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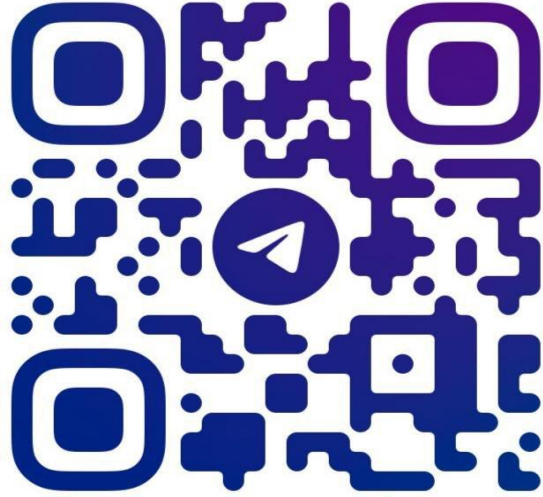
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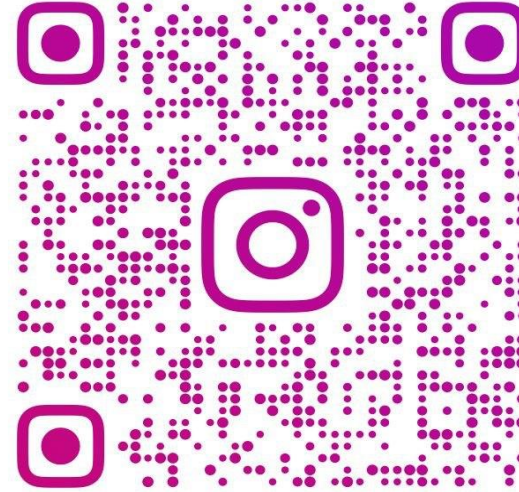


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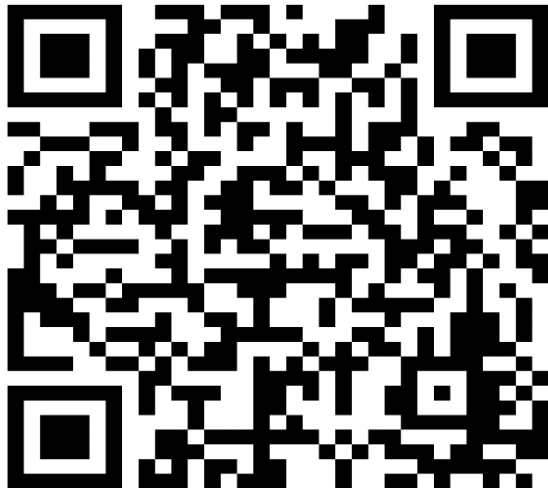
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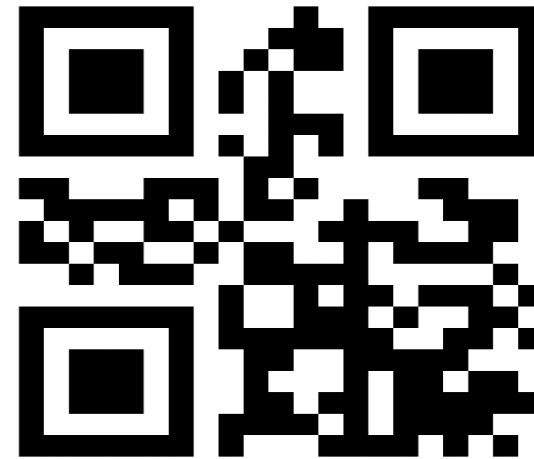
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FM & SM
SUPER CHART BOOK

FM Chapter 1

Scope and Objectives of Financial Management

By CA Mohnish Vora (MVSIR)

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CHAPTER 1 – Scope and Objectives of Financial Management

Introduction

For the purpose of starting any new business, an entrepreneur goes through the following stages of decision making

Step- 1

Decide **which assets** (premises, machinery, equipment etc.) to buy.

Step- 2

Determining what is **total investment** (since assets cost **money**) required for buying assets.

Step- 3

Apart from buying assets the entrepreneur would also need to determine **how much cash he would need to run the daily operations** (payment for **raw material, salaries, wages** etc.). In other words this is also defined as **Working Capital requirement**.

Step- 4

The next stage is to decide what all **sources**, does the entrepreneur need to tap to finance the total investment (assets and working capital). The sources could be –
 ✓ **Share Capital** (Equity & Preference) or
 ✓ **Borrowing** from Banks or
 ✓ **Investment** from Financial Institutions etc.

While deciding how much amount to take from each source, a finance manager focusses on 3 aspects –

- 1) Risk (should be as per tolerable limit)
- 2) Control (existing shareholders control should not dilute much)
- 3) Cost of capital (should be minimum)

Practically achieving all 3 together would be difficult, thus finance manager need to achieve a trade-off (balance)

- **Financial Management** is concerned with efficient
 - ❑ **acquisition** (financing) and
 - ❑ **allocation** (investment in assets, working capital etc.) of funds
 with an **objective to-**
 - ✓ **Maximisation** of **profits**, &
 - ✓ **Maximisation** of **wealth** (value) of shareholders.
- In other words, focus of financial management is to address three major financial decision areas –

1

Where to get the money from? (**Financing Decision**)

2

Where to invest the money? (**Investment Decision**)

3

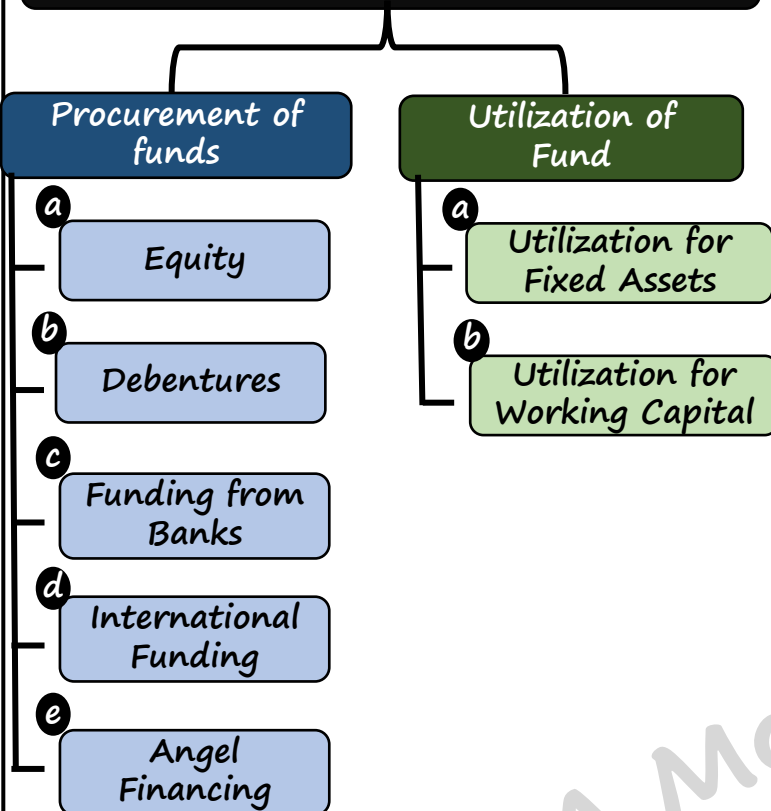
How much to distribute amongst shareholders to keep them satisfied? (**Dividend Decision**)

Another very elaborate definition of FM given by **Phillippatus** is "Financial Management is concerned with the **managerial decisions** that result in the **acquisition** and **financing** of **short term** and **long term credits** for the firm."



CHAPTER 1 – Scope and Objectives of Financial Management

Aspects of Financial Management



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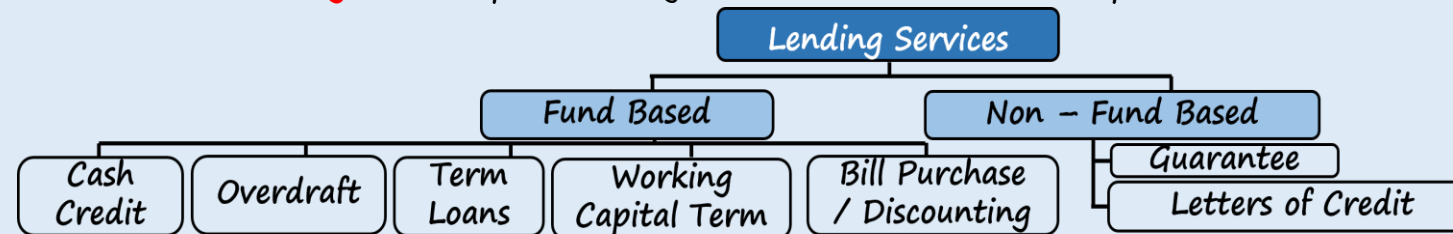
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Procurement of funds

- The **cost** of funds should be **minimum** level for that a **proper balancing of risk and control** factors must be carried out.
- Another key consideration in choosing the source of new business finance is to **strike a balance between equity and debt** to ensure the **funding structure suits the business**.

| | |
|--------------------------|--|
| A) Equity | <ul style="list-style-type: none"> ➤ Best from the risk point of view for the firm → no question of repayment of equity capital except when firm is under liquidation. ➤ From cost point of view → most expensive source of funds because- <ul style="list-style-type: none"> ✓ dividend expectations of shareholders is higher than interest rate, & ✓ dividends are an appropriation of profit, not allowed as an expense in Income Tax. ➤ Also issue of new shares may dilute control of existing shareholders. |
| B) Debentures | <ul style="list-style-type: none"> ➤ Debentures are comparatively cheaper than shares because of their tax advantage. ➤ Interest on debenture is free of tax, unlike dividend. ➤ Debentures have high degree of risk <ul style="list-style-type: none"> ✓ they have to be repaid, & also ✓ interest payment has to be made whether or not company makes profits (charge against profits) |
| C) Funding from Banks | <ul style="list-style-type: none"> ➤ Commercial Banks play an important role in funding of business enterprises. ➤ Apart from supporting businesses in their routine activities (deposits, payments etc.) they play an important role in meeting the long term & short term needs of a business enterprise. ➤ Different lending services provided by Commercial Banks are depicted as follows:- |





CHAPTER 1 – Scope and Objectives of Financial Management

| | |
|--------------------------|--|
| D) International Funding | <ul style="list-style-type: none"> ➤ Funding today is not limited to domestic market. With liberalization and globalization a business enterprise has options to raise capital from International markets also. ➤ Foreign Direct Investment (FDI) and Foreign Institutional Investors (FII) are two major routes for raising funds from foreign sources besides ADR's (American depository receipts) and GDR's (Global depository receipts). [Depository receipt is traded in local markets but represent the equity of a company listed in another country.] |
| E) Debentures | <ul style="list-style-type: none"> ➤ Angel Financing is a form of an equity-financing where an angel investor is a wealthy individual who provides capital for start-up or expansion, in exchange for an ownership/equity in the company. ➤ Angel investors have idle cash available and are looking for a higher rate of return than what is given by traditional investments. ➤ Typically, angels, as they are known as, will invest around 25 to 60 per cent to help a company get started. ➤ This source of finance sometimes is the last option for startups which doesn't qualify for bank funding and are too small for venture capital financing. |

Effective Utilization of Fund

| | |
|------------------------------------|---|
| A) Utilization for Fixed Assets | <ul style="list-style-type: none"> ➤ The funds are to be invested in the manner so that the company can produce at its optimum level without endangering its financial solvency. For this, the finance manager would be required to possess sound knowledge of techniques of capital budgeting. ➤ Capital budgeting (or investment appraisal) is the planning process used to determine whether a firm's long term investments such as new machinery, replacement machinery, new plants, new products, and research development projects would provide the desired return (profit). |
| B) Utilization for Working Capital | <ul style="list-style-type: none"> ➤ The finance manager must also keep in view the need for adequate working capital and ensure that while the firms enjoy an optimum level of working capital they do not keep too much funds blocked in inventories, book debts, cash etc. |

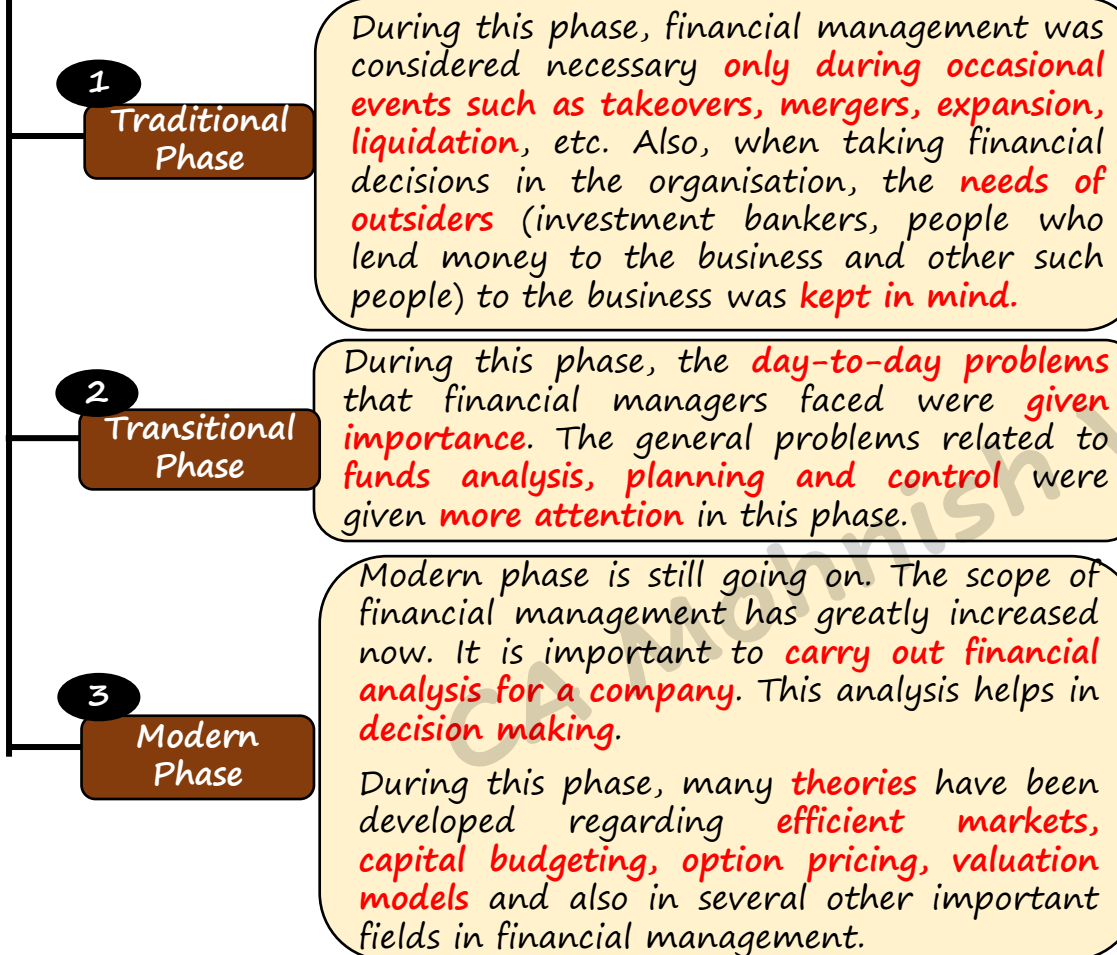
Notes:



CHAPTER 1 – Scope and Objectives of Financial Management

Evolution Of Financial Management

Financial management evolved gradually over the past 50 years. The evolution of financial management is divided into three phases. The three stages of its evolution are:

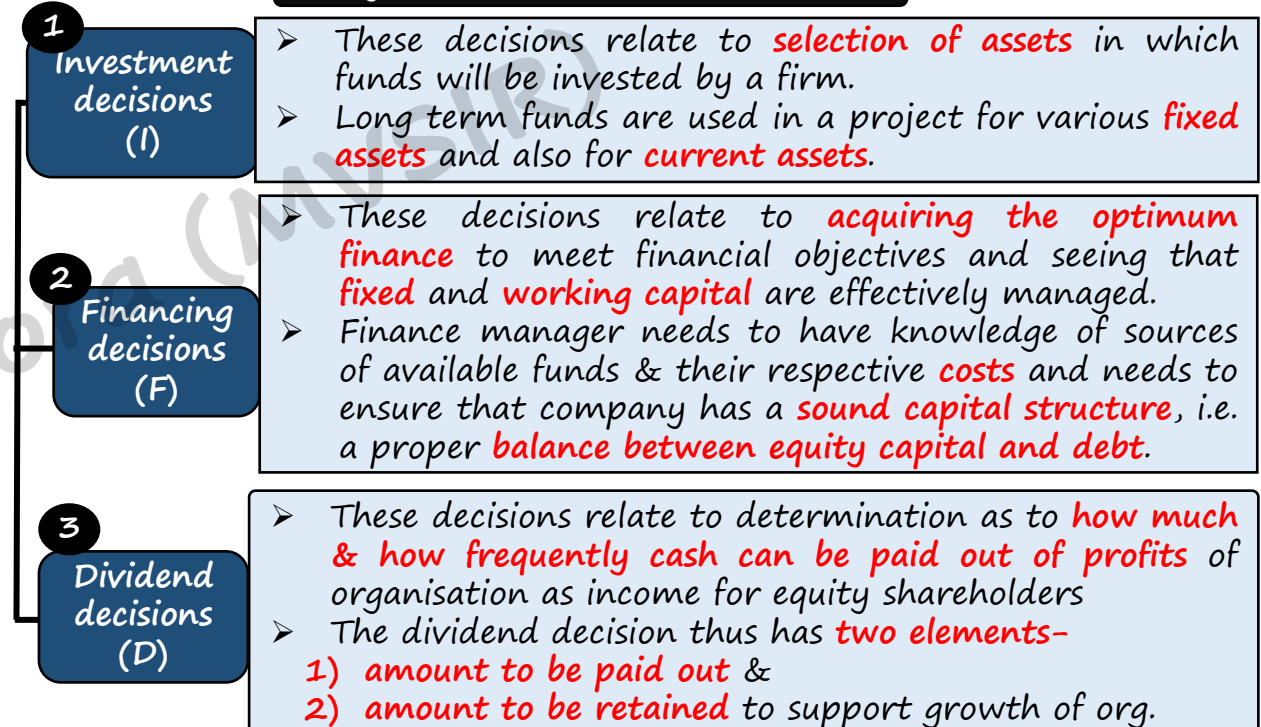


Finance Functions / Finance Decision

Value of a firm will depend on various finance functions/decisions. It can be expressed as : $V = f(I, F, D)$

The finance functions are divided into long term and short term functions / decisions

Long term Finance Function Decisions



Short term Finance Function Decisions

Working capital Management (WCM): Generally short term decision are reduced to **management of current asset & current liability** (i.e., working capital Management)



CHAPTER 1 – Scope and Objectives of Financial Management

Importance Of Financial Management

The best way to demonstrate the importance of good financial management is to describe some of the tasks that it involves:-

- 1) Taking care **not to over-invest** in fixed assets
- 2) **Balancing cash-outflow** with **cash-inflows**
- 3) Ensuring that there is a **sufficient level** of **short-term working capital**
- 4) **Setting sales revenue targets** that will deliver growth
- 5) **Increasing gross profit** by setting the **correct pricing** for products or services
- 6) **Controlling the level of general and administrative expenses** by finding more **cost-efficient** ways of running the day-to-day business operations, and
- 7) **Tax planning** that will minimize taxes to be paid.

Scope Of Financial Management

Based on financial management guru Ezra Solomon, scope of FM includes-

- a) Determination of **size of the enterprise** and **determination of rate of growth**.
- b) Determining the **composition of assets** of the enterprise.
- c) Determining the **mix of enterprise's financing** i.e. consideration of level of **debt to equity**, etc.
- d) **Analysis, planning** and **control** of **financial affairs** of the enterprise.

Role of Financial Controller

- The role of financial controller has undergone **changes over the years**.
- Earlier, its scope was limited to **procurement of funds** under **major events** in life of the company like promotion, expansion, merger, etc.
- In **modern times**, role of financial controller includes besides procurement of funds, the three different kinds of decisions -
 - 1) **investment**,
 - 2) **financing** and
 - 3) **dividend**.
- The financial controller, in order to maximize shareholders' wealth, should strive to **maximize returns in relation to given risk**. He should seek courses of actions that **avoid unnecessary risks**.
- To ensure maximum return, **funds flowing in & out** of the firm should be **constantly monitored** to assure that they are **safeguarded & properly utilized**.

Objectives Of Financial Management

Profit
Maximisation

Wealth / Value
Maximisation

Profit Maximisation

Traditionally been argued that **primary objective** of a company is to **earn profit**; This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximised.

Each alternative, therefore, is to be seen as to whether or not it gives maximum profit. However, profit maximisation cannot be the sole objective of a company. It is at best a limited objective.



CHAPTER 1 – Scope and Objectives of Financial Management

Profit maximization **cannot** be the **sole objective** of the firm. If profit is given undue importance, number of problems can arise.

- The term profit is vague. It does not clarify what exactly it means. It **conveys a different meaning to different people**.
- For example, profit may be in **short term** or **long term** period; it may be **total** profit or **rate** of profit etc.
- Profit maximisation has to be **attempted with a realisation of risks involved**. There is a direct relationship between risk and profit. If profit maximisation is the only goal, then **risk factor is ignored**.
- Profit maximisation as an objective **does not take into account the time pattern of returns**.
- Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns of proposal A begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is more early and quick.
- Profit maximisation as an objective is **too narrow**.
- It **fails** to take into **account the social considerations & obligations** to various **interests of workers, consumers, society etc.** If these factors are ignored, a **company cannot survive for long**.
- Profit maximization at cost of social & moral obligations is a **short sighted policy**.

Wealth / Value Maximisation

- Shareholders wealth are the result of **cost benefit analysis** adjusted with their **timing and risk** i.e. **time value of money**.

$$\text{Wealth} = \text{Present value of benefits} - \text{Present Value of Costs}$$

- The shareholder value maximization model holds that the **primary goal** of the firm is to **maximize its market value** and implies that business decisions should seek to **increase the net present value of the economic profits of the firm**.

So for measuring and maximising shareholders wealth finance manager should follow-

- ✓ Cash Flow approach not Accounting Profit
- ✓ Cost benefit analysis
- ✓ Application of time value of money.

How do we measure the value/wealth of a firm?

According to Van Horne,

- "Value of a firm is represented by the **market price of the company's common stock**. The market price of a firm's stock **represents the judgment of all market participants** as to **what the value of the particular firm is**.
- It takes into account-
 - ✓ present & prospective **future earnings per share**,
 - ✓ timing & risk of these earnings,
 - ✓ **dividend policy** of the firm, &
 - many other factors** that bear upon the market price of the stock.
- The **market price** serves as a **performance index** or **report card** of firm's progress. It indicates **how well management is doing** on behalf of stockholders."

CHAPTER 1 – Scope and Objectives of Financial Management

Some of the other goals a business enterprise

- Achieving a **higher growth rate**
- Attaining a **larger market share**
- Gaining **leadership** in market in terms of products & technology
- Promoting **employee welfare**
- Increasing **customer satisfaction**
- Improving **community life, supporting education and research, solving societal problems**, etc.

Conflicts In Profit Versus Value Maximisation Principle

- In any company, the **management** is the **decision taking authority**. As a normal tendency the **management** may **pursue its own personal goals** (profit maximization).
- But in an organization where there is a **significant outside participation** (shareholders, lenders etc.), the management may **not be able to exclusively pursue its personal goals** due to **constant supervision** of various **stakeholders**.
- Every **entity associated with company** will **evaluate the performance** of management from the fulfilment of its **own objective**. The **survival of the management** will be **threatened** if the **objective** of any of the **entities** remains **unfulfilled**.
- The **wealth maximization objective** is generally **in accord with the interests of the various stakeholders**, & thus, it may be **consistent with management objective of survival**.
- Owing to **limitations** (timing, social consideration etc.) **in profit maximization**, in today's world which is uncertain in nature, **wealth maximization is a better objective**.
- Where the **time period is short** and degree of uncertainty is not great, wealth maximization and profit maximization amount to essentially the **same**.

