of the plant are severely strained.
- Over-reliance on minimal inventory can be risky in situations where demand suddenly spikes or when there are disruptions in the supply chain.

- Striking the right balance between holding inventory and managing costs is a crucial aspect of effective business operations.

Question 20

WHAT ARE THE DIFFERENT LEVEL OF INVENTORY HOLDING?

Answer:

- Inventory management is the process of efficiently overseeing and controlling the acquisition, storage, and usage of goods or materials within a business.
- Effective inventory management is crucial for ensuring that a company has the right amount of stock on hand to meet customer demand while minimizing holding costs and the risk of overstock or stockouts.
- Therefore, an efficient inventory management requires that a firm should maintain an optimum level of inventory where inventory costs are the minimum and at the same time there is no stock-out which may result in loss of sale or stoppage of production.
- Various stock levels are as follows:
 - (a) Minimum Level:** This represents the quantity of stock that should be held at all time, stock level is normally not allowed falling below this level.
Fall in stock level below minimum level will indicate potential danger to the business.
Minimum Stock Level = Re-order Level - (Normal Consumption x Normal re-order Period)
 - (b) Re-ordering Level:** When the quantity of materials reaches a certain figure then fresh order is sent to get materials again. This is the safety line to safeguard the company from understocking or reaching to minimum stock level. The level depends on the monthly or weekly demand of the raw material along with the carrying period required to refill the RM.
Re-ordering Level = Maximum Consumption x Maximum Re-order period.
 - (c) Maximum Level:** It is the quantity of materials beyond which a firm should not exceed its stocks. It can cause Overstocking that will mean blocking of more working capital, more space for storing the materials, more wastage of materials and more chances of losses from obsolescence. Maximum stock level = Re-ordering Level + Re-ordering Quantity - (Minimum Consumption x Minimum Re-ordering period)
 - (d) Danger Level:** It is the level beyond which materials should not fall in any case.
Danger Level = Average Consumption x Maximum re-ordering period for emergency purchases
 - (e) Average Stock Level:** The average stock level is calculated as such: Danger Level = Average Consumption x Maximum re-ordering period for emergency purchases

Question 21

WRITE SHORT NOTE ON: EOQ .

Answer:

- Economic Order Quantity, and it is a concept in inventory management and supply chain management. EOQ is used to determine the optimal order quantity that a company should order for a particular product to minimize total inventory costs.
- These costs include holding costs (the costs of storing and carrying inventory) and ordering costs (the costs associated with placing and receiving orders).
- In determining this point ordering costs and carrying costs are taken into consideration. Ordering costs are basically the cost of getting an item of inventory and it includes cost of placing an order. Carrying cost includes costs of storage facilities, property insurance, loss of value through physical deterioration, cost of obsolescence

$$EOQ = \sqrt{\frac{2 \times R \times C_p}{C_h}}$$

Where

R = Annual quantity used (in units)

CP = Cost of placing an order / ordering cost per order

CH = Cost of holding 1 unit/Inventory carrying cost of 1 unit / carrying cost of 1 unit per year

- Assumptions required for EOQ are as under:
 1. While calculating EOQ the following assumptions are made:
 2. The supply of goods is satisfactory. The goods are purchased whenever these are needed.
 3. The quantity to be purchased by the concern is certain.
 4. The prices of goods are stable. It helps to stabilize carrying costs.

Question 22

WHAT ARE THE TYPES OF FACTORING?

Answer:

Types of factoring are as follows:

- (a) Non-Recourse/Full factoring:** Under this type of factoring the bank takes all the risk and bear all the loss in case of debts becoming bad debts
- (b) Recourse Factoring:** Under this type of factoring the bank purchases the receivable on the condition that any loss arising out or bad debts will be borne by the company which has taken factoring,
- (c) Maturity Factoring:** Under this type of factoring bank does not give any advance to the company rather bank collects it from customers and pays to the company either on the date of collection from the customers or on a guaranteed payment date
- (d) Advance Factoring:** Under advance factoring arrangement the factor provides an advance against the uncollected and non-due receivables to the firm.
- (e) Undisclosed Factoring:** Under this type of factoring, the customer is not informed of the factoring arrangement. The firm may collect dues from the customer on its own or instruct to make remit once at some other address.

- (f) **Invoice Discounting:** Under this type of factoring the bank provide an advance to the company against the account receivables and in turn charges interest rate from the company for the payment which bank has given to the company.

Question 23

WRITE A SHORT NOTE ON: BILLS RE-DISCOUNTING.

Answer:

- Generally, bill of exchange and other negotiable instruments are discounted with bank. But due to such discounting bank may face a problem of liquidity hence banks or financial institutions discounts the bill discounted in other banks or financial institution or with central bank which is called as rediscounting of bill.
- Bills rediscounting is a financial practice commonly used in banking and financial institutions.
- It involves the process of selling or lending a bill of exchange (a financial instrument used in international trade and commerce) to a bank or another financial institution before the bill's maturity date.
- Banks can rediscount the bills with the RBI and other approved institutions like LIC, GIC, UTI, ICICI, IFCI, DFHI etc.
- Purpose of bill rediscounting are as follows:
 - (a) **Providing Liquidity:** Bills rediscounting allows businesses or individuals holding bills of exchange to obtain cash or credit before the bills mature.
 - (b) **Risk management:** By rediscounting bills, the holder transfers the risk of non-payment or default to the bank or financial institution.
 - (c) **Interest income:** For banks and financial institutions, bills rediscounting can be a source of interest income and profit.
- The bill rediscounting plays a role in the broader monetary and economic policies of a country through the actions of central banks.
- As per RBI's guidelines regarding bill discounting by the commercial banks should not rediscount the bill discounted by NBFC as the RBI has provided enough rediscounting facilities to the banks, they can get the bill rediscounted from other banks.

Question 24

WRITE A SHORT NOTE ON: FACTORING.

Answer:

- Factoring" refers to a financial transaction where a business sells its accounts receivable, or invoices, to a third party for a fee, known as a "factor."
- This allows the business to obtain immediate cash, often at a discount from the face value of the invoices.

