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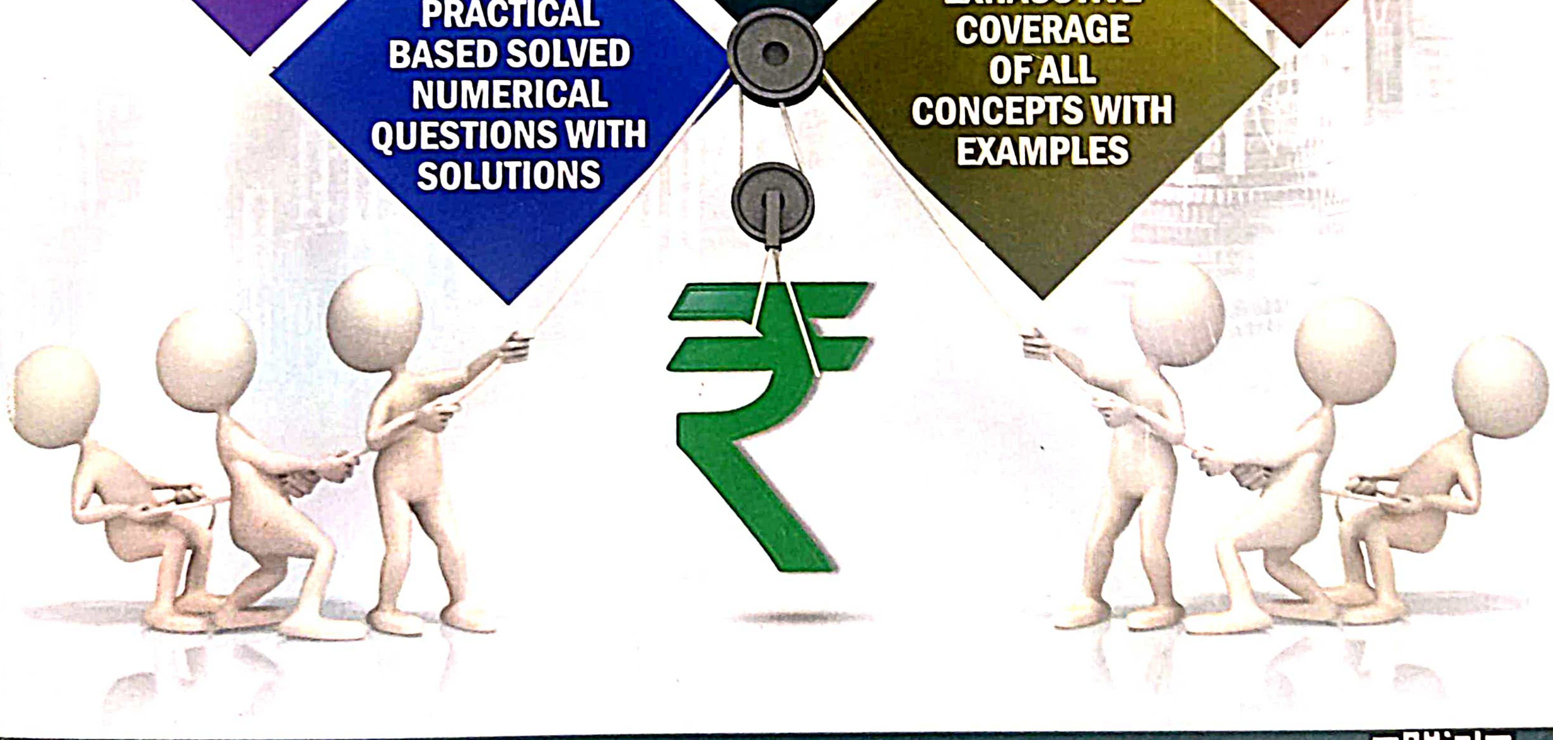