Advantages and Disadvantages of both Profit maximization and Wealth maximization goals

| Goal | Objective | Advantages | Disadvantages |
|----------------------------------|---------------------------------|---|--|
| Profit Maximization | Large amount of profits | 1) Easy to calculate profits 2) Easy to determine the link between financial decisions and profits. | 1) Emphasizes the short term gains 2) Ignores risk or uncertainty 3) Ignores the timing of returns 4) Requires immediate resources. |
| Shareholders Wealth Maximisation | Highest market value of shares. | 1) Emphasizes the long term gains 2) Recognises risk or uncertainty 3) Recognises the timing of returns 4) Considers shareholders' return. | 1) Offers no clear relationship between financial decisions and share price. 2) Can lead to management anxiety and frustration. |

Other Important Points

- **Profit maximization** can be **achieved** in the **short term** at the **expense** of the **long term goal**, that is, wealth maximization.
- For example, a costly investment may **experience losses in the short term** but **yield substantial profits in the long term**. Also, a firm that wants to **show a short term profit** may, for example, postpone major repairs or replacement, although such postponement is likely to hurt its long term profitability.



CHAPTER 1 – Scope and Objectives of Financial Management

Role Of Finance Executive

- The finance executive of an organisation plays an important role in the company's goals, policies, and financial success. His responsibilities include:
 - a) **Financial analysis and planning:** Determining the **proper amount of funds to employ** in the firm, i.e. designating the size of the firm and its rate of growth.
 - b) **Investment decisions:** The **efficient allocation of funds** to specific assets.
 - c) **Financing and capital structure decisions:** **Raising funds on favourable terms** as possible i.e. determining the composition of liabilities.
 - d) **Management of financial resources** (such as working capital).
 - e) **Risk management:** **Protecting assets.**

Role of Finance executive in today's World vis-a-vis in the past

Today, the role of chief financial officer, or CFO, is no longer confined to accounting, financial reporting and risk management. It's about being a strategic business partner of the CEO.

What a CFO used to do?

- 1) Budgeting
- 2) Forecasting
- 3) Accounting
- 4) Treasury (cash management)
- 5) Preparing internal financial reports for management.
- 6) Preparing quarterly, annual filings for investors.
- 7) Tax filing
- 8) Tracking accounts payable and accounts receivable.
- 9) Travel and entertainment expense management.

What a CFO now does?

- 1) Budgeting
- 2) Forecasting
- 3) Managing M&As
- 4) Profitability analysis (for example, by customer or product)
- 5) Pricing analysis
- 6) Decisions about outsourcing
- 7) Overseeing the IT function.
- 8) Overseeing the HR function.
- 9) Strategic planning (sometimes overseeing this function)
- 10) Regulatory compliance.
- 11) Risk management.

Financial Distress And Insolvency

- There are various factors like price of the product/ service, demand, price of inputs e.g. raw material, labour etc., which is to be managed by org. on a continuous basis.
- **Proportion of debt** also need to be **managed** by an organisation very delicately. **Higher debt** requires **higher interest** and if the **cash inflow is not sufficient** then it will **put lot of pressure** to the organisation. Both **short term** and **long term creditors** will **put stress** to the firm.
- If **all the above factors** are **not well managed** by the firm, it can **create situation** known as **distress**, so financial distress is a position where **Cash inflows** of a firm are **inadequate** to **meet all its current obligations**.
- Now if **distress continues for a long period** of time, firm may have to **sell its asset**, even many times at a lower price. Further when **revenue is inadequate** to revive the situation, firm will **not be able to meet its obligations** and become **insolvent**.
- **Insolvency** basically means **inability of a firm to repay various debts** and is a result of **continuous financial distress**.



CHAPTER 1 – Scope and Objectives of Financial Management

11. Relationship Of Financial Management With Related Disciplines

11.1 Financial Management and Accounting

- **Accounting** is an important **input** in **financial decision making** or financial management function.
- Financial **accounting generates information** relating to operations of the organisation. The **outcome** of accounting is the **financial statements** such as balance sheet, income statement, and the statement of changes in financial position.
- The **information contained** in these statements and reports **helps the financial managers** in gauging the past performance and future directions of the organisation.
- Some of the **differences** between financial management and accounting are:-

11.1 Financial Management and Accounting

Treatment of Funds

Decision making

Treatment of Funds

- In **accounting**, the **measurement of funds** is based on the **accrual principle** i.e. revenue & expense is recognised at the point of sale or incurred, and not when actually collected or paid. An **organisation** which has **earned profit** (sales less expenses) may said to be profitable in the accounting sense but it **may not be able to meet its current obligations** due to shortage of liquidity. Such an organisation will not survive.
- The treatment of funds in **financial management** is based on **cash flows**. The **revenues** are recognised **only when cash is actually received** (i.e. cash inflow) and **expenses** are recognised on **actual payment** (i.e. cash outflow).

Decision making

- The purpose of **accounting** is to **collect and present financial data** of the **past, present and future** operations of the organization. The **financial manager** uses these data for **financial decision making**. Thus, in a way it can be stated that **financial management begins where accounting ends**.

11.2 Financial Management and other Related Disciplines

- For its day to day decision making process, financial management also draws on other related disciplines such as **marketing, production and quantitative methods** apart from accounting.
- For instance, financial managers should consider the **impact of new product development and promotion plans** made in **marketing** area since their plans will **require capital outlays** and have an **impact on the projected cash flows**.
- Likewise, **changes in the production process** may require **capital expenditures** which the financial managers must evaluate and finance. Finally, the tools and techniques of analysis developed in the quantitative methods discipline are helpful in analyzing complex financial management problems.



CHAPTER 1 – Scope and Objectives of Financial Management

12. Agency Problem & Agency Cost

- Though in a sole proprietorship firm, partnership etc., owners participate in management but **in corporates, owners are not active in management** so, there is a **separation** between **owner/ shareholders** and **managers**.
- In theory **managers should act in the best interest of shareholders** however in reality, **managers may try to maximise their individual goal** like salary, perks etc., so there is a **principal agent relationship** between managers and owners, which is known as **Agency Problem**.
- In a nutshell, Agency Problem is the **chances that managers may place personal goals ahead of the goal of owners**. Agency Problem leads to **Agency Cost**.
- **Agency cost** is the **additional cost borne by the shareholders to monitor the manager and control their behaviour** so as to maximise shareholders wealth. Generally,
- Agency Costs are of four types-
 - (i) **monitoring**
 - (ii) **opportunity**
 - (iii) **bonding**
 - (iv) **structuring**

Addressing the agency problem

- The agency problem arises if **manager's interests are not aligned** to the interests of the debt lender and equity investors.
- The **agency problem of debt lender** would be addressed by **imposing negative covenants** i.e. the **managers cannot borrow beyond a point**.
- Agency problem between the managers and shareholders can be **addressed if the interests of the managers are aligned to the interests of the share-holders**. It is easier said than done.
- However, following **efforts** have been made **to address these issues**:
 - 1) **Managerial compensation** is **linked to profit** of company & also with long term objectives of company.
 - 2) **Employee stock option plan** can be designed to address the issue with underlying assumption that **maximisation of stock price** is **objective of the investors**.
 - 3) **Effecting monitoring** can be done.

Types of Agency Cost

Monitoring Cost

- Cost of keeping a check on activities of management.
- Expenses of audit & control procedures

Opportunity Cost

- Cost of lost opportunity
- There is a project that management can undertake but it may lead to termination of their jobs. However, shareholders are of the opinion that if company undertakes the project it will improve the shareholders' values and if the management rejects the project it will have to face a huge loss in terms of shareholders' stake.

Bonding Cost

- Contractual obligations are entered between the company and the agent. A manager continues to stay with a company even after it is acquired.

Structuring Cost

- Cost incurred in structuring incentive plans.
Eg- Employee stock option.



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FM Chapter 2 Types of Financing

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CHAPTER 2 – Types of Financing

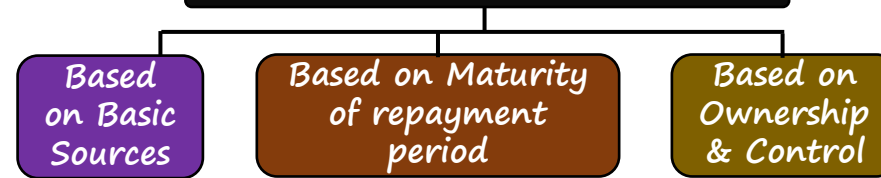
Financial Needs And Sources Of Finance Of A Business

| | |
|-----------------------------|--|
| Long-term financial needs | Such needs generally refer to those requirements of funds which are for a period <u>exceeding 5-10 years</u> . All investments in plant, machinery, land, buildings , etc., are considered as long-term financial needs. Funds required to finance permanent or hard-core working capital should also be procured from long term sources . |
| Medium-term financial needs | Such requirements refer to those funds which are required for a period <u>exceeding one year but not exceeding 5 years</u> . This might be needed for stores and spares, critical spares, tools, dies, moulds. |
| Short-term financial needs | Such financial needs arise to finance current assets such as stock, debtors, cash . Investment in these assets are known as meeting of working capital requirements of concern. The main characteristic of short-term financial needs is that they arise for a short period of time <u>not exceeding</u> the accounting period. i.e., <u>one year</u> . |

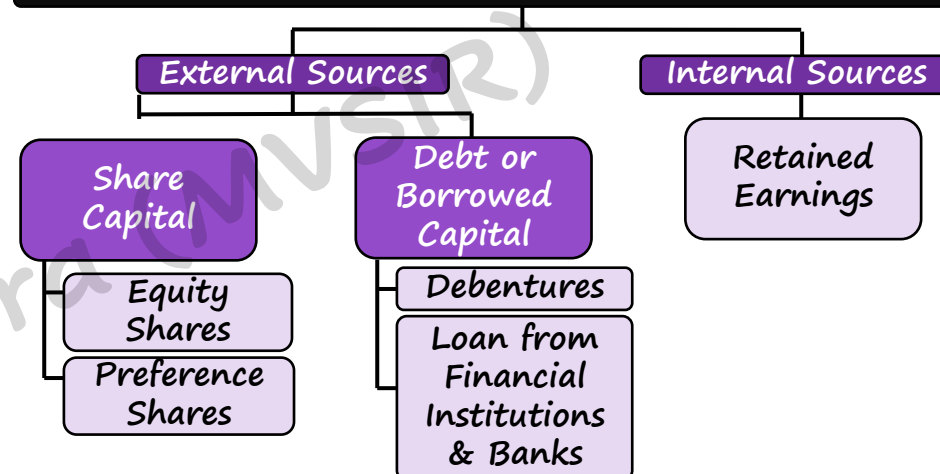
Basic Principle for Funding Various Needs

| Stage | Type of Borrowing | Borrower nature |
|--------------|------------------------------|---|
| Early stage | High Uncertainty | <ul style="list-style-type: none"> Equity; mainly Angel fund |
| | High to moderate Uncertainty | <ul style="list-style-type: none"> Equity; Venture capital; Debt |
| Growth Stage | Moderate to Low Uncertainty | <ul style="list-style-type: none"> Debt; Venture Capital; Private Equity |
| Stable stage | Low Uncertainty | <ul style="list-style-type: none"> Debt |

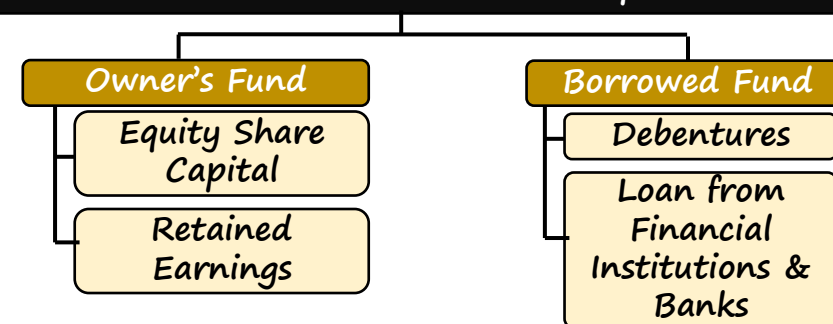
Classification Of Financial Sources



Sources of finance based on Basic Sources



Sources of finance based on Ownership and Control



Notes



CHAPTER 2 – Types of Financing

Sources of Finance based on Maturity of Payment

Long term

- Share capital or Equity shares
- Preference shares
- Retained earnings
- Debentures/Bonds of different types
- Loans from financial institutions
- Loans from State Financial Corporations
- Loans from commercial banks
- Venture capital funding
- Asset securitisation
- International financing like Euro issues, Foreign currency loans

Medium term

- Preference shares
- Debentures/Bonds
- Public deposits/fixed deposits for duration of three years
- Medium term loans from Commercial banks, Financial Institutions, State Financial Corporations
- Lease financing/Hire Purchase financing
- External commercial borrowings
- Euro-issues
- Foreign Currency bonds

Short term

- Trade credit
- Accrued expenses and deferred income
- Short term loans like Working Capital Loans from Commercial banks
- Fixed deposits for a period of 1 year or less
- Advances received from customers
- Various short-term provisions

Long-term Sources Of Finance

Share capital
(both equity and preference)

Debt
(including debentures, long term borrowings or other debt instruments)

Owners Capital or Equity Capital

A public limited company may raise funds from promoters or from public by way of owner's capital or equity capital by issuing ordinary equity shares.

Characteristics of Owners/Equity Share Capital are:-

- 1) A source of **permanent capital**. The **holders** are called **equity shareholders** or **ordinary shareholders**.
- 2) Equity shareholders are **owners** of co. as they undertake **highest risk**.
- 3) They are entitled to **dividends** after **income claims of other stakeholders** are satisfied. Dividends are **appropriation of profits**.
- 4) In event of **winding up**, ordinary shareholders can exercise their **claim** on assets **after claims of other suppliers** of capital have been met.
- 5) **Cost** of equity is the **highest**, due to the fact that equity shareholders **expect higher rate of return** (as their risk is highest) as compared to other suppliers of capital.
- 6) Ordinary share capital also **provides a security to other suppliers** of funds. Any institution giving loan to a company would make sure the **debt-equity ratio** is **comfortable** to **cover the debt**.
- 7) Various types of equity shares like- **New issue, Rights issue, Bonus Shares, Sweat Equity**.



CHAPTER 2 – Types of Financing

Advantages of issuing Equity Shares Capital

- 1) A **permanent source** of finance, since such shares are **not redeemable**, company has **no liability for cash outflows** due to redemption. Once company has issued equity shares, they are **tradable** (purchased & sold). So, a company is **not responsible for any cash outflows of investors**, by which they become shareholders by purchasing shares of existing holders.
- 2) Equity capital **increases company's financial base** & helps to **further borrowing powers** of company → **helps it to raise more funds with help of debt**. This is because; **debt will enable company to increase its EPS** & further, its **share prices**.
- 3) Company is **not obliged legally to pay dividend**, thus in times of **uncertainties** or when company is not performing well → **dividend payments can be reduced or even suspended**.
- 4) Co. can **further increase its share capital** by initiating a **right issue**.

Disadvantages of issuing Equity Shares Capital

- 1) Dividend is **taxable** in **hands of recipient**.
- 2) **Investors** find equity shares **riskier** due to **uncertain dividend payments** & capital gains.
- 3) **Issue of new equity reduces EPS** of existing shareholders (unless profits are proportionately increased).
- 4) **Issue of new equity reduces** (dilutes) **ownership** & **control** of existing shareholders.

Preference Share Capital

Holders of such shares **enjoy priority (preference)**, in both –

- 1) **payment of fixed amount of dividend**, &
- 2) **repayment of capital on winding up** of co.

Characteristics of Preference Share Capital

- 1) **Long-term funds** from pref. shares can be raised through a **public issue**.
- 2) Such shares are **normally cumulative**, i.e., **dividend payable in a year of loss** gets **carried over to next year till there are adequate profits** to pay.
- 3) **Rate of pref. dividend** is **higher than** rate of **interest on debentures**.
- 4) They carry a **stipulation of period** & funds **have to be repaid at end** of a stipulated period.
- 5) Preference share capital is a **hybrid form** of financing [Equity + Debt].
 - ✓ Similar to equity → **pref. dividend**, like equity dividend is **not tax-deductible**.
 - ✓ Similar to debt → **rate of preference dividend is fixed**.
- 6) **Cumulative Convertible Preference Shares (CCPs)**– Under which the shares would **carry cumulative dividend of specified limit for a period** of say three years **after which the shares are converted into equity shares**. These shares are **attractive for projects with long gestation period**.
- 7) Pref. share capital may be **redeemed at**–
 - ✓ **pre decided future date**, or
 - ✓ **at an earlier stage out of profits**.

This enables promoters to withdraw their capital from company which is now self-sufficient, & withdrawn capital may be reinvested in other profitable ventures.

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CHAPTER 2 – Types of Financing

Various types of Preference shares

| | Type of Preference Share | Salient Features |
|----|--------------------------|---|
| 1. | Cumulative | Arrear Dividend will accumulate |
| 2. | Non-cumulative | No right to arrear dividend. |
| 3. | Participating | Can participate in the surplus which remains after payment to equity shareholders |
| 4. | Non-Participating | Cannot participate in the surplus after payment of fixed rate of Dividend. |
| 5. | Convertible | Option of converting into equity Shares. |
| 6. | Redeemable | Redemption should be done. |

Advantages of Preference Share Capital

- 1) **No dilution in EPS** due to pref. shares.
- 2) There is also advantage of **leverage** as it **bears a fixed charge** (as cos. are required to **pay fixed rate of pref. dividend**). **Non-payment** of pref. dividends **does not force** a company into **liquidity**.
- 3) There is **no risk of takeover** by acquiring pref. shares as the pref. shareholders **do not have voting rights** except where **dividend payment are in arrears**.
- 4) **Pref. dividends** are **fixed & pre-decided**. Hence pref. shareholders **cannot participate in surplus profits** as equity shareholders can **except** in case of **participating preference shareholders**.
- 5) Preference capital can be **redeemed** after a specified period.

Disadvantages of Preference Share Capital

- 1) Pref. dividend is **not tax deductible** & so **does not provide tax shield** to co. Hence pref. shares are **costlier than debt**.
- 2) **Pref. dividends** are **cumulative** in nature. This means that if in a particular year pref. dividends are **not paid** they shall be **accumulated & paid later**. Also, if **pref. dividends are not paid, no dividend can be paid to equity shareholders**. Non-payment of dividend to equity shareholders could **seriously impair reputation** of co.

Difference between Equity Shares and Preference Shares

| | Basis of Distinction | Equity Share | Preference Shares |
|---|----------------------|--|--|
| 1 | Preference dividend | Equity Dividend is paid after preference dividend. | Payment of preference dividend is preferred over equity dividend |
| 2 | Rate of dividend | Fluctuating | Fixed |
| 3 | Convertibility | Not convertible | Convertible |
| 4 | Voting rights | Equity shareholders enjoy voting rights | They have very limited voting rights |



CHAPTER 2 – Types of Financing

Retained Earnings

- Long-term funds may also be provided by **accumulating profits** of company & by **ploughing them back into business**.
- Such funds **belong to equity shareholders** & **increase net worth** of co.
- A public limited company must plough back a reasonable amount of profit every year considering legal requirements & also for its own **expansion plans**.
- Such funds entail **almost no risk**.
- Further, **control of present owners** is also **not diluted** by retaining profits.

Debentures

Characteristics of Debenture

- Debentures are issued in **different denominations** ranging from **₹100 to ₹1,000** & carry **different rates of interest**.
- They are issued on basis of **debenture trust deed** which lists **terms & conditions** on which debentures are floated.
- They are used for **raising long-term debt** capital.
- The **period of maturity** varies from **3 to 10 years** & may increase for high gestation projects.
- Debentures are either **secured** or **unsecured**.
- They **may or may not be listed** on stock exchange.
- The **cost of using debentures** is **quite low** since **interest** is a **tax-deductible expense**.
- From **investors' point of view**, debentures are **more attractive** than pref. shares since **interest** is payable **whether or not company makes profits**.

Debentures can be divided into the following three categories based on their convertibility

1 Non-convertible debentures

Debentures which **do not have any feature of conversion** & are repayable on maturity.

2 Fully convertible debentures

Such debentures are **converted into equity shares** as per terms of issue in relation to price & time of conversion. **Interest rates** on such debentures are **less than non-convertible debentures** because of feature of conversion into shares.

3 Partly convertible debentures

These debentures carry **features of both convertible and non-convertible** debentures. The **investor** has **advantage** of having **both features** in one debenture.

Other types of Debentures with their features

| | Type of Debenture | Salient Feature |
|----|-------------------|--|
| 1. | Bearer | Transferable like negotiable instruments |
| 2. | Registered | Interest payable to registered person |
| 3. | Mortgage | Secured by a charge on Asset(s) |
| 4. | Naked or simple | Unsecured |
| 5. | Redeemable | Repaid after a certain period |
| 6. | Non-Redeemable | Not repayable |

Advantages of Debentures

- The **cost** of debentures is **much lower than** the **cost of preference or equity** as the **interest** is **tax-deductible**. Also, **investors consider** debenture investment **safer** than equity or preference investment & thus **require lower return** on deb.
- Debenture financing **does not result in dilution** of control.
- In period of **rising prices**, **debenture issue is advantageous**. **Fixed monetary outgo decreases in real terms** as **price level increases**. Since, company has to **pay a fixed rate** of interest.



CHAPTER 2 – Types of Financing

Disadvantages of Debenture

- i. Debenture interest & principal repayment is an **obligatory payment**.
- ii. Debenture financing **enhances financial risk** because of the reasons given in point (i).
- iii. **Protective covenants** associated with debenture issue may be **restrictive**.
- iv. Since debentures need to be **paid at time of maturity**, a **large amount of cash outflow** is needed at that time.

Public issue of debentures or private placement to mutual funds now require that a debenture issue must be **rated by a credit rating agency** like **CRISIL** (Credit Rating and Information Services of India Ltd.).

The **credit rating** is given **after evaluating factors** like **track record of the company**, **profitability**, **debt servicing capacity**, **credit worthiness** and the **perceived risk of lending**.

Difference between Preference Shares and Debentures

| Basis of difference | Preference shares | Debentures |
|-------------------------------|--|---|
| Ownership | It is a special kind of share | It is a type of loan which can be raised from public |
| Payment of Dividend/ Interest | Pref. shareholders enjoy priority both as regard to payment of fixed dividend & repayment of principal in case of winding up of a company | It carries fixed percentage of interest . |
| Nature | Pref. shares are a hybrid form of financing with some characteristic of equity shares & some of Debt Capital. | They are instrument for raising long term capital with fixed period of maturity . |

Bond

Bond is fixed income security created to raise fund. Bonds can be raised through Public Issue and through Private Placement.