- A large business house has two options, namely either to manage its own receivables or to entrust the task of such management to a third party for a fee In factoring arrangement the debts as and when fall due are collected by the factor.
- Parties in Factoring: The factoring transaction involves three parties.
 - (a) The Seller, who has produced the goods/services and raised the invoice
 - (b) The Buyer, the consumer of goods/services and the party to pay
 - (c) The Factor, the financial institution that advances the portion of funds to the seller and recovers the amount from buyer
- Factoring Arrangement:
 - (a) The factor enters into an agreement with the seller for rendering factor services Le collection of receivables/debts
 - (b) The factor pays 80% or more of the amount of receivables copies of sale documents
 - (c) The factor receives payments from the buyer on due dates and pays the balance money to the seller after deducting the service charges.
- Functions of a Factor: The purchase of book debts or receivables is central to the function of factoring permitting the factor to provide basic services such as:
 - (a) Administration of sellers' sales ledger.
 - (b) Collection of receivables purchased.
 - (c) Provision of finance.
 - (d) Protection against risk of bad debts/credit control and credit protection.
 - (e) Rendering advisory services by virtue of their experience in financial dealings with customers.

Question 25

DISTINGUISH BETWEEN: FACTORING & DEBT SECURITIZATION

Answer:

FACTORING	DEBT SECURITIZATION
Factoring involves the sale of accounts receivable, which are typically short-term trade debts owed to a company by its customers. These receivables are essentially unpaid invoices for goods or services that have already been delivered.	Debt securitization involves packaging various types of debt, such as loans or mortgages, into securities or bonds that can be sold to investors. These debts are usually longer-term in nature, and they can include a broader range of financial assets.
In factoring, the ownership of accounts receivable is transferred from the company to a third-party factor. The factor takes on the credit risk associated with the receivables.	Debt securitization typically involves creating a special purpose vehicle (SPV) to hold the bundled debts. The originating institution may still carry some of the credit risk but often shifts a significant portion of it to investors in the form of securities.

Factoring is primarily used to improve cash flow and working capital management. Companies use factoring to get immediate cash by selling their accounts receivable, helping them meet short-term financial needs.	Debt securitization is used to raise capital by converting illiquid assets (debt) into tradable securities. It is often used for long-term financing, especially in industries like mortgage lending or auto loans.
Factoring involves short term finance arrangement	Securitization is long term finance arrangement
Factoring is an off-balance-sheet financing method. When a company factors its receivables, it doesn't create additional liabilities on its balance sheet. It's a sale of assets.	Debt securitization results in the creation of securities that represent financial assets on the balance sheet of the issuer. This can lead to an increase in both assets and liabilities.
Three parties involved: company, debtor and factoring firm	Four parties involved: obligor, owner, SPV and investor
This process is governed by private contract between factoring firm and company.	Securitization is governed by capital market mechanism.
Factoring is generally limited to accounts receivable and is common in industries with trade credit practices.	Debt securitization can involve various types of loans, including mortgage-backed securities, auto loan-backed securities, and credit card receivables.

Question 26

WRITE A SHORT NOTE ON: FORFAITING.

Answer:

- Forfaiting is a financial mechanism that facilitates international trade by providing a means for exporters to obtain immediate cash flow from their overseas sales, particularly in cases involving large and high-value transactions.
- It is a specialized form of trade finance and risk management primarily used in the export of goods and services.
- Forfaiting is a means of financing used by exporters that enables them to receive cash immediately by selling their medium-term receivables at a discount, and eliminate risk by making the sale without recourse, meaning the exporter has no liability regarding possible default by the importer on paying the receivables.
- The forfeiter is the individual or entity that purchases the receivables, so the importer is then obligated to pay the receivables amount to the forfeiter A forfeiter is typically a bank or a financial firm that specializes in export financing.

- A forfeiter purchase of the receivables, the sum of which is typically guaranteed by the importer's bank, expedites payment and cash flow for the exporter, in addition to eliminating the credit risk involved with making a sale to an importer on credit.
- Forfaiting expedites payment for the exporter and facilitates the transaction for an importer that cannot afford to pay in full for goods upon delivery.
- Forfaiting is most commonly used in regard to large, international sales of commodities or capital goods where the sale price exceeds Rs 1,00,000,
- Advantages of Forfaiting:
Forfaiting eliminates all risk of the exporter not receiving payment, including credit risk and transfer risk, as well as risks posed by foreign exchange. By transforming a credit-based sale into a cash transaction, forfeiting simplifies the transaction, providing immediate cash flow and eliminating collection costs for the seller rate or interest rate changes and the need to carry the accounts receivables on its balance sheet as contingent liabilities.
- Forfaiting is flexible and can be tailor-made to suit the needs of the exporter and adapted to a variety of international transactions. It can be utilized in place of credit or insurance coverage for a sale. It is helpful in situations where a country or a specific bank within the country does not have access to an export credit agency, allowing an exporter to transact business with buyers in countries with high levels of political risk.

Question 27

RISK IS ALWAYS ASSOCIATED WITH RECEIVABLES. COMMENT.

Answer:

- Risk is indeed inherently associated with receivables in the world of finance and business. Receivables, which represent amounts owed to a company by its customers or debtors, are assets that carry various risks due to the uncertainties surrounding repayment
- In business there always remains a risk of default by debtors.
- Risk of non-payment may due to insolvency, liquidity problems or intention of cheating.
- Thus, risk of receivables turning into bad debts is an integral part of business.
- The risk is related to bad debt losses to the profit margin i.e, a company can bear more risk with great profit margin.
- Risk associated with receivables can be accounted for by adjusting-
 - (a) The discount rate used to ascertain the present value of receivables.
 - (b) The cash flow resulting from receivables. Standard deviation and co-efficient of variation is tool that may be used to determine the degree of risk associated with cash group.

Question 28

HOW DO FIRMS MANAGE REQUIRED LEVEL OF RECEIVABLES?

Answer:

- Managing the required level of receivables is crucial for businesses to maintain a healthy cash flow and ensure that they have enough working capital to cover their operational needs.
- Here are some common strategies and techniques that firms use to manage their receivables effectively
 - Firms should set clear credit policies that define who is eligible for credit, the credit terms, and the maximum credit limits. These policies help ensure that customers are creditworthy and able to meet their payment obligations.
 - Conduct thorough credit checks on potential customers before extending credit. This can include assessing their financial statements, credit history, and payment behavior. Use credit scoring models or credit reports to evaluate creditworthiness.
 - Send out invoices promptly and accurately after delivering goods or services. Ensure that invoices are clear, complete, and easy for customers to understand.
 - Encourage early payment by offering discounts or incentives for customers who settle their invoices ahead of the due date.
 - Consider using trade credit insurance to protect against the risk of non-payment. Credit insurance can help mitigate the impact of bad debts
 - Regularly monitor accounts receivable to identify any overdue or delinquent accounts. Promptly follow up with customers who have overdue payments.
 - If necessary, adjust credit terms to be more favourable to the firm, such as shortening payment periods or reducing credit limits.
- Effective receivables management is essential to maintaining a healthy cash flow and minimizing the risk of bad debts. Firms should tailor their receivables management strategies to their specific industry, customer base, and financial circumstances.

