



# ICAI

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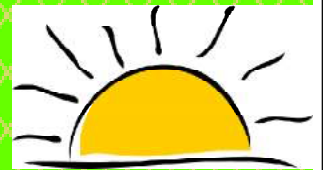
## Theory

# FULLY AMENDED

(DO NOT REFER ANY OTHER THEORY NOTES.THIS  
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ATTEMPT FULL CA FINAL SFM  
SYLLABUS IS AMENDED**

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# **LIST OF IMPORTANT QUESTIONS**

## **SFM-NOV 2008 THEORY QUESTIONS**

**QUESTION NO. 1** What are drawbacks of investments in Mutual Funds ?

**CHAPTER 9**

**QUESTION NO. 2** Write short notes on any four of the following :

- |                             |                   |
|-----------------------------|-------------------|
| (a) Financial restructuring | <b>CHAPTER 13</b> |
| (b) Cross border leasing    | <b>CHAPTER 3</b>  |
| (c) Embedded derivatives    | <b>CHAPTER 5</b>  |
| (d) Arbitrage operations    | <b>CHAPTER 12</b> |
| (e) Rolling settlement      | <b>CHAPTER 5</b>  |

## **SFM-MAY 2009 THEORY QUESTIONS**

**No Question Was Asked In This Attempt**

## **SFM-NOV 2009 THEORY QUESTIONS**

**QUESTION NO. 1** What are the limitations of Credit Rating? **CHAPTER 8**

**QUESTION NO. 2** What is the impact of GDRs on Indian Capital Market?

**CHAPTER 11**

## **SFM-MAY 2010 THEORY QUESTIONS**

**QUESTION NO. 1** List and briefly explain the main functions of an investment bank. **CHAPTER 8**

**QUESTION NO. 2** How is a stock market index calculated? Indicate any two important market indices. **CHAPTER 5**

**QUESTION NO. 3** Write a short note on Debt Securitisation. **CHAPTER 5**

**QUESTION NO. 4** Write a short note on Exchange Traded Funds (ETFs)

**CHAPTER 9**

**QUESTION NO. 5** Explain briefly, how financial policy is linked to Strategic Management. **CHAPTER 1**

## **SFM-NOV 2010 THEORY QUESTIONS**

**QUESTION NO. 1**

- (i) What is the meaning of NBFC?
- (ii) What are the different categories of NBFCs?

(iii) Explain briefly the regulation of NBFCs under RBI Act. **CHAPTER 8**  
**QUESTION NO. 2** Explain the concept 'Zero date of a Project' in project management. **CHAPTER 2**

**QUESTION NO. 3** Give the meaning of 'Caps, Floors and Collars' options. **CHAPTER 5**

**QUESTION NO. 4** Distinguish between Open-ended and Close-ended Schemes. **CHAPTER 9**

**QUESTION NO. 5** Explain CAMEL model in credit rating. **CHAPTER 8**

### SFM-MAY 2011 THEORY QUESTIONS

**QUESTION NO. 1** Mention the functions of a stock exchange. **CHAPTER 5**

**QUESTION NO. 2** Mention the various techniques used in economic analysis **CHAPTER 6**

**QUESTION NO. 3**

(a) Explain the significance of LIBOR in international financial transactions. **CHAPTER 12**

(b) Discuss how the risk associated with securities is effected by Government policy. **CHAPTER 7**

(c) What is the meaning of :(i) Interest rate parity and (ii) Purchasing power parity ? **CHAPTER 12**

(d) What is the significance of an underlying in relation to a derivative instrument? **CHAPTER 5**

(e) What are the steps for simulation analysis? **CHAPTER 2**

### SFM-NOV 2011 THEORY QUESTIONS

**QUESTION NO. 1** Write a short notes on

(a) LEADING & LAGGING **CHAPTER 11**

(b) CAPITAL RATIONING **CHAPTER 2**

(c) EMBEDDED DERIVATIVE **CHAPTER 5**

(d) MONEY MARKET MUTUAL FUND **CHAPTER 10**

(e) TAKE OVER BY REVERSE BID **CHAPTER 13**

(f) DEPOSITORY PARTICIPANT **CHAPTER 8**

### SFM-MAY 2012 THEORY QUESTIONS

**QUESTION NO. 1** Write a short notes on

- |  |            |
|--|------------|
| (a) Zero coupon bonds                    | CHAPTER 6  |
| (b) Interest swap                        | CHAPTER 12 |
| (c) Inter-Bank Participation Certificate | CHAPTER 10 |
| (d) Meaning and Advantages of Netting    | CHAPTER 11 |
| (e) Nostro, Vostro and Loro Accounts     | CHAPTER 12 |

### SFM-NOV 2012 THEORY QUESTIONS

QUESTION NO. 1 Write a short notes on

- |  |            |
|--|------------|
| (a) Interface of Financial Policy and Strategic Management | CHAPTER 1  |
| (b) Commercial Paper                                       | CHAPTER 10 |
| (c) American Depository Receipt                            | CHAPTER 11 |
| (d) Advantages of holding securities in 'Demat' form       | CHAPTER 8  |
| (e) Synergy in the context of Mergers and acquisitions     | CHAPTER 13 |

### SFM-MAY 2013 THEORY QUESTIONS

QUESTION NO.1 Write short notes on any four of the following:

- |                            |            |
|----------------------------|------------|
| (a)Credit Rating           | CHAPTER 8  |
| (b)Asset Securitization    | CHAPTER 5  |
| (c)Call Money              | CHAPTER 13 |
| (d)Euro Convertible Bonds  | CHAPTER 11 |
| (e)Financial Restructuring | CHAPTER 13 |

### SFM-NOV 2013 THEORY QUESTIONS

QUESTION NO.1 Explain "Zero date of the Project" in Project Management?

CHAPTER 2

QUESTION NO.2 What is an Exchange Traded Fund? What are its key features?

CHAPTER 9

QUESTION NO.3 What is an Equity Curve out? How does it differ from a Spin Off?CHAPTER 13

QUESTION NO.4 What is Money Market? What are its features? What kind of inefficiencies it is suffering from? CHAPTER 10

### SFM-MAY 2014 THEORY QUESTIONS

QUESTION NO.1 Explain in brief the contents of a Project Report.

CHAPTER 2

QUESTION NO.2 Write short notes on any four of the following:

- |  |            |
|--|------------|
| (a) Traditional & Walter Approach to Dividend Policy       | CHAPTER 4  |
| (b) Factors affecting Value of an Option                   | CHAPTER 5  |
| (c) Forward Rate Agreements                                | CHAPTER 5  |
| (d) American Depository Receipts                           | CHAPTER 11 |
| (e) Balancing Financial Goals vis-a-vis Sustainable Growth | CHAPTER 1  |

**SFM-NOV 2014 THEORY QUESTIONS**

**QUESTION NO.1** Write short notes on any four of the following:

- (a) What are the signals that indicate that is time for an investor to exit a mutual fund scheme? CHAPTER 9
- (b) What is cross border leasing? State its objectives. CHAPTER 3
- (c) Explain Takeover by reverse bid. CHAPTER 13
- (d) What are the risks to which foreign exchange transactions are exposed? CHAPTER 12
- (e) Explain the term “Insider Trading” and why Insider Trading is punishable? CHAPTER 5

**SFM-MAY 2015 THEORY QUESTIONS**

**QUESTION NO.1** Write short notes on any four of the following:

CHAPTER 12

- (a) Explain the meaning of the following in respect of Swap transaction

Plain Vanilla Swaps

Basis Rate Swaps

Asset Swaps

Amortising Swaps

- (b) Difference between Open Ended Scheme and Close Ended Scheme

CHAPTER 9

- (c) State any four assumptions of Black Scholes Model CHAPTER 5

- (d) Give the meaning of Cap, Floor and Collar options with respect to Interest.

CHAPTER 5

- (e) Global depository receipts (GDR) CHAPTER 11

**SFM-NOV 2015 THEORY QUESTIONS**

Write short notes on any four of the following

- (a) Assumption Of MM CHAPTER 4

- (b) Delta;Gamma;Vega;Rho CHAPTER 5



- (c) MMMF CHAPTER 10  
(d) Instrument Of International Finance CHAPTER 11  
(e) Forfaiting Vs Export Factoring CHAPTER 8

### SFM-MAY 2016 THEORY QUESTIONS

Write short notes on any four of the following

- (a) What is the difference between Capital Market and Money Market?  
CHAPTER 10  
(b) Difference Commercial Banking and Investment Banking? CHAPTER 8  
(c) Difference Between Horizontal merger & Vertical merger? CHAPTER 13  
(d) What are the risks to which foreign exchange transactions are exposed?  
CHAPTER 12  
(e) Interface of Financial Policy and Strategic Management . CHAPTER 1

### SFM-NOV 2016 THEORY QUESTIONS

Write short notes on any four of the following

- (A) What is Cross Border Leasing ? State its advantages? CHAPTER 3  
(B) What are the rigidities in the Indian Money Market ? CHAPTER 10  
(C) Write short note on 'Exchange Traded Funds' ? What are its advantage?  
CHAPTER 9  
(D) What are problems for Merger & Acquisition in India? CHAPTER 13  
(E) What makes an organization sustainable ? State the specific steps?  
CHAPTER 1

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**Aaditya Sir**

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**Aaditya Sir**

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DELHI STUDENT, KPMG ARTICLESHIP**



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Test Date	Test Centre	Marks Obtained (%)	Remarks
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July 31, 2014	Delhi	100.0	Pass

Date: July 31, 2014

Place: Mumbai

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This is to certify that Mr. VINAY GUPTA, Registration Number NCFM-00001175477, has successfully completed the Equity Derivatives: A Beginner's Module of the NCFM. The details of the test taken by him are as follows:

Test Date	Test Centre	Marks Obtained (%)	Remarks
November 20, 2014	Delhi	100.0	Pass

Date: November 20, 2014

Place: Mumbai

Valid upto: November 20, 2019

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Test Date	Test Centre	Marks Obtained (%)	Remarks
May 22, 2015	Delhi	100.0	Pass

Date: May 22, 2015

Place: Mumbai

Valid upto: May 22, 2020

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Test Date	Test Centre	Marks Obtained (%)	Remarks
May 15, 2015	Delhi	100.0	Pass

Date: May 15, 2015

Place: Mumbai

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Date: July 14, 2015

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source:<http://www.rediff.com/money/2006/mar/13iim.htm>



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4. HSBC
5. BNP Paribas
6. Deutsche Bank
7. McKinsey
8. UBS
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11. Blackstone Capital Partners
12. Accenture
13. Credit Suisse
14. Bloomberg
15. Morgan Stanley
16. ANZ
17. Bank of America
18. Deloitte
19. Macquarie
20. Ernst & Young

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[http://articles.economictimes.indiatimes.com/2012-08-10/news/33137856\\_1\\_fund-managers-l-t-mutual-fund-mid-cap-funds](http://articles.economictimes.indiatimes.com/2012-08-10/news/33137856_1_fund-managers-l-t-mutual-fund-mid-cap-funds)

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<http://www.consumerismcommentary.com/want-to-make-450k-a-year-become-a-portfolio-manager/>



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“AADITYA JAIN”

97



MARKS

BY **Shruti Goyal**;ROLL NO.-110629;PIN-2610;

EMAIL-GOYALSHRUTI281@GMAIL.COM

ALL INDIA **1ST RANK** IN CS FINAL

ALL INDIA **5TH RANK** IN CA FINAL

OTHERS-PRIYANKA BATHWAL; **95** MARKS IN SFM;ROLL NO.-127761;PIN-1234;RANK-3

4TH RANK; Rishu Chitkara: **90** MARKS IN SFM



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CA Examination Results

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Examination Results, NOV 2012


**Final Examination Result**

ROLL Number		110629
<b>Name</b>		<b>SHRUTI GOYAL</b>
<b>Group I</b>		
Financial Reporting		076
Strategic Financial Management		097
Advanced Auditing and Professional Ethics		062
Corporate and Allied Laws		080
<b>Total</b>		<b>315</b>
<b>Result</b>		<b>PASS</b>
<b>Group II</b>		
Advanced Management Accounting		072
Information Systems Control and Audit		069
Direct Tax Laws		062
Indirect Tax Laws		069
<b>Total</b>		<b>272</b>
<b>Result</b>		<b>PASS</b>
<b>Grand Total</b>		<b>587</b>

CA Examination Results

 **The Institute of Chartered Accountants of India**  
Examination Results, NOV 2012

**Final Examination Result**

ROLL Number		127761
<b>Name</b>		<b>PRIYANKA BATHWAL</b>
<b>Group I</b>		
Financial Reporting		061
Strategic Financial Management		095
Advanced Auditing and Professional Ethics		066
Corporate and Allied Laws		064
<b>Total</b>		<b>286</b>
<b>Result</b>		<b>PASS</b>
<b>Group II</b>		
Advanced Management Accounting		072
Information Systems Control and Audit		059
Direct Tax Laws		052
Indirect Tax Laws		056
<b>Total</b>		<b>239</b>
<b>Result</b>		<b>PASS</b>
<b>Grand Total</b>		<b>525</b>



The Institute of Chartered Accountants of India  
Examination Results, NOV 2012

**Final Examination Result**

ROLL Number	127761
<b>Name</b>	<b>PRIYANKA BATHWAL</b>
<b>Group I</b>	
Financial Reporting	061
Strategic Financial Management	095
Advanced Auditing and Professional Ethics	066
Corporate and Allied Laws	064
<b>Total</b>	<b>286</b>
<b>Result</b>	<b>PASS</b>
<b>Group II</b>	
Advanced Management Accounting	072
Information Systems Control and Audit	059
Direct Tax Laws	052
Indirect Tax Laws	056
<b>Total</b>	<b>239</b>
<b>Result</b>	<b>PASS</b>
<b>Grand Total</b>	<b>525</b>



The Institute of Chartered Accountants of India  
Examination Results, June 2009

Final Examination Results

ROLL Number	25862	<i>*Check Merit</i>
<b>Name</b>	<b>GIRIRAJ AJMERA</b>	
<b>Group I</b>		
Advanced Accounting	075	
Management Accounting and Financial Analysis	093	
Advanced Auditing	059	
Corporate Laws and Secretarial Practice	057	
<b>Total</b>	<b>284</b>	
<b>Result</b>	<b>PASS</b>	
<b>Group II</b>		
Cost Management	062	
Management Information & Control Systems	079	
Direct Taxes	067	
Indirect Taxes	069	
<b>Total</b>	<b>277</b>	
<b>Result</b>	<b>PASS</b>	
<b>Grand Total</b>	<b>561</b>	



The Institute of Chartered Accountants of India  
Examination Results, MAY 2016

Final Examination Results, MAY 2016

Roll Number	477751
<b>Name</b>	<b>VIBHOR AGARWAL</b>
<b>Group I</b>	
Financial Reporting	072
Strategic Financial Management	097
Advanced Auditing and Professional Ethics	059
Corporate and Allied Laws	062
<b>Total</b>	<b>290</b>
<b>Result</b>	<b>PASS</b>
<b>Group II</b>	
Advanced Management Accounting	066
Information Systems Control and Audit	055
Direct Tax Laws	058
Indirect Tax Laws	073
<b>Total</b>	<b>252</b>
<b>Result</b>	<b>PASS</b>
<b>Grand Total</b>	<b>542</b>

**“If you have a dream,  
don’t just sit there.  
Gather courage to believe  
that you can succeed and  
leave no stone unturned  
to make it a reality.”**



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**8285042929**



# CHAPTER-1

## FINANCIAL POLICY AND CORPORATE STRAT-

**QUESTION NO.1** Explain briefly, how financial policy is linked to strategic management ?  
(Nov 2009)(May2010)

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

→ The linkage can be clearly seen in respect of many business decisions.

