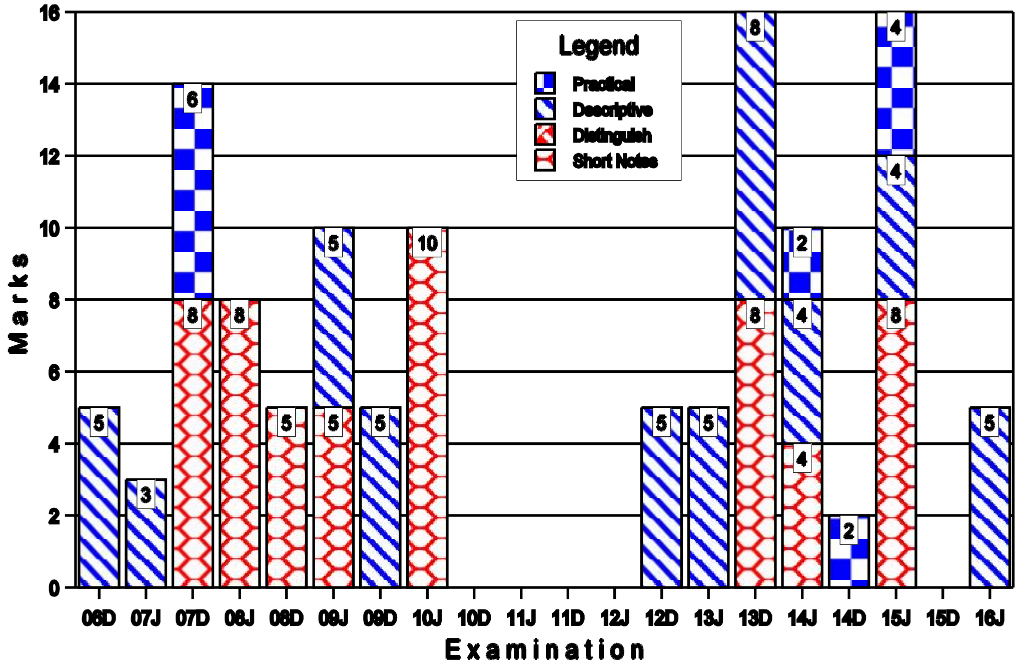
1 Overview of Financial Management

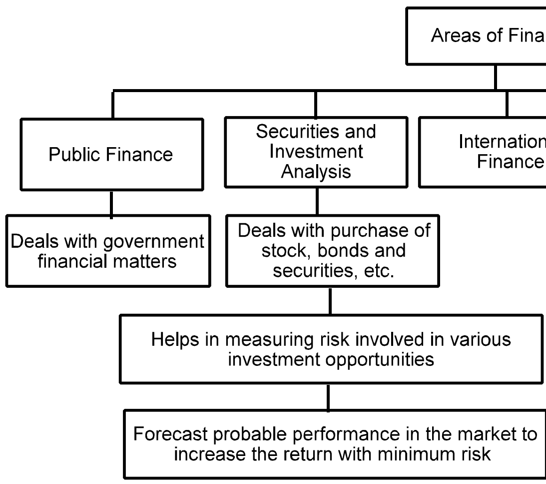
This Chapter Includes : Financial Management: Objectives, Key Decisions, Functions; Planning Environment, National & International Sources of Finance, Role of Finance Manager, Securities and Exchange Board of India Act 1992, Future Value, Present Value.

Marks of Short Notes, Distinguish Between, Descriptive & Practical Questions



Summary of Chapter at a Glance

1.1 Introduction



1.2 Meaning of Financial Management.

FM is a managerial activity which relates with planning and controlling of firm's financial resources. It is planning of decisions in order to maximize Shareholders' wealth. Financial Management comprises the forecasting, planning, organizing, directing, coordinating and controlling of all activities relating to acquisition and application of the financial resources of an undertaking in keeping with its financial objective.

Management of funds is an important aspect of financial management. Management of funds acts as the primary concern whether it may be in a business undertaking or in an educational institution. Financial management is meant for dealing with management of money matters.

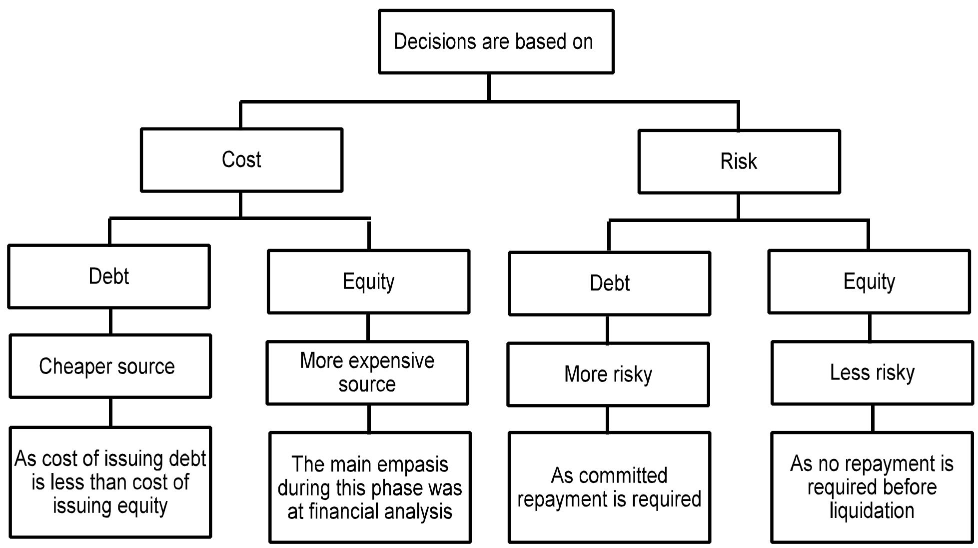
By Financial Management we mean efficient use of economic resources namely capital funds. According to Phillippatus, "Financial management is concerned with the managerial decisions that result in the acquisition and financing of short term and long term credits for the firm". Here it deals with the situations that require selection of specific assets (or combination of assets).

The analysis is based on the expected inflows and outflows of funds and their effect on managerial objectives.

1.2a Procurement of funds and effective utilization of funds

There are number of sources to procure funds, hence decision regarding, from where to procure the funds is a major decision for managers. For an organization to raise funds from equity capital is a costly affair while debt is a cheaper source.

Procurement of funds



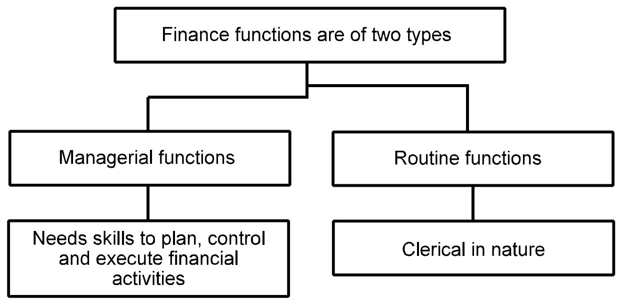
It includes following interrelated aspects of acquiring and managing resources from outside.

- Financial institutions
- Financial instruments
- Legal and accounting relationship between firm and its resources.

Effective utilization of Funds:

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

1.2b Finance functions



1.2c Major decisions taken as finance functions

Investment decisions	Relating to long term and short term decisions.
Financing Decisions	Relating to capital structure decisions. Optimum capital structure is when market value of shareholders is maximum.
Dividend decision	Relating to how much profits be distributed and how much to retain in business for investments.
Liquidity decisions	Related to firm's ability to meet its current obligations.

1.4 Scope of financial management

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

From time to time it is observed that many firms have been liquidated not because their technology was obsolete or because their products were not in demand or their labour was not skilled and motivated, but that there was a mismanagement of financial affairs. Even in a boom period, when a company make high profits there is also a fear of liquidation because of bad financial management.

Financial management optimizes the output from the given input of funds. In a country like India where resources are scarce and the demand for funds are many, the need of proper financial management is required. In case of newly started companies with a high growth rate it is more important to have sound financial management since finance alone guarantees their survival. Financial management is very important in case of non-profit organizations, which do not pay adequate attentions to financial management.

However a sound system of financial management has to be cultivated among bureaucrats, administrators, engineers, educationalists and public at a large.

Objectives of financial management

A. Profit Maximization

Objective of financial management is same as the objective of a company that is to earn profit. But profit maximization cannot be the sole objective of a company. It is a limited objective. If profits are given undue Importance then problems may arise.

Drawbacks of considering profit maximization as sole objective are discussed below.

- The term profit is vague and it involves much contradictions.
- Profit maximization has to be attempted with a realization of risks involved. A positive relationship exists between risk and profits. So both risk and profit objectives should be balanced.
- Profit Maximization does not take into account the time pattern of returns.
- Profit maximization fails to take into account the social considerations.

B. Wealth Maximization

It is commonly agreed that the objective of a firm is to maximize value or wealth.

Value of a firm is represented by the market price of the company's common stock. The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes in to account present and prospective future earnings per share, the timing and risk of these earning, the dividend policy of the firm and many other factors that bear upon the market price of the stock. Market price acts as the performance index or report card of the firm's progress.

