

Chapter 1

STRATEGIC FINANCIAL MANAGEMENT

CHAPTER OVERVIEW

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Strategic Financial Management – Basics	Risk Management
<ol style="list-style-type: none"> 1. Concept of Strategy in Financial Management 2. Functions of Strategic Financial Management 3. Agency Theory 4. Strategic Decision Making Process 5. Levels of Strategic Decision Making 6. Financial Planning – Objectives, Adv & Disadv 7. Interface of Financial Planning with Corporate Strategic Management 8. Investing, Financing and Dividend Decisions 	<ol style="list-style-type: none"> 1. Types of Risk 2. Types of Financial Risks 3. Evaluation of Financial Risks 4. Value at Risk 5. Identification and Management of Risk

1. Strategic Financial Management – Basics

1. Discuss the concept of 'Strategy' in the context of Financial Management.

1. **Meaning:**

- (a) A Strategy is an Entity's plan of action in relation to the External Environment.
- (b) Strategy is the long term direction and scope of a Firm, to achieve competitive advantage, by managing its resources within a changing environment, for the fulfilment of stakeholder's aspirations and expectations.
- (c) Strategic Financial Management is the portfolio constituent of the corporate strategic plan, that embraces the optimum investment and financing decisions required to attain the overall specified objectives.

2. **Need for Strategy:** All Businesses require the following three fundamental essential elements –

- (a) A clear and realistic **Strategy** to provide direction to activities,
- (b) The **financial** resources, controls and systems to see it through, and
- (c) The right **management** team and processes to make it happen.

Thus, **Strategy + Finance + Management = Fundamental Needs of Business.**

3. **Strategic Financial Management:**

- (a) Strategic Financial Management combines the backward looking, report focused discipline of (financial) accounting, with the more dynamic, forward looking subject of Financial Management.
- (b) It deals with the identification of the possible strategies capable of maximizing a Firm's Market Value.
- (c) It involves the allocation of scarce capital resources among competing opportunities.
- (d) It encompasses the implementation and monitoring of the chosen strategy, so as to achieve agreed objectives.

2. List the functions of Strategic Financial Management.

Strategic Financial Management involves the following functions –

1. Continual search for best investment opportunities,
2. Selection of the best profitable opportunities,
3. Determination of optimal mix of funds for the opportunities,
4. Establishment of systems for internal controls, and
5. Analysis of results for future decision-making.

3. Identify the role of CFOs in addition to traditional role in post pandemic time. M 25

In post pandemic time, role of CFOs has been advanced in the following areas in addition to traditional role:

- (a) **Risk Management:** CFOs are expected to look after overall functioning of the framework of Risk Management system.
- (b) **Supply Chain:** Post pandemic supply chain management system has been posing the challenge for the company to maintain the sustainable growth. Since CFOs are care takers of finance of the company, considering the financial viability of the Supply Chain Management their role has now become more critical.
- (c) **Mergers, acquisitions, and Corporate Restructuring:** To maintain the growth and capture the market share, there has been a spate of Mergers and Acquisitions and hence the role of CFOs has become more crucial because these are strategic decision and any error in them can lead to collapse of the whole business.
- (d) **Environmental, Social and Governance (ESG) Financing:** With the evolving of the concept of ESG their role has been shifted from traditional financing to sustainability financing.

4. Write short notes on 'Agency Theory' in Strategic Financial Management.

As per **Agency Theory** (of Jenson and Meckling), Strategic Financial Management is the function by which the Management of the Entity seeks to maximize returns to the Owners. Accordingly, Strategic Financial Management is the function of 4 major components based on the concept of maximization of Expected NPV (Net Present Value) –

- 1. **Financing Decisions:** This deals with the mode of financing or mix of Equity and Debt. The objective is to obtain the optimal financial mix, by altering Equity and Debt, such that the Market Value of the Company is maximized. An understanding of Cost of Capital, Capital Structure and Leverage Principles is a pre-requisite for these decisions.
- 2. **Investment Decisions:** This involves the profitable utilization of a Firm's funds in long-term capital projects. To maximize the Market Value of the Company, the Finance Manager will select projects with maximum returns and minimum risk. An understanding of Cost of Capital, and Capital Budgeting are required for these decisions.
- 3. **Dividend Decisions:** Dividend Decision determines the division of earnings between payments to shareholders and re-investment in the Company. A mature Company having less re-investment options and idle cash can opt for higher dividend distribution, while a growth-oriented Company having many investment opportunities and need for funds should prefer to retain its earnings. Retained Earnings are one of the most significant sources of funds for financing corporate growth, but Dividends constitute the Cash Flows that accrue to Shareholders. The Finance Manager should balance both growth and dividend goals.
- 4. **Portfolio Decisions:** Portfolio Analysis is a method of evaluating investments based on their contribution to the aggregate performance of the entire Company, rather than on the isolated characteristics of the investments themselves. Strategic Portfolio Management takes the insights gained from Portfolio Analysis and integrates them into the decision making process of a Company, to manage risks effectively.

5. Write short notes on the process of Strategic decision-making.

Mintzberg, Raisinghani, and Theoret, provided a model of the process of strategic decision-making and identified three major phases with sub-routines or sub-phases within each. These are –

Phase	Description
1. Identification Phase	(a) Decision Recognition Routine: To identify opportunities, problems, and crises, to commence decisional activity. (b) Diagnosis Routine: To collect information relevant to opportunities, problems, and crises, to identify problems more clearly.
2. Development Phase	(a) Search Routine: To generate alternative solutions to problems. (b) Design Routine: To design new solutions to problems on hand, and to adopt or modify previously identified ready-made solutions.
3. Selection Phase	Screen Routine: This is required when the Search Routine identifies more alternatives than can be intensively evaluated. Alternatives are quickly scanned and the infeasible ones are eliminated.

6. Explain the three levels of Strategy in a Business Entity.

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The three levels of an Enterprise Strategy are –

Level	Description
1. Corporate Level Strategy	Corporate Level Strategy is concerned with – (a) Reach , i.e. defining the issues that are overall corporate responsibilities. (b) Competitive Contact , i.e. defining where competition is to be localized in the Firm. (c) Managing Activities and Business Interrelationships , i.e. to develop synergies by sharing and co-ordinating staff and other resources across business units, investing financial resources across business units, and using business units to complement other corporate business activities. (d) Management Practices , i.e. how business units are to be governed, e.g. through direct corporate intervention (centralization) or through autonomous governance (decentralization).
2. Business Unit Level Strategy	Here, the strategic issues deal with – (a) practical co-ordination of operating units (b) developing and sustaining a competitive advantage for the Firm’s products and services.
3. Functional Level Strategy	(a) Functional Level Strategies in R&D, Operations, Manufacturing, Marketing, Finance, and Human Resources involve the development and co-ordination of resources through which Business Unit Level Strategies can be executed effectively and efficiently. (b) Among the different functional activities, Finance assumes highest importance during the top down and bottom up interaction of planning.

7. What is meant by Financial Planning? What are its objectives?

- Meaning:** Financial Planning is the backbone of the business planning and corporate planning. It helps in defining the feasible area of operation for all types of activities and thereby defines the overall planning framework.
- Components:** The three components of Financial Planning are – (a) Financial Resources, (b) Financial Tools, and (c) Financial Goals.
- Financial Planning Objectives:**
 - The outcomes of Financial Planning are the Financial Objectives, financial decision-making and financial measures for the evaluation of the corporate performance.
 - Financial Objectives are to be decided reasonably early, so that the other decisions can be taken accordingly.
 - The objectives should be consistent with the corporate mission and corporate objectives.
- Objectives of Profit and Value Maximisation:** The two objectives of Financial Planning are – (a) Profit Maximisation, (b) Wealth / Value Maximisation.
 - Profit Maximisation:** The basic business motive is Profitability. So, the Finance Manager has to take his decisions in order to maximise the profits of the business. Profit Maximisation is a basic and long-term objective, but has a short-term measurement focus (say a financial year.) Profit Maximisation, as an objective has the following advantages and limitations –

Advantages	Disadvantages / Limitations
<ul style="list-style-type: none"> Must for survival of business, else Capital is lost. Essential for growth & development of business. Impact on society through factor payments. Profit-making firms pursue social obligations. 	<ul style="list-style-type: none"> The term "Profit" is vague. Higher the profits, higher the risks involved. It ignores time pattern of returns. It ignores social & moral obligations of business.

Hence, Profit Maximisation is viewed as a limited objective, i.e. essential but not sufficient.

