CA Final

STRATEGIC FINANCIAL MANAGEMENT

Super 30

Kunal Doshi, CFA

Top 30 shortlisted theories for CA Final SFM Old and New Course

VIDEO OF SUPER30 AVAILABLE ON OUR YouTube channel at: kunal Doshi, CFA
About the author

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In last 6 Years, he has been teaching at various institutes for the courses of Chartered Accountancy, Chartered Financial Analyst, Company Secretary and other graduation courses of Mumbai University, Warwick Business School, UK etc. He has helped organisations in their Training Programmes for financial planning and conducted Career-Solution Workshops for institutions & trusts to help students across communities.

Sources of the book

ICAI Study Material
ICAI Revision Test Papers
A2A Book
Economic Times
Business Standard
Investopedia
1. Explain the reasons of Reverse Stock Split.

- ‘Reverse Stock Split’ is a process whereby a company decreases the number of shares outstanding by combining current shares into fewer or lesser number of shares.

- Since the number of Shares outstanding decreases after the Reverse Merger, EPS as well as MPS increases but Market Capitalization of the company is not impacted.

The various reasons for Reverse Split are:

(i) To attract Institutional Investors and Mutual Funds:
Institutional Investors would want to avoid penny stocks and would only invest in stocks with high safety margin. To attract these investors the company may adopt the route of “Reverse Stock Split” to increase the price per share.

(ii) To avoid the tag of “Penny Stock”:
If the price of shares of a company goes below a limit it may be called “Penny Stock”. Investors which such stocks are worried that those may be delisted or suspended from trading by exchanges and investors may be blocked.

(iii) Avoiding delisting from stock exchange:
A substantial price fall can lead to delisting from stock exchanges and in order to avoid the said regulation, the company may resort to reverse stock split up.

(iv) Avoiding removal from constituents of Index:
Adding or removal from Index depends on the Stock performance and a large slump in prices may lead to removal of the security from the Index Composition resulting in huge negative outcome especially as the stock becomes subject to selling pressure from institutional investors. In recent years, stocks like Rcom, Indiabulls Housing, etc. have been subject to removal from Index due to heavy price fall.
2. Briefly explain Green Shoe Option

(i) Under this option underwriters are allowed to sell additional shares up to a certain pre-determined quantity, if the demand is high or if there is oversubscription in case of an IPO.

(ii) It was first used by Green Shoe Manufacturing Company in 1919 and became popular since then.

(iii) It is also used as a tool to stabilize price of the stock in the Market as an Overallotment option would also bring the Price Up once it falls in the primary market after being sold.

(iv) As per SEBI guidelines, public issues contain a ceiling of around 15 per cent of the offer made to public, for accepting over-subscriptions.
3. **Difference between Money Market and Capital Market.**

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<tr>
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<th><strong>Money Market</strong></th>
<th><strong>Capital Market</strong></th>
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<tbody>
<tr>
<td>(i)</td>
<td>It is a market for short-term borrowing and lending (less than a year)</td>
<td>It is a market for long-term requirement (more than 1 year)</td>
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<td>(ii)</td>
<td>Supplies funds for working capital requirement</td>
<td>Supplies funds for fixed capital requirements</td>
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<td>(iii)</td>
<td>There is no classification between primary market and secondary market</td>
<td>There is a classification between primary market and secondary market</td>
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<td>(iv)</td>
<td>Instruments include interbank call money, notice money up to 14 days, short-term deposits up to three months, commercial paper, 91 days treasury bills</td>
<td>Capital Market instruments are shares and debt instruments</td>
</tr>
<tr>
<td>(v)</td>
<td>Money market participants are Banks, financial institution, RBI and Government</td>
<td>Capital Market participants include retail investors, institutional investors like Mutual Funds, Financial Institutions, corporate and banks</td>
</tr>
<tr>
<td>(vi)</td>
<td>Each single instrument is of a large amount</td>
<td>Each single instrument is of a small amount</td>
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<td>(vii)</td>
<td>Transactions take place over phone calls. Hence there is no formal place for transactions</td>
<td>Transactions are at a formal place viz. the stock exchange</td>
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4. **Describe the factors affecting Industry Analysis.**

The three major factors considered while doing a top-down or bottom-up approach under Fundamental Analysis includes – Economic Analysis, Industry Analysis and Company Analysis.

**The following factors should be considered while assessing the Industry Analysis:**

(i) **Product Life-Cycle:** An industry usually exhibits high profitability in the initial and growth stages, medium but steady profitability in the maturity stage and a sharp decline in profitability in the last stage of growth.  
   Eg. Fintech

(ii) **Demand Supply Gap:** Excess supply reduces the profitability of the industry while insufficient supply and high demand tends to improve the profitability because of higher unit price realization.  
   Eg. Edutech

(iii) **Barriers to Entry:** The potential entrants to the industry, face different types of barriers to entry like investment in R&D, advance technology, high Capex, Natural resources availability, etc. also there are various other barriers are created by existing firms in the industry.  
   Eg. Telecomm or Power

(iv) **Government Attitude:** The attitude of the government towards an industry is a crucial determinant of its prospects.  
   Eg. Electronic Cars

(v) **State of Competition in the Industry:** Leadership capability in foreign & domestic market, nature/type of products, demand prospects, Supply-logistics Management, etc. are various factors which will define the course of competition that the industry or company can manage with.  
   Eg. Retail

(vi) **Technology and Research:** Technology is subject to change very fast leading to obsolescence. Industries which update themselves have a competitive advantage over others in terms of quality, price etc.  
   Eg. Smart-Phones
5. **Explain the challenges to Efficient Market Theory/Hypothesis (EMH)**

EMH is a concept where markets are said to be efficient when prices reflect all information immediately and neither technical nor fundamental analysis can generate consistent excess returns i.e. alpha, except the ones with inside information. In reality, finding a complete efficient market i.e. strong form of EMH is a rare possibility.