For example :

- (i) Manner of raising capital as source of finance and capital structure are the most important dimensions of strategic plan.
- (ii) Cut-off rate (opportunity cost of capital) for acceptance of investment decisions.
- (iii) Investment and fund allocation is another important dimension of interface of strategic management and financial policy.
- (iv) Foreign Exchange exposure and risk management.
- (v) Liquidity management.
- (vi) A dividend policy decision deals with the extent of earnings to be distributed and a close interface is needed to frame the policy so that the policy should be beneficial for all.
- (vii) Issue of bonus share is another dimension involving the strategic decision.

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

**QUESTION NO.2** Write a short note on Balancing Financial Goals vis-à-vis Sustainable Growth ? (May 2014)

→ The concept of sustainable growth can be helpful for planning healthy corporate growth.

→ This concept forces managers to consider the financial consequences of sales increases and to set sales growth goals that are consistent with the operating and financial policies of the firm.

→ Often, a conflict can arise if growth objectives are not consistent with the value of the organization's sustainable growth. Question concerning right distribution of resources may take a difficult shape if we take into consideration the rightness not for the current stakeholders but for the future stakeholders also.

→ To take an illustration, let us refer to fuel industry where resources are limited in quantity and a judicious use of resources is needed to cater to the need of the future customers along with the need of the present customers. One may have noticed the save fuel campaign, a demarketing campaign that deviates from the usual approach of sales growth strategy and preaches for conservation of fuel for their use across generation. This is an example of stable growth strategy adopted by the oil industry as a whole under resource constraints and the long run objective of survival over years.

→ Incremental growth strategy, profit strategy and pause strategy are other variants of stable growth strategy.

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

→ The sustainable growth rate (SGR), concept by Robert C. Higgins, of a firm is the maximum rate of growth in sales that can be achieved, given the firm's profitability, asset utilization, and desired dividend payout and debt (financial leverage) ratios. The sustainable growth rate is a measure of how much a firm can grow without borrowing more money. After the firm has passed this rate, it must borrow funds from another

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*Winning doesn't always mean being first....*

*Winning mean you're doing better than you've done before.*

*SFM SYLLABUS FULLY AMEDNDED-cafinalsfm@gmail.com*

source to facilitate growth. Variables typically include the net profit margin on new and existing revenues; the asset turnover ratio, which is the ratio of sales revenues to total assets; the assets to beginning of period equity ratio; and the retention rate, which is defined as the fraction of earnings retained in the business.  $SGR = ROE \times (1 - \text{Dividend payment ratio})$

→ Sustainable growth models assume that the business wants to: **1)** maintain a target capital structure without issuing new equity; **2)** maintain a target dividend payment ratio; and **3)** increase sales as rapidly as market conditions allow.

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

**QUESTION NO.3 What makes an organization sustainable ? State the specific steps? (Nov 2016)**

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

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- (2) maintain a target dividend payment ratio; and
- (3) increase sales as rapidly as market conditions allow.

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→ To be financially sustainable, an organisation must:

- (i) have more than one source of income;
- (ii) have more than one way of generating income;
- (iii) do strategic, action and financial planning regularly;
- (iv) have adequate financial systems;
- (v) have a good public image;
- (vi) be clear about its values (value clarity); and
- (vii) have financial autonomy.



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*The happiest people don't necessarily have the best of everything.  
They just make the most of everything that comes along their way.*

*SFM SYLLABUS FULLY AMEDNDED-cafinalsfm@gmail.com*



## CHAPTER-2

# PROJECT PLANNING AND CAPITAL BUDGETING

### QUESTION NO.1 What are the Contents Of a Project Report ?(May 2014 )

The following aspects need to be taken into account for a Project Report -

**1. Promoters:** Their experience, past records of performance form the key to their selection for the project under study.

**2. Industry Analysis:** The environment outside & within the country is vital for determining the type of project one should opt for.

**3. Economic Analysis:** The demand and supply position of a particular type of product under consideration, competitor's share of the market along with their marketing strategies, export potential of the product, consumer preferences are matters requiring proper attention in such type of analysis.

**4. Cost of Project:** Cost of land, site development, buildings, plant and machinery, utilities e.g. power, fuel, water, vehicles, technical know how together with working capital margins, preliminary/pre-operative expenses, provision for contingencies determine the total value of the project.

**5. Inputs:** Availability of raw materials within and outside the home country, reliability of suppliers cost escalations, transportation charges, manpower requirements together with effluent disposal mechanisms are the points to be noted.

**6. Technical Analysis:** Technical know-how, plant layout, production process, installed and operating capacity of plant and machinery form the core of such analysis.

**7. Financial Analysis:** Estimates of production costs, revenue, tax liabilities, profitability and sensitivity of profits to different elements of costs and revenue, financial position and cash flows, working capital requirements, return on investment, promoters contribution together with debt and equity financing are items which need to be looked into for financial viability.

**8. Social Cost Benefit Analysis:** Ecological matters, value additions, technology absorptions, level of import substitution form the basis of such analysis.

**9. SWOT(strengths, weaknesses, opportunities, and threats ) Analysis:** Liquidity/ Fund constraints in capital market, limit of resources available with promoters, business/

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*Success is not the result of spontaneous combustion.*

*You must first set yourself on fire.*

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financial risks, micro/macro economic considerations subject to government restrictions, role of Banks/Financial Institutions in project assistance, cost of equity and debt capital in the financial plan for the project are factors which require careful examinations while carrying out SWOT analysis.

**10. Project Implementation Schedule:** Date of commencement, duration of the project, trial runs, cushion for cost and time over runs and date of completion of the project through Network Analysis have all to be properly adhered to in order to make the project feasible.

**QUESTION NO.2 What are the steps for simulation analysis ? (May 2011)**

**→ Steps For Simulation Analysis:**

1. Modelling the project. The model shows the relationship of N.P.V. with parameters and exogenous variables. (Parameters are input variables specified by decision maker and held constant over all simulation runs. Exogenous variables are input variables, which are stochastic in nature and outside the control of the decision maker) .
2. Specify values of parameters and probability distributions of exogenous variables.
3. Select a value at random from probability distribution of each of the exogenous variables.
4. Determine NPV corresponding to the randomly generated value of exogenous variables and pre-specified parameter variables.
5. Repeat steps (3) & (4) a large number of times to get a large number of simulated NPVs.
6. Plot frequency distribution of NPV

**Note:** Refer CA Final Costing for practical part of "simulation" concept.

**QUESTION NO.3 Write a short note on CAPITAL BUDGETING UNDER CAPITAL RATIONING (Nov 2011)**

- When there is a scarcity of funds, capital rationing is resorted to.
- Capital rationing means the utilization of existing funds in most profitable manner by selecting the acceptable projects in the descending order or ranking with limited available funds.

- ↪ The firm must be able to maximize the profits by combining the most profitable proposals.
- ↪ Capital rationing may arise due to
- (i) external factors such as high borrowing rate or non-availability of loan funds due to constraints of Debt-Equity Ratio; and
  - (ii) Internal Constraints Imposed by management. Project should be accepted as a whole or rejected. It cannot be accepted and executed in piecemeal.
- ↪ IRR or NPV are the best basis of evaluation even under Capital Rationing situations.
- ↪ The objective is to select those projects which have maximum and positive NPV.
- ↪ Preference should be given to interdependent projects.
- ↪ Projects are to be ranked in the order of NPV.
- ↪ Where there is multi-period Capital Rationing, Linear Programming Technique should be used to maximize NPV.
- ↪ In times of Capital Rationing, the investment policy of the company may not be the optimal one.

**QUESTION NO.4 Write a short note on "Zero Date Of Project Management"**  
**? (Nov 2010)**

↪ Zero Date of a Project means a date is fixed from which implementation of the project begins. It is a starting point of incurring cost. The project completion period is counted from the zero date. Pre-project activities should be completed before zero date.

↪ The pre-project activities are:

- (a) Identification of project/product
- (b) Determination of plant capacity
- (c) Selection of technical help/collaboration
- (d) Selection of site.
- (e) Selection of survey of soil/plot etc.
- (f) Manpower planning and recruiting key personnel
- (g) Cost and finance scheduling.



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*The great thing a little lamp can do which the big sun cannot do is, it gives light at night.*

*No one is superior by size, but by purpose..*

*SFM SYLLABUS FULLY AMEDNDED-cafinalsfm@gmail.com*

# CHAPTER-3

## LEASING

**QUESTION NO.1 Write a short note on Cross Border Leasing ?**

*(Nov 2008)(Nov 2014)*

*or*

**QUESTION NO.1 What is Cross Border Leasing ? State its advantages?**

*(Nov 2016)*

➔ Cross-border leasing is a leasing agreement where lessor and lessee are situated in different countries. This raises significant additional issues relating to tax avoidance and tax shelters.

➔ It has been widely used in some European countries, to arbitrage the difference in the tax laws of different countries.

➔ Cross-border leasing have been in practice as a means of financing infrastructure development in emerging nations , such as rail and air transport equipment, telephone and telecommunications equipment, and assets incorporated into power generation and distribution systems and other projects that have predictable revenue streams.

➔ **Objective Of Cross Border Leasing** : A major objective of cross-border leases is to reduce the overall cost of financing of lessor through tax depreciation allowances to reduce its taxable income. The tax savings are passed through to the lessee as a lower cost of finance. The basic pre-requisites are relatively high tax rates in the lessor's country, liberal depreciation rules and either very flexible or very formalistic rules governing tax ownership.

Other important objectives of cross border leasing include the following :

(i) The lessor is often able to utilize non recourse debt to finance a substantial portion of the equipment cost.

(ii) Also, depending on the structure, in some countries the lessor can utilize very favourable "leveraged lease" financial accounting treatment for the overall transaction.

(iii) In some countries, it is easier for a lessor to repossess the leased equipment following a lessee default.

(iv) Leasing provides the lessee with 100% financing.

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*Hurting someone is as easy as cutting a tree- within a moment!*

*But making someone happy is like growing a tree- Takes a lot of time, care & patience!!*

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## **ADVANTAGE OF CROSS-BORDER LEASING**

➔ A major advantage of cross-border leasing is to reduce the overall cost of financing through utilization by the lessor of tax depreciation allowances to reduce its taxable income. The tax savings are passed through to the lessee as a lower cost of finance. The basic prerequisites are relatively high tax rates in the lessor's country, liberal depreciation rules and either very flexible or very formalistic rules governing tax ownership.

➔ Other important advantages of cross border leasing include the following:

- The lessor is often able to utilize nonrecourse debt to finance a substantial portion of the equipment cost. The debt is secured by among other things, a mortgage on the equipment and by an assignment of the right to receive payments under the lease.
- Also, depending on the structure, in some countries the lessor can utilize very favourable "leveraged lease" financial accounting treatment for the overall transaction.
- In some countries, it is easier for a lessor to repossess the leased equipment following a lessee default because the lessor is an owner and not a mere secured lender.
- Leasing provides the lessee with 100% financing.



# CHAPTER-4

## DIVIDEND DECISION

**QUESTION NO.1** Write short notes on Traditional & Walter Approach to Dividend Policy?(May 2014)

### A. Traditional Position/Graham and Dodd Model

➔ According to the traditional position expounded by Graham and Dodd, the stock market places considerably more weight on dividends than on retained earnings.

➔ For them, the stock market is overwhelmingly in favour of liberal dividends as against niggardly dividends. Their view is expressed quantitatively in the following valuation model:

$$\text{➔ Symbolically } P_0 = m \times \left( D + \frac{E}{3} \right)$$

➔ Under this model the weights attached to dividend is equal to four times the weights attached to retained earnings.

$$P_0 = m \times \left( D + \frac{E}{3} \right) \Rightarrow P_0 = m \times \left( D + \frac{D+R}{3} \right) \Rightarrow P_0 = m \times \left( \frac{4D}{3} \right) + m \times \left( \frac{R}{3} \right)$$

➔ The weights provided by Graham and Dodd are based on their subjective judgments and not derived from objective empirical analysis. Notwithstanding the subjectivity of these weights, the major contention of the traditional position is that a liberal payout policy has a favourable impact on stock prices.

### B. Walter Approach

➔ The formula given by Prof. James E. Walter shows how dividend can be used to maximise the wealth position of equity holders.

$$\text{➔ Symbolically: } P_0 = \frac{DPS + \frac{r}{K_e}(EPS - DPS)}{K_e}$$

Where,  $P_0$  = Current Market Price Ex-Dividends,  $DPS$  = Dividend Per Share,  $EPS$  =

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*Nothing of great value in this life comes easily. The things of highest value sometimes come hard.*

*The gold that has the greatest value lies deepest in the earth, As do the diamonds*

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Earning Per Share,  $K_e$  = Cost of Equity,  $r$  = Rate of Return

→ **Optimum Dividend As Per Walter's Model** :He suggested that optimum dividend payout depends on the relationship between  $K_e$  and  $r$ .

<u>Nature Of Firm</u>	<u>Relationship</u>	<u>Optimum Dividend Payout</u>
Growth Company	$K_e < r$	0%
Declining Company	$K_e > r$	100%
Normal Company	$K_e = r$	Indifferent

The rationale is that if  $r > K_e$ , the firm is able to earn more than the shareholders and hence in such case dividend payout should be zero. The implication of  $r < K_e$  is that shareholders can earn a higher return than the company and hence in such case dividend payout should be 100%.

→ **Assumption of Walter's Model**

1. The firm has an infinite life.
2. The firm cost of equity ( $K_e$ ) and rate of return ( $r$ ) is constant.
3. Earning Per Share & Dividend Per Share is also assumed to be constant.
4. The firm does the entire financing through retained earnings. It does not use external sources of funds such as debt or new equity capital.

**QUESTION NO.2 Write assumptions of MM Approach ? (Nov 2015)**

- (i) The firm operates in perfect capital markets in which all investors are rational and information is freely available to all.
- (ii) There are no taxes. Alternatively, there are no differences in the tax rates applicable to capital gains and dividends.
- (iii) The firm has a fixed investment policy.
- (iv) There are no flotation or transaction costs.
- (v) Risk of uncertainty does not exist. Investors are able to forecast future prices and dividends with certainty, and one discount rate is appropriate for all securities and all time periods.



# CHAPTER-5

## INDIAN CAPITAL MARKET

### QUESTION NO.1 What are the functions of the Stock Exchanges ?

(May 2011)

Functions of Stock Exchange are as follows:

1. **Liquidity and marketability of securities**- Investors can sell their securities whenever they require liquidity.
2. **Fair price determination**-The exchange assures that no investor will have an excessive advantage over other market participants
3. **Source for long term funds**-The Stock Exchange provides companies with the facility to raise capital for expansion through selling shares to the investing public.
4. **Helps in Capital formation**- Accumulation of saving and its utilization into productive use creates helps in capital formation.
5. **Creating investment opportunity of small investor**- Provides a market for the trading of securities to individuals seeking to invest their saving or excess funds through the purchase of securities.
6. **Transparency**- Investor makes informed and intelligent decision about the particular stock based on information. Listed companies must disclose information in timely, complete and accurate manner to the Exchange and the public on a regular basis.