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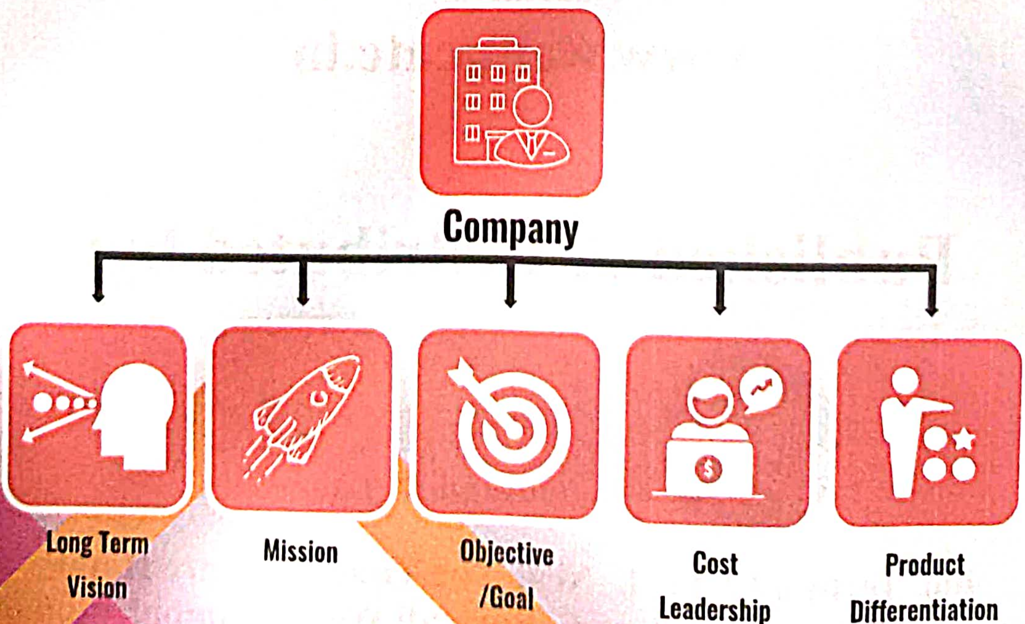
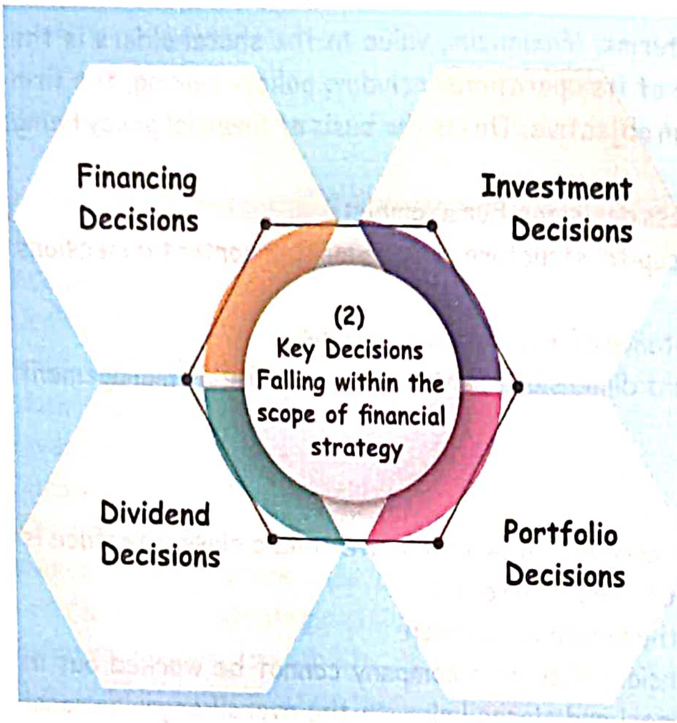
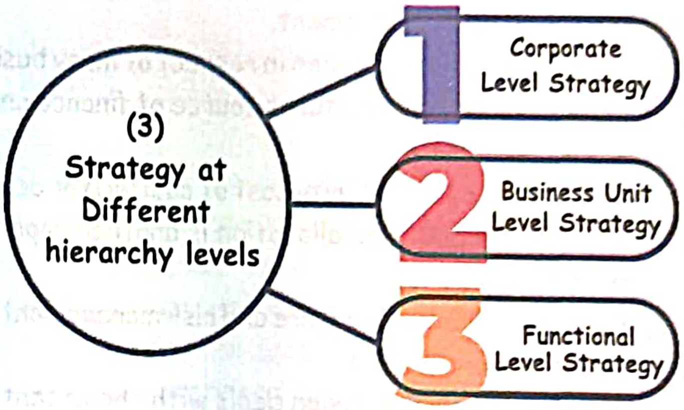
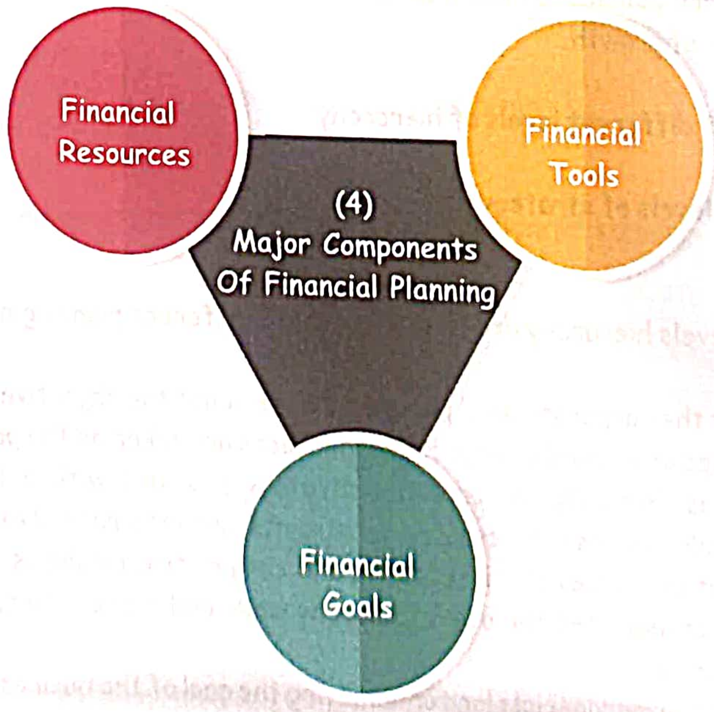
SUBJECT INDEX



(1) STRATEGY + FINANCE + MANAGEMENT = FUNDAMENTALS OF BUSINESS







1. Linking of financial policy to strategic management

Or

Explain briefly, how financial policy is linked to Strategic Management.