**The challenges to EMH are:**

(i) **Information inadequacy:** Information is neither freely available nor rapidly transmitted to all participants in the stock market. There is a calculated attempt by many companies to circulate misinformation.

(ii) **Limited information processing capabilities:** Human information processing capabilities are sharply limited. The behavioural finance explains the psychological part of humans with respect to investments. Notable economists like Herbert Simon and investors like David Dreman have worked and proved the same in the past.

(iii) **Irrational behaviour:** It is generally believed that investors’ rationality will ensure a close correspondence between market prices and intrinsic values. But in practice this is not true. The market seems to function largely on hit or miss tactics rather than on the basis of informed beliefs about the long-term prospects.

(iv) **Monopolistic influence:** A market is regarded as highly competitive. No single buyer or seller is supposed to have undue influence over prices. In practice, powerful institutions and big operators wield great influence over the market. The monopolistic power enjoyed by them diminishes the competitiveness of the market.
6. Briefly discuss Co-location/proximity hosting

(i) It is a facility offered by the stock exchanges to stock brokers/data vendors, whereby their trading or data-vending systems are allowed to be located within or at close proximity to the premises of the stock exchanges.

(ii) This facility is available to all the co-located brokers, who are desirous to avail such connectivity, in a fair and equitable manner.

(iii) These services are however, chargeable and involves high cost as well.

(iv) It helps brokers secure advantage over others due to proximity to exchange servers as data transmission takes less time.

(v) Orders reach exchange servers faster than those who have not availed of the facility.

(vi) A whistleblower in 2014-15 complained to SEBI saying some brokers in collusion with a few top NSE officials had abused the colocation facility whereby they got the first access to the NSE’s servers giving them a head start.
7. Explain the role of Clearing Houses

A Clearing House is an exchange-associated body charged with the function of ensuring (guaranteeing) the financial integrity of each trade.

The capital market regulator SEBI has recently shortlisted National Securities Clearing Corporation Ltd (NSCCL), Indian Clearing Corporation Ltd (ICCL) and MCX-SX Clearing Corporation Ltd (MCX-SXCL) as the only qualified central counterparties (QCCPs) in the Indian securities market.

Clearing houses provide a range of services related to the guarantee of contracts, clearance and settlement of trades, and management of risk for their members and associated exchanges.

Role of Clearing Houses

(i) It ensures adherence to the system and procedures for smooth trading.

(ii) It minimizes credit risks by being a counter party to all trades.

(iii) It involves daily accounting of all gains or losses.

(iv) It ensures delivery of payment for assets on the maturity dates for all outstanding contracts.

(v) It monitors the maintenance of speculation margins.
8. Briefly discuss the Pros and Cons of Depository Services

- In India, there are two depositories namely National Securities Depository Limited (NSDL) or Central Depository Services (India) Limited (CDSL) that are registered with SEBI.

- Their role comes into play from the time an investor makes decision on investing.

- They are integral institutions in the Indian Capital Market and their functionality can be compared to banking entities.

The major benefits accruing to investors and other market players are as follows:

(i) Securities are held in a safe and convenient manner
(ii) Transfer of securities is executed immediately
(iii) Stamp duty for transfer is eliminated and transaction costs are reduced
(iv) Paper work is minimized
(v) Bad deliveries, fake securities and delays in transfers are eliminated.
(vi) Routine changes can be taken care of simultaneously for all securities with little delay.
(vii) Benefit accruing from issue of bonus shares, consolidation, split or merger is credited without much difficulty.
(viii) Payment of dividends and interest is expedited by the use of electronic clearing system.
(ix) Securities held in electronic form can also be pledged for any credit facility.

There are however risks as well:

(i) **Systemic failure**: Unforeseen failures, intentional or otherwise, on the part of the individuals entrusted with protecting data integrity, cybertheft, hacking, etc. could lead to chaos.
(ii) **Additional record keeping**: Companies will invariably need to maintain records on a continuous basis for securities held in physical form. Periodical reconciliation between demat segment and physical segment is very much necessary.
(iii) **Cost of Depository Participant (DP)**: A one-time fee is levied by the depository participant which small investors consider to be an avoidable cost.
(iv) **Human Fraud**: Unlawful transfers by individuals against whom insolvency proceedings are pending or transfers authorities with specific or limited powers are possible.
9. Describe External Commercial Borrowings (ECB)

**ECB Meaning**

(i) There are various forms of foreign investment routes which Indian companies can avail which includes FDI and FPI, trade credit, NRI Deposits and includes the External Commercial Borrowings (ECBs).

(ii) When a non-resident lender like foreign commercial banks or any other institutions lends to Indian company it is called as External Commercial Borrowings (ECBs).