### QUESTION NO.2 How is a stock market index calculated? Indicate any two important market indices ? (May 2010)

➔ **Stock Market Index**: It is representative of the entire stock market.

➔ **How is the index calculated :**

1. A base year is set alongwith a basket of base shares.
2. The changes in the market price of these shares is calculated on a daily basis.
3. The shares included in the index are those shares which are traded regularly in high volume.
4. In case the trading in any share stops or comes down then it gets excluded and another company's shares replace it.

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*Life is like a coin. Pleasure and Pain are the two sides. Only one side is visible at a time.*

*But remember other side is also waiting for it's turn.*

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5. Following steps are involved in calculation of index on a particular date:

- Calculate market capitalization of each individual company comprising the index.
- Calculate the total market capitalization by adding the individual market capitalization of all companies in the index.
- Computing index of next day requires the index value and the total market capitalization of the previous day and is computed as follows:

$$\text{Index Value} = \frac{\text{Yesterday's Index Point}}{\text{Yesterday's Market Capitalisation}} \times \text{Today's Market Capitalisation}$$

### → Two important market indices

**Sensex and Nifty** are two important share indices in India.

**Sensex** is an index number that measures the relative average change in prices of 30 shares listed in the Bombay Stock Exchange Ltd (BSE).

**Nifty** tracks the performance of equity share of 51 important companies listed on NSE.

Other Index Of the World Market:

US Markets: Nasdaq; Dow Jones

European Markets: FTSE; CAC; DAX

Asia: Nikkei; Straits Times; Hang Seng; KOSPI

### QUESTION NO.3 Write a short note on Rolling Settlement ? (Nov 2008)

→ Rolling Settlement Cycle: SEBI introduced a new settlement cycle known as the 'rolling settlement cycle'. This cycle starts and ends on the same day and settlement takes place on the 'T+X' days where X is 2 days, which is the business days from the date of the transactions.

→ NSE Settlement Cycle: The NSE follows a T+2 rolling settlement cycle. In this settlement for all trade executed on trading day i.e. T day. The obligations are determined on T+1 day and settlement on T+2 basis i.e. on the 2nd working day.

→ BSE Settlement Cycle: The BSE settlement cycle is similar to that of the NSE T+2 i.e. rolling settlement.

→ Advantages of Rolling Settlements: In rolling settlements, payments are quicker than in weekly settlements. Thus, investors benefit from increased liquidity. From an investor's perspective, rolling settlement reduces delays. This also reduces the tendency for price trends to get exaggerated. Hence, investors not only get a better price but can also act at their leisure.

**QUESTION NO.4 What are the Factors Affecting Value of an Option ?(May 2014)**

(a) **Price of the Underlying:** The value of calls and puts are affected by changes in the underlying stock price in a relatively straightforward manner. When the stock price goes up, calls should gain in value and puts should decrease. When the stock market falls put options should increase in value and call options should drop in value .

(b) **Time:** The value of an option declines more rapidly as the option approaches the expiration day. That is good news for the option seller, who tries to benefit from time decay, especially during that final month when it occurs most rapidly.

(c) **Volatility:** The beginning point of understanding volatility is a measure called statistical volatility, or SV for short. SV is a statistical measure of the past price movements of the stock; it tells you how volatile the stock has actually been over a given period of time.

(d) **Interest Rate:** Another feature which effects the value of an Option is the time value of money. The greater the interest rates, the present value of the future exercise price is less.

**QUESTION NO.5 Write a short note on : Assumption Of Black-Scholes Model ?**

(May 2015)

➔ The Black-Scholes model is used to calculate a theoretical price of an Option.

➔ The following assumptions accompany the model :

1. European Options are considered.
2. No transaction costs.
3. Short term interest rates are known and are constant
4. Stocks do not pay dividend.
5. Stock price movement is similar to a random walk.
6. Stock returns are normally distributed over a period of time.
7. The variance of the return is constant over the life of an Option.

**QUESTION NO.6 Define the following Greeks with respect to options:**

(i) Delta (ii) Gamma (iii) Vega (iv) Rho ?

(Nov 15)

(i) **Delta:** It is the degree to which an option price will move given a small change in the underlying stock price. For example, an option with a delta of 0.5 will move half a rupee

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*"Don't Tell God How Big Your Problems Are, Learn to Tell Your Problems How Big Your God is!!*

*Live only for today, for tomorrow may never come.*

*SFM SYLLABUS FULLY AMEDNDED-cafinalsfm@gmail.com*

for every full rupee movement in the underlying stock.

The delta is often called the hedge ratio i.e. if you have a portfolio short “n” options (e.g. you have written n calls) then n multiplied by the delta gives you the number of shares (i.e. units of the underlying) you would need to create a riskless position - i.e. a portfolio which would be worth the same whether the stock price rose by a very small amount or fell by a very small amount.

$$\text{Delta } \Delta = \frac{\text{Change in Option Premium}}{\text{Change in Price of Underlying Asset}}$$

**(ii)Gamma:** It measures how fast the delta changes for small changes in the underlying stock price i.e. the delta of the delta. If you are hedging a portfolio using the delta-hedge technique described under “Delta”, then you will want to keep gamma as small as possible, the smaller it is the less often you will have to adjust the hedge to maintain a delta neutral position. If gamma is too large, a small change in stock price could wreck your hedge. Adjusting gamma, however, can be tricky and is generally done using options.

$$\text{Gamma} = \frac{\text{Change in Delta}}{\text{Change in Price of Underlying Asset}}$$

**(iii)Vega:** Sensitivity of option value to change in volatility. Vega indicates an absolute change in option value for a one percentage change in volatility.

$$\text{Vega} = \frac{\text{Change in Option Premium}}{\text{Change in Volatility of Price}}$$

**(iv)Rho:** The change in option price given a one percentage point change in the risk-free interest rate. It is sensitivity of option value to change in interest rate. Rho indicates the absolute change in option value for a one percent change in the interest rate.

$$\text{Rho} = \frac{\text{Change in Option Premium}}{\text{Change in Rate of Interest}}$$

### **QUESTION NO.7 Write a short note on : EMBEDDED DERIVATIVES**

*(Nov 2011)(Nov 2008)*

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*Man asked a fallen rose- ‘Don’t you get hurt when plucked??’Rose replied- ‘No! I forget my pain thinking that I’m the reason for someone else’s smile!!’*  
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➔ **Meaning Of Derivative:** A derivative is defined as a contract that has all the following characteristics:

- Its value changes in response to a specified underlying, e.g. an exchange rate, interest rate or share price;
- It requires little or no initial net investment;
- It is settled at a future date;
- The most common derivatives are currency forwards, futures, options, interest rate swaps etc.

➔ **Meaning Of Embedded Derivative:** An embedded derivative is a derivative instrument that is embedded in another contract - the host contract. The host contract might be a debt or equity instrument, a lease, an insurance contract or a sale or purchase contract. Sometimes entities combine the derivatives with some non-derivative items; for example, a contract having a derivative characteristic may be combined in a loan, bond, share, lease, insurance contract or purchase or sale contract. "When a derivative feature is combined in a non-derivative contract, the derivative is referred to as embedded derivative and such non-derivative contract is called host contract. The combined contract is called hybrid contract."

➔ **Illustration :**

(a) A Canadian company might enter into a sales contract with a Chinese company, creating a host contract. If the contract is denominated in a foreign currency, such as the U.S. dollar, an embedded foreign currency derivative is created.

(b) A coal purchase contract may include a clause that links the price of the coal to a pricing formula based on the prevailing electricity price or a related index at the date of delivery. The coal purchase contract, is described as the host contract, and the pricing formula is the embedded derivative. The pricing formula is an embedded derivative because it changes the price risk from the coal price to the electricity price.

(c) Suppose entity ABC enters into a contract to issue a bond, and the payment of interest and principal of the bond is indexed with the price of gold. Here, the payment will increase or decrease according to the movement in the price of gold; and the debt instrument is host contract with an embedded derivative

➔ Derivatives require being marked-to-market through the income statement, other than qualifying hedging Instruments. This requirement on embedded derivatives is designed to ensure that marked-to-market through the income statement cannot be avoided by including embedding - a derivative in another contract or financial instrument that is not marked-to



market through the income statement.

➔ An embedded derivative can arise from deliberate financial engineering and intentional shifting of certain risks between parties. Many embedded derivatives, however, arise inadvertently through market practices and common contracting arrangements. Even purchase and sale contracts that qualify for executory contract treatment may contain embedded derivatives. An embedded derivative causes modification to a contract's cash flow, based on changes in a specified variable

**QUESTION NO.8 What is the significance of an underlying in relation to a derivative instrument ? (May 2011)**

➔ The underlying may be a share, a commodity or any other asset which has a marketable value which is subject to market risks.

➔ The importance of underlying in derivative instruments is as follows:

- All derivative instruments are dependent on an underlying to have value.
- The change in value in a forward contract is broadly equal to the change in value in the underlying.
- In the absence of a valuable underlying asset the derivative instrument will have no value.
- On maturity, the position of profit/loss is determined by the price of underlying instruments. If the price of the underlying is higher than the contract price the buyer makes a profit. If the price is lower, the buyer suffers a loss.

**QUESTION NO.9 Explain the term Insider Trading and why Insider Trading is punishable ? (Nov 2014)**

➔ The insider is any person who accesses the price sensitive information of a company before it is published to the general public.

➔ Insider includes corporate officers, directors, owners of firm etc. who have substantial interest in the company.

➔ Insider includes persons who have access to non-public information due to their relationship with the company such as internal or statutory auditor, agent, advisor, analyst consultant etc.

➔ Insider trading practice is the act of buying or selling or dealing in securities by a person

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*Nurture your mind with great thoughts.*

*Motivation is what gets you started. Habit is what keeps you going.*  
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having unpublished inside information with the intention of making abnormal profits and avoiding losses.

➔ This inside information includes dividend declaration, issue or buy back of securities, amalgamation, mergers or take over, major expansion plans etc.

➔ The word insider has wide connotation. An outsider may be held to be an insider by virtue of his engaging himself in this practice on the strength of inside information.

➔ Insider trading practices are lawfully prohibited. The regulatory bodies in general are imposing different fines and penalties for those who indulge in such practices.

➔ Based on the recommendation of Sachar Committee and Patel Committee, SEBI has framed various regulations and implemented the same to prevent the insider trading practices.

➔ Recently SEBI has made several changes to strengthen the existing insider Trading Regulation, 1992 and new Regulation as SEBI (Prohibition of Insider Trading) Regulations, 2002 has been introduced.

➔ Insider trading which is an unethical practice resorted by those in power in corporates has manifested not only in India but elsewhere in the world causing huge losses to common investors thus driving them away from capital market. Therefore, it is punishable.

**QUESTION NO.10 Write a short note on Debt Securitisation? OR Write a short note on Asset Securitisation ? (May 2013)**

➔ Debt Securitisation is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this assets pool market securities can be issued.

➔ The process can be classified in the following three functions:

**1. The origination function** – A borrower seeks a loan from finance company, bank, housing company or a financial institution. On the basis of credit worthiness repayment schedule is structured over the life of the loan.

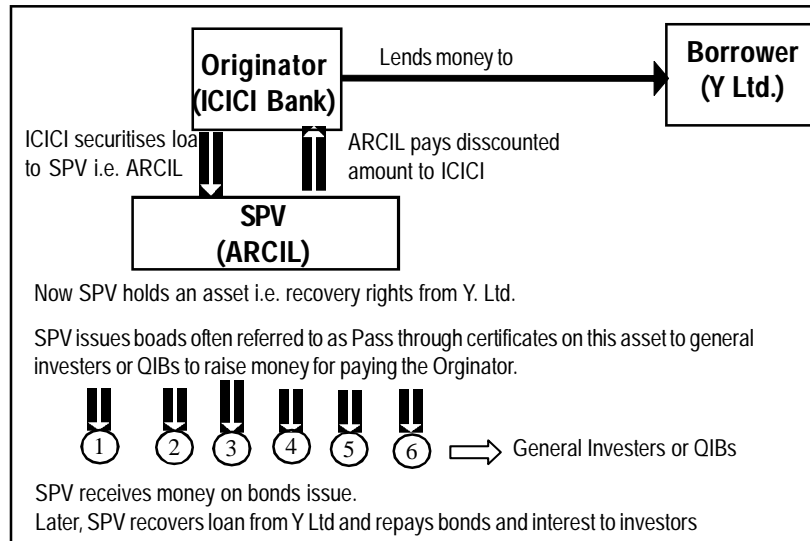
**2. The pooling function** – Many similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favour of a SPV (Special Purpose Vehicle), which acts as a trustee for the investor. Once the assets are transferred they are held in the organizers portfolios.

**3. The securitisation function** – It is the SPV's job to structure and issue the securities on the basis of asset pool. The securities carry coupon and an expected maturity, which can be asset base or mortgage based. These are generally sold to investors through merchant

bankers. The investors interested in this type of securities are generally institutional investors like mutual fund, insurance companies etc. The originator usually keeps the spread available (i.e. difference) between yield from secured asset and interest paid to investors.

➔ Generally the process of securitisation is without recourse i.e. 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 the collateral.

The digrame bellow illustrates the process of Scuritisation in India



### QUESTION NO. 11 Write a short note on Forward Rate Agreements ? (May 2014)

➔ **Meaning:** In finance, a **forward rate agreement (FRA)** is a forward contract in which one party pays a fixed interest rate, and receives a floating interest rate and vice versa. In other words, Agreement to borrow or lend at a specified future date at an interest rate that is fixed today.

➔ **How It Is Quoted :** FRAs are quoted in the format AxB, with (A) representing the number of months until the loan is set to begin, and (B) representing the number of months until the loan ends. To find the length of the loan, subtract A from B.

#### For Example :

➔ A 1 x 4 quote would mean a 3 month loan, set to begin 1 month in the future.

➔ **Payoff formula :** The netted payment made at the effective date is:

$$\frac{\text{Notional Amount Of Loan} \times (\text{Rate At Expiration or LIBOR or Reference Rate} - \text{FRA or Fixed Rate}) \times \frac{\text{Days in Underlying Rate or FRA Days}}{360}}{1 + \text{Rate At Expiration or LIBOR or Reference Rate} \times \frac{\text{Days in Underlying Rate or FRA Days}}{360}}$$

*Remember, happiness doesn't depend upon who you are or what you have,  
it depends solely upon what you think.*  
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**Following are main features of FRA:**

- Normally it is used by banks to fix interest costs on anticipated future deposits or interest revenues on variable-rate loans indexed to LIBOR.
- It is an off Balance Sheet instrument.
- It does not involve any transfer of principal. The principal amount of the agreement is termed “notional” because, while it determines the amount of the payment, actual exchange of the principal never takes place.
- It is settled at maturity in cash representing the profit or loss. A bank that sells an FRA agrees to pay the buyer the increased interest cost on some “notional” principal amount if some specified maturity of LIBOR is above a stipulated “forward rate” on the contract maturity or settlement date. Conversely, the buyer agrees to pay the seller any decrease in interest cost if market interest rates fall below the forward rate.

**Note:**Refer practical part on FRA covered in class for better understanding.

**QUESTION NO.12 Write a short note on INTEREST RATE CAP/FLOOR/COLLAR**

?