Or

Linkage between Financial Policy & Strategic Management.

SOLUTION

The success of any business is measured in financial terms. Maximizing value to the shareholders is the ultimate objective. For this to happen, at every stage of its operations including policy- making, the firm should be taking strategic steps with value maximization objective. This is the basis of financial policy being linked to strategic management.

The linkage can be clearly seen in respect of many business decisions. For example:

(i) Manner of raising capital as source of finance and capital structure are the most important dimensions of strategic plan.

(ii) Cut-off rate (opportunity cost of capital) for acceptance of investment decisions.

(iii) Investment and fund allocation is another important dimension of interface of strategic management and financial policy.

(iv) Foreign Exchange exposure and risk management.

(v) Liquidity management

(vi) A dividend policy decision deals with the extent of earnings to be distributed and a close interface is needed to frame the policy so that the policy should be beneficial for all.

(vii) Issue of bonus share is another dimension involving the strategic decision.

Thus, from above discussions it can be said that financial policy of a company cannot be worked out in isolation to other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth.

2. Enumerate Strategy at different levels of hierarchy.

Or

Explain the different levels of strategy

SOLUTION

Strategies at different levels hierarchy are the outcomes of different planning needs. There are basically three types of strategies:

(i) Corporate Strategy: At the corporate level planners decide about the objective or objectives of the firm along with their priorities and based on objectives, decisions are taken on the participation of the firm in different product fields. Basically, a corporate strategy provides with a framework for attaining corporate objectives under values and resource constraints, and internal and external realities. It is the corporate strategy that describes the interest in and competitive emphasis to be given to different businesses of the firm. It indicates the overall planning mode and propensity to take risk in the face of environmental uncertainties.

(ii) Business Strategy: It is the managerial plan for achieving the goal of the business unit. However, it should be consistent with the corporate strategy of the firm and should be drawn within the framework provided by the corporate planners. Given the overall competitive emphasis, business strategy specifies the product market power i.e, the way of competing in that particular business activity. It also addresses coordination and alignment issues covering internal functional activities. The two most important internal aspects of a business strategy are the identification of critical resources and the development of distinctive competence for translation into a competitive advantage.

(iii) Functional Strategy: It is the low level plan to carry out principal activities of a business. In this sense, functional strategy must be consistent with the business strategy, which in turn must be consistent with the corporate strategy. Thus, strategic plans come down in a cascade fashion from the top to the bottom level of planning pyramid and performances of functional strategies trickle up the line to give shape to the business performance and then to the corporate performance.

3. Explain-Processes of Strategic Decision Making

SOLUTION

Capital investment is the springboard for wealth creation. In a world of economic uncertainty, the investors want to maximize their wealth by selecting optimum investment and financial opportunities that will give them maximum expected returns at minimum risk. Since management is ultimately responsible to the investors, the objective of corporate financial management should implement investment and financing decisions which should satisfy the shareholders by placing them all in an equal, optimum financial position. The satisfaction of the interests of the shareholders should be perceived as a means to an end, namely maximization of shareholders' wealth. Since capital is the limiting factor, the problem that the management will face is the strategic allocation of limited funds between alternative uses in such a manner, that the companies have the ability to sustain or increase Investor returns through a continual search for Investment opportunities that generate funds for their business and are more favorable for the investors. Therefore, all businesses need to have the following three fundamental essential elements:

- A clear and realistic strategy,
- The financial resources, controls and systems to see it through and
- The right management team and processes to make it happen.

4. Discuss briefly the key decisions falling within the scope of financial strategy.

SOLUTION

The key decisions falling within the scope of financial strategy include the following:

1. Financing decisions: These decisions deal with the mode of financing or mix of equity capital and debt capital.
2. Investment decisions: These decisions involve the profitable utilization of firm's funds especially in long-term projects (capital projects). Since the future benefits associated with such projects are not known with certainty, investment decisions necessarily involve risk. The projects are therefore evaluated in relation to their expected return and risk.
3. Dividend decisions: These decisions determine the division of earnings between payments to shareholders and reinvestment in the company.
4. Portfolio decisions: These decisions involve evaluation of investments based on their contribution to the aggregate performance of the entire corporation rather than on the isolated characteristics of the investments themselves.

5. Write a short note on Financial Planning.

SOLUTION

Financial planning is the backbone of business planning and corporate planning.

