



GRAPH PAPER IS ON THE PENULTIMATE PAGE

Book No. 1 (containing 28 pages)

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

Inter (New) Examination

Group No. 2 Paper No. 8

Subject: Financial Management & Economics

Number of Answer Books used : Main + 5 additional sheets

For use by ICAI only

431510

Rupin Kachhadiya (AIR 14)



17 MAY 2018

Q.No.	To be ticked (✓) by the candidate against the Questions answered	Marks Awarded (to be filled by Examiner)					Total
		a	b	c	d	e	
1	✓	2	5	5	5	-	17
2							-
3	✓						05
4	✓						10
5	✓						10
6	✓	4	2	2	-	-	08
7	✓	2	1	3	1	-	07
8	✓	3	4	-	-	-	07
9	✓	5	5	-	-	-	10
10	✓	1	4	-	-	-	05
Total							79

Use only Blue / Black Ball Point Pen to write and shade the circles. **AVOID RED PEN.** Write the marks in the boxes before shading the respective circles.

Total Marks awarded

79



Total Marks awarded (in words)

Seventy Nine

Examiner's Signature



INSTRUCTIONS TO THE CANDIDATE**Answers are not to be written on this page**

- Answers should be written in figures and words in the allotted space at the right hand corner of the answer book and nowhere else including additional answer book/s and graph paper.
- Roll number should be written in the box in numbers and darken the appropriate circles of the OMR bubbles provided in the right hand corner of the cover page with **Black / Blue** ball point pen.
- Write particulars such as name of Examination, Group No., Paper No. and subject at the appropriate space provided at the left hand upper corner.
4. Remove the Bar Code sticker of the particular paper from the Attendance sheet and affix the same on the box provided in the right hand corner of the cover page.
 5. Since a machine will read the Roll no., please check and ensure that Roll number written in numbers, words and circles darkened are correct. In case any candidate fills this information wrongly, Institute will not take any responsibility for rectifying the mistake.
 6. The answers should be written neatly and legibly
 7. The answer to each question must be commenced on a fresh page and question number prominently written at the top of each answer. Alternatively, the question number should be distinctly written in the margin.
 8. The answer to each question in all parts should be fully completed in one page, or in a consecutive set of pages, before the next question is taken up.
9. Writing of Roll number in place/s other than the space provided for the purpose or writing distinguishing mark, symbols like "OM", "Sri", "Jesus", "786", etc., will tantamount to adoption of "unfair means"
10. Before submission of answer book to the invigilator after completion of the exam, take care to score out (X) blank pages, if any, that you might have left.



1(9)

(i) → Market value of levered firm (V_L) = market value of unlevered firm (V_U) + tax benefit on debt

$$= ₹1140 \text{ lakhs} + \left(₹200 \text{ lakhs} \times \frac{30\%}{100} \right)$$

$$= 1140 + 60$$

$$= ₹1200 \text{ lakhs}$$

(ii) → Current market value (V_L) = $\frac{\text{EBIT} (1 - \text{tax rate})}{k_e}$

$$\therefore 1140 = \frac{\text{EBIT} (1 - 0.30)}{0.20}$$

$$\therefore \text{EBIT} = ₹325.71 \text{ lakhs}$$



$$\rightarrow \text{Cost of Capital (Kc)} = \frac{\text{EBIT}}{\text{Value of firm}} \times 100$$

$$= \frac{\text{₹ } 325.71 \text{ lakhs}}{\text{₹ } 1200 \text{ lakhs}} \times 100$$

$$= 27.14\%$$

(iii)

	[₹ in lakhs]
EBIT	325.71
Less: Interest [200 x 15%]	(30.00)
	295.71
Less: Tax @ 30%	(88.71)
Earnings for equity shareholders	207.00

$$\rightarrow \text{Equity share capital} = \text{value of firm} - \text{debentures}$$

$$= \text{₹ } 1200 \text{ lakhs} - \text{₹ } 200 \text{ lakhs}$$

$$= \text{₹ } 1000 \text{ lakhs}$$



$$\rightarrow K_e = \frac{\text{earnings for equity shareholder}}{\text{equity share capital}} \times 100$$

$$= \frac{\text{₹ } 100}{\text{₹ } 207 \text{ lakh}} \times 100$$
$$= \frac{\text{₹ } 20.7 \text{ lakh}}{\text{₹ } 100 \text{ lakh}}$$

$$\text{Cost of equity} = 20.7\%$$



I (b)

(i) \rightarrow Combined leverage = Operating leverage
 \times Financial leverage

$$\therefore 2.16 = 1.2 \times \text{Financial leverage}$$

\therefore Financial leverage = 1.8

(ii) \rightarrow Let, the P/V ratio be $x\%$ and
 Fixed cost be $\text{₹} y$.