Prices in the share markets are largely affected by many factors like general economic outlook, outlook of particular company, technical factors and even mass psychology. Normally this value is a function of two factors as given below.

- The anticipated rate of earnings per share of the company
- The capitalization rate.

The likely rate of earnings per shares (EPS) depends upon the assessment as to how profitably a company is growing to operate in the future. The capitalization rate reflects the liking of the investors for the company.

C. Other financial objectives

- **Achieving a target market share.**
  The enterprise will set objective to be the market leader or maintain its market stand. The reason behind this objective is that performance of the enterprise depends on being able to retain market share but also be able to capture other new customers.
- **Survival**
  Where competition is stiff the firm may set as its objective to survive. The firm may employ such tactics like maintaining a market niche, intensifying on barriers to entry into the industry it is operating but also choosing non growth strategy to ensure that they are able to stick to what they know.
- **Maximizing the profits**
  This is a complementary objective to above primary objective, because maximization of shareholders' profit requires the business to generate more profits. Maximization of profits will increase the market value of the business thereby increasing the shareholders' fund.

Wealth maximization vs. Profit maximization

Shareholders' wealth is talking about the value of the company generally expressed in the value of the stock. Profit maximization refers to how much profit the company makes. It might seem like making as much profit as possible would yield the highest value for the stock but that is not always the case.

When investors look at a company they not only look at profits but also profit margins, return on capital and other indicators of efficiency. Say there are two companies working in the same field. Company A had sales of ₹100 million and profit of ₹10 million. Company B had sales of ₹ 200 million and profit of ₹12 million. One can look at Company B and say they are less valuable because they clearly do not operate as efficiently as Company A. So even though Company B had more profits, Company A will have more shareholders' value.

Frequently, maximization of profits is regarded as the proper objective of the firm, but it is not as inclusive a goal as that of maximizing stockholders wealth. For one thing, total profits are not as important as earnings per stock. A firm could always raise total profits by issuing stock and using the proceeds to invest in Treasury bills. Even maximization of earnings per stock, however, is not a fully appropriate objective, partly because it does not specify the timing or duration of expected returns.

Another shortcoming of the objective of maximizing earnings per stock is that it does not consider the risk or uncertainty of the prospective earnings stream. Some investment projects are far more risky than others. As a result, the prospective stream of earnings per stock would be more uncertain if these projects were undertaken. In addition, a company will be more or less risky depending upon the amount of debt in relation to equity in its capital structure. This financial risk is another uncertainty in the minds of investors when they judge the firm in the marketplace. Finally, earnings per stock objective do not take into account any dividend the company might pay.

FUNCTIONS OF A FINANCIAL MANAGER

The executive who manages the financial affairs of a business is called 'financial manager'. The financial manager essentially has to manage funds and is concerned with the optimum utilisation of funds and with their procurement in a manner that the risk, cost and control considerations are properly balanced in a given situation. All the functions of finance manager may be divided into two categories as follows:

(i) Primary Functions

1. **Estimating the Capital Requirements :** Once the physical activities of the organisation have been properly forecast, the financial manager has to decide how much funds are required for long-term, mid-term and short-term purposes.
2. **Financing or Capital Structure Decision :** After estimating the requirements of funds, the financial manager has to decide about the sources from which funds are to be procured keeping in mind three factors viz., cost, risk and control. He should work out a proper mix of various sources in such a manner that the funds are procured at optimum cost with the least risk and the least dilution of control of the present owners. The financial manager has to decide:
   (a) What should be the proportion of equity and debt in the capital structure?
   (b) From which sources the equity should be raised - whether by issue of equity shares or preference shares.
   (c) From which sources the debt should be raised - whether by issue of debentures or raising long term loans.
3. **Utilization of Funds or Investment Decision:** After procuring the funds, the financial manager has to decide about the assets in which the funds are to be invested. Long-term funds should be invested only after a careful assessment of the various projects through capital budgeting techniques and uncertainty analysis. A part of long-term funds has also to be kept for financing the hard core working capital requirements. He has to participate in the formation of working capital management policies with regard to management of cash, inventories, debtors etc. The financial manager has to decide :
   (a) What should be the Fixed Assets Management Policy?
   (b) What should be the Cash Management Policy?
   (c) What should be the Inventory Management Policy?
   (d) What should be the Debtors Management Policy?
4. **Disposal of Surplus or Dividend Decision:** The financial manager is also concerned with the decision as to how much earnings are to be retained and how much to be distributed. Economically, this decision should depend on whether the company or the

shareholders can make a profitable use of the funds. However, in practice, a large number of considerations like the trend of earnings, the trend of share market price, the requirements of funds for future growth, the cash flow situation, the tax brackets of shareholders are to be kept in mind with an ultimate eye on the wealth maximisation objective. The optimum dividend payout ratio maximises shareholders' wealth.

5. **Management of Cash :** The financial managers must ensure the availability of adequate cash as and when needed. To purchase raw-material, to pay wages and salaries and to meet other day to day expenses.
6. **Financial Control :** The financial manager exercises the financial control by providing planned utilisation with which actual utilisation may be compared.

(ii) Subsidiary Functions:

(a) Ensuring the optimum level of inventory and receivables.

(b) Supplying funds to all the parts of the organisation.

(c) Evaluating financial performance of various units of the organisation.

(d) Carrying out financial negotiations with financial institutions, banks, underwriters, inter corporate depositors (ICD).

(e) Keeping track of stock exchange quotations and behaviour of share prices.

CHANGING SCENARIO OF FINANCIAL MANAGEMENT IN INDIA

Modern Financial Management has come a long way from the traditional corporate finance. As the economy is opening up and global resources are being tapped, the opportunities available to finance managers virtually have no limits. The finance manager is now responsible for shaping the fortunes of the enterprise and is involved in the most vital decision of the allocation of capital.

Due to the changes in the global environment the finance manager needs to have a broader and far-sighted outlook, and must realize that his actions would have far reaching consequences for the firm because they influence the size, profitability, growth, risk and survival of the firm and as a consequence, affect the overall value of the firm.

Some of the important changes in the environment are:

1. Free pricing and book building for IPOs, seasoned equity offerings.
2. Share buybacks and Reverse Book Building.
3. Raising resources globally through ADRs/GDRs.
4. Risk Management due to introduction of Options and Futures Trading and other derivative instruments.
5. Fully Convertibility of Rupee on Current Account.
6. External Commercial Borrowings.
7. Treasury Management.
8. Optimum debt-equity mix is possible. The firms have to take advantage of financial leverage to increase shareholders' wealth.
9. Interest rates have been freed from regulation.

INFLATION AND FINANCIAL MANAGEMENT

The direct consequence of inflation has been to distort the significance of operating results and utility of financial statements (based on historical cost) for various managerial accounting and financial decision making purposes. Even though it is beyond the scope of finance manager to control inflation, he is required to consider the impact of inflation on various financial management policies. Some of the prominent areas which are affected by inflation and are required to be re-oriented are as follows.

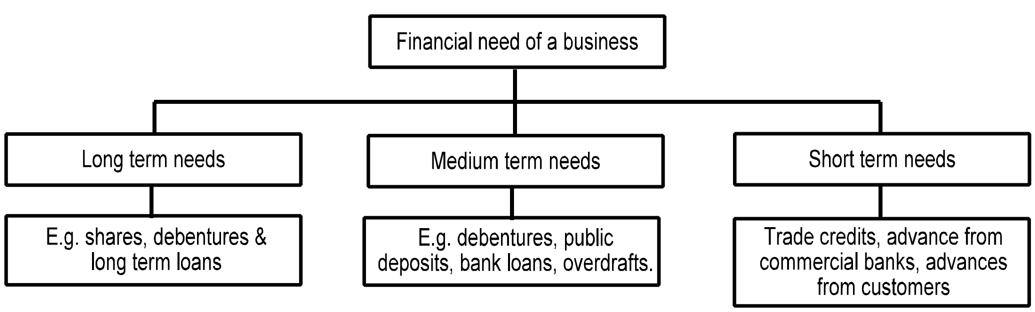
1. **Financing Decisions:** The finance manager is required to consider the impact of inflation while taking finance decisions (i.e., deciding about the sources of funds) since Interest to Suppliers of Debt, Pref. Dividend to Pref. Shareholders and Equity Dividend to Equity Shareholders are to be given out of profits and profits are affected by inflation. This involves identifying the sources from which the finance manager should raise the quantum of funds required by a company. The debenture holders and preference shareholders are interested in fixed income while equity shareholders are interested in higher profits to earn high dividend. The finance manager is required to estimate the amount of profits he is going to earn in future. While estimating the revenue and costs, he must take into consideration the inflation factor.

2. **Investment Decisions:** The finance manager is required to consider the impact of inflation on the project's profitability since the cash flows of an investment project which occur over a long period of time are affected by Inflation.
3. **Working Capital Decisions:** The finance manager is required to consider the impact of inflation while estimating the requirements of working capital since more funds may have to be tied up in inventories and receivables due to increase in input prices and manufacturing costs as a result of inflation.
4. **Dividend Decision:** The finance manager has to consider the impact of inflation while taking Dividend decision because dividend can be paid out of profits after depreciation and in a inflationary situation the depreciation provided on the basis of historical costs of assets would not provide adequate funds for replacement of fixed assets at the expiry of their useful lives.