(iii) ECB loans includes bank loans, supplier credit, securitized instruments, credit from export credit agencies and borrowings from multilateral financial institutions.

(iv) These securitize instruments may be FRNs, FRBs etc.

**ECB regulations**

(i) Borrowings from overseas must follow the applicable ECB guidelines/provisions contained in the Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2018, as amended from time to time.

(ii) 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.

(iii) These ECB 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 economy.

(iv) 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.

(v) Units in SEZ are permitted to use ECBs under a special window.

**ECB Market Overall**

ECBs had touched a historic high when Indian entities, primarily led by large corporates and oil marketing companies (OMCs), borrowed as much as $41 billion during the FY 2018-19, registering a 58% increase from the previous year amount of $26 billion. The earlier high was $31 billion, achieved in 2014-15.
10. **Explain takeover by Reverse Bid**

- When a large company is being taken over by a smaller company, it is reverse merger. It is mostly seen in cases of sick units being acquired by smaller but stronger financial companies. Ex. Tata steel acquiring Corus, a company bigger than its size.

- It can be in various forms like when a private company takes over a publicly listed company (Lenovo acquiring Motorola) or a subsidiary company acquiring or merging with holding company (ICICI Bank merging with Holding co, ICICI Ltd).

**There three tests pre-requisites for a deal to be termed as reverse takeover:**

(i) The assets of the Target company are greater than the Acquiring company,

(ii) Equity capital to be issued by the Acquiring company pursuant to the acquisition exceeds its original issued capital, and

(iii) The change of control in the Acquiring company through the introduction of a minority holder or group of holders.
11. Briefly explain the concept of Exchange Traded Fund

Introduced in US in 1993 and came to India around 2002, Exchange Traded Funds (ETFs) are funds listed on stock exchanges and they combine the features of an index mutual fund and stock.

Some important features of ETFs are as follows:

(i) Their prices are linked to the underlying index which can be a single security as well as basket of multiple securities. Various ETFs benchmarks include indexes based on NIFTY, SENSEX, DOWJONES, S&P500, Currencies like dollar, commodities like Gold, etc.

(ii) NAV of an ETF is the value of the underlying component of the benchmark index held by the ETF plus all accrued dividends less accrued management fees.

(iii) Like any other stock on stock exchange, ETFs, can be bought and sold any time during the market hours at prices that are expected to be closer to the NAV at the end of the day.

(iv) There is no paper work involved for investing in an ETF.

(v) This gives an investor the benefit of investing in a commodity like gold, silver, sugar etc. without physically purchasing them or without bearing the costs of storage.

(vi) They are passively managed and there is almost no churning of portfolio unless the Index or benchmark is reconstituted. This reduces the Fund management costs and helps in generation of higher net of cost returns.
12. Explain Money Market Mutual Fund

(i) An important part of financial market is Money market. It is a market for short-term money. It plays a crucial role in maintaining the equilibrium between the short-term demand and supply of money.

(ii) Such schemes invest in safe highly liquid instruments included in commercial papers certificates of deposits and government securities.

(iii) Accordingly, the Money Market Mutual Fund (MMMF) schemes generally provide high returns and highest safety to ordinary investors.

(iv) MMMFs are active players of the money market. They channelize the idle short funds, particularly of corporate world, to those who require such funds.

(v) This process helps those who have idle funds to earn some income without taking any risk and with surety that whenever they will need their funds, they will get (generally in maximum three hours of time) the same. Short-term/emergency requirements of various firms are met by such Mutual Funds.

(vi) Participation of such Mutual Funds provide a boost to money market and help in controlling the volatility.
13. Explain the concept of side pocketing in mutual funds.

**Concept & Process**

(i) Side Pocketing in Mutual Funds is a concept whereby Fund Houses separate risky assets from other investments and cash holdings and cap redemption. Once they are segregated, one unit will contain investment made in risky (stressed assets) papers while the other unit will contact other investments and cash holding.

(ii) The purpose is to make sure that money invested in a mutual fund, which is linked to stressed assets, gets locked until the fund recovers the money from the company or could avoid distress selling of illiquid securities.

(iii) Whenever there are big defaults in the capital market with respect to companies unable to service their debt on time, any big downgrade of credit ratings, etc., the fund’s value also takes a setback if it is exposed to those risky assets.

**Outcome & Benefit**

(i) The fund shifts the illiquid assets into a side pocket so that current unitholders can be benefitted from the liquid assets. Since the fund is now split into risky and other assets, the segregated portion with risky investments gets closed for subscription and redemption. Consequently, the Net Asset Value (NAV) of the fund will then reflect the actual value of the liquid assets.

(ii) Side Pocketing is beneficial for those investors who wish to hold on to the units of the main funds for long term. Therefore, the process of Side Pocketing ensures that liquidity is not the problem even in the circumstances of frequent allotments and redemptions.

**History**

(i) Although quite common internationally, Side Pocketing is a very recent phenomena in Indian market. Previously, SEBI was not in favour of allowing Side Pocketing.

(ii) However, in 2016, after the default of Amtek Auto, AMFI on behalf of JP Morgan AMC approached SEBI to set rules for creation for Side Pockets.

**Challenges or Limitations**

(i) In India, the recent debacle of IL&FS, DHFL, ZEE, etc. has led to many discussions on the concept of side pocketing.