\rightarrow

$$\rightarrow \text{Operating leverage} = \frac{\text{Contribution}}{\text{EBIT}}$$

$$\therefore 1.2 = \frac{\text{Sales} \times \text{P/V ratio}}{\text{Sales} \times \text{P/V ratio} - \text{Fixed Cost}}$$

$$\therefore 1.2 = \frac{100x}{100x - y}$$

$$\therefore 120x - 1.2y = 100x$$

$$\therefore 20x = 1.2y$$



$$\boxed{\therefore x = 0.06y}$$

$$\rightarrow \text{Financial leverage} = \frac{\text{EBIT}}{\text{EBT}}$$

$$\therefore 1.8 = \frac{\text{EBIT}}{\text{EBIT} - \text{Interest}}$$

$$\therefore 1.8 = \frac{100x - y}{(100x - y) - 10}$$

$$\Rightarrow 180x - 1.8y - 18 = 100x - y$$

$$\Rightarrow 80x = 0.8y + 18$$

$$\therefore 80[0.06y] = 0.8y + 18$$

$$\therefore 4.8y = 0.8y + 18$$

$$\therefore 4y = 18$$

$$\therefore y = 4.5$$

$$\boxed{\therefore \text{Fixed cost} = \text{₹} 4,50,000}$$



$$\begin{aligned} \rightarrow x &= 0.06 y \\ &= 0.06 [4.5] \\ &= 0.27 \end{aligned}$$

$$\therefore \text{P/V ratio} = 27\%$$

+3

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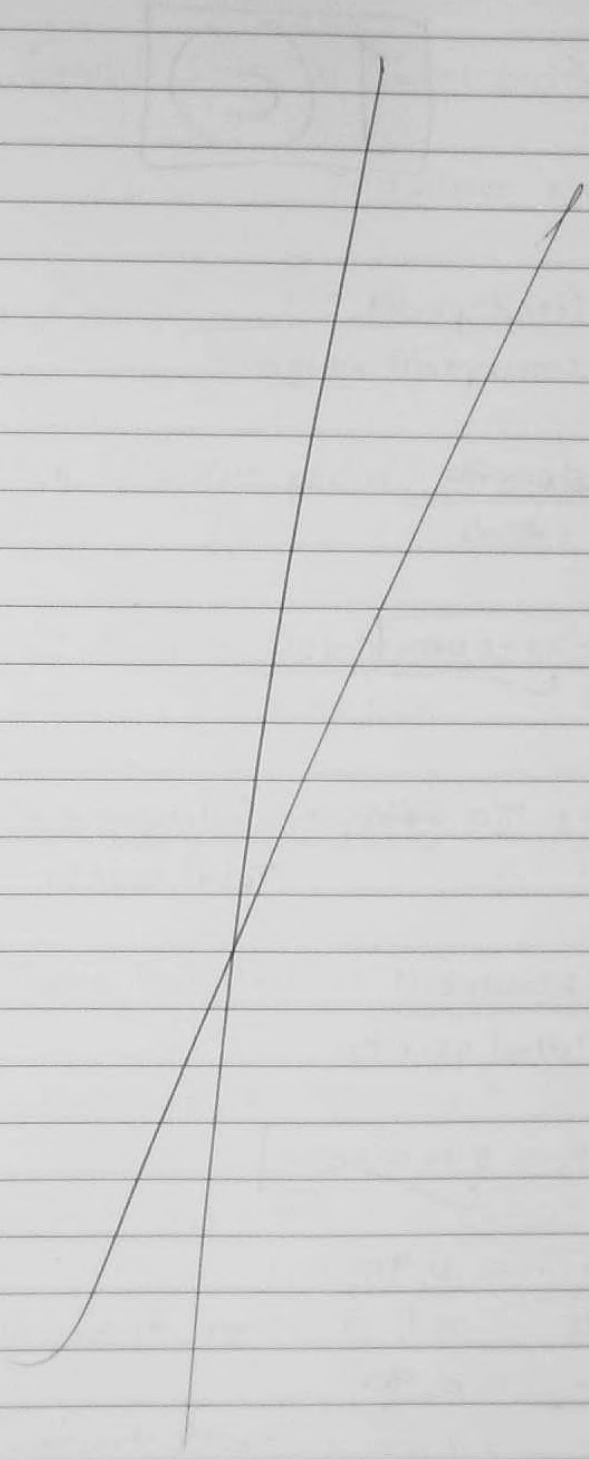
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1(c)

$$\rightarrow \text{Sales} = \frac{\text{Gross profit}}{\text{Gross profit margin}}$$

$$= \frac{\text{₹ } 60,000}{20\%}$$

$\frac{1}{2}$ = ₹ 3,00,000

$$\rightarrow \text{Total Asset T.O. ratio} = \frac{\text{Sales}}{\text{Total assets}}$$