(Nov 10)

**Cap:** It is a series of call options on interest rate covering a medium-to-long term floating rate liability. Purchase of a Cap enables a borrowers to fix in advance a maximum borrowing rate for a specified amount and for a specified duration, while allowing him to avail benefit of a fall in rates. The buyer of Cap pays a premium to the seller of Cap.

**Floor:** It is a put option on interest rate. Purchase of a Floor enables a lender to fix in advance, a minimal rate for placing a specified amount for a specified duration, while allowing him to avail benefit of a rise in rates. The buyer of the floor pays the premium to the seller.

**Collars:** It is a combination of a Cap and Floor. The purchaser of a Collar buys a Cap and simultaneously sells a Floor. A Collar has the effect of locking its purchases into a floating rate of interest that is bounded on both high side and the low side.

**Note:**Refer practical part on “INTEREST RATE CAP/FLOOR/COLLAR” covered in class for better understanding



# CHAPTER-6

## SECURITY ANALYSIS

### **QUESTION NO. 1 What are the various techniques are used in Economic Analysis ?** (May 2011)

Some of the techniques used for economic analysis are:

(a) **Anticipatory Surveys**: They help investors to form an opinion about the future state of the economy. It incorporates expert opinion on construction activities, expenditure on plant and machinery, levels of inventory – all having a definite bearing on economic activities. Also future spending habits of consumers are taken into account.

(b) **Barometer/Indicator Approach**: Various indicators are used to find out how the economy shall perform in the future. The indicators have been classified as under:

(1) **Leading Indicators**: They lead the economic activity in terms of their outcome. They relate to the time series data of the variables that reach high/low points in advance of economic activity.

(2) **Roughly Coincidental Indicators**: They reach their peaks and troughs at approximately the same time as the economy.

(3) **Lagging Indicators**: They are time series data of variables that lag behind in their consequences vis-a- vis the economy. They reach their turning points after the economy has reached its own already. All these approaches suggest direction of change in the aggregate economic activity but nothing about its magnitude.

(c) **Economic Model Building Approach**: In this approach, a precise and clear relationship between dependent and independent variables is determined. GNP model building or sectoral analysis is used in practice through the use of national accounting framework.

### **QUESTION NO. 2 Write short notes on Zero coupon bonds ? (May 2012)**

➔ As name indicates these bonds do not pay interest during the life of the bonds.

➔ Instead, zero coupon bonds are issued at discounted price to their face value, which is the amount a bond will be worth when it matures or comes due.

➔ When a zero coupon bond matures, the investor will receive one lump sum (face value) equal to the initial investment plus interest that has been accrued on the investment made.

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*To succeed, you will soon learn, as I did, the importance of a solid foundation in the basics of education—  
literacy, both verbal and numerical, and communication skills.*

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→ The maturity dates on zero coupon bonds are usually long term. These maturity dates allow an investor for a long range planning.

→ Zero coupon bonds issued by banks, government and private sector companies. However, bonds issued by corporate sector carry a potentially higher degree of risk, depending on the financial strength of the issuer and longer maturity period, but they also provide an opportunity to achieve a higher return.



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*"Money can't buy friends. But you can afford a better class of enemy."  
It doesn't matter where you are coming from. All that matters is where you are going.*

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# CHAPTER-7

# PORTFOLIO THEORY

**QUESTION NO.1** Discuss how the risk associated with securities is effected by Government policy ? (May 2011)

➔ The risk from Government policy to securities can be impacted by any of the following factors.

- (i) Licensing Policy.
- (ii) Restrictions on commodity and stock trading in exchanges.
- (iii) Changes in FDI and FII rules.
- (iv) Export and import restrictions.
- (v) Restrictions on shareholding in different industry sectors.
- (vi) Changes in tax laws and corporate and Securities laws.



# CHAPTER-8

## FINANCIAL SERVICES IN INDIA

**QUESTION NO.1** List and briefly explain the main functions of an investment bank ?  
(May 2010)

**Main Functions of an Investment Bank**: The following are, briefly, a summary of investment banking functions:

- **Managing an IPO (Initial Public Offering)**: This includes hiring managers to the issue, due diligence and marketing the issue.
- **Issue of debt**: When a company requires capital, it sometimes chooses to issue public debt instead of equity.
- **Mergers and Acquisitions**: Acting as intermediary between Acquirer and target company
- **Private Placement**: A private placement differs little from a public offering aside from the fact that a private placement involves a firm selling stock or equity to private investors rather than to public investors.
- **Financial Restructuring**: When a company cannot pay its cash obligations - it goes bankrupt. In this situation, a company can, of course, choose to simply shut down operations and walk away or, it can also restructure and remain in business.

**QUESTION NO.2** Write a note on "Credit Rating" in India? OR Briefly explain the meaning and importance of "Credit Rating"? (May 2013)

➔ Credit rating is a symbolic indication of the current opinion regarding the relative capability of a corporate entity to service its debt obligations in time with reference to the instrument being rated.

➔ It enables the investor to differentiate between instruments on the basis of their underlying credit quality.

➔ To facilitate simple and easy understanding, credit rating is expressed in alphabetical or alphanumerical symbols.

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*Beautiful pictures are developed by negatives in a dark room so if you see darkness in ur life assume that God is making a beautiful picture for you. A joke is a very serious thing.*



➔ Thus Credit Rating is:

- 1) An expression of opinion of a rating agency.
- 2) The opinion is in regard to a debt instrument.
- 3) The opinion is as on a specific date.
- 4) The opinion is dependent on risk evaluation.
- 5) The opinion depends on the probability of interest and principal obligations being met timely.

➔ Credit rating aims to

- (i) provide superior information to the investors at a low cost;
- (ii) provide a sound basis for proper risk-return structure;
- (iii) subject borrowers to a healthy discipline and
- (iv) assist in the framing of public policy guidelines on institutional investment.

➔ In India the rating coverage is of fairly recent origin, beginning 1988 when the first rating agency CRISIL was established. At present there are few other rating agencies like:

- (i) Credit Rating Information Services of India Ltd. (CRISIL).
- (ii) Investment Information and Credit Rating Agency of India (ICRA).
- (iii) Credit Analysis and Research Limited (CARE).
- (iv) Duff & Phelps Credit Rating India Pvt. Ltd. (DCRI)
- (v) ONICRA Credit Rating Agency of India Ltd.
- (vi) Fitch Ratings India (P) Ltd.

**QUESTION NO.3 Write a short note on CAMEL MODEL In Credit Rating ?**  
(Nov 2010)

➔ CAMEL Stands for Capital, Assets, Management, Earnings and Liquidity. The CAMEL model adopted by the Rating Agencies deserves special attention, it focuses on the following aspects:

- (a) **Capital** – Composition of Retained Earnings and External Funds raised; Fixed dividend component for preference shares and fluctuating dividend component for equity shares and adequacy of long term funds adjusted to gearing levels; ability of issuer to raise further borrowings.
- (b) **Assets** – Revenue generating capacity of existing / proposed assets, fair values, technological / physical obsolescence, linkage of asset values to turnover, consistency,

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*What do to when u face choices? Simple! Just toss a coin. It works. Not becoz it settles the confusion, but while the coin is in d air, u suddenly know what ur heart hopes for.*

appropriation of methods of depreciation and adequacy of charge to revenues. Size, ageing and recoverability of monetary assets viz receivables and its linkage with turnover.

(c) **Management** – Extent of involvement of management personnel, teamwork, authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.

(d) **Earnings** – Absolute levels, trends, stability, adaptability to cyclical fluctuations ability of the entity to service existing and additional debts proposed.

(e) **Liquidity** – Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.

➔ These five aspects form the five core bases for estimating credit worthiness of an issuer which leads to the rating of an instrument. Rating agencies determine the predominance of positive / negative aspects under each of these five categories and these are factored in for making the overall rating decision.

#### **QUESTION NO.4 Write a short note on Limitations Of Credit Rating ?**

(Nov 2009)

➔ Credit rating is a very important indicator for prudence but it suffers from certain limitations. Some of the limitations are:

(i) **Conflict of Interest** – The rating agency collects fees from the entity it rates leading to a conflict of interest. Since the rating market is very competitive, there is a distant possibility of such conflict entering into the rating system.

(ii) **Industry Specific rather than Company Specific** – Downgrades are linked to industry rather than company performance. Agencies give importance to macro aspects and not to micro ones; overreact to existing conditions which come from optimistic / pessimistic views arising out of up / down turns. At times, value judgments are not ruled out.

(iii) **Rating Changes** – Ratings given to instruments can change over a period of time. They have to be kept under constant watch. Downgrading of an instrument may not be timely enough to keep investors educated over such matters.

(iv) **Corporate Governance Issues** – Special attention is paid to:

(a) Rating agencies getting more of their revenues from a single service or group.

(b) Rating agencies enjoying a dominant market position. They may engage in aggressive competitive practices by refusing to rate a collateralized / securitized instrument or

*If you like someone, show it. It will be sweeter than telling. But if you don't like someone. Just tell it. It will be less painful than showing it.*

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compel an issuer to pay for services rendered.

(c) Greater transparency in the rating process viz. in the disclosure of assumptions leading to a specific public rating.

(v) **Basis of Rating** – Ratings are based on ‘point of time’ concept rather than on period of time’ concept and thus do not provide a dynamic assessment.

(vi) **Cost Benefit Analysis** – Since rating is mandatory, it becomes essential for entities to get themselves rated without carrying out cost benefit analysis.

**QUESTION NO.5** Write a short note on Depository? State Advantages of holding securities in ‘Demat’ form ? (Nov 2012)(May 2010)(Nov 2011)

### Meaning

→ Under this system, the securities (shares, debentures, bonds, Government Securities, MF units etc.) are held in electronic form just like cash in a bank account.

→ To speed up the transfer mechanism of securities from sale, purchase, transmission, SEBI introduced Depository Services also known as Dematerialization of listed securities. → It is the process by which certificates held by investors in physical form are converted to an equivalent number of securities in electronic form. The securities are credited to the investor’s account maintained through an intermediary called Depository Participant (DP). → Shares/Securities once dematerialized lose their independent identities. Separate numbers are allotted for such dematerialized securities.

→ Organization holding securities of investors in electronic form and which renders services related to transactions in securities is called a Depository.

→ A depository holds securities in an account, transfers securities from one account holder to another without the investors having to handle these in their physical form.

→ The depository is a safe keeper of securities for and on behalf of the investors.

→ All corporate benefits such as Dividends, Bonus, Rights etc. are issued to security holders as were used to be issued in case of physical form.

### Advantages of holding securities in ‘Demat’ form

→ From an individual investor point of view, the following are important advantages of holding securities in demat form:

- It is speedier and avoids delay in transfers.
- It avoids lot of paper work.
- It saves on stamp duty.

---

*A man who had half of his body amputated after being run over by a truck opened his own bargain supermarket, called the Half Man-Half Price Store.*

➔ From the issuer-company point of view also, there are significant advantages due to dematting, some of which are:

- Savings in printing certificates, postage expenses.
- Stamp duty waiver.
- Easy monitoring of buying/selling patterns in securities, increasing ability to spot takeover attempts and attempts at price rigging .

**QUESTION NO.6 What are the difference between Factoring & Forfaiting?**  
(Nov 2015)

**Factoring**

- (i) This may be with recourse or without recourse to the supplier.
- (ii) It usually involves trade receivables of short maturities.
- (iii) It does not involve dealing in negotiable instruments.
- (iv) The seller (client) bears the cost of factoring.
- (v) Usually it involves purchase of all book debts or all classes of book debts.
- (vi) Factoring tends to be a case of sell of debt obligation to the factor, with no secondary market.

**Forfaiting**

- (i) This is without recourse to the exporter. The risks are borne by the forfeiter.
- (ii) It usually deals in trade receivables of medium and long term maturities.
- (iii) It involves dealing in negotiable instrument like bill of exchange and promissory note.
- (iv) The overseas buyer bears the cost of forfaiting
- (v) Forfaiting is generally transaction or project based. Its structuring and costing is case to case basis.
- (vi) There exists a secondary market in forfaiting. This adds depth and liquidity to forfaiting.

**QUESTION NO.7 ((Nov 2010)**

- (i) What is the meaning of NBFC?
- (ii) What are the different categories of NBFCs?
- (iii) Explain briefly the regulation of NBFCs under RBI Act.
- (i) **Meaning of NBFC (Non Banking Financial Companies) :**

*When defeat comes, accept it as a signal that ur plans are not sound,  
rebuild those plans & set sail once more toward your coveted goal.*

NBFC stands for Non-Banking financial institutions, and these are regulated by the Reserve Bank of India under RBI Act, 1934. NBFC's principal business is receiving of deposits under any scheme or arrangement or in any other manner or lending on any other manner. They normally provide supplementary finance to the corporate sector.

**(ii) Different categories of NBFC are :**

1. Loan companies
2. Investment Companies.
3. Hire Purchase Finance Companies.
4. Equipment Leasing Companies.
5. Mutual Benefit Finance Companies.
6. Housing Finance Companies
7. Miscellaneous Finance Companies

**(iii) Regulation of NBFCs-**

RBI regulates the NBFC through the following measures:

- (a) Mandatory Registration.
- (b) Minimum owned funds.
- (c) Only RBI authorized NBFCs can accept public deposits.
- (d) RBI prescribes the ceiling of interest rate.
- (e) RBI prescribes the period of deposit.
- (f) RBI prescribes the prudential norms regarding utilization of funds.
- (g) RBI directs their investment policies.
- (h) RBI inspectors conduct inspections of such companies.
- (i) RBI prescribes the points which should be examined and reported by the auditors of such companies.
- (j) RBI prescribes the norms for preparation of Accounts particularly provisioning of possible losses.
- (k) If any of interest or principal or both is/ are due from any customer for more than 6 months, the amount receivable (interest or principal or both) is termed as non-performing asset.

**QUESTION NO.8 Difference between Commercial Banking and Investment Banking?**  
*(May 2016)*

Commercial and Investment Banking share many aspects, but also have many

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*Past scholars studied to improve themselves; Today's scholars study to impress others. Work is a necessity for man. Man invented the alarm clock. When your work speaks for itself, don't interrupt.*



fundamental differences. Both investment banking and commercial banking thus bring about a redistribution of the capital in existence, though they do this in different ways and for different purposes.

→ A commercial bank takes deposits for current and savings accounts from consumers while an investment bank does not take deposit.

→ An investment bank does not have an inventory of cash deposits to lend as a commercial bank does.

→ An investment bank acts as an intermediary, and matches sellers of stocks and bonds with buyers of stocks and bonds.

→ Because commercial banks already have funds available from their depositors and an investment bank does not, an I-bank must spend considerable time finding investors in order to obtain capital for its client.

→ Investment banks typically sell public securities .

→ The investment bank makes money by charging the client a small percentage of the transaction upon its completion. Investment banks call this upfront fee the “underwriting discount.” In contrast, a commercial bank making a loan actually receives the interest and simultaneously owns the debt.

→ Commercial Banking is the day to day business banking of a client. Investment Banking is all dealing in IPO, Shares, and Mutual Funds.

→ Thus the fundamental differences between an investment bank and a commercial bank can be outlined as follows:

**Investment Banks** :1. Investment Banks help their clients in raising capital by acting as an intermediary between the buyers and the sellers of securities (stocks or bonds)

**Commercial Banks** :1. Commercial Banks are engaged in the business of accepting deposits from customers and lending money to individuals & corporates.