It helps in defining the feasible area of operation for all types of activities and thereby defines the overall planning framework. Financial planning is a systematic approach whereby the financial planner helps the customer to maximize his existing financial resources by utilizing financial tools to achieve his financial goals.

There are 3 major components of Financial planning:

- Financial Resources (FR)
- Financial Tools (FT)
- Financial Goals (FG)

Financial Planning: FR + FT + FG

For an individual, financial planning is the process of meeting one's life goals through proper management of the finances. These goals may include buying a house, saving for children's education or planning for retirement. It is a process that consists of specific steps that helps in taking a big-picture look at where you financially are. Using these steps you can work out where you are now, what you may need in the future and what you must do to reach your goals.

Outcomes of the financial planning are the financial objectives, financial decision making and financial measures for the evaluation of the corporate performance. Financial objectives are to be decided at the very outset so that rest of the decisions can be taken accordingly. The objectives need to be consistent with the corporate mission and corporate objectives. Financial decision making helps in analyzing the financial problems that are being faced by the corporate and accordingly deciding the course of action to be taken by it. The financial measures like ratio analysis, analysis of cash flow statement are used to evaluate the performance of the Company. The selection of these measures again depends upon the corporate objectives.

6. What makes an organization sustainable? State the specific steps.

SOLUTION

The concept of sustainable growth can be helpful for planning healthy corporate growth The concept forces managers to consider the Financial consequences of sales increases and to set sales growth goals that are consistent with the operating and financial policies of the firm often, a conflict can arise if growth objectives are not consistent with the value of the organization Sustainable growth Question concerning right distribution of resources may take a difficult shape we take into consideration the rightness not for the current stakeholders but for the future stakeholders also

Sustainable growth is important to enterprise long-term development. Too fast or too slow growth will go against enterprise growth and development, so financial should play important role in enterprise development, adopt suitable financial policy initiative to make sure enterprise growth speed close to sustainable growth ratio and have sustainable healthy development.

Sustainable growth models assume that the business wants to:

(1) maintain a target capital structure without issuing new equity;

(2) maintain a target dividend payment ratio; and

(3) increase sales as rapidly as market conditions allow.

Since the asset to beginning of period equity ratio is constant and the firm's only source of new equity is retained earnings, sales and assets cannot grow any faster than the retained earnings plus the additional debt that the retained earnings can support. The sustainable growth rate is consistent with the observed evidence that most corporations are reluctant to issue new equity. If, however, the firm is willing to issue additional equity, there is in principle no financial constraint on its growth rate.

7. Discuss the importance of strategic management in today's scenario?

SOLUTION

Strategic management intends to run an organization in a systematized fashion by developing a series of plans and policies known as strategic plans, functional policies, structural plans and operational plans. It is a systems approach, which is concerned with where the organization wants to reach and how the organization proposes to reach that position. Thus, strategic management is basically concerned with the futurity of the current decisions without ignoring the fact that uncertainty in the system is to be reduced, to the extent possible, through continuous review of the whole planning and implementation process. It is therefore necessary for an organization Interested in long run survival and command over the market, to go for strategic planning and the planning process must be holistic, periodic, futuristic, intellectual and creative with emphasis given on critical resources of the firm otherwise, the organization will fall in the traps of tunneled and myopic vision.

8. How financial goals can be balanced vis-à-vis sustainable growth?

SOLUTION

The concept of sustainable growth can be helpful for planning healthy corporate growth. This concept forces managers to consider the financial consequences of sales increases and to set sales growth goals that are consistent with the operating and financial policies of the firm. Often, a conflict can arise if growth objectives are not consistent with the value of the organization's sustainable growth Question concerning right distribution of resources may take a difficult shape if we take into consideration the rightness not for the current stakeholders but for the future. stakeholders also. To take an illustration, let us refer to fuel industry where resources are limited in quantity and a judicial use of resources is needed to cater to the need of the future customers along with the need of the present customers. One may have noticed the save fuel campaign, a demarketing campaign that deviates from the usual approach of sales growth strategy and preaches for conservation of fuel for their use across generation. This is an example of stable growth strategy adopted by the oil industry as a whole under resource constraints and the long run objective of survival over years. Incremental growth strategy, profit strategy and pause strategy are other variants of stable growth strategy.

Sustainable growth is important to enterprise long term development. Too fast or too slow growth will go against enterprise growth and development, so financial should play important role in enterprise development, adopt suitable financial policy initiative to make sure enterprise growth speed close to sustainable growth ratio and have sustainable healthy development.

9. "Starting point and end point of an organization is money" Explain

SOLUTION

No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both internally and externally mobilized financial base. Sources of finance and capital structure are the most important dimensions of a strategic plan. The generation of funds may arise out of ownership capital and or borrowed capital. A company may issue equity shares and/or preference shares for mobilizing ownership capital.

Along with the mobilization of funds, policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital. There are some norms for debt equity ratio. However, this ratio in its ideal form varies from industry to industry. It also depends on the planning mode of the organization under study.