Types of BondBased on call

- 1) Callable Bond
- 2) Puttable Bond

Foreign Bonds

- 1) Foreign Currency Convertible Bond (FCCB)
- 2) Plain Vanilla Bond
- 3) Convertible Floating Rate Notes (FRN)
- 4) Drop Lock Bond
- 5) Variable Rate Demand Obligations
- 6) Yield Curve Note (YCN)
- 7) Euro Bond
- 8) Emerging Market Bond

Indian Bonds

- 1) Masala Bond
- 2) Municipal Bond
- 3) Government or Treasury Bonds

Notes



CHAPTER 2 – Types of Financing

Based on Call

| S. No. | Based on Call | Meaning |
|--------|---------------|---|
| 1. | Callable Bond | A callable bond has a call option which gives issuer the right to redeem bond before maturity at a pre-determined price known as call price (Generally at premium). |
| 2. | Puttable Bond | Puttable bonds give investor a put option (i.e. right to sell bond) back to company before maturity |

Foreign Bonds

| | Name | Meaning |
|----|--|---|
| 1. | Foreign Currency Convertible Bond (FCCB) | <ul style="list-style-type: none"> ➤ Issued by multinational companies looking to raise capital in foreign currencies. It is issued in the currency other than home currency. ➤ This bond comes at a very low rate of interest. ➤ The advantage to the issuer is that the issuer can get foreign currency at a very low cost. ➤ The risk is that in case the bond has to be redeemed on the date of maturity, the issuer has to make the payment and at that time the issuer may not have the money. |
| 2. | Plain Vanilla Bond | <ul style="list-style-type: none"> ➤ The issuer would pay the principal amount along with the interest rate. ➤ This type of bond would not have any options [Basic type] ➤ This bond can be issued in the form of discounted bond or can be issued in the form of coupon bearing bond. |

| | Name | Meaning |
|----|---------------------------------------|---|
| 3. | Convertible Floating Rate Notes (FRN) | <ul style="list-style-type: none"> ➤ A convertible FRN is issued by giving its holder an option to convert it into a longer term debt security with a specified coupon ➤ It protects an investor against falling interest rate ➤ The long-term debt security can be sold in the market and the investor can earn profit ➤ Capital gain is not applicable to FRN |
| 4. | Drop Lock Bond | <ul style="list-style-type: none"> ➤ It is a Floating Rate Note with a normal floating rate ➤ The floating rate bond would be automatically converted into fixed rate bond if interest rate falls below a predetermined level ➤ The new fixed rate stays till the drop lock bond reaches its maturity ➤ The difference between the convertible floating rate note and drop lock bond is that the former is a long option structure and the latter one is a short option structure |
| 5. | Variable Rate Demand Obligations | <ul style="list-style-type: none"> ➤ A normal floating rate note with a nominal maturity ➤ The holder of the floating rate note can sell the obligation back to the trustee at par plus accrued interest ➤ It gives the investor an option to exit, so it is more liquid than the normal FRN |



CHAPTER 2 – Types of Financing

| | Name | Meaning |
|----|------------------------|---|
| 6. | Yield Curve Note (YCN) | <ul style="list-style-type: none"> ➤ It is a structured debt security ➤ Yield increases when prevailing interest rate declines ➤ Yield decreases when prevailing interest rate increases ➤ This is used to hedge the interest rate ➤ This works like inverse floater |
| 7. | Euro Bond | <ul style="list-style-type: none"> ➤ Euro bonds are issued or traded in a country using a currency other than the one in which the bond is denominated. This means that the bond uses a certain currency, but operates outside the jurisdiction of the Central Bank that issues that currency ➤ Eurobonds are issued by multinational corporations, for example, a British company may issue a Eurobond in Germany, denominating it in U.S. dollars ➤ It is important to note that the term has nothing to do with the euro, and the prefix "euro-" is used more generally to refer to deposit outside the jurisdiction of the domestic central bank |
| 8 | Emerging Market Bond | <ul style="list-style-type: none"> ➤ A debt instrument issued by the developing countries. ➤ It provides higher yields in comparison to U.S. corporate and Treasury bonds. ➤ Credit default swap (CDS) is used to protect the bondholders against the default. ➤ It tend to carry higher risks than domestic debt instruments. |

| Indian Bonds | | |
|--------------|------------------------------|--|
| | Name | Meaning |
| 1. | Masala Bond | <ul style="list-style-type: none"> ➤ Masala (means spice) bond is an Indian name used for Rupee denominated bond that Indian corporate borrowers can sell to investors in overseas markets. ➤ These bonds are issued outside India but denominated in Indian Rupees. ➤ NTPC raised Rs 2,000 crore via masala bonds for its capital expenditure in the year 2016. |
| 2. | Municipal Bonds | <ul style="list-style-type: none"> ➤ Municipal bonds are used to finance urban infrastructure are increasingly evident in India. ➤ Ahmedabad Municipal Corporation issued a first historical Municipal Bond in Asia to raise Rs 100 crore from the capital market for part financing a water supply project. |
| 3. | Government or Treasury Bonds | <ul style="list-style-type: none"> ➤ Government or Treasury bonds are bonds issued by Government of India, Reserve Bank of India, any state Government or any other Government department. |

Notes:



CHAPTER 2 – Types of Financing

Loans from Financial Institutions

(i) Financial Institutions : National

| | Name of the Financial Institution | Year of Establishment | Remarks |
|---|---|-----------------------|----------------------------------|
| 1 | Industrial Finance Corporation of India (IFCI) | 1918 | Converted into public company |
| 2 | State Financial Corporations (SFCs) | 1951 | - |
| 3 | Industrial Development Bank of India (IDBI) | 1954 | Converted into Bank |
| 4 | National Industrial Development Corporation (NIDC) | 1954 | - |
| 5 | Industrial Credit and Investment Corporation of India (ICICI) | 1955 | Converted into Bank & Privatised |
| 6 | Life Insurance Corporation of India (LIC) | 1956 | - |
| 7 | Unit Trust of India (UTI) | 1964 | - |
| 8 | Industrial Reconstruction Bank of India (IRBI) | 1971 | - |

(ii) Financial Institutions : International Institutions

| S. No. | Name of the Financial Institution | Year of Establishment |
|--------|--|-----------------------|
| 1. | The World Bank/ International Bank for Reconstruction and Development (IBRD) | 1944 |
| 2. | The International Finance Corporation (IFC) | 1956 |
| 3. | Asian Development Bank (ADB) | 1966 |

Loans from Commercial Banks

The primary role of banks is to cater to **short-term requirements** of industry.

But, banks have started taking interest in long term financing also-

- The banks provide long term loans for the purpose of **expansion** or **setting up of new units**. Their **repayment** is usually scheduled over a **long period of time**. The **liquidity** of such loans is said to depend on the **anticipated income of the borrowers**.
- As part of the long-term funding for a company, the banks also fund the **long term working capital requirement** (it is also called WCTL i.e. working capital term loan). It is **funding of that portion** of working capital which is **always required** (the minimum level) & is not impacted by seasonal requirement of the co.

Bridge Finance

- It refers to loans taken by co. from commercial banks for a **short period** because of **pending disbursement of loans** sanctioned by financial institutions (FIs).
- It **takes time** for FIs to **disburse loans** to companies.
- However, **once loans are approved** by FIs, companies, in order **not to lose further time in starting** their projects, **arrange short term loans** from commercial banks.
- Bridge loans are **repaid/ adjusted** out of the term loans **as and when disbursed** by the concerned institutions.
- They are normally **secured** by **hypothecating movable assets, personal guarantees & demand promissory notes**.
- Generally, rate of **interest** on bridge finance is **higher** as compared with that on term loans.



CHAPTER 2 – Types of Financing

Venture capital financing

Meaning of VCF

Under venture capital financing, venture capitalist make investment to **purchase equity or debt securities** from **inexperienced entrepreneurs** (with **lack of funds**) who undertake highly risky ventures with potential to succeed in future.

Characteristics of VCF

- 1) It is basically an **equity finance** in **new companies**.
- 2) It can be viewed as a **long-term investment** in **growth-oriented small/medium firms**.
- 3) Apart from providing funds, the investor also provides **support** in form of-
 - ✓ **sales strategy,**
 - ✓ **business networking &**
 - ✓ **management expertise,**
 enabling the growth of the entrepreneur

Methods of Venture Capital Financing

1) Equity financing

- The venture capital undertakings require funds for a longer period but **may not be able to provide returns** to investors during the **initial stages**.
- Therefore, it is generally provided by way of **equity share capital**.
- The equity contribution of venture capital firm **does not exceed 49%** of the total equity capital of venture capital undertakings so that the **effective control** and ownership **remains with the entrepreneur**.

2) Conditional loan

- A conditional loan is repayable in the form of a **royalty** after the venture is able to generate sales. **No interest is paid** on such loans.
- In India venture capital financiers charge royalty ranging between **2 to 15 %**; actual rate depends on various other factors.
- Some Venture capital financiers give a **choice** to the enterprise of **paying a high rate of interest** (which could be well above 20 per cent) **instead of royalty on sales** once it becomes commercially sound..

3) Income note

- It is a **hybrid** security which combines the features of both **conventional loan** and **conditional loan**.
- The entrepreneur has to **pay both interest & royalty** on sales but at substantially **low rates**.
- IDBI's VCF provides funding equal to **80 – 87.50% of the projects cost** for commercial application of indigenous technology.

4) Participating debenture

- Such security carries charges in **three phases**-
- ✓ in start-up phase **no interest** is charged,
- ✓ next stage a **low rate of interest** is charged up to a particular level of operation,
- ✓ after that, a **high rate of interest** is required to be paid.



CHAPTER 2 – Types of Financing

Debt Securitisation

- Securitisation is a process in which **illiquid assets** are **pooled into marketable securities** that can be sold to investors.
- It 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 asset pool, **market securities can be issued**, e.g. housing finance, auto loans, and credit card receivables.

1) The origination function

- A **borrower seeks a loan** from a finance company or bank.
- **Credit worthiness** of borrower is **evaluated** & **contract is entered** into with **repayment schedule structured** over life of loan.

2) The pooling function

- **Similar loans** on receivables are **clubbed together** to create an **underlying pool of assets**.
- The pool is **transferred in favour of Special purpose Vehicle (SPV)**, which acts as a **trustee** for investors.

1) The securitisation function

- SPV will **structure & issue securities** on basis of asset pool.
- The securities carry a **coupon** & expected **maturity** which can be asset based/ mortgage based.
- These are generally sold to investors **through merchant bankers**. Investors are – **pension funds, mutual funds, insurance funds**.
- The process of securitization is generally **without recourse** i.e. **investors bear credit risk** & issuer is under an obligation to pay to investors only if cash flows are received by him from collateral.
- The **benefits to the originator** are that **assets are shifted off the balance sheet**, thus giving the originator recourse to **off-balance sheet funding**.

Lease financing

- Leasing is a **contract** between **owner** & **user** of asset over a specified period.
- Asset is purchased initially by lessor (leasing co.) & thereafter leased to user (lessee co.) which pays a **rent** at periodical intervals.
- Thus, leasing is an **alternative to purchase of an asset** out of own or borrowed funds. Moreover, lease finance can be **arranged much faster** as compared to term loans from financial institutions.

| S.no | Financial Lease | Operating Lease |
|------|--|---|
| 1. | Risk & reward incident to ownership are passed on to lessee . Lessor only remains the legal owner of the asset | Lessee is only provided use of asset for a certain time. Risk incident to ownership belong wholly to the lessor . |
| 2. | Lessee bears risk of obsolescence | Lessor bears risk of obsolescence |
| 3. | Lessor is interested in his rentals & not in the asset . He must get his principal back along with interest. Lease is non-cancellable by either party . | As the lessor does not have difficulty in leasing the same asset to other willing lessee, the lease is kept cancelable by the lessor . |
| 4. | Lessor enters into transaction only as financier . He does not bear cost of repairs, maintenance or operations | Usually, the lessor bears cost of repairs, maintenance or Operations |
| 5. | Lease is usually full payout , that is, the single lease repays the cost of the asset together with the interest | Lease is usually non-payout , since the lessor expects to lease the same asset over and over again to several users |



CHAPTER 2 – Types of Financing

Other Types of Leases

1) Sales and Lease Back

- Here, the **owner** of an asset **sells the asset** to a party (the buyer), who **in turn leases back the same asset** to the owner in consideration of a **lease rentals**.
- Under this arrangement, the asset is **not physically exchanged** but it all **happen in records only**. The main advantage of this method is that the **lessee can satisfy himself regarding quality** of an asset & after possession of asset convert sale into lease agreement.
- The **seller** assumes role of **lessee** (as the same asset which he has sold came back to him in the form of lease) & **buyer** assumes role of a **lessor** (as asset purchased by him was leased back to the seller).
- So, the **seller gets the agreed selling price** & **buyer gets lease rentals**.

2) Leveraged Lease

- Here, third party is involved besides lessor & lessee.
- **Lessor borrows a part of the purchase cost** (say 80%) of asset **from third party** i.e., lender & asset so purchased is held as **security** against loan.
- The **lender is paid off** from the **lease rentals** directly by the lessee and the **surplus** after meeting the claims of the lender **goes to the lessor**.
- **Lessor** is entitled to **claim depreciation** allowance.

3) Sales-aid Lease

- Here, lessor enters into a **tie up with a manufacturer** for **marketing** the latter's product through his own leasing operations.
- In consideration of the aid in sales, manufacturer may grant either **credit** or **commission to lessor**.
- **Lessor** earns from **both sources** → **lessee** & **manufacturer**.

4) Close-ended and Open-ended Leases

- In close-ended lease, the **assets get transferred to the lessor** at the **end** of lease, the risk of obsolescence, residual value etc., remain with the **lessor** being the **legal owner** of the asset.
- In open-ended lease, the **lessee has the option of purchasing the asset** at the **end** of the lease period.

Advantages of Leasing

- 1) **Lease is a low cost alternative:** Leasing is **alternative to purchasing**. As lessee is to make a series of payments for using an asset, lease arrangement is **similar to debt contract**. Many lessees find **lease more attractive**, due to **low cost**.
- 2) **Tax benefit:** In certain cases **tax benefit of depreciation** available for owning an asset may be **less than that** available for **lease** payment
- 3) **Working capital conservation:** When a firm buys an equipment by borrowing from bank, they **never provide 100% financing**. But in case of **lease** one gets normally 100% financing. This enables **conservation of working capital**.
- 4) **Preservation of Debt Capacity:** So, **operating lease does not matter** in computing **debt equity ratio**. This enables the lessee to go for debt financing more **easily**. The **access** to and **ability** of a firm to get debt financing is called **debt capacity** (aka. reserve debt capacity).
- 5) **Obsolescence and Disposal:** After purchase of leased asset there may be **technological obsolescence** of the asset. To retain competitive advantage the lessee as user may have to go for the **upgraded asset**

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CHAPTER 2 – Types of Financing

Limitations of Leasing

- 1) Lease rentals become **payable soon after acquisition** of assets & **no moratorium period** is permissible as in case of loans from banks/FIs. The lease arrangement may **not be suitable** for setting up of the **new projects** as it would entail cash outflows even before the project comes into operation.
- 2) The leased assets are **purchased by the lessor** who is the **owner** of equipment. The **seller's warranties** for **satisfactory operation** of the leased assets may sometimes **not be available to lessee**.
- 3) **Lessor** generally **obtains credit facilities from banks** to purchase the leased equipment which are subject to **hypothecation charge in favour of the bank**. **Default in payment by the lessor** may sometimes result in **seizure of assets** by banks causing **loss to the lessee**.
- 4) Lease financing has a **very high cost of interest** as compared to interest charged on loans by banks/FIs.

Short term sources of finance

- 1) Trade Credit
- 2) Accrued Expenses and Deferred (Unearned) Income
- 3) Advances from Customers
- 4) Commercial Paper
- 5) Treasury Bills
- 6) Certificates of Deposit (CD)
- 7) Bank Advances
 - a) Short Term Loans
 - b) Overdraft
 - c) Clean Overdrafts
 - d) Cash Credits
 - e) Advances against goods
 - f) Bills Purchased/ Discounted
- 8) Financing of Export Trade by Banks
 - a) Pre-Shipment Finance

Types of Packing Credit

 - i. Clean packing credit
 - ii. Packing credit against hypothecation of goods
 - iii. Packing credit against pledge of goods
 - iv. E.C.G.C. guarantee
 - v. Forward exchange contract
 - b) Pre-Shipment Finance
 - i. Purchase/discounting of documentary export bills
 - ii. E.C.G.C. Guarantee
 - iii. Advance against export bills sent for collection
 - iv. Advance against duty draw backs, cash subsidy, etc
- 9) Inter Corporate Deposits
- 10) Public Deposits

1) Trade Credit

- It represents **credit granted by suppliers** of goods, etc., as an **incident of sale**.
- The usual duration of such credit is **15 to 90 days**.
- It generates **automatically** in the **course of business** and is **common** to almost all business operations. It can be in the form of an **'open account'** or **'bills payable'**.
- It is preferred since it's **without any explicit cost** & till a business is a going concern it keeps on rotating.
- It **enhances automatically** with the **increase in the volume of business**.

Notes: _____



CHAPTER 2 – Types of Financing

2) Accrued Expenses and Deferred (Unearned) Income

- Accrued expenses represent **liabilities** which a co. has to pay for **services which it has already received** like wages, taxes, interest & dividends.
- Such expenses arise out of the **day-to-day activities** of co. & hence is a **spontaneous source of finance**.
- Deferred income → reflects **amount of funds received** by co. in lieu of **goods and services to be provided in future**.
- Since these receipts **increase a company's liquidity**, they are also a source of spontaneous finance.

3) Advances from Customers:

- Manufacturers & contractors engaged in producing or constructing costly goods involving **considerable length of manufacturing** or construction time usually **demand advance money** from their customers at the **time of accepting their orders** for executing their contracts or supplying the goods.
- This is a **cost free source of finance** and really useful.

4) Commercial Paper

- It is an **unsecured money market instrument** issued in the form of a **promissory note**.
- RBI introduced commercial paper scheme in **1989** with a view to enabling **highly rated** corporate borrowers to **diversify their sources of short term borrowings** & to provide an additional instrument to investors.
- CP are issued in denominations of **Rs 5 lakhs or multiples** thereof & **interest rate** is **linked** to the yield on **one-year government bond**.
- All eligible issuers are required to get the **credit rating** from credit rating agencies specified by RBI.

5) Treasury Bills

- Treasury bills are a class of **Central Government Securities**.
- Commonly referred to as **T-Bills** are issued by GOI to meet **short term borrowing requirement**s with maturities ranging between **14 to 364 days**.

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6) Certificates of Deposit (CD)

- CD is a document of title similar to a time deposit receipt with a **fixed maturity date of not less than 7 days** up to a **maximum of one year** issued by a **bank** except that there is **no prescribed interest rate** on such funds.
- The main advantage of CD is that **banker is not required to encash the deposit before maturity period** and the investor is assured of **liquidity** because he **can sell the CD in secondary market**.

7) Bank Advances

- Banks **receive deposits from public** for different periods at varying rates of interest.
- These funds are **invested and lent** in such a manner that when required, they may be called back.
- **Lending results in gross revenues** out of which costs, such as interest on deposits, administrative costs, etc., are met and a **reasonable profit** is made.
- A bank's lending policy is not merely profit motivated but has to also keep in mind the **socio-economic development** of the country.



CHAPTER 2 – Types of Financing

Types of Bank Advances

Notes:

a) Short Term Loans

In a loan account, entire advance is disbursed at one time either in cash or by transfer to current account of borrower. It is a **single advance** and **given against securities** like shares, govt. securities, insurance policies & FD etc. **Repayment** under the loan account is made either by way of **repaying the full amount** or by way of **schedule of repayments agreed upon**.

b) Overdraft

Under this facility, customers are allowed to **withdraw in excess of credit balance** standing in their **Current Account**. A **fixed limit** is granted to borrower within which borrower is allowed to overdraw his account. Though overdrafts are **repayable on demand**, they generally continue for long periods by **annual renewals** of the limits. **Interest is charged on daily balances**. Since these accounts are operated in the same way as cash credit and current accounts, **cheque books** are provided.

c) Clean Overdrafts

Request for clean advances are entertained only from parties which are **financially sound** and having **reputation** for their **integrity**. The bank has to **rely upon the personal security** of borrowers (no backing of any tangible security). If the parties are already enjoying secured advance facilities, this may be a point in favor and may be taken into account while screening such proposals. The **amount of turnover** in the account, **satisfactory dealings** for considerable period and **reputation in the market** are some of the factors which the bank normally see. As a **safeguard**, banks take **guarantees from other persons** who are credit worthy before granting this facility. A clean advance is generally granted for a **short period** & must **not be continued for long**.

d) Cash Credits

Cash Credit is an arrangement under which a customer is allowed an **advance up to certain limit** against credit granted by bank. Under this arrangement, a **customer need not borrow the entire amount** of advance at one time; he can **only draw to the extent of his requirements** and deposit his surplus funds in his account. **Interest** is charged on **amount actually availed by him**. Generally, cash credit limits are sanctioned **against the security of tradable goods** by way of pledge or **hypothecation**. Though these accounts are **repayable on demand**, banks usually **do not recall** such advances, unless they are compelled to do so.



CHAPTER 2 – Types of Financing

Types of Bank Advances

e) Advances against goods

They are a **reliable source of repayment**. Advances against them are **safe and liquid**. Also, there is a **quick turnover** in goods, as they are in **constant demand**. So a banker generally **accepts them as security**. Furthermore, goods are charged to the bank either by way of **pledge** or **hypothecation**. The term 'goods' includes all forms of **movables** which are offered to bank as security → agricultural commodities, raw materials or partly finished goods.

f) Bills Purchased/ Discounted

Banks give **advances against security of bills** which may be clean or documentary. Bills are sometimes **purchased from approved customers** in whose favour limits are sanctioned. Before granting a limit, the **banker satisfies himself as to the credit worthiness** of the drawer (the one who prepared the bill of exchange, who is creditor or the payee). In actual practice bank holds bills only as **security for the advance**. The bank, in addition to the rights against the parties liable on the bills, **can also exercise a pledge's rights over the goods** covered by the documents.

8) Financing of Export Trade by Banks

Banks provide short-term export finance mainly by way of pre and post-shipment credit.

Pre-Shipment Finance

- This is in form of **packing credit facility** → packing credit is an **advance extended by banks to an exporter** for purpose of **buying, manufacturing, processing, packing, shipping goods to overseas buyers**.
- Any exporter, having at hand a **firm export order** from foreign buyer or an irrevocable letter of credit opened in his favour, can approach a bank for availing of packing credit.
- An advance so taken by an exporter is required to be **liquidated within 180 days** from-
 - ✓ date of its commencement by negotiation of export bills, or
 - ✓ receipt of export proceeds in an approved manner.
- Thus, packing credit is essentially a **short-term advance**.

Types of Packing Credit

- a) Clean packing credit: An **advance given to exporter** only on production of a **firm export order** or **letter of credit without exercising any charge or control over raw material or finished goods**. It is a **clean** type of export advance. Advance is given according to **requirements of trade & credit worthiness** of exporter. A suitable **margin** has to be maintained. Also, Export Credit Guarantee Corporation (**ECGC**) **cover** should be obtained by bank.
- b) Packing credit against hypothecation of goods: Export finance is made available on certain **terms and conditions** where the exporter has pledge able interest and the **goods are hypothecated to the bank as security** with stipulated margin. At the time of utilising the advance, the exporter is required to submit, along with the firm export order or letter of credit relative **stock statements** and thereafter **continue submitting them every fortnight** and/or whenever there is any movement in stocks.



CHAPTER 2 – Types of Financing

Types of Packing Credit

- c) **Packing credit against pledge of goods:** Export finance is made available on certain terms and conditions where the **exportable finished goods** are **pledged to the banks** with **approved clearing agents** who will **ship the same from time to time as required by the exporter**. The possession of the goods so pledged lies with the bank and is kept under its **lock and key**.
- d) **E.C.G.C. guarantee:** Any loan given to an exporter for the manufacture, processing, purchasing, or packing of goods meant for export against a firm order qualifies for the **packing credit guarantee issued by Export Credit Guarantee Corporation**.
- e) **Forward exchange contract:** Another requirement of packing credit facility is that **if export bill is to be drawn in a foreign currency**, exporter should enter into a **forward exchange contact with bank**, thereby **avoiding risk involved** in a possible **change in the rate of exchange**.