(ii) Many of them have failed to fulfill its repayments obligations due to severe liquidity crisis.
(iii) The concept in application is very complex and involves issues with regards to valuation as well as transparency. Also, there are possible abuse by Fund Managers to move poorly performing assets into Side Pockets in order to hide the true pictures to avoid reduction of management fees.

(iv) Although meant for protection of investors, it can also harm them, especially the retail investors.
14. Describe the various parameters to identify the currency risk.

**The parameters to identify the currency risk are as follows:**

(i) **Nominal Interest Rate:**
   As per interest rate parity (IRP) the currency exchange rate depends on the nominal interest difference between the economies.

(ii) **Inflation Rate:**
   As per interest rate parity (PPP) the currency exchange rate also depends on the Inflation difference between the economies.

(iii) **Macro-Economic Factors:**
   Along with Interest rates and inflation, GDP growth rate, Trade Surplus or Deficit or the overall Balance of Payment situation, the forex currency reserves, FDI and other foreign investments and many other Macro Economic factors are major factors of currency risk.

(iv) **Government Action:**
   Government exchange control systems can influence the currency as few countries like China pegs its currency against US Dollars which becomes a big reason for US worry on increase of its Trade Deficit with China.

(v) **Political Factors:**
   Many times, financial and economic sanctions by one government on another makes currency of the sanctioned nation very weak and volatile. The Iranian Rial, Russian Ruble or the Turkish Lira have noticed high fluctuations and weakening in their currencies in the past due to political sanctions by US.

(vi) **Speculation:**
   Majority of the fluctuation in forex rates globally has been the amount of speculation and the number of speculators. In fact it is believed that almost 90% of the total forex variation is due to speculation activity especially in the Derivatives market.

(vii) **Other reasons:**
   Any Natural Calamities, War, Coup, Rebellion etc. can have negative and a far-reaching impact on a country’s exchange rates.
15. Briefly discuss the concept of Purchasing Power Parity.

+ Purchasing Power Parity theory (PPP) theory states that the exchange rate between two countries reflects the relative purchasing power of the two countries i.e. the price at which a basket of goods can be bought in the two countries.

+ This purchasing power is measured by a tool called – inflation and hence it is the Inflation difference between two countries which will determine their exchange rate’ relationship.

**There are two forms of PPP theory:**

(i) **The Absolute Form:**
   It is also called the ‘Law of One Price’ suggests that “prices of similar products of two different countries should be equal when measured in a common currency”. If a discrepancy in prices as measured by a common currency exists, the demand should shift so that these prices should converge.

(ii) **The Relative Form:**
   It is an alternative version that accounts for the possibility of market imperfections such as transportation costs, tariffs, and quotas. It states that the rate of change in the prices of products should be approximately similar when measured in a common currency, as long as the transportation costs and trade barriers are unchanged.

**The formula for computing the forward rate using the inflation rates in domestic and foreign countries is as follows:**

\[
F = S \times \frac{(1 + i_D)}{(1 + i_F)}
\]

Where,
- \(F\) = Forward Rate of foreign currency
- \(S\) = Spot Rate
- \(i_D\) = Domestic inflation rate
- \(i_F\) = Inflation rate in foreign country
16. Explain Leading and Lagging in context of forex market

- Leading means advancing a payment i.e. making a payment before it is due.

- Lagging involves postponing a payment i.e. delaying payment beyond its due date.

**In forex market leading and lagging are used for two major purposes:**

(i) **Hedging foreign exchange risk:**
- An importer has forex risk with foreign currency appreciating or domestic currency depreciating.
- A company can lead payments if it expects the Foreign currency required to be paid is likely to appreciate. However, paying now instead of later does involve a finance cost i.e. Interest cost of money used for purchasing the currency.
- A company may lag the payment payments if it expects the Foreign currency required to be paid is likely to depreciate, provided the receiving party (exporter) agrees for this proposition. The receiving party may demand interest for this delay and that would be the cost of lagging.

(ii) **Favorable credit terms:**
- Many multinational corporations which have subsidiaries across multiple countries have access to credit from those countries as well.
- Hence, they can tactically choose between the cheapest options and accordingly reduce their cost of interest. This will either make them pay early or delay the payment depending on the interest rates of both the economies.
- Between the group companies, one of them may grant credit for longer period to the other to get the best advantage for the group as a whole.

- Therefore, the decision regarding leading and lagging should be made after **considering the below factors** of both the country’s:

  (i) Expected changes in the exchange rate
  (ii) Expected changes in interest rates
17. Forfaiting versus Export Factoring

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<thead>
<tr>
<th>Forfaiting</th>
<th>Export Factoring</th>
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<tbody>
<tr>
<td>(i) Forfaiting implies a transaction in which the forfafter purchases</td>
<td>Factoring is sale of firm’s receivables to another firm or party known as a factor at discounted prices</td>
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<tr>
<td>claims from the exporter in return for cash payment.</td>
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<tr>
<td>(ii) Forfaiting deals in the account receivables whose maturity ranges</td>
<td>Factoring deals in the receivable with shorter maturities for ex. Those that fall due within 90 days.</td>
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<tr>
<td>from medium to long term.</td>
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<td>(iii) A forfafter discounts the entire value of the note/bill.</td>
<td>A factor arranges finance to the extent of anywhere between 75-85% but not 100%.</td>
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<td>(iv) Forfaiting is always non-recourse.</td>
<td>Factoring can be recourse or non-recourse.</td>
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<td>(v) Forfaiting cost is incurred by the overseas buyer.</td>
<td>Factoring cost is incurred by the seller or client.</td>
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18. Explain cash settlement and physical settlement in derivative contracts and their relative advantages and disadvantages.