Another important dimension of strategic management and financial policy Interface is the Investment and fund allocation decisions. A planner has to frame policies for regulating investments. in fixed assets and for restraining of current assets. Investment proposals mooted by different. business units may be addition of a new product, Increasing the level of operation of an existing product and cost reduction and efficient utilization of resources through a new approach and closer monitoring of the different critical activities.

Now, given these three types of proposals, a planner should evaluate each one of them by making within group comparison in the light of capital budgeting exercise. Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all. Dividend policy decision deals with the extent of earnings to be distributed as dividend and the extent of earnings to be retained for future expansion scheme of the firm.

It may be noted from the above discussions that the financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth. These policies related to external awareness about the firm, specially the awareness of the investors about the firm, in respect of its internal performance. There is always a process of evaluation active in the minds of the current and futures take holders of the company. As a result, preference and patronage for the company depends significantly on the financial policy framework. And hence attention of the corporate planners must be drawn while framing the financial policies not at a later stage but during the stage of corporate planning itself.

10. Interface of Financial Policy and Strategic Management.

SOLUTION

The interface of strategic management and financial policy will be clearly understood if we appreciate the fact that the starting point of an organization is money and the end point of that organization is also money. No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both internally and externally mobilized financial base. Sources of finance and capital structure are the most important dimensions of a strategic plan. The need for fund mobilization to support the expansion activity of firm is very vital for any organization. The generation of funds may arise out of ownership capital and or borrowed capital. A company many issue equity shares and/or preference shares for mobilizing ownership capital and debenture to raise borrowed capital. Policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital. There are some norms for debt equity ratio.

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11. Three basis questions that can be answered by Corporate Level Strategy

SOLUTION

Corporate level strategy should be able to answer three basic questions:

Suitability- Whether the strategy would work for the accomplishment of common objective of the company.

Feasibility- Determines the kind and number of resources required to formulate and implement the strategy.

Acceptability- It is concerned with the stakeholders' satisfaction and can be financial and non- financial.

11. What makes an organization financially sustainable?

SOLUTION

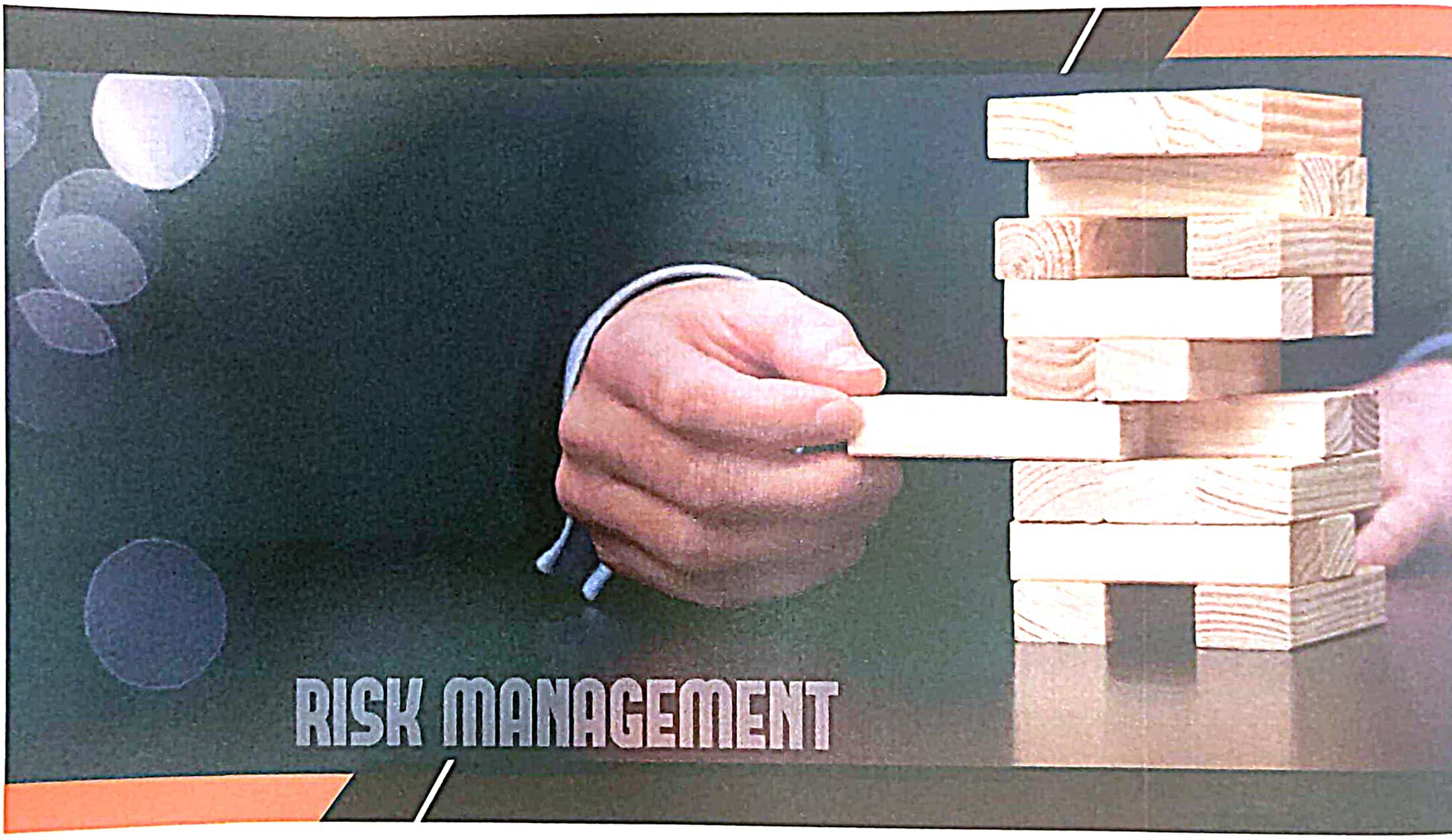
To be financially sustainable, an organization must:

