STRATEGIC FINANCIAL MANAGEMENT
CA - FINAL

THEORY BOOK

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STRATEGIC FINANCIAL MANAGEMENT THEORY

1. FINANCIAL POLICY AND CORPORATE STRATEGY

Q.1) Explain the Interface of Financial Policy and Strategic Management.

a) Sources of finance and capital structure are the most important dimensions of a strategic plan.
b) The generation of funds may arise out of ownership capital and or borrowed capital.
c) A company may issue equity shares and/or preference shares for mobilizing ownership capital and debentures to raise borrowed capital.
d) There are some norms for debt equity ratio which need to be followed for minimizing the risks of excessive loans. For instance, in case of public sector organizations, the norm is 1:1 ratio and for private sector firms, the norm is 2:1 ratio. However this ratio in its ideal form varies from industry to industry. It also depends on the planning mode of the organization.
e) Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions.
f) 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 divided into three groups.
g) One type of proposal will be for addition of a new product by the firm. Another type of proposal will be to increase the level of operation of an existing product through either an increase in capacity in the existing plant or setting up of another plant for meeting additional capacity requirement.
h) Cost reduction and efficient utilization of resources through a new approach and/or closer monitoring of the different critical activities.

Q.2) Write a short note on Balancing Financial Goals vis-à-vis Sustainable Growth.

a) The concept of sustainable growth can be helpful for planning healthy corporate growth.
b) 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.
c) Often, a conflict can arise if growth objectives are not consistent with the value of the organization's sustainable growth. 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.

d) Financial goal plays an important role in enterprise development as it helps enterprises in achieving sustainable growth and not too fast and too slow which will be against the enterprise growth and development policies.

Q.3) What makes an organization financially sustainable?

To be financially sustainable, an organization must:

a) Have more than one source of income;
b) Have more than one way of generating income;
c) Do strategic, action and financial planning regularly;
d) Have adequate financial systems;
e) Have a good public image;
f) Be clear about its values (value clarity); and
g) Have financial autonomy.

Q.4) What makes an organization sustainable?

In order to be sustainable, an organization must:

a) Have a clear strategic direction
b) Be able to scan its environment or context to identify opportunities for its work
c) Be able to attract, manage and retain competent staff
d) Have an adequate administrative and financial infrastructure
e) Be able to demonstrate its effectiveness and impact in order to leverage further resources; and
f) Get community support for, and involvement in its work.

2. INDIAN FINANCIAL SYSTEM

Q.1) Explain the important characteristics of Financial Instruments.

Financial instruments are those instruments which have a monetary value.

The important characteristics of financial instruments are enumerated as below:

a) **Marketing**
   1. Financial instruments facilitate easy trading on the market.
   2. They have a ready market.

b) **Maturity period**
   The maturity period of financial instruments may be short term, medium term or long term.

c) **Risk**
   1. Financial instruments carry risk.
   2. Equity based instruments are riskier in comparison to debt based instruments because the payment of dividend is uncertain.
   3. A company may not declare dividend in a particular year.
   4. However, payment of principle or interest is more or less certain unless the company gets insolvent.

d) **Future trading**
   Financial instruments facilitate future trading so as to cover risks arising out of price fluctuations, interest rate fluctuations etc.

e) **Transferability**
   Financial instruments can be transferred from one person to another.

f) **Transaction cost**
   1. Financial instruments involve buying and selling cost.
   2. The buying and selling costs are called transaction costs.

g) **Collateral value**
   Financial instruments can be pledged for getting loans.

h) **Liquidity**
   Financial instruments provide liquidity. These can be easily and quickly converted into cash.

Q.2) Explain various types of Financial Services.

Financial services are services which involves investment, lending, management of money and assets.

The various types of financial services are briefly explained as below:

a) Asset Restructuring/Management Company

1. Asset reconstruction company's (ARC) first task is to manage and convert the sick companies or those companies whose NPA's rose to a significant level into profitable ones.
2. Asset Management Companies (AMC's) pool large amount of funds from various source of investors and invest these pooled resources in diverse securities by paying out proportional returns to the investors. Simply put, they help their client to invest money and buy securities.

b) Debit Cards

1. Debit cards are also known as cheque cards.
2. A debit card is a plastic card that provides the cardholder electronic access to his or her bank account(s) at a financial institution.
3. Debit cards are different from credit cards. While a credit card is to "pay later," a debit card is to "pay now."
4. When one uses a debit card his money is immediately deducted from his cheque or savings account.

c) Online Share Trading

Online stock trading is an internet based stock trading facility where investor can trade shares through a website without any manual intervention from the broker.

d) Factoring

This concept has not been fully developed in our country and most of their work is done by companies themselves.

e) Investment Banking

1. Companies need cash in order to grow and expand their businesses.
2. Investment banks sell securities to public investors in order to raise the cash. These securities come in the form of stocks or bonds.
3. Thus, Investment banks are essentially financial intermediaries, who assist their clients in raising capital either by underwriting their shares or bonds or by acting as an agent (merchant banker) in the issuance of securities.

f) Credit Rating

Credit Rating means an assessment made from credit-risk evaluation, translated into a current opinion as on a specific date on the quality of a specific debt security issued or on obligation undertaken by an enterprise in terms of the ability and willingness of the obligator to meet principal and interest payments on the rated debt instrument in a timely manner.

g) Housing Finance

Housing loans are viewed as one of the important barometers of measuring growth in an economy. The demand for Housing Finance comes from:

- Salary earners and self-employed professionals with their basic need of a roof over their head.
- Nonresidents having an eye on capital appreciation of the asset or with an eye to their possible resettlement in India for NRIs.

Q.3) What are the key elements of a well-functioning of a Financial System.