+ In Derivatives, contracts are settled either by Delivery of Asset or by Cash Settlement i.e. Net Off. The settlement mode of the contract depends on various factors including whether the contract is traded on exchange or over the counter (OTC).

+ The Indian Derivatives market is considered one of the most speculative in the world. As of date, out of the 200 stocks traded in the futures & options segment, the physical settlement mechanism already exists in the 50 stocks. SEBI plans to put all the remaining ones under the physical settlement bucket by the end of 2019.

**Physical settlement**

(i) Under physical settlement, the underlying assets are actually delivered on the specified delivery date. In other words, traders will have to take delivery of the shares against position taken in the derivative contract.

(ii) The main advantage of physical settlement is in those cases wherein the asset is actually required on future date. For ex. under a Forward Contract, an Importer would want delivery of foreign currency on due date instead of cash settlement so that the currency acquired can be used to pay the foreign seller. Similarly, a farmer who wishes to lock price of the commodity may short the same and will deliver it on maturity instead of cash settlement. It also helps in avoiding scarcity of goods in critical times and ensure smooth functioning of Inventory management system.

(iii) However, there are some disadvantages like the cost of storing the asset till delivery, the quality of asset, the risk of damage, delay in transport, etc.

**Cash settlement**

(i) Under cash settlement, the contract is settled by transfer of net difference (outflow/inflow) instead of the delivery of the underlying asset.

(ii) Most of the derivatives contracts are cash settled, this means if a futures or options contract is bought or sold on a particular date it has to settled in cash instead of actually taking the delivery of asset.

(iii) The main advantage is that it makes it very easy and opportunistic for many including speculators who can bet on the direction of asset without actually dealing with holding it physically. Hence, due to the presence of non-delivery seeking players like speculators or arbitrageurs, there is high volume and more liquidity in markets with cash settlement comparatively.

(iv) The existence of multiple players in the market is a disadvantage of cash settlement as it leads to unnecessary inflated events during the period of crises. It has been the reason of many bubbles as well as bursts.
19. Explain Exposure Netting

✦ Companies apply various methods to manage their currency exposures. Many use derivatives like forwards, futures, options, etc. to cover their currency risk. However, hedging through derivatives is many times not a completely risk-free strategy and above all it also involves cost. On the contrary, some companies may leave their currency exposures completely unhedged and take the currency risk as part of operational risk and absorb it. There are also many who use the method of Exposure Netting.

✦ Exposure Netting refers to offsetting exposures in one currency with counter exposures in the same or another currency. Here, the basic expectation is that the counter positions will net off the effect of currency, where exchange rates are expected to move in such a way that losses or gains in one position are partially or completely offset by gains or losses in another exposure.

✦ This method is like portfolio management approach used in handling systematic risk where we take stocks in the portfolio with opposite risk or negative correlations in order to ensure that the portfolio is diversified.

✦ For example, let us assume that an Indian exporter is exposed to receivables of US$ 10,000 due 3 months hence. The company can traditionally book a forward contract and get rid-off the currency risk. However, if not covered by a derivative contract like forward, the exporter is at a currency exposure to US$ with the risk of fall in its value. Now if the company/exporter also imports US$ 10,000 worth of goods/commodities it has actually built up a reverse exposure and has thus done Exposure Netting. The company has now strategically left both exposures open and not covered by derivatives thus doing an exercise in exposure netting.

✦ The concept is not very new and has been used in various industries already. In fact, for years now, the banking transactions have been based on the principle of netting, where only the difference of the summed transactions between the parties is actually transferred. This is called settlement netting.

✦ However, Exposure Netting are also subject to risk which is known as settlement risk. If the counter party defaults in one transaction, the company is still exposed to the risk of another exposure along with bearing the already occurred default loss.

✦ In the event of slowdown and volatility in Global Economy, markets have become more volatile and thus companies have become more cost conservative. This have led, many companies in India, like IT companies, which are exposed heavily to currency fluctuations, resort to a variety of Risk Management techniques including exposure netting.
20. Explain the process of Strategic Decision Making

✦ The satisfaction of the interests of the shareholder should be perceived paramount.

✦ 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 decision which should satisfy the shareholders by placing them all in an equal, optimum financial position.

✦ Capital investment is the foundation for wealth creation. However, like the traditional economic problem, this capital is not unlimited. Therefore, the problem arises with the optimum utilization of these scare capital resources between alternative options to create best yield at lowest risk for the investor.

✦ This is the point where the management will need to have in place a proper strategic decision-making process in place to constantly search for investment opportunities that generate funds for their business and are more favourable for the investors.

Overall, all businesses need to have the following three fundamental essential elements:

(i) A clear and realistic strategy – which is unambiguous, not subjective as well an achievable.

(ii) The financial resources, controls and systems - to ensure resources are available and utilized in efficient manner and

(iii) The right management team and processes to make it happen – because at the end it’s the people, principles, team coordination and clarity of vision across various sections will help achieve sustainable positive results which would be in the best interest of shareholders.