Question 29

DISTINGUISH BETWEEN: FORFAITING & EXPORT FACTORING.

Answer:

FORFEITING	EXPORT FACTORING
Forfeiting is primarily used to finance medium to long-term export receivables, usually with a credit period of one to five years.	Export factoring, on the other hand, is designed for short-term financing [ranging from 30 to 180 days] of accounts receivable generated from the sale of goods or services to foreign buyers .
It involves the purchase of trade-related payment obligations, such as promissory notes or bills of exchange, from an exporter by a forfeiter.	Export factoring companies purchase invoices or receivables from the exporter and take over the responsibility of collecting payment from the importer. It is a revolving credit facility.
Forfeiting is a non-recourse financing method. Once the forfeiter purchases the	Export factoring can be recourse or non-recourse, depending on the agreement between the exporter

exporter's receivables, the exporter is relieved of all credit and payment risk related to those receivables.	and the factoring company. In recourse factoring, the exporter remains responsible for any bad debt losses.
Forfaiting involves the transfer of negotiable financial instruments, such as promissory notes, bills of exchange, or letters of credit.	Export factoring deals with invoices or accounts receivable, which are not typically negotiable instruments but are instead straightforward commercial invoices.

Question 30

CREDIT TERMS TO DEBTORS CAN BE RELAXED SO LONG AS ADDITIONAL COST OF INVESTMENT DOES NOT EXCEED ADDITIONAL CONTRIBUTION.

Answer:

Receivables means the book debts or debtors and these arise, if the goods are sold on credit. Debtors involve an element of risk and bad debts also. Hence, it calls for careful analysis and proper management. The goal of receivables management is to maximize the value of the firm by achieving a trade-off between risk and profitability. Timely realization of receivables is an important element of working capital management. Practices in this respect vary from firm to firm.

Relaxing the credit policy means increasing the credit period. If the firm is allowing 30 days for making payment to debtors then increase in such period to 45 days is known as relaxing the credit policy. Obviously by relaxation in credit period the firm's sale will increase which will also lead to increase the profit. However, the cost of administration, bad debt and cost of investment in debtor will also increase. Thus, firm should make proper analysis as what extent the credit period can be relaxed. Any increase in credit period by which firm's increase in profit due to increased sale is less than its cost as referred above will lead to loss and hence it is rightly said that credit terms to debtors can be relaxed so long additional cost of investment does not exceed additional contribution.

CS | LAW

Topic 18

SECURITY ANALYSIS

Question 1

WRITE A SHORT NOTE ON: DOW JONES THEORY.

Answer:

- The Dow Theory, often referred to as the foundation of technical analysis, is a set of principles and ideas developed by Charles H. Dow and his partner Edward D. Jones.
- According to this theory, share prices demonstrate a pattern over 4 to 5 years.
- These patterns can be divided into three distinct cyclical trends - primary, secondary and minor trends.

A. Primary trend:

- lasts from one to three years
- Definite upward or downward movement is shown in share price is the major - trend of the market, which makes it the most important
- Upward= bullish phase of the market. & Downward = Bearish phase of market

B. Secondary trend:

- trend moves in the opposite direction of the primary trend, or as a correction to the primary trend.
- It last for 2 to 3 months
- upward primary trend will be composed of secondary downward trends

C. Minor trend:

- market movement lasting less than three weeks.
- This are the daily moments in the price of share that doesn't affect the long-term price of share a lot

- According to the Dow Theory, all available information is already reflected in a security's price. This means that any news, events, or rumors are quickly factored into a stock's or market's value.
- The Three Phases of Trends: Dow identified three phases within a primary trend: accumulation, public participation, and distribution. During the accumulation phase, informed investors start buying or selling a stock.
- One of the key principles of the Dow Theory is that to establish a valid trend, both the Dow Industrial Average and the Dow Transportation Average must confirm each other's movements. If one index reaches a new high or low and the other doesn't follow, it might be a sign of a trend reversal.

Question 2

WRITE A SHORT NOTE ON: TECHNICAL CHARTS.

Answer:

- Technical charts, also known as price charts, are graphical representations of historical price and volume data for financial assets such as stocks, bonds, commodities, or currencies.

- They are a fundamental tool in technical analysis, a method of evaluating and forecasting future price movements based on historical price and volume patterns.
- Technical charts are used by traders and investors to make informed decisions about buying, selling, or holding financial assets.
- Here are some key points about technical charts:
 - (a) **Types of Charts:** There are several types of technical charts, but the most common ones include line charts, bar charts, candlestick charts, and point and figure charts.
 - (b) **Line Charts:** Line charts connect closing prices over a specific time period to create a simple line graph. They provide a quick overview of a security's price trend but lack detail.
 - (c) **Bar Charts:** Bar charts display a security's price data as a series of vertical bars. Each bar represents the high, low, open, and close prices for a specific time interval. Bar charts offer more information than line charts.
 - (d) **Candlestick Charts:** Candlestick charts provide the same information as bar charts but in a more visually informative way. They use candlestick shapes to represent price data for a given time period, showing the open, close, high, and low prices.
 - (e) **Point and Figure Charts:** Point and figure charts focus on price movements, ignoring time. They use X's and O's to represent price changes and are particularly useful for identifying trends and reversal patterns.
- In summary, technical charts are a foundational component of technical analysis, providing visual representations of price and volume data to assist traders and investors in making informed decisions.
- By studying historical price patterns and applying technical indicators, individuals can gain insights into potential future price movements and develop trading strategies to capitalize on market opportunities.

Question 3

THE PORTFOLIO MANAGERS GENERALLY ATTEMPT TO DIVERSIFY RISKS BY INVESTING IN DEBTS AND EQUITY INSTRUMENTS. COMMENT.

Answer:

- Portfolio managers often aim to diversify risks by investing in a mix of debt and equity instruments.
- This diversification strategy is grounded in the fundamental principle of risk management, which is to spread investments across different asset classes to reduce exposure to any one specific risk.
- Debt and equity instruments have different risk profiles. Debt instruments, such as bonds, are generally considered less risky than equities (stocks). By holding both in a portfolio, the manager can mitigate the impact of adverse market movements in either asset class.