Key elements of a well-functioning financial system are explained as below:

a) A strong legal and regulatory environment

1. Capital market is regulated by SEBI which acts a watchdog of the securities market.
2. This has been ensured through the passing of SEBI Act, Securities Contract Regulation Act and numerous SEBI rules, regulations and guidelines.
3. Likewise money market and foreign exchange market is regulated by RBI and this has been ensured through various provisions of the RBI Act, Foreign Exchange Management Act etc.

b) Stable money

1. Money is an important part of an economy.
2. Frequent fluctuations and fluctuations and depreciations in the value of money lead to financial crises and restrict the economic growth.

c) Sound public finances and public debt management

1. Public debt management refers to managing the government's debt in order to raise the required amount of funding.
2. It also includes developing and maintaining an efficient market for government securities.

d) Sound banking system

1. A well-functioning financial system must have large variety of banks both in the private and public sector having both domestic and international operations.
2. Banks also undertake credit risk analysis and assess the expected risk and return of a project before giving any loan for a proposed project.

e) A central bank

1. A central bank supervises and regulates the operations of the banking system.
2. It acts as a banker to the banks and government, manager of money market and foreign exchange market and also lender of the last resort.

f) Information System

All the participants in the financial system requires information at some stage or the other. Proper information disclosure practices form basis of a sound financial system.

Q.4) Explain the various banking functions of RBI.

As per the RBI Act, 1934, RBI performs three types of functions:

(i) Banking Functions

a) **Issuer of Bank Notes**

1. Under Section 22 of the Reserve Bank of India Act, the bank has the sole right to issue bank notes of all denominations.
2. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government.

b) **To act as government banker, agent and adviser**

1. The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser.
2. The Reserve Bank is agent of Central Government and of all State Governments in India except the State of Jammu and Kashmir.

c) **Bankers' Bank and Lender of the Last Resort**

The commercial banks always look up to RBI in case of any need for funds. Therefore, they are called bankers' bank and lender of the last resort.

d) **Controller of Credit**

1. The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India.
2. It can do so through changing the Bank rate or through open market operations.
3. Further, on every weekly Friday which is called the reporting Friday, the commercial banks have to report to the RBI that they are complying with CRR (presently 4%) and SLR (presently 20.5%) requirements.

(ii) Supervisory Functions

The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation.

(iii) Promotional Functions

1. The Central Bank (RBI) now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking.
2. So, the Reserve Bank was asked to promote banking habit amongst the people.
3. People are encouraged to open Jan Dhan Account in urban and rural areas on the basis of their Aadhar Card.
4. Now, people are asked to resort to online banking as the Government is promoting cashless economy. Earlier, the Reserve Bank has helped in the setting up of the IFCI, SFCs, it set up the DIC, UTI, IDBI, NABARD.

Q.5) Explain the importance of IRDA

Importance of Insurance Regulatory and Development Authority (IRDA):

a) **Regulation of Insurance Sector**
   1. IRDA has a significant effect on the overall regulation of Indian Insurance Sector.
   2. In order to keep the proper protection of the policy holder's interests, Insurance Regulatory and Development Authority (IRDA) closely observe the different activities of insurance sector in India.

b) **Protection of Policyholders Interests**
   The core objective or purpose of the Insurance Regulatory and Development Authority is to protect the interests of policyholders and IRDA is doing that with aplomb.

c) **Awareness to Insurance**
   In order to increase the awareness of insurance in the society, IRDA is trying to convince the prospective investors about the transparency of the system and the effort being put by the regulator to put this into practice.

d) **Saving and Investment of Individual**
   Insurance Regulatory and Development Authority has made insurance a popular & profitable mode of investment and inculcate saving habits among various sections of the society.

e) **Banks and Post Offices**
   Insurance sector is now giving security against any kind of uncertainty or risk, so the insurance sector has now become a popular medium for savings & investments and is gradually diverting the flow of funds from banks & post offices to insurance industry.

f) **Insurance Market**
   Insurance sector has grown leap and bounds due to the concerted efforts of Insurance Regulatory and Development Authority with respect to marketing of insurance products, competition & customer awareness.

Q.6) Write short note on RERA.

a) Even though it has such strong presence in the country, it never had a regulating body. Due to the failure of the government to observe this, many people have become the victims of some scheming people doing the real estate business. Finally, the government delivered by making an authority known as RERA which stands for Real Estate Regulatory Authority.
This promises to bring a justice to the buyer through making strict policies that have to be fulfilled by the developers to sell their projects. The major problem is that of the delayed possession given to the home seeker by the rich and the cunning builders.

b) Following are some of the risks that people face through developers:
   - Selling of flats multiple times to different parties.
   - Delay in giving possession to the buyer which happens due to various reasons and malpractices.
   - The contracts made are one-sided in the favour of the developer.

c) Apart from these risks, the buyer has to unwillingly become a part of a major tussle between the developers and the government relating to the approval of the projects.

d) There will be a huge relief for the buyers regarding developer-specific risk.

e) Transparency is the key point regarding the rules under RERA as the government wants that every aspect of information that the general public should know should be made available on an informational portal.

f) All the builders will have to register themselves under RERA which will see a low risk in the property business.

Q.7) Write short note on AMFI.

<u>Objectives of AMFI:</u>

a) To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry.

b) To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management.

c) To interact with the Securities and Exchange Board of India (SEBI) and to represent to SEBI on all matters concerning the mutual fund industry.

d) To represent to the Government, Reserve Bank of India and other bodies on all matters relating to the Mutual Fund Industry.

e) To undertake nationwide investor awareness programme so as to promote proper understanding of the concept and working of mutual funds.

f) To disseminate information on Mutual Fund Industry and to undertake studies and research directly and/or in association with other bodies.

g) To protect the interest of investors/unit holders.

