



Subject: Business Finance

Chapter: Unit 1 & 2

**Category: Assignment 1
solutions**

Answer 1:

- i) • Written agreements between the various classes of stakeholder may specify key aspects of the relationship between them, but cannot realistically cover all possible future eventualities. Such agreements therefore need to be supplemented by less formal understandings and arrangements.
- Firms must take into account the effects of their policies and actions on society as a whole. The expectations of workers, consumers and various interest groups create other dimensions of the external environment that firms must respond to. 'Externalities' (such as pollution, product safety and job security) must be considered when formulating policy. Some of these expectations are embodied in law, eg health and safety at work, employment protection, consumer protection, environmental protection. Beyond these laws, there are unwritten, implicit rules of behaviour. Companies' reputations can be seriously damaged if they are found to be untrustworthy or thought to be unethical, and there can be serious consequences for the share price.
- ii)
- A bill of exchange is a negotiable instrument.
 - It is issued by a company/sole proprietor with good credibility, accepted by the receiver of a good, and guaranteed by an investment bank.
 - Bills of exchange may be referred to as two-name instruments.
 - The supplier may sell the bill to a discount house for cash rather than waiting for the acceptor to pay the bill at the end of the stated time period.
 - Bills of exchange provide short-term cash/credit to the issuer.
 - Where the endorser is an "eligible" bank, the bill is known as an "eligible bill of exchange" which is a very secure investment.

Answer 2:

- i) Maximising the returns to shareholders is the primary objective of a Finance Manager.
- ii) Factors that influence his decisions while trying to achieve the above objective:
- a) The variability of anticipated returns (having regard to the nature of the business)
 - b) The owners' desire for immediate profit rather than future high growth
 - c) The risk appetite of the owners of the business
 - d) The willingness (or otherwise) of the owners to put additional capital into the business
 - e) Their willingness to see a reduction in the proportion of the business which they own
- iii) Factors that influence the decision on how an asset is financed:
- a) The acceptable degree of gearing
 - b) The effect of taxation.
 - c) The nature of business as also the volatility of its cash flows and profits.

Answer 3:

A warrant is an option issued by a company. The holder has a right to repurchase shares at a specified price at specified times in future.

Answer 4:

Agency costs refer to the problems created in an organisation when there are conflicts in the objectives of different stakeholders (owners and managers) Agency costs are incurred when:

- managers (as agents) do not attempt to maximize the value of the company
- shareholders(as principals) incur costs monitoring the managers and attempting to influence their actions.

Answer 5:

i) **Medium term Finance**

1. Hire purchase
2. Credit sale
3. Leasing
4. Bank loan

Short term finance

1. Bank overdraft
2. Trade credit
3. Factoring
4. Bills of exchange
5. Commercial paper

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ii) Generally the long term finance is more expensive than the short term finance because of following reasons:

1. Long term finance require longer term commitment from the lender and to compensate for longer commitment higher return is required
2. The default risk increases with increase in the loan term. To compensate for higher default risk in long term finance higher return is expected.
3. Uncertainty related to higher inflation is higher in case of long term finance and hence higher return is required.

Answer 6:

i) Major types of business entities

1. Sole Trader
2. Hindu Undivided Family
3. Partnership Firm
4. Limited Liability Partnership

5. Limited Company (Public or Private)

	Ownership	Liability	Legal Status
Sole Trader	Individual	Unlimited	Not Separate
Hindu Undivided Family	Members by virtue of birth in family	Unlimited	Separate
Partnership Firm	Partners	Unlimited	Not Separate
Limited Liability Partnership	Members	Limited	Separate
Limited Company (Public or Private)	Shareholders	Limited	Separate

ii)

The best form from the point of view of minimizing the tax amount would be a Sole Trader.