**Investment Banks**: 2. Investment Banks do not take deposits from customers.

**Commercial Banks**:2. Commercial banks can legally take deposits from customers .

**Investment Banks** :3. The Investment Banks do not own the securities and only act as an intermediary for smooth transaction of buying and selling securities.

**Commercial Banks** :3. Commercial Banks own the loans granted to their customers.

**Investment Banks** :4. Investment Banks earn underwriting commission;

**Commercial Banks**:4. Commercial banks earn interest on loans granted to their customers.

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*Set your goals high, and don't stop till you get there. Begin - to begin is half the work, let half still remain; again begin this, and you will find that the work is finished. A nation's treasure is in its scholars.*

# CHAPTER-9

## MUTUAL FUNDS

**QUESTION NO.1** What are the limitations/drawbacks of investing in Mutual Fund? (Nov 2008)

- (a) There is no guarantee of return as some Mutual Funds may under perform and Mutual Fund Investment may depreciate in value which may even effect erosion / Depletion of principal amount
- (b) Diversification may minimize risk but does not guarantee higher return.
- (c) Mutual funds performance is judged on the basis of past performance record of various companies. But this can not take care of or guarantee future performance.
- (d) Mutual Fund cost is involved like entry load, exit load, fees paid to Asset Management Company etc.
- (e) There may be unethical Practices e.g. diversion of Mutual Fund amounts by Mutual Fund /s to their sister concerns for making gains for them.
- (f) MFs, systems do not maintain the kind of transparency, they should maintain.
- (g) Many MF scheme are, at times, subject to lock in period, therefore, deny the market drawn benefits.
- (h) At times, the investments are subject to different kind of hidden costs.
- (i) Redressal of grievances, if any , is not easy.

**QUESTION NO.2** Write short note on 'Signals Highlighting The Exit Of The Investor From The Mutual Fund Scheme' ? (Nov 2014)

- (1) When the mutual fund consistently under performs the broad based index, it is high time that we should get out of the scheme. It would be better to invest in the index itself either by investing in the constituents of the index or by buying into an index fund.
- (2) When the mutual fund consistently under performs its peer group instead of it being at the top. In such a case, it would be better to get out of the scheme and invest

---

*Avoid competency traps. Do not stay only where you are good at things,  
Go out and be challenged.*

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in the winning schemes.

(3) When the mutual fund changes its objectives e.g. instead of providing a regular income to the investor, the composition of the portfolio has changed to a growth fund mode which is not in tune with the investor's risk preferences.

(4) When the investor changes his objective of investing in a mutual fund which no longer is beneficial to him.

(5) When the fund manager, handling the mutual fund schemes, has been replaced by a new entrant whose image is not known.

**QUESTION NO.3** Write short note on 'Exchange Traded Funds' ?What are its key features? (May 2010)(Nov 2013)

or

**QUESTION NO.3** Write short note on 'Exchange Traded Funds' ?What are its advantage? (Nov 2016)

↪ Exchange Traded Funds (ETFs) were introduced in US in 1993 and came to India around 2002.

↪ ETF is a hybrid product that combines the features of an index mutual fund and stock and hence, is also called index shares. These funds are listed on the stock exchanges and their prices are linked to the underlying index. The authorized participants act as market makers for ETFs.

↪ ETF can be bought and sold like any other stock on stock exchange. In other words, they can be bought or sold any time during the market hours at prices that are expected to be closer to the NAV at the end of the day. 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.

↪ There is no paper work involved for investing in an ETF. These can be bought like any other stock by just placing an order with a broker.

↪ Some other important advantages of ETF are as follows:

1. It gives an investor the benefit of investing in a commodity without physically

---

*There is joy in work. There is no happiness except in the realization that we have accomplished something.*

*Give a man a fish and you feed him for a day. Teach a man to fish and you feed him for a lifetime*

purchasing the commodity like gold, silver, sugar etc.

2.It is launched by an asset management company or other entity.

3.The investor does not need to physically store the commodity or bear the costs of upkeep which is part of the administrative costs of the fund.

4.An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed ended fund, which trades throughout the trading day at prices that may be more or less than its net asset value.

➔ **Some other important features of ETF are as follows:**

1.It gives an investor the benefit of investing in a commodity without physically purchasing the commodity like gold, silver, sugar etc.

2.It is launched by an asset management company or other entity.

3.The investor does not need to physically store the commodity or bear the costs of upkeep which is part of the administrative costs of the fund.

4. An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-ended fund, which trades throughout the trading day at prices that may be more or less than its net asset value.

**QUESTION NO.4 Distinguish between Open-ended and Close-ended Schemes ?**

(May 2015)(Nov 2010)

➔ **Open Ended Scheme** do not have maturity period. These schemes are available for subscription and repurchase on a continuous basis. Investor can conveniently buy and sell unit. The price is calculated and declared on daily basis. The calculated price is termed as NAV. The buying price and selling price is calculated with certain adjustment to NAV. The key feature of the scheme is liquidity.

➔ **Close Ended Scheme** has a stipulated maturity period normally 5 to 10 years. The Scheme is open for subscription only during the specified period at the time of launch of the scheme. Investor can invest at the time of initial issue and there after they can buy or sell from stock exchange where the scheme is listed. To provide an exit route some close-ended schemes give an option of selling back (repurchase) on the basis of NAV. The NAV is generally declared on weekly basis.

*Happiness always looks small if you hold in your hands. But learn to share it,  
you will realize how big and precious it is .*

*SFM SYLLABUS FULLY AMEDNDED-cafinalsfm@gmail.com*

# CHAPTER-10

## MONEY MARKET OPERATIONS

**QUESTION NO. 1** What is Money Market? What are its features? What kind of inefficiencies it is suffering from? (Nov 2013)

or

**QUESTION NO. 1** What are the rigidities in the Indian Money Market ? (Nov 2016)

→ The money market is a market for short term financial assets that are close substitutes for money. → The important feature of money market instrument is that it is liquid. → This is market for borrowing and lending Short-term funds. → Money market instrument are those instruments which have a maturity period of less than one year . → Example: Treasury Bills, Certificate of Deposits, Commercial Paper, Repo etc.

### **Features:**

- (i) The term short-term means generally a period upto one year and near substitutes to money is used to denote any financial asset which can be quickly converted into money.
- (ii) Low cost.
- (iii) It provides an avenue for equilibrating the short-term surplus funds of lenders and the requirements of borrowers.
- (iv) It, thus, provides a reasonable access to the users of short term money to meet their requirements at realistic prices.
- (v) The money market can also be defined as a centre in which financial institutions congregate for the purpose of dealing impersonally in monetary assets.

### **Few rigidities in the Indian Money Market :**

The money market is not free from certain rigidities which are hampering the growth of the market. The most important rigidities in the Indian money market are:

- (i) Markets not integrated.
- (ii) High volatility,
- (iii) Players restricted,
- (iv) Supply based-sources influence uses,
- (v) Not many instruments,
- (vi) Players do not alternate between borrowing and lending,

---

*The permanent temptation of life is to confuse dream with reality .But the permanent defeat of life comes when we surrender our dreams toward reality.Great ideas originate in the muscles.*



- (vii) Reserve requirements,
- (viii) Lack of transparency,
- (ix) Inefficient Payment Systems ,
- (x) Interest rates not properly aligned,
- (xi) Seasonal shortage of funds,
- (xii) Commercial transactions are mainly in cash, and
- (xiii) Heavy Stamp duty limiting use of exchange bills .

**QUESTION NO.2 Write a short note on :**

**A. CALL/NOTICE MONEY**

*(May 2013)*

➔ The Call Money is a part of the money market where, day to day surplus funds, mostly of banks, are traded. Moreover, the call money market is most liquid of all short-term money market segments.

➔ The maturity period of call loans vary from 1 to 14 days. The money that is lent for one day in call money market is also known as 'overnight money'.

➔ The interest paid on call loans are known as the call rates. The call rate is expected to freely reflect the day-to- day lack of funds. These rates vary from day-to-day and within the day, often from hour-to-hour. High rates indicate the tightness of liquidity in the financial system while low rates indicate an easy liquidity position in the market.

➔ In India, call money is lent mainly to even out the short-term mismatches of assets and liabilities and to meet CRR requirement of banks. The short-term mismatches arise due to variation in maturities i.e. the deposits mobilized are deployed by the bank at a longer maturity to earn more returns and duration of withdrawal of deposits by customers vary.

➔ Thus, the banks borrow from call money markets to meet short-term maturity mismatches.

➔ Moreover, the banks borrow from call money market to meet the cash Reserve Ratio (CRR) requirements that they should maintain with RBI every fortnight and is computed as a percentage of Net Demand and Time Liabilities (NDTL).

**B. INTER-BANK PARTICIPATION CERTIFICATE (IBPC)**

*(May 2012)*

➔ The IBPCs are short-term instruments to even-out the short-term liquidity within the banking system.

- ➔ The primary objective is to provide some degree of flexibility in the credit portfolio of banks and to smoothen the consortium arrangements.
- ➔ The IBPC can be issued by scheduled commercial bank and can be subscribed to by any commercial bank.
- ➔ The IBPC is issued against an underlying advance, classified standard . During the currency of the participation, the aggregate amount of participation should be covered by the outstanding balance in account.
- ➔ The participation can be issued in two types, viz. with and without risk to the lender.
- ➔ While the participation without risk , can be issued for a period not exceeding 90 days.Participation with risk can be issued for a period between 91 days and 180 days.
- ➔ The interest rate on IBPC is freely determined in the market.
- ➔ The certificates are neither transferable nor prematurely redeemable by the issuing bank.
- ➔ In the case of the bank issuing IBPC with risk, the aggregate amount of participation would be reduced from the aggregate advance outstanding.
- ➔ The scheme is beneficial both to the issuing and participating banks. The issuing bank can secure funds against advances without actually diluting its asset-mix. A bank having the highest loans to total asset ratio and liquidity bind can square the situation by issuing IBPCs. To the lender, it provides an opportunity to deploy the short-term surplus funds in a secured and profitable manner.

### **C. MONEY MARKET MUTUAL FUNDS (MMMMFs)** (Nov 2011)(Nov 2015)

- ➔ MMMF pools the resources from the investors and invests them in a basket of money market instruments to generate the desired income.
- ➔ The Government of India thought of introducing Money Market Mutual Funds (MMMMFs) on Indian financial canvass in 1992.
- ➔ 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.
- ➔ Such schemes invest in safe highly liquid instruments included in commercial papers certificates of deposits and government securities.
- ➔ Accordingly, the Money Market Mutual Fund (MMMMF) schemes generally provide high returns and highest safety to the ordinary investors.

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*Life is tough, and if you have the ability to laugh at it you have the ability to enjoy it. Dreams give support to Hope . Hope inspires efforts , efforts results in success . So Dreams are roots of success.*

→ MMMF schemes are active players of the money market. They channallize the idle short funds, particularly of corporate world, to those who require such funds. 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. Participation of such Mutual Funds provide a boost to money market and help in controlling the volatility.

## **D. COMMERCIAL PAPER (CP)**

(Nov 2012)

→ A commercial paper is an unsecured money market instrument issued in the form of a promissory note.

→ Since the CP represents an unsecured borrowing in the money market, the regulation of CP comes under the purview of the Reserve Bank of India which issued guidelines in 1990 on the basis of the recommendations of the Vaghul Working Group.

→ These guidelines were aimed at:

(i) Enabling the highly rated corporate borrowers to diversify their sources of short term borrowings, and

(ii) To provide an additional instrument to the short term investors.

→ It can be issued for maturities between 7 days and a maximum upto one year from the date of issue. These can be issued in denominations of Rs. 5 lakh or multiples therefore.

→ All eligible issuers are required to get the credit rating from credit rating agencies.

→ Eligibility criteria for issuer of commercial paper

The companies satisfying the following conditions are eligible to issue commercial paper.

(i) The tangible net worth of the company is Rs. 5 crores or more as per audited balance sheet of the company.

(ii) The fund base working capital limit is not less than Rs. 5 crores.

(iii) The company is required to obtain the necessary credit rating from the rating agencies such as CRISIL, ICRA etc.

(iv) The issuers should ensure that the credit rating at the time of applying to RBI should not be more than two months old.

(v) The minimum current ratio should be 1.33:1 based on classification of current assets and liabilities.

(vi) For public sector companies there are no listing requirement but for companies other

than public sector, the same should be listed on one or more stock exchanges.  
(vii) All issue expenses shall be borne by the company issuing commercial paper.

**QUESTION NO.3 What is the difference between Capital Market and Money Market? (May 2016)**

The capital market deals in financial assets. Financial assets comprises of shares, debentures, mutual funds etc. The capital market is also known as stock market. Stock market and money market are two basic components of Indian financial system. Capital market deals with long and medium term instruments of financing while money market deals with short term instruments.

Some of the points of distinction between capital market and money market are as follows:

(i) **Money Market:** There is no classification between primary market and secondary market.

**Capital Market:** There is a classification between primary market and secondary market.

(ii) **Money Market** It deals for funds of short-term requirement (less than a year).

**Capital Market:** It deals with funds of long-term requirement (more than 1 year).

(iii) **Money Market** Money market instruments include interbank call money, notice money upto 14 days, short-term deposits upto three months, commercial paper, 91 days treasury bills.

**Capital Market:** Capital Market instruments are shares and debt instruments.

(iv) **Money Market** Money market participants are banks, financial institution, RBI and Government.

**Capital Market:** Capital Market participants include retail investors, institutional investors like Mutual Funds, Financial Institutions, corporate and banks.

(v) **Money Market** Supplies funds for working capital requirement.

**Capital Market:** Supplies funds for fixed capital requirements.

(vi) **Money Market** Each single instrument is of a large amount.

**Capital Market:** Each single instrument is of a small amount.

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*No one gets a sudden RISES, even the SUN. No one gets a sudden FALL, even the MOON.*

*So, stabilize your LIFE with the POSITIVE APPROACH*

SFM SYLLABUS FULLY AMEDNDED-cafinalsfrm@gmail.com

(vii)**Money Market** Risk involved in money market is less due to smaller term of maturity. In short term the risk of default is less.

**Capital Market:**Risk is higher.

(viii)**Money Market** Transactions take place over phone calls. Hence there is no formal place for transactions.

**Capital Market:**Transactions are at a formal place viz.the stock exchange.

(ix)**Money Market** The basic role of money market is liquidity adjustment.

**Capital Market:**The basic role of capital market includes putting capital to work,preferably to long term, secure and productive employment.

(x)**Money Market** Closely and directly linked with the Central Bank of India

**Capital Market:**The Capital market feels the influence of the Central Bank but only indirectly and through the money market .

(xi)**Money Market** Commercial Banks are closely regulated.