Q.8) Write short note on FEDAI.

Foreign Exchange Dealers Association of India (FEDAI) was set up in 1958 as an Association of banks dealing in foreign exchange (forex) in India (typically called Authorised Dealers - ADs) as a self-regulatory body.

It's major activities include framing of rules governing the conduct of inter-bank foreign exchange business among banks vis-a-vis public and liaison with RBI for reforms and development of forex market.

Functions:

Presently, some of the functions of FEDAI are as follows:

a) Guidelines and Rules for Forex Business.
b) Training of Bank Personnel in the areas of Foreign Exchange Business.
c) Accreditation of Forex Brokers.
d) Advising/Assisting member banks in settling issues/matters in their dealings.
e) Represent member banks on Government/Reserve Bank of India/Other Bodies.
f) Announcement of daily and periodical rates to member banks.

3. RISK MANAGEMENT

Q.1) Write note on identification of types of risk faced by an organization.

a) Strategic Risk

1. Strategic risk is a risk in which a company's strategy becomes less effective and it struggles to achieve its goal.
2. It could be due to technological changes, a new competitor entering the market, shifts in customer demand, increase in the costs of raw materials, or any number of other large-scale changes.

b) Compliance Risk

1. Every business needs to comply with rules and regulations.
2. For example with the advent of Companies Act, 2013, and continuous updating of SEBI guidelines, each business organization has to comply with plethora of rules, regulations and guidelines. Non compliance leads to penalties in the form of fine and imprisonment.

c) Operational Risk

1. It also relates to failure on the part of the company to cope with day to day operational problems.
2. Operational risk relates to 'people' as well as 'process'. We will take an example to illustrate this. For example, an employee paying out 1,00,000 from the account of the company instead of 10,000.

d) Financial Risk

1. Financial Risk is referred as the unexpected changes in financial conditions such as prices, exchange rate, Credit rating, and interest rate etc.
2. Accordingly, the Financial Risk can be divided into following categories:
   - Counter Party Risk
   - Political Risk
   - Interest Rate Risk
   - Currency Risk

Q.2) Write note on evaluation of financial risk.

The financial risk can be evaluated from different point of views as follows:

a) From stakeholder's point of view

1. 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 event of winding up of a company they will be least prioritized.
2. 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 or (like Lehman Brothers) down grading of any financial institution leading to spread of distrust among society at large.

Q.3) Write note on application of VALUE-AT-RISK.

a) VAR is a measure of risk of investment.
b) Given the normal market condition in a set of period, say, one day it estimates how much an investment might lose. This investment can be a portfolio, capital investment or foreign exchange etc.,
c) VAR answers two basic questions -
    - What is worst case scenario?
    - What will be loss?
d) VAR can be applied:
    - To measure the maximum possible loss on any portfolio or a trading position.
    - As a benchmark for performance measurement of any operation or trading.
    - To fix limits for individuals dealing in front office of a treasury department.
    - To enable the management to decide the trading strategies.
    - As a tool for Asset and Liability Management especially in banks.

4. SECURITIZATION

Q.1) Write note on Securitization.

The process of securitization typically involves the creation of pool of assets from the illiquid financial assets, such as receivables or loans which are marketable.

The securitization has the following features:

a) **Creation of Financial Instruments**
   The process of securities can be viewed as process of creation of additional financial product of securities in market backed by collaterals.

b) **Trenching**
   Portfolio of different receivable or loan or asset are split into several parts based on risk and return they carry called 'Trenche'. Each Trench carries a different level of risk and return.

c) **Structured Finance**
   In the process of securitization, financial instruments are tailor structured to meet the risk return trade of profile of investor, and hence, these securitized instruments are considered as best examples of structured finance.

d) **Homogeneity**
   Under each trenche the securities are issued of homogenous nature and even meant for small investors the who can afford to invest in small amounts.

e) **Bundling and Unbundling**
   When all the assets are combined in one pool it is bundling and when these are broken into instruments of fixed denomination it is unbundling.

Q.2) Write note on benefits of Securitization.

The benefits of securitization can be viewed from the angle of various parties involved as follows:

From the angle of originator

Originator (entity which sells assets collectively to Special Purpose Vehicle) achieves the following benefits from securitization

a) 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 leading to improved liquidity position which helps expanding the business of the company.

b) More specialization in main business
   1. By transferring the assets the entity could concentrate more on core business as servicing of loan is transferred to SPV.
   2. Further, in case of non-recourse arrangement even the burden of default is shifted.

c) **Helps to improve financial ratios**
Especially in case of Financial Institutions and Banks, it helps to manage Capital -To-Weighted Asset Ratio effectively.

d) **Reduced borrowing Cost**
Since securitized papers are rated due to credit enhancement even they can also be issued at reduced rate as of debts and hence the originator earns a spread, resulting in reduced cost of borrowings.

From the angle of investor
Following benefits accrues to the investors of securitized securities.

a) **Diversification of Risk**
Purchase of securities backed by different types of assets provides the diversification of portfolio resulting in reduction of risk.

b) **Regulatory requirement**
Acquisition of asset backed belonging to a particular industry say micro industry helps banks to meet regulatory requirement of investment of fund in industry specific.

c) **Protection against default**
1. In case of recourse arrangement if there is any default by any third party then originator shall make good the least amount.
2. Moreover, there can be insurance arrangement for compensation for any such default.

Q.3) Write note on participants in Securitization.