- Wealth Maximisation:** The second objective of Financial Management is to maximise the Value of Wealth of the Firm and that of its Investors. Wealth or Value of a Firm is represented by the Market Price of its Capital (i.e. Shares and Debentures). **Value of a Firm** = $\frac{\text{Earnings}}{\text{Capitalisation Rate}}$.
 - Earnings:** It takes into account, the present and prospective earnings, the timings and risk of these earnings, the dividend policies of the Firm and other factors governing revenues.
 - Capitalisation Rate:** It is the cumulative result of the assessment of the various stock-holders (Equity and Debt) regarding the risk and other qualitative factors of a Company. This rate reflects the liking of the investors for a Company.
 - Wealth Maximization is a better objective for a business since it represents both return and risk.

8. List the merits and demerits of "Wealth/Value Maximisation Objective".

1. Superiority/Merits of Wealth Maximisation Objective:

- (a) Wealth Maximisation objective takes into account, all future cash flows, dividends, EPS, etc. whereas Profit Maximisation objective does not recognize the effect of future cash flows, dividend decisions, EPS, etc.
- (b) A Firm with Profit Maximisation objective may refrain from payment of dividend to its Shareholders. However, a Firm with Wealth Maximisation objective may pay regular dividends to its Shareholders.
- (c) Shareholders prefer an increase in the Firm's wealth as against mere increase in flow of profits.
- (d) Shareholders prefer a Firm to use its funds effectively, e.g. a Firm which is able to generate a higher rate of return on its own retained funds, may be able to increase its Wealth / Value. If the Firm had distributed its profits by way of dividends, the rate of earning may not be high.

2. Limitations/Demerits of Wealth or Value Maximisation Objective:

- (a) **Timing:** The timing or duration of expected returns is not specified. So, one cannot be sure whether an investment fetching ₹ 10 Lakhs return after 5 years is more or less valuable than an investment fetching ₹ 1.50 Lakhs per year for the next five years.
- (b) **Risk:** The risk factor of projects to be undertaken is not considered properly. A Firm with a higher Debt Capital may have the same EPS as a Firm having a lesser Debt Capital in the capital structure. However, the Market Price per Share of the two Companies shall be different.
- (c) **Dividends:** The effect of dividend policy on Market Price per Share is not fully considered. To maximize EPS, Companies may not pay any dividend. In such cases the EPS may increase but the Market Price per Share may go down due to adverse reactions from the Shareholders.

However, for routine decision-making purposes, the Finance Manager views Profit Maximisation as a short-term objective and Value Maximisation as a medium / long-term objective.

9. Differentiate between Profit Maximisation and Wealth Maximisation objectives of Financial Planning.

The areas of difference of Profit Maximisation and Wealth Maximisation Objectives are:

Profit Maximisation	Wealth Maximisation
Does not consider the effect of Future Cash Flows, Dividend Decisions, EPS, etc.	Recognises the effect of all Future Cash Flows, Dividends, EPS, etc.
A Firm with Profit Maximisation objective may refrain from payment of dividend to its Shareholders.	A Firm with Wealth Maximisation objective may pay regular dividends to its Shareholders.
Ignores time pattern of returns.	Recognises the time pattern of returns.
Focus on Short-Term.	Focus on Medium / Long-Term.
Does not consider the effect of uncertainty / risk.	Recognises the risk-return relationships.
Comparatively easy to determine the relationship between financial decisions and profits.	Offers no clear or specific relationship between financial decisions and share market prices.

10. Describe the interface of Financial Policy (FP) with Corporate Strategic Management (CSM). M 16, M 18, N 24
This decision determine the division of earnings between payments to shareholders and reinvestment in the company. What this decision is called? What are other decisions falling in this strategy? Briefly explain.
"The starting point of an organisation is money and the end point of that organization is also money". Explain the statement to clearly understand this interface of strategic management and financial policy.

The interface of Financial Planning with Corporate Strategic Management is based on the idea that the starting point and end point of every Firm is "money". No Firm can run the existing business and promote a new expansion project without a suitable internally mobilized financial base or both internally and externally mobilized financial base. Accordingly, the following dimensions/interfaces emerge –

1. Sources of Finance and Capital Structure:

- (a) Funds may be raised by way of Own Capital (Equity and Preference Shares) and Borrowed Capital (Debt).
- (b) Along with the quantification of funds required, the policy makers should decide on the **capital structure**, to indicate the desired mix of Equity Capital and Debt Capital.
- (c) The ideal Debt-Equity Ratio varies from industry to industry, and also depends in the planning mode of the Firm.

2. **Effective Fund Allocation/ Capital Budgeting:**

- (a) A Planner has to frame policies for regulating investments in Fixed Assets, and for restraining of Current Assets. Investment Proposals originated by different Business Units may be divided into three groups namely –
- **Addition of a product** to the existing product portfolio.
 - **Increase the level of operations** of an existing product, either through an increase in capacity in the existing Plant or setting up of another plant for meeting additional capacity requirement.
 - **Cost Reduction** and efficient utilization of resources through a new approach and or closer monitoring of the different critical activities for improvements.
- (b) Project Evaluation and Project Selection are the two most important jobs under Capital Budgeting. The Planner's task is to make the best possible allocation under resource constraints.

3. **Dividend Policy:** Dividend Policy decision deals with the extent of earnings to be distributed as Dividend, and the extent of earnings to be retained for future expansions of the Firm. From the viewpoint of long-term funding of business growth, Dividend can be considered as that part of Total Earnings, which cannot be profitably utilized by the Company. [**Note:** The various Dividend Policies are described in **Chapter 10**]

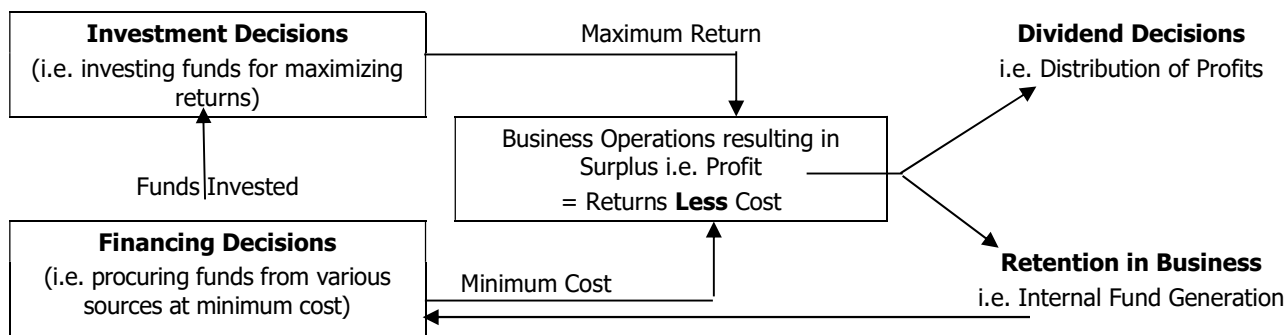
4. **Inter-relationship:**

- (a) The Financial Policy of a Company cannot be worked out in isolation of other Functional Policies. It has a close link with the overall organizational performance and direction.
- (b) The nature of interdependence of the policies is the crucial factor to be studied and modelled, by using an in depth analytical approach.
- (c) At certain times, Corporate Strategy is the cause and Financial Policy is the effect, whereas at other times Financial Policy is the cause and Corporate Strategy is the effect.

11. Explain the inter-relationship between Investment, Financing and Dividend Decisions.

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1. **Objective:** The underlying objective of all the three decisions viz. – Investment, Financing and Dividend decisions is "maximization of Shareholders' wealth". The Finance Manager has to consider the joint impact of these three decisions on the market price of the Company's Shares.
2. **Linkage:**
- (a) A new project (investment) needs finance. Also, a Company may have to expand / develop its operations, which require funds. Hence, Investment Decisions are based on the Financing Decisions.
- (b) The Financing decision is influenced by, and influences the Dividend decision, since retained earnings used in internal financing means reduction in dividends paid to Shareholders.
- (c) So, the inter-relationship between the three types of decisions should be analysed jointly, in order to maximize the Shareholders' wealth.
3. **Decision-Making:** The 3 decisions can be linked to maximize Shareholders' wealth, in the following way –
- (a) **Investment Decisions:**
- Investment in Long Term Projects should be made after Capital Budgeting and uncertainty analysis.
 - Projects which give reasonable returns (higher than cost) in order to add to the surplus of the Shareholders', should be selected. The returns should be high enough as to distribute reasonable dividends and also retain adequate resources for the Company's growth prospects.
- (b) **Financing Decisions:**
- Proper balancing between long-term and short-term funds, as well as own funds and loan funds, will help the Firm to minimize its overall cost of capital and increase its wealth / value.
 - Low cost of funds will mean higher profit margins, which can be used for dividend distribution as well as internal financing of new projects / growth plans.
- (c) **Dividend Decisions:**
- The optimum dividend pay-out ratio ensures that shareholders' wealth is optimized.
 - Where the funds at the disposal of the Company earn a higher return than if distributed to shareholders, wealth maximization can be achieved by retaining the funds, rather than declaration of dividend.