**Capital Market:**The institutions are not much regulated.

### **Distinction between Money Market and Capital Market**

<b><u>Basis</u></b>	<b><u>Money Market</u></b>	<b><u>Capital Maket</u></b>
1.Maturity of Instruments	1 year or less	More than 1 year
2. Risks	Less	More and varied
3. Instruments	Treasury bills, CDs, etc	Shares, bonds, etc
4. Finance	Short term	Long term
5. Relation with Central Bank	Direct	Indirect





## CHAPTER-11

### FDI, FIIs AND INTERNATIONAL FINANCIAL MANAGEMENT

#### **QUESTION NO.1 Write a short note on instruments of International Finance ?**

(Nov 2015)

The various financial instruments dealt with in the international market are :

- 1. Euro Bonds** : Euro Bonds are debt instruments denominated in a currency issued outside the country of that currency e.g. A Yen floated in Germany; a yen bond issued in France.
- 2. Foreign Bonds**: These are debts instruments denominated in a currency which is foreign to the borrower and is sold in a country of that currency. A British firm placing \$ denominated bonds in USA is said to be selling foreign bonds.
- 3. Fully Hedged Bonds** : In foreign bonds, the risk of currency fluctuations exist. Fully hedged bonds eliminate that risk by selling in forward markets the entire stream of interest and principal payments.
- 4. Floating Rate Notes** : These are issued upto 7 years maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They provide cheaper money than foreign loans. Currently they are not very popular.
- 5. Euro Commercial Papers** : Euro Commercial Papers (ECPs) are short-term money market instruments. They are for maturities for less than a year. They are usually designated in US dollars.

#### **QUESTION NO.2 Write a short note on the following topics :**

**A. GDR (Global Depository Receipts) (May 2015) & Impact of GDRs on Indian Capital Market (Nov 2009)**

##### **Meaning:**

- ➔ It is an instrument in the form of a depository receipt or certificate created by the overseas depository bank outside India denominated in dollar and issued to non-resident investor against the issue of ordinary shares or FCCBs (Foreign currency convertible bonds) of the issuing company. It is traded in stock exchange in Europe or USA or Both.
- ➔ A GDR usually represent one or more shares or convertible bonds of the issuing company.
- ➔ A holder of a GDR is given an option to convert it into number of shares/bonds that it represents after 45 days from the date of allotment.

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*Time is really the only capital that any human being has, and the only thing he can't afford to lose.*

**REMEMBER : Behind every successful man there's a lot u unsuccessful years -**

➔ The share or bond which a holder of GDR is entitled to get are traded in Indian Stock Exchanges.

➔ Till conversion, the GDR does not carry any voting right.

➔ There is no lock-in-period for GDR.

### **Impact of GDRs on Indian Capital Market**

➔ After the globalization of the Indian economy, accessibility to vast amount of resources was available to the domestic corporate sector. One such accessibility was in terms of raising financial resources abroad by internationally prudent companies. Among others, GDRs were the most important source of finance from abroad at competitive cost. Global depository receipts are basically negotiable certificates denominated in US dollars, that represent a non-US company's publicly traded local currency (Indian rupee) equity shares. Companies in India, through the issue of depository receipts, have been able to tap global equity market to raise foreign currency funds by way of equity.

➔ Since the inception of GDRs, a remarkable change in Indian capital market has been observed. Some of the changes are as follows:

(i) Indian capital market to some extent is shifting from Bombay to Luxemburg and other foreign financial centres.

(ii) There is arbitrage possibility in GDR issues. Since many Indian companies are actively trading on the London and the New York Exchanges and due to the existence of time differences, market news, sentiments etc. at times the prices of the depository receipts are traded at discounts or premiums to the underlying stock. This presents an arbitrage opportunity wherein the receipts can be bought abroad and sold in India at a higher price.

(iii) Indian capital market is no longer independent from the rest of the world. This puts additional strain on the investors as they now need to keep updated with worldwide economic events.

(iv) Indian retail investors are completely sidelined. Due to the placements of GDRs with Foreign Institutional Investor's on the basis free pricing, the retail investors can no longer expect to make easy money on heavily discounted right/public issues.

(v) A considerable amount of foreign investment has found its way in the Indian market which has improved liquidity in the capital market.

(vi) Indian capital market are now impacted by world economic changes, good or bad.

(vii) Indian capital market has not only been widened but deepened as well.

(viii) It has now become necessary for Indian capital market to adopt international practices in its working including financial innovations.

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*Nothing can stop the man with the right mental attitude from achieving his goal; nothing on earth can help the man with the wrong mental attitude. Doubters do not win and Winners do not doubt.*

## **B. Euro Convertible Bonds**

*(May 2013)*

➔ They are bonds issued by Indian companies in foreign market with the option to convert them into pre-determined number of equity shares of the company. Usually price of equity shares at the time of conversion will fetch premium. The Bonds carry fixed rate of interest.

➔ The issue of bonds may carry two options:

**Call option:** Under this the issuer can call the bonds for redemption before the date of maturity. Where the issuer's share price has appreciated substantially, i.e., far in excess of the redemption value of bonds, the issuer company can exercise the option. This call option forces the investors to convert the bonds into equity. Usually, such a case arises when the share prices reach a stage near 130% to 150% of the conversion price.

**Put option:** It enables the buyer of the bond a right to sell his bonds to the issuer company at a pre-determined price and date.

➔ The payment of interest and the redemption of the bonds will be made by the issuer-company in US dollars.

## **C. American Depository Receipts**

*(Nov 2012)(May 2014)*

➔ A depository receipt is basically a negotiable certificate denominated in US dollars that represent a non- US Company's publicly traded local currency (INR) equity shares/ securities. While the term refer to them is global depository receipts however, when such receipts are issued outside the US, but issued for trading in the US they are called ADRs.

➔ An ADR is generally created by depositing the securities of an Indian company with a custodian bank. In arrangement with the custodian bank, a depository in the US issues the ADRs.

➔ The ADR subscriber/holder in the US is entitled to trade the ADR and generally enjoy rights as owner of the underlying Indian security. ADRs with special/unique features have been developed over a period of time and the practice of issuing ADRs by Indian Companies is catching up.

➔ Only such Indian companies that can stake a claim for international recognition can avail the opportunity to issue ADRs. The listing requirements in US and the US GAAP requirements are fairly severe and will have to be adhered. However if such conditions are met ADR becomes an excellent sources of capital bringing in foreign exchange.

➔ These are depository receipts issued by a company in USA and are governed by the

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*"Be not afraid of growing slowly, be afraid of standing still" Where the willingness is great, the difficulties cannot be great" Impossible is a word to be found only in the dictionary of fools.*

provisions of Securities and Exchange Commission of USA. As the regulations are severe, Indian companies tap the American market through private debt placement of GDRs listed in London and Luxemburg stock exchanges.

→ Apart from legal impediments, ADRs are costlier than Global Depository Receipts (GDRs). Legal fees are considerably high for US listing. Registration fee in USA is also substantial. Hence, ADRs are less popular than GDRs.

### **QUESTION NO.3 Write a short note on Leading And Lagging ?**

*(Nov 2011)*

→ 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 purposes:-

**(1) Hedging foreign exchange risk:** A company can lead payments required to be made in a currency that is likely to appreciate. For example, a company has to pay \$100000 after one month from today. The company apprehends the USD to appreciate. It can make the payment now. Leading involves a finance cost i.e. one month's interest cost of money used for purchasing \$100000.

A company may lag the payment that it needs to make in a currency that it is likely to depreciate, provided the receiving party agrees for this proposition. The receiving party may demand interest for this delay and that would be the cost of lagging. Decision regarding leading and lagging should be made after considering

**(i)** likely movement in exchange rate **(ii)** interest cost and **(iii)** discount (if any).

**(2) Shifting the liquidity by modifying the credit terms between inter-group entities:**

For example, A Holding Company sells goods to its 100% Subsidiary. Normal credit term is 90 days. Suppose cost of funds is 12% for Holding and 15% for Subsidiary. In this case the Holding may grant credit for longer period to Subsidiary to get the best advantage for the group as a whole. If cost of funds is 15% for Holding and 12% for Subsidiary, the Subsidiary may lead the payment for the best advantage of the group as a whole. The decision regarding leading and lagging should be taken on the basis of cost of funds to both paying entity and receiving entity. If paying and receiving entities have different home currencies, likely movements in exchange rate should also be considered.



*I have not failed. I've just found 10,000 ways that won't work. - Thomas Alva Edison*  
*"If you want to feel rich, just count all of the things you have that money can't buy."*

SFM SYLLABUS FULLY AMEDNDED-cafinalsfm@gmail.com

# CHAPTER-12

## FOREIGN EXCHANGE EXPOSURE & RISK MANAGEMENT

**QUESTION NO.1** Write a short note on Exchange Rate Theories ? Or What is the meaning of :

(i) Interest rate parity and (ii) Purchasing power parity ? (May 2011)

### Interest Rate Parity (IRP)

↪ Interest rate parity is a theory which states that ‘the size of the forward premium (or discount) should be equal to the interest rate differential between the two countries of concern’.

↪ When interest rate parity exists, covered interest arbitrage (means foreign exchange risk is covered) is not feasible, because any interest rate advantage in the foreign country will be offset by the discount on the forward rate. Thus, the act of covered interest arbitrage would generate a return that is no higher than what would be generated by a domestic investment.

↪ The Covered Interest Rate Parity equation is given by:

$$(1 + r_D) = F/S (1 + r_F)$$

Where  $(1 + r_D)$  = Amount that an investor would get after a unit period by investing a rupee in the domestic market at  $r_D$  rate of interest and  $(1 + r_F) F/S$  = is the amount that an investor will receive by investing in the foreign market at  $r_F$ ;  $F/S$  ensures that the investment of one rupee yield same return in the domestic as well as in the foreign market.

↪ Thus IRP is a theory which states that the size of the forward premium or discount on a currency should be equal to the interest rate differential between the two countries of concern.

### Purchasing Power Parity (PPP)

↪ Purchasing Power Parity theory focuses on the ‘inflation & exchange rate’ relationship.

↪ There are two forms of PPP theory:-

**The ABSOLUTE FORM**, 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.

*Samsung accounts for 20% of Korea's  
gross domestic product.*



**The RELATIVE FORM** is an alternative version that accounts for the possibility of market imperfections such as transportation costs, tariffs, and quotas. It suggests that 'because of these market imperfections, prices of similar products of different countries will not necessarily be the same when measured in a common currency.' However, it states that the rate of change in the prices of products should be somewhat 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:

$$F = S \times (1 + iD) / (1 + iF)$$

Where F= Forward Rate of Foreign Currency and S= Spot Rate; iD = Domestic Inflation Rate and iF= Inflation Rate in foreign country

➔ Thus 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.

## **QUESTION NO.2 What are the risks to which foreign exchange transactions are exposed? (Nov 2014)**

A firm dealing with foreign exchange may be exposed to the following types of risks:

(i) **Transaction Exposure**: A firm may have some contractually fixed payments and receipts in foreign currency, such as, import payables, export receivables, interest payable on foreign currency loans etc. All such items are to be settled in a foreign currency. Unexpected fluctuation in exchange rate will have favourable or adverse impact on its cash flows. Such exposures are termed as transactions exposures.

(ii) **Translation Exposure**: The translation exposure is also called accounting exposure or balance sheet exposure. It is basically the exposure on the assets and liabilities shown in the balance sheet and which are not going to be liquidated in the near future. It refers to the probability of loss that the firm may have to face because of decrease in value of assets due to devaluation of a foreign currency despite the fact that there was no foreign exchange transaction during the year.

(iii) **Economic Exposure**: Economic exposure measures the probability that fluctuations in foreign exchange rate will affect the value of the firm. The intrinsic value of a firm is calculated by discounting the expected future cash flows with appropriate discounting

*"Obstacles are things a person sees when he takes his eyes off his goal." A man who lives fully is prepared to die at any time. "If you want to feel rich, just count all of the things you have that money can't buy."*

rate. The risk involved in economic exposure requires measurement of the effect of fluctuations in exchange rate on different future cash flows.

**QUESTION NO.3 Write a short note on following : Interest Swaps ?**

( May 2012 )

- ➔ A swap is a contractual agreement between two parties to exchange, or “swap,” future payment streams based on differences in the returns to different securities or changes in the price of some underlying item.
- ➔ Interest rate swaps constitute the most common type of swap agreement.
- ➔ In an interest rate swap, the parties to the agreement, termed the swap counterparties, agree to exchange payments indexed to two different interest rates. Total payments are determined by the specified notional principal amount of the swap, which is never actually exchanged.
- ➔ Financial intermediaries, such as banks, pension funds, and insurance companies, as well as non-financial firms use interest rate swaps to effectively change the maturity of outstanding debt or that of an interest-bearing asset.
- ➔ Swaps grew out of parallel loan agreements in which firms exchanged loans denominated in different currencies.

**QUESTION NO.4 Explain the meaning of the following in respect of Swap transaction**

**(i) Plain Vanilla Swaps (ii) Basis Rate Swaps (iii) Asset Swaps (iv) Amortising Swaps**  
(May 2015)

**Plain Vanilla Swaps:** These are fixed-to-floating interest rate swaps between two parties in which each contracts to make payments to the other on particular dates in the future till a specified termination date.

**Basis rate swaps:** These are similar to plain vanilla swaps but in a basis rate swap both legs are floating rate but measured against different benchmarks. For example, a US corporate that has a Floating rate bond benchmarked to US 10 year treasury notes could swap the floating interest to LIBOR (which itself is a floating rate). In basis swaps, the initial value of the swap is not equal to Zero.

**Asset Swaps:** These can be either a plain vanilla or a basis rate swap. Instead of swapping the interest payments on liability, one of the parties to the swap is swapping the interest receipts on an asset.

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*In Business, the competition will bite you if you keep running, if you stand still, they will swallow you  
“If you must trust anyone in life, let it be yourself.”*

**Amortising Swaps:** These are swaps for which the notional principal falls over its term. They are particularly useful for borrowers who have issued redeemable debt. It enables them to match interest rate hedging with the redemption profile of the bonds.

**QUESTION NO.5 Write a short note on the following topics ?**

**A. ARBITRAGE**

*(Nov 2008)*

- ➔ Arbitrage is the buying and selling of the same commodity in different markets.
- ➔ A number of pricing relationships exist in the foreign exchange market, whose violation would imply the existence of arbitrage opportunities - the opportunity to make a profit without risk or investment.
- ➔ These transactions refer to advantage derived in the transactions of foreign currencies by taking the benefits of difference in rates between two currencies at two different centers at the same time or of difference between cross rates and actual rates.
- ➔ For example, a customer can gain from arbitrage operation by purchase of dollars in the local market at cheaper price prevailing at a point of time and sell the same for sterling in the London market. The Sterling will then be used for meeting his commitment to pay the import obligation from London.

**B. NOSTRO, VOSTRO AND LORO ACCOUNTS**

*(May 2012)*

- ➔ In interbank transactions, foreign exchange is transferred from one account to another account and from one centre to another centre. Therefore, the banks maintain three types of current accounts in order to facilitate quick transfer of funds in different currencies. These accounts are Nostro, Vostro and Loro accounts meaning “our”, “your” and “their”.
- ➔ A bank’s foreign currency account maintained by the bank in a foreign country and in the home currency of that country is known as Nostro Account or “**our account with you**”. For example, An Indian bank’s Swiss franc account with a bank in Switzerland.
- ➔ Vostro account is the local currency account maintained by a foreign bank/branch. It is also called “**your account with us**”. For example, Indian rupee account maintained by a bank in Switzerland with a bank in India.
- ➔ The Loro account is an account wherein a bank remits funds in foreign currency to another bank for credit to an account of a third bank. In other words, it is an expression used, by one bank when telling another bank to transfer money to the account of a third

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*Practice Golden Rule 1 of management in everything you do. “Manage others the way you would like to be managed”. Do one thing every day that scares you*

*SFM SYLLABUS FULLY AMEDNDED-cafinalsfm@gmail.com*

bank. Example: Just like State bank Of India maintaining an account with foreign correspondent say BTC, New York, Canara Bank may also maintain a Nostro Account with them. When SBI advises BTC New York for transfer of funds to Canara Bank Account with them, Canara Bank Account is titled as Loro Account “**i.e. their account with you**”

**QUESTION NO.6 Explain the significance of LIBOR in international financial transactions ?** *(May 2011)*

➔ LIBOR stands for London Inter Bank Offered Rate.