 жизнедеятельность

+ Industrial capital investment projects are normally subjected to rigorous feasibility analysis and cost benefit study from the point of view of the investors.

+ Conventional cost-benefit analysis ignores or does not consider the societal effects like impact on environment, culture, weaker sections, health & safety, use scarce natural resources, impact to the national exchequer and many other non-financial but important impact of such projects.

+ SCB analysis refers to the moral responsibility of all the enterprises to undertake socially desirable projects.

+ There can be many socially negative effects of a financially viable projects which needs to be considered before accepting. For ex. A project of installing a nuclear power plant in the nearby vicinity is not allowed by many citizens even if it is highly cost saving for a power shortage city or country.

+ Similarly, there can be many positive effects of project which needs to considered will doing the evaluation, otherwise a worthy project may get rejected. For ex. Infrastructure projects like High Speed Train may not make financial sense for many, if evaluated only based on financial outcome, especially, in a nation with high proportion of poor people.

**There are various indicators of the social contribution such as:**

(i) Employment potential criterion
(ii) A lower Carbon emission to GDP ratio
(iii) Capital output ratio – that is the output per unit of capital
(iv) Value added per unit of capital
(v) Foreign exchange benefit ratio
22. Explain linking of financial policy to strategic management

The success of any business is measured in financial term. Shareholders wealth maximization is the ultimate objective and to realise this, at every stage of its operations including policy-making, the firm should be taking strategic steps. This is the basis of financial policy being linked to strategic management.

The 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.

Some of the various aspects where the linkage between financial policy and strategic management is visible are as follows:

(i) Source of finance and capital structure are the most important dimensions of strategic plan. Companies strategize to structure the capital in a manner that optimizes the cost.

(ii) Cut-off rate (opportunity cost of capital) for acceptance of investment decisions which becomes the basis of selecting between the multiple choices of investment by choosing the one which gives highest NPV.

(iii) Investment and fund allocation whereby important Capex decisions are considered, is another important dimension of interface of strategic management and financial policy.

(iv) Risk management and mitigation strategies including managing Foreign Exchange exposures.

(v) Liquidity management - efficient utilization of company's resources and ensuing it meets up its short term as well as long term commitments.

(vi) Distribution of wealth decision also known as dividend policy decision or Issue of bonus share etc. which includes decision on whether to distribute or reinvest. This requires a close interface with the overall strategic management so that the policy should be beneficial for all.
23. Explain Financial Planning

✦ 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.

✦ Financial planning is the backbone of the Individual personal finance as well as of strategic business & corporate planning.

✦ 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.

✦ An Individual’s family, income, wealth, lifestyle, expectation of returns, tolerance of risk, liquidity preferences, unique circumstances like ethical preferences, etc. are some of the factors considered while framing the financial objective or a financial plan.

✦ For a Corporate these goals can include decisions on sources & cost of capital, optimum capital structure, capital appraisal decisions, dividend decisions, internal or external restructuring like M&A etc.

✦ The financial measures like ratio analysis, analysis of cash flow statements, multiple valuation methods, etc., are used to evaluate the performance of the Company.

**Overall there are 3 major components of Financial planning:**

(i) Financial Resources (FR)
(ii) Financial Tools (FT)
(iii) Financial Goals (FG)
24. Describe Value at Risk and its application.

+ Value at Risk (VAR) is a statistical measurement of risk.

+ It estimates how much maximum an investment might lose its value at a given probability. This investment can be a portfolio of multiple assets for an Investment management firm, capital investment in a project appraisal company, NPA for Bank or NBFC or foreign exchange exposure for an MNC, etc.

+ It was first applied in 1922 in NYSE, entered the financial world in 1990s and become world’s most widely used measure of financial risk. Many institutes, regulatory bodies have made it compulsory for firms to calculate and publish VAR on a regular basis. It has come more in light especially after the global banking and financial crises of 2007.

**Overall VAR can be applied for the following:**

(i) To measure the maximum possible loss on any portfolio or a trading position.

(ii) As a benchmark for performance measurement of any operation or trading.

(iii) To fix limits for individuals dealing in front office of a treasury department.

(iv) To enable the management to decide the trading strategies.

(v) As a tool for Asset and Liability Management especially in banks.
25. Briefly discuss Debt/Asset Securitization

- Securitization is a process of raising funds by grouping illiquid assets into investible securities. These underlying assets can be receivables for a Bank, NBFC or any other financial institution in the various forms like commercial or residential mortgages, business loans, student/education loans, credit-card debt, gold loans, hire purchase debtors, lease receivables, trade debtors, etc.

- These assets which are generating steady cash flows are bundled or packaged together and against this assets pool, marketable securities can be issued.

- Institutional Investors with surplus funds like Mutual Funds, Insurance companies, Pension & retirement Funds, Sovereign Wealth Funds as well as other Banks and NBFCs, park their money under such securitized papers to obtain better yield, maturity and also get the advantage of diversified risk.

**The process or mechanism can be classified in the following steps:**

(i) **The origination function**
   A borrower also known as obligor here, seeks a loan from finance company, which can be a bank or housing finance company, like HDFC, LIC or PNB Housing finance, etc. On the basis of the borrower’s credit worthiness, a repayment schedule is structured over the life of the loan.