$$\therefore \frac{0.30}{1} = \frac{3,00,000}{\text{Total assets}}$$

$\frac{1}{2}$ $\therefore \text{Total assets} = \text{₹ } 10,00,000$

$$\rightarrow \frac{\text{Net worth}}{\text{Total assets}} = \frac{0.90}{1}$$

$$\therefore \frac{\text{Net worth}}{10,00,000} = 0.90$$

$\frac{1}{2}$ $\therefore \text{Net worth} = \text{₹ } 9,00,000$



$$\rightarrow \text{Credit Sales} = \frac{\text{Total sales} \times 0.8}{1}$$

$$= 3,00,000 \times 0.8$$

$$= \boxed{\text{₹ } 2,40,000}$$

$$\rightarrow \text{Avg. Collection period} = \frac{\text{Avg. debtors}}{\text{Credit sales}} \times 360$$

$$\therefore 60 \text{ days} = \frac{\text{Debtors}}{2,40,000} \times 360$$

$$\frac{1}{2} \therefore \text{Debtors} = \boxed{\text{₹ } 40,000}$$

$$\rightarrow \text{Total liabilities} = \text{Networth} + \text{Current liabilities}$$

$$\therefore 10,00,000 = 9,00,000 + \text{Current liabilities}$$

$$\frac{1}{2} \therefore \text{Current liabilities} = \boxed{\text{₹ } 1,00,000}$$

$$\rightarrow \text{Current ratio} = 1.5$$

$$\therefore \frac{\text{Current Assets}}{\text{Current liabilities}} = 1.5$$



$$\therefore \frac{\text{Current Assets}}{1,00,000} = 1.5$$

$$\therefore \text{Current Assets} = \text{₹}1,50,000$$

$$\rightarrow \frac{\text{Liquid Assets}}{\text{Current Liab.}} = 1$$

$$\therefore \text{Liquid assets} = \text{₹}1,00,000$$

$$\rightarrow \text{Liquid Assets} = \text{Current Assets} - \text{stock}$$

$$\therefore 1,00,000 = 1,50,000 - \text{stock}$$

$$\therefore \text{stock} = \text{₹}50,000$$

$$\rightarrow \text{Cash} = \text{Current Assets} - \text{debtors} - \text{stock}$$

$$= 1,50,000 - 40,000 - 50,000$$

$$= \text{₹}60,000$$



$$\rightarrow \text{Fixed Assets} = \text{Total assets} - \text{Current Assets}$$

$$= 10,00,000 - 1,50,000$$

$$\rightarrow \boxed{= ₹ 8,50,000}$$

Balance sheet of Moon Ltd.

₹		₹	
Networth	9,00,000	Fixed Assets	8,50,000
Current liabilities	1,00,000	Stock	50,000
		Debtors	40,000
		Cash	60,000
	<u>10,00,000</u>		<u>10,00,000</u>



I(d)

	Plan I	Plan II
<u>No. of Equity shares (A)</u>	4,00,000	1,00,000
	$\left[\frac{\text{₹ 100 lakhs}}{\text{₹ 10} + \text{₹ 15}} \right]$	$\left[\frac{\text{₹ 25 lakhs}}{\text{₹ 10} + \text{₹ 15}} \right]$
12% debt (₹)	-	75,00,000
EBIT	40.00	40.00
		[₹ in lakhs]
(₹: Interest @ 12%)	-	(9.00)
EBT	40.00	31.00
Less: Tax @ 30%	(12.00)	(9.30)
EAT (B)	28.00	21.70
EPS $\frac{(B)}{(A)}$	₹ 7 / share	₹ 21.7 / share
	✓	✓



(ii) At financial breakeven point,
EBIT is equal to interest.

∴ Financial breakeven point of Plan I = ₹ 0

1 ∴ " " Plan II = ₹ 9,00,000

$$(iii) \rightarrow \frac{(EBIT - I_1)(1-t)}{\text{No. of shares}} = \frac{(EBIT - I_2)(1-t)}{\text{No. of shares}}$$

$$\therefore \frac{(EBIT - 4,00,000)(1-0.30)}{4,00,000} = \frac{(EBIT - 9,00,000)(1-0.30)}{1,00,000}$$

$$\therefore \frac{0.70 \times EBIT}{4,00,000} = \frac{0.70 \times EBIT - 6,30,000}{1,00,000}$$