2. Risk Management

12. What are the types of risks faced by a Business Organization?

Risk	Description
1. Strategic Risk	(a) It is a risk in which a Company's Strategy becomes less effective, and it struggles to achieve its goal. (b) Reasons include technological changes, entry of a new competitor, shift in customer demand, increase in the costs of raw materials, etc.. (c) Examples: <ul style="list-style-type: none"> • When Digital Camera was discovered by others, Kodak failed to develop it and was left behind. • Nokia failed to upgrade its technology to develop touch screen Mobile Phones. • When Laser Printing was developed, Xerox was quick to lap up this opportunity and changed its business model to develop laser printing. So, it survived strategic risk and overcame.
2. Compliance Risk	(a) Every Business needs to comply with Rules & Regulations, i.e. Companies Act, SEBI Guidelines etc. (b) Non-compliance leads to penalties in the form of fine & imprisonment. Risk increases when a Company ventures into a new business line or a new geographical area. (c) Example: A Company pursuing Cement Business likely to venture into Sugar Business in a different State. But, the law applicable to the Sugar Mills in that State are different. So, that poses a Compliance Risk. If the Company fails to comply with laws related to a new area or industry or sector, it will pose a serious threat to its survival.
3. Operational Risk	(a) It covers Internal Risk, and includes failure on the part of the Company to cope with day to day operational problems. Operational Risk relates to 'people' as well as 'process'. (b) Example: An Employee paying out ₹ 1,00,000 from the account of the Company instead of ₹ 10,000. This is a 'people' as well as a 'process' risk. An Entities can employ another person to check the work of that person who has mistakenly paid ₹ 1,00,000 or it can install an electronic system that can flag off an unusual amount.
4. Financial Risk	It refers to unexpected changes in financial conditions such as Prices, Exchange Rate, Credit Rating, Interest Rate, etc. Note: Though Political Risk is not a Financial Risk in direct sense, but it can be included herein as any unexpected political change in any Foreign Country may lead to Country Risk which may ultimately may result in Financial Loss.

13. What are the different types of Financial Risks?

Risk	Description
1. Counter Party Risk	This risk occurs due to non-honouring of obligations by the Counter Party, e.g. failure to deliver the goods for the payment already made or vice-versa, or non-repayment of borrowings and interest, etc. Thus, this risk also covers the Credit Risk i.e. default by the Counter Party.
2. Political Risk	Generally this type of risk is faced by Overseas Investors, as the adverse action by the Government of Host Country may lead to huge losses. This can be in any of the following form – <ol style="list-style-type: none"> (a) Confiscation or destruction of Overseas Properties, (b) Restrictions / Rationing of Remittance to Home Country, (c) Restriction on Conversion of Local Currency of Host Country into Foreign Currency, (d) Restriction as Borrowings, (e) Invalidation of Patent, (f) Price Control of Products, etc.

3. Interest Rate Risk	This risk occurs due to change in Interest Rate resulting in change in Assets and Liabilities. This risk is more important for Banking Companies as their Balance Sheet's items are more interest sensitive and their base of earning is spread between borrowing and lending rates. [Refer Chapter 12 Swaps]
4. Currency Risk	(a) It mainly affects the Entity dealing with Foreign Exchange as their Cash Flows changes with the movement in the Exchange Rates. This risk can be affected by Cash Flow adversely or favourably. (b) Example: If Rupee depreciates, Entities having US\$ Receivables will stand to gain (Exporter: Infosys) & Entities having US\$ Payables will stand to lose (Importer Indian Oil Corporation Ltd).

14. Mr. PK imports raw materials from China, processes them in India and manufactures finished goods which are then sold in the American market. In this transaction what types of risk faced by Mr. PK? M 25

- Currency Risk (Exchange Rate Risk):** Since raw materials imported from China and finished goods sold in the USA, fluctuation in exchange rates between Yuan, Indian rupee and US Dollar could impact cost and revenue.
- Political and Trade Risk:** Changes in trade policies, tariffs, or political instability in China, India, or the U.S. may affect the cost and availability of raw materials or access to markets.
- Transaction Risk or Exposure:** Since Mr. PK is importing raw materials from China and selling finished goods in the American Market change in the exchange rate of any currency will impact the revenue as well as cost.
- Regulatory Risk:** Mr. PK must comply with various regulations in each country, including import/export laws, quality standards, and customs regulations.
- Economic Exposure:** Exchange rate changes significantly alter the cost of a firm's inputs & prices of its outputs and thereby influence its competitive position substantially. This exposure is important when the product demand is elastic.
- Market Risk:** The demand for the finished products in the US may fluctuate, affecting sales and profitability.
- Counterparty Risk:** Risk that Chinese suppliers fail to deliver raw materials on time or US buyers default on payments, affecting operations or cash flows.

15. How can Financial Risk be evaluated from different point of view points? N 18

1. Viewpoint of Stakeholder	(a) Major Stakeholders are Equity Shareholders and they view Financial Gearing, i.e. Ratio of Debt in Capital Structure as Risk, since in event of winding up they will have the least priority. (b) For a Lender also, the existing Gearing is a risk, since a Company having high Gearing faces more risk in default of payment of Interest, and of Principal Repayment.
2. Company	If a Company borrows excessively or lends to someone who defaults, then it can be forced to go into liquidation.
3. Government	Financial Risk can be viewed as failure of any Bank or downgrading of any Financial Institution, leading to spread of distrust among society at large. This risk also includes Willful Defaulters. This rule can also be extended to sovereign debt crisis.

16. Briefly explain the concept of VAR (Value at Risk).

1. Meaning VAR's	(a) Value at Risk (VAR) is a measure of Risk of Investment. Given the normal market condition in a given period, say, 1 day, it estimates how much an Investment might lose. This Investment can be a Portfolio, Capital Investment or Foreign Exchange etc. (b) The world's most widely used measure of Financial Risk. VAR answers two basic questions – (i) What is the worst case scenario? (ii) What will be the Loss?
2. Features	(a) Components of Calculations: VAR Calculation is based on following three components – (a) Time Period, (b) Confidence Level – Generally 95% and 99%, (c) Loss in Percentage or in Amount. (b) Statistical Method: It is a type of statistical tool based on Standard Deviation. (c) Time Horizon: VAR can be applied for different time horizons, i.e. one day / week / month and so on. (d) Probability: Assuming the values are normally attributed, Probability of Max. Loss can be predicted. (e) Control Risk: Risk can be controlled by selling limits for Maximum Loss. (f) Z Score: Z Score indicates how many Standard Deviations is away from Mean Value of a Population. When it is multiplied with Standard Deviation, it provides VAR.
3. Appli-cation	VAR can be applied – (a) to measure the Maximum Possible Loss on any portfolio or a trading position. (b) as a benchmark for Performance Measurement of any operation or trading. (c) to fix limits for individuals dealing in Front Office of a Treasury Department. (d) to enable the Management to decide the Trading Strategies. (e) as a tool for Asset and Liability Management especially in Banks.

17. Briefly explain the methods for identification and management of various types of Financial Risk.

Risk	Identification	Management
1. Counter Party Risk	(a) Failure to obtain necessary resources to complete project or transaction undertaken (b) Regulatory Restrictions from the Government (c) Hostile action of Foreign Government (d) Let down by Third Party (e) Insolvency	(a) Due Diligence before dealing with any third party. (b) Avoid over-commitment to a single Entity or group or connected Entities. (spreading the risk) (c) Setting the exposure limits for transactions, (d) Regular Review of the limits and procedure for credit approval. (e) Rapid action in case of any likelihood of defaults. (f) Use of Performance Guarantee, Insurance or other Instruments.
2. Political Risk	(a) Insistence on Resident Investors or labour (b) Restriction on Conversion of Currency (c) Repatriation of Foreign Assets of the Local Government (d) Price Control / Regulation / Fixation for products	(a) Referring to political ranking published by different Business Magazines. (b) Evaluating the Host country's macro-economic conditions. (c) Analyzing the popularity of current Government and assessing their stability. (d) Taking advices from the Embassies of the Home Country in the Host Countries. (e) Techniques to mitigate: Local sourcing of Raw Materials and labour, Entering into Joint Ventures, Local Financing and Prior negotiations.
3. Interest Rate Risk	(a) Monetary Policy of the Government (b) Government Action such as demonetization (c) Economic Growth (d) Release of Industrial Data (e) Investment by Foreign Investors (f) Stock Market changes	Refer Chapter 12 for detailed discussion about Re-arrangement of Interest Risk
4. Currency Risk	(a) Government Action, Change of Government (b) Nominal Interest Rate & Inflation Rate (c) Natural Calamities, War, Coup, Rebellion, etc.	Refer Chapter 13 for detailed discussion on Foreign Currency related concepts

18. Anand holds ₹ 2 Crore Shares of X Ltd, whose Market Price Standard Deviation is 2% per day. Assuming 252 Trading Days a year, determine Maximum Loss Level over the period of 1 Trading Day and 10 Trading Days with 99% Confidence Level.