(ii) **The pooling function**
   Many similar loans or receivables from various borrowers with variety of maturity, credit risk, payment schedule, etc. are clubbed together to create an underlying pool of assets. This pooled assets and its claim is then transferred from the Originator to the SPV (Special Purpose Vehicle), which is specifically created for the purpose of securitization.

(iii) **The securitization function**
   The SPV structures and bundles the assets into variety of securities which are then sold to the potential investors directly or through the help of Investment bankers. These securities carry coupon and an expected maturity, which can be asset base or mortgage based. The originator usually keeps the spread available (i.e. difference) between yield from secured asset and interest paid to investors.

(iv) **The repayment function**
   The SPV will repay the funds in the form of interest and principle to the investors of the securitized papers which if received from the pooled assets. Generally, the process of securitization can be without recourse where the investor bears the credit risk of default and the issuer is under an obligation to pay to investors only if the cash flows are received by issuer from obligors or from the collateral.
(v) **Credit rating**

To ensure the credit worthiness as well as to assess the risk of the issuer, the securitized papers are rated through credit rating agencies. A credit enhancement in the form of additional assets as collateral, bank guarantee, insurance, letter of credit, etc. can add as a cushion for investors in the event of uncertain financial crises.
26. Explain the primary participants and secondary participants in securitization

**Primary Participants**

They are the main parties to this process who wish to raise capital or invest the surplus.

(i) **Originator:**
Originator is the initiator of the deal and can be termed as sponsor. It is an entity which sells the assets lying in its books and receives the funds generated through the sale of such assets.

(ii) **Special Purpose Vehicle:**
A SPV is created especially for the purpose of securitization only and normally could be in form of a company, a firm, a society or a trust. Since issuer originator transfers all rights in assets to SPV, it holds the legal title of these assets.

(iii) **The Investors:**
Investors are the buyers of securitized papers which are mostly institutional investors such as mutual funds, provident funds, insurance companies, sovereign wealth funds, corporates, other Banks and NBFCs, etc.

**Secondary Participants**

They are the ones involved in helping the process of securitization.

(i) **Obligors:**
They are the original borrowers or the parties who owe money to the originator firm and therefore are assets in the Balance Sheet of Originator.

(ii) **Agent or Trustee:**
Trustees are appointed to oversee that all parties to the deal perform in the true spirit of terms of agreement. Normally, it takes care of interest of investors who acquires the securities.

(iii) **Rating Agency:**
The credit rating agencies are appointed to assess the credibility of the borrower. Since the securitization is based on the pools of assets rather than the originators the asset quality is evaluated by these agencies which forms an indicator for investment risk and yields.

(iv) **Credit Enhancer:**
To lower the risk of papers, investors seek additional comfort in the form of credit enhancement. It can be done through providing additional security, bank guarantee, better quality assets, Insurance, LC, etc.
(v) **Receiving and Paying Agent (RPA):**
Also, called Servicer or Administrator, it collects the payment due from obligor(s) and passes it to SPV. It also follows up with defaulting borrower and if required initiate appropriate legal action against them. Originator itself or a third party say a bank may provide an additional comfort called Credit Enhancer. While originator provides his comfort in the form of over collateralization or cash collateral, the third party provides it in form of letter of credit or surety bonds.

(vi) **Structurer:**
It brings together the originator, investors, credit enhancers and other parties to the deal of securitization. Normally, these are investment bankers also called arranger of the deal. It ensures that deal meets all legal, regulatory, accounting and tax laws requirements.
27. Explain the benefits of Securitization from the point of view of originator

+ The securitization process helps not only the originator, but it also comes with several benefits for the investors. Overall it helps the markets as well by spreading the risk which no longer gets concentrated in the hands of few as it was evident in the 2008 subprime financial mortgage crises with the collapse of giant investment banks like Lehman bros or Bear sterns and many more.

The various benefits of securitization to the originator are as follows:

(i) **Off-Balance Sheet Financing:**
When loan/receivables are securitized it release a portion of capital tied up in these assets, resulting in off Balance Sheet financing which helps in improving the liquidity position thus expanding the business of the company.

(ii) **Focus on core business:**
By transferring the assets to the SPV, the Originator can now concentrate more on core business of creating more loans instead of spending time and resources on the other activities like servicing of loan. Further, in case of non-recourse arrangement even the burden of default is shifted.

(iii) **Helps to improve financial ratios:**
Especially in case of Financial Institutions and Banks, it helps to manage Capital-To-Weighted Asset Ratio effectively. It also helps in improving the NPA position especially with the burden of default being shifted from the books of originator with factoring.

(iv) **Reduced borrowing Cost:**
Since securitized papers are relatively less risky due to the aspect of diversification, their improved credit rating and credit enhancement helps the originator earn a healthy spread and further helps it to issue or raise additional debt at reduced cost of borrowings.

+ Overall, in context of India the impact of securitization has been more or less similar to the global markets, whereby on one hand few companies like Bajaj Finance, LIC Housing Finance or HDFC have made tremendous amount of wealth for the company as well as shareholders. However, some recent cases like the debacle of DHFL, IL&FS, etc. have raised some concerns regarding mishandling and complexities with securitization.
28. Compare and contrast start-ups and entrepreneurship. Describe the priorities and challenges which start-ups in India are facing.