- Have more than one source of income;
- Have more than one way of generating income;
- Do Strategic, action and financial planning regularly;
- Have adequate financial systems;
- Have a good public image;
- Be clear about its values (value clarity); and
- Have financial autonomy

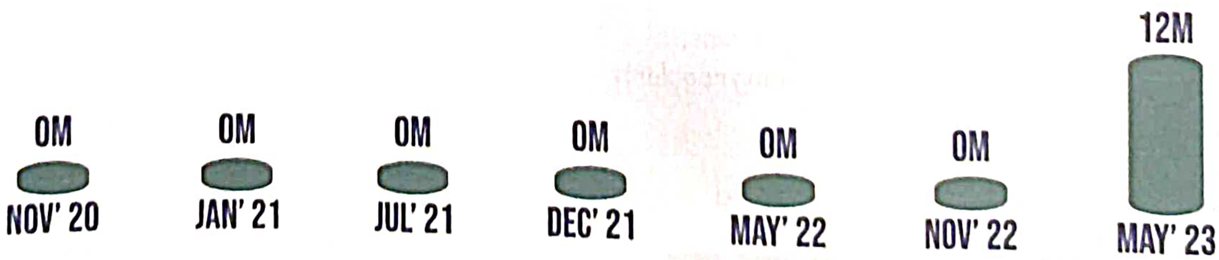
CHAPTER 2

RISK MANAGEMENT

"The More Difficult the Victory, the Greater Happiness in Winning..." PELE



MARKS ALLOCATION (ICAI PAST EXAMS)