Post-shipment Finance

- a) **Purchase/discounting of documentary export bills:** Finance is provided to exporters by **purchasing export bills drawn payable at sight** or by **discounting usance export bills** covering confirmed sales and **backed by documents** including documents of the title of goods such as bill of lading, post parcel receipts, or air consignment notes.
- b) **E.C.G.C. Guarantee:** Post-shipment finance, given to an exporter by a bank through purchase, negotiation or discount of an export bill against an order, qualifies for post-shipment export credit guarantee. It is necessary, however, that exporters should **obtain a shipment or contracts risk policy of E.C.G.C.** Banks insist on the exporters to take a contracts shipments (comprehensive risks) policy covering both **political** and **commercial risks**. The Corporation, on acceptance of the policy, will **fix credit limits** for individual exporters and the Corporation's **liability will be limited to extent of limit so fixed** for exporter concerned irrespective of amount of policy.
- c) **Advance against export bills sent for collection:** Finance is provided by banks to exporters by way of **advance against export bills forwarded through them for collection**, taking into account the **creditworthiness** of the party, **nature of goods exported**, **usance**, **standing of drawee** etc.
- d) **Advance against duty draw backs, cash subsidy, etc.:** To **finance export losses** sustained by exporters, bank advance against duty draw-back, cash subsidy etc., receivable by them against export performance. Such advances are of **clean** nature; hence necessary **precaution** should be exercised.

9) Inter Corporate Deposits

The companies can borrow funds for a **short period**, say **6 months**, **from other companies** which have surplus liquidity. Rate of **interest** on inter corporate deposits **varies** depending upon amount involved & time period.

10) Public Deposits

A company can accept public deposits subject to the **stipulations of RBI** from time to time upto a **maximum amount of 35%** of its **paid up capital and reserves**. These deposits may be accepted for a period of **six months to three years**. Public deposits are **unsecured loans**; they should **not be used for acquiring fixed assets** since they are to be **repaid** within a period of **3 years**. These are used to **finance working capital requirements**.

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CHAPTER 2 – Types of Financing

Short term sources of finance

1) Seed Capital Assistance

- It is designed by **IDBI** for professionally qualified entrepreneurs &/or persons possessing relevant experience & skills but lack adequate financial resources.
- All the projects eligible for financial assistance from IDBI, directly or indirectly through **refinance** are eligible under the scheme.
- The Seed Capital Assistance is **interest free** but carries a **service charge of one per cent per annum** for the **first five years** and at **increasing rate** thereafter.
- However, **IDBI** will have the **option to charge interest** at such rate **as may be determined by IDBI** on the loan if the financial position and profitability of the company so permits during the currency of the loan. The **repayment schedule is fixed** depending upon the **repaying capacity** of the unit with an **initial moratorium up-to five years**.

2) Internal Cash Accruals

- Existing profit-making companies which undertake an expansion/diversification programme may be **permitted to invest a part of their accumulated reserves** or cash profits for **creation of capital assets**.
- In such cases, **past performance** of the company **permits** the capital expenditure from within the company by way of disinvestment of working/invested funds.
- In other words, the **surplus generated from operations**, after meeting all the contractual, statutory and working requirement of funds, is **available for further capital expenditure**.

3) Unsecured Loans

- Unsecured loans are typically **provided by promoters** to meet the promoters' contribution norm. These loans are **subordinate to institutional loans**.
- The **rate of interest** chargeable on these loans should be **less than or equal to** the rate of interest on institutional loans and interest can be **paid only after payment of institutional dues**.
- These loans **cannot** be repaid **without the prior approval** of financial institutions.
- Unsecured loans are considered as **part of the equity** for the purpose of calculating debt equity ratio.

4) Deferred Payment Guarantee

- Many a time **suppliers of machinery** provide **deferred credit facility** under which payment for the purchase of machinery can be made over a period of time.
- The **entire cost of the machinery** is **financed** and the company is not required to contribute any amount initially towards acquisition of the machinery.
- Normally, the supplier of machinery insists that **bank guarantee** should be furnished by the buyer.
- Such a facility **does not have a moratorium period** for repayment. Hence, it is advisable only for an **existing profit-making company**.



CHAPTER 2 – Types of Financing

Short term sources of finance

5) Capital Incentives

- The **backward area development incentives** available often determine the **location** of a new industrial unit.
- These incentives usually consist of a **lump sum subsidy** and **exemption from or deferment of sales tax**.
- The quantum of incentives is determined by degree of backwardness of location.
- The special capital incentive in the form of a **lump sum subsidy** is a quantum sanctioned by the implementing agency as a **percentage of the fixed capital investment** subject to an overall ceiling.
- This amount forms a **part of long term means of finance** for project. However, it may be mentioned that **viability** of project must **not be dependent** on quantum & availability of incentives.
- Institutions, while appraising the project, assess viability of project per se, without considering the impact of incentives on cash flows & profitability of project.
- Special capital incentives are sanctioned and released to the units only after they have **complied with the requirements** of the relevant scheme. The requirements may be classified into **initial effective steps** and **final effective steps**.

6) Deep Discount Bonds

- It is a form of **zero-interest bonds**.
- These bonds are **sold at a discounted value** and on **maturity, face value is paid** to the investors.
- In such bonds, there is **no interest payout** during lock in period.

7) Secured Premium Notes

- It is issued along **with a detachable warrant** and is **redeemable** after a notified period of **4 to 7 years**.
- The **conversion** of detachable warrant **into equity shares** will have to be done **within time period** notified by the company.

8) Zero Interest Fully Convertible Debentures

- These are fully convertible debentures which **do not carry any interest**.
- The debentures are **compulsorily and automatically converted** after a specified period of time and holders thereof are entitled to new equity shares of the company at predetermined price.
- From the **point of view of company**, this kind of instrument is **beneficial** in the sense that **no interest** is to be paid on it.
- If the **share price** of the company in the market is **very high** then the **investors tends to get equity shares** of the company at the **lower rate**.

9) Zero Coupon Bonds

- A Zero Coupon Bond **does not carry any interest** but it is sold by the issuing company **at a discount**.
- The difference between the discounted value and maturing or **face value** represents the interest to be earned by the investor on such bonds.

10) Option Bonds

- These are **cumulative** and **non-cumulative** bonds where interest is payable on maturity or periodically.
- **Redemption premium** is also offered to attract investors.

11) Zero Coupon Bonds

- Inflation Bonds are the bonds in which **interest rate is adjusted for inflation**.
- Thus, the **investor gets interest** which is **free from the effects of inflation**.
- For eg, if interest rate is 11% & inflation is 5%, investor will earn 16% meaning thereby that investor is protected against inflation.



CHAPTER 2 – Types of Financing

12) Floating Rate Bonds

- This as the name suggests is bond where the **interest rate is not fixed** & is allowed to float depending upon market conditions.
- This is an ideal instrument which can be resorted to by the issuer to **hedge** themselves against the **volatility in the interest rates**.
- This has become more popular as a **money market instrument** and has been successfully issued by financial institutions like IDBI, ICICI etc.

13) High Yield Bonds (or Junk Bonds)

- Junk Bond is a bond that is **rated below investment grade** by credit rating agencies.
- It has a **low credit rating** and a **high risk of default**. Because of the higher risk, investors are compensated with **higher interest rates**, which is why junk bonds are also called high-yield bonds.

International Financing

- 1) Commercial Banks
- 2) Development Banks
- 3) Discounting of Trade Bills
- 4) International Agencies
- 5) International Capital Markets
- 6) Financial Instruments
 - a) External Commercial Borrowings (ECB)
 - b) Euro Bonds
 - c) Foreign Bonds
 - d) Fully Hedged Bonds
 - e) Medium Term Notes (MTN)
 - f) Floating Rate Notes (FRN)
 - g) Euro Commercial Papers (ECP)
 - h) Foreign Currency Option (FC)
 - i) Foreign Currency Futures
 - j) Foreign Euro Bonds
 - k) Euro Convertible Bonds
 - l) Euro Convertible Zero Bonds
 - m) Euro Bonds with Equity Warrants
 - n) Environmental, Social and Governance-linked bonds (ESG)
 - Project Based
 - i. Green Bonds
 - ii. Social Bonds
 - Target-Based
 - i. Sustainability linked bonds (SLBs)
- 7) Euro Issues by Indian Companies
 - a) American Depositary Receipts (ADRs)
 - b) Global Depositary Receipts (GDRs)
 - c) Indian Depositary Receipts (IDRs)

1) Commercial Banks

- Like domestic loans, commercial banks all over the world extend **Foreign Currency (FC) loans** also for international operations.
- These banks also provide to **overdraw over and above the loan amount**.

2) Development Banks

- Development banks offer long & medium term loans including FC loans.
- Many agencies at the national level offer a number of **concessions to foreign companies** to invest within their country and to finance exports from their countries e.g. EXIM Bank of USA.

3) Discounting of Trade Bills

- This is used as a **short-term** financing method.
- It is used widely in Europe and Asian countries to finance both domestic and international business.

4) International Agencies

- A number of international agencies have emerged over the years to finance international trade & business.
- More notable among them include-
 - ✓ **International Finance Corporation (IFC),**
 - ✓ **International Bank for Reconstruction and Development (IBRD),**
 - ✓ **Asian Development Bank (ADB),**
 - ✓ **International Monetary Fund (IMF), etc.**



CHAPTER 2 – Types of Financing

5) International Capital Markets

- Today, modern organisations including **MNC's** depend upon sizeable borrowings in Rupees as well as Foreign Currency (FC).
- In order to cater to the needs of such organisations, international capital markets have sprung all over the globe such as in London.
- In international capital market, the availability of FC is available under the four main systems viz:
 - ✓ **Euro-currency market**
 - ✓ **Export credit facilities**
 - ✓ **Bonds issues**
 - ✓ **Financial Institutions**

6) Financial Instruments

- **Development banks** offer long & medium term loans including FC loans.
- Many agencies at the national level offer a number of **concessions to foreign companies** to invest within their country and to **finance exports from their countries** e.g. EXIM Bank of USA.

Financial Instrumentsa) External Commercial Borrowings (ECB):

- ECBs refer to commercial loans (in the form of bank loans, buyers credit, suppliers credit, securitised instruments (e.g. floating rate notes and fixed rate bonds) **availed from non-resident lenders** with **minimum average maturity of 3 years**.
- Borrowers can raise ECBs through internationally recognised sources like

- (i) international banks,
- (ii) international capital markets,
- (iii) multilateral financial institutions such as the IFC, ADB etc,
- (iv) export credit agencies,
- (v) suppliers of equipment,
- (vi) foreign collaborators
- (vii) foreign equity holders.

External Commercial Borrowings can be accessed under **two routes** viz

- (i) Automatic route and
- (ii) Approval route.

➤ Under the **Automatic route**, there is **no need to take the RBI/Government approval** whereas such **approval is necessary** under the **Approval route**.

➤ Company's registered under the Companies Act and NGOs engaged in micro finance activities are eligible for the Automatic Route whereas Financial Institutions and Banks dealing exclusively in infrastructure or export finance and the ones which had participated in the textile and steel sector restructuring packages as approved by the government are required to take the Approval Route.

b) Euro Bonds:

- Euro bonds are debt instruments which are **not denominated in the currency of the country in which they are issued** e.g. a Yen note floated in Germany.
- Such bonds are generally **issued in a bearer form** rather than as registered bonds and in such cases they **do not contain the investor's names** or the country of their origin. These bonds are an attractive proposition to investors seeking **privacy**.



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c) Foreign Bonds:

- These are debt instruments **issued by foreign corporations** or foreign governments.
- Such bonds are exposed to **default risk**, especially the corporate bonds.
- These bonds are **denominated in the currency of the country where they are issued**, however, in case these bonds are **issued in a currency other than the investors home currency**, they are **exposed to exchange rate risks**. An example of a foreign bond 'A British firm placing Dollar denominated bonds in USA'.

d) Fully Hedged Bonds:

As mentioned above, in foreign bonds, the **risk of currency fluctuations exists**. Fully hedged bonds **eliminate the risk** by **selling in forward markets** the entire stream of principal and interest payments.

e) Medium Term Notes (MTN):

- Certain issuers need frequent financing through the Bond route including that of the Euro bond. However, it may be **costly** and **ineffective** to go in for frequent issues. Instead, investors can follow the MTN programme.
- Under this programme, **several lots of bonds can be issued**, all having **different features** e.g. **different coupon rates**, **different currencies** etc. The **timing of each lot** can be decided keeping in mind the future market opportunities. The **entire documentation** and various regulatory **approvals** can be taken **at one point of time**.

f) Floating Rate Notes (FRN): These are issued **up to seven years maturity**. **Interest rates are adjusted** to reflect the **prevailing exchange rates**. They provide **cheaper** money than foreign loans.

g) Euro Commercial Papers (ECP): ECPs are **short term money market** instruments. They have maturity period of **less than one year**. They are usually designated in **US Dollars**.

h) Foreign Currency Option (FC):

A FC Option is the **right (and not the obligation)** to buy or sell, foreign currency at a certain specified price on or before a specified date. It provides a **hedge** against financial and economic risks.

i) Foreign Currency Futures:

FC Futures are **obligations (and not the right)** to buy or sell a specified foreign currency in the present for **settlement at a future date**.

j) Foreign Euro Bonds:

In domestic capital markets of various countries the Bonds issues referred to above are known by different names such as **Yankee Bonds** in the US, **Swiss Francs** in Switzerland, **Samurai Bonds** in Tokyo and **Bulldogs** in UK.

k) Euro Convertible Bonds:

A convertible bond is a **debt instrument** which gives the holders of the bond an option to **convert the bonds into a pre-determined number of equity shares** of the company. Usually the price of the equity shares at the time of conversion will have a **premium** element.



CHAPTER 2 – Types of Financing

These bonds carry a **fixed rate of interest** and if the issuer company so desires may also include –

- ✓ **Call Option** (where the issuer company has the option of calling/buying the bonds for redemption prior to the maturity date) or
- ✓ **Put Option** (which gives the holder the option to put/sell his bonds to the issuer company at a pre determined date and price).

l) Euro Convertible Zero Bonds: These bonds are structured as a **convertible bond**. **No interest** is payable on the bonds. But conversion of bonds takes place on **maturity** at a **pre-determined price**. Usually there is a **five years maturity period** and they are treated as a **deferred equity issue**.

m) Euro Bonds with Equity Warrants: These bonds carry a **coupon rate determined by market rates**. The **warrants are detachable**. Pure bonds are traded at a **discount**. **Fixed Income Funds Management** may like to invest for the purposes of regular income in this case.

n) Environmental, Social and Governance-linked bonds (ESG): These bonds carry a **responsibility of the issuer company** to prioritize optimal **environmental, social and governance (ESG)** factors. Investing in ESG bonds is considered as **socially responsible investing**. ESG bonds can be project-based – green bonds and social bonds; and target-based – sustainability-linked bonds (SLBs).

- **Project Based**
 - i. Green Bonds
 - ii. Social Bonds
- **Target-Based**
 - i. Sustainability linked bonds (SLBs)

Project Based

i) Green bonds:

- These are the most popular ESG bonds, where the bond proceeds are used to **finance “green projects”**. Green projects are aimed at **positive environmental and climate impact** including the **cultivation of eco-friendly technology**.
- India is the **second-largest green bond market**. For example: Ghaziabad Municipal Corporation (GMC) becomes the first Municipal Corporation to raise ₹ 150 crore from Green Bond in the Year 2021.

ii) Social bonds:

- These bonds finance the **socially impactful projects**.
- The projects here are related to the social concerns such as **Human rights, Equality, animal welfare** etc.
- For eg, “Vaccine bonds” are social bonds, issued to fund **vaccination of vulnerable childrens & protection of people in lower income countries**.

Target Based

Sustainability-linked bonds (SLBs):

- These bonds are **combination** of **green** bonds and **social** bonds.
- Proceeds of SLBs are not meant for a specific project but for **general corporate purpose** to **achieve Key Performance Indicator (KPIs)**.
- For example: **UltraTech** Cement raises US\$ 400 million through India's first sustainability-linked bonds in year 2021.
- The company aims to **reduce carbon emissions** through the life of bond of 10 years.



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7) Euro Issues by Indian Companies:

- Euro issuance refers to the sources of funding or capital that can be accessed to **raise money outside the home country in foreign currency.**
- **Indian companies** are permitted to raise foreign currency resources through **issue of ordinary equity shares** through Global Depository Receipts (**GDRs**)/ American Depository Receipts (**ADRs**) and / or issue of Foreign Currency Convertible Bonds (**FCCB**) to **foreign investors** i.e. institutional investors or individuals (including NRIs) residing abroad.
- Such investment is treated as **Foreign Direct Investment (FDI).**
- The government guidelines on these issues are covered under the **Foreign Currency Convertible Bonds and Ordinary Shares (through depository receipt mechanism) Scheme, 1993** and notifications issued after the implementation of the said scheme.

7) a) American Depository Receipts (ADRs)

- These are securities **offered by non-US companies** who want to **list on any of the US exchange.** Each ADR represents **a certain number of a company's regular shares.** ADRs **allow US investors** to buy shares of these companies **without the costs** of investing directly in a foreign stock exchange.
- The Indian companies have preferred the **GDRs** to ADRs because the **US market exposes** them to a **higher level of responsibility** than a European listing in the areas of **disclosure, costs, liabilities and timing.**
- The **regulations** are somewhat more **stringent** and onerous, even for companies already listed and held by retail investors in their home country.
- The most onerous aspect of a US listing for the companies is to provide **full, half yearly and quarterly accounts** in accordance with, or at least reconciled with **US GAAPs.**

7) b) Global Depository Receipts (GDRs)

- These are **negotiable certificates held in the bank of one country** representing a **specific number of shares** of a stock traded on the **exchange of another country.**
- These financial instruments are used by companies to **raise capital** in either **dollars** or **Euros.** These are mainly traded in European countries and particularly in London.

ADRs/GDRs and the Indian Scenario:

- Indian companies are shedding their reluctance to tap the US markets. **Infosys Technologies** was the **first Indian company** to be **listed on NASDAQ in 1999.**
- However, the **first Indian firm** to **issue sponsored GDR or ADR** was **Reliance industries Limited.**
- Beside these two companies there are several other Indian firms which are also listed in the overseas bourses. These are Wipro, MTNL, State Bank of India, Tata Motors, Dr. Reddy's Lab, etc.

c) Indian Depository Receipts (IDRs):

- The concept of the depository receipt mechanism which is used to raise funds in foreign currency has been **applied in the Indian Capital Market** through the issue of Indian Depository Receipts (IDRs).
- IDRs are **similar to ADRs/GDRs** in the sense that **foreign companies can issue IDRs** to **raise funds from the Indian Capital Market** in same lines as an Indian company uses ADRs/GDRs to raise foreign capital.
- The IDRs are **listed and traded in India** in the same way as other Indian securities are traded.



CHAPTER 2 – Types of Financing

Contemporary Sources Of Funding

1) Crowd funding

- Crowdfunding means **raising money** for an individual or organisation **from a group of people** to fund a project, through **internet** (social media and crowdfunding websites).
- It generally involves collecting funds from-
 - ✓ **family, friends, strangers, corporates** in exchange of **equity** (known as Equity funding),
 - ✓ **loans** (known as P2P lending) or
 - ✓ **nothing at all** (i.e. donation).
- This source of funding also **helps start-up** to **substantiate demand** for their product **before entering into production**.
- Crowdfunding process involves **three parties** i.e. **fund raiser, mediator & fund investor**.
- Platforms (mediator) may also **charge certain fees** in form of processing fee, transaction fee → either as fixed amount or percentage or in combination of both.

2) Equity funding

- Equity crowdfunding is a mechanism where **investor invests money** in an org. & receive **securities** of that org. in return.
- Every investor would be entitled to a **stake** in the organisation depending on their investment.
- The **digital nature** of crowdfunding targets **large number of investors** with **small contributions**.
- This type of funding is mostly adopted by **startups**.
- Some of platforms offering equity crowdfunding are
 - ✓ **StartEngine,**
 - ✓ **EquityNet,**
 - ✓ **SeedInvest,** etc.

3) Peer-to-Peer (P2P) lending

- Here **lenders match with borrowers** in order to provide **unsecured loans** through **online platform**.
- The fund raised are paid back by the borrowers with **interest**, though this kind of lending involves certain **risk of defaults** (just as the banks bear in the case of conventional method of lending).
- Anyone interested in investing money under P2P lending can visit the **P2P lending platforms** and **choose amongst borrowers** considering **risk & returns**.
- Some of platforms offering P2P lending are-
 - ✓ **i2iFunding,**
 - ✓ **Lendbox, Faircent,**
 - ✓ **RupeeCircle,** etc.

4) Start-up funding

- A **start-up** company being **newly formed** needs **fund before starting** any project.
- However, as a start-up, it is **difficult to manage loans from bank**, leaving crowd funding as one of sources of finance.
- Through crowd funding, a start-up company can raise money from **large group of people**.
- Crowdfunding may be in form of-
 - ✓ **equity** funding,
 - ✓ **P2P** lending or
 - ✓ **both**.

5) Donation-based Crowdfunding

- It is a source of finance where large group of people **donate money** as a **charity** for some cause with **no expectation** of any **ownership or debt**.
- Platforms used for donation based crowdfunding are-
 - ✓ **GoFundMe** (used for donations against medical needs, education, etc.),
 - ✓ **Ketto** (used for donation against medical needs),
 - ✓ **FuelADream** (used for donation against charity projects, new ideas), etc.