Primary Participants
Primary Participants are main parties to this process. The primary participants in the process of securitization are as follows:

a) **Originator**
1. It is the initiator of deal or can be termed as securitizer.
2. It is an entity which sells the assets lying in its books and receives the funds generated through the sale of such assets. The originator transfers both legal as well as beneficial interest to the Special Purpose Vehicle (discussed later).

b) **Special Purpose Vehicle**
1. Also, called SPV is created for the purpose of executing the deal.
2. Since issuer originator transfers all rights in assets to SPV, it holds the legal title of these assets. It is created especially for the purpose of securitization only.
3. The main objective of creating SPV to remove the asset from the Balance Sheet of Originator. Since, SPV makes an upfront payment to the originator, it holds the key position in the overall process of securitization.

c) **The Investors**

1. Investors are the buyers of securitized papers which may be an individual, an institutional investor such as mutual funds, provident funds, insurance companies, mutual funds, Financial Institutions etc.
2. Since, they acquire a participating in the total pool of assets/receivable, they receive their money back in the form of interest and principal as per the terms agree.

Secondary Participants

Besides the primary participants other parties involved into the securitization process are as follows:

a) **Obligors**

1. Actually they are the main source of the whole securitization process.
2. They are the parties who owe money to the firm and are assets in the Balance Sheet of Originator. The amount due from the obligor is transferred to SPV and hence they form the basis of securitization process and their credit standing is of paramount importance in the whole process.

b) **Rating Agency**

1. Since the securitization is based on the pools of assets rather than the originators, the assets have to be assessed in terms of its credit quality and credit support available.
2. Rating agency assesses the following:
   - Strength of the Cash Flow.
   - Mechanism to ensure timely payment of interest and principle repayment.
   - Credit quality of securities.
   - Liquidity support.
   - Strength of legal framework.
3. Although rating agency is secondary to the process of securitization but it plays a vital role.

c) **Receiving and Paying agent (RPA)**

1. Also, called Servicer or Administrator, it collects the payment due from obligor(s) and passes it to SPV.
2. It also follow up with defaulting borrower and if required initiate appropriate legal action against them. Generally, an originator or its affiliates acts as servicer.

d) **Agent or Trustee**

1. Trustees are appointed to oversee that all parties to the deal perform in the true spirit of terms of agreement.
2. Normally, it takes care of interest of investors who acquires the securities.

Q.4) Write note on mechanism (Steps) of Securitization.

a) **Creation of Pool of Assets**
The process of securitization begins with creation of pool of assets by segregation of assets backed by similar type of mortgages in terms of interest rate, risk, maturity and concentration units.

b) **Transfer to SPV**
One assets have been pooled, they are transferred to Special Purpose Vehicle (SPV) especially created for this purpose.

c) **Sale of Securitized Papers**
SPV designs the instruments based on nature of interest, risk, tenure etc. based on pool of assets. These instruments can be Pass Through Security or Pay Through Certificates, (discussed later).

d) **Administration of assets**
The administration of assets in subcontracted back to originator which collects principal and interest from underlying assets and transfer it to SPV, which works as a conduct.

e) **Recourse to Originator**
Performance of securitized papers depends on the performance of underlying assets and unless specified in case of default they go back to originator from SPV.

f) **Repayment of funds**
SPV will repay the funds in form of interest and principal that arises from the assets pooled.

g) **Credit Rating to Instruments**
Sometime before the sale of securitized instruments credit rating can be done to assess the risk of the issuer.

Q.5) Write note on problems in Securitization.

a) **Stamp Duty**
1. Stamp Duty is one of the obstacle in India.
2. Under Transfer of Property Act, 1882, a mortgage debt stamp duty which even goes upto 12% in some states of India and this impeded the growth of securitization in India.

b) **Taxation**
1. Taxation is another area of concern in India.
2. In the absence of any specific provision relating to securitized instruments in Income Tax Act experts opinion differ a lot.
3. Some are of opinion that in SPV as a trustee is liable to be taxed in a representative capacity then other are of view that instead of SPV, investors will be taxed on their share of income.

4. Clarity is also required on the issues of capital gain implications on passing payments to the investors.

c) <u>Accounting</u>

1. Accounting and reporting of securitized assets in the books of originator is another area of concern.
2. Although securitization is slated to an off-balance sheet instrument but in true sense receivables are removed from originator's balance sheet.
3. Problem arises especially when assets are transferred without recourse.

d) <u>Lack of standardization</u>

Every originator follows own format for documentation and administration have lack of standardization is another obstacle in growth of securitization.

e) <u>Inadequate Debt Market</u>

Lack of existence of a well-developed debt market in India is another obstacle that hinders the growth of secondary market of securitized or asset backed securities.

Q.6) Write note on Securitization instruments.

On the basis of different maturity characteristics, the securitized instruments can be divided into following three categories:

a) <u>Pass Through Certificates (PTCs)</u>

1. As the title suggests originator (seller of eh assets) transfers the entire receipt of cash in form of interest or principal repayment from the assets sold. Thus, these securities represent direct claim of the investors on all the assets that has been securitized through SPV.
2. Since all cash flows are transferred the investors carry proportional beneficial interest in the asset held in the trust by SPV.

b) <u>Pay Through Security (PTS)</u>

1. As mentioned earlier, since, in PTCs all cash flows are passed to the performance of the securitized assets. To overcome this limitation and limitation to single mature there is another structure i.e. PTS.
2. In contrast to PTC in PTS, SPV debt securities backed by the assets and hence it can restructure different tranches from varying maturities of receivables.
3. In other words, this structure permits desynchronization of servicing of securities issued from cash flow generating from the asset. Further, this structure also permits the SPV to reinvest surplus funds for short term as per their requirement.

c) Stripped Securities

1. Stripped Securities are created by dividing the cash flows associated with underlying securities into two or more new securities. Those two securities are as follows:
    - Interest Only (I0) Securities
    - Principle Only (PO) Securities
2. As each investor receives a combination of principal and interest it can be stripped into two portion of Interest and Principle.
3. Accordingly, the holder of 10 securities receives only interest while PO security holder receives only principal. Being highly volatile in nature these securities are less preferred by investors.
4. In case yield to maturity in market rises , PO price tends to fall as borrower prefers to postpone the payment on cheaper loans. Whereas if interest rate in market falls, the borrower tends to repay the loans as they prefer to borrow fresh at lower rate of interest.
5. In contrast, value of IO's securities increases when interest rate goes up in the market as more interest is calculated on borrowings.
6. However, when interest rate due to prepayments of principals, IO's tends to fall.
7. Thus, from the above, it is clear that it is mainly perception of investors that determines the prices of IOs and Pos.