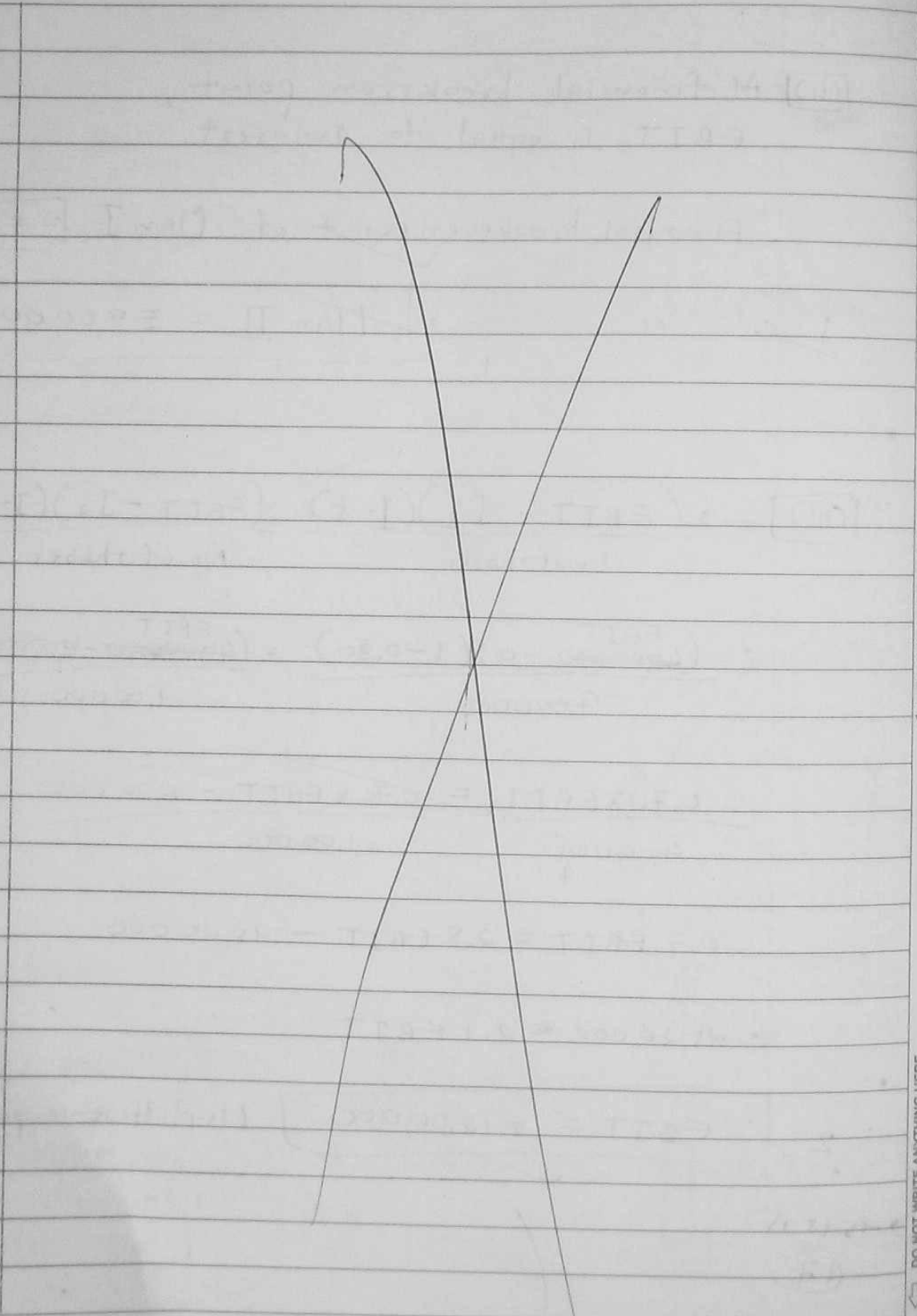
$$\therefore 0.7 EBIT = 2.8 EBIT - 25,20,000$$

$$\therefore 25,20,000 = 2.1 EBIT$$

$$\therefore EBIT = ₹ 12,00,000 \quad (\text{indifference point})$$

$$2 - 15 + 15$$

$$= (17)$$



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3

(1) Option I - purchase

$$\rightarrow \text{Annual payments} = \frac{\text{Cost of plant}}{1 + PVIFA(12\%, 4)}$$

$$= \frac{\text{₹ } 200 \text{ lakhs}}{1 + 3.038}$$

$$= \text{₹ } 49,53,947$$

$$= \text{₹ } 49.53 \text{ lakhs}$$

Interest

(₹ in lakhs)				
Years	(1) Principal @ beginning	(2) Interest (1) x 0.12	(3) Principal paid [49.53 - (2)]	Balance o/s (1) - (3)
0	200.00	-	49.53	150.47
1	150.47	18.06	31.47	119.00
2	119.00	14.28	35.25	83.75
3	83.75	10.05	39.48	44.27
4	44.27	5.31 5.26 *	44.22 44.27	0.05
∞	0.05			

* diff. due to rounding off



Present Value

[₹ in lakhs]

Year	(1) Installments	(2) Int.	(3) tax shield on interest [(2) × 0.30]	Cashflow (1) - (3)	PVF@10%	Present Value
0	49.53	-	-	49.53	1.000	49.53
1	49.53	18.06	5.42	44.11	0.909	40.10
2	49.53	14.28	4.28	45.25	0.826	37.38
3	49.53	10.05	3.01	46.52	0.751	34.94
4	49.53	5.26	1.58	47.95	0.683	32.75
5						