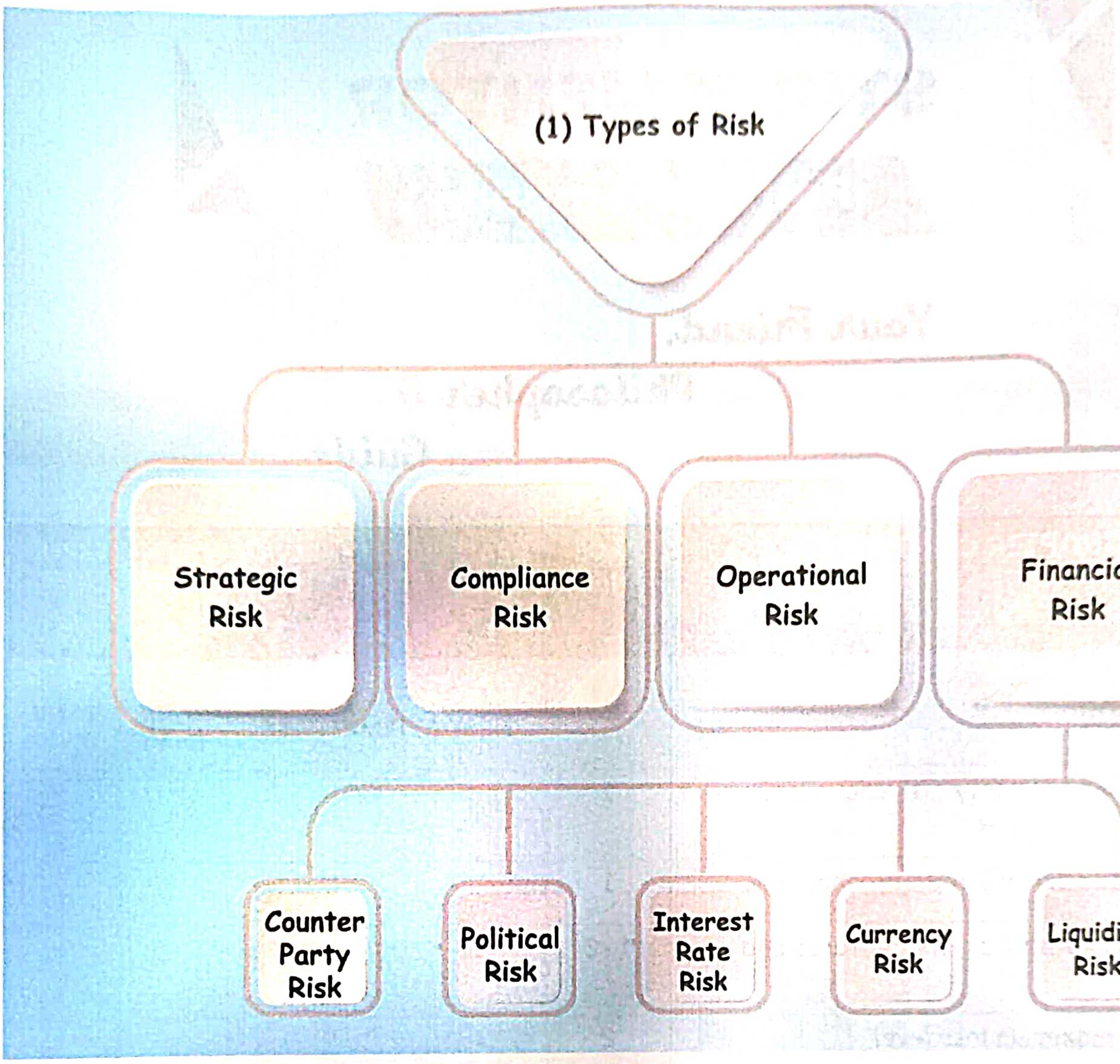


STUDY MENTOR

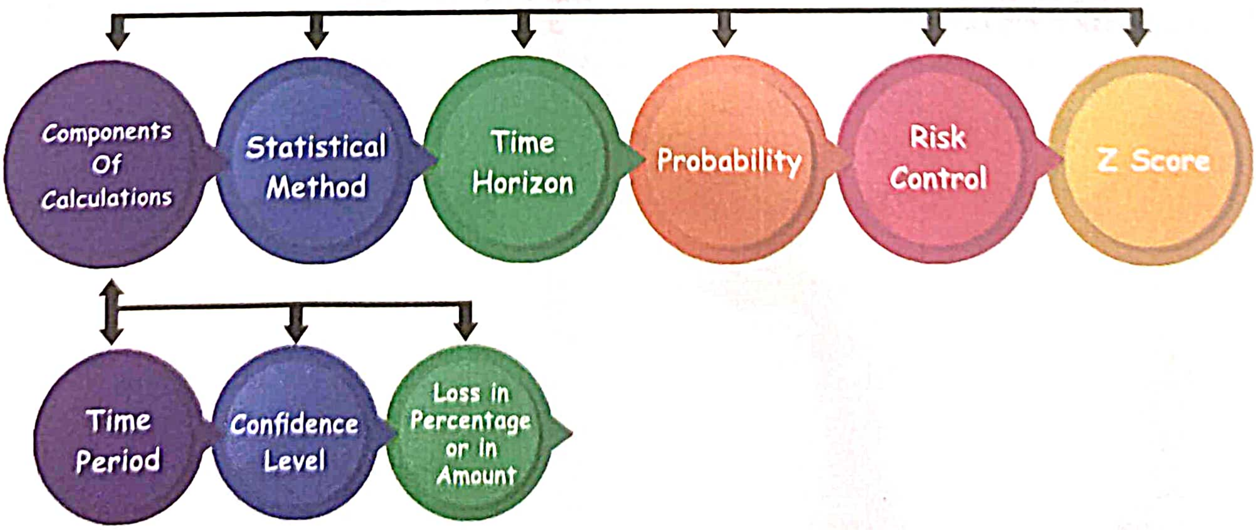
Path to Exemption

Your Friend,
Philosopher &
Guide...

SR. No.	CHAPTER CONTENT	PAGE No.	READ ①	UNDER-STAND ②	REVISE ③	STREN-GTHEN ④	EXPER-TISE ⑤
	How to Achieve		FIRST ATTEMPT PASS			RANK 11-50	RANK 01-10
1	Concept of Counter party risk and various techniques to manage it	1					
2	Parameters to Identify the Currency risk	1					
3	Concept of Value at Risk, its Features and Application	1-2					
4	Determining maximum loss level	2					
5	Determining maximum loss level	3					
6	Financial risk from Different viewpoints	3					



(2) Features Of VAR



1. Briefly explain Counter Party Risk and the various techniques to manage this risk.

SOLUTION

The various hints that may provide counter party risk are as follows:

(a) Failure to obtain necessary resources to complete the project or transaction undertaken.
(b) Any regulatory restrictions from the Government.
(c) Hostile action of foreign government.
(d) Let down by third party.
(e) Have become insolvent.

The various techniques to manage this type of risk are as follows:

(1) Carrying out Due Diligence before dealing with any third party.
(2) Do not over commit to a single entity or group or connected entities.
(3) Know your exposure limits.
(4) Review the limits and procedure for credit approval regularly.
(5) Rapid action in the event of any likelihood of defaults.
(6) Use of performance guarantee, insurance or other instruments.