<u>5. INTERNATIONAL FINANCIAL CENTRE (IFC)</u>

Q.1) Write note on benefits of IFC.

IFC is a hub that deals with flow of funds, financial products and financial services though in own land but with different set of regulation and laws.

Some major benefits emanating from establishing IFC are as follows:

a) Opportunity for qualified professionals working outside India come here and practice their profession.
b) A platform for qualified and talented professionals to pursue global opportunities without leaving their homeland.
c) Stops Brain Drain from India.
d) Bringing back those financial services transactions presently carried out abroad by overseas financial institutions/entities or branches or subsidiaries of Indian Financial Market.
e) Trading of complicated financial derivative can be started from India.

Q.2) Write note on constituents of IFC.

Although there are many constituents for IFC but some of the important constituent are as follows:

a) <u>Highly developed Infrastructure</u>

A leading edge infrastructure is prerequisite for creating a platform to offer internationally completive financial services.

b) <u>Quality Life</u>

The quality of life at the center showed be good as center retains highly paid professional from own country as well from outside.

c) <u>Stable Political Environment</u>

Destabilized political environment brings country risk investment by foreign nationals. Hence, to accelerate foreign participation in growth of financial center, stable political environment is prerequisite.

d) <u>Strategic Location</u>

The geographical location of the finance center should be strategic such as near to airport, seaport and should have friendly weather.

e) <u>Sustainable Economy</u>

The economy should be sustainable and should possess capacity to absorb all the shocks as it will boost investors' confidence.

Q.3) Write note on GIFT – India's First International Financial Center.

a) To compete with its rivals Dubai, Hong Kong the idea of setting up an International Financial Center in India was coined in 2007 at Gandhinagar, Gujarat.
b) The main motive of setting up IFC in India was to retain the financial services businesses in India which moves out of India.
c) Since foreign investors normally remains hesitant to get registered in India GIFT city provides them a separate jurisdiction where it is easy to do business because of relaxed tax and other laws.
d) With the objective of achieving sustainable growth and achieving above cited objective India's honorable Prime Minister in inaugurated India's first International Exchange - India INX, a wholly owned subsidiary of Bombay Stock Exchange on 9/1/2017. The India INX has stated trading in Index, currency, commodity and equity derivatives.
e) On 5th June, 2017, National Stock Exchange (NSE) the competitor of Bombay Stock Exchange (BSE) also launched its trading at GIFT. Initially, it started trading in derivative products in equity, currency, interest rate futures and commodities. However, it is planning to trade in more equity instruments of Indian and foreign companies, base metals, energy and interest rates.

Q.4) How is Islamic Finance different from Conventional Finance.

Basis	**Islamic Finance**	**Conventional Finance**
Promotion	Islamic Finance promotes just, fair and balanced society. Hence, interest is prohibited.	Based on commercial objectives and interest must be paid irrespective of outcome of business.
Ethical framework	Structured on ethical and moral framework of Sharia, holy Quran and tradition from As-Sunnah are two divine guidance.	No such framework.
Speculation	The financial transactions should be free from the element of uncertainty (Gharar) and gambling (Maisir).	No such restrictions.
Unlawful Goods and Services	Islamic Finance must not be involved in any transactions not allowed as per Islamic principles such as alcohol, armaments, pork and other socially detrimental products.	There are no such restrictions

Q.5) Explain the concept of Riba.

a) In Islamic Finance, the meaning of Riba is interest or usury.
b) In Islamic Finance money is considered as medium of exchange or unit of measurement only.
c) Riba is considered haram i.e. unfair reward to the provider of capital for little or no effort or risk undertaken.
d) Due to this reason, Islamic finance models are based on risks and profit/loss sharing contract.
e) Riba is equated with wrongful appropriation of property belonging to others and hence Muslims are asked to accept principal only and forego principal even, if borrower is unable to repay the same.
f) Since, interest is not allowed in Islamic Finance, depositors are rewarded by a share in the profit from the underlying business (after deduction of management fees) in which the funds of depositors have been channeled.
g) Thus, it can be said that money has no intrinsic value i.e. time value of money. The relationship between depositor and banker can be viewed as:
    - Agent and Principal or
    - Depositor and Custodian or
    - Investor and Entrepreneur or
    - Fellow joint partners.

Q.6) Explain the concept of Mudaraba. (Venture Financing)

a) Kind of profit sharing arrangement.
b) One party provides 100% of capital involved and other party provides specialized knowledge with exclusive responsibility of working.
c) Profit sharing in pre decided ratio and loss borne by financers.

Q.7) Explain the concept of Musharaka. (Joint Venture)

a) Joint business venture business.
b) All parties provide the capital in agreed ratio and also have right to participate in the business.
c) Loss is strictly shared in the ratio of their capital contribution, the profit is shared as per pre-agreed ratio.