194.70

PV of
Less: depreciation tax shield

$$\left[\frac{(200 - 40) \times 0.30 \times 3.79}{5 \text{ year}} \right]$$

(36.38)

PV of scrap value

$$[40 \times 0.621]$$

- (24.84)

Net Cash outflow

133.48

4
-
2

(2) Lease

[₹ in lakhs]

Lease rentals 48.00

Less: tax shield @ 30% (14.40)post tax lease rentals (A) 33.60PVFA (~~12%~~^{10%}, 5) (B) 3.792 Net Cashflow (AxB) 127.34

→ As, net cash outflow in leasing option is lower; company should lease the plant.

(10)



4

	₹
Annual Cashflow before tax & dep.	24,00,000
Less: depreciation p.a.	
$\left[\frac{\text{₹ } 60,00,000}{5 \text{ years}} \right]$	(12,00,000)
Cashflow before tax	12,00,000
Less: tax @ 30%	(3,60,000)
Cashflow after tax	8,40,000
1 Add: depreciation	✓ 12,00,000
3 Annual Cashflow p.a.	✓ 20,40,000
PVIFA (12%, 5)	3.605
PVIFA (6%, 5)	4.213



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Year	(1) Annual cashflow-p.a.	(2) PVIF(R%,n)	(3) PVIF(6%,n)	Present value (₹) [(1) × (2) × (3)]
1	20,40,000	0.893	0.943	17,17,882
2	20,40,000	0.797	0.890	14,47,360
3	20,40,000	0.712	0.840	12,20,083
4	20,40,000	0.636	0.793	10,27,572
5	20,40,000	0.567	0.747	8,64,040

~~62,75,937~~

62,76,610

Add: Terminal Cashflow

working capital released

$$[12,00,000 \times 0.567 \times 0.747] \quad 5,08,259$$

Less: Initial Outflow

working capital

12,00,000

~~cost of initial inv.~~

60,00,000

(72,00,000)

NPV in real terms

(4,15,131)

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→ At NPV is negative, co. should not accept project

⑤

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5

⇒ Calculation of WC requirement (current basis)

Current Assets

₹

Raw Material stock

$$1 \left[\frac{(31,200 + 12,000) \times ₹40 \times 30}{360} \right] \quad \checkmark 1,44,000$$

WIP stock

$$2 \left[12,000 \times \left(₹40 + \frac{₹15 + ₹30}{2} \right) \right] \quad \checkmark 7,50,000$$

Finished Goods stock

$$1 \left[24,000 \times ₹85 \right] \quad \checkmark 20,40,000$$

Debtors

$$3 \left[\frac{(31,200 - 24,000) \times ₹85 \times 60}{360} \right] \quad \checkmark 1,02,000$$



₹

Cash balance 2,00,000

total current assets (A) 32,36,000

Current liabilities ₹

Creditors for :-

Raw material (W.N. I) ~~18,72,000~~

1,56,000

Wages

$$\left[\frac{[(31,200 \times ₹15) + (12,000 \times ₹15 \times 50\%)] \times 15}{360} \right] \leftarrow 23,250$$

total current liabilities (B) ~~18,95,250~~
1,79,250

Net Working Capital requirement (A-B) 30,56,750
~~13,40,750~~



Working Notes

(1) As it is first year of operation ;
closing stock will also to be purchased.

∴ Creditors for Raw Material

$$= (\text{total consumption} + \text{stock}) \times \frac{30}{360}$$

$$= \left[[(31,200 + 12,000) \times ₹40] + 1,44,000 \right] \times \frac{30}{360}$$

$$= ₹1,56,000$$

(10)



6(b)

⇒ Certainty Equivalent (CE)