- Diversification is most effective when the assets in the portfolio are not perfectly correlated. Debt and equity investments often have a low or negative correlation, meaning that they tend to move in opposite directions or are not strongly influenced by the same economic factors.
- A portfolio with a higher allocation to equities may be suitable for long-term growth objectives, while a greater emphasis on debt can be more suitable for income generation or capital preservation.
- Hence, the inclusion of both debt and equity instruments in a portfolio allows for a more balanced and risk-managed approach to investment

Question 4

ALPHA IS AN INDICATOR OF THE EXTENT TO WHICH THE ACTUAL RETURN OF A STOCK DEVIATES FROM THOSE PREDICTED BY ITS BETA VALUE." DISCUSS.

Answer:

- Alpha and beta are two key concepts in finance, particularly in the context of evaluating the performance and risk of individual stocks or investment portfolios.
- They are often used in the context of the Capital Asset Pricing Model (CAPM) and the Arbitrage Pricing Theory (APT) to analyse and assess the potential returns of investments.
- Alpha is an indicator of the extent to which the actual return of a security deviates from those predicated by its beta value. It is denoted by symbol α . Alpha value help an investor to decide whether security overvalued, undervalued or rightly valued.
 - (a) Positive Alpha Value:** Positive alpha value indicates that expected return is more than required return as per CAPM and hence security is undervalued. Such security should be bought.
 - (b) Negative Alpha Value:** Negative alpha value indicates that expected return is less than required return as per CAPM and hence security is overvalued. Such security should be sold.
 - (c) Zero Alpha Value:** Zero alpha value indicates that expected return is equal to required return as per CAPM and hence security is correctly valued. Such security should be hold.

Question 5

THE RISK OF THE PORTFOLIO WHICH COMBINES BOTH A RISKY AND A RISK-FREE ASSET WILL BE REDUCED TO THE STANDARD DEVIATION OF THE RISKY SECURITY, WEIGHTED FOR ITS PROPORTIONATE VALUE IN THE PORTFOLIO." DO YOU AGREE? DISCUSS.

Answer:

- The risk of a portfolio that combines both a risky asset and a risk-free asset will not be reduced to the standard deviation of the risky security weighted for its proportionate value in the portfolio.
- Risk free security has no risk i.e. its standard deviation is zero. If investor invests his whole funds in security having some risk then his portfolio risks is equal to risk of that particular security.

- If investor decides to form a portfolio by investing some funds in risk free security and some funds in risk security then his return will be equal weighted average return and his portfolio risk will also be reduced.
- The risk of such a portfolio is determined by the combination of the risky asset and the risk-free asset and is influenced by their correlation and the allocation between them.

(a) Risk of a Portfolio:

- (i) The risk of a portfolio is not solely determined by the standard deviation of the risky asset (often represented as the portfolio's volatility) and its weight in the portfolio.
- (ii) The risk of a portfolio is a function of both the risk associated with the risky asset and the correlation between the risky asset and the risk-free asset.

(b) Risk-Free Asset:

- (i) A risk-free asset, typically represented by government bonds or similar securities, has zero volatility because its returns are known with certainty. Therefore, its contribution to the overall risk of the portfolio is minimal in terms of volatility.
- The risk of the portfolio is a weighted combination of the risk associated with the risky asset and the risk-free asset. If the two assets are negatively correlated, it's possible to construct a portfolio that has lower risk than holding the risky asset alone. This is due to the risk-free asset acting as a hedge against the fluctuations in the risky asset.
- The reduction in risk depends on the correlation and allocation between the risky and risk-free assets in the portfolio.

Question 6

DISTINGUISH BETWEEN: SEMI-STRONG FORM OF EFFICIENT MARKET HYPOTHESIS & STRONG FORM OF EFFICIENT MARKET HYPOTHESIS.

Answer:

SEMI STRONG FORM OF ECMH	STRONG FORM OF ECMH
The semi-strong form of EMH asserts that all publicly available information is already reflected in stock prices.	In Strong form of ECMH, all information, whether public or private available in public domain, is already reflected in stock prices.
Insider trading is possible in this form. i.e. excess profit can be made by investors by excessing the private information	Insider trading would not be profitable, as the market already accounts for all material non-public information.
semi-strong form is a more accurate representation of how financial markets operate in the short term	Strong form of market is relatively less accurate representation of financial market
It is relatable form of market	It is hypothetical form of market

Question 7

CAPM IS A TOOL TO WORKOUT COST OF EQUITY. COMMENT.

Answer:

- The Capital Asset Pricing Model (CAPM) is a widely used financial model that helps investors and financial analysts determine an appropriate expected rate of return for an investment, considering its risk relative to the overall market.
- CAPM is a fundamental concept in finance and is used in the valuation of assets and the determination of the required rate of return for various investments.
- Formula for Computing Expected Return:

$$K_e(RP) = R_f + \beta (R_m - R_f)$$
 Where,
- **Expected Return (R_i):** CAPM is used to calculate the expected return on an individual asset or investment, denoted as "R_i."
- **Risk-Free Rate (R_f):** This is the theoretical return an investor would expect to receive from a risk-free investment, such as government bonds. It serves as the baseline for calculating expected returns on riskier assets.
- **Market Risk Premium (R_m - R_f):** The market risk premium represents the additional return an investor expects to earn by investing in a diversified portfolio of risky assets compared to a risk-free asset. It's calculated as the difference between the expected return on the market as a whole (R_m) and the risk-free rate (R_f).
- **Beta (β):** Beta is a measure of an asset's sensitivity to market movements. It quantifies the asset's risk relative to the overall market. A beta of 1 means the asset's returns move in line with the market, while a beta greater than 1 indicates higher volatility, and a beta less than 1 indicates lower volatility.

Question 8

INTRINSIC VALUE OF A SECURITY IS VALID FOR A GIVEN SET OF CONDITIONS. COMMENT.

Answer:

- Intrinsic value is the actual value of a security as opposed to its market price or book value. Intrinsic value includes other variable such as brand name, trademarks and copyrights.
- Different investors use different techniques to calculate intrinsic value of security with given set of conditions like dividend per share, growth factor, required rate of return etc.
- Analysts employ these methods to see whether intrinsic value of security is higher or lower than its current market price allowing them to categories it as 'overvalued' or 'undervalued' in order to take investment decisions.
- Hence, intrinsic value of a security is valid for a given set of conditions.