Q.8) Explain the concept of Sukuk. (Debt Certificate)

a) One of the most popular Islamic financial products.
b) Kind of 'Debt Certificate' representing ownership in business or assets.
c) Through this instrument company borrows the money.
d) It differs from conventional debt instruments in following aspects:
    - To have share in profit of assets.
    - To have share in the underlying assets on realization of assets.

Q.9) Explain the concept of Ijara. (Lease)

a) lease financing arrangement.
b) One party transfer the asset to other partly for some specific time for specific fee.
c) It includes capital cost of assets and profit margin of the lessor.
d) The responsibility for maintenance of the leased items remains with the lessor.

Q.10) Explain the concept of Istisna. (Construction Contracts)

a) Kind of funding arrangements for long term construction contracts.
b) Client pays some initial amount and balance amount is payable is repaid in installments.
c) The whole project is funded by the financer and on completion of project it is delivered to the client.

Q.11) Explain the concept of Murabaha. (Cost plus Contact, Trade Credit)

a) Cost plus contract
b) Kind of trade credit or loans
c) Helps exporters and importer in meeting their funding requirements.
d) Profit margin of the financier is known to the buyer.
e) Financier buys thee assets and sells to the buyer (client) and buyer pays to the financier in installments consisting of:
    - Cost of asset financed.
    - Financier's profit on acquisition of asset.

Q.12) Explain the concept of Salam. (Forward Contract)

a) It is analogues (similar) to forward contract in the conventional finance.
b) Cash is received by the seller immediately on sale but goods as per pre-decided quality, quantity and time shall only be delivered in future.
c) Sale shall be at the discounted price so that financer could make some profit out of the deal.
d) Salam is prohibited in commodities such a gold, silver and other type of monetary assets.

6. STARTUP FINANCE

Q.1) What are ways/sources of funding a startup?

a) **Personal financing.**
   1. It may not seem to be innovative but you may be surprised to note that most budding entrepreneurs never thought of saving any money to start a business.
   2. This is important because most of the investors will not put money into a deal if they see that you have not contributed any money from your personal sources.

b) **Personal credit lines.**
   1. Credit cards are a good example of this. However, banks are very cautious while granting personal credit lines.
   2. They provide this facility only when the business has enough cash flow to repay the line of credit.

c) **Purchase order financing.**
   1. The most common scaling problem faced by startups is the inability to find a large new order.
   2. The reason is that they don't have the necessary cash to produce and deliver the product. Purchase order financing companies often advance the required funds directly to the supplier.

d) **Family and friends.**
   1. These are the people who generally believe in you, without even thinking that your idea works or not.
   2. However, the loan obligations to friends and relatives should always be in writing as a promissory note or otherwise.

e) **Factoring accounts receivables.**
   1. Factor will pay most of the sold amount upfront and rest of the amount later.
   2. In this way startup can meet is day to day expenses.

f) **Microloans.**
   1. Microloans are small loans that are given by individuals at a lower interest to a new business ventures.
   2. These loans can be issued by a single individual or aggregated across a number of individuals who each contribute a portion of the total amount.

Q.2) Write note on pitch presentation.

a) Introduction
b) Team
c) Problem

d) Solution
e) Marketing/Sales
f) Projections
    - Income Statement
    - CFS
    - B/S
g) Competition
h) Business Model
i) Financing

Q.3) What are the modes of financing for startups?

a) Bootstrapping

An individual is said to be boot strapping when he or she attempts to found and build a company from personal finances or from the operating revenues of the new company. Here are some of the methods in which a startup firm can bootstrap:

- **Trade Credit**
    1. When a person is starting his business, suppliers are reluctant to give trade credit.
    2. However, a way out in this situation is to prepare a well-crafted financial plan.
    3. The next step is to pay a visit to the supplier's office.
    4. Communication skills are important here. The financial plan has to be shown. So trade credit is one of the most important ways to reduce the amount of working capital one needs.

- **Factoring**
    1. This is a financing method where accounts receivable of a business organization is sold to a commercial finance company to raise capital.
    2. Factoring can be performed on a non-notification basis. It means customers may not be told that their accounts have been sold.
    3. The process of factoring may actually reduce costs for a business organization associated with maintaining accounts receivable such as bookkeeping, collections and credit verifications.

- **Leasing**
    1. Another popular method of bootstrapping is to take the equipment on lease rather than purchasing it.
    2. It will reduce the capital cost and also help lessee to claim tax exemption.
    3. So, it is better to a take a photocopy machine, an automobile or a van on lease to avoid paying out lump sum money which is not at all feasible for a startup organization.

b) Angel Investors

1. Angel investors invest in small startups or entrepreneurs.
2. Often, angel investors are among an entrepreneur's family and friends.

3. The capital angel investors provide may be a one-time investment to help the business propel or an ongoing injection of money to support and carry the company through its difficult early stages.
4. Angel investors provide more favorable terms compared to other lenders, since they usually invest in the entrepreneur starting the business rather than the viability of the business. Angel investors are focused on helping startups take their first steps, rather than the possible profit they may get from the business.
5. Essentially, angel investors are the opposite of venture capitalists.
6. Angel investors typically use their own money, unlike venture capitalists who take care of pooled money from many other investors and place them in a strategically managed fund.

c) <u>Venture Capital Funds</u>

a) Venture capital means funds made available for startup firms and small businesses with exceptional growth potential.

b) Venture capital is money provided by professionals who alongside management invest in young, rapidly growing companies that have the potential to develop into significant economic contributors.

c) Venture Capitalists generally:
   - Finance new and rapidly growing companies.
   - Purchase equity securities
   - Assist in the development of new products or services.
   - Add value to the company through active participation.

Q.4) Structure of Venture Capital Fund in India.