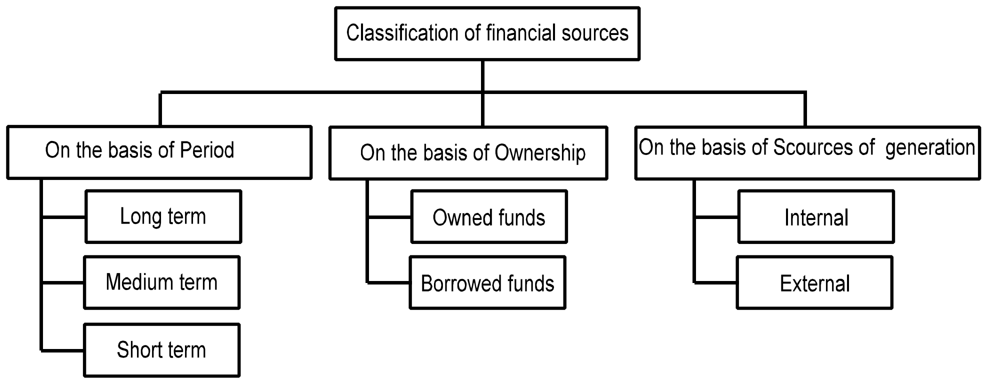
Sources of finance – depends upon financial strategy of organisation

- Leveraged planned by company.
- Financial conditions prevailing in the economy
- Risk profile of company and industry

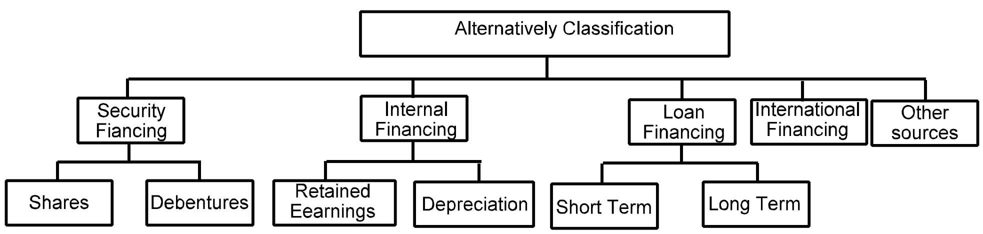
Financial need of a business



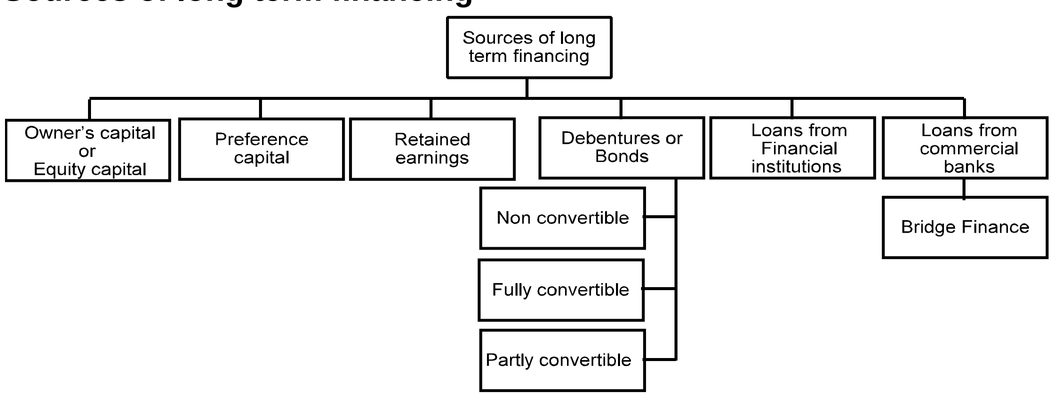
Classification of financial sources



Alternative classification



Sources of long term financing



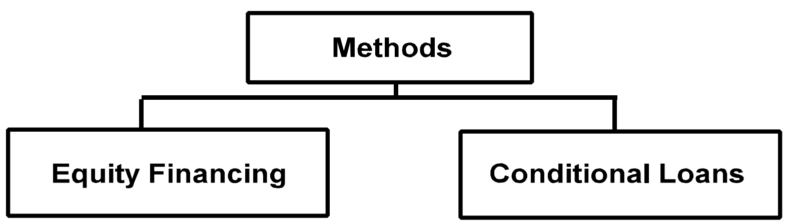
Bridge Financing

- Financing extended to people, company, using existing assets as collateral security in order to acquire new assets.
- It is a short term financing given by commercial bank.

- It is used to solidify a position until more permanent financing can be made.
- It bridges the gap between today's need for immediate cash to meet the initial cost and final implementation of long term financing.
- The funds are supplied by the bank/financial institution who in turn receives shares of the company at a discount declared by issue house.
- The rate of interest is higher as compared to other term loans.

Venture capital financing

It is meant for financing of innovative and high risk technology programme. Venture capital refers to capital investment. Capital investment may be in the form of debt or equity or both. It is an investment for medium or long term seeking to maximize return.



Equity financing	Conditional loans
For long period	Repaying in the form of royalty after the sales made by firm.
In form of equity share capital	Royalty charge between 2 to 15%
No return on initial stage.	Rate depends upon gestation period, cash flows, risk, etc.
Cannot exceed 49% of total equity capital.	

Lease Financing

As per AS-17 issued by ICAI lease is "an agreement whereby a lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time".

A lease is a contract between lessor and lessee, whereby former gives right to use and control the property for a specified period of time, without conveying ownership, in exchange of rent.

Advantages of leasing

1. The lessee can claim depreciation.
2. The lessee can enjoy tax benefit.
3. The procedure is simple.
4. It is easy cheaper method of financing.
5. The lessee can avoid the risk of obsolescence by taking asset on lease basis.
6. It is free from restrictive covenants.
7. The leasing company may finance 100% of cost of equipment.
8. It is an "Off the balance sheet" financing.

Disadvantages of leasing

1. It is costly for the lessee.
2. Default in payment by the lessor May sometime result in seizure of assets by bank.
3. The financial lease has all the rigidities of other methods of financing.

Short term sources of finance

A Trade credit

- It is credit granted to supplier of goods
- Credit period 15-90 days
- It can be in the form of bills payable

B Accrued Exp. and deferred Income

- Accrued expenses are current liabilities and spontaneous source of finance.
- Deferred Income is the amount which is to be received in future. It is also spontaneous source of finance.

C Advance from customers

- It is cost free source of finance.

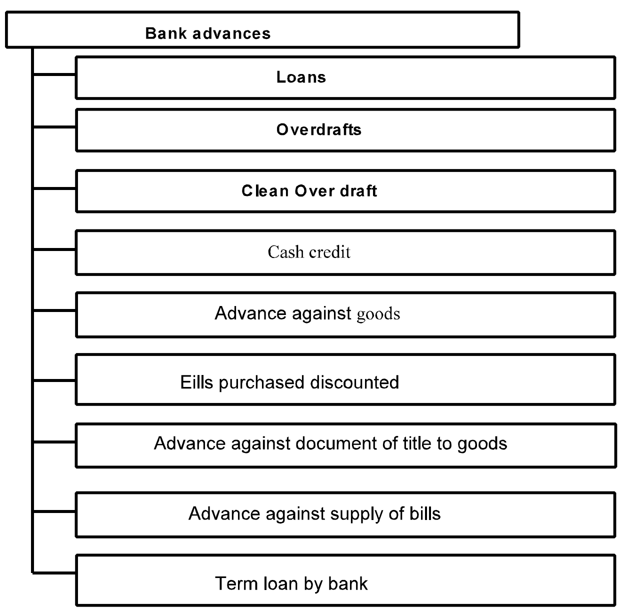
D Commercial papers

- A company can issue CP as per the guidelines issued by RBI.
- CP can be issued by company directly or through bank.
- CP is "usance promissory note"
- Conditions
  - ✓ Issue Company's tangible worth is not less than ₹ 4 crores as per the latest balance sheet.
  - ✓ Working capital limit should not be less than ₹ 4 crores.

- ✓ It is issued at a discount.(Discount rate determined by market)
- ✓ It can be issued for a period less than 7 days to 1 year from the date of its issue.
- ✓ There is no grace period for payment of commercial paper.
- ✓ The current ratio should be more than 1.33 as per the latest balance sheet.
- ✓ The company should have minimum P_2 rating from CRISIL or any other rating agency.

- The minimum size of CP is ₹ 25 Lacs and further in multiples of ₹ 5 Lacs
- The maximum size of CP is 100% of the issuer's working capital.
- The issue expenses are borne by issuer.
- The issue expenses are less as compared to bank financing.
- It is highly flexible and liquid.
- It provides higher yield.