Question 9

HOW DOES CAPITAL ASSET PRICING MODEL (CAPM) HELP IN ESTIMATING EXPECTED RATE OF RETURN OF A SECURITY? WHAT ARE THE ASSUMPTIONS OF CAPM ?

Answer:

- The Capital Asset Pricing Model (CAPM) is a widely used financial framework for estimating the expected rate of return for an individual security or an investment portfolio.
- CAPM helps investors and financial analysts by providing a systematic way to evaluate the potential return of an investment, considering its risk relative to the overall market.
- Formula for Computing Expected Return:

$$K_e(RP) = R_f + \beta (R_m - R_f)$$

Where,
 $K_e(RP)$ = Expected Return on Portfolio
 R_f = Risk Free Rate of Interest/ Return
 β = Portfolio Beta
 R_m = Expected Return on Market Portfolio
- CAPM provides a systematic approach to estimating the expected return on an asset by considering the asset's sensitivity to market movements (as represented by its beta).
- One can compare CAPM return and expected return for his investment decision.
 - (a) CAPM Return < Expected return: Buy
 - (b) CAPM Return > Expected return: Sell
 - (c) CAPM Return = Expected return: Hold
- Assumptions: The CAPM is based on a list of critical assumptions which are as follows:
 - Investors are risk averse and use the expected rate of return and standard deviation of return as appropriate measures of risk and return for their portfolio.
 - Investors make their investments decisions based on a single period horizon which is the immediate next time period.
 - Transaction costs are either absent or so low,
 - Assets can be bought and sold in any desired unit.
 - Taxes do not affect the choice of buying assets.
 - All individuals assume that they can buy the assets at the going market price and they all agree on the nature of the return and risk associated with each investment.

Question 10

DISTINGUISH BETWEEN: EFFICIENT PORTFOLIO & OPTIMAL PORTFOLIO. (NOT IMPORTANT)

Answer:

Efficient Portfolio: Efficient Portfolio is that which lies along the capital market line. These are the portfolios which offer-

- (a) the maximum level of expected return for a given level of risk or
- (b) the minimum level of risk for a given level of return.

These portfolios lie along the efficient frontier of the set of all possible portfolios in a graph of portfolio returns against portfolio risk. It is not possible to determine that which portfolio an individual will prefer, as it would be decided by the risk-return attitude of investor.

Optimal Portfolio: The efficient portfolio which is best suited to the risk return characteristics of a particular individual investor is an optimal portfolio for the investor. It represents a tangency point of the individual investor's utility function or indifference curve on the efficient frontier.

Question 11

EXPLAIN THE STATEMENT "HIGHER THE RETURN THE HIGHER WILL BE THE RISK".

Answer:

- The statement "Higher the return, the higher will be the risk" is a general principle in the world of finance and investment.
- It reflects the fundamental concept that there is typically a positive relationship between the potential return on an investment and the level of risk associated with that investment.
- Higher return should be expected by those who are willing to bear higher risk. If any investor is not willing to go for higher risk, he should invest in risk-free securities like government securities and should not expect higher returns.
- There are two parts of return from investment - risk free return and risk premium. It is the premium that enhances the return from investment.
- Risk premium is the function of risk. It changes in the direct proportion to risk. Total risk is the summation of systematic risk and unsystematic risk.
- As per Capital Asset Pricing Model (CAPM), unsystematic risk can be diversified away but systematic risk, on the other hand cannot be diversified away without cost.
- In other words, investors need to be compensated by a certain risk premium for bearing systematic risk.

$$K_e(RP) = R_f + \beta (R_m - R_f)$$

Where,

KE(RP) = Expected Return on Portfolio

RF = Risk Free Rate of Interest/ Return

β = Portfolio Beta

RM = Expected Return on Market Portfolio

In this way, if an investor is expecting higher return, he must be ready to take higher risk.

Question 12

THE EFFICIENT MARKET HYPOTHESIS SUPPORTS THE ASSUMPTION OF SUPREMACY TO MARKET FORCES. COMMENT.

Answer:

- 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:
 - (a) Prices must be efficient so that new inventions and better products will cause a firm's securities prices to rise and motivate investors to buy the stocks.
 - (b) Information must be discussed freely and quickly across the nations so that all investors can react to the new information.
 - (c) Transaction costs such as brokerage on sale and purchase of securities are ignored.
 - (d) Taxes are assumed to have no noticeable effect on investment policy.
 - (e) Every investor has similar access to investible funds at the same terms and conditions.

Investors are rational and make investments in the securities providing maximum yield.

Question 13

EXPLAIN THE COMPONENTS OF THE TOTAL RISK OF A SECURITY. PROVIDE NECESSARY EXAMPLES FOR EACH COMPONENT OF RISKS.

Answer:

- The total risk of a security is composed of several components, each of which represents a different source of uncertainty and potential loss for investors. These components can be broadly categorized into two main types: systematic risk and unsystematic risk.
 - (a) Systematic Risk/Non-Diversifiable Risk:**
 - Systematic risk is the risk which is caused by factors beyond the control of specific company, such as general factors in the market, GDP, inflation, interest rates, tax policy, government policy, etc.
 - These factors affect all the companies and cause variability in their returns.
 - Systematic risk cannot be reduced by holding an efficiently diversified portfolio. Therefore, systematic risk is that part of total risk which cannot be eliminated by diversification.
 - However, the systematic risk may be managed by ensuring that the portfolio includes variety asset classes, like fixed income, cash and real estate, each of which will react differently in the event of a major systemic change.
 - Systematic risk of a security is indicated by beta coefficient (β). β captures the sensitivity of a security's return with respect to market return.
 - (b) Unsystematic Risk/Diversifiable Risk:**
 - It is that part of total risk which is diversifiable. It is caused by factors which are within the control of a specific company, such as management, operational efficiency, labour conditions and financial leverage.

- The sources of unsystematic risk are business risk and financial risk.
- Securities which are less than perfectly and positively correlated can be combined together to diversify away unsystematic risk.
- It can be observed that unsystematic risk can be reduced to zero in an efficiently diversified portfolio; hence the only relevant risk in such a portfolio is systematic risk.
- Investors can reduce unsystematic risk through diversification by holding a mix of different securities in their portfolio. However, systematic risk is inherent to the broader market and can only be managed to some extent through asset allocation and risk management strategies.