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Particulars	Computation	Result
(a) Equivalent Z Score for level of 99%	From Normal Table of Cumulative Area	2.33
(b) Volatility in terms of Rupees	2% of ₹ 2 Crore	₹ 4 Lakhs
(c) Maximum Loss for 1 day at 99% Confidence Level	₹ 4 Lakhs × 2.33	₹ 9.32 Lakhs
(d) Expected Maximum Loss for 10 Trading Days	$\sqrt{10} \times ₹ 9.32 \text{ Lakhs}$	₹ 29.47 Lakhs

19. Neel holds ₹ 1 Crore Shares of XY Ltd, whose Market Price Standard Deviation is 2% per day. Assuming 252 Trading Days in a Year, determine Maximum Loss Level over the period of 1 Trading Day and 10 Trading Day with 99% Confidence Level. Assuming Share Prices are normally for level of 99%, the equivalent Z Score from Normal Table of Cumulative Area shall be 2.33.

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Particulars	Computation	Result
(a) Volatility in terms of Rupees = SD × Value	2% of ₹ 1 Crore	2 Lakhs
(b) Maximum Loss for 1 day at 99% Confidence Level = Volatility × Cum. Area	2 Lakhs × 2.33	4.66 Lakhs
(c) Expected Maximum Loss for 10 Trading Days = Max Loss × $\sqrt{\text{Days}}$	4.66 Lakhs × $\sqrt{10}$	14.74 Lakhs

20. Consider a Portfolio consisting of ₹ 2 Crores Investment in Shares of X Ltd and ₹ 2 Crores Investment in Shares of A Ltd. The Daily Standard Deviation of both Shares is 1% and that the coefficient of correlation between them is 0.3. You are required to determine the 10–day 99% Value at Risk for the Portfolio?

Particulars	Computation	Result
(a) Equivalent Z Score for level of 99%	From Normal Table of Cumulative Area	2.33
(b) Standard Deviation of each Asset	₹ 2 Crores × 1%	₹ 2 Lakhs
(c) Variance of the Portfolio [Note]	$2^2 + 2^2 + (2 \times 0.3 \times 2 \times 2)$	₹ 10.4 Lakhs
(d) Standard Deviation of the Portfolio	$\sqrt{10.4 \text{ Lakhs}}$	₹ 3.22 Lakhs
(e) Standard Deviation of 10–Day Change	$\sqrt{10} \times ₹ 3.22 \text{ Lakhs}$	₹ 10.18 Lakhs
(f) 10–Day 99% Value at Risk	₹ 10.18 Lakhs × 2.33	₹ 23.72 Lakhs

Note: Refer Chapter 4 Portfolio Management for computing the Variance of the Portfolio.

21. On Tuesday Morning (before opening for the Capital Market) an Investor, while going through his bank statement, has observed that an amount of ₹ 7 Lakhs is lying in his bank account. This amount is available for use from Tuesday till Friday. The Bank requires a minimum balance of ₹ 1,000 all the time. The Investor desires to make a maximum possible investment where Value at Risk (VaR) should not exceed the balance lying in his bank account. The Standard Deviation of Market Price of the Security is 1.5 per cent per day. The required Confidence Level is 99%. Standard Normal Probabilities are given as under –

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Z	0.00	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
2.2	0.9861	0.9864	0.9868	0.9871	0.9875	0.9878	0.9881	0.9884	0.9887	0.9890
2.3	0.9893	0.9896	0.9998	0.9901	0.9904	0.9906	0.9909	0.9911	0.9913	0.9916
2.4	0.9918	0.9920	0.9922	0.9923	0.9925	0.9929	0.9931	0.9932	0.9934	0.9936

You are required to determine the maximum possible investment.

Particulars	Computation	Result
(e) Equivalent Z Score for level of 99%	From Given Table of Cumulative Area	2.3 + 0.03 = 2.33
(f) Volatility in terms of Rupees	Let the Investment be 'A'	1.5% of A = 0.015A
(g) Max Loss for 1 day at 99% Confidence Level	0.015A × 2.33	0.03495A
(h) Number of Trading Days	Tuesday to Friday	4
(i) Expected Max Loss for 4 Trading Days	$\sqrt{4} \times 0.03495A = 0.0699A$	7,00,000 – 1,000 = 6.99 Lakhs

By Solving 0.0699A = 6.99 Lakhs, Investment Value = 6.99 Lakhs ÷ 0.0699 = 100 Lakhs.

22. ABC Ltd is considering a Project X, which is normally distributed and has Mean Return of ₹2 Crores with Standard Deviation of ₹ 1.60 Crores. In case, ABC Ltd loses on any project more than ₹ 1 Crore there will be financial difficulties. Determine the probability the Company will be in financial difficulty. Standard Normal Distribution Table (Z Score) providing area between Mean and Z Score –

Z Score	1.85	1.86	1.87	1.88	1.89
Area	0.4678	0.4686	0.4693	0.4699	0.4706

For calculating Probability of financial difficulty, the area under Normal Curve corresponding to the Z Score obtained shall be calculated from the following equation (how many SD is away from Mean Value of financial difficulty):

$$z = \frac{x - \mu}{\sigma} = \frac{-1 \text{ Crore} - 2 \text{ Crores}}{1.60 \text{ Crores}} = -1.875 \text{ say } 1.875$$

At 1.87, Normal Area is 0.4693. At 1.88, Normal Area is 0.4699. Corresponding area at 1.875 shall be found by using interpolation as under –

$$\text{Corresponding Value of 0.005 Z Score} = \frac{0.0006}{0.01} \times 0.005 = 0.0003. \quad \text{Value of 1.875} = 0.4693 + 0.0003 = 0.4696.$$

Thus, the Probability the Company shall be in financial difficulty is 46.96%.

23. Explain the term 'Business Model' with the help of an illustration.

1. The term business model is a wide term denoting core aspects of a business including purpose, business process, target customers, offerings, strategies, infrastructure, organizational structures, sourcing, trading practices, and operational processes and policies including culture.
2. Further, a business model is the way in which a company generates revenue and makes a profit from Company Operations. Analysts use the term gross profit as a way to compare the efficiency and effectiveness of a firm's Business Model. Gross profit is calculated by subtracting the cost of goods sold from revenues.
3. **Illustration:**
 - (a) There are two Companies – Company A and Company B. Both the companies are engaged in the business of renting movies. Prior to the advent of internet both the Companies Rent Movies physically. Both the Companies made ₹ 5 Crore as Revenues. Cost of goods sold was ₹ 4 Crore. So, the Companies made ₹ 1 Crore as Gross Profit.
 - (b) After the introduction of Internet, Company A started to offer movies online instead of renting or selling it physically. This change affected the business model of Company A positively.
 - (c) Revenue is still ₹ 5 Crore but the significant part is that cost of goods sold is now ₹ 2 Crore only. Because online sales lead to significant reduction of storage and distribution costs. So, Gross Profit increases from 20% to 60%.
 - (d) Therefore, Company A is not making more in sales, but it figured out a way to revolutionize its business model, which greatly reduces costs. Managers at company A have an additional 40% more in margin to play with than managers at company A. Managers at company A have little room for error and they have to tread carefully.

24. Explain the term 'Cyber Risk'.

Cyber Risk is defined as the risk of damages due to lawsuits / compensation on account of being a victim of cyber-attack, due to which data of customers, vendors or any other counterparty can be leaked to an unauthorised, malevolent Entity.

25. Are Sustainable Growth Rate and Internal Growth Rate being same concepts? Explain.

1. Although both concepts appear to be same but there are some differences between them. The Internal Growth Rate can be defined as the maximum growth that a firm can achieve from using internal sources of fund i.e. without resorting to external funding.
2. The Sustainable Growth Rate 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 .