E Bank advances



Other Short term sources of finance

A Inter corporate deposit

- The company can borrow funds from other organisation which have surplus liquidity.
- It is only a short term source for maximum of 6 months.
- The rate of interest depends upon the time period and the amount.

B Certificates of Deposits (COD)

Certificate of Deposits (CDs) is a negotiable money market instrument and issued in dematerialised form or as Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time.

Eligibility

CDs can be issued by:

(i) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and

(ii) selected all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI.

Minimum Size of Issue and Denominations

Minimum amount of a CD should be ₹1 lakh i.e., the minimum deposit that could be accepted from a single subscriber should not be less than ₹1 lakh and in the multiples of ₹ 1 lakh thereafter. CDs can be issued to individuals, corporations, companies, trusts, funds, associations, etc. Non-Resident Indians (NRIs) may also subscribe to CDs, but only on non-repatriable basis which should be clearly stated in the Certificate. Such CDs cannot be endorsed to another NRI in the secondary market.

Maturity

The maturity period of CDs issued by banks should not be less than 7 days and not more than one year from the date of issue. The FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue.

C Public deposits

- A company can accept deposits subject to the stipulation of RBI.
- Maximum amount – upto 35% of the paid up capital and reserve.

Other sources of finance

A Seed capital assistance

- It is only for professionally skilled firm or company.
- It is designed by IDBI.
- Maximum assistance – 50% or promoter's contribution of 15 lacs whichever is lower.
- The assistance is initially interest free but carries a service charge of 1% p.a. for the 1st five years.

B Internal cash accruals

It is capital expenditure out of all the reserves of the company after meeting all other requirements.

C Capital incentive

It is a kind of subsidy given to backward area. It also includes deferment of sales tax and octroi duty.

New instruments

A Secured premium note

- It is issued with a warrant attached with SPN.
- It is redeemable after specified period.
- It can be converted into equity share within this specified period.

B Deep discount bond

- It is a type of Zero interest bond
- It is redeemed at the expiry of specified period at face value.
- The gain to the holder is the difference between issue price and maturity value.
- DDB of face value ₹ 1 lakh was sold for ₹ 2,700 having maturity period of 25 years. The rate of return was 15.50%.

C Zero Interest Convertible Debt

- Debentures are compulsorily fully converted into equity shares after the specified period (not more than 3 years).
- No interest is payable.
- The gain is the difference between the issue price and the market price of convertible shares.

D Option bond

- These are cumulative and non cumulative bonds where interest is payable at maturity or periodically.
- Double option bonds have two parts one for principal and other for interest.
- The investor can sell these certificates either individually or separately.

E Inflation bond

- When interest rate is adjusted for inflation.
  e.g. interest rate is 10% and inflation rate is 2%. Investor will earn 12%.
- Investor is protected against inflation.

Other financial services :

1. Hire Purchase System: A system, by which a buyer pays for a thing in regular installments while enjoying the use of it. During the repayment period, ownership (title) of the item does not pass to the buyer. Upon the full payment of the loan, the title passes to the buyer. Thus hire-purchase means a transaction where the goods are sold by vendor to the purchaser under the following conditions :

Characteristics of Hire-Purchase System

1. The price under hire-purchase system is paid in instalments.
2. The goods are delivered in the possession of the purchaser at the time of commencement of the agreement.
3. Hire vendor continues to be the owner of the goods till the payment of last instalment.
4. The hire-purchaser has a right to use the goods as a bailer.
5. The hire-purchaser has a right to terminate the agreement at any time in the capacity of a hirer.
6. The hire-purchaser becomes the owner of the goods after the payment of all instalments as per the agreement.
7. If there is a default in the payment of any instalment, the hire vendor will take away the goods from the possession of the purchaser without refunding him any amount.

2. **Forfeiting :** Forfeiting is purchasing by discounting the receivables secured with payment bank Guarantees and Letters of Credit with deferred payment, that are due for payment on a future date and that arise from delivery of goods and services. With the forfeiting, by facilitating export with deferred payment that is 100% financed by the Bank, your export with deferred payment is transformed into a cash transaction and your product becomes competitive on the world market. Also, the forfeiting enables inflow of liquid funds for continuous production for export.
3. **Bill discounting:** A bill discounting is a process that involves effectively selling a bill to a bank or similar entity for an amount that is slightly less than the par value and before the maturity date associated with the bill of exchange. Business activities across borders are done through letter of credit. Letter of credit is an instrument issued in the favor of the seller by the buyer bank assuring that payment will be made after certain time frame depending upon the terms and conditions agreed, it is drawn for a short period of 3 to 6 months and in some cases for 9 months. Now when the seller receives the letter of credit through bank, seller prepares the documents and presents the same to the bank. The most important element in the same is the bill of exchange which is used to negotiate a letter of credit. Seller discounts that bill of exchange with the bank and gets money. Now it is seller's bank responsibility to send documents and bill of exchange to buyer's bank for onward forwarding to the buyer for the acceptance and the buyer finally, accepts bill of exchange drawn by the seller on buyer's bank because he has opened that LC. Buyers bank then gets that signed bill of exchange from the buyer as guarantee and release payment to the seller's bank and waits for the time span.
4. **Factoring:** Factoring is a financial transaction in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. In "advance" factoring, the business owner sells his receivables in the form of invoice to the factor, who makes an advance of 70-85% of the purchase price of the receivable amount. The factor collects the full amount from the customer in due course and pays the balance amount due to the business owner after deducting his commission and other charges. In "maturity" factoring, the factor makes

no immediate advance on the purchased accounts; but sees to it that the customer pays the invoiced amount within the stipulated time i.e. on maturity. However, if the customer fails to make payment within the stipulated time e.g. 30 days, the factor makes payment to the client and proceeds to collect the payment from the customer.

Benefit of factoring:

i. Factoring provides specialized service in credit management and this helps the firm's management to concentrate on manufacturing and marketing.

ii. Factoring helps to save cost of credit administration due to the scale of economies and specialization.

iii. When business of a factor grows, he employs specialist, whose service a businessman may not ordinarily be available to help.

5. **Securitization:** Securitization is a process of pooling and repackaging homogeneous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in or are secured by a segregated income producing asset or a pool of assets. The pool of assets collateralizes securities. These assets are generally secured by personal or real property.

Parties: Parties to the Securitization are originator, SPV, investors, obligors, rating agencies, administrator, agent and trustee, structures.

Instruments of Securitization includes Pass Through Certificate (PTC), Pay Through Securities (PTS) and Stripped securities. Securities may be asset backed and mortgaged back.

Debt Securitization

➢ It is a financial transaction in which assets generating cash flows are pooled together and securities representing interest in pool are issued.

➢ It is a method of recycling of funds.

Process of Debt Securitization

1. Origination function
   - Borrower seeks loan.
   - His credit worthiness is evaluated.
   - A contract is entered.
2. Pooling function

- Similar loans of receivables are clubbed and
- Transferred in favour of SPV and then placed in originator's portfolio.

3. Securitization function
   - SPV issue securities carrying coupon rate.
   - These are sold to investors and originator seeks the difference between yield and interest paid.

   Advantages
   - It converts illiquid asset to liquid asset.
   - The originator's credit rating enhances.
   - Assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.

International Financing:

A. External Commercial Borrowings (ECBs):

ECB include bank loans, supplier credit, securities instruments, credit from export credit agencies and borrowings from multilateral financial institutions. These securitized instruments may be FRNs, FRBs etc. Indian corporate sector is permitted to raise finance through ECBs within the framework of the policies and procedures prescribed by the Central Government. Multilateral financial institutions like IFC, ADB, AFIC, CDC are providing such facilities while the ECB policy provides flexibility in borrowing consistent with maintenance of prudential limits for total external borrowings, its guiding principles are to keep borrowing maturities long, costs low and encourage infrastructure/core and export sector financing which are crucial for overall growth of the economy. The government of India, from time to time changes the guidelines and limits for which the ECB alternative as a source of finance is pursued by the corporate sector. During past decade the government has streamlined the ECB policy and procedure to enable the Indian companies to have their better access to the international financial markets. The government permits the ECB route for variety of purposes namely expansion of existing capacity as well as for fresh investment. But ECB can be raised through internationally recognized sources. There are caps and ceilings on ECBs so that macro economy goals are better achieved. Units in SEZ are permitted to use ECBs under a special window.

B. Euro bonds

They are long term loans denominated in a currency issued outside the country of that currency. Cost of borrowing is lower but issue cost is high.

C. American depositary receipts

It is a negotiable certificate which represents a Non US company's publically traded local currency equity shares but is issued outside the US, for trading in the US. They are also dollar denominated. They are issued in accordance with the provision stipulated by SEC of USA. An ADR is generally created by depositing the securities of an Indian Company with custodian bank. ADR holders enjoy right as owner of underlying Indian security. The provision are very strict. The cost of issuing ADR's is quite high. Now ADR can be privately placed with the class of institutional investors known as qualified institutional buyer (QIB). Infosys, Wipro, MTNL, Rediff, VSNL, ICICI and many more Indian companies have issued ADR.