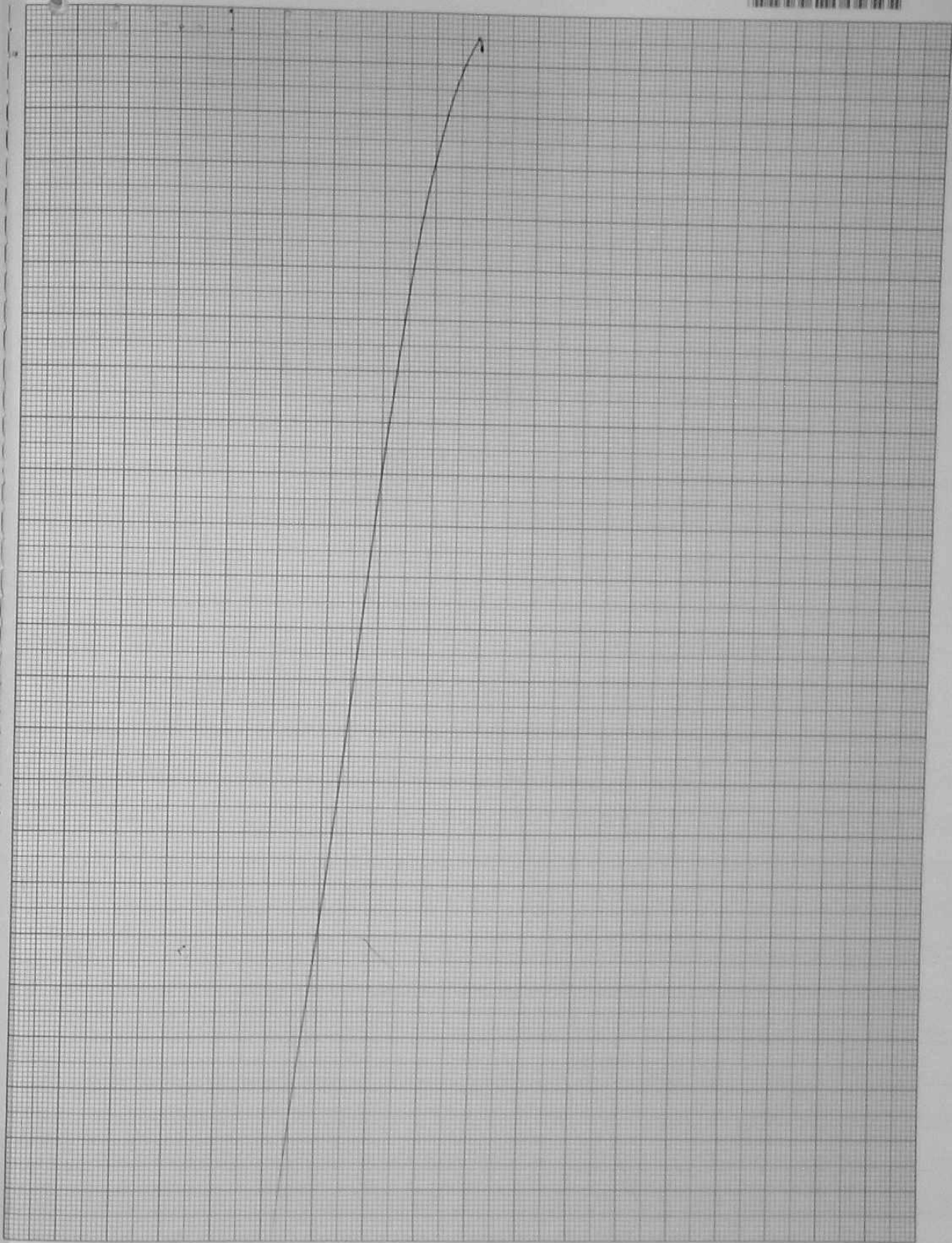
→ It is an approach to represent the risky cashflow in certain terms which are equivalent of risky cashflow.

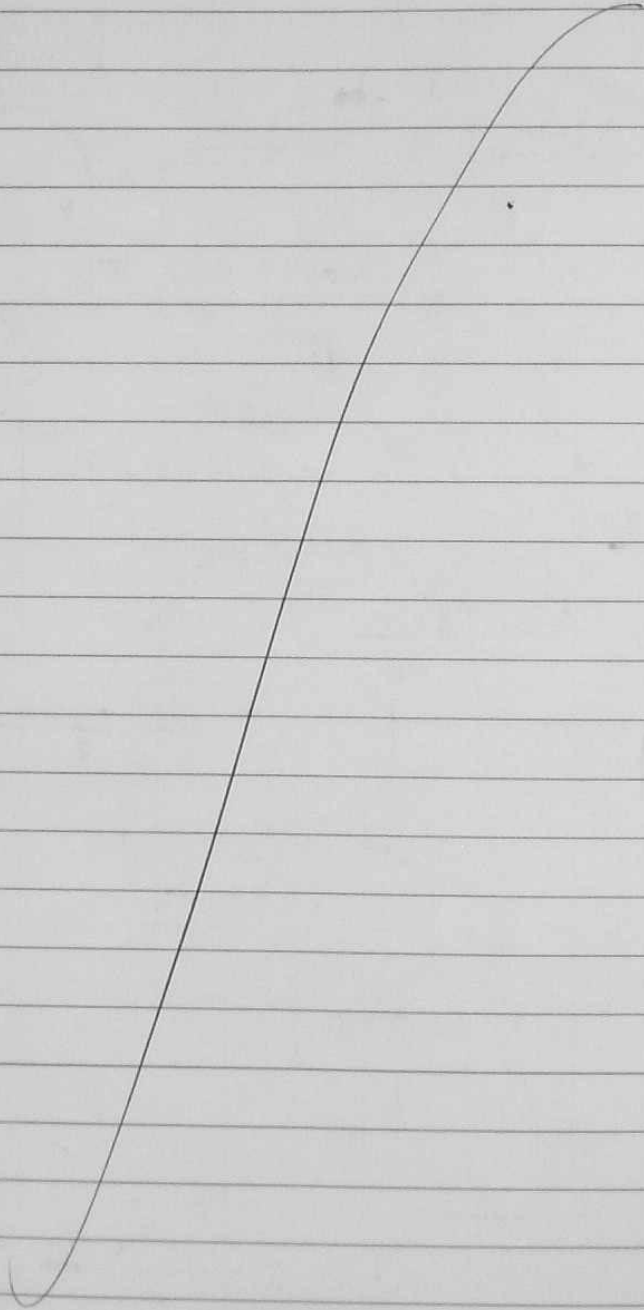
→ User is indifferent between risky cashflow and certain cashflow.