Three main types of fund structure exist: one for domestic funds and two for offshore ones:

a) <u>Domestic Funds</u>

1. Domestic Funds (i.e. one which raises funds domestically) are usually structured as:
   - a domestic vehicle for the pooling of funds from the investor, and
   - a separate investment adviser that carries those duties of asset manager.
2. The choice of entity for the pooling vehicle falls between a trust and a company, with the trust form prevailing due to its operational flexibility.

b) **<u>Offshore Funds</u>**

Two common alternatives available to offshore investors are:
The "offshore structure" and
The "unified structure".

- **Offshore structure**
  1. Under this structure, an investment vehicle (an LLC or an LP organized in a jurisdiction outside India) makes investments directly into Indian portfolio companies.
  2. Typically, the assets are managed by an offshore manager, while the investment advisor in India carries out the due diligence and identifies deals.

- **Unified Structure**
  1. When domestic investors are expected to participate in the fund, a unified structure is used.
  2. Overseas investors pool their assets in an offshore vehicle that invests in a locally managed trust, whereas domestic investors directly contribute to the trust. This is later device used to make the local portfolio investments.

Q.5) Explain the characteristics of Venture Capital Financing?

a) Long time horizon
1. The fund would invest with a long time horizon in mind.
2. Minimum period of investment would be 3 years and maximum period can be 10 years.

b) Lack of liquidity
1. When VC invests, it takes into account the liquidity factor.
2. It assumes that there would be less liquidity on the equity it gets and accordingly it would be investing in that format.
3. They adjust this liquidity premium against the price and required return.

c) Equity Participation
1. Most of the time, VC would be investing in the form of equity of a company.
2. This would help the VC participate in the management and help the company grow.
3. Besides, a lot of board decisions can be supervised by the VC if they participate in the equity of a company

d) High Risk
1. VC would not hesitate to take risk. It works on principle of high risk and high return.
2. So, high risk would not eliminate the investment choice for a venture capital.

Q.6) What are the advantages of bringing VC in the company?

a) It injects long- term equity finance which provides a solid capital base for future growth.
b) The venture capitalist is a business partner, sharing both the risks and rewards. Venture capitalists are rewarded with business success and capital gain.
c) The venture capitalist is able to provide practical advice and assistance to the company based on past experience with other companies which were in similar situations.
d) The venture capitalist also has a network of contacts in many areas that can add value to the company.
e) The venture capitalist may be capable of providing additional rounds of funding should it be required to finance growth.
f) Venture capitalists are experienced in the process of preparing a company for an initial public offering (IPO) of its shares onto the stock exchanges or overseas stock exchange such as NASDAQ.

g) They can also facilitate a trade sale.

Q.7) Explain the stages of funding for VC?

a) **Seed Money**
   Low level financing needed to prove a new idea.

b) **Start-up**
   Early stage firms that need funding for expenses associated with marketing and product development.

c) **First-Round**
   Early sales and manufacturing funds.

d) **Second-Round**
   Working capital for early stage companies that are selling product, but not yet turning in a profit.

e) **Third Round**
   Also called Mezzanine financing, this is expansion money for a newly profitable company.

f) **Fourth-Round**
   Also called bridge financing, it is intended to finance the "going public" process.

Financial Stage	Period (Funds locked in years)	Risk Percepti-on	Activity to be financed
Seed Money	7-10	Extreme	For supporting a concept or idea or R&D for product development
Start Up	5-9	Very High	Initializing prototypes operations or developing
First Stage	3-7	High	Start commercials marketing production and
Second Stage	3-5	Sufficiently high	Expand market and growing working capital need
Third Stage	1-3	Medium	Market expansion, acquisition & product development for profit making company
Fourth Stage	1-3	Low	Facilitating public issue

Q.8) Explain VC Investment Process?

The entire VC Investment process can be segregated into the following steps:

a) Deal Origination

1. VC operates directly or through intermediaries. Mainly many practicing Chartered Accountants would work as intermediary and through them VC gets the deal.
2. Before sourcing the deal, the VC would inform the intermediary or its employees about the following so that the sourcing entity does not waste time :
   - Sector focus
   - Stages of business focus
   - Promoter focus
   - Turn over focus

b) Screening

1. Once the deal is sourced the same would be sent for screening by the VC.
2. The screening is generally carried out by a committee consisting of senior level people of the VC. Once the screening happens, it would select the company for further processing.

c) Due Diligence

1. The screening decision would take place based on the information provided by the company.
2. Once the decision is taken to proceed further, the VC would now carry out due diligence. This is mainly the process by which the VC would try to verify the veracity of the documents taken.

d) Deal Structuring

1. Once the case passes through the due diligence it would now go through the deal structuring.
2. The deal is structured in such a way that both parties win.
3. In many cases, the convertible structure is brought in to ensure that the promoter retains the right to buy back the share.
4. There is also a tag- along clause.

e) Post Investment Activity

1. In this section, the VC nominates its nominee in the board of the company.
2. The company has to adhere to certain guidelines like strong MIS, strong budgeting system, strong corporate governance and other covenants of the VC and periodically keep the VC updated about certain mile-stones.

f) Exit plan

1. At the time of investing, the VC would ask the promoter or company to spell out in detail the exit plan.
2. Mainly, exit happens in two ways i.e one way is 'sell to third party(ies)'. This sale can be in the form of IPO or Private Placement to other VCs. The second way to exit is that promoter

would give a buy back commitment at a pre agreed rate (generally between IRR of 18% to 25%).