Startups are different from entrepreneurship. The major differences between them have been discussed in the following paragraphs:

<table>
<thead>
<tr>
<th>Start-Ups</th>
<th>Entrepreneurship</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) Refer to newly emerged business venture</td>
<td>Refers to all business ventures whether new or old.</td>
</tr>
<tr>
<td>(ii) They are started with intention to solve unique problems and grow at large scale with focus on innovation and technology</td>
<td>Entrepreneurs look for business opportunities that creates ways to make profitable business</td>
</tr>
<tr>
<td>(iii) They are highly risky and have a huge rate of failure</td>
<td>An established entrepreneurship is relatively less risky but may also not grow at very high rates as the start-up</td>
</tr>
<tr>
<td>(iv) Getting funding is generally difficult for a startup</td>
<td>An established entrepreneurship gets fund easily from the traditional banking and non-banking sources due to its age and past credit</td>
</tr>
</tbody>
</table>

Priorities and challenges which startups in India are facing

+ In a country with high rate of unemployment and with the disruption of technology, it is perhaps difficult to provide jobs to everyone. Thus, by creating a conducive environment, the society and government can both work together to ensure the sustainability and growth of startups which are in itself opportunities for generating more employment and economic benefit.

+ However, even after a constant support and assistance, startups still face challenges or difficulties in India, some of which are highlighted as below:

(i) **Lack of skilled workforce:** Adding huge amount of time and money in training.

(ii) **Human resource issues:** It is very difficult to get a resource at right time at right cost. Also, startups have high rate of staff turnover and even layoffs can be a nightmare for many startups.

(iii) **Funding:** Startups are known for cash burn; hence they require funding in multiple rounds, and many have been closed due to the inability to raise more money.

(iv) **Regulations:** Although quite eased, there are still many bureaucratic hindrances and policy roadblocks like Angel Tax, which makes it difficult for startups to function smoothly.
29. Explain the concept of Bootstrapping and describe the various methods of bootstrapping used by startups.

- Funding is the fuel for startups and hence, they hunt for various sources. Until they find a proper source of finance through Venture Capital or Angel Investor or any HNI, they resort to funding themselves by investing their own money.

- Bootstrapping is one of the most important and primary sources of funding a start-up. It is known as self-funding and is an effective way when starting a new business.

- It is a process whereby the startup founders attempt to fund and build the company from their personal finances or from the operating revenues generated from the start-up company itself.

- It is a more cautious approach compared to and helps to avoid some common mistake made by most founders who make unnecessary expenses towards marketing, lavish offices and equipment that they cannot really afford. Thus, it helps curbs wasteful expenditure which is vital for the start-ups long run sustainability.

**There are various methods through which a Startups can Bootstrap:**

1. **Trade Credit:** It is highly difficult for a startup company to get trade credit from traditional channels of banks due to the strict credit guidelines of banking regulations, etc. Therefore, startups try getting access to trade credit by mortgaging their own assets like property or goods or even personal belongings like gold, company stocks, etc.

2. **Factoring:** This is a financing method where accounts receivable of a business organization is sold to a commercial finance company to raise capital. The factor assumes the task of collecting the receivables as well as providing vital funding.

3. **Leasing:** Investing or blocking huge capital in buying real assets is not wise for a startup which already faces funding issues. Thus, bootstrapping is to take the equipment on lease rather than purchasing it. Startups can also use shared office spaces like WEWORK, etc. which will reduce its operating as well as capital cost.

4. **Credit Card:** Many startup founders use their personal credit card limits to buy necessary things like small equipment and thus reduce the cost as well take advantage of the credit points or cashbacks to buy more goods.

5. **Other Sources:** Various other sources including but not limited to loans from relatives, friends, pre-order booking, contests and even government sources are used for funding the company itself instead of arranging from other sources.
30. Explain Startup India Initiative

With the aim of simplifying the process and improving the ease of doing business in India, the Hon. Prime Minister of India, Narendra Modi, on his address to the nation on occasion of 15th August 2015, announced the launch of the **Startup India Initiative**.

The major objective of the initiative is to discard the restrictive policies like multiple licenses, land permissions, environment clearances, foreign investment restrictions, etc.

**As per the program, a startup is:**

(i) An entity incorporated or registered in India  
(ii) Opened in less than 7 years ago  
(iii) Has annual turnover of less than Rs. 25 Crore in last F.Y.

**The 19-point Startup India Action Plan envisaged several measures which includes few major ones like:**

- Creation of Rs.10,000 Crore of Start-Up pool  
- No capital gains tax for the first 3 years of operation  
- No tax on income for the first 3 years of operation  
- MUDRA Bank to provide micro finance at concessional rates  
- Improvement in Bankruptcy code with 90-day exit window  
- Setting up of new research parks in IITs of Rs. 100 Crore each  
- Setting up multiple incubators and innovation centres at national institutes  
- A single portal for registration, clearances and approval

Since, its launch, the programme has seen a phenomenal growth story so far. India has climbed up to the 77th position in UN's Ease of Doing Business Ranking from 142 in 2014 to 77 in 2018. It has also been attracting globally-acclaimed investors, multinationals leveraging Indian tech start-ups to supplement their technology, and is home to more than 39K start-ups.
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