Reasons:

1. There is an exemption limit from tax depending on the age and gender of the Sole Trader. No such exemption limit for limited company.
2. Lower marginal rates of income tax are applicable for lower levels of income above the exemption limit for Sole Trader. No such lower marginal rates for limited company.
3. Sole Trader can claim tax exemptions applicable to an individual which are not applicable to limited company.

Answer 7:

i) The company will be able to sell or make major alterations to specific secured assets mentioned in the legal documentation for the mortgage debenture only with the prior permission of the mortgage debenture holders.

In case of a floating charge debenture, the company can change the secured assets in the normal course of business. For example, it can sell the assets, so long as they are replaced by equally satisfactory assets from the debenture holders' viewpoint.

ii) (a) Remedies available to mortgage debenture holders:

- 1) When a company fails to make an interest or capital payment, the debenture holders can apply to the courts to make the floating charge become a fixed charge. This is called "crystallising".
- 2) Appoint a receiver to intercept income from secured assets which will be used to settle the claims of the debenture holders.
- 3) Take possession of secured assets to sell it.
- 4) If the security proves insufficient to meet their claims, they can sue the company for the balance amount and will rank at par with other unsecured creditors of the company.

(b) Remedies available to the unsecured loan stock holders:

1) Sue the company for the amount due which in effect means petitioning for liquidation of the company. The unsecured loan stock holders will rank at par with other unsecured creditors of the company.

iii) Although the friend has a valid point in saying that unsecured loan stock is risky because there is no specific security assigned to it and since it ranks after debenture holders and at par with other unsecured creditors, there is a significant possibility that in case of insolvency of the company, very little or nothing will be received by the holders.

However the following protect the unsecured loan stock holders to some extent:

- 1) Appointment of a trustee who monitors the servicing of the unsecured loan stocks.
- 2) Restrictions on further borrowing by the company which are generally found in the trust deed
- 3) Since the servicing of the unsecured loans is dependent on the profitability of the company, there is no harm in buying unsecured loan stocks of companies in stable sectors which are making sizeable profits. The interest coverage ratio, the debt equity ratio and net asset value per share of the issuing company could help identify a good company where the chances of default are minimal. Analysing profitability ratios such as EPS, ROCE and the trends in these ratios over the last few years will be useful.
- 4) Due to the inherent riskiness of the instrument, returns are usually higher as compared to other secured form of debt. So an investor could allocate a relatively small portion of his total wealth to investments in unsecured debt and earn the extra returns. Besides, diversification between several unsecured debt issues will reduce the risk of losing money.
- 5) Unsecured loan stock holders rank above share holders and hence have some level of security.

Answer 8:

In theory, incorporation would limit the liability of the consultants.

Lenders would have a claim against the company's assets but not those of the individuals who own it.

This advantage could prove costly though.

Lenders will perceive a higher risk. They might respond by charging a higher rate of interest which will, eventually lead to lower profits for the consultants.

They might also seek additional security over assets, thereby imposing some constraints on the consultants freedom to trade.

They might even demand personal guarantees from the consultants so that they become liable for the loans despite the incorporation.

Even if the lenders did not take action to protect themselves, limited companies are subject to some additional regulatory requirements that have to be set against the benefits of limited liability.

For example, limited companies are subject to some reporting and filing requirements that partnerships are not.

This would involve paying to put trading information in the public domain, where it might prove useful to competitors or other parties.

Answer 9:

Gabrielle is risk taking and therefore would suggest her to invest in equity shares. She has no obligations and therefore is free to explore upside potential of investment. No obligations to provide for, could handle the volatility. Main features

- 1) Voting rights
- 2) Last to be paid in case of winding up
- 3) Potential of high return for high risk
- 4) Usually highly marketable

Susan seems to have limited means and obligations to provide for and needs certainty. Therefore would suggest her to invest in loan stock that promises regular income and known redemption amount. Main features:

- 1) No voting rights
- 2) Less volatile than equity shares
- 3) Do not participate in dividend growth enjoyed by
- 4) Usually less marketable than equity shares

Answer 10:

(i) Add back any business expenses or potential expenditure shown in the accounts which are not allowable for tax.