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FM Chapter 3 Ratio Analysis

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CHAPTER 3 – Ratio Analysis

Liquidity Ratios

| | |
|--|---|
| Current Ratio | $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ |
| Quick Ratio or Acid Test Ratio | $\frac{\text{Quick Assets}}{\text{Current Liabilities}} \quad \text{Quick assets} = \text{CA} - \text{inventory} - \text{prepaid exp}$ |
| Cash Ratio / Absolute Liquidity Ratio | $\frac{\text{Cash \& Bank Bal + Marketable Securities}}{\text{Current Liabilities}}$ Or, $\frac{\text{Cash \& Bank Bal + Current Investments}}{\text{Current Liabilities}}$ |
| Basic Defense Interval or Interval Measure | $\frac{\text{Cash \& Bank Bal + Net Receivables + Marketable Securities}}{\text{Daily Operating Expenses / No. of Days}}$ $\frac{\text{Current Assets} - \text{Inventories} - \text{Prepaid Expenses}}{\text{Daily Operating Expenses}}$ |
| Daily Operating Expenses | $\left[\frac{\text{Cost of Goods Sold + Selling, Admin \& Other General Exp} - \text{Depreciation \& Non Cash Exp}}{\text{No. of Days in a year}} \right]$ |
| Net Working Capital Ratio | $\text{Current Assets} - \text{Current Liabilities}$ |

Long-term Solvency Ratios / Leverage Ratios

Capital Structure Ratios

| | |
|---|---|
| Equity Ratio | $\frac{\text{Equity}}{\text{Total Funds}}$ |
| Debt Ratio | $\frac{\text{Total Debt}}{\text{Total Funds}} \quad \text{OR} \quad \frac{\text{Long Term Debt}}{\text{Total Funds}}$ |
| Preference Ratio | $\frac{\text{Preference Share Capital}}{\text{Capital Employed}}$ |
| Debt to Equity Ratio | $\frac{\text{LTD}}{\text{Equity}} \quad \text{OR} \quad \frac{\text{Total Debt}}{\text{Sh. Fund}}$ |
| Total Assets → Financed by [Owned funds → Proprietary Ratio Borrowed funds → Debt to Total Assets Ratio] | |
| Debt to Total Assets Ratio | $\frac{\text{Total Outside Liabilities}}{\text{Total Assets}} \quad \text{OR} \quad \frac{\text{Total Debt}}{\text{Total Assets}}$ |
| Proprietary Ratio | $\frac{\text{Proprietary Fund}}{\text{Total Assets}}$ |
| Capital Gearing Ratio | $\frac{\text{Fixed Cost Bearing Funds}}{\text{Non-Fixed Cost Bearing Funds}}$ $= \frac{\text{PSC} + \text{LTD}}{\text{ESC} + \text{R\&S}}$ |



CHAPTER 3 – Ratio Analysis

Capital Structure

| | |
|---|--|
| | Equity Share Capital |
| + | Reserves & Surplus |
| - | Fictitious Assets |
| - | P&L Dr. Bal [Acc. Losses] |
| | Equity |
| + | Preference Share Capital |
| | Shareholders' Fund or Net Assets or Net Worth or Proprietary Fund |
| + | Long Term Debt |
| | Capital Employed [Total Funds invested in business] |

Alternative Formula

$$\begin{aligned} \text{Net Assets} &= \text{Total Assets} - \text{Total Liabilities} \\ \text{Or Net Worth} &= [\text{FA} + \text{CA}] - [\text{LTD} + \text{CL}] \end{aligned}$$

$$\begin{aligned} \text{Capital Employed} &= \text{FA} + [\text{CA} - \text{CL}] \\ &= \text{FA} + \text{WG} \end{aligned}$$

Note: When LTD = 0,
Capital Employed = Proprietary Fund = Sh. Fund

Income Statement

| | Particulars | Amt |
|------|---|-----|
| | Sales | xxx |
| Less | Variable Cost | xxx |
| | Contribution | xxx |
| Less | Fixed Cost (excluding dep & int) | xxx |
| | Earnings Before Interest, Tax, Depreciation & Amortization [EBITDA] or [PBITDA] | xxx |
| Less | Depreciation & Amortization | xxx |
| | Earnings Before Interest & Tax [EBIT] or [PBIT] [Operating Profit] | xxx |
| Less | Interest | xxx |
| | Earnings Before Tax [EBT] or [PBT] | xxx |
| Less | Tax | xxx |
| | Earnings After Tax [EAT] or [PAT] or [Net Profit] | xxx |
| Less | Preference Dividend | xxx |
| | Earnings for Equity Shareholders [EFES] | xxx |
| Less | Dividend for Equity Holders | xxx |
| | Retained Earnings | xxx |



CHAPTER 3 – Ratio Analysis

| Long-term Solvency Ratios / Leverage Ratios | |
|--|--|
| Coverage Ratios | |
| Debt-Service Coverage Ratio (DSCR) | $\frac{\text{Earnings available for debt services}}{\text{Interest + Instalments}}$ <p style="text-align: center;">OR</p> $\frac{\text{EBITDA}}{\text{Interest + Instalments}}$ |
| Where, <u>Net Operating Income or EADS</u> = PBIT → [PAT + Tax + Int] (+) Loss on sale of F.A. & other Adjustments [Non operating exp] (+) Non Cash Exp [Dep & Amortization] | |
| Interest Coverage Ratio | $\frac{\text{Earnings before interest and taxes (EBIT)}}{\text{Interest}}$ |
| Preference Dividend Coverage Ratio | $\frac{\text{Net Profit after taxes (PAT)}}{\text{Preference dividend liability}}$ |
| Fixed Charges Coverage Ratio | $\frac{\text{EBIT + Fixed Charges}}{\text{Interest + Fixed Charges}}$ |
| Activity / Efficiency / Performance / Turnover Ratios | |
| Total Assets Turnover Ratio | $\frac{\text{Sales}}{\text{Total Assets}}$ <p style="text-align: center;">OR</p> $\frac{\text{Cost of Goods Sold}}{\text{Total Assets}}$ |
| Fixed Assets Turnover Ratio | $\frac{\text{Sales}}{\text{Fixed Assets}}$ <p style="text-align: center;">OR</p> $\frac{\text{Cost of Goods Sold}}{\text{Fixed Assets}}$ |
| Capital Turnover Ratio | $\frac{\text{Sales}}{\text{Capital Employed}}$ <p style="text-align: center;">OR</p> $\frac{\text{Cost of Goods Sold}}{\text{Capital Employed}}$ |
| Current Assets Turnover Ratio | $\frac{\text{Sales}}{\text{Current Assets}}$ <p style="text-align: center;">OR</p> $\frac{\text{Cost of Goods Sold}}{\text{Current Assets}}$ |
| Working Capital Turnover Ratio | $\frac{\text{Sales}}{\text{Working Capital}}$ <p style="text-align: center;">OR</p> $\frac{\text{Cost of Goods Sold}}{\text{Working Capital}}$ |
| Inventory/ Stock Turnover Ratio | $\frac{\text{Sales}}{\text{Average Inventory}}$ <p style="text-align: center;">OR</p> $\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$ <p style="text-align: center;">Where, Average Inventory = $\frac{\text{Op. Stock + Cl. Stock}}{2}$</p> |
| Inventory Holding period Or Inventory Velocity | $\frac{12 \text{ mts}/365 \text{ days}/52 \text{ weeks}}{\text{Inventory T/O ratio}}$ <p style="text-align: center;">OR</p> $\frac{\text{Average Inventory}}{\text{Daily/Monthly/weekly COGS}}$ |
| Raw Material Inventory T/o Ratio | $\frac{\text{R.M Consumption}}{\text{Average R.M. Stock}}$ |
| Receivables (Debtors) T/o Ratio | $\frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$ |
| Receivables (Debtors') Velocity | $\frac{\text{Average Accounts Receivable}}{\text{Average Daily Credit Sales}}$ <p style="text-align: center;">OR</p> $\frac{12 \text{ months}/52 \text{ weeks}/360 \text{ day}}{\text{Receivable Turnover Ratio}}$ <p style="text-align: center;">Average Daily Credit Sales = $\frac{\text{Credit Sales}}{\text{No. of days in year (say 360)}}$</p> |



CHAPTER 3 – Ratio Analysis

Activity / Efficiency / Performance / Turnover Ratios

| | |
|---|---|
| Payables (Creditors) Turnover Ratio | $\frac{\text{Annual Net Credit Purchase}}{\text{Average Accounts Payables}}$ |
| Payable Velocity/ Average payment period | $\frac{\text{Average Accounts Payable}}{\text{Average Daily Credit Purchases}} \text{ OR } \frac{12 \text{ months}/52 \text{ weeks}/360 \text{ day}}{\text{Payables Turnover Ratio}}$ |

Profitability Ratios

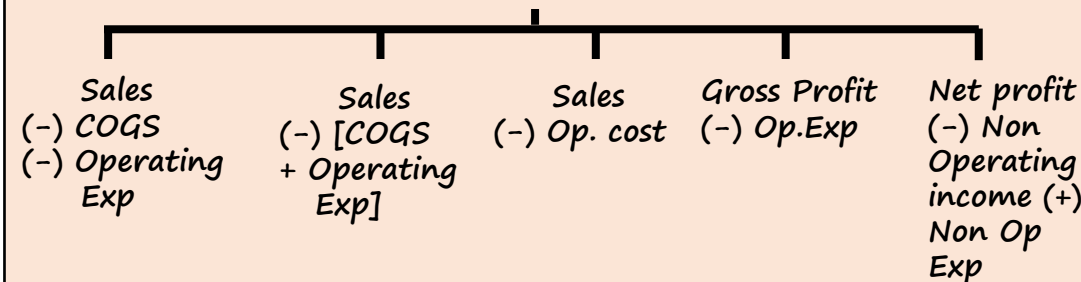
Profitability Ratios Related to Sales

| | |
|---------------------------|---|
| a) Gross Profit Ratio | $\frac{\text{Gross Profit}}{\text{Sales}} \times 100$ |
| b) Net Profit Ratio | $\left[\frac{\text{Net Profit}}{\text{Sales}} \times 100 \right] \text{ OR } \left[\frac{\text{Earnings after taxes (EAT)}}{\text{Sales}} \times 100 \right]$ |
| Pre-tax Profit Ratio | $\frac{\text{Earnings before taxes (EBT)}}{\text{Sales}} \times 100$ |
| c) Operating Profit Ratio | $\left[\frac{\text{Operating Profit}}{\text{Sales}} \times 100 \right] \text{ OR } \left[\frac{\text{Earnings before interest \& taxes (EBIT)}}{\text{Sales}} \times 100 \right]$ |

d) Expenses Ratio

| | |
|---------------------------------|---|
| Cost of Goods Sold (COGS) Ratio | $\frac{\text{COGS}}{\text{Sales}} \times 100$ |
| Operating Expenses Ratio | $\frac{\text{Administrative exp. + Selling \& Distribution OH}}{\text{Sales}} \times 100$ |
| Operating Ratio | $\frac{\text{COGS} + \text{Operating Exp.}}{\text{Sales}} \times 100$ |
| Financial Exp Ratio | $\frac{\text{Financial Exp}}{\text{Sales}} \times 100$ Financial Exp = Interest + Equity & Pref Dividend |

Operating Profit



$$\text{COGS Ratio} + \text{GP Ratio} = 100\%$$

$$\text{Op. cost ratio} + \text{Op. profit ratio} = 100\%$$



CHAPTER 3 – Ratio Analysis

Profitability Ratios Related to Overall Return on Assets/ Investments

a) Return on Investment (ROI)

$$\frac{\text{Return / Profit / Earnings}}{\text{Investment}} \times 100$$

OR

$$\text{Profitability Ratio} \times \text{Investment Turnover Ratio}$$

The concept of investment varies and accordingly there are **three broad categories of ROI**

i) Return on Capital Employed (ROCE)

$$\text{ROCE (Pre-tax)} = \frac{\text{EBIT}}{\text{Capital Employed}} \times 100$$

$$\text{ROCE (Post-tax)} = \frac{\text{EBIT (1-t)}}{\text{Capital Employed}} \times 100$$

$$\text{ROCE (Post-tax)} = \frac{\text{PAT + Interest (1-t)}}{\text{Capital Employed}} \times 100$$

ii) Return on Assets (ROA)

$$\frac{\text{Net Profit after taxes}}{\text{Average Total Assets}}$$

OR

$$\frac{\text{Net Profit after taxes}}{\text{Average Tangible Assets}}$$

OR

$$\frac{\text{Net Profit after taxes}}{\text{Average Fixed Assets}}$$

As Assets are also financed by lenders, hence ROA can be calculated as–

$$\text{ROA} = \frac{\text{Net Profit after taxes + Interest}}{\text{Average Total Assets or Average Tangible Assets or Average Fixed Assets}}$$

ii) Return on Assets (ROA)

$$\text{Return on Total Assets (ROTA)} = \frac{\text{EBIT (1-t)}}{\text{Average Total Assets}}$$

$$\text{Return on Net Assets (RONA)} = \frac{\text{EBIT (1-t)}}{\text{Average Net Assets}}$$

iii) Return on Equity (ROE)

$$\frac{\text{Net Profit after taxes - Preference dividend (if any)}}{\text{Equity}} \times 100$$

As per Du Pont Model → ROE has three components

$$\text{ROE} = \underbrace{\frac{\text{Profit or Net Income}}{\text{Sales or Revenue}}}_{\text{Net Profit Margin}} \times \underbrace{\frac{\text{Sales or Revenue}}{\text{Investment or Assets or Capital}}}_{\text{Asset Turnover}} \times \underbrace{\frac{\text{Investment or Assets or Capital}}{\text{Equity}}}_{\text{Equity Multiplier}}$$

$$\text{Return on Total Shareholders Fund} = \frac{\text{Net Profit after taxes}}{\text{Total Shareholders Fund (incl. Pref Capital)}} \times 100$$



CHAPTER 3 – Ratio Analysis

Profitability Ratios Required for Analysis from Owner's Point of View

| | |
|---------------------------------|---|
| a) Earnings per Share (EPS) | $\frac{\text{Net profit available to equity shareholders}}{\text{Number of equity shares outstanding}}$ |
| b) Dividend per Share (DPS) | $\frac{\text{Total Equity Dividend}}{\text{Number of equity shares outstanding}}$ |
| c) Dividend Pay-out Ratio (DPR) | $\frac{\text{Dividend per equity share (DPS)}}{\text{Earning per Share (EPS)}}$ |

Other Ratios related to DPS

| | |
|-----------------------------------|---|
| Retained Earning per Share (REPS) | $\frac{\text{Retained Earning}}{\text{Number of equity shares}}$ |
| EPS | DPS + REPS |
| Dividend Pay-out Ratio (DPR) | $\frac{\text{Total Eq. Dividend}}{\text{Earning per Eq Share}} \text{ OR } \frac{\text{DPS}}{\text{EPS}}$ |
| Dividend Rate | $\frac{\text{Total Eq. Dividend}}{\text{FV of ESC}} \text{ OR } \frac{\text{DPS}}{\text{FVPS}}$ |
| Retention ratio [b] | $\frac{\text{Retained Earnings}}{\text{EFES}} \text{ OR } \frac{\text{REPS}}{\text{EPS}}$ |

Profitability Ratios related to market/ valuation/ Investors

| | |
|---|--|
| a) Price- Earnings Ratio (P/E Ratio) | $\frac{\text{Market Price per Share (MPS)}}{\text{Earning per Share (EPS)}}$ |
| b) Dividend and Earning Yield | $\frac{\text{Dividend} \pm \text{Change in share price}}{\text{Initial Share Price}} \times 100$ OR $\frac{\text{Dividend per Share (DPS)}}{\text{Market Price per Share (MPS)}} \times 100$ |
| Earnings Yield or Earnings Price (EP) Ratio | $\frac{\text{Earning per Share (EPS)}}{\text{Market Price per Share (MPS)}} \times 100$ |

Profitability Ratios related to market/ valuation/ Investors

| | |
|--|---|
| c) Market Value /Book Value per Share (MVBV) | $\frac{\text{Average share price}}{\text{Equity} \div \text{No. of equity shares}} \text{ OR } \frac{\text{Closing Share Price}}{\text{Equity} \div \text{No. of equity shares}}$ |
| d) Q Ratio | $\frac{\text{Market Value of equity and liabilities}}{\text{Estimated replacement cost of assets}}$ OR $\frac{\text{Market Value of a Company}}{\text{Assets' Replacement Cost}}$ |



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CHAPTER 4 – Cost of Capital

Cost of Long Term Debt (K_d)

Cost of Irredeemable Debt

$$K_d = \frac{\text{Interest}}{NP} \times (1-t)$$

- Net proceeds mean issue price less issue expenses.
- If current market price is given in question, then Issue Price = CMP
- If issue expenses are not given then assume, IE = 0

Cost of Redeemable Debt

Approximation or Short-Cut Method

$$K_d = \frac{I(1-t) + \frac{(RV - NP)}{n}}{\frac{(RV + NP)}{2}}$$

YTM or IRR Method

Calculate NPV of relevant cash flows at 2 discount rates, such that
NPV @ higher rate = -ve
NPV @ lower rate = +ve

| Year | Cash flows |
|--------|--------------------------------|
| 0 | NP or CMP |
| 1 to n | Interest net of tax $[I(1-t)]$ |
| n | Redemption value (RV) |

$$IRR = \text{Lower Rate} + \frac{NPVL}{NPVL - NPVH} \left[\text{Higher Rate} - \text{Lower Rate} \right]$$

Amortisation of Bond

$$V_B = \frac{C_1}{(1+K_d)^1} + \frac{C_2}{(1+K_d)^2} + \dots + \frac{C_n}{(1+K_d)^n}$$

Cost of Convertible Debentures

→ Holders of convertible debentures have an option on maturity to either

Receive Cash Or Receive Specified no. of equity shares

→ Calculation of cost of convertible debentures is same as that of redeemable debentures
1) Approximation method or,
2) YTM/IRR Method

However difference lies in calculation of Redemption Value.

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CHAPTER 4 – Cost of Capital

COST OF EQUITY SHARE CAPITAL
(K_e)Dividend Price
Approach

$$K_e = \frac{D_1}{P_0}$$

Earnings Price
Approach

$$\frac{EPS}{P_0} \text{ or } \frac{1}{PE \text{ Ratio}}$$

Growth Approach
or Gordon's Model

$$K_e = \frac{D_1}{P_0} + g$$

Capital Asset
pricing model

$$K_e = R_f + \beta (R_m - R_f)$$

$R_m - R_f$ =
Market Risk Premium

$\beta (R_m - R_f)$ =
Security Risk Premium

- D_1 = Expected Dividend
- P_0 = Current Market Price (Ex Dividend)
- Ex Div Price = Cum Div Price (-) DPS
- If Floatation Cost is given, then subtract it in denominator $\rightarrow [P_0 - FC]$
- $g = b(x)r$

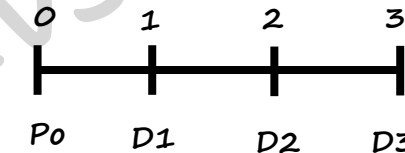
Generally, K_e = **Cost of Retained Earnings (K_r)**

However, difference comes when floatation cost & personal tax exists

- If personal tax $[tp]$ is given in ques
 $K_r = K_e (1-FC) (1-tp)$
- If we have to calculate both K_e & K_r & Ques mentions \rightarrow issue price, FC, & CMP {illu. 13}
 - For K_e (assuming new issue of equity shares) $\rightarrow P_0$ = Issue Price - F.C
 - For $K_r \rightarrow P_0$ = C.M.P

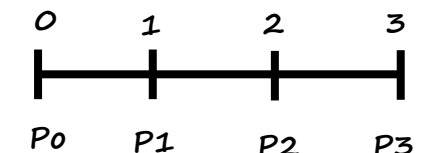
Realised Yield approach
2 ways to calculate K_e as per above method

If ques mentions
opening price &
closing price (at
maturity) &
dividend payments
every year



Calculate K_e by
using "YTM/IRR"
method
[Illus 10]

If ques mentions
opening & closing
price of every year
along with
dividend payments
every year



i) Calculate returns of
each year \rightarrow

$$\left[\begin{array}{l} (1+r_1) \frac{P_1+D_1}{P_0} \\ = \\ (1+r_2) \frac{P_2+D_2}{P_1} \\ = \end{array} \right]$$

$$K_e = \left[\sqrt[n]{(1+r_1) \times (1+r_2) \dots \times (1+r_n)} \right] - 1$$



CHAPTER 4 – Cost of Capital

Cost Of Preference Share Capital (Kp)

Cost of Irredeemable Preference Shares

$$K_p = \frac{\text{Annual Pref Div (Pd)}}{\text{Net Proceeds}}$$

- Net proceeds mean issue price less issue expenses.
- If current market price is given in question, then Issue Price = CMP
- If issue expenses are not given then assume, IE = 0

Cost of Redeemable Preference Shares

$$K_p = \frac{Pd + \left[\frac{(RV - NP)}{n} \right]}{\left[\frac{(RV + NP)}{2} \right]}$$

Where,

- if R.V. is not given in Ques, then assume FV = RV
- YTM/IRR method can also be used. (If ques mentions to do so)

Floatation Cost

Floatation cost is the cost which a company incurs while issuing a security [shares, deb etc]
They are aka. **Issue Expenses**.
E.g. Legal Fees, Registration fees, Commission, listing exp, etc.

Treatment of Floatation Cost

- ✓ If F.C. is given in “%” form → then logically F.C. should be calculated on **Issue Price**.
[But, if issue price is not given & C.M.P. is given → then use CMP as IP]
- ✓ However if Ques specifically mentions to calculate F.C. on **FACE VALUE** → then do so

WEIGHTED AVERAGE COST OF CAPITAL (WACC)

| Sources of Finance | Amount | Proportion / Weights (Wi) | Cost of Capital (Ki) | Wi x Ki |
|----------------------|--------|---------------------------|----------------------|---------|
| Equity Share Capital | xxx | We | Ke | We x Ke |
| Retained Earnings | xxx | Wr | Kr | Wr x Kr |
| Pref Share Capital | xxx | Wp | Kp | Wp x Kp |
| Long Term Debt | xxx | Wd | Kd | Wd x Kd |
| | xxx | | | WACC |

Data Given in Question

| Face Value | Issue Price | Current Market Price (CMP) | FC to be calculated on |
|------------|-------------|----------------------------|--|
| ✓ | ✗ | ✗ | Face Value |
| ✗ | ✓ | ✗ | Issue Price |
| ✓ | ✗ | ✓ | CMP |
| ✗ | ✗ | ✓ | CMP |
| ✓ | ✓ | ✓ | If New Issue then take IP |
| | | | If Existing Issue then take CMP |

CHAPTER 4 – Cost of Capital

Choice of weights

Book value

Simply take book value given in question.

Market value

- No separate MV of R&S
- Thus, MV of equity shares is to be divided as per

to

MV of ESC

MV of R&S

$$\text{MV of Equity} \times \frac{\text{BV of ESC}}{\text{BV of ESC (+) BV of R\&S}}$$

$$\text{MV of Equity} \times \frac{\text{BV of ESC}}{\text{BV of ESC (+) BV of R\&S}}$$

Uses of WACC

- 1) Security analysts use WACC for **valuing & selecting investments**.
- 2) In discounted cashflow analysis, WACC is used as the **discounting rate** for calculating NPV.
- 3) WACC is used as **hurdle rate** to assess the **return on capital investments**.
- 4) Investors use WACC as a **tool to decide whether or not to invest**.