D. Global depositary receipts

It is a negotiable certificate which represents Non US company publically traded local currency equity shares. It is a dollar denominated instrument of a company traded in stock exchange outside the country of origin. It represents certain no. of equity denominated in rupees. Equity shares are registered in the name of an intermediary abroad called overseas depositary bank. The share certificates are delivered to another intermediary called domestic custodian bank. The issuer does not assume any exchange collected by way of issue proceeds. GDR's are freely transferable outside India. There is arbitrage possibility in GDR issue. There is a two way fungibility i.e. GDR can be converted into shares and *vice versa*. The lock in period for GDR is 45 days after the allotment. The shares underlying the depositary receipt do not carry voting rights.

ADR vs. GDR

ADR	GDR
The depositary receipts in US market is ADR.	The depositary receipt in world market is GDR.
It is issued outside USA but traded in USA.	It is not for trading in USA

Issued in accordance with the provision of SEC of USA.	Not comply with any of the condition of SEC of USA.
It has very strict provisions.	Disclosure requirement is less stringent.
Cost of issuing ADR is high.	Cost is not high.
It is not so popular only 10 companies have issued ADR.	It is much preferable than ADR.
ADR are listed in American stock exchange.	GDR are listed in other than ASE like Luxemburg, etc.

CONTEMPORARY DEVELOPMENTS:

1. **WTO :** The **World Trade Organization (WTO)** deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible. The organization officially commenced on 1 January 1995 under the Marrakech Agreement, replacing the General Agreement on Tariffs and Trade (GATT), which commenced in 1948. The organization deals with regulation of trade between participating countries; it provides a framework for negotiating and formalizing trade agreements and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements, which are signed by representatives of member governments and ratified by their parliaments. Most of the issues that the WTO focuses on derive from previous trade negotiations, especially from the Uruguay Round (1986–1994).

   Function of WTO:

   Main two most important functions are:

   (i) It oversees the implementation, administration and operation of the covered agreements.

   (ii) It provides a forum for negotiations and for settling dispute.

   Some of the major features of WTO and GATT are:

   (i) World Trade Organization (WTO), was formed in 1995, head quartered at Geneva, Switzerland.

   (ii) It has 152 member states.

(iii) It is an international organization designed to supervise and liberalize international trade.

(iv) It succeeds the General Agreement on Tariffs and Trade.

(v) It deals with the rules of trade between nations at a global level.

(vi) It is responsible for negotiating and implementing new trade agreements and is in charge of policing member countries' adherence to all the WTO agreements, signed by the bulk of the world's trading nations and ratified in their parliaments.

(vii) Most of the WTO's current work comes from the 1986-94 negotiations called the Uruguay Round and earlier negotiations under the GATT. The organization is currently the host to new negotiations, under the Doha Development Agenda (DDA) launched in 2001.

(viii) Governed by a Ministerial Conference, which meets every two years; a General Council, which implements the conference's policy decisions and is responsible for day-to-day administration; and a director-general, who is appointed by the Ministerial Conference.

2. **GATT:** The **General Agreement on Tariffs and Trade (GATT)** was a multilateral agreement regulating international trade. Purpose of GATT was the "substantial reduction of tariffs and other trade barriers and the elimination of preferences, on a reciprocal and mutually advantageous basis." It was negotiated during the United Nations Conference on Trade and Employment and was the outcome of the failure of negotiating governments to create the International Trade Organization (ITO). GATT was signed in 1947 and lasted until 1994, when it was replaced by the World Trade Organization in 1995.

4. **TRIMS:** The **Agreement on Trade Related Investment Measures** (TRIMs) are rules that apply to the domestic regulations a country applies to foreign investors, often as part of an industrial policy. The agreement was agreed upon by all members of the World Trade Organization. RIMs are rules that restrict preference of domestic firms and thereby enable international firms to operate more easily within foreign markets.

5. **TRIPS:** The **Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS)** is an international agreement administered by the World Trade Organization (WTO) that sets down minimum standards for many forms of intellectual property (IP) regulation as applied to nationals of other WTO Members.
6. **SEBI:** The capital market in India is one of the emerging and promising capital markets of the World. During last two decades, particularly after 1990. There was a need to established a separate regulating agency for the securities market. It was officially established by the Government of India in the year 1988 and given statutory powers in 1992 with SEBI Act, 1992 being passed by the Indian Parliament, which came into force on 30th January, 1992.

Objectives of SEBI: Main objectives are-

(i) To provide a degree of protection to the investors and safeguard their rights.
(ii) To promote fair dealing issuer of the securities.
(iii) To regulate and develop code of conduct for the financial intermediaries.
(iv) To provide for the matter connecting with or incidental to the above.

Powers of SEBI:

1. to approve by-laws of stock exchanges.
2. to require the stock exchange to amend their by-laws.
3. inspect the books of accounts and call for periodical returns from recognized stock exchanges.
4. inspect the books of accounts of a financial intermediaries.
5. compel certain companies to list their shares in one or more stock exchanges.
6. registration brokers.

In pursuance of its powers SEBI has formulated guidelines and regulations relating to:

(i) Merchant bankers,
(ii) Bankers to an issue,
(iii) Registrars to issue,
(iv) Share transfer agents,
(v) Debentures trustees,

(vi) Underwriters,
(vii) FIIs,
(viii) Insider trading,
(ix) Registration of brokers,
(x) Guidelines of portfolio management services,
(xi) Capital adequacy guidelines,
(xii) Guidelines for mutual funds,
(xiii) Guidelines for asset management companies,
(xiv) Guidelines relating to disclosure and investor protection,
(xv) Book building,
(xvi) Substantial acquisition of shares and takeovers,
(xvii) Depositories and participants etc

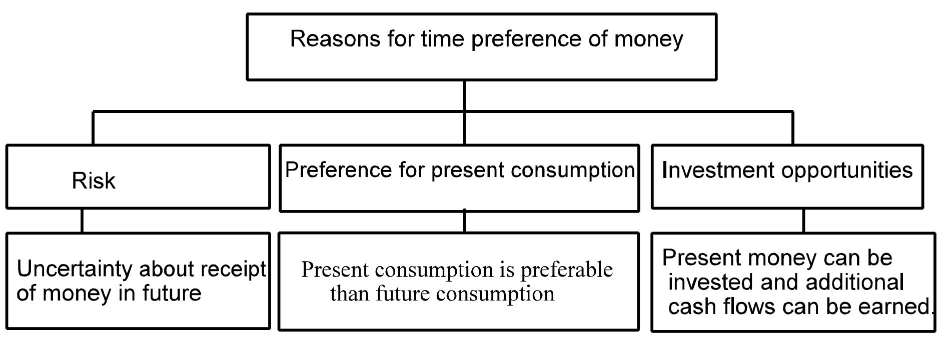
TIME VALUE OF MONEY

1 Time value of money:

The Time value of money means the difference between worth of rupee received today and worth of rupee received in future.

For a rational individual a Re. 1 received today is more valuable than Re. 1 received in future.

Reasons for time value of money



2 Simple interest

It is defined as "Interest calculated as a simple percentage of the original principal amount."

$$\boxed{S.I. = Prt}$$

Where, P = Principal, r = Rate of interest, t = Time period

Amount = Principal + Interest

3 Compound interest

Compounding means calculating future value of cash flows at a given interest rate at the end of a given period of time

$$\boxed{A = P\,(1 + I)^{n}}$$

Where, A = Amount, P = Principal, i = Interest rate, n = time period

4 Effective rate

$$\boxed{E = \left(1 + \frac{I}{m}\right)^{m} - 1}$$

Where, E = Effective rate, i = Interest rate, m = Time period

5 Present value

Present value is defined as "the amount of money that represents the sum of principal and interest if principal P is required to be invested now at a certain rate compounded over number of time periods."

$A = \dfrac{A}{(1 + I)^{n}}$ or $P = A\,(1 - i)^{-1}$

6 Annuity

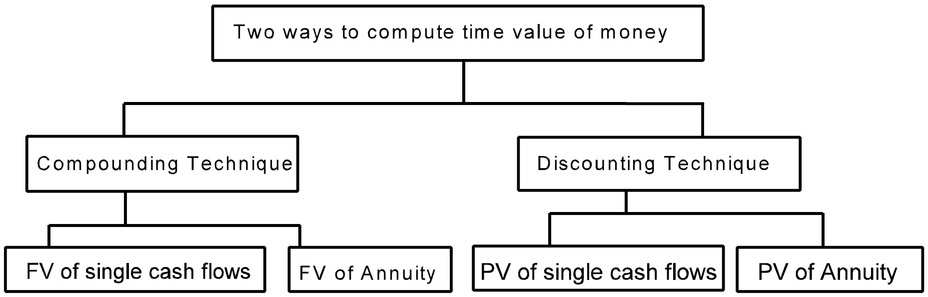
It is stream of regular periodic payment. It is a periodic fixed payment/receipt of an amount for a specific number of years. Period may be a month, quarter, a year or no. of years.

Annuity Regular = $A\left[\dfrac{(1 + I)^{n} - 1}{I}\right]$

7 Sinking Fund

It is created out of the fixed payment by way of sequence of periodic payment over a time period at a specified interest rate.