Multiple Choice Questions

1. Strategic Financial Management is the function of ____ based on the concept of maximization of Expected NPV.
 - (a) 2 major components
 - (b) 3 major components
 - (c) 4 major components
 - (d) 5 major components
2. ____ with the mode of financing or mix of Equity and Debt.
 - (a) Financing Decisions
 - (b) Investment Decisions
 - (c) Dividend Decisions
 - (d) Portfolio Decisions
3. ____ involves the profitable utilization of a Firm's funds in long-term capital projects.
 - (a) Financing Decisions
 - (b) Investment Decisions
 - (c) Dividend Decisions
 - (d) Portfolio Decisions
4. ____ determines the division of earnings between payments to shareholders and re-investment in the Company.
 - (a) Financing Decisions
 - (b) Investment Decisions
 - (c) Dividend Decisions
 - (d) Portfolio Decisions
5. ____ is a method of evaluating investments based on their contribution to the aggregate performance of the entire Company, rather than on the isolated characteristics of the investments themselves.
 - (a) Financing Decisions
 - (b) Investment Decisions
 - (c) Dividend Decisions
 - (d) Portfolio Decisions
6. The levels of an Enterprise Strategy are –
 - (a) 2
 - (b) 3
 - (c) 4
 - (d) 5
7. ____ is concerned with defining the issues that are overall corporate responsibilities and defining where competition is to be localized in the Firm.
 - (a) Corporate Level Strategy
 - (b) Business Unit Level Strategy
 - (c) Functional Level Strategy
 - (d) State Level Strategy
8. ____ deals with practical co-ordination of operating units developing and sustaining a competitive advantage for the Firm's products and services.
 - (a) Corporate Level Strategy
 - (b) Business Unit Level Strategy
 - (c) Functional Level Strategy
 - (d) State Level Strategy
9. ____ involve the development and co-ordination of resources through which Business Unit Level Strategies can be executed effectively and efficiently.
 - (a) Corporate Level Strategy
 - (b) Business Unit Level Strategy
 - (c) Functional Level Strategy
 - (d) State Level Strategy
10. ____ deals with Managing Activities and Business Interrelationships and Management Practices.
 - (a) Corporate Level Strategy
 - (b) Business Unit Level Strategy
 - (c) Functional Level Strategy
 - (d) State Level Strategy
11. Match the following:

Risk Management	1. Amounts to be retained by the company
Dividend Decisions	2. Financial planning, controlling & decision making
Financial manager's primary responsibility	3. Determining the proper amount of funds to be employed
Financial Analysis & Planning	4. Collect data and present the data
	5. Protecting assets

 - (a) 5,1,2,3
 - (b) 5,1,4,3
 - (c) 5,1,3,2
 - (d) 3,2,1,4
12. The purpose of financial markets is to:
 - (a) Increase the price of common stocks
 - (b) Lower the yield on bonds
 - (c) Allocate savings efficiently
 - (d) Control inflation
13. Investment decisions are concerned with –
 - (a) Efficient allocation of funds to specific assets
 - (b) Determining the proper amount of funds to be employed in the firm.
 - (c) Determining the composition of liabilities
 - (d) Short-run projects
14. ____ ensures that the firm utilizes its available resources most efficiently under conditions of competitive markets.
 - (a) Wealth Maximization
 - (b) Profit Maximization
 - (c) Value Maximization
 - (d) Relation Maximization

15. For which of the following reason(s) profit maximization concept is criticized –
1. It is vague conceptually.
 2. It ignores the timing of returns.
 3. It ignores the risk factor
 4. Its emphasis is generally on short-run projects.
- Select the correct answer from the options given below.
- (a) 1
 - (b) 1 & 2
 - (c) 1, 2 & 3
 - (d) 1,2, 3 &4
16. _____consistent with the object of maximizing the owner's economic welfare.
- (a) Profit Maximization
 - (b) Wealth Maximization
 - (c) Relation Maximization
 - (d) All of the above
17. FinancialManagementis concerned with –
- (a) Profit Maximization
 - (b) Both (A) & (C)
 - (c) Wealth Maximization
 - (d) Both (A) & (C) plus Relation Maximization
18. Assertion (A):
Profit maximization as an objective does not take into account the time pattern of returns.
Reason (R):
The finance managers will accept highly risky proposals if they give high profits by applying the profit maximization concept.
Select the correct answer from the options given below.
- (a) Both A and R are true and R is the correct explanation of A.
 - (b) Both A and R are true but R is not a correct explanation of A.
 - (c) A is true but R is false
 - (d) A is false but R is true
19. Profit maximization –
- (a) Cannot be the sole objective of a company
 - (b) Is at best a limited objective.
 - (c) Has to be attempted with a realization of risks involved
 - (d) All of the above
20. Under inflationary conditions, the value of money expressed in terms of its purchasing power over goods and services
- (a) Incline
 - (b) Declines
 - (c) Increases
 - (d) Remains constant
21. _____is a condition where a company cannot meet or has difficulty paying off, its financial obligations to its creditors, typically due to high fixed costs, illiquid assets, or revenues sensitive to economic downturns.
- (a) Financial risk
 - (b) Financial uncertainty
 - (c) Financial certainty
 - (d) Financial distress
22. _____means the organization can no longer meet its financial obligations with its lender or lenders as debts become due.
- (a) Financial certainty
 - (b) Financial insolvency
 - (c) Financial risk
 - (d) Identified risk
23. A permanent may lead an organization to the chaotic state _____
- (a) Financial insolvency; financial certainty
 - (b) Financial distress; Identified risk
 - (c) Identified risk; financial insolvency
 - (d) Financial distress; financial insolvency
24. Using _____in the capital structure of a company is called financial gearing
- (a) Borrowed funds or fixed cost funds
 - (b) Owners funds or fixed cost funds
 - (c) Owners funds
 - (d) Reserve or balance of profit & loss account
25. High financial gearing will____
- (a) Decrease the EPS of the company if earnings before interest and taxes are rising
 - (b) Increase the EPS of the company if earnings before interest and taxes are declining
 - (c) Decrease the EPS of the company if earnings before interest and taxes are declining
 - (d) Increase the EPS of the company if earnings before interest and taxes are rising
26. Higher the level of financial gearing____
- (a) Greater will be the risk.
 - (b) Lower will be the risk.
 - (c) Risk will be constant.
 - (d) None of the above
27. Financial management is broadly concerned with____
- (a) Raising of funds
 - (b) Creating value to the assets of the business enterprise
 - (c) Efficient allocation of funds
 - (d) All of the above

28. Financial Management can be judged by the study of the nature of____
 (a) Corporate, social & benefit decisions.
 (b) Accounting, financing & dividend decisions.
 (c) Personnel, human cost & economic decisions
 (d) Investment, financing & dividend decisions.
29. Which of the following is/are a major aspect of the investment decision-making process?
 (a) Capital budgeting
 (b) Formulation of Functional Strategy
 (c) Strategic implementation
 (d) All of the above
30. Investment decisions encompass____
 (a) Cost of capital
 (b) Capital budgeting
 (c) Management of liquidity and current assets
 (d) All of the above
31. Optimal investment decisions need to be made taking into consideration such factors as____
 (a) Estimation of capital outlays & future earnings of the proposed project focusing on the task of value engineering and market forecasting;
 (b) Availability of capital and considerations of cost of capital focusing attention on financial analysis
 (c) A set of standards by which to select a project for implementation and maximizing returns therefrom focusing attention on logic and arithmetic.
 (d) All of the above
32. Anand holds ₹ 2 Crore Shares of X Ltd, whose Market Price Standard Deviation is 2% per day. Assuming 252 Trading Days a year, Maximum Loss Level over the period of 1 Trading Day with 99% Confidence Level Z Score 2.33 =
 (a) 9.32 Lakhs
 (b) 29.47 Lakhs
 (c) 4.66 Lakhs
 (d) 14.74 Lakhs
33. Anand holds ₹ 2 Crore Shares of X Ltd, whose Market Price Standard Deviation is 2% per day. Assuming 252 Trading Days a year, Maximum Loss Level over the period of 10 Trading Day with 99% Confidence Level Z Score 2.33 =
 (a) 9.32 Lakhs
 (b) 29.47 Lakhs
 (c) 4.66 Lakhs
 (d) 14.74 Lakhs
34. Neel holds ₹ 1 Crore Shares of XY Ltd, whose Market Price Standard Deviation is 2% per day. Assuming 252 Trading Days in a Year, Maximum Loss Level over the period of 1 Trading Day with 99% Confidence Level. Z Score 2.33
 (a) 9.32 Lakhs
 (b) 29.47 Lakhs
 (c) 4.66 Lakhs
 (d) 14.74 Lakhs
35. Neel holds ₹ 1 Crore Shares of XY Ltd, whose Market Price Standard Deviation is 2% per day. Assuming 252 Trading Days in a Year, Maximum Loss Level over the period of 10 Trading Day with 99% Confidence Level. Z Score 2.33
 (a) 9.32 Lakhs
 (b) 29.47 Lakhs
 (c) 4.66 Lakhs
 (d) 14.74 Lakhs
- Consider a Portfolio consisting of ₹ 2 Crores Investment in Shares of X Ltd and ₹ 2 Crores Investment in Shares of A Ltd. The Daily Standard Deviation of both Shares is 1% and that the coefficient of correlation between them is 0.3.**
36. Standard Deviation of A Ltd in INR =
 (a) 3.22 Lakhs
 (b) 10.18 Lakhs
 (c) 23.72 Lakhs
 (d) 2 Lakhs
37. Standard Deviation of the Portfolio in INR =
 (a) 3.22 Lakhs
 (b) 10.18 Lakhs
 (c) 23.72 Lakhs
 (d) 2 Lakhs
38. Standard Deviation of 10 day change in INR =
 (a) 3.22 Lakhs
 (b) 10.18 Lakhs
 (c) 23.72 Lakhs
 (d) 2 Lakhs
39. 10-Day 99% Value at Risk in INR =
 (a) 3.22 Lakhs
 (b) 10.18 Lakhs
 (c) 23.72 Lakhs
 (d) 2 Lakhs