Question 14

DIFFERENCE BETWEEN INVESTMENT AND SPECULATION

Answer:

INVESTMENT	SPECULATION
The primary objective of investment is to preserve and grow capital over the long term. Investors typically seek stable, long-term returns and are often more concerned with the safety of their principal investment.	Speculation focuses on short-term profit through the anticipation of price movements. Speculators are more interested in capitalizing on price fluctuations, often with a willingness to accept higher levels of risk for potentially higher returns.
Investors typically have a longer time horizon, often measured in years. They are willing to hold assets for an extended period and may rely on the compounding of returns.	Speculators have a shorter time horizon, often measured in days, weeks, or months. They aim to profit quickly from market fluctuations .
Investors tend to have a lower risk tolerance.	Speculators generally have a higher risk tolerance
RETURN on the investment is change in value of assets	Return on speculation is change in price
Investors has Moderate return capacity	Speculators have High return capacity
Considered as stable income	Uncertainty in the income stability

Question 15

WHAT IS FUNDAMENTAL ANALYSIS? WHAT ARE THE STAGES OF FUNDAMENTAL ANALYSIS?

Answer:

- Fundamental analysis is a crucial component of security analysis. Security analysis is the broader process of evaluating and selecting various financial assets, such as stocks, bonds, or other securities, to make informed investment decisions.

- Fundamental analysis is one of the key methodologies employed within security analysis to assess the intrinsic value and potential risks of these assets.
- 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) ECONOMIC ANALYSIS:

- Performance of a company is intimately related to the overall economic environment of the country.
- If the country has an improving GDP growth rate, then chances are that the valuation of securities shall be liberal.
- if the GDP growth rate slackens, the performance of industries is expected to slow down.
- Macro-economic factors to be considered while analyzing economy of country are as follows:
 - Gross Domestic Product
 - Savings And Investment
 - Inflation
 - Interest Rates
 - Budget
 - Tax Structure
 - Other Factors

(b) INDUSTRY ANALYSIS:

- Industry level analysis focuses on a particular industry rather than on the broader economy
- Composition, national economy, industry life cycle, barriers to new entrants etc. are some factors which are to be analyzed
- Industry growth cycle have 3 stage:
 - **Pioneering stage:** This stage is related to sunrise status of the industry. It is the stage when technological development takes places. This is the demand making and marketing stage.
 - **Expansion stage:** Here, the demand for the products increases but at a lower rate. This is the profiting stage and capital is easily available to the firm.
 - **Stagnation stage:** At this stage, the growth rate initially slows down. There is no product innovation. External capital is hard to come by.

(c) COMPANY ANALYSIS:

- It is the analysis of information Company information is generated internally and externally.
- Financial statement annually, semi or quarterly are generated to analyse.
- Accounting statements, ratio analysis, etc are tools of company analysis

- Traditional techniques of company analysis 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.
- Modern methods are regression analysis, and the related tools of trend and correlation analysis, decision tree analysis and simulation.
- Fundamental analysis are done using tools such as :
 - Earnings per Share - EPS
 - Price to Earnings Ratio - P/E
 - Projected Earnings Growth - PEG
 - Price to Sales - P/S
 - Price to Book - P/B
 - Dividend Yield

Question 16

WHAT IS COMMON SIZE STATEMENT?

Answer:

- A common size statement, also known as a common-size financial statement, is a financial report in which each line item is expressed as a percentage of a base item, typically total revenue (for income statements) or total assets (for balance sheets).
- This presentation format standardizes financial statements, making it easier to analyze and compare the financial performance and structure of different companies or different periods for the same company.
- Common size statements are useful for financial analysis and can reveal important insights about a company's financial health and efficiency.
- There are two common types of common size statements:

Common Size Income Statement: In a common size income statement, each line item (e.g., revenue, expenses, net income) is expressed as a percentage of total revenue. This format helps analysts understand the composition of a company's revenue and cost structure. It is particularly useful for comparing the cost and expense breakdown between companies of different sizes or within the same company over different time periods.

Common Size Balance Sheet: In a common size balance sheet, each line item (e.g., assets, liabilities, equity) is expressed as a percentage of total assets. This format allows for a detailed analysis of a company's asset composition and capital structure. It can be used to compare the allocation of resources between different companies or to monitor changes in a company's capital structure over time.

Topic 19

OPERATIONAL APPROACH TO FINANCIAL DECISION

Question 1

THE TECHNIQUE OF MARGINAL COST CAN BE A VALUABLE AID TO MANAGEMENT". DISCUSS.

Answer:

- The technique of marginal cost analysis is indeed a valuable aid to management in decision-making and cost control.
- Marginal cost refers to the additional cost incurred when producing one more unit of a product or service. It is an essential concept in economics and cost accounting, and its application can provide several benefits to management.
- Here are some key points to discuss the value of marginal cost analysis to management:
 - (a) Marginal cost analysis helps management determine the most cost-effective level of production. By comparing the marginal cost to the selling price, management can make informed decisions about how much to produce and at what price to maximize profit.
 - (b) Management can use marginal cost analysis to identify cost drivers and inefficiencies in the production process. By focusing on reducing or controlling marginal costs, an organization can improve its cost structure and overall profitability.
 - (c) Marginal cost analysis is particularly useful for short-term decision-making. For example, when deciding whether to accept a special order or make or buy components, managers can compare the marginal cost to the relevant revenue or cost savings to determine the best course of action.
 - (d) When an organization has limited resources, such as labor or machine hours, marginal cost analysis can help in allocating these resources efficiently. It allows management to prioritize production activities that generate the highest contribution.
 - (e) Marginal cost is a key component in break-even analysis, which helps management determine the level of sales required to cover both fixed and variable costs.
 - (f) In some cases, marginal cost analysis can be used in evaluating the performance of different departments, divisions, or product lines within an organization. By comparing their contribution margins, management can make informed decisions about resource allocation and investment.
- In conclusion, the technique of marginal cost is a valuable aid to management as it provides crucial insights into cost structure, profit optimization, and resource allocation.
- By considering the marginal cost in decision-making, management can make more informed choices that can lead to improved profitability and cost control within an organization.

Question 2

WHAT IS MARGIN OF SAFETY? HOW MAY IT BE IMPROVED?

Answer:

- Sales above the volume necessary to break even are referred to as the margin of safety.
- It represents the degree of cushion or safety that exists between the current or estimated value of an asset, investment, or project and its breakeven or intrinsic value.
- Margin of safety is the difference between the actual sales and break-even sales. Margin of safety represents the strength of the organization.
- A high margin of safety gives confidence to the organization. On the other hand, an undertaking with low margin of safety may wipe off the profit and turn into a loss with a drop-in sale.