8 Techniques to compute time value of money



A. Compounding techniques

a. FV of single cash flows

$$FV = PV\,(1 + i)^n$$

Where,

FV = Future value, PV = Present value, i = Interest rate, n = Time period

b. FV of Annuity

$$FV = A\left[\frac{(1+i)^n - 1}{i}\right]$$

Where,

FV = Future value, A = Present value, i = Interest rate, n = Time period

B. Discounting Technique

a. PV of single cash flows

$$PV = FV\,(1 + i)^{-n}$$

Where,

FV = Future value, PV = Present value, i = Interest rate, n = Time period

b. PV of Annuity

$$PV = A\left[\frac{(1+i)^n - 1}{i\,(1+i)^n}\right]$$

Where,

FV = Future value, PV = Present value, i = Interest rate, n = Time period.

SHORT NOTES

2007 - Dec [8] Write short notes on the following:

(d) Consortium lending (4 marks)

(e) Financial Engineering (4 marks)

Answer :

(d) Consortium Lending : Consortium means a group or association. When the cost of project is too high for a single bank, a consortium of banks is formed to finance the project. Normally a big bank like the SBI is made the leader of the group and called Lead Banker for the project. Lead banker normally performs the evaluation of all aspects of the project however, each bank of the group can conduct its own due diligence analysis of the project in order to determine the financial parameters of client and project. The client does not have to submit all the details to each bank separately.

The LB employs the services of a lead engineer to monitor the progress of the project on behalf of all the lenders on a continuing basis. The finances are released by the consortium on the basis of report of lead engineer.

Answer:

(e) Financial Engineering : Engineering is the practical application of mathematical or scientific principles to solve problems or design useful products or services. Similarly, financial engineering involves the design, development and implementation of new financial instruments and processes and the formulation of creative solutions to problems of finance.

For instance, a civil engineer designing a bridge has many physical and budgetary constraints and has to answer questions like: how much load can it support at any point of time? Can it withstand the worst-ever earthquake? Will it be completed within ₹ 10 crores?

Similarly, a financial engineer also works within given physical and budgetary constraints. He tries to answer the questions like: Will the instrument deliver the desired result, even if the market moves in an erratic manner ? Or how will it withstand the financial earthquakes like default from one counterpart?

To succeed, both the engineers have to find optimal solutions within the constraints, which are conflicting in nature most of the time. Hence, the crux of financial engineering lies in innovation and creativity to promote market efficiency.

Financial engineering means designing the financial instruments in a new way with new qualities and parameters. Something new and something better is what engineering is all about. Same is true with financial engineering where new financial instruments with new features with better qualities are designed, produced and presented. In particular, financial engineering may involve bringing into play instruments like bonds or debentures with warrants entitling shares after certain period, issued at discount or at par, being convertible or non-convertible. Investor should comprehend the rate of return easily on the investment made by him. Financial engineering would require assessment of not only the company's fund position but also circumstances in which funds are sought to be raised and deployed, and also the assessment of external costs that influence the source of such funds.

2008 - June [8] Write short notes on the following :

(e) Role of mutual funds in the financial market, (4 marks)

(f) Secondary market. (4 marks)

Answer:

(e) Role of Mutual funds in the financial market: A mutual fund is a collective investment scheme which has three components viz. sponsor, trust and asset management company. The mutual fund is organized as trust with a board of trustees. The AMC organized as a joint stock company, manages the funds of the investors under various schemes.

The mutual fund have recorded a very impressive growth in India. In 1986 there was only one mutual fund i.e. Unit Trust of India now there are many mutual funds operating in India. All of them sufficient funds from the general public showing their faith in the system.

Answer:

(f) Secondary Market: Secondary market is a market where transactions, transfers and transmissions of shares of existing companies are done. This is popularly known as stock market. This market is regulated by SEBI. The companies listed in the stock market have to enter into an agreement with SEBI which is called listing agreement. All the listed companies have to follow the terms and conditions of listing agreement.

The shares allotted in the primary market (P market) are traded in secondary market (S market). The S market gives liquidity to shares allotted in P market. The P and S market exist together and each needs the other for its survival. There are mainly two reasons why people go to S market.

First is information motivated reasons: It is purely subjective in nature hence all persons may have all kinds of reasons. One person may believe that some share should be sold because it is overpriced and will fall in prices in future. On this information or knowledge or anticipation, the person sells his shares but there is another person who buys those shares and what does he think while buying? Just opposite of what the first person thought at the time of selling. Both the types always present in the S market making the market move.

The second reason may be **liquidity motivated reasons**, the investor may be having lack or excess of liquid cash and may find the S market very convenient place to park or to get cash.

2008 - Dec [8] Write a short note on the following :

(a) Off Balance Sheet Financing (5 marks)

Answer :

A company when takes some assets on lease basis, it does not become owner of the asset though it is making full use of those assets and will ultimately own those assets if lease agreement has the terms and conditions to this effect. As the company is not owner of the assets taken on lease, it does not show those assets on its balance sheet. This is understatement of assets which may some time lead to some wrongful estimation of balance sheet figures. The non-appearance of leased assets on the balance sheet is sometimes referred to as off balance sheet financing.

2009 - June [8] Write a short note on the following :
(a) Financial Planning Environment; (5 marks)

Answer :

The financial planning is not same as it used to be some years ago. This is because of drastic change in the environment in which the financial planning is to be made and implemented. All the dimensions and aspects of financial planning have undergone basic changes in these years whether laws, rules, regulations, investors attitude and awareness, company's responsibility, accountability and liability, international finance and exchange and many others.

The financial planning environment is changing on daily bases with regard to national and international laws, exchange rates, interest rates and exim policy etc. The financial planning should have adequate measures to respond to these factors in an efficient and effective way.

2010 - June [8] Write short notes on the following:
(c) Commercial paper as a source of Financing; (5 marks)
(d) Limitation of Financial Planning. (5 marks)

Answer :

(c) Commercial paper is a financial instrument in which a company promises to pay a certain sum after a certain period. Naturally the issue value is less than the maturity value. The CP is not covered by any security as its life is short between some days to some weeks.

Other plus points of commercial paper are as follows :

1. It is transferable and can be used as ordinary currency or money.
2. Maturity can be made flexible to suit the requirements of the company.
3. It can bring funds even if other instruments are not able to raise funds.
4. Maturity can be delayed by replacing the old CPs with fresh CPs.
5. The company can raise funds at lower rate than from other sources of finances. Normally rate of interest paid by the company on CP is less than what it would have paid to the bank for raising the same amount of money.

Answer:

(d) Limitations of Financial planning : Any planning relates to future and future is uncertain. The facts relate to past and planning requires facts. Thus it is impossible to have full proof planning in any matter. That is true with financial planning as well. This is the first and most important limitation of financial planning.

The forecasts provide the basis of planning and the forecasts are always doubtful. More the time length of forecast and more doubtful it becomes.

Planning becomes facts due to certain circumstances. A capital expenditure is made and some amount is to be paid every year as installment. The planning of payment of such installments is based on facts.

(The reader may add his/her own points)

2013 - Dec [8] (b) Write a short note on Commercial Paper in India.

(4 marks)

Answer:

Issue of Commercial Papers in India: Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note. It was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors. Subsequently, primary dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. Since the CP represents an unsecured borrowing in the money market, the regulation of CP comes under the purview of the Reserve Bank of India:

(a) CP can be issued in multiples of ₹5 Lakhs.
(b) CP can be issued for a minimum duration of 7 days and maximum period of 1 year.
(c) For issuing CP the company's net worth should be more than ₹ 5 crores.
(d) CP can neither be redeemed before maturity nor can be extended beyond the maturity period.
(e) CP issue requires a credit rating of P2 from CRISIL or A2 from ICRA.

2013 - Dec [9] (b) Answer the following:

(ii) Write a short note on Foreign Currency Convertible Bonds (FCCBs)

(4 marks)

Answer:

Foreign currency convertible bonds (FCCBs):

Foreign currency convertible bonds (FCCBs) are a type of convertible bonds that are issued in currency other than the domestic currency of the issuing company. FCCB's are issued by corporates for raising funds in foreign currency. With all the inherent features of convertible bonds, FCCBs emerge as a good bet for both the issuers and investors. The FCCBs are unsecured; carry a fixed rate of interest and an option for conversion into a fixed number of equity, shares of the issuer company. Interest and redemption is payable in dollars price only if conversion option is not exercised. Interest rates are very low by Indian domestic standards. FCCBs are denominated in any freely convertible foreign currency.

FCCBs with a maturity term of 3-7 years provide an option to the bondholders to either redeem their investments or convert FCCBs into equities at or before maturity term at pre-determined price. Consequently, FCCBs entitle an investor for coupon rate payments with an additional option of conversion of bonds into equities.

Salient features of FCCBs

1. FCCBs carry comparably lower interest rates in comparison to regular bonds. Low interest is partly on account of the inherent option available to investors for conversion of FCCBs into equities.
2. Issuance of FCCBs does not require any collateral or security.
3. FCCBs are a low-cost source of borrowing for corporates.
4. Funds raised through issuance of FCCBs meet various expansion plans and capital expenditure requirement of corporates.