→ It is better than risky cashflow to evaluate project on less amount but more certain cashflow.

→ Finance manager gets ~~effective~~ opportunity to exercise his skill in estimating cashflow.

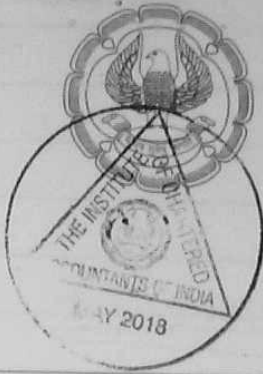
→ Finance manager is sure about cashflow and hence more informed and ~~more~~ accurate decisions can be made.







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→ Containing equivalent

$$= \frac{\text{certain cashflow}}{\text{risky / possible cashflow}}$$

2



6(e)

Role of Finance executive

(1) Financing decisions

→ it is important to finance the capital requirements from right sources so as to maintain the risk at lower.

(2) Investment decisions

→ employing resources to right uses to optimize utilization

(3) Dividend decisions

→ Pay appropriate dividend on basis of profitability and to maintain the trust of shareholders.



6(a)

* Sources of Short term finance

(1) Trade Credit

→ company can enjoy credit allowed by suppliers.

(2) Bank overdraft (BOD)

→ Bank allows some credit to overdraw above balance.

(3) ~~Financing~~ Short-term loans

→ Company can avail short term loans to finance its capital requirement.

(4) Commercial Papers

→ Company can raise short-term finance from this source.



~~(5) Security premium~~

(5) Short-term Bonds

→ Company can issue short term bonds based on requirement for the time period.

(6) loan by hypothecation of stocks

→ Company can hypothecate its stock and avail loan from bank,

→ Company has to regularly submit stock details to the bank.

4

2+2+4

= 8

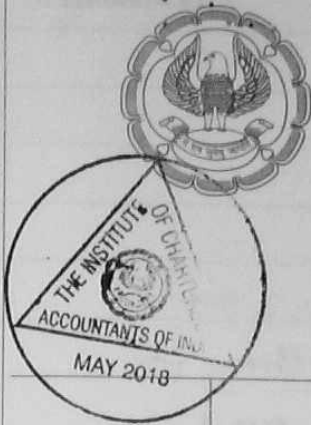


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7 (9)

$$\rightarrow MPC = \frac{\text{change in consumption } (\Delta C)}{\text{change in income } (\Delta Y)}$$

$$= \frac{9000 - 6000}{12000 - 8000}$$

$$= \frac{3000}{4000}$$

✓ $\boxed{= 0.75}$

$$\rightarrow MRS = 1 - MPC$$

$$= 1 - 0.75$$

✓ $\boxed{= 0.25}$

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7(b)

(i) → If banks keep 100% reserve, then it would not be able to create any credit

0 → Hence, credit multiplier will be 0.

(ii) → If banks do not keep reserve, then it would be in position to advance all the funds.

1 → Hence, credit multiplier will be infinity (∞)

(iii) → Excess reserves do not create any credit money & money will be blocked,

0 → Hence, credit multiplier would be reduced to the extent of excess reserve.



$F(C)$

→ Richard Musgrave identified the role of government in these 3 areas of market economy :-

(1) Allocation function

→ It involves allocation of a society's scarce resources to right place so as to ensure optimum resource utilization

→ It tends to remove inefficiencies in allocation.

(2) Redistribution Function

→ It involves distribution of resources and income on equitable principles, namely, equity and fairness.

→ It focuses on equality of distribution



(3) Stabilization Function

→ It involves stabilizing the economy.

→ It is a macroeconomic function to maintain price levels, employment, income, interest rate etc.

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7(d)

* Fixed Exchange rate

→ under this regime, government or central bank announces a fixed rate and hence tries to establish fixed parity.

→ Adopted in Fixed exchange rate regimes.

* Floating exchange rate

→ Exchange rate is market determined by demand of, and supply of, money. foreign exchange.

→ Central Gov. or bank do not intervene.