Q.9) Write note on Startup India Initiative.

a) Startup India scheme was initiated by the Government of India on 16^{th} of January, 2016.
b) The definition of startup was provided which is applicable only in case of Government Schemes.
c) Startup means an entity, incorporated or registered in India:
   - Not prior to five years,
   - With annual turnover not exceeding 25 crore in any preceding financial year, and
   - Working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property.
d) Provided that such entity is not formed by splitting up, or reconstruction, of a business already in existence.
e) Provided also that an entity shall cease to be a Startup if its turnover for the previous financial years has exceeded 25 crore or it has completed 5 years from the date of incorporation/ registration.
f) Provided further that a Startup shall be eligible for tax benefits only after it has obtained certification from the Inter-Ministerial Board, setup for such purpose.

7. SMALL AND MEDIUM ENTERPRISES

Q.1) What are the types of arranging finance?

a) This need for finance can be classified into following types:
   - Long and medium term loans
   - Short term or working capital requirements
   - Risk Capital
   - Seed Capital/Marginal Money
   - Bridge loans

b) Financial assistance in India for MSME units is available from a variety of institutions. The important ones are:
   - Commercial/Regional Rural/Co-operative Banks.
   - SIDBI: Small Industries Development Bank of India (refinance and direct lending)
   - SFCs/SIDCs: State Financial Corporations (e.g. Delhi Financial Corporation)/State Industrial Development Corporations.

c) Long and medium term loans are provided by SFCs, SIDBI and SIDCs.

d) Banks also finance term loans. This type of financing is needed to fund purchase of land, construction of factory building/shed and for purchase of machinery and equipment.

e) The short-term loans are required for working capital requirements, which fund the purchase of raw materials and consumables, payment of wages and other immediate manufacturing and administrative expenses. Such loans are generally available from commercial banks.

f) The commercial banks also sanction composite loan comprising of working capital and term loan up to a loan limit of Rs.1crore.

Q.2) SMEs Finance – A Global Perspective.

a) Small and Medium Enterprises (SMEs) play a major role in most economies, particularly in developing countries.

b) Formal SMEs contribute up to 45 percent of total employment and up to 33 percent of national income (GDP) in emerging economies.

c) These numbers are significantly higher when informal SMEs are included.

d) According to estimates, 600 million jobs will be needed in the next 15 years to absorb the growing global workforce, mainly in Asia and Sub-Saharan Africa.

e) In emerging markets, most formal jobs are with SMEs, which also create 4 out of 5 new positions.

f) However, access to finance is a key constraint to SME growth; without it, many SMEs languish and stagnate.

g) SMEs are less likely to be able to secure bank loans than large firms; instead, they rely on internal or "personal" funds to launch and initially run their enterprises.

h) While the gap varies considerably between regions, it's particularly wide in Africa and Asia.

Q.3) What are the benefits available to Micro, Small or Medium enterprises?

a) It enables reservation of certain items for exclusive manufacture of MSME enterprises. It helps them to protect their interest.

b) This policy helps in generating employment for the people and consequently, enhances the standard of living of people. To encourage the small scale units, SEZ's are required to allocate 10% space for small scale units.

c) Under the MSME act, protections are offered in relation to timely payment by buyers to MSME's.

d) Assistance is also available in obtaining finance; help in marketing; technical guidance; training and technology upgradation, etc.

e) Further , an enterprise, whose post-issue face value does not exceed Rs. 25,00,00,000 (Rupees Twenty Five Crores only), is entitled to obtain certain exemptions from the eligibility requirement under the ICDR Regulation.

Q.4) What are the criteria for SME Listing?

a) Incorporation

The Company shall be incorporated under the Companies Act, 2013.

b) Financials

1. **Post Issue Paid up Capital**

   The post-issue paid up capital of the company shall be at least Rs. 3 crore.

2. **Net worth**

   Net worth (excluding revaluation reserves) of at least Rs.3 crore as per the latest audited financial results.

3. **Net Tangible Assets**

   At least Rs.3 crore as per the latest audited financial results.

4. **Track Record**

   - Distributable profits in terms of Section 123 of the Companies Act 2013 for at least two years out of immediately preceding three financial years (each financial year has to be a period of at least 12 months).
   - Extraordinary income will not be considered for the purpose of calculating distributable profits.
   - Or, the net worth shall be at least Rs.5 crores.

Q.5) What are the guidelines for Listing?

a) **Capital**

The post issue face value capital should not exceed Rs. 25 crores.

b) **Trading lot size**

1. The minimum application and trading lot size shall not be less than Rs.1,00,000/-.
2. The minimum depth shall be Rs.1,00,000/- and at any point of time it shall not be less than Rs 1,00,000/-.
3. The investors holding with less than Rs.1,00,000/- shall be allowed to offer their holding to the Market Maker in one lot.
4. However in functionality the market lot will be subject to revival after a stipulated time.

c) **Participants**

The existing Members of the Exchange shall be eligible to participate in SME Plat form.

d) **Underwriting**

The issues shall be 100% underwritten and Merchant Bankers shall underwrite 15% in their own account.

Q.6) What are the benefits of Listing SME?

a) **Easy access to Capital**

BSE SME provides an avenue to raise capital through equity infusion for growth oriented SME's.

b) **Encourages Growth of SMEs**

Equity financing provides growth opportunities like expansion, mergers and acquisitions thus being a cost effective and tax efficient mode.

c) **Ensures Tax Benefits**

In case of listed securities Short Term Gains Tax is 15% and there is absolutely no Long Term Capital Gains Tax.

d) **Enables Liquidity for Shareholders**

Equity financing enables liquidity for shareholders provides growth opportunities like expansion, mergers and acquisitions, thus being a cost effective and tax efficient mode.

e) **Equity financing through Venture Capital**

Provides an incentive for Venture Capital Funds by creating an Exit Route and thus reducing their lock in period.

f) **Employee Incentives**

Employee Stock Options ensures stronger employee commitment, participation and recruitment incentive.