Add back any charge for depreciation, and instead subtract the allowable "capital allowance"

Deduct any special reliefs, e.g. research and development costs may be able to be deducted immediately.

(ii) Tax free income –

- Most forms of social security benefits
- Dividends declared by companies
- Income from agricultural activities.

Any other tax free income as per Indian Tax Laws will be eligible for marks.

Tax free expenditure –

- Contribution to approved pension schemes
- Charitable gifts

- Interest on housing loan
- Life insurance premium and Equity linked saving schemes subject to maximum limit.

Any other tax free expenditure as per Indian Tax Laws will be eligible for marks.

(iii) Exceptions to chargeable capital gain tax are –

- Private motor cars
- Foreign currency obtained for personal use
- Govt securities and other qualifying fixed – interest stocks.

Any mention of LTCG on share sale will not be considered for mark as it is not exception of capital gains tax.

Answer 11:

i) Liquidity preference-

The liquidity preference theory is based on the generally accepted belief that investors prefer liquid assets to illiquid ones. Investors require a greater return to encourage them to commit funds for a longer period. Long-dated stocks are less liquid than short-dated stocks, so yields should be higher for long-dated stocks.

Appropriate examples-

1. Government bonds are usually more marketable and hence more liquid than corporate bonds and therefore corporate bonds have a higher yield to encourage investors to buy relatively illiquid assets.
2. 10 year bonds are relatively less liquid than One year bonds and hence there is a higher yield on 10 year bonds than on One year bonds.

Answer 12:

1. Previously, dividend payout decisions are likely to have been based on the business expansion plans coupled with the preference of the limited number of 1-3 shareholders, which in turn could be based on their own tax position and investment horizon.
2. Post listing, market sentiment will need to be kept in mind while making dividend payout decisions. Many stock market analysts compare shares to one another on the basis of dividend yields. Stock market analysts will find the share relatively more attractive if the dividend yield is higher.
3. Long-term insurance business is capital intensive hence aggressive expansion plans will strain profits hence any dividend declaration must be prudent and sustainable.
4. Dividend decision should be aligned with the investor base (in terms of tax position and nature of investors). Investors who are putting money in insurance company stocks recognizing the long term return potential of the industry will not be uncomfortable with a modest dividend payout policy. Frequent changes however should be avoided.
5. Competitor dividend practice should be kept in mind.

Answer 13:

Factors influencing the dividend policy of the company:

- 1) Reaction of the stock market to fluctuations in declared dividends. So managers tend to holdback some profits in good years to be used to reward shareholders during adverse phases of the economic cycle
- 2) Availability of cash. A huge cash pile may lead to a hostile takeover and hence paying out dividends may be preferred.
- 3) Tax position of the company and its shareholders and the relative taxation on capital gains and dividends.
- 4) Requirements for any planned projects and future growth prospects of the industry and the company.
- 5) Past dividend payouts
- 6) Ability to borrow during adverse times.

Answer 14:

Modigliani and Miller's first irrelevance proposition: The market value of any firm is independent of its capital structure. Modigliani and Miller's second irrelevance proposition: The expected rate of return on the company's shares increases in proportion to the debt-equity ratio, expressed in market values.

Answer 15:

If a company has accumulated large amounts of cash which it does not need in running the business, or if it wishes to change its capital structure by replacing equity with debt, it will generally undertake a share repurchase or buyback exercise.