2. Explain briefly the parameters to identify the currency risk

SOLUTION

Some of the parameters to identity the currency risk are as follows:

(a) Government Action: The Government action of any country has visual impact in its currency. For example, the UK Govt. decision to divorce from European Union i.e. Brexit brought the pound to its lowest since 1980's.
(b) Nominal Interest Rate: As per interest rate parity (IRP) the currency exchange rate depends on the nominal interest of that country.
(c) Inflation Rate: Purchasing power parity theory impact the value of currency.
(d) Natural Calamities: Any natural calamity can have negative impact.
(e) War, Coup, Rebellion etc.: All these actions can have far reaching impact on currency's exchange rates.
(f) Change of Government: The change of government and its attitude towards foreign investment also helps to identify the currency risk.

3. Describe Value at Risk and its application.

Or

Explain the Significance of VAR.

SOLUTION

VAR is a measure of risk of investment. Given the normal market condition in a set of periods, say, one day it estimates how much an investment might lose. This investment can be a portfolio, capital investment or foreign exchange etc., VAR answers two basic questions -

I. What is worst case scenario?
ii. What will be loss?

It was first applied in 1922 in New York Stock Exchange, entered the financial world in 1990s and become world's most widely used measure of financial risk.

Features of VAR

Following are main features of VAR

(i) Components of Calculations: VAR calculation is based on following three components:
 (a) Time Period
 (b) Confidence Level-Generally 95% and 99%
 (c) Loss in percentage or in amount

(ii) Statistical Method: It is a type of statistical tool based on Standard Deviation.

(iii) Time Horizon: VAR can be applied for different time horizons say one day, one week, one month and so on.

(iv) Probability: Assuming the values are normally attributed, probability of maximum loss can be predicted.

(v) Control Risk: Risk can be controlled by selling limits for maximum loss.

(vi) Z Score: Z Score indicates how many standard Deviations is away from Mean value of a population. When it is multiplied with Standard Deviation it provides VAR.

Application of VAR

VAR can be applied

(a) to measure the maximum possible loss on any portfolio or a trading position.
(b) as a benchmark for performance measurement of any operation or trading.
(c) to fix limits for individuals dealing in front office of a treasury department.
(d) to enable the management to decide the trading strategies.
(e) as a tool for Asset and Liability Management especially in banks.

4. Suppose Mr. A holds Rs.2 crore shares of X Ltd. Whose market price standard deviation is 2% per day. Assuming 252 trading days a year, determine maximum loss level over the period of 1 trading day and 10 trading days with 99% confidence level.

SOLUTION

$VAR_{1\ day}$ = Z Score × $SD_{1\ days}$
= 2.33 × 4,00,000

$VAR_{1\ day}$ = Rs.9,32,000

$VAR_{10\ day}$ = Z Score × $SD_{10\ days}$

Or

$VAR_{1\ day} \times \sqrt{t}$

$= \text{Z Score} \times SD_{1\ day} \times \sqrt{t}$

$= 2.33 \times 4{,}00{,}000 \times \sqrt{10}$ or $9{,}32{,}000 \times \sqrt{10}$

= Rs. 29,45,120 or Rs. 29,45,120

5. Neel holds Rs.1 Crore shares of XY Ltd. Whose market price standard deviation is 2% per day Assuming 252 trading days in a year, determine maximum loss level over the period of 1 trading day and 10 trading days with 99% confidence level. Assuming share prices are normally for 1 level of 99%, the equivalent 2 score from Normal table of Cumulative Area shall be 2.33.

SOLUTION

Assuming share prices are normally distributed, for level of 99%, the equivalent Z score from Normal table of Cumulative Area is 2.33.

Volatility in terms of Rupee is
2% of Rs.1 Crore = Rs.2 Lakh

The maximum loss for 1 day at 99% Confidence level is
Rs.2 Lakh x 2.33 = Rs.4.66 Lakhs,
and expected maximum loss for 10 trading days shall be:

$\sqrt{10} \times$ Rs. 4.66 lakhs = 14.74 Lakhs

6. Explain how Financial Risk can be viewed from different viewpoints.

SOLUTION

The financial risk can be viewed by different stakeholders as follows:

(a) From shareholder's and lender's point of view: Major stakeholders of a business are equity shareholders and they view financial gearing i.e. ratio of debt in capital structure of company as risk since in the event of winding up of a company they will be least be given priority
Even for a lender, existing gearing is also a risk since company having high gearing faces more risk in default of payment of interest and principal repayment.

(b) From Company's point of view: From company's point of view if a company borrows excessively or lend to someone who defaults, then it can be forced to go into liquidation

(c) From Government's point of view: From Government's point of view, the financial risk can be viewed as failure of any bank (like Lehman Brothers) or down grading of any financial institution leading to spread of distrust among society at large. Even this risk also includes willful defaulters. This can also be extended to sovereign debt crisis.