Formula:

$$\text{Margin of safety} = \text{Actual sales} - \text{BEP sales}$$

OR

$$\text{Margin of safety (Units)} = \text{Profit} / \text{Contribution per unit}$$

OR

$$\text{Margin of safety (Value)} = \text{Profit} / \text{P.V ratio}$$

- Margin of safety and BEP are complement of each other; that is to say if BEP is 60% of Sales Margin of Safety is 40% of sales and so on.
- If the margin of safety is small, any fall in sales revenue may touch BEP and finally results into a loss which is a serious matter to be considered.
- Improvement in Margin of Safety can be made in the following way:
 - (a) Increase in the selling price, provided the demand is inelastic so as to absorb the increased prices.
 - (b) Reduction in fixed expenses.
 - (c) Reduction in variable expenses.
 - (d) Increasing the sales volume provided capacity is available.
 - (e) Substitution or introduction of a product mix such that more profitable.

Question 3

INDICATE ANY FIVE CIRCUMSTANCES UNDER WHICH YOU WILL PERMIT TO FIX A PRICE, WHICH IS LESS THAN THE MARGINAL COST OF THE PRODUCT.

Answer:

- Fixing a price that is less than the marginal cost of a product is typically not a sustainable long-term pricing strategy for a business, as it can lead to financial losses.
- However, there are certain circumstances where a company might consider such a pricing strategy as a short-term or tactical measure to achieve specific goals or address particular situations.
- Selling at or below marginal cost: During periods of recession or in case of competition, the firm may sell the product at or below the marginal cost. If the products are sold at marginal cost, the firm will not be able to recover the fixed costs and incur the losses to this extent.

- If they are sold below the marginal cost, the firm will not only be unable to recover the fixed costs but also part of the variable cost. Then, the losses will be further higher and the firm has to take action to reduce the losses.
- Reduction of prices even below the marginal cost may be justified for a short while due to several other reasons as indicated below:
 - (a) To introduce a new product or to popularize it.
 - (b) To eliminate the weaker competitors.
 - (c) To explore the foreign market and earn the foreign exchange.
 - (d) When there is recession in the market.
 - (e) When the employees cannot be retrenched and production is to be maintained.
 - (f) When the sale of one product will push up the sale of another co-product which is making a considerable profit.
 - (g) To dispose off perishable goods.

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Question 4

ENUMERATE THE PRACTICAL APPLICATIONS OF PROFIT VOLUME RATIO.

Answer:

- "Profit-Volume (P/V) Ratio," is a financial metric used in cost-volume-profit (CVP) analysis. CVP analysis is a management accounting technique that helps businesses understand the relationship between costs, volume, and profit.
- The P/V ratio is a crucial component of this analysis, as it provides insights into how changes in sales volume affect a company's profit.
- This ratio is calculated as:

$$\text{P/V Ratio} = \frac{\text{Contribution}}{\text{Sales}} \times 100$$
 Where, contribution = sale - VC
- Significance of P/V Ratio:
 - (a) P/V Ratio is considered to be the basic indicator of the profitability of the business.
 - (b) The higher the P/V Ratio, the better it is for a business. In the case of a firm enjoying steady business conditions over a period of years, the P/V Ratio will also remain stable and steady.
 - (c) If P/V Ratio is improved, it will result in better profits.
- P/V Ratio can be improved by the following means:
 - (i) By increasing the share of products with higher P/V Ratio in the overall sales mix.
 - (ii) By reducing the variable cost
 - (iii) By increasing the selling price.
- Uses of PV ratio are as under:
 - To compute the variable costs for any volume of sales.
 - To measure the efficiency or to choose a most profitable line. The overall profitability of the firm can be improved by increasing the sales/output of a product giving a higher P/V ratio.

- To determine break-even point and the level of output required to earn a desired profit.
- To decide more profitable sales-mix.

Question 5

SUNK COSTS ARE IRRELEVANT FOR DECISION MAKING. COMMENT.

Answer:

- Sunk costs are the Historical costs that have already been incurred and cannot be recovered, regardless of the decision at hand.
- When making decisions, especially those related to the future, such as whether to continue a project, invest in a new venture, or change course, sunk costs should generally be considered irrelevant.
- The statement "sunk costs are irrelevant for decision making" is a fundamental principle in cost accounting and decision analysis

Question 6

DEFINE COST ACCOUNTING. EXPLAIN HOW DOES IT HELP THE MANAGEMENT IN TRADE DEPRESSION AND TRADE COMPETITION.

Answer:

As per the provision of Companies Act, 2013

- Cost accounting is a science and art of calculating the cost. it is a branch of accounting that focuses on the systematic recording, analysis, and control of costs incurred by a business in the production of goods or services.
- Importance of cost accounting can be discussed under following heading:
 - (a) Cost as an aid to management:** It provides detailed costing information to enable them to maintain effective control over various cost items. The various advantages derived by the management from a good system of costing are as follows:
 - It helps in periods of trade depression and trade competition.
 - It aids in price fixation.
 - It helps in making estimates.
 - It helps in channelling production on right lines.
 - It eliminates wastages.
 - It makes comparisons possible.
 - It provides data for periodical P&L A/c.
 - It helps in determining and enhancing efficiency.
 - It helps in inventory control.
 - (b) Costing as an aid to creditors:** Investors, financial institutions are interested in the success of the business concern and hence they also get benefitted by the installation of an efficient system of costing. They can base their judgment about the profitability & future prospects of the enterprise on the costing records.

- (c) **Costing as an aid to employees:** Employees have interest in enterprise in which they are employed. They are benefitted by a number of ways by the installation of an efficient system of costing. They are benefitted through continuous employment and higher remuneration by way of incentives, bonus plans, etc.
- (d) **Costing as an aid to national economy:** An efficient system of costing brings prosperity to the business enterprise, which in turn results in stepping up of this Govt. revenue. The overall economic development of a country takes place; as a consequence increase in efficiency of production. Control of costs, elimination of wastages and inefficiency led to the progress of the industry and, in consequence of the nation as a whole.

Question 7

DISTINGUISH BETWEEN: COSTING & COST ACCOUNTING.