Solutions

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
C	a	b	c	d	b	a	b	c	a	a	c	a	b	d	b	b	b	d	b

21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39
d	b	d	a	d	a	d	d	a	d	d	a	b	c	d	d	a	b	c

STUDENTS' NOTES

Chapter 2

CAPITAL MARKET & RELATED SERVICES

CHAPTER OVERVIEW

(1)	(2)	(3)	(4)	(5)
Capital Market, Stock Exchange – Basics	Concepts relating to Capital Issues	Investment Banking	Credit Rating	Depository Services
1. Financial Market 2. Capital Market 3. Primary and Secondary Market 4. Functions of Stock Exchange 5. Stock Market Index 6. Settlement Cycle 7. Clearing House 8. Margins	1. Types of Instruments 2. Issue Mechanism, i.e. Methods of Issue 3. Green Shoe Option 4. GDR's / ADR's 5. Debt Securitisation	1. Meaning 2. Major Departments and their Inter-relationships 3. Syndicate of Investment Banks 4. Commercial Banking vs Investment Banking 5. Handling an IPO – Process 6. Functions of Investment Banks	1. Meaning and Features 2. Process 3. Summary of Rating Scores 4. Benefits 5. Limitations 6. CAMEL Model 7. Exclusions in Credit Rating	1. Meaning 2. Physical vs Demat Form 3. Demat vs Remat 4. Advantages of Demat 5. Disadvantages of Demat 6. Online Trading

1. Capital Market, Stock Exchange – Basics

1. Write short notes on Financial Markets.

1. **Meaning:** Financial Markets refers to the arrangement / set-up where Financial Assets / Instruments such as Shares, Debentures, Derivatives, Bonds, etc. issued by different Entities are issued and traded (bought and sold).
2. **Types:** Financial Markets, inter alia, may be classified into –
 - (a) **Capital Market** – where long-term (> 1 year) Equity and Debt Instruments (Stocks and Bonds) are issued / traded, and used by Companies / Issuers for tapping long-term funds, and
 - (b) **Money Market** – where short-term Debt Securities are traded (i.e. instruments with a tenor of upto 1 year), and used by Companies / Issuers for tapping short-term funds.
3. **Features / Functions:**
 - (a) **Intermediaries:** Financial Markets are characterized by the presence of a number of Intermediaries providing market-related services (Investment Banking, Credit Rating, Depository, Online Trading, etc.) These Intermediaries, viz. Merchant Bankers, Brokers, Bankers to Issues, Debenture Trustees, Portfolio Managers, Registrars to Issues, Depositories, and Share Transfer Agents, etc. are regulated by SEBI.
 - (b) **Economic Indicator:** The growth, vibrant nature and activity levels of Financial Markets give an indication of the economy's performance, industrial growth and capital formation.
 - (c) **Capital Needs:** Primary Market provides promising Companies with the capital they need to invest in growing their businesses. Secondary Market aids capital formation indirectly, where existing investors in one sector can sell their holdings, and invest their money in the next growing sector.
 - (d) **Investment Opportunities:** Financial Markets provide investment opportunities to Investors, who do not have sufficient funds to start their own business / venture.
 - (e) **Risk Sharing:** Stock Prices provide signals on the important opportunities which act as risk management tools, by letting Investors diversify their investments and transfer risk to those who can tolerate the risk.

2. Write short notes on Capital Markets / Securities Market.

1. **Meaning:** Capital Markets are relatively for long-term (more than 1 year maturity) Financial Instruments / Assets (e.g. Bonds and Stocks). It is used by Companies / Issuers for tapping long-term funds.
2. **Features:** Capital Market –
 - (a) is the indicator of the inherent strength of the economy.
 - (b) is the largest source of funds with long and indefinite maturity for Companies.
 - (c) enhances the capital formation in the country.
 - (d) offers various investment avenues to both Institutional and Individual Investors.
 - (e) helps in channeling the savings pool in the economy towards optimal allocation of capital in the country.
3. **Parts / Types:** The Securities / Capital Market has into two parts, Primary Market and Secondary Market.

3. Write short notes on Primary Markets and Secondary Markets.

Differences:

Point	Primary Market	Secondary Market
Meaning	It is a Market where new securities are bought and sold for the first time.	It is a Market in which an Investor purchases a security from another Investor, rather than the Issuer, subsequent to the original issuance in the Primary Market.
Also called	New Issues Market or IPO Market.	Stock Market or Over-the-Counter (OTC) Market.
Types of Securities	New Securities , i.e. Securities which were not previously available and are, therefore, offered to the investing public for the first time.	Old Securities , i.e. Securities which have been issued already and granted Stock Exchange recognition for listing / quotation.
Intent	Securities are offered to the Public , for subscription, for raising Capital / Fund. Such issue may be a first time issue (called Initial Public Offering), or subsequent issue of Capital (called Follow-on Offering).	Already issued Securities are traded among Investors . Stock Exchanges, provide institutional support for liquidity and marketability of securities, i.e. a regular and continuous market for buying and selling of securities.
Seller	The Company / Issuer raising finance.	Any Person .
Money Flow to Company	It provides additional funds to the Issuing Companies. So, its contribution to Company Financing is direct .	It does not supply additional funds to the Company, since the Company is not involved in the transaction. So, its role in the supply of capital is indirect .
Place of Exchange	Trading Members are not involved, as subscription money is directly sent to the Company.	Transactions take place at a Stock Exchange, through its members or even privately.
Location	Primary Market is not located in any particular spot and has no geographical existence. It has no tangible form or administrative organizational setup like Stock Exchanges. It is recognized only by the services that it renders to the Lenders and Borrowers of capital funds at the time of any particular operation, e.g. IPO Issue.	Stock Exchanges have physical existence and are located in a particular geographical area. They have a specified administrative / organizational set-up.

Similarities / Inter-dependence: Some similarities between Primary Market and Secondary Markets are –

1. **Listing:** Securities issued in the Primary Market are invariably listed on a Recognized Stock Exchange for dealings therein. Listing provides assurance to the potential investors that there is a valid arrangement to subsequently dispose off their holdings (allotted to them in Primary Market) at any time.
2. **Control:** Stock Exchanges exercise control over the organization of New Issues, since Exchange permission is required for listing.
3. **Investor Response to New Issues:** The behaviour of the Stock Exchanges has a significant bearing on the level of activity in the Primary Market and, therefore, its responses to Capital Issues. The flow of new savings into new securities is deeply influenced by the conditions prevailing in the Secondary Market, in terms of prices and acceptability of the new issues.
4. **Pricing:** Prices of New Issues are influenced by the Price Movements on the Stock Market. The Stock-Demand-and-Supply Curves, (not Flow-Demand-and-Supply Curves), exert a dominant influence on price determination.

4. What is a Stock Exchange? What are the functions of a Stock Exchange? M 11

1. **Meaning:** A Stock Exchange is a Market for Securities / Secondary Market. It is an organisation incorporated as a Company and formed for the purpose of buying and selling of securities by Individual and Institutional Investors.
2. **Functions of Stock Exchange:**
 - (a) **Liquidity and Marketability of Securities:** Stock Market creates a continuous market for securities where Investors can convert their securities into cash at any time at the prevailing market price and vice-versa. It ensures the liquidity and marketability of the instruments.
 - (b) **Determination of Fair Price:** Stock Market is a nearly perfect market characterised by – (i) a large number of Buyers and Sellers, (ii) relatively free flow of information, (iii) active bidding, etc. This ensures that a Fair Price is determined for Securities, based on demand and supply.
 - (c) **Source of Long term Funds:** Corporates, Government and Public Bodies raise funds from the equity market. These securities are negotiable and transferable. They are traded and change hands from one Investor to the other without affecting the long-term availability of Funds to the Issuing Companies.
 - (d) **Aids Capital Formation:** Stock Exchanges are the nexus between the savings and the investments of the community. The savings of the community are mobilized and channeled by Stock Exchanges for investment into those sectors and units which are favoured by the community at large, on the basis of such criteria as good return, appreciation of capital, and so on. It is the preference of investors for individual units as well as industry groups, which is reflected in the share price, which is a criterion for investment.
 - (e) **Reflects the Economy's status:** The performance of the Stock Markets reflects the general economic trend, i.e. barometer of the economy. Monetary and Fiscal measures are framed depending upon the state of the Economy.