2014 - June [7] (b) Write a short note on Global Depository Receipt.

(4 marks)

Answer:

Global Depositary Receipts

It is a negotiable certificate which represents Non US company publically traded local currency equity shares. It is a dollar denominated instrument of a company traded in Stock Exchange outside the country of origin. It represents certain no. of equity denominated in rupees. Equity shares are registered in the name of an intermediary abroad called Overseas Depositary Bank. The share certificates are delivered to another intermediary called Domestic Custodian Bank. The issuer does not assume any exchange collected by way of issue proceeds. GDRs are freely transferable outside India. There is arbitrage possibility in GDR issue. There is a two way fungibility i.e. GDR can be converted into shares and *vice versa.* GDRs are also issued with warrant attached to them. Warrants give the investors an option to get it converted into share to equity at a later date.

Voting rights

Rule 6 provides the provisions for voting rights of depository receipts holder.

(1) A holder of depository receipts may become a member of the company and shall be entitled to vote as such only on conversion of the depository receipts into underlying shares after following the procedure provided in the Scheme and the provisions of this Act.

(2) Until the conversion of depository receipts, the overseas depository shall be entitled to vote on behalf of the holders of depository receipts in accordance with the provisions of the agreement entered into between the depository, holders of depository receipts and the company in this regard.

2015 - June [III] (b) (ii) Write short notes on:

(a) Letter of credit

(b) Issue of commercial papers in India (4 + 4 = 8 marks)

Answer:

(a) Letter of Credit: A letter of credit is an arrangement whereby a bank helps its customer to obtain credit from its (customer's) suppliers. When a bank opens a letter of credit in favour of its customer for some specific purchases, the bank undertakes the responsibility to honour the obligation of its customer, should the customer fails to do so.

Answer:

(b) Issue of Commercial Papers in India: Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note. It was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors.

Subsequently, primary dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. Since the CP represents an unsecured borrowing in the money market, the regulation of CP comes under the purview of the Reserve Bank of India:

(a) CP can be issued in multiples of ₹5 Lakhs.

(b) CP can be issued for a minimum duration of 7 days and maximum period of 1 year.

(c) For issuing CP the company's net worth should be more than ₹ 5 crores.

(d) CP can neither be redeemed before maturity nor can be extended beyond the maturity period.

(e) CP issue requires a credit rating of P2 from CRISIL or A2 from ICRA.

DESCRIPTIVE QUESTIONS

2006 - Dec [3] (a) Briefly explain the salient feature of non-recourse project financing. (5 marks)

Answer :

Project financing should be distinguished from conventional direct financing, or what may be termed financing on a firm's general credit. In connection with a conventional direct financing, lenders to the firm look to the firm's asset portfolio to generate the cash flow to service their loans. The assets and their financing are integrated into the firm's asset and liability portfolios. Often; such loans are not secured by any pledge or collateral. The critical distinguishing feature of a project financing is that the project is a distinct legal entity; project assets, project related contracts, and project cash flows are segregated to a substantial degree from the sponsoring entity. The financing structure is designed to allocate financial returns and risks more efficiently than a conventional financing structure.

In a project financing, the sponsors provide, at most, limited recourse to cash flows from their other assets that are not part of the project. Also, they typically pledge the project assets, but none of their other assets, to secure the project loans.

Project financing arrangements invariably involve strong contractual relationships among multiple parties. Project financing can only work for those projects that can establish such relationships and maintain them at a tolerable cost. Project financing will not necessarily lead to a lower cost of capital in all circumstances. Project financing will be more cost-effective than conventional direct financing when

(i) Project financing permits a higher degree of leverage than the sponsors could achieve on their own and

(ii) The increase in leverage produces tax shield benefits sufficient to offset the higher cost of debt fund, resulting in a lower overall cost of capital for the project.

2007 - June [4] (b) Briefly explain the following concepts :

(i) Debt securitization, (3 marks)

Answer:

Debt Securitization: Asset based securitization or debt securitization or asset securitization denote the same concept. Debt securitization is the process of converting debt instruments into security (like shares, debentures or negotiable instruments). Worded differently it is the process by which non-tradable assets are converted into tradable assets. Debts are given by institutions and such debts are secured by some documents. A package of these documents is made and a guarantee is also given about the package. Such packages are then sold like any security or negotiable instruments to investors. The package will naturally be made in accordance with the legal framework. In this process, non-liquid assets like mortgage loans, auto loans etc are packaged and sold in the form of securities (like shares, debentures) to investors.

In securitization the loan installments receivables are converted to negotiable instruments and then sold to customers. These negotiable instruments are backed or secured by assets on which original loan was taken (underlying assets). Assets which could be securitized are auto loans, housing loans, consumer loans etc. Assets must be of good quality for the purpose of securitization.

2009 - June [4] (a) Comment on the emerging role of the Financial Manager in India. (5 marks)

Answer:

The Job of the Financial Manager in India has become more important, Complex and demanding. More so in the wake of global competition, Technological developments, volatile financial prices, economic uncertainty, tax law changes, ethical concerns over financial dealings and shareholder activism.

The key challenges for a modern Finance Manager in India has changed from a mere Finance function of securing and managing funds to encompass the following, to name a few important areas :

1. Investment Planning
2. Financial Structure
3. Mergers, Acquisitions and Restructuring
4. Working Capital Management
5. Performance Management
6. Risk Management
7. Treasury Management
8. Portfolio Management
9. Investor relations
10. Corporate Governance etc.

Indian Finance Professionals are respected across the globe and to-day occupy top positions in several organizations including MNCs.

2009 - Dec [3] (a) Explain briefly the functions performed by the Securities & Exchange Board of India (SEBI). (5 marks)

Answer :

Functions of SEBI: The chief function of SEBI is to protect the interests of investors in the securities market. To achieve this main aim SEBI has been given various powers and with the use of those powers it can take various measures to fulfill its objectives.

1. It is the central authority to enact SEBI Act 1992.
2. It controls and monitors all activities related to stock exchanges.
3. It regulates the business in stock exchanges.

4. It registers, controls and regulates all the persons relating to securities market. Without its registration certificate one cannot function in securities market. It registers and regulates stock brokers, sub-brokers, share transfer agents, fund managers, underwriters, portfolio managers, bankers to an issue, registrars to the issue.
5. It registers and regulates various funds and schemes for the securities market like venture capital funds, mutual funds, collective investment scheme.
6. It checks insider trading, fraudulent and unfair trade practices in the securities market.
7. It can call for any information, records or explanation from any bank, board, authority, company or corporation in respect of transactions in securities market.
8. Its chief function is to reduce the grievances of investors, it can take all actions and performs all functions in this regard.

Powers of SEBI: SEBI can

1. Suspend the trading of any securities in a recognised stock exchange.
2. Prohibit any person to buy, sell or deal in securities;
3. restrict or check any person to enter the securities market ;
4. ask investigation of any transaction and to retain the securities or proceeds related to that transaction
5. direct any intermediary in any manner relating to any transactions which are under investigation.
6. Prohibit any company from issuing any prospectus or offer document for the issue of securities;
7. specify terms and conditions under which any prospectus, offer document or any advertisement may be issued.

2012 - Dec [6] (c) What do you understand by 'External Commercial Borrowing' (ECB)? Mention two agencies engaged in ECB. (5 marks)

Answer:

External Commercial Borrowings (ECBs) : As the name indicates, ECBs are borrowing from external commercial institutions. The government sometimes borrows money from the international institutions to fulfill its requirements or to cover the deficits. The external commercial borrowings can be made from various institutions like IMF International Monetary Fund, US EXIM Bank, ADB Asian Development Bank etc. The ECBs can be in the form of raising loans from external commercial banks, or raising funds by issuing bonds in the international market or by export credit etc.

2013 - June [4] (b) What are the basic financial decisions? How do they involve risk-return trade off? (5 marks)

Answer:

The basic financial decisions include long term investment decision, financial decision and dividend decisions

(i) **Investment Decision:** Investment Decision relates to the selection of assets (fixed and current) in which funds will be invested by a firm. These decisions are of two types' Capital Budgeting Decision and Working Capital Decisions. Long-term investment decision is known as capital budgeting and short-term investment decision (current assets) is identified as working capital management – Proper trade – off between liquidity and profitability.

(ii) **Financing Decision:** The Concern of financial is with financial mix or capital structure or leverage of firm – trade off between risk and return by maintaining a proper balance between debt and equity capital.

(iii) **Dividend Decision:** Concerned with the distribution of profits of firm to the share holders. It will depend upon the preference of the shareholders, investment opportunities available within the firm and opportunities for future expansion of the firm.

2013 - Dec [8] (c) What is factoring? Explain the concept of full service factoring. (4 marks)

Answer:

Factoring: Factoring means an arrangement between a factor and his client which includes at least two of the following services to be provided by the factor –

- Finance
- Maintenance of debt
- Collection of debts
- Protection against credit risk.