Marginal Cost of Capital (MCC)

- MCC is **cost of raising additional capital**.
- MCC is calculated using **marginal weights**.
- Marginal weights represent the **proportion of funds which a firm intends to employ**.
- Thus, here there is **no problem** of choosing between **BV & MV** weights.
- When additional (marginal) funds are raised in same proportion as the existing capital structure & if cost of individual sources remain same, then → **WACC = MCC**

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FM Chapter 5 Capital Structure

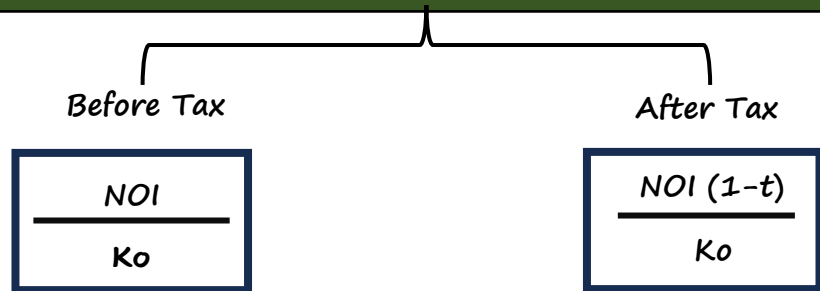
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CHAPTER 5 – Capital Structure

Value of the firm



OR

$$V_f = \text{Mkt Value of Equity} + \text{Mkt Value of Debt}$$

$$= \frac{\text{Net income}}{K_e} + \frac{\text{Interest}}{K_d}$$

$$\text{Value of Firm (Vf)} = S + D$$

Cost of Capital

$$K_o = (\text{Cost of debt} \times \text{weight of debt}) + (\text{Cost of equity} \times \text{weight of equity})$$

$$K_o = \left[\{K_d \times D / (D+S)\} + \{K_e \times S / (D+S)\} \right]$$

$$K_o = \{K_d \times W_d\} + \{K_e \times W_e\}$$

OR

$$\text{Overall cost of capital} = \frac{EBIT}{\text{Value of the firm}}$$

Note :

1) In this chapter we will mainly study about “capital structure theories”, where we assume, that a firm has only

Two sources of finance

Equity

Debt

2) In this chapter, EBIT = Net operating Income = NOI

When tax exists

$$\frac{NOI}{(-) \text{Interest}}$$

$$\frac{EBT}{(-) \text{Tax}}$$

$$\text{Net Income [EAT = EFES]}$$

Or

$$NI = (NOI - \text{Interest}) (1-t)$$

No taxes

$$\frac{NOI}{(-) \text{Interest}}$$

$$\text{Net Income [EBT = EAT = EFES]}$$

$$NI = NOI - \text{Interest}$$

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CHAPTER 5 – Capital Structure

| Capital Structure Theories | | | | | | | | | | |
|---|---|---|-------------------------------------|-------------------------------------|--------|--|--------|---|--------|---|
| Relevance Theory (capital structure decision is relevant to the value of the firm) | Net Income (NI) Approach | NI Approach suggests, a firm should have maximum debt in its capital structure → for minimizing K_o & thereby maximizing V_f | | | | | | | | |
| | Traditional Approach | A firm should increase leverage (debt) only upto Optimum point, where K_o is minimum & V_f is maximum | | | | | | | | |
| | Modigliani-Miller (MM) Approach-1958 (With Tax) | As per this approach, $V_L > V_{UL}$ $V_L = V_{UL} + \text{Tax Advantage} \dots \text{OR}$ $V_L = V_{UL} + [\text{Debt} \times \text{Tax Rate}]$ <u>Steps to solve Ques of MM Approach (with tax)</u> <table><tr><td>Step 1</td><td>$V_{UL} = \frac{NOI(1-t)}{K_{oUL}}$</td></tr><tr><td>Step 2</td><td>$V_L = V_{UL} + \text{Tax Advantage} [\text{Debt} \times t]$</td></tr><tr><td>Step 3</td><td>$K_o \text{ of levered co.} = \frac{NOI(1-t)}{V_L}$</td></tr><tr><td>Step 4</td><td>$K_o \text{ of levered co.} = \frac{NI}{S} = \frac{(NOI - \text{Int})(1-t)}{V_L - D}$</td></tr></table> | Step 1 | $V_{UL} = \frac{NOI(1-t)}{K_{oUL}}$ | Step 2 | $V_L = V_{UL} + \text{Tax Advantage} [\text{Debt} \times t]$ | Step 3 | $K_o \text{ of levered co.} = \frac{NOI(1-t)}{V_L}$ | Step 4 | $K_o \text{ of levered co.} = \frac{NI}{S} = \frac{(NOI - \text{Int})(1-t)}{V_L - D}$ |
| | | Step 1 | $V_{UL} = \frac{NOI(1-t)}{K_{oUL}}$ | | | | | | | |
| Step 2 | $V_L = V_{UL} + \text{Tax Advantage} [\text{Debt} \times t]$ | | | | | | | | | |
| Step 3 | $K_o \text{ of levered co.} = \frac{NOI(1-t)}{V_L}$ | | | | | | | | | |
| Step 4 | $K_o \text{ of levered co.} = \frac{NI}{S} = \frac{(NOI - \text{Int})(1-t)}{V_L - D}$ | | | | | | | | | |
| | | | | | | | | | | |

| | | |
|--|--|---|
| Irrelevance Theory (capital structure is irrelevant to the value of the firm) | Net Operating Income (NOI) Approach | The increase in debt in the capital structure leads to increase in K_e such that K_o remains constant. Thus, V_f does not change by the amount of debt in total capital. |
| | Modigliani-Miller (MM) Approach-1958 (Without Tax) | Propositions of MM Approach (without tax) 1) V_f [Levered or unlevered] = NOI/K_o <div>Value of Lev Co. = Value of Unlev Co.</div> 2) K_e of Levered Co [K_{eL}] > K_e of Unlevered Co [K_{eU}] <div>$K_{eL} = K_o + [K_o - K_d] D/S$</div> 3) Capital Structure does NOT affect K_o or value of firm |

Arbitrage

Case 1: When Value of Levered > Value of Unlevered

- Step 1: Sell (assuming we have 10% equity) Shares of Levered Co. & receive cash
- Step 2: Personally Borrow an amount equal to 10% of (Debt of Levered Co.) at the same interest rate of levered cos. debt.
- Step 3: Buy 10% Equity of Unlevered Co.
✓ Now balance cash left will be →
(Amt recd from shares + Debt Taken) – Value of Unlev Co. 10% sh.
- Step 4: Calculate Return due to arbitrage (which will be “0”) & you will be left with balance cash

Arbitrage

Case 1: When Value of Levered > Value of Unlevered

- **Step 1:** Sell (assuming we have 10% equity) Shares of Levered Co. & receive cash
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- **Step 4:** Calculate Return due to arbitrage (which will be "0") & you will be left with balance cash



CHAPTER 5 – Capital Structure

Alternatively from step 3, we can also do the following (when que asks to calculate INCREASE in return due to arbitrage)

- **Step 3:** Buy Equity of Unlevered Co. of the WHOLE AMOUNT → (Amt recd from shares + Debt Taken)
- ✓ Now balance cash left will be → 0
- **Step 4:** Calculate Return due to arbitrage (which will now have some positive value)

Case II: When Value of Unlevered > Value of Levered

- **Step 1:** Sell (assuming we have 10% equity) Shares of Unlevered Co. & receive cash
- **Step 2:** Buy 10% Equity & Debt of Levered Co.
- ✓ Now balance cash left will be → (Amt recd from shares + Debt Taken) – Value of Unlev Co. 10% shares
- **Step 3:** Calculate Return due to arbitrage (which will be “0”) & you will be left with balance cash

Alternatively from step 2, we can also do the following (when que asks to calculate INCREASE in return due to arbitrage)

- **Step 2:** Buy Equity & Debt of Levered Co. of the WHOLE AMOUNT → value should in proportion to Debt to Equity Ratio of Levered co.
- ✓ Now balance cash left will be → 0
- **Step 3:** Calculate Return due to arbitrage (which will now have some positive value)

Trade-Off Theory

$$VL = VuL + \text{Tax Advantage} - \text{Cost of Financial Distress}$$

As per trade off theory, as leverage (amt of debt) increases, there will be a trade-off between – Tax shield on interest [Tax adv] & Cost of Financial Distress

Pecking Order Theory

This theory suggests that capital structure decisions are affected by manager's choice of source of capital. A Manager will always prefer to give priority to those sources which reveal least amount of info to others.

A co. issues –

- Debt → when it is positive about future earnings.
- Equity → [External equity / New equity shares] → issued when a company is doubtful about future earnings & Retained earnings [internal equity] is insufficient.
- Thus, managers will raise funds in following ORDER-
 - i. Internal Finance → Retained Earnings
 - ii. Debt
 - iii. Equity share → Last option

Optimal Capital Structure

EBIT-EPS-MPS Analysis

In these type of questions, a company would require funds for a project. Further ques will mention about Expected EBIT & alternative options of financing the required amount.

First we will calculate “EPS” of each alternative.

If PE Ratio is not given

Choose the alternative with highest EPS

If PE Ratio is given

- $MPS = EPS \times PE \text{ Ratio}$
- Calculate for each alternative
- Choose the alternative with highest MPS

CHAPTER 5 – Capital Structure

If question does **NOT** give value of “Expected EBIT” after additional investment, then –

- 1) First calculate “Existing ROCE” = $\frac{\text{Existing EBIT}}{\text{Existing Cap. Employed.}}$
- 2) Then assuming ROCE will remain same,
New EBIT = (New Cap Emp) x ROCE

Indifference point

- AKA. EPS Equivalency Point
- It is the amount of EBIT where, value of EPS is equal in two alternative options of financing.

$$\frac{(\text{EBIT}_1 - \text{Int})(1-t) - \text{PD}}{\text{No. of Equity shares}} = \frac{(\text{EBIT}_2 - \text{Int})(1-t) - \text{PD}}{\text{No. of Equity shares}}$$

- If amount of ESC is same under two financial plans (alternative), then

No Indifference Point

Or

Many (infinite) Indifference points

If after tax cost of source [other than ESC] is **NOT SAME** under both plans

If after tax cost of source [other than ESC] is **SAME** under both plans

Financial Break-Even Point [BEP]

It is the **minimum level of EBIT** needed to satisfy all the fixed financial charges, i.e. interest & pre. Dividend

It is the **Amount of EBIT** where, $\text{EPS} = 0$ of a particular alternative of financing.

$$\frac{(\text{EBIT} - \text{Int})(1-t) - \text{PD}}{\text{No. of Eq. shares}} = 0$$

$$\text{F.BEP wala EBIT} = \frac{\text{PD}}{(1-t)} + \text{Interest}$$

Sales BEP

At what level (amt) of sales

$$\text{EBIT} = 0$$

$$\begin{array}{r} \text{Sales} \\ (-) \text{VC} \\ \hline \text{Contribution} \\ (-) \text{FC} \\ \hline \text{EBIT} \end{array} \rightarrow 0$$

Financial BEP

At what level (amt) of EBIT

$$\text{EPS} = 0$$

$$\frac{(\text{EBIT} - \text{Int})(1-t) - \text{PD}}{\text{No. of Eq. shares}} = \text{EPS} = 0$$

We find out this EBIT, where $\text{EPS} = 0$



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CHAPTER 5 – Leverage Analysis

| Formula of Leverages | | Alternative Formula | | Margin of Safety and Operating Leverage |
|------------------------------|--|---|---|---|
| Degree of Operating Leverage | $DOL = \frac{\% \Delta EBIT}{\% \Delta Sales}$ | When Pref Div does not exist $DOL = \frac{Contribution}{EBIT}$ | When P_D exists $DOL = \frac{Contribution}{EBIT}$ | $MOS = \frac{Sales - BEP Sales}{Sales} \times 100$ $MOS = \frac{Sales - BEP Sales}{Sales} \times \frac{PV Ratio}{PV Ratio}$ $MOS = \frac{EBIT}{Contribution}$ |
| Degree of Financial Leverage | $DFL = \frac{\% \Delta EPS}{\% \Delta EBIT}$ | $DFL = \frac{EBIT}{EBT}$ | $DFL = \frac{EBIT}{EBT - \left[\frac{P_D}{1 - t} \right]}$ | $MOS = \frac{EBIT}{Contribution}$ |
| Degree of Combined Leverage | $DCL = \frac{\% \Delta EPS}{\% \Delta Sales}$ | $DCL = \frac{Contribution}{EBT}$ | $DCL = \frac{Contribution}{EBT - \left[\frac{P_D}{1 - t} \right]}$ | Degree of Operating leverage = $\frac{1}{\text{Margin of safety (in \%)}}$ |

| Formula of BEP Sales | | |
|-----------------------|------------|--------------|
| In Units | In Amount | In % |
| Fixed Cost | Fixed Cost | Fixed Cost |
| Contribution per unit | PV Ratio | Contribution |

| Formula of MOS Sales | | |
|-----------------------|-----------|---------------------------------|
| In Units | In Amount | In % |
| EBIT | EBIT | EBIT |
| Contribution per unit | PV Ratio | Contribution Or $\frac{1}{DOL}$ |

| Combined Analysis of DOL & DFL | | |
|--------------------------------|------|--|
| DOL | DFL | Comments |
| Low | High | Moderate Total Risk. → Best Combination Low DOL → Low F.C → High EBIT High DFL → Can take Adv. Of T.O.E High Financial risk is balanced by lower operating Risk. |



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CHAPTER 7 – Investment Decisions

Capital Budgeting Process

Planning → Evaluation [NPV] → Selection → Implementation → Control

Review

Purpose of Capital Budgeting

- 1) Substantial Expenditure
- 2) Irreversible Decision
- 3) Long time period → Affects long term profitability
- 4) Complex Decision → Multiple factors are involved

Capital Budgeting Techniques

Traditional OR Non-Discounting Techniques

- 1) Payback Period
- 2) Payback Reciprocal
- 3) Accounting Rate of return (ARR)

Time Adjusted OR Discounting Techniques

- 1) Net Present Value (NPV) method
- 2) Profitability Index (PI)
- 3) Internal Rate of return (IRR) method
- 4) Modified IRR
- 5) Discounted Payback period

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Traditional OR Non-Discounting Techniques

Payback period

$$\frac{\text{Initial Investment}}{\text{Annual C.I}}$$

Payback Reciprocal

$$\frac{\text{Average annual cash in flow}}{\text{Initial investment}}$$

Accounting rate of return (ARR)

$$\frac{\text{Average annual net income}}{\text{Average or initial Investment}}$$

Where, Average Investment = Avg funds which remain blocked during the lifetime of the project.

$$= \frac{\text{Value of Int @ Beginning (+) Value of Invt @ End}}{2}$$

Or

$$= \left[\frac{1}{2} (\text{Initial Invt.} - \text{Salvage Value}) \right] + \text{Salvage Value (SV)}$$

Or

$$= \left[\frac{1}{2} (\text{Initial Invt.} - \text{SV}) \right] + \text{SV} + \text{Working Capital (if any)}$$



CHAPTER 7 – Investment Decisions

Time Adjusted OR Discounting Techniques

Sum of PV of cash inflow discounted @ WACC[Ko] - initial investment

$$= \left[\frac{C_1}{(1+K_o)^1} + \frac{C_2}{(1+K_o)^2} + \dots + \frac{C_n}{(1+K_o)^n} \right] (-) \text{ Initial Investment}$$

| Year | Particulars | Cf | Df | Dcf |
|------|-------------|----|----|-----|
| | | | | |

How to take decision as per NPV Method?

NPV > 0
Accept

NPV = 0
Accept/ Reject

NPV < 0
Reject

NPV /= Profit

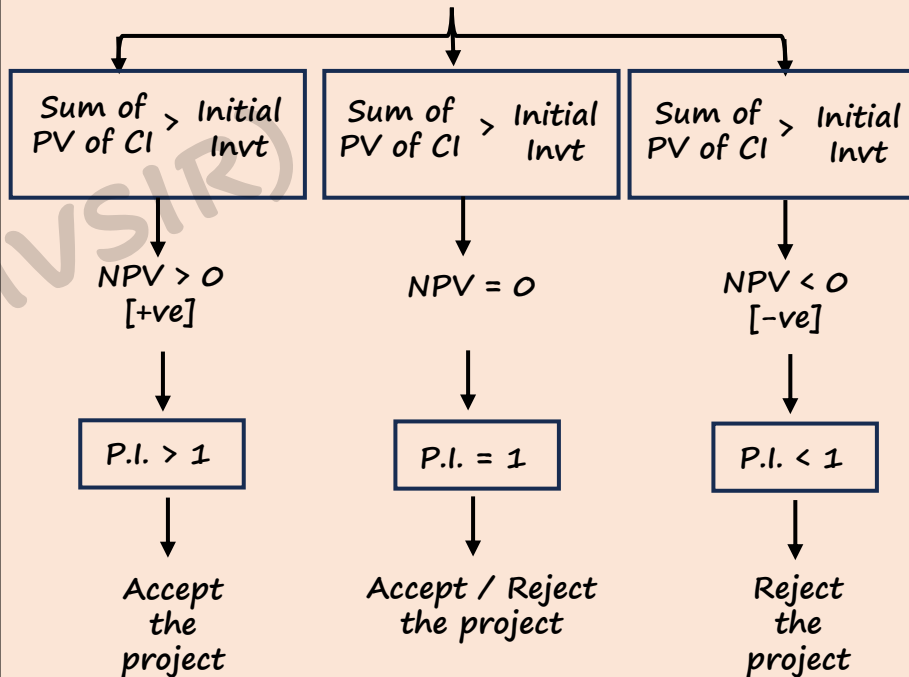
1) When NPV is +ve → It means that the project is able to generate return more than our expectation [Ko]

1) When NPV is -ve → It means that the project is not able to generate returns as per our expectation [Ko]

Net Present Value (NPV) method

Time Adjusted OR Discounting Techniques

Sum of PV of C.I discounted @ Ko
Initial investment



Profitability Index (PI)

CHAPTER 7 – Investment Decisions

Time Adjusted OR Discounting Techniques

IRR is the discounting rate at which

$$\text{Sum of PV of cF @ IRR} = \text{Initial Investment}$$

i.e, when IRR is discounting rate, then $\text{NPV} = 0$

$$\text{Lower Rate} + \frac{\text{NPVLR}}{\text{NPVLR} - \text{NPVHR}} (\text{HR} - \text{LR})$$

Here, we calculate NPV at 2 discounting rates, such that

$\text{NPVLR} \rightarrow +ve$

& $\text{NPVHR} \rightarrow -ve$

➤ How to take decision as per IRR method ?

$\text{IRR} > K_o$



Accept
the
project

$\text{IRR} = K_o$



Accept / Reject
the project

$\text{IRR} < K_o$



Reject
the
project

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Internal
Rate of
return
(IRR)
method

Time Adjusted OR Discounting Techniques

▪ Steps of solving MIRR Questions

Step 1: All cashflows [except initial investment] are to be re-invested till the end [terminal year] of the project, using WACC as compounding rate.

This will result in a single cashflow at the end of the project, i.e, "Terminal CF".

Step 2: MIRR is the rate at which

$$\frac{\text{Terminal Cf}}{(1 + \text{MIRR})^n} = \text{Initial Investment}$$

Modified IRR

Then, calculate MIRR by using "Dirty Power" method on calculator

➤ How to take decision as per MIRR ?

$\text{MIRR} > K_o$



Accept the
project

$\text{MIRR} = K_o$



Accept / Reject
the project

$\text{MIRR} < K_o$



Reject the
project

Discounted
Payback
period

"Discounted Payback Period" is the time taken to recover the initial investment of the project in discounted cashflow terms

➤ How to take decisions as per DPP ?
Projects having Lower DPP shall be selected.



CHAPTER 7 – Investment Decisions

Cash Inflow Vs. Cash Outflow

| | |
|--------------|--|
| Cash Inflow | <ul style="list-style-type: none"> When we actually receive money, due to purchase of asset. When due to purchase of an asset → an expenditure which was happening earlier, is now saved. This is also considered cash inflow. <p>[Eg → Tax saving due to Depn, Rent saved due to Purchase of a factory]</p> |
| Cash Outflow | <ul style="list-style-type: none"> When we actually pay money, due to purchase of asset. When due to purchase of an asset → an income which we used to receive, will now b NOT received. <p>[Jo income mil rahi thi, vo ab nahi mil rahi, new aaset ke wajah se Eg → Hospital - Commission]</p> |

Treatment of Various Amounts

| | |
|---------------------|---|
| Depreciation | Depreciation is NON-CASH Exp. So NOT an outflow But, Tax Saving on Dep is INFLOW |
| Opportunity Cost | Cost of next best alternative foregone. Considered as Cash Outflow |
| Sunk Cost | Irrelevant for decision making. NOT an outflow |
| Allocated Overheads | Irrelevant for decision making. NOT an outflow |

Treatment of Various Amounts

| | |
|-----------------|--|
| Working Capital | WC Required (At Yr=0) → Cash Outflow WC Released (At last year) → Cash Inflow |
|-----------------|--|

Block of Assets

➤ Case 1:

- Ek hi asset tha. [No other asset is block]
- Usse hi hamne seel kar diya. Block will cease to exist.
- Jis year sell karte hain machine → uss year mei dep. calculate Nahi karte.

Profit → STCG
Or
Loss → STCL

➤ Case 2:

- More than one asset in the block.
- Usme sirf 1 asset sell kar diya. Block will still continue.

Sale value of
1 machine< WDV of
Block

- No STCL
- We will calculate depreciation on balance WDV. Further, the tax saving on Dep. will be cash inflow.

WDV of
Block < Sale value

- STCG
- Additional Tax due to STCG will be outflow

Notes:



CHAPTER 7 – Investment Decisions

Special cases in capital budgeting

a) Capital Rationing

Sometimes due to resource [capital] constraints [rationing], a company may have to select some projects amount various projects, all having positive NPV

Independent or Divisible projects

- Projects where either
→ Whole project or
→ Part project can be selected
- If only a part of project is selected, then both initial investment & NPV are reduced pro-rata.
- Projects are ranked as per NPV per rupee Invested = $\frac{\text{NPV}}{\text{Initial investment}}$
- Amount will be invested as per above ranking, until all funds are used.

Non-Divisible projects

- Projects which can be accepted or rejected wholly, i.e, part project cannot be accepted
- Ranking is done on the basis of "Absolute NPV"
- We will make combinations of projects as per Capital available & select the combination with highest NPV

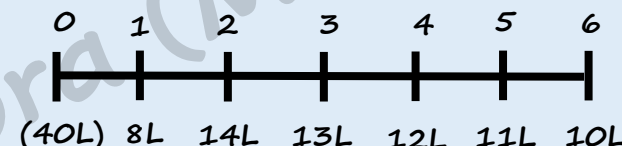
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b) Projects with unequal life

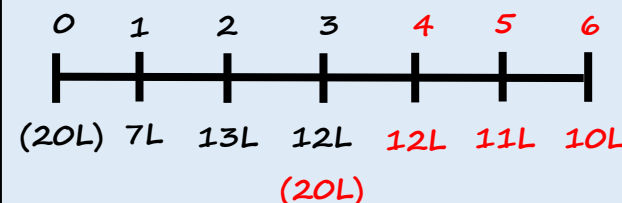
Sometimes while evaluating mutually – exclusive projects, problem arises in comparing NPV of projects having UNEQUAL LIFE.
Such situations can be dealt with –

Replacement chain method

- AKA common life method
- Illustration 14 (of ICAI SM)
- Project A



Project B



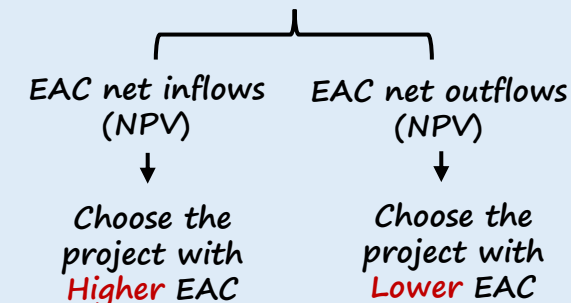
Equivalent Annualised criterion [EAC]

- Step 1 : Compute NPV of all projects.
- Step 2 : Compute PVAF of projects as per the respective life.

- Step 3 : Compute

$$EAC = \frac{NPV}{PVAF}$$

& compare the same





CHAPTER 7 – Investment Decisions

ADJUSTED PRESENT VALUE [APV]

- APV is calculated to show separately, the advantage of financing a project using DEBT.

$$\text{Adjusted PV} = \text{Base case NPV} + \text{PV of tax shield on Int. (-) Issue cost}$$

ADJUSTED DISCOUNT RATE [ADR]

$$\text{ADR} = \frac{\text{Annual C. I. where APV} = 0}{\text{Total funds Raised as DEBT}}$$

REPLACEMENT OF MACHINERY

- STEP 1 : Calculation of initial cash outflow
(if new m/c is Purch & old is sold)
- STEP 2 : Calculation of incremental Base for Depreciation.
- STEP 3 : Calculation of Incremental PBDT
Calculation of Incremental NPV

| Yr. | Incr. PBDT | Incr. Depr. | Incr. PBT | Incr. PAT | Incr. CFAT | Df | DCF |
|-----|------------|-------------|------------------|----------------------|------------------|----|-----|
| | (1) | (2) | (3) = (1)-(2) | (4) = (3) × (1-t) | (5) = (2)+(4) | | |

Sum of PV of Incremental CF
(+) P. V. of Incremental Salvage value
(-) Initial Cash outflow
Incremental NPV

↓
Replace old m/c, if Incremental NPV is +ve

Old M/C
(purch 3 yrs ago)

0 ————— 10

NEW M/C
(total life 10 yrs)

0 ————— 10

Total Approach

Separately calculate NPV
of old & new M/C
Old M/C → NPV
New M/C → NPV
↓
Then compare,
If NPV of New M/C > NPV of old M/C
↓
Purch new m/c

Incremental Approach
(follow this in exams)

Agar new m/c leke old wale ko
replace kar diya toh
↓
Incr. CI (-) Incr. C.O. = Incr. NPV
If incr. NPV is positive, then purchase
new M/C

If old m/c is the only machine in
block of asset
[Illu 18 of ICAI SM]
↓ Then
The value of new m/c will not
be added to the WDV of old
m/c

If old m/c is part of block of
assets having other m/c also
[PP 11 of ICAI SM]
↓ then
The value of new m/c will be
added to the WDV of old m/c.