Answer:

COSTING	COST ACCOUNTING
Costing refers to the process of determining the cost of a specific product, service, project, or activity. It involves the allocation of costs to various cost centres or cost objects to establish the total cost associated with that particular entity.	Cost accounting is a broader system of accounting that encompasses various processes related to the classification, allocation, recording, and analysis of costs within an organization.
Costing is a narrower concept that focuses on estimating and calculating costs for a specific purpose. It covers individual products, determine project costs, or analyse the cost of providing specific services.	Cost accounting extends beyond the determination of product or service costs. It covers a wide range of activities, including cost control, cost reduction, budgeting, performance measurement, and providing cost information to management for decision-making.
The primary objective of costing is to determine the cost of a specific item or activity.	The primary objective of cost accounting is to provide management with accurate and timely cost information to support strategic and operational decisions.
Costing is primarily used for pricing decisions, budgeting, and assessing the profitability of specific products or services.	Cost accounting serves a broader managerial purpose, aiding in strategic planning, performance evaluation, control of operations, and optimizing resource utilization across the entire organization.

Question 8

NOTIONAL COST AND IMPUTED COST MEANS THE SAME THING. COMMENT.

Answer:

- Imputed/notional/hypothetical costs are those costs which do not involve cash outlays.
- They are included in cost account and are important for taking into consideration while making management decisions.
- In case two projects require unequal outlays of cash, the management must take into consideration interest on capital to judge the relative profitability of the projects.
- The British equivalent term of the American term 'Imputed Cost' is 'Notional Cost'.

Question 9

DIFFERENCE BETWEEN IMPLICIT COST AND EXPLICIT COST.

Answer:

IMPLICIT COST	EXPLICIT COST
Implicit costs are not incurred through actual monetary transactions. They represent the opportunity cost of using resources that an individual or business already owns. Implicit costs are the benefits or returns that could have been earned from the next best alternative use of those resources.	Explicit costs, also known as out-of-pocket costs, are the actual, direct, and tangible expenses that a firm or individual incurs when they engage in an economic activity. These costs involve a clear and measurable monetary outlay.
Implicit costs are not recorded in accounting statements because they don't involve actual cash expenditures. Instead, they are considered when evaluating the true cost or profitability of an economic decision.	Explicit costs are easily recorded in accounting and financial statements because they represent real cash transactions.
Implicit costs are crucial when calculating economic profit, as they reflect the full cost of an economic activity, including the value of resources that the entity already possesses and uses.	Explicit costs are important for calculating accounting profit and economic profit

Question 10

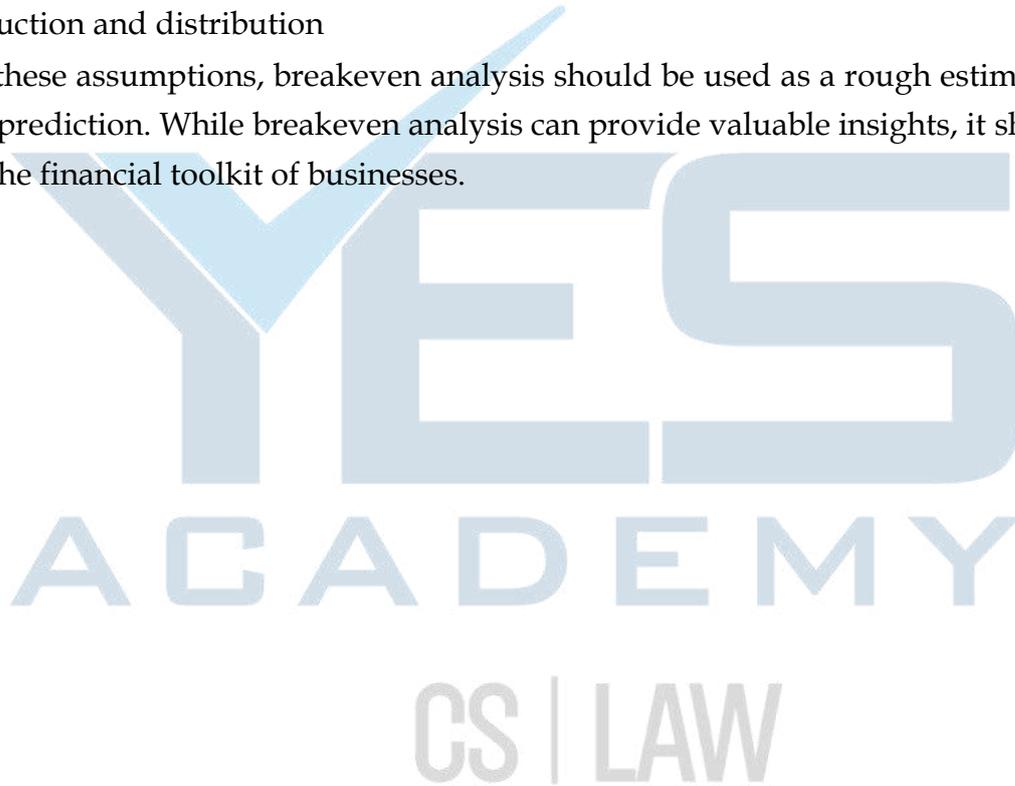
THE ASSUMPTION IN BREAKEVEN ANALYSIS LIMITS THE ACCURACY OF BREAK-EVEN POINT AND MAKES UNREALISTIC. COMMENT.

Answer:

- The break-even point is the point at which total cost and total revenue are equal
- At BEP there is no profit & no loss
- In other words, you've reached the level of production at which the costs of production equal the revenues for a product.
- The break-even point (break-even price) for a trade or investment is determined by comparing the market
- Formula to calculate the Breakeven point is:

$$\text{Fixed Costs} / (\text{Price} - \text{Variable Costs}) = \text{Breakeven Point in Units}$$

- However, several key assumptions underlie this analysis, and when these assumptions don't hold in the real world, it can lead to inaccuracies and unrealistic results. Here are some common assumptions in breakeven analysis:
 - All expenditures must be divided into fixed and variable components.
 - All fixed costs are expected to remain constant throughout all levels of activity
 - The variable cost per unit of the product stays the same And is directly related to volume
 - The production and sales units are equal, and that there is no inventory at the start or end of the period under consideration.
 - The sales mix does not change and that the selling price stays the same at all output levels.
 - A break-even chart can only show the position of one product; it is necessary to create separate charts for each product.
 - No change in productivity, operational effectiveness, product requirements, or methods of production and distribution
- Due to these assumptions, breakeven analysis should be used as a rough estimate rather than a precise prediction. While breakeven analysis can provide valuable insights, it should be just one tool in the financial toolkit of businesses.





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