5. How is the Stock Market Index computed? Indicate any two important Stock Market Indices. M 10
Write short notes on Stock Market Index.

1. **Significance:** Stock Market Index –
 - (a) is an answer to the question “**how is the market doing?**”
 - (b) is representative of the **entire stock market**, and not a few Securities / Companies.
 - (c) represents the **Average Returns** obtained by Investors in the Stock Market.
 - (d) reflects **expectation** about future performance of the Companies listed in the Stock Market, or performance of the industrial sector. When the Index goes up, the market thinks that the future returns will be higher than they are at present and vice-versa.
 - (e) is influenced by **country specific news** (e.g. monsoon, budget, elections, government policies, wars, etc.), which is common to all stocks, and not merely Company-specific news, which relates to specific companies.
2. **Examples:** In India: BSE 500, Sensex, S&P Nifty, etc. Outside India: Dow Jones, FTSE, etc.
3. **Computation of Stock Market Index:**
 - (a) **Index for the First Day / Time:**
$$\frac{\text{Closing Market Capitalisation of all Stocks for the day}}{\text{Opening Market Capitalisation of all Stocks for the day}} \times 100$$
 - (b) **Subsequent Days Index:**
$$\frac{\text{Closing Market Capitalisation of all Stocks for the day}}{\text{Opening Market Capitalisation of all Stocks for the day}} \times \text{Previous Index}$$

Note:

- Stocks / Shares included in the Index are those, which are traded regularly in high volume. If the trading in any Share stops or comes down then it gets excluded and another Company's Shares replace it.
- Indices **may** also be calculated using the Price Weighted Method, using Share Prices of the constituent Companies as the weights. But, almost All Equity Indices world-wide are calculated using Market Capitalization Weighted Method.

6. Write short notes on Rolling Settlement. N 08

1. **Settlement:** Settlement refers to the process in which Traders who have made purchases make payments while those who have sold shares, deliver them. The Stock Exchange ensures that Buyers receive their shares and the Sellers receive payment for the same. The process of settlement is managed by Stock Exchanges through Clearing Houses / Clearing Corporations.

2. **Rolling Settlement:** A Rolling Settlement is the settlement cycle of the Stock Exchange, where all trades outstanding at the end of the day have to be settled, i.e. the Buyer has to make payments for securities purchased and Seller has to deliver the securities sold.
3. **T+X Days:** Settlement is generally specified as 'T+X' day/s where X = number of business days from the date of the transactions. In case of T + 1 Settlement, transactions entered on a day should be settled within the next working day. In case of T + 2 Settlement, settlement should be made within 2 working days from the date of transaction.

Note: NSE follows a T+2 Rolling Settlement Cycle. T Day = Trading Day, i.e. Date of Transaction, T+1 = Date of determination of obligations, T+2 = Settlement day.

4. **Advantages:**

- (a) **Liquidity:** Investors benefit from the increased liquidity because of payouts, i.e. settlement of money for sale of stocks made by Investors is quicker than in weekly settlements.
- (b) **Separation of Cash and Forward Markets:** The Rolling Settlement System helps to keep cash and forward market separate.
- (c) **Safety:** In case of Rolling Settlements, there is a higher degree of safety because the settlement is made on a day-to-day basis, and hence fluctuations can be taken care of (favourable as well as adverse).
- (d) **Electronic Trading:** Rolling Settlements require electronic transfers of funds and demat facilities in respect of securities being traded. This avoids paperwork and related risks (bad deliveries, forged documents, etc.)

7. **Write short notes on Clearing House Operations.**

1. **Meaning:** Clearing House is a body either owned by or independently associated with an Exchange and charged with the function of ensuring the financial integrity of each trade. Orders entered into by Members are cleared by means of the Clearing House.
2. **Services:** Clearing Houses provide a range of services related to the Guarantee of Contracts, Clearance and Settlement of Trades, and management of risk for their Members and Associated Exchanges.
3. **Role:**
 - (a) It ensures adherence to the system and procedures for smooth trading.
 - (b) It minimises credit risks by being a counter party to all trades.
 - (c) It involves daily accounting of all gains or losses.
 - (d) It ensures delivery of payment for assets on the maturity dates for all outstanding contracts.
 - (e) It monitors the maintenance of speculation margins.
4. **Working:**
 - (a) Clearing House acts as the medium of transaction between the Buyer and the Seller. Every contract between a Buyer and a Seller is substituted by **two** contracts, i.e. Clearing House becomes the Buyer to every Seller, and the Seller to every Buyer.

Example: In a transaction where P sells futures to R, R is replaced by the Clearing House, and the risk taken by P becomes insignificant. Similarly, the credit risk of R is taken over by the Clearing House, thus, the credit risk is now assumed by the Clearing House rather than by individuals.
 - (b) The Credit Risk of the Clearing House is minimized by collecting **Margins** depending upon the volatility of the instrument and adjusted everyday for price movements.
5. **Requirements imposed by CC:**
 - (a) **Margins:** Clearing House imposes margin requirements on its Members. Margins include Cash Margins, Bank Guarantees, Collaterals, etc.
 - (b) **Capital Adequacy:** This is to ensure that only financially sound Firms become members, and honour their commitment at the time of settlement.
 - (c) **Net Position Limits:** This is to contain the overall exposure of individual members in the market. The sum total of exposures of all members is the Net Exposure of the CC. This is done to diversify the CC's risk.
 - (d) **Daily-Price Limits:** Price Limits are fixed for both the upper and lower level, for each day. Trading is halted when these limits are touched. These restrictions are imposed to ensure that no member is subjected to significant liquidity crunch due to extreme swings in the market.

8. Write short notes on the various types of Margins.

Margins (normally in form of Cash or T-Bills) are amounts to be maintained by the Members of the Stock Exchange with the Clearing House. Margins can be categorised into the following types –

1. **Initial Margins on Securities:** It is paid by purchasers and short sellers, and generally function as a security for loan. It is similar to a down payment required for the purchase of a security.
2. **Initial Margins on Derivatives:** It refers to funds paid as guarantee to ensure that the party to the transaction will perform its obligation under the contract. Initial Margin on Derivatives is aimed to cover future changes that may occur in the value.
3. **Maintenance Margins:** It refers to the value over and above the Initial Margin, which must be maintained in a margin account at all times after the initial margin requirement, if any, is satisfied.
4. **Variation Margin:** It refers to funds that are required to be deposited in, or paid out of, a margin account that reflects changes in the value of the relevant instrument.

2. Concepts relating to Capital Issues

9. List the major methods by which funds can be tapped from Capital Markets.

The following are the major mediums of approaching Capital Markets –

1. Equity Shares
2. Preference Shares
3. Debentures/ Bonds
4. ADRs / GDRs
5. Derivatives

10. What are the different types of Issue Mechanism by which new issues can be made?

Issue Mechanism, i.e. methods by which New Issues are made can be classified into – (1) Public Issue through Prospectus, (2) Tender / Book Building, (3) Offer for Sale, (4) Placements, (5) Rights Issue.

Note: Every type of issue is governed by the stipulations laid down by the Regulatory Authorities, viz. SEBI, Stock Exchanges, Companies Act, etc.

1. **Public Issue through Prospectus:**

Concept	Issuing Companies themselves offer directly to general public a fixed number of shares at a stated price.
Merits	<ul style="list-style-type: none"> • Generally, Issues are underwritten to ensure success arising out of unsatisfactory public response. • Transparency and wide distribution of Shares are its important advantages of Prospectus Issue.
Demerits	High Cost of Floatation, viz. Underwriting Expenses, Brokerage, and other Administrative Expenses.

2. **Tender / Book Building:**

Concept	<ul style="list-style-type: none"> • In a Book Building Mechanism, the Issuer / Company does not pre-determine the Issue Price (for Shares) or Interest Rate (for Bonds) and invite subscription to the issue. • The Issuer / Company starts with an indicative Price Band / Interest Band (for Stocks and Bonds respectively) which is determined through consultative process with its Merchant Banker, and asks its Merchant Banker to invite bids from prospective investors at different prices (or different rates). • Based on the response received from Investors, the Final Price / Interest Rate is selected. • The Merchant Banker (called as Book Runner) manages the entire Book Building Process. • Investors who have bid a price equal to or more than the Final Price selected are given allotment at the Final Price selected. Those who have bid for a lower price will get their money refunded.
Merits	<ul style="list-style-type: none"> • This allows for price and demand discovery. • Cost of Issue is comparatively lower than Prospectus based issue. • Demand for Shares is known under Book Building, even before the issue closes. So, if there is not much demand, the issue may be deferred and res-scheduled to a later date.
Demerits	Cost of Floatation, viz. Underwriting Expenses, Brokerage, and other Administrative Expenses.