➔ Main features of LIBOR are as follows:

- (i) It is the base rate of exchange with respect to which most international financial transactions are priced.
- (ii) It is used as the base rate for a large number of financial products such as options and swaps.
- (iii) Banks also use the LIBOR as the base rate when setting the interest rate on loans, savings and mortgages.
- (iv) It is monitored by a large number of professionals and private individuals worldwide.



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*The world's first commercial GSM call was made in 1991 in Helsinki over a Nokia-supplied network, by Prime Minister of Finland Harri Holkeri, using a Nokia phone*

# CHAPTER-13

## MERGER AND ACQUISITION

### QUESTION NO.1 Write a short note on Synerge Gains ? (Nov 2012 )

➔ **Synergy May be defined as follows:**  $V(AB) > V(A) + V(B)$ .

➔ In other words the combined value of two firms or companies shall be more than their individual value. This may be result of complimentary services, economics of scale or both.

➔ A good example of complimentary activities can a company may have a good networking of branches and other company may have efficient production system. Thus the merged companies will be more efficient than individual companies.

➔ On Similar lines, economics of large scale is also one of the reason for synergy benefits. The main reason is that, the large scale production results in lower average cost of production e.g. reduction in overhead costs on account of sharing of central services such as accounting and finances, Office executives, top level management, legal, sales promotion and advertisement etc.

➔ These economics can be “real” arising out of reduction in factor input per unit of output, whereas pecuniary economics are realized from paying lower prices for factor inputs for bulk transactions.

➔ **Example :** Value of Company A = Rs. 200, Value of Company B = Rs. 100, Combined Value of Company A&B after merger = Rs.350, Therefore Synergy =  $350 - (200 + 100) = 50$

### QUESTION NO.2 What is a Takeover by Reverse Bid or Reverse Takeover?

(Nov 2011)

➔ Generally, a big company takes over a small company. When the smaller company gains control of a larger one then it is called “Take-over by reverse bid”.

➔ In case of reverse take-over, a small company takes over a big company.

➔ This concept has been successfully followed for revival of sick industries.

➔ The acquired company is said to be big if any one of the following conditions is satisfied:

(i) The assets of the transferor company are greater than the transferee company;

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*Live in your dreams, but dreams may die... do not get shattered, never ever cry. The world is big and has lots to give. Pick up a new dream, that's the way to live.*



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

(iii) The change of control in the transferee company will be through the introduction of minority holder or group of holders.

➔ Reverse takeover takes place in the following cases:

(1) When the acquired company (big company) is a financially weak company

(2) When the acquirer (the small company) already holds a significant proportion of shares of the acquired company (small company)

(3) When the people holding top management positions in the acquirer company want to be relieved off of their responsibilities.

➔ The concept of take-over by reverse bid, or of reverse merger, is thus not the usual case of amalgamation of a sick unit which is non-viable with a healthy or prosperous unit but is a case whereby the entire undertaking of the healthy and prosperous company is to be merged and vested in the sick company which is non-viable.

### **QUESTION NO.3 Write a short note on Financial Restructurings ?**

*(Nov 2008)(May 2013)*

➔ Financial restructuring, is carried out internally in the firm with the consent of its various stakeholders.

➔ Financial restructuring is a suitable mode of restructuring of corporate firms that have incurred accumulated sizable losses for / over a number of years.

➔ As a sequel, the share capital of such firms, in many cases, gets substantially eroded / lost; in fact, in some cases, accumulated losses over the years may be more than share capital, causing negative net worth.

➔ Given such a dismal state of financial affairs, a vast majority of such firms are likely to have a dubious potential for liquidation.

➔ Can some of these Firms be revived ? Financial restructuring is one such a measure for the revival of only those firms that hold promise/prospects for better financial performance in the years to come.

➔ To achieve the desired objective, 'such firms warrant / merit a restart with a fresh balance sheet, which does not contain past accumulated losses and fictitious assets and shows share capital at its real/true worth.

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*Memories play a very confusing role...They make you laugh when u remember the time u cried.But make you cry when you remember the time u laughed.We cannot learn without pain.*

**QUESTION NO.4 What is an Equity Curve out? How does it differ from a Spin Off?**  
(Nov 2013)

→ Equity Curve out can be defined as partial spin off in which a company creates its own new subsidiary and subsequently bring out its IPO. It should be however noted that parent company retains its control and only a part of new shares are issued to public.

→ On the other hand in Spin off parent company does not receive any cash as shares of subsidiary company are issued to existing shareholder in the form of dividend.

**QUESTION NO.5 Difference Between Horizontal merger & Vertical merger?**  
(May 2016)

**Horizontal merger**- The two companies which have merged are in the same industry, normally the market share of the new consolidated company would be larger and it is possible that it may move closer to being a monopoly or a near monopoly.

**Vertical merger**- The merger of two companies which are in different field altogether, the coming together of two concerns.

**QUESTION NO.6 What are problems for Merger & Acquisition in India?**

(i) Indian corporates are **largely promoter-controlled and managed**. It is difficult for either of the two promoters to voluntarily relinquish management control in favour of the other, as a merger between two companies implies .

(ii) In some cases, the need for prior negotiations and concurrence of financial institutions and banks is an added rider, besides **SEBI's rules and regulations**.

(iii) The **reluctance of financial institutions and banks** to fund acquisitions directly.

(iv) The **BIFR route**, although tedious, is preferred for obtaining financial concessions.

(v) **Lack of Exit Policy** for restructuring/downsizing.

(vi) **Absence of efficient capital market system** makes the Market capitalisation not fair in some cases.

(vii) Valuation is **still evolving** in India.

# OTHER IMPORTANT QUESTIONS

## THESE ARE NEW IMPORTANT QUESTIONS. VERY VERY IMPORTANT FOR EXAM

**QUESTION NO.1** Write a short note on

- (a) Factors that affect Bond's Duration
- (b) Process of Portfolio Management
- (c) Benefits of International Portfolio Investment
- (d) Benefits of Debit Card
- (e) Factors affecting the selection of Mutual Funds

**Solution:**

(a) **Factors that affect Bond's Duration**

Following are some of factors that affect bond's duration:

(1)**Time to maturity:** Consider two bonds that each cost Rs. 1,000 and yield 7%. A bond that matures in one year would more quickly repay its true cost than a bond that matures in 10 years. As a result, the shorter-maturity bond would have a lower duration and less price risk. The longer the maturity, the higher the duration.

(2)**Coupon rate:** Coupon payment is a key factor in calculation of duration of bonds. If two identical bonds pay different coupons, the bond with the higher coupon will pay back its original cost quicker than the lower-yielding bond. The higher the coupon, the lower is the duration.

(b) **Process of Portfolio Management**

Portfolio management is a process and broadly it involves following five phases and each phase is an integral part of the whole process and the success of portfolio management depends upon the efficiency in carrying out each of these phases.

**(1) Security Analysis:** Security analysis constitutes the initial phase of the portfolio formation process and consists in examining the risk-return characteristics of individual securities and also the correlation among them. A simple strategy in securities investment is to buy underpriced securities and sell overpriced securities. But the basic problem is how to identify underpriced and overpriced securities and this is what security analysis is all about. There are two alternative approaches to analyse any security viz. fundamental analysis and technical analysis. They are based on different premises and follow different techniques.

**(2) Portfolio Analysis:** Once the securities for investment have been identified, the next step is to combine these to form a suitable portfolio. Each such portfolio has its own specific risk and return characteristics which are not just the aggregates of the characteristics of the individual securities constituting it. The return and risk of each portfolio can be computed mathematically based on the risk-return profiles for the constituent securities and the pair-wise correlations among them.

**(3) Portfolio Selection:** The goal of a rational investor is to identify the Efficient Portfolios out of the whole set of Feasible Portfolios mentioned above and then to zero in on the Optimal Portfolio suiting his risk appetite. An Efficient Portfolio has the highest return among all Feasible Portfolios having identical Risk and has the lowest Risk among all Feasible Portfolios having identical Return.

**(4) Portfolio Revision:** Once an optimal portfolio has been constructed, it becomes necessary for the investor to constantly monitor the portfolio to ensure that it does not lose its optimality. In light of various developments in the market, the investor now has to revise his portfolio. This revision leads to addition (purchase) of some new securities and deletion (sale) of some of the existing securities from the portfolio. The nature of securities and their proportion in the portfolio changes as a result of the revision.

**(5) Portfolio Evaluation:** This process is concerned with assessing the performance of the portfolio over a selected period of time in terms of return and risk and it involves quantitative measurement of actual return realized and the risk borne by the portfolio over the period of investment. Various types of alternative measures of performance evaluation have been developed for use by investors and portfolio managers.

### **(c) Benefits of International Portfolio Investment**

Benefits of International Portfolio Investment are as follows:

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*All great achievements require time. We must travel in the direction of our fear.*

*The best dreams happen when you're awake.*

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**(a) Reduce Risk:** International investment aids to diversify risk as the gains from diversification within a country are therefore very much limited, because macro economic factors of different countries vary widely and do not follow the same phases of business cycles, different countries have securities of different industries in their market portfolio leading to correlation of expected returns from investment in different countries being lower than in a single country.

**(b) Raise Return through better Risk - Return Trade off:** International Investment aids to raise the return with a given risk and/or aids to lower the risk with a given rate of return. This is possible due to profitable investment opportunities being available in an enlarged situation and at the same time inter country dissimilarities reduce the quantum of risk.

#### **(d) Benefits of Debit Card**

##### **Benefits of Debit cards are as follows:**

- 1) Obtaining a debit card is often easier than obtaining a credit card.
- 2) Using a debit card instead of writing cheques saves one from showing identification or giving his personal information at the time of the transaction.
- 3) Using a debit card frees him from carrying cash or a cheque book.
- 4) Using a debit card means he no longer has to stock up on traveller's cheques or cash when he travels
- 5) Debit cards may be more readily accepted by merchants than cheques, in other states or countries wherever the card brand is accepted.
- 6) The debit card is a quick, "pay now" product, giving one no grace period.
- 7) Using a debit card may mean one has less protection than with a credit card purchase for items which are never delivered, are defective, or misrepresented. But, as with credit cards, one may dispute unauthorized charges or other mistakes within 60 days. One should contact the card issuer if a problem cannot be resolved with the merchant.
- 8) Returning goods or canceling services purchased with a debit card is treated as if the purchase were made with cash or a cheque.

#### **(e) Factors affecting the selection of Mutual Funds**

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*The difference between a successful person and others is not a lack of strength, not a lack of knowledge, but rather a lack in will*



Factors affects the selection of Mutual Funds is as follows:

(1) **Past Performance** - The Net Asset Value is the yardstick for evaluating a Mutual Fund. The higher the NAV, the better it is. Performance is based on the growth of NAV during the referral period after taking into consideration Dividend paid.

$$\text{Growth} = (\text{NAV}_1 - \text{NAV}_0) + D1 / \text{NAV}_0.$$

(2) **Timing** - The timing when the mutual fund is raising money from the market is vital. In a bullish market, investment in mutual fund falls significantly in value whereas in a bearish market, it is the other way round where it registers growth. The turns in the market need to be observed.

(3) **Size of Fund** - Managing a small sized fund and managing a large sized fund is not the same as it is not dependent on the product of numbers. Purchase through large sized fund may by itself push prices up while sale may push prices down, as large funds get squeezed both ways. So it is better to remain with medium sized funds.

(4) **Age of Fund** - Longevity of the fund in business needs to be determined and its performance in rising, falling and steady markets have to be checked. Pedigree does not always matter as also success strategies in foreign markets.

(5) **Largest Holding** - It is important to note where the largest holdings in mutual fund have been invested.

(6) **Fund Manager** - One should have an idea of the person handling the fund management. A person of repute gives confidence to the investors.

(7) **Expense Ratio** - SEBI has laid down the upper ceiling for Expense Ratio. A lower Expense Ratio will give a higher return which is better for an investor.

(8) **PE Ratio** - The ratio indicates the weighted average PE Ratio of the stocks that constitute the fund portfolio with weights being given to the market value of holdings. It helps to identify the risk levels in which the mutual fund operates.

(9) **Portfolio Turnover** - The fund manager decides as to when he should enter or quit the market. A very low portfolio turnover indicates that he is neither entering nor quitting the market very frequently. A high ratio, on the other hand, may suggest that too frequent moves have lead the fund manager to miss out on the next big wave of investments. A simple average of the portfolio turnover ratio of peer group updated by mutual fund tracking agencies may serve as a benchmark. The ratio is lower of annual purchase plus annual sale to average value of the portfolio.

**QUESTION NO.2** Write a short note on

- (a) Project Appraisal in inflationary conditions
- (b) Bought Out Deals (BODs)
- (c) Financial Engineering

(a) Under conditions of inflation, the project cost estimates that are relevant for a future date will suffer escalation. Inflationary conditions will tend to initiate the measurement of future cash flows. Either of the following two approaches may be used while appraising projects under such conditions:

(i) Adjust each year's cash flows to an inflation index, recognising selling price increases and cost increases annually; or

(ii) Adjust the 'Acceptance Rate' (cut-off) suitably retaining cash flow projections at current price levels.

An example of approach (ii) above can be as follows:

Normal Acceptance Rate	15.0%
Expected Annual Inflation	5.0%
Adjusted Discount Rate	$15.0 * 1.05$ or 15.75%

It must be noted that measurement of inflation has no standard approach nor is easy. This makes the job of appraisal a difficult one under such conditions.

(b) It is a new method of offering equity shares, debentures etc., to the public. In this method, instead of dealing directly with the public, a company offers the shares/ debentures through a sponsor. The sponsor may be a commercial bank, merchant banker, an institution or an individual. It is a type of wholesale of equities by a company. A company allots shares to a sponsor at an agreed price between the company and sponsor. The sponsor then passes the consideration money to the company and in turn gets the shares duly transferred to him. After a specified period as agreed between the company and sponsor, the shares are issued to the public by the sponsor with a premium. After the public offering, the sponsor gets the shares listed in one or more stock exchanges. The holding cost of such shares by the sponsor may be reimbursed by the company or the sponsor may get the profit by issue of shares to the public at premium.

Thus, it enables the company to raise the funds easily and immediately. As per SEBI guidelines, no listed company can go for BOD. A privately held company or an unlisted

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*" Life may not always be as good as it should be,  
but it's never as bad as it could be!"*

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company can only go for BOD. A small or medium size company which needs money urgently chooses to BOD. It is a low cost method of raising funds. The cost of public issue is around 8% in India. But this method lacks transparency. There will be scope for misuse also. Besides this, it is expensive like the public issue method. One of the most serious short coming of this method is that the securities are sold to the investing public usually at a premium. The margin thus between the amount received by the company and the price paid by the public does not become additional funds of the company, but it is pocketed by the issuing houses or the existing shareholders.