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FM Chapter 8 Dividend Decisions

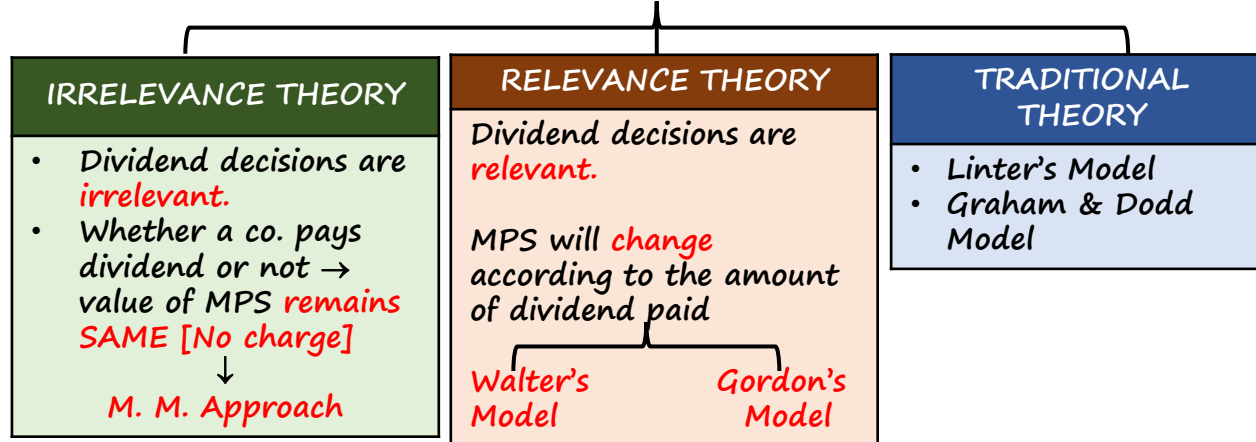
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CHAPTER 8 – Divident Decisions

THEORIES OF DIVIDEND



STEPS FOR SOLVING M. M. APPROACH QUESTION RELATED TO DIVIDEND DECISION

Calculate the following 4 things, in two case :

CASE I : Dividend are not paid

CASE II : Dividend are paid

i. Calculation of price at the end of 1st year [P₁]

$$P_1 = P_0 (1 + K_e) - D_1$$

ii. Calculation of funds required for investment

| Particular | Amount |
|---|--------|
| Earning | Xx |
| Less : Dividend | (xx) |
| Retained earnings | xx |
| Total amount required for investment | xx |
| Balance (Additional) funds required for invt. | xx |

[Balanced additional fund to be raised by issuing → **new (n₁) eqn sh. @ price P₁**]

iii. No. of equity shares to be issued for valance funds required [n₁]

$$n_1 = \frac{\text{Bal funds read. for investment}}{P_1}$$

iv. Calculation of value of firm

$$V_f = \frac{(n + n_1) P_1 + E - I}{(1 + K_e)}$$

❖ Formula of theoretical MPS [walter's model]

$$MPS = \frac{D + (E - D) (r/K_e)}{K_e}$$

❖ Proposition of Walter

| Situation | Type of co. | Optimum DPR | Correlation between size of dividend & MPS |
|-----------|---------------|-------------|--|
| $r > K_e$ | Growth co. | 0% | Negative |
| $r < K_e$ | Declining co. | 100% | Positive |
| $r = K_e$ | Constant co. | 0 - 100% | No co-relation |



CHAPTER 8 – Divident Decisions

Proposition of Gordon

- $r > K_e \rightarrow$ share price will **increase** \rightarrow DPR **decrease**
Or
- $r < K_e \rightarrow$ share price will **decrease** \rightarrow DPR **increase**

| Situation | Type of co. | Optimum DPR |
|-----------|---------------|-------------|
| $r > K_e$ | Growth co. | 0% |
| $r < K_e$ | Declining co. | 100% |
| $r = K_e$ | Normal co. | 0 – 100% |

a. Zero growth

$$\text{Theoretical MPS} = PO = \frac{D_1}{K_e}$$

b. Constant Growth Model [Gordon]

$$PO = \frac{DO(1+g)}{K_e - g} \quad \text{or} \quad \frac{D_1}{K_e - g} \quad \text{or} \quad \frac{E_1(1-b)}{K_e - b.r}$$

When data of EPS [E] & retention ratio [b] is given in question, then prefer formula (3)

c. Variable Growth model [not part of Gordon]

$$\text{Intrinsic value} = \frac{D_1}{(1+K_e)^1} + \frac{D_2}{(1+K_e)^2} + \dots + \frac{D_n}{(1+K_e)^n} + \frac{Sv}{(1+K_e)^n}$$

IMPORTANT POINTS

$$1) \text{ Retention ratio } [b] = \frac{\text{REPS}}{\text{EPS}} \quad \text{or} \quad \frac{\text{Ret Earnings}}{\text{EFES}}$$

$$= 100\% - \text{DPR}$$

2) When “ke” is not given in Question directly, But PE ratio is given, then

$$K_e = \frac{1}{\text{PER}} = \frac{\text{EPS}}{\text{MPS}} \quad [\text{Earnings price approach}]$$

3)

- | | | | | | |
|---|---|-----------|---|---|-----------|
| <ul style="list-style-type: none"> • Current dividend • Last year dividend • Had paid dividend | } | DO | <ul style="list-style-type: none"> • Expected to pay div. • Div at end of 1st year • Next year div. | } | D1 |
|---|---|-----------|---|---|-----------|

- Expected to pay dividend \rightarrow assuming dividends are expected to grow by ___% \rightarrow then consider DPS it “DO”

Traditional Theories of Dividend

a) Graham & Dodd Model

$$PO = m \left[\text{DPS} + \frac{\text{EPS}}{3} \right]$$

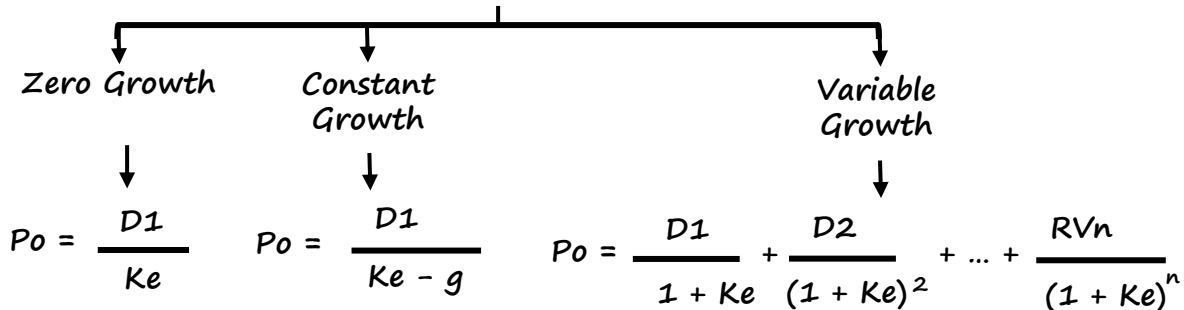
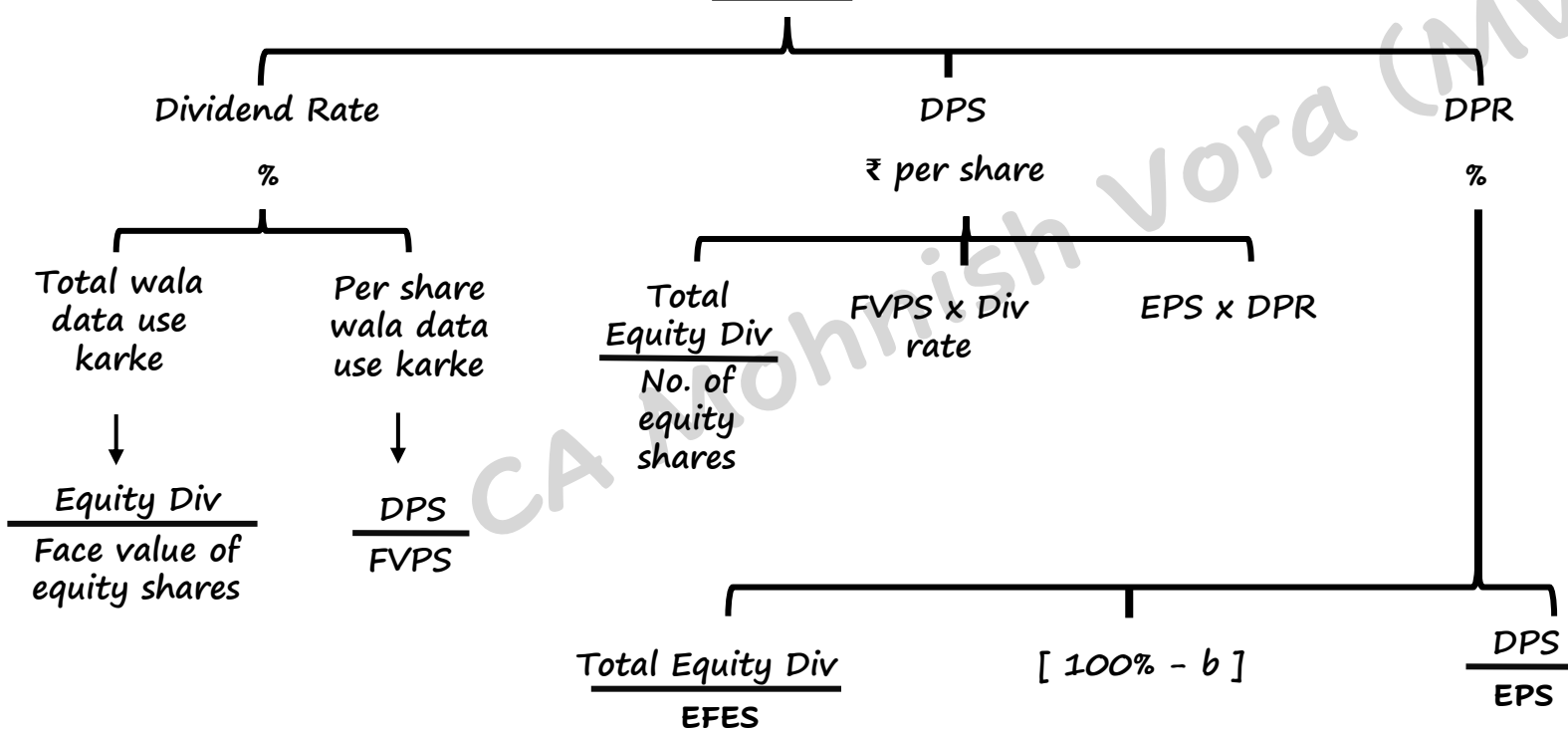
Note:
Value of multiplier “m” will be given in Question

b) Linter's model

$$D_1 = DO + [(EPS \times \text{target DPR}) - DO] \times Af$$

Note:
Value of Adjustment factor [Af] will be given in Question

CHAPTER 8 – Divident Decisions

Dividend Discount ModelDividend

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FM Chapter 9 Working Capital Management

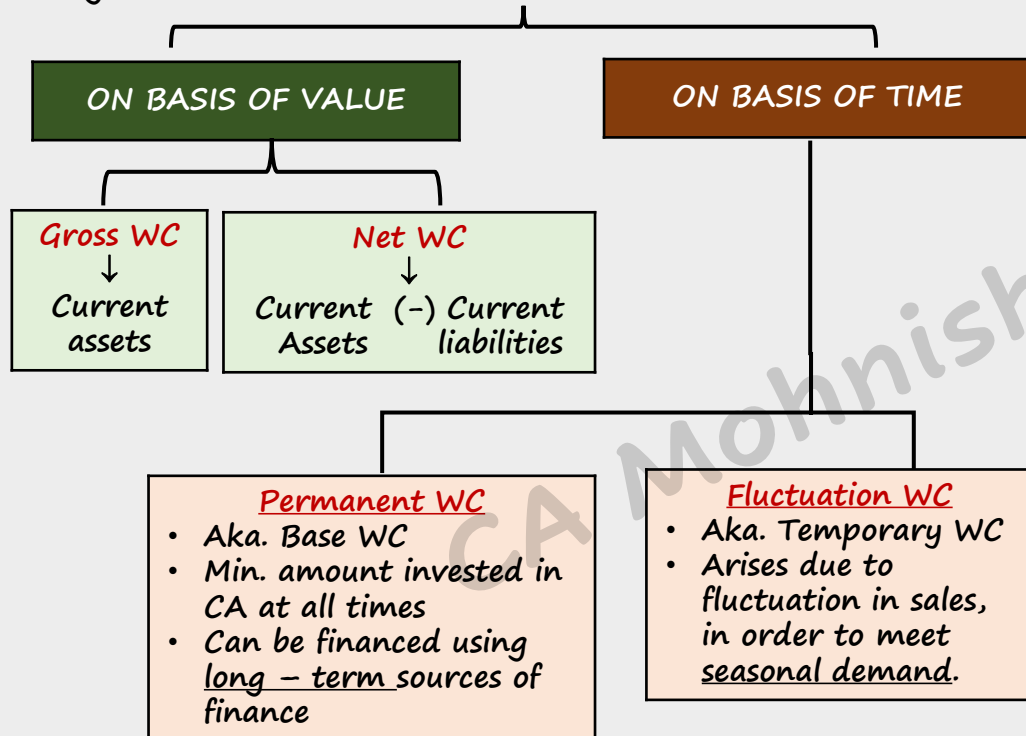
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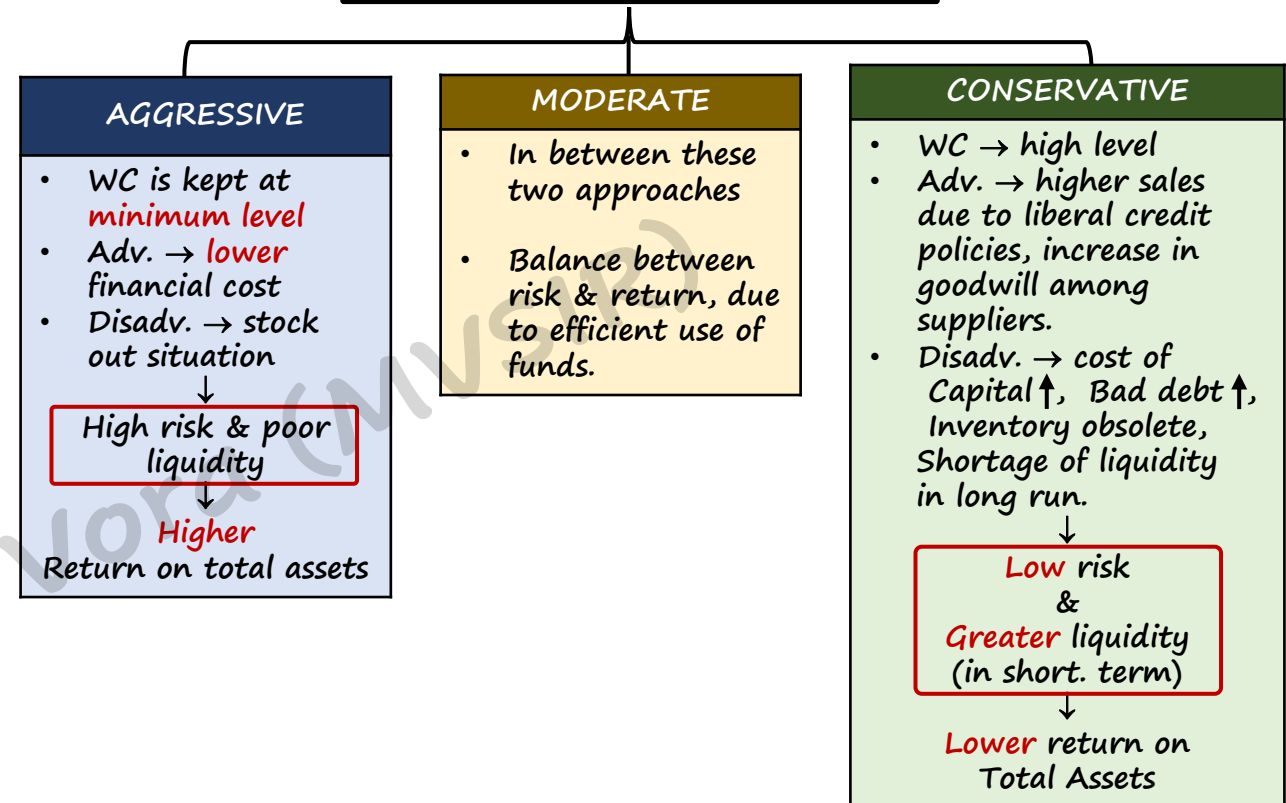
CHAPTER 9 – Working Capital Management

Chp 9 – Unit 1

- **Working capital** is the amount (capital) which is used by a business organization to meet its current (short – term) obligations.
- In other words, it is the amount used for carrying out **day to day operations** of the organization.
- The concept of working capital can be explained through two angles.



Approaches of WC Investment



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CHAPTER 9 – Working Capital Management

ESTIMATION OF WORKING CAPITAL NEEDS

1) CURRENT ASSET HOLDING PERIOD

This method is based on operating cycle concept.
↓
Will use it in this chapter.

2) RATIO OF SALES

Here, it is assumed that investment in CA changes with changes in sales
[WC → % of sales]

3) RATIO OF FIXED INVESTMENTS

Here, WC is calculated as a percentage of fixed investment
[WC → % of FA]

$$\text{Net WC cycle} = R + W + F + D (-) C$$

NOTE :

RM stock $\xrightarrow[\text{On}]{\text{Calculated}}$ RM consumed

Creditors $\xrightarrow[\text{On}]{\text{Calculated}}$ Credit → RM purchase

$$\text{RM consumed} = \text{RM Purchase} + \text{Opening RM} - \text{Closing RM}$$

➤ Number of operating cycles in a year (in times)

$$\frac{\text{No. of days / Months / weeks in year}}{\text{Net WC cycle}}$$

$$\text{Amount of WC reqd.} = \frac{\text{Annual op. cost}}{\text{No. of op. cycles in a year}}$$

$$\text{Receivables (Debtors)} = \frac{\text{Estimated Cr. Sales}}{12 \text{ mts} / 365 \text{d} / 52 \text{w}} \times \frac{\text{Estimated cost of sales P. V.}}{\text{Avg Rec. Collection period}}$$

If cash cost Basis
1st pref. → Cash cost of sales
2nd pref. → Cash COGS

If Ques mentions to calculate debtors value on selling price, then do so [pp 14]

Effect of Double Shift on working capital

Due to working on double shift quantity of

- Production → double
- RM stock → double (p.u. value may change due to discount)
- FG stock → double
- WIP stock → remains same
- Debtors balance → double (if selling price remains same)

NOTE :

When production charges

- VC total value charges.
 - VC is constant PER UNIT
- FC is constant in total
 - FC per unit value charges.



CHAPTER 9 – Working Capital Management

❖ Calculation of WC on cash – cost basis

→ When nothing is mentioned in Question separately, it is always logical to calculate WC on “cash – cost Basis”

Here, Debtors are valued at **cash cost of sales** & not total sales also, depreciation & other Non-cash Exp are **ignored**.

❖ Statement of cost (Required for FM question)

| Particulars | Amount (Rs.) |
|---|--------------|
| Direct material | |
| (+) direct labour (wages) | |
| (+) direct Exp. (MFG Exp.) | |
| Prime cost | |
| (+) op. WIP | |
| (-) CS WIP | |
| Factory cost | |
| (+) admin overheads (related to production) | |
| Cost of production | |
| (+) op. FG stock | |
| (-) CS FG stock | |
| Cost of goods sold | |
| (+) Selling & Distribution OH | |
| (+) Admin overheads (General) | |
| Cost of sales | |

NOTE :

1) In some questions, ICAI has considered
Admin OH → related to **Production** → PP7& in other que,
Admin OH → **General** (not related to prod.) → Illu 4 & PP4

2) When question mentions, it is “**newly commenced business**” it means opening balance will be “0”

ESTIMATION OF WORKING CAPITAL REQUIREMENT

| Particulars | Working | Amount (Rs.) |
|--|---------|--------------|
| A) Current Assets | | |
| R. M. Stock | | |
| WIP Stock | | |
| FG Stock | | |
| Debtors / Bills Rec. | | |
| Prepaid Exp. | | |
| Cash Bank Balance | | |
| Total CA / Gross WC | | |
| B) Current Liabilities | | |
| Creditors / Bills Pay. | | |
| Outstanding Wages | | |
| Outstanding Overheads | | |
| Tax Payable | | |
| Total CL | | |
| C) Excess of CA over CL [A – B] | | |
| D) Add : Safety margin [only if given in Question] | | |
| E) Net WC Required [C + D] | | |



CHAPTER 9 – Working Capital Management

IMP POINTS WHILE SOLVING QUESTIONS

1. Admin Exp ko “ Not related to prod “ hi lete hai If que is silent. Lekin jaise PP – 7, isko related to production liya hai, kyuki,
 $\text{Sales} - \text{GP} = \text{COGS}$ (ye amt. mei admin Exp included tha)

2. Debtors ki value (Jab Ques silent ho)
 Sales pe le sakte hai → lekin generally cash cost basis follow karna zyada logical hota hai

Toh, for debtors

1st preference : cost of sales

Agar que mei Admin Exp & selling Exp diya hai, toh cost of sales pe hi lena chahiye debtors ko.

2nd preference : COGS

If Qn → Admin & selling exp → NAHI diya then COGS pe le lo Debtors ko.

3rd preference : sales

PP 3 → mei bal sheet banana bola, our WC nikalne bola uske hisab se

Now, bal sheet mei debtors ki value toh, “sales” pe hi hoti hai isliye is que mei humne sales pe hi liya debtors ko.

Also so if que mentions to calculate debtors on selling price or sales → then do so.

| If you | Then | EFFECT ON WC CYCLE |
|--|-----------------------------------|--------------------|
| Collect receivable (debtors) faster | You release cash from the cycle | Decrease |
| Collect receivables (debtors) slower | Your receivables soak up cash. | Increase |
| Get better credit (in terms of duration or amount) from suppliers. | You increase your cash resources. | Decrease |
| Shift inventory (stocks) faster | You free up cash | Decrease |
| Move inventory (stocks) slower | You consume more cash. | Increase |

❖ Cash Budget

It is used to plan & control cash receipts & payments. It represents cash requirements of business during the budget period.

Chp 9 – Unit 2

Cash budget [format]

| Particulars | Month 1 | Month 2 | Month 3 |
|---|---------|---------|---------|
| a) Opening cash Bal. | | | |
| b) <u>Receipts</u> | | | |
| • Cash sales | | | |
| • Collection from decisions [on credit sales] | | | |
| • Other Receipts | | | |
| Total receipts | | | |
| c) <u>Payments</u> | | | |
| • Payment to creditors | | | |
| • Wages | | | |
| • Overheads | | | |
| • Interest / dividend | | | |
| • Tax | | | |
| • Other payments | | | |

CHAPTER 9 – Working Capital Management

Total payments

d) Excess of receipts over payments $[a + b - c]$
 e) Surplus to be invested deficit to be borrowed

f) Closing balance $[d - e]$

❖ Cash Management Models

I) William J. Baumol EOQ Model

$$\text{Optimum cash balance} \Rightarrow C = \sqrt{\frac{2 \times U \times P}{S}}$$

Where,

 C = optimum cash Balance U = Annual (or monthly) cash Disbursement [Requirement] P = Fixed cost per transaction S = opportunity cost per rupee per annum [or per month]

II) Miller – orr cash management Model [1966]

→ According to this model, net cash outflow is completely **stochastic**. [having random probability or pattern that may be analysed statistically but may not be predicted precisely]

→ When changes in cash balance occur randomly the application of control theory [like miller – orr model] serves useful purpose

→ In this model, control limits are set for cash balances these limits are

“ h ” → upper limit i “ z ” → Return point,
 zero → lower limit

• When cash balance reaches upper limit $[h]$

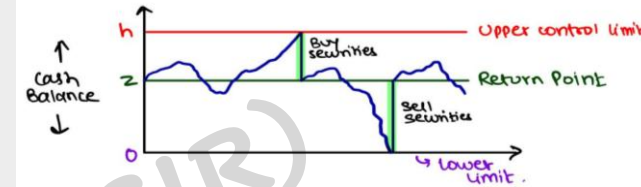
Transfer of cash equal to “ $h - z$ ” is invested in metastable securities account.
 [Buy securities]

• When cash balance touches lower limit [zero]

Transfer from marketable securities account to cash account is made. [sell securities]

• When cash balance stay between (h, z) or (z, o) , i.e. high & low limits

No transaction between cash & marketable securities is made



→ Miller orr Model is more realistic since it allows variations in cash balance within lower & upper limits.