Note: For details of Book Building compliance under SEBI Regulatory Framework, students are advised to refer **Padhuka’s Students’ Handbook on Corporate and Allied Law – For CA Final.**

3. **Offer for Sale:**

Concept	<ul style="list-style-type: none"> Here, the Issuing Company first sells the securities at an agreed fixed price to Sponsoring Institutions or Intermediaries, viz. Issue Houses / Merchant Banks / Investment Banks or Firms of Stockbrokers. The Issue Houses re-sell the Securities to the ultimate Investors, at a price higher the price at which they were acquired from the Company. Difference between the Sale Price and Purchase Price (called as Turn), represents the remuneration of the Issue Houses.
Merits	<ul style="list-style-type: none"> Issues are underwritten to ensure success of issue, and also to avoid the possibility of the issue being left largely in the hands of Issuing Houses.
Demerits	<ul style="list-style-type: none"> High Cost of Floatation / Issue Expenses. Margin between the amount received by the Company and the price paid by the public does not become additional funds, but it is pocketed by the Issuing Houses or the existing Shareholders.

4. **Placement:**

Concept	<ul style="list-style-type: none"> Placement involves sale by an Issue House or Broker, to their own Clients, of Securities which have been previously purchased or subscribed. Securities are first acquired by Issue Houses, similar to Offer for Sale method, but instead of being subsequently offered to the public, they are placed with the Clients of the Issue Houses, both Individual and Institutional Investors.
Merits	<ul style="list-style-type: none"> Formal Underwriting of the issue is not required as the placement itself amounts to underwriting since the Issue Houses agree to place the issue with their Clients. Savings in Issue Costs, viz. reduction in Underwriting Commission, Expense relating to Applications, Allotment of Shares, Stock Exchange requirements relating to contents of the Prospectus and its Advertisement, etc. Suitable for Small Companies with unsatisfactory financial performances, which are not certain about the success of their issue through Prospectus.
Demerits	<ul style="list-style-type: none"> Securities are offered only to a select group of Investors, leading to the concentration of Shares into a few hands, who may manipulate the market, e.g. create artificial scarcity of scrips in times of hectic dealings in such Shares.

5. **Rights Issue:**

Concept	<ul style="list-style-type: none"> In case of Companies whose Shares are already listed and widely-held, Shares can be offered to the existing Shareholders, by circular.
Merits	<ul style="list-style-type: none"> Control is not diluted since Existing Shareholders are offered the right, to subscribe to new shares in proportion to the number of shares they already hold. Flexible since existing Shareholders also have a right to renounce their in favour of a Nominee.
Demerits	<ul style="list-style-type: none"> Lower costs of Floatation.

Note: IPO through Stock Exchange On-line System (e-IPO)

- The Issuing Company would have the option to issue securities to public either through the on-line system of the Stock Exchange or through the existing Banking Channel.
- For e-IPO, the Company should enter into agreement with the Stock-Exchange(s). The Stock Exchange would appoint SEBI Registered Stockbrokers of the Stock Exchange to accept applications.
- The Brokers and other Intermediaries are required to maintain records of – (a) orders received, (b) applications received, (c) details of allocation and allotment, (d) details of margin collected and refunded, and (e) details of refund of application money.

11. Write short notes on Green Shoe Option.

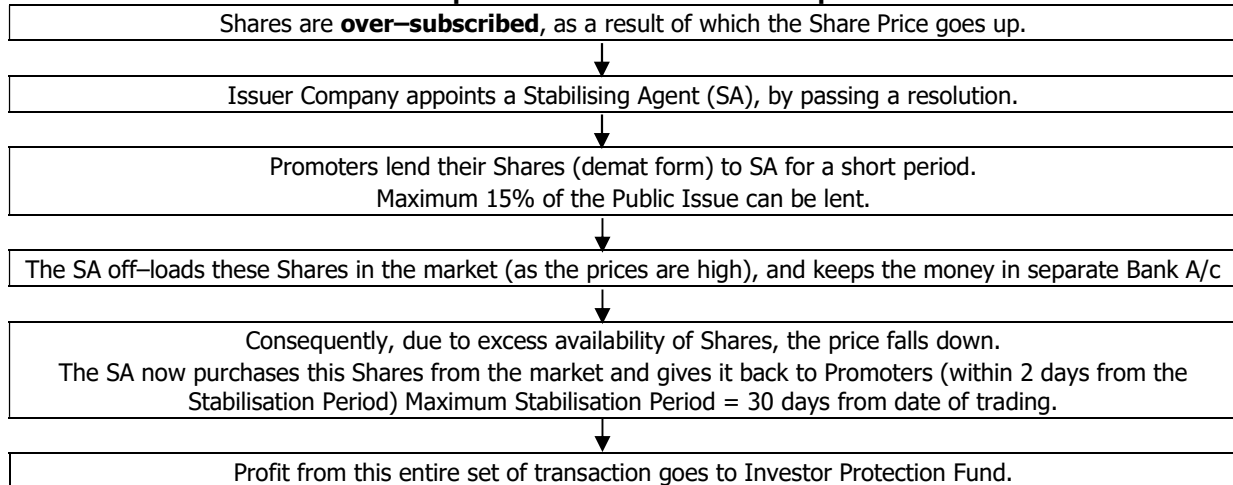
- Meaning:** GSO means an option of allocating shares in excess of the shares included in the Public Issue and operating a post-listing Price Stabilising Mechanism through a Stabilising Agent (SA).
- Purpose:** A Company making an IPO of Equity Shares through the Book-Building Mechanism can avail of the Green Shoe Option (GSO) for **stabilising the post-listing price** of its Shares.

3. **Authorisation by Shareholders:** The Issuing Company should seek authorisation for the possibility of allotment of further issues to the SA at the end of the stabilising period, together with the authorisation for the Public Issue, in the General Meeting of its Shareholders.

4. **Role of Parties / Operation of GSO:**

Issuing Company	<ul style="list-style-type: none"> Appoints one of the Lead Book Runners as the SA, who would be responsible for price stabilisation process. Discloses the details of agreements between Company and SA, as well as Promoters and SA, in the Draft Red Herring Prospectus, Red Herring Prospectus and Final Prospectus. Includes these agreements as material documents for public inspection in terms of the disclosures in the contents of the Offer Documents.
Stabilising Agent (SA)	<ul style="list-style-type: none"> Enters into an agreement with the Issuer Company (prior to filing of Offer Document with SEBI), clearly stating all the terms and conditions relating to GSO including fees charged/expenses to be incurred by him for this purpose. Enters into an agreement with Promoter(s), who would lend their shares, specifying the maximum number of shares that may be borrowed from their Promoters (maximum 15% of Issue Size).
Lead Book Runner	<ul style="list-style-type: none"> The Lead Book Runner, in consultation with the SA, would determine the amount of Shares to be over-allotted with the public issue, within the ceiling specified above. Over-allotment refers to an allocation of shares in excess of the size of the Public Issue made by the SA, out of Shares borrowed from the Promoters in pursuance of a GSO exercised by the Issuing Company.

Concept Flow Chart of Green Shoe Option



5. **Operation of GSO:**

- (a) The SA should borrow Shares from the Promoters to the extent of the proposed over-allotment. These Shares should be in a demat form only, and their allocation should be pro-rata to all the Applicants.
- (b) The Stabilisation Mechanism would be available for the period disclosed by the Company in the Prospectus, up to a maximum of 30 days from the date when the trading permission was granted by the Stock Exchanges.
- (c) Money received from the Applicants against the over-allotment in the GSO, should be kept in the GSO Bank Account to be used for the purpose of buying shares from the market during the stabilisation period. These Shares are to be credited to the GSO Demat Account.
- (d) These Shares should be returned to the Promoters immediately within 2 working days after the close of the Stabilisation Period.
- (e) To stabilise the post listing prices of the Shares, the SA would determine the timing of buying them, the quantity to be bought, the prices at which to be bought and so on.
- (f) In case the SA does not buy Shares to the extent of their over-allotment from the market, the Issuer Company should allot Shares to the extent of the shortfall in demat form to the GSO Demat Account within 5 days of the closure of the Stabilisation Period. Those would be returned to the Promoters by the SA in lieu of those borrowed from them and the GSO Demat Account would be closed.
- (g) The SA would remit the Issue Price (i.e. further shares allotted by the Issuer Company to the GSO Demat Account) to the Company from the GSO Bank Account.
- (h) The remaining balance, net of deduction of expenses incurred by the SA, would be transferred to the Investor Protection Fund of the concerned Stock Exchange, and the GSO Bank Account would be closed.