(c)“Financial Engineering” involves the design, development and implementation of innovative financial instruments and processes and the formulation of creative solutions and problems in finance. Financial engineering lies in innovation and creativity to promote market efficiency. It involves construction of innovative asset- liability structures using a combination of basic instruments so as to obtain hybrid instruments which may either provide a risk-return configuration otherwise unviable or result in gain by heading efficiently, possibly by creating an arbitrage opportunity. It is of great help in corporate finance, investment management, trading activities and risk management.

Over the years, Financial managers have been coping up with the challenges of changing situations. Different new techniques of financial analysis and new financial instruments have been developed. The process that seeks to adopt existing financial instruments and develop new ones so as to enable financial market participants to cope more effectively with changing conditions is known as financial engineering.

In recent years, the rapidity with which corporate finance and investment finance have changed in practice has given birth to new area of study known as financial engineering. It involves use of complex mathematical modelling and high speed computer solutions. Financial engineering includes all this. It also involves any moral twist to an existing idea and is not limited to corporate finance. It has been practiced by commercial banks in offering new and tailor made products to different types of customers. Financial engineering has been used in schemes of merger and acquisitions.

The term financial engineering is often used to refer to risk management.

**QUESTION NO.3** Write short notes on any of four of the following:

- (a) Non-compete fee in mergers and acquisitions.
- (b) Meaning of open interest and its relevance in the stock market.
- (c) Exposure Netting.

**(a) Non-compete fee in mergers and acquisitions.**

Non-compete fee is a fee paid by purchasing company to the promoters of the vendor company in case of mergers and acquisitions. The principle reason for paying this fee is to deter selling promoters to compete against the acquiring company in any way. In other words, non-compete fee is paid to selling promoters by the acquirer, so that they do not re-enter the business and pose serious competition to the acquired company. The logic is that the selling promoters may have picked up considerable expertise in the course of their running the business and it is quite possible, that they may regroup, arrange money and other resources and re-enter the business.

However, certain loopholes have been observed in the way non-compete fee is handled in practical situations. SEBI Takeover Code mandates that non-compete fee should be included in the deal value. It helps minority shareholders to get a share of this fee. However, in a scheme of amalgamation, the non-compete fee is paid outside the deal value. It means that minority shareholders do not get any share of the non-compete fee.

Now, SEBI wants to fix this loophole. SEBI is mulling possibilities if such schemes of merger and amalgamation are to be included in the purview of takeover regulations and thus increase pay out to retail investors. So, SEBI plans to amend the Takeover Code to ensure that minority shareholders also get their due in the non-compete fee.

**(b) Meaning of open interest and its relevance in the stock market.**

Open interest is total number of outstanding futures and options that exist on a particular day. Open interest is generally associated with the futures and options markets, where the number of existing contracts changes from day to day – unlike the stock market, where the outstanding shares of a company's stock remain constant once a stock issue is completed.

For every buyer of a futures or options there is a seller also. One buyer and one seller

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*" There's no such thing of having a bad day, just bad things happening on a good day." " Why look at the ground? The stars are in the sky."*

create one contract. Therefore, the total open interest in the market for a specified futures or option market equals the total number of buyers or the total number of sellers, and not the total of both added together.

Further, increasing open interest gives an indication that more money is coming into the stock market. On the other hand, decreasing open interest gives an indication that money is going out of the stock market. Therefore, it can be said that as increasing open interest is an indication that more money is coming into the market, it also shows that existing market is gaining momentum and is likely to continue in the future. In the same way, as decrease in open interest indicates that money is going out of the market, it generally depicts that existing trend is diminishing leading to a trend change.

### **(c) Exposure Netting.**

Exposure Netting refers to offsetting exposures in one currency with Exposures in the same or another currency, where exchange rates are expected to move in such a way that losses or gains on the first exposed position should be offset by gains or losses on the second currency exposure.

The objective of the exercise is to offset the likely loss in one exposure by likely gain in another. This is a manner of hedging foreign exchange exposures though different from forward and option contracts. This method is similar to portfolio approach in handling systematic risk.

For example, let us assume that a company has an export receivables of US\$ 10,000 due 3 months hence, if not covered by forward contract, here is a currency exposure to US\$.

Further, the same company imports US\$ 10,000 worth of goods/commodities and therefore also builds up a reverse exposure. The company may strategically decide to leave both exposures open and not covered by forward, it would be doing an exercise in exposure netting.

Despite the difficulties in managing currency risk, corporates can now take some concrete steps towards implementing risk mitigating measures, which will reduce both actual and future exposures. For years now, 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. Strictly speaking in banking terms this is known as settlement risk. Exposure netting occurs where outstanding positions are netted against one another in the event of counter party default.

### **QUESTION NO.3** Write Short Note On

- (a) Timing of Investment Decisions as per Dow Jones Theory  
 (a) Elliot Wave Theory

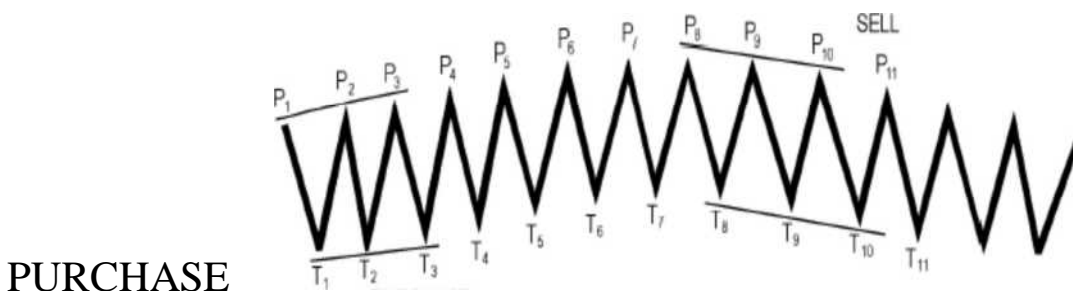
### **Timing of Investment Decisions as per Dow Jones Theory**

(a) Ideally speaking, the investment manager would like to purchase shares at a time when they have reached the lowest trough and sell them at a time when they reach the highest peak.

However, in practice, this seldom happens. Even the most astute investment manager can never know when the highest peak or the lowest trough has been reached. Therefore, he has to time his decision in such a manner that he buys the shares when they are on the rise and sells them when they are on the fall. It means that he should be able to identify exactly when the falling or the rising trend has begun.

This is technically known as identification of the turn in the share market prices. Identification of this turn is difficult in practice because of the fact that, even in a rising market, prices keep on falling as a part of the secondary movement. Similarly even in a falling market prices keep on rising temporarily. How to be certain that the rise in prices or fall in the same is due to a real turn in prices from a bullish to a bearish phase or *vice versa* or that it is due only to short-run speculative trends?

Dow Jones theory identifies the turn in the market prices by seeing whether the successive peaks and troughs are higher or lower than earlier. Consider the following graph:



*All dreams can come true if we have the courage to pursue them  
 As you think, so shall you become.*

According to the theory, the investment manager should purchase investments when the prices are at T1. At this point, he can ascertain that the bull trend has started, since T2 is higher than T1 and P2 is higher than P1.

Similarly, when prices reach P7 he should make sales. At this point he can ascertain that the bearish trend has started, since P9 is lower than P8 and T8 is lower than T7.

## **Elliot Wave Theory**

Inspired by the Dow Theory and by observations found throughout nature, Ralph Elliot formulated Elliot Wave Theory in 1934. This theory was based on analysis of 75 years stock price movements and charts. From his studies, he defined price movements in terms of waves. Accordingly, this theory was named Elliot Wave Theory. Elliot found that the markets exhibited certain repeated patterns or waves. As per this theory wave is a movement of the market price from one change in the direction to the next change in the same direction. These waves are resulted from buying and selling impulses emerging from the demand and supply pressures on the market. Depending on the demand and supply pressures, waves are generated in the prices.

As per this theory, waves can be classified into two parts:-

- Impulsive patterns
- Corrective patterns

Let us discuss each of these patterns

(i) **Impulsive Patterns-(Basic Waves)** - In this pattern there will be 3 or 5 waves in a given direction (going upward or downward). These waves shall move in the direction of the basic movement. This movement can indicate bull phase or bear phase.

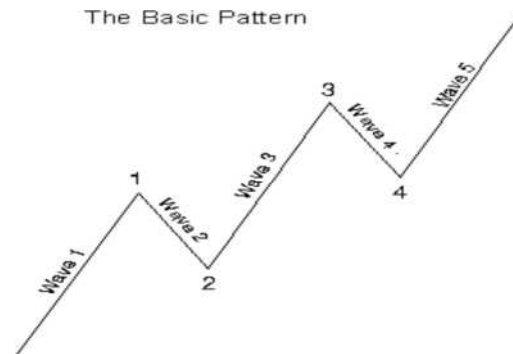
(ii) **Corrective Patterns- (Reaction Waves)** - These 3 waves are against the basic direction of the basic movement. Correction involves correcting the earlier rise in case of bull market and fall in case of bear market.

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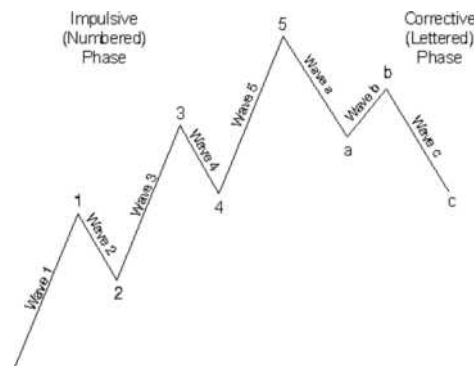
*There are Two Kind of People in this world 1- Those Who Remember Names & 2- Those Whose Names are Remembered...Choice Is Yours.*

As shown in the following diagram waves 1, 3 and 5 are directional movements, which are separated or corrected by wave 2 & 4, termed as corrective movements.

**Complete Cycle** - As shown in following figure five-wave impulses is following by a three-wave correction (a,b & c) to form a complete cycle of eight waves.



One complete cycle consists of waves made up of two distinct phases, bullish and bearish. On completion of full one cycle i.e. termination of 8 waves movement, the fresh cycle starts with similar impulses arising out of market trading.



#### **QUESTION NO.4 Write a short note on**

- (a) Lintner's Model of actual dividend behaviour
- (b) Necessary conditions to introduce 'Commodity Derivative'
- (c) 'Starting point and end point of an organisation is money'
- (d) Benefits of Real Estate Investment Trusts (REITs)
- (e) Chop Shop Method of Valuation

#### **a) Lintner's Model of actual dividend behaviour**

*"It is too risky not to take a risk. Life is worth some risks."*

*"Time stays long enough for anyone who will use it."*

*SFM SYLLABUS FULLY AMEDNDED-cafinalsfm@gmail.com*

The classic study of the actual dividend behavior was done by John Lintner in 1956. The study was conducted in two stages. First, he conducted a series of interviews with businessmen to form a view of how they went about their dividends decisions. He then formed a model on the basis of those interviews which could be tested on a larger data. His formula is

$$D_i = D_0 + [(EPS \times \text{Target Payout}) - D_0] \times A_F$$

Where

$D_i$  = Dividend in year 1

$D_0$  = Dividend in year 0

EPS = Earning Per Share

$A_F$  = Adjustment Factor Lintner model has two parameters:

- (1) The target pay-out ratio and
- (2) The spread at which current dividends adjust to the target.

From the interviews he conducted, it emerged that investment needs were not a major consideration in the determination of dividend policy, rather the decision to change the dividend was usually a response to a significant change in earnings which had disturbed the existing relationship between earnings and dividends.

Lintner concluded that

- (1) Companies tend to set long run target dividends-to-earning ratios according to the amount of positive net present value (NPV) project that are available.
- (2) Earning increases are not always sustainable. As a result, dividend policy is not changed until managers can see that new earnings level are sustainable.

**(b) Necessary conditions to introduce 'Commodity Derivative'**

The following attributes are considered crucial for qualifying for the derivatives trade:

- (1) a commodity should be durable and it should be possible to store it;
- (2) units must be homogeneous;

- (3) the commodity must be subject to frequent price fluctuations with wide amplitude; supply and demand must be large;
- (4) supply must flow naturally to market and there must be breakdowns in an existing pattern of forward contracting.

The first attribute, durability and storability, has received considerable attention in commodity finance, since one of the economic functions often attributed to commodity derivatives markets is the temporal allocation of stocks.

Since commodity derivatives contracts are standardized contracts, the second attribute, requires the underlying product to be homogeneous, so that the underlying commodity as defined in the commodity derivatives contract corresponds with the commodity traded in the cash market. This allows for actual delivery in the commodity derivatives market.

The third attribute, a fluctuating price, is of great importance, since firms will feel little incentive to insure themselves against price risk if price changes are small. A broad cash market is important because a large supply of the commodity will make it difficult to establish dominance in the market place and a broad cash market will tend to provide for a continuous and orderly meeting of supply and demand forces.

The last crucial attribute, breakdowns in an existing pattern of forward trading, indicates that cash market risk will have to be present for a commodity derivatives market to come into existence. Should all parties decide to eliminate each and every price fluctuation by using cash forward contracts for example, a commodity derivatives market would be of little interest.

**(c) 'Starting point and end point of an organisation is money'**

No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both internally and externally mobilized financial base.

Sources of finance and capital structure are the most important dimensions of a strategic

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*Dream is not what you see in sleep. A dream is the thing which does'nt let you sleep , makes you persevere till it comes out true before you eyes.*



plan. The generation of funds may arise out of ownership capital and or borrowed capital. A company may issue equity shares and / or preference shares for mobilizing ownership capital.

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

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

Now, given these three types of proposals a planner should evaluate each one of them by making within group comparison in the light of capital budgeting exercise.

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all. Dividend policy decision deals with the extent of earnings to be distributed as dividend and the extent of earnings to be retained for future expansion scheme of the firm.

It may be noted from the above discussions that financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth. These policies related to external awareness about the firm, specially the awareness of the investors about the firm, in respect of its internal performance. There is always a process of evaluation active in the minds of the current and future stake holders of the company.

As a result, preference and patronage for the company depends significantly on the financial policy framework. And hence attention of the corporate planners must be drawn while framing the financial policies not at a later stage but during the stage of corporate planning itself.

#### **(d) Benefits of Real Estate Investment Trusts (REITs)**

Reits typically offer the following benefits:

>For the Investors: REITs as an investment class provide the common man an opportunity to invest in fixed income securities which also provide long term capital appreciation and a natural inflation hedge. It also opens to small investors an arena (i.e. rent generating real estate assets) which was hitherto the monopoly of large investors.

>For the Industry: Reits assist in streamlining the real estate sector by creating a new and transparent source of raising finance in the real estate sector. Further, Reits can provide developers with institutional capital to sell their assets and use funds to repay banks and/or utilize the funds for more development.

#### **(e) Chop Shop Method of Valuation**

This approach attempts to identify multi-industry companies that are undervalued and would have more value if separated from each other. In other words as per this approach an attempt is made to buy assets below their replacement value. This approach involves following three steps:

**Step 1:** Identify the firm's various business segments and calculate the average capitalization ratios for firms in those industries.

**Step 2:** Calculate a "theoretical" market value based upon each of the average capitalization ratios.

**Step 3:** Average the "theoretical" market values to determine the "chop-shop" value of the firm.