→ Adopted under floating exchange rate regimes.

211341
⑦



$Q(d)$

(i)

→ According to Keynesian theory (Liquidity preference theory) people hold money for the 3 purpose

(1) Transaction motive

→ for buying goods and service in day to day life, by eliminating gap between demand and payment.

(2) Precautionary motive

→ unexpected and abnormal events occur which causes cash outflow

→ To protect against such demand, they hold money.

(3) Speculative motive

→ to take advantage of price differences and finance attractive investment at right time.

3



(cii) Gov. Interventions in case of Information failure :-

→ Gov. enforces various disclosures requirement for products such labeling, content disclosure so as to inform buyer.

→ Gov. undertakes public information dissemination on large scale to provide knowledge.

→ Gov. regulates the advertisement campaigns so as to make them moderate and less persuasive.

2



9(b)

(ii) → disposable income (Y_d)

$$= Y - \text{tax} + \text{transfer payment}$$

$$= Y - (20 + 0.20Y) + 40$$

$$\therefore Y_d = Y - 20 - 0.20Y + 40$$

$$\therefore Y_d = 0.80Y + 20$$

$$\rightarrow Y = C + I + G + X - M$$

$$\therefore Y = 150 + 0.75[0.80Y + 20] + 100 + 115$$

$$+ 35 - [15 + 0.1Y]$$

$$\therefore Y = 0.60Y - 0.1Y + 400$$

$$\therefore 0.5Y = 400$$

$$\therefore Y = 800 \quad \left[\text{total equilibrium national income} \right]$$



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(ii) Consumption at equil. level (c)

$$= 150 + 0.75 Y_d$$

$$= 150 + 0.75 [0.80 Y + 20]$$

$$= 150 + 0.75 [0.80 (800) + 20]$$

$$= 150 + 495$$

1 ~~$$= ₹ 645$$~~

(iii) Net exports = $X - M$

$$= 35 - [15 + 0.1 Y]$$

$$= 35 - [15 + 0.1 (800)]$$

$$= 35 - 95$$

1 ~~$$= ₹ -60$$
 negative~~

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1
$$\frac{5+5}{-10}$$



[10(a)]

(i) LAF

→ Liquidity Adjustment Facility is provided by Reserve Bank to all scheduled commercial banks to raise liquidity in case of need or to park ~~excess~~ excess fund. on overnight basis

→ Thus, it is overnite liquidity adjustment facility

MSF

→ Marginal standing facility is agreement reached between Gov. and RBI.

→ Gov. will sell securities to RBI for aiding in sterilisation operations of ~~gov~~ RBI

→ RBI will afford these securities, and eliminate the effects of foreign capital inflow on domestic liquidity



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(₹ in crores)

Value of output in

secondary sector	1000
tertiary sector	3000
Primary sector	800

GDP mp 4800

Add: Net factor income from abroad (100)

GNP mp 4700

→ Intermediate consumption is not considered in value added method.

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10(b)

(i) Anti-dumping duties

→ It is a duty imposed by importing country to ~~removing~~ remove the dumping effects created by exporting country by selling its product below market price or its average cost.

→ Anti-dumping offsets the price difference

→ It protects the ~~domestic~~ domestic industry from the predatory practice initiated by exporting country.

(ii) deterrents to FDI

→ high volatility - volatility of exchange rate, interest rate.

→ Unstable economic environment.

→ Change in Government and Government policies.

→ Inconsistent fiscal & monetary policies

1+4=5



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8(9)

(i) $\rightarrow MV + M'V' = PT$

M = amount of money in circulation
at any point of time.

V = transaction velocity
(no. of times an avg. rupee is spend
in an economy.)

M' = amount of credit money

V' = transaction velocity of credit money

P = Average price level

T = Avg. no. of transactions in an economy

$\rightarrow MV + M'V' =$ amt. of money flow (demand)

$\rightarrow PT =$ value of transaction (supply)

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(ii) Crowding Out effect

- It is said to occur when Government or public expenditure in form of investment in market outperforms private expenditure.
- The money flow is transferred from private sector to public sector.
- Private spending is replaced by Gov. spending and hence ~~it is said to~~ it is said to be 'crowded out'
- When government borrows money from markets, it causes interest to rise and adverse effect on private spending
- However it could be negligible if private spending is already minimal.

2



8(b)

(i) Leakages

→ these are money flows which are out from circular flow.

e.g. government taxes, duties, investment in non-trading etc.

Injection

→ these are money inflows in the circular flow which stimulates demand, and which is not earned

e.g. transfer payment, bonus, unemployment compensation

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(ii) Public Good

- These are goods whose consumption is essentially collective in nature.
- they are known as 'collective consumption goods'
- they are characterised by non-excludibility and non-rivalry.
- Once provided, additional cost of using goods is zero.
- National defence, national resources etc etc. fall in this category.
- They are socially desirable.

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