Under a typical factor arrangement a factor collects the accounts on due dates, effects payments to the firm on these dates and also assumes the credit risks associated with the collections.

In order to provide a gamut of financial services under one roof, Corporation has also started factoring services. Under the scheme Corporation shall be at the time being only providing advances or prepayments against receivable and other services provided by the factor such as debt collection and administration of sales ledger etc. shall be taken later on.

Under the scheme receivables only arising out of domestic trade shall be considered for factoring. Supplier/Borrower shall draw bills of exchange for goods supplied and the purchaser shall accept that. After acceptance of bills of exchange, Corporation shall make prepayment of 80% of invoice value after deducting its discount charges @ 17% to 18% p.a. for period of bill of exchange to supplier. Balance payment of 20% of the invoice value shall be made after collecting the payment from purchaser. If purchaser fails to pay the due amount on due dates, the supplier shall make the payment.

Full Services Factoring- Under Full service factoring all kinds of services are provided i.e. Thus, a factor provides finance, administers the sales ledger, collects the debts at his risk and renders consultancy service. This type of factoring is a standard one. If the debtors fail to repay the debts, the entire responsibility falls on the shoulders of the factors since he assumes the credit risk also. Under this responsibility cannot be transferred to client and, hence, this type of Factoring is also called 'Without recourse' factoring.

2013 - Dec [9] (b) Answer the following:

(iii) Explain the procedure involved in the 'Forfeiting' Financial Service. (4 marks)

Answer:

Forfeiting is a financial transaction involving the purchase of receivables from exporters by a forfeiter. The forfeiter takes on all the risks associated with the receivables but earns a margin. The purchasing of an exporter's receivables (the amount importers owe the exporter) at a discount by paying cash. The forfeiter, the purchaser of the receivables, becomes the entity to whom the importer is obliged to pay its debt.

By purchasing these receivables - which are usually guaranteed by the importer's bank - the forfeiter frees the exporter from credit and from the risk of not receiving payment from the importer who purchased the goods on credit. While giving the exporter a cash payment, forfeiting allows the importer to buy goods for which it cannot immediately pay in full. The receivables, becoming a form of debt instrument that can be sold on the secondary market, are represented by bills of exchange or promissory notes, which are unconditional and easily transferred debt instruments.

In summarized way 'Forfeiting' Financial Services:

(a) The exporter sells the goods to the importer on a deferred payment basis spread over 3-5 years.

(b) The importer draws a series of promissory notes in favour of the exporter for the payments to be made inclusive of interest charges.

(c) Such promissory notes are availed or guaranteed by a reputed international bank which can also be the importer's banker, (it is endorsed on the promissory note by the guaranteeing bank that it covers any default of payment of the buyer).

(d) The exporter now sells the availed notes to a forfeiter (which may be the exporter's banker) at a discount without recourse.

(e) The forfeiter may hold these notes till maturity or sell them to group of investors interested in taking up such high-yielding unsecured paper.

Forfeiting of Promissory notes-

(a) Promissory notes sent for availing to the importer's banker

(b) Availed notes returned to the importer

(c) Availed notes sent to exporter

(d) Availed notes sold at a discount to a forfeiter on a non - recourse basis

(e) Exporter obtains finance

(f) Forfeiter holds the notes till maturity or sells the short-term paper either to a group of investors or to investors in the secondary market.

2014 - June [9] (b) Answer the following

(ii) What are the distinctive features of a financial lease and an operating lease? (4 marks)

Answer:

Distinctive features of Financial Lease and Operating Lease

Financial Lease	Operating Lease
(i) It is usually non cancellable by the lessee prior to its expiration date.	(i) The lease is usually cancellable at short- notice by the lessee.
(ii) Financial Lease is for a longer period of time.	(ii) It is a short term lease. The lease period in such a contract is less than the useful life of asset.
(iii) A Financial Lease usually provides the lessee an option of renewing the lease for further period at a normal rent.	(iii) The lessee usually has the option of renewing the lease after the expiry of lease period.
(iv) The present value of the total lease rentals payable during the period of the lease exceeds or is equal substantially the whole of the fair value of the leased asset. It implies that within the lease period, the lessor recovers his investment in the asset along with an acceptable rate of return.	(iv) As the period of an operating lease less than the useful life of the asset, it does not necessarily amortize the original cost of the asset. The lessor has to make further leases or sell the asset to recover his cost of investment and expected rate of return.

2015 - June [III] (a) (ii) List the usual forms of bank credit available in India for a business. (4 marks)

Answer:

The usual form of bank credit is as follows:

1. Overdraft
2. Cash Credit
3. Letter of Credit
4. Working Capital Term Loan
5. Funded Interest Term Loan
6. Bills Purchased and Bills Discounting.

2016 - June [8] (b) What is Global Depository Receipt (GDR)? List three of its characteristics. (2 + 3 = 5 marks)

PRACTICAL QUESTIONS

2007 - Dec [2] (b) Amol Ltd. makes a rights issue at ₹ 5 a share of one of the new share for every 4 shares held. Before the issue, there were 10 million shares outstanding and the share price was ₹ 6. Based on the above information, you are required to compute:

(i) the total amount of new money raised.
(ii) how many rights are required to buy one new share?
(iii) what is the value one right?
(iv) what is the prospective ex–rights price?
(v) how far could the total value of the company fall before shareholders would be unwilling to take up their rights?
(vi) whether the company's shareholders are just as well as off, if right shares are issued at ₹ 4 rather than a rights issue at ₹ 5?

(1+1+1+1+1+1= 6 marks)

Answer :

AMOL LTD.

No. of shares = 10 million, Price per share = ₹ 6

(i) No. of new shares issued = 10/4 = 2.5 million
Therefore Money raised –5 × 2.5 – 12.5 million = ₹ 1.25 Crore
(ii) Four rights.
(iii) Value of right = P0 - S/N + 1 = (6 - 5)/4 + 1
= 1/5 = ₹ 0.20
OR $\frac{1\times5}{4\times6}$ = 0.20
(iv) Ex-rights price = nP0 + S/N + 1 = (4 × 6 + 5)/5 = ₹ 5.8
(v) The price has to fall to ₹ 5 per share to make the rights issue unattractive.
Therefore the value should fall to 5 × 10 = 50 million i.e. by ₹ (60 – 50) = 10 million
(vi) The rights price does not affect the shareholder's wealth. Therefore shareholders will be as well as off, if shares are issued at ₹ 4.

2014 - June [6] {C} Answer the following. (No credit will be given for answer without the reasoning)

(a) X deposits ₹ 1,00,000 at the beginning of each of years 1 and 3, and ₹ 1,00,000 at the end of each of the years 2, 4 and 5. Find the discounted value of the investments at the end of year 3 with a discount rate of 10%. (P.V. factor of 10% at the year end 0, 1, 2, 3, 4, 5 and 6 are respectively: 1, 0.909, 0.826, 0.751, 0.683, 0.621, 0.564) (2 marks)

Answer:

Discounted value at the end of 3 years

Year	Investment	PV factor at 10% at end of year 3	Discounted value
Beginning of year 1	1,00,000	$(1.1)^3$ = 31.331	1,33,100
End of year 2	2,00,000	$(1.1)^1$= 1.1	2,20,000
End of year 4	1,00,000	1/(1.1)= 0.909	90,900
End of year 5	1,00,000	$1/(1.1)^2$ = 0.826	82,600
Discounted value of the investments at the end of year 3			5,26,600

2014 - Dec [1] Answer the question:

(h) Ascertain the discounted value at 10% p.a. at the end of year 1 of an investment of ₹ 2,00,000 to be made at the end of year 2 and ₹ 30,000 made immediately. (2 marks)

Answer:

Discounted value at the end of year 1, Invested ₹ 30,000 now and 2,00,000 at the end of year 2.

3,00,000 (1 + 0.10)	= 3,30,000
2,00,000 (1/1+0.10)	= 1,81,818
Total	**5,11,818**

2015 - June [I] (c) Ascertain the future value of annuity of ₹ 25,000 at the end of 6 years at 9% p.a. compounded annually. Assume that the amount is deposited at the beginning of every year. (2 marks)

(h) Mr. X expects to receive ₹ 2,00,000 at the end of three years. What would be the present value if the rate of discount is 10%? (2 marks)

Answer:

(c) Calculation of Future Value of Annuity:

Year	**Annuity Amount** (₹)	**Future Value of** (₹) **1**	**Future Value** (₹)
1	25,000	1,677	41,925
2	25,000	1,539	38,475
3	25,000	1,412	35,300
4	25,000	1,295	32,375
5	25,000	1,188	29,700
6	25,000	1,090	27,250
Future value of Annuity at the end of 6th year			2,05,025

Answer:

(h) Present value $= \dfrac{\text{future value}}{(1 + I)^n}$

$= \dfrac{2,00,000}{(1 + 0.10)^3}$

$= \dfrac{2,00,000}{1.331}$

= ₹ 1,50,263

Table Showing Marks of Compulsory Questions										
Year	11 D	12 J	12 D	13 J	13 D	14 J	14 D	15 J	15 D	16 J
Practical						2				
Total						2				