Procedure or Ways to Repurchase Shares are:

- a. **Purchase of shares in the Open Market**, often by a gradual repurchase program over a period of time
- b. **Fixed Price Offer** - If the company repurchases a stated number of shares at a fixed price (typically at a significantly higher price than the current market value), the shareholders are informed of the company's intention and are free to accept the offer or not.
- c. **Tender Offer** (either a Dutch or uniform price auction) – In a Dutch auction, the company states a series of prices at which it is prepared to repurchase shares. Shareholders reply to this offer, informing the company of how many shares they are willing to sell at each price. The company then calculates the lowest price at which it can buy the required number of shares.
- d. **Repurchase by Direct Negotiation** with a major Shareholder Effect of Share Buyback on Shareholders

Answer 16:

The motives for growth can therefore be found in the many ways in which growth can help a company achieve its overall aim, including:

1. Increased profitability.

By increasing its output and sales, a business can:

- benefit from economies of scale (i.e. lower average costs, e.g. by buying in bulk, obtaining better credit terms from suppliers, by investing in machinery and techniques that improve productivity);
- increase its market share and hence its market power (i.e. its power to increase prices); and
- expand into new and growing markets.

2. Increased security.

A larger business:

- can defend itself against an unwelcome takeover bid;
- can overcome barriers to entry in new markets;
- can benefit from risk diversification by expanding the product range, especially if the present market seems saturated;
- is a greater threat to a potential rival;
- might face lower transactions costs, i.e. costs of making contracts with other firms;
- might face less uncertainty and/or is in a better position to cope with uncertainty; and
- will obtain more business as it is seen by customers to be a more reliable and secure source of supplies.

3. Increased motivation for managers and employees.

A larger business can:

- provide an environment of increased power, prestige and salary;
- offer decreased employment risk for managers;
- result in improved staff morale;
- often attract more able, more ambitious and more productive staff.

Answer 17:**Steps taken in an acquisition**

The buying process is complex and the advice and expertise of an investment bank will usually be sought.

1. Check government policy and relevant regulations and legislation on acquisitions. For example, in the UK a company must make a cash offer when its shareholding reaches 30% of the target's shares.
2. Obtain shareholders' approval for the purchase of the target's shares.
3. Arrange the raising of finance to purchase the target's shares. The funds could be raised by a

rights issue or a new debt issue.

4. Determine the method of payment for the target firm's shares. The acquirer provides cash, loan stock and/or shares of the acquirer's company in exchange for the shares of the target company. Which method is chosen depends on the capital structure of the acquirer and the extent to which the target's shareholders are likely to want to share risk in the larger company of the acquirer.
5. Approach the board of directors of the target company and make an offer. If the directors are receptive to the approach, a friendly takeover can be negotiated. If not, a hostile bid will be made.
6. If the takeover is friendly, discussions will take place, due diligence will be performed (i.e. investigations and checks of financial records, tax records and senior management etc.), a definitive agreement on financial matters and non-financial matters (such as management structures) will be reached, and shareholders and regulators will be asked to approve.
7. In the case of a hostile takeover, the target's board of directors tries to prevent the takeover (possibly taking action to make the target seem less attractive) so the acquirer either withdraws interest or must make a bid directly to the shareholders.

Answer 18:

Internal growth occurs when a business expands its own operations rather than by operating with other business. This can be achieved in three ways. A firm can expand by:

- Horizontal expansion, i.e. by increasing production of goods or services at the same stage of the production process, e.g. a food manufacturer.
- Vertical expansion, i.e. by developing new operations at a different stage in the production process, e.g. a food manufacturer might move backwards into farming or forwards into retailing.
- Diversification, i.e. by moving into completely different markets, e.g. a mail-order business might expand into radio stations, trains, airlines and banking.

Answer 19:

The company conducts a very simple business. It buys raw materials for cash, processes them into finished goods, and then sells these goods on credit. The interval between the firm's payment for its raw materials and the collection of payment from the customer is known as the cash cycle or cash conversion period:

$$\begin{aligned}\text{Cash cycle} &= \text{operating cycle} - \text{accounts payable period} \\ &= (\text{inventory period} + \text{accounts receivable period}) - \text{accounts payable period}\end{aligned}$$

The delay between initial investment in inventories and the final sale date is called the **inventory period**.

The delay between the time that the goods are sold and when the customers finally pay their bills is the **accounts receivable period**.