The finance manager can set limits according to firms liquidity requirements.

I. Economic order Quantity (EOQ)

Chp 9 – Unit 3

$$EOQ = \sqrt{\frac{2 \times A \times O}{C}}$$

Where,

 A = annual requirements of raw materials [or monthly] C = carrying cost p. u. p. a. O = ordering cost per order

II. Lead Time

The no. of days / months it takes between when a purchase order is placed to replenish products & when the order is received in Warehouse.

III. Lead time consumption

$$LTC = \text{Annual Requirement} \times \frac{\text{Lead Time}}{365 \text{ days / weeks / 12 months}}$$



CHAPTER 9 – Working Capital Management

IV. Re order stock level (ROL)

The level at which fresh order should be placed for replenishment of stock.

$ROL = \text{lead time consumption (+) minimum stock level (if any)}$

Minimum stock level is the level of stock which is to be maintained at all times. It is aka. Safety stock.

V. Average stock level

$ASL = \text{minimum stock level (+) } \left[\frac{1}{2} \times \text{Reorder qty} \right]$

❖ Evaluation of credit policies

[when Qn is silent → use total approach, use incremental approach, only if Qn specifically asks]

Chp 9 – Unit 4

| Particulars | Present policy | Proposed policy I | Proposed policy II |
|--|----------------|-------------------|--------------------|
| A) <u>Expected profit</u> | | | |
| a) Credit sales | | | |
| b) Total cost | | | |
| Other than bad debits | | | |
| i) Variable cost | | | |
| ii) Fixed cost | | | |
| c) Bad debts | | | |
| d) Cash discounts | | | |
| e) Expected net profit before tax [a – b- c- d] | | | |
| f) Tax (if any) | | | |

| | | | |
|--|--|--|--|
| g) Expected profit after Tax [e – f] | | | |
| B) Opportunity cost of Inv. In Receivables | | | |
| C) Net benefits [A – b] | | | |

Advice : The policy _____ should be adopted since the net benefits are highest

NOTE :

→ Fixed cost = [avg. cost (-) variable cost] (x) no. of units in present policy

→ opportunity cost = $\frac{\text{total cost of credit sales}}{\text{collection period}} \times \frac{\text{Required rate if return}}{100}$

➤ There is one more method to evaluate credit policies → **Expected rate of return method** [use this only if Que mentions]

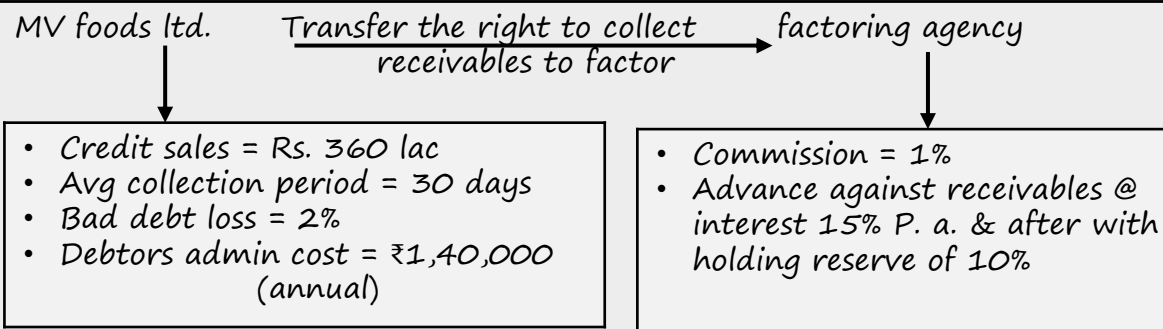
Expect rate of return = $\frac{\text{incremental expected profit}}{\text{incremental invt in receivables}} \times 100$

→ Above method can be used only after making table of incremental approach.
→ Here, policy with highest exp rate is selected.

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CHAPTER 9 – Working Capital Management

Factoring of receivables

i. Avg level of receivables = $360L \times \frac{30}{360} = \text{Rs. } 30L$

ii. Calculation of net amount of Advance

| Particulars | Amt. (Rs.) |
|---|-------------------------|
| Factoring commission [$30L \times 1\%$] Reserve [$30L \times 10\%$] | 30,000 3,00,000 |
| Total (a) | 3,30,000 |
| Thus, amt. available for advance Avg level of receivables Less : total (a) from above | 30,00,000 (3,30,000) |
| Amt. available for advance | 26,70,000 |
| Less : int on advance @ 15% pa for 30 days ($26,70,000 \times 15\% \times \frac{30}{360}$) | (33,375) |
| Net amt. of advance (Adv to be paid) | 26,36,625 |

iii) Evaluation of Factoring Proposal

| Particulars | Amt. (Rs.) |
|---|------------|
| A) Savings due to factoring | |
| Admin cost | 1,40,000 |
| Bad debts [$360L \times 2\%$] | 7,20,000 |
| Total saving | 8,60,000 |
| B) Costs due to factoring | |
| Factoring commission [$360L \times 1\%$] or [$30,000 \times \frac{360}{30}$] | 3,60,000 |
| Interest charge [$33,375 \times \frac{360}{30}$] | 4,00,500 |
| Total cost | 7,60,500 |
| C) Net Benefits to firm [A - B] | 99,500 |

Since net benefits due to factoring are **positive** [savings cost] factoring proposal should be **accepted**.

❖ **Rate of effective cost of factoring** (Can be calculated one when Costs due to factoring are more than savings)

$$\frac{\text{Net annual cost of factoring}}{\text{advance to be paid (Net)}} \times 100$$

Where,

Advance to be paid (net amt of adv)

= amount available for advance (-) interest deducted by factor

• Company should avail factoring services,

When,

Effective cost of factoring } **lower than** } existing cost of borrowings



CHAPTER 9 – Working Capital Management

Cost of not taking Discount [CNTD]

Chp 9 – Unit 5

1. Simple interest method

$$\text{CNTD} = \frac{d}{100-d} \times \frac{365}{t} \times 100$$

2. Compound interest method

$$\text{CNTD} = \left[\frac{100}{100-d} \right]^{\frac{365}{t}} - 1$$

Where, d = amt of discount

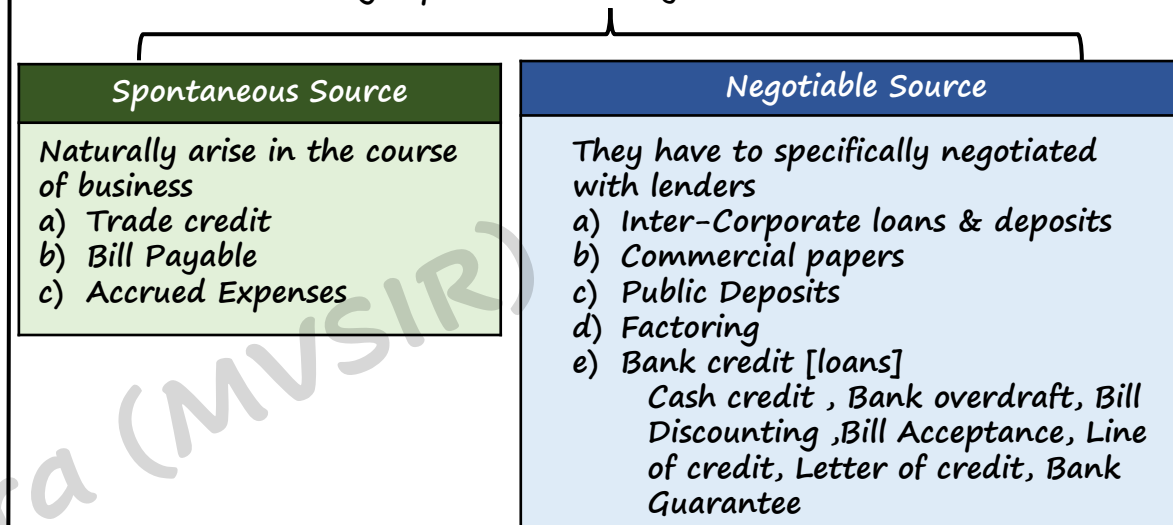
t = Gap period = Total credit period (-) Discount period

Note: If question does not mention anything about the type of interest [simple or compounding] → then use SIMPLE Interest method only.

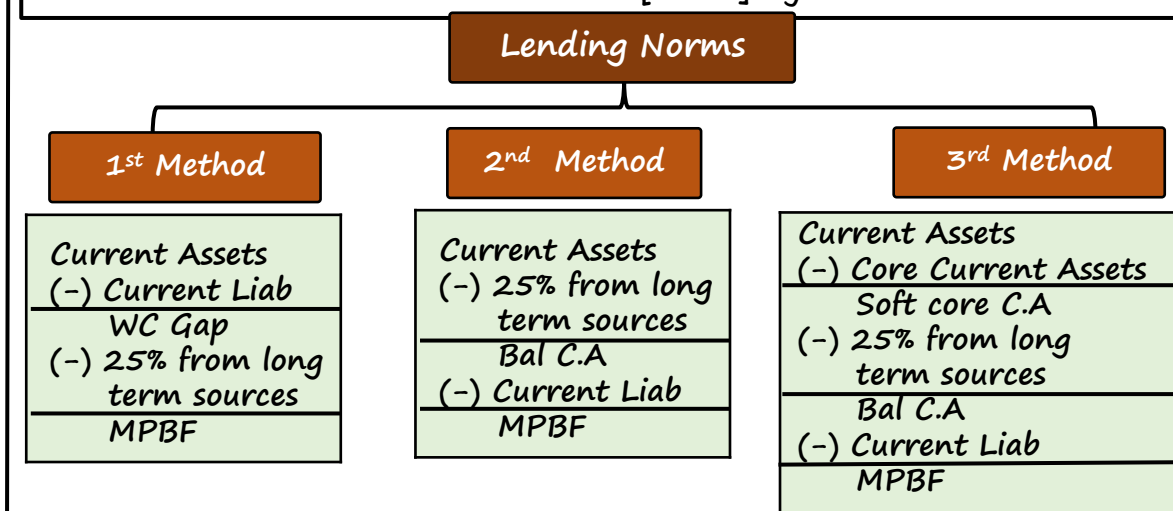
- When, Return on alternative investment (opp. Cost) $>$ CNTD → **Reject** the discount given by creditor
- Or
- When, Return on alternative investment (opp. Cost) $<$ CNTD → **Accept** the discount given by creditor

Chp 9 – Unit 6

Working capital finance may be classified into -



Maximum Permissible Bank Finance [MPBF] By Tandon Committee



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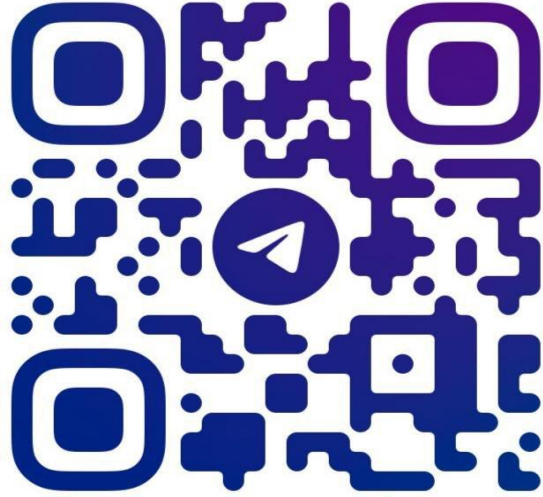


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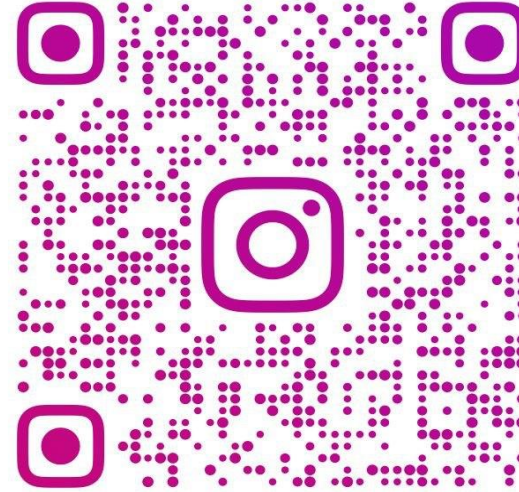


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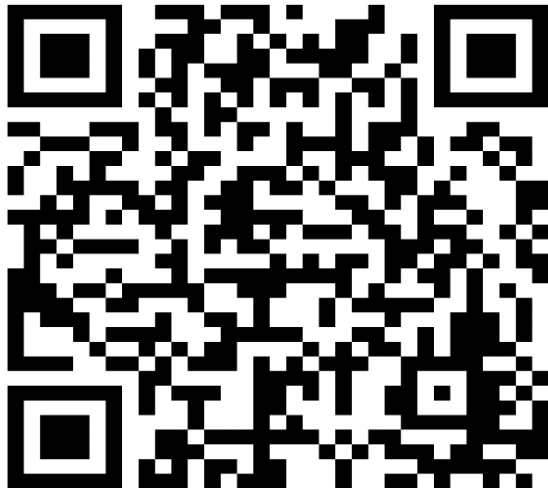
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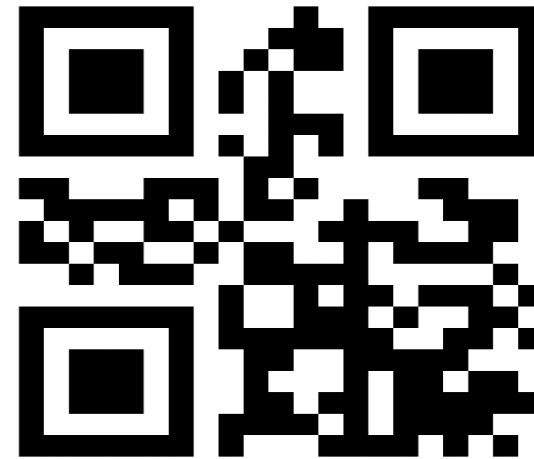
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CA Intermediate (New Syllabus) SM Super Chart Book

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| Chp No. | Chapter Name | Marks Weightage | Page No. |
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| 3 | Strategic Analysis: Internal Environment | 15-25% (7 - 12 M) | 3.1 - 3.10 |
| 4 | Strategic Choices | 15-25% (7 - 12 M) | 4.1 - 4.11 |
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CA Intermediate – New Syllabus



FM & SM
SUPER CHART BOOK

SM Chapter 1

Introduction to Strategic Management

By CA Mohnish Vora (MVSIR)

Become a CA not just for yourself, but for your family. You are bound to be successful.



CHAPTER 1 - INTRODUCTION TO STRATEGIC MANAGEMENT

Management

1) **Key group** → in-charge of its affairs

➤ Chief Organ → make organization a **purposeful** & **productive** entity, by **bringing together** & **integrating disorganised resources** → **combined into a functioning whole**.

➤ **Survival & success** of org. depends on **competence & character** of its management.

2) Set of inter-related functions & processes

Planning, Organising, Directing, Staffing & Control.

They range from - **MT: Control MAD Goals**

- **installation of control system**
- **mobilisation & acquisition** of resources,
- **allocation of tasks & resources**
- **design** of organization &
- **determination of the goals**

Strategy

Game plan that mgt. uses to -

- **conduct** its operations, **MT: C²OMA**
- **compete** successfully,
- achieve **organizational objectives**
- take **market position**, &
- **attract** and **satisfy** customers.

It is also **long-range blueprint** of an organization's **MT: 3 D**

- **desired image** (what it **wants to be**)
- **Direction** (what it **wants to do** & **how** it wants to do things)
- **Destination** (**where** it wants to go).

Scheme of corporate intent & action -

- to **mobilise resources**, **MT: Utilise M²DH**
- to **direct human effort** and behaviour,
- to **handle events** and problems,
- to **perceive** and **utilise opportunities**, and
- to **meet challenges and threats** for corporate survival and success.

Integrated framework for top mgt. -

- to **use resources & strengths**, **MT: SWOT**
- to **offset** corporate **weaknesses**.
- to **search, evaluate & exploit** beneficial **opportunities**,
- to **perceive & meet threats** & crisis,

Strategy is no substitute for sound & alert management

- **Strategy** can **never be perfect, flawless and optimal**.
- It is the very nature of strategy → **flexible & pragmatic** to take care of **sudden emergencies** & **avoid failures**
- Sound strategy → **allowances are made for miscalculations** & **unanticipated event**

Strategy is partly proactive and partly reactive

- Strategy is a blend of:
 - ✓ **Proactive actions** → managers to **improve company's market position & financial performance**
 - ✓ **Reactions to unanticipated developments & fresh market conditions** in dynamic business environment. **Adapting** to environment.

Strategic Management

Strategic management is made up of several distinct activities:

- developing **vision & mission**;
- **strategic analysis**;
- developing **objectives**;
- **creating, choosing, & implementing** strategies; and
- measuring & **evaluating performance**
- Taking **corrective adjustments** wherever required

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CHAPTER 1 - INTRODUCTION TO STRATEGIC MANAGEMENT

Strategic Management

Importance/Benefits of Strategic Management

MT: Facebook pe Frame wali DP C2yu Lagate hai ?

- 1) SM prepares organisation to face the future → act as **pathfinder to various opportunities**.
- 2) SM provides frameworks for all major decisions → on products, businesses, markets, etc. (PBM)
- 3) SM **gives a direction** → to move ahead. Helps **define goals & mission**. Defining **objectives** → **in line with vision**
- 4) SM helps org. to be **proactive instead of reactive**. → **analyse & take actions** → take **control their own destiny**
- 5) SM serves as a **corporate defence mechanism** against mistakes & pitfalls. → **avoid costly mistakes**
- 6) SM helps org. to **develop core competencies & competitive advantages** → fight for **survival and growth**
- 7) SM helps to **enhance the longevity** of business. It helps org to **take a clear stand** → not just surviving on luck. **Actions over expectations** is what SM ensures.

Limitations of Strategic Management

MT: Costly ETC

- 1) SM is a **costly process**. **Expert strategic planners**, efforts for analysis of environments, devise & implement strategies.
- 2) It is **difficult to clearly estimate the competitive responses**. Difficult to know strategies of competitors → **taken within closed doors**. For eg, Apple removing 3.5mm audio jack from iPhones.
- 3) SM is a **time-consuming process**. Org spend lot of time in → **preparing & communicating** the strategies → may **impede daily operations**
- 4) Environment is **highly complex & turbulent difficult to understand environment**. The org. **estimate** about future may go **wrong**. For eg, Two-Wheeler Electric Vehicles → incidents of battery catching fire.

Objectives of Strategic Management

- 1) To **create competitive advantage** → to **outperform the competitors**.
- 2) To **guide company through all changes** in environment → **React in right manner**

Strategic Intent

- Refers to **purposes** of **what organisation strives for**
- Senior managers must define-
 - ✓ "**what** they want to do" and
 - ✓ "**why** they want to do".
 "**Why they want to do**" represents **strategic intent**
- It is the **philosophical base** of SM.
- Answers the question- **what organisation strives or stands for?**

Elements of Strategic Intent
Strategic intent could be in form of

vision & mission
statements
at
corporate
level

business definition & business model
at
business level

goals & objectives
at
Functional
(Operational)
level



CHAPTER 1 - INTRODUCTION TO STRATEGIC MANAGEMENT

Vision

Meaning

- Vision is the blueprint of the company's future position
- ✓ It shows **management's aspirations** for business,
- ✓ Provides a **panoramic view** of "where we want to go" &
- ✓ a **rationale for why this makes good business sense**.
- Vision thus points out-
 - ✓ a **particular direction**,
 - ✓ **charts a strategic path**
 - ✓ **moulding organisational identity**

Essentials of a Strategic Vision

MT: CEED

- 1) Challenge → **think creatively** about **how to prepare a co. for future**.
- 2) Forming vision → **exercise** in intelligent entrepreneurship.
- 3) Well-articulated vision **creates enthusiasm** among members of org.
- 4) It **illuminates direction** in which org. is headed

Mission

Why should an org. have a mission?

MT: PUT BMW in Focus

- 1) To **specify organisational purposes** & **translation** of purposes into **goals**.
- 2) To ensure **unanimity of purpose**
- 3) To establish a **general tone** or **organisational climate**
- 4) To **develop a basis** for **allocating resources**.
- 5) To provide a **basis for motivating** the use of **resources**.
- 6) To facilitate **translation of objective** & goals into a **work structure** involving assignment of tasks.
- 7) To serve as a **focal point** → who can identify with org's purpose & direction.

Meaning

- A mission is an answer to the basic question-
 - ✓ what business are we in? ; &
 - ✓ what we do?
- It describe an organisations **present-**
 - ✓ **activities**,
 - ✓ **business makeup**
 - ✓ **capability & customer focus**

MT: ABC

Components of a good mission statement

- 1) Mission statement should give org its own-
 - ✓ **special identity**,
 - ✓ **business emphasis** &
 - ✓ **path for devp.** - one that sets it apart.
- 2) Mission should specify-
 - ✓ **what needs org is trying to satisfy**,
 - ✓ **which customer groups it is targeting** &
 - ✓ **technologies & competencies it uses** &
 - ✓ **activities it performs**
- 3) **Unique** to the org.
- 4) **Not be to make profit**

Peter Drucker & Theodore Levitt → org should answer these questions before starting its business

MT: PUB+G MSN²

- 1) What is our **ultimate purpose**?
- 2) Do we **understand our business correctly**?
- 3) What do **we want to become**?
- 4) What **business** are we in?
- 5) In what **business** would we like to be in **future**?
- 6) What **brings us** to this particular business?
- 7) What kind of **growth** do we seek?
- 8) What is our **mission**?
- 9) **Whom** do we intend to serve?
- 10) What human **need** do we intend to serve through our offer?
- 11) What would be **nature** of business in **future**?



CHAPTER 1 - INTRODUCTION TO STRATEGIC MANAGEMENT

Goals & Objectives

Goals

Goals are **open-ended attributes** that denote the **future states or outcomes**.

Objectives

- Objectives are **close-ended attributes** → **precise** & expressed in **specific** terms.
- They translate goals to → short-term & long-term perspective
- They are **performance targets** – results org wants to achieve.
- They function as **yardsticks** (benchmark) for tracking an org's **performance**.

Characteristics of Objectives

MT: S²MART & Challenging Performance

- 1) **Concrete** & **specific**.
- 2) Provide basis for **strategic decision-making**.
- 3) **Measurable** and **controllable**.
- 4) Facilitative towards **achievement of mission & purpose**.
- 5) Should **define** organisation's **relationship with its environment**.
- 6) Related to a **time frame**.
- 7) **Challenging**.
- 8) Provide **standards for performance appraisal**.
- 9) Should **correlate with each other**.
- 10) Set within constraints of organisational resources & external environment.

LTO are established in 7 areas
OR Key areas in which the strategic planner should concentrate his mind to achieve desired results.

- ✓ **Profitability**
- ✓ **Productivity**
- ✓ **Public Responsibility**
- ✓ **Employee Development**
- ✓ **Employee Relations**
- ✓ **Competitive Position**
- ✓ **Technological Leadership**

MT: 3P 2E CT

Intent vs Values – Which is broader concept?

- Intent is the **purpose of doing business**
- Values are **principles** that **guide decision making** of business.
- They both go hand in hand, while the **intent is driven by values**.
- So **values** more or so is **wider than Intent**

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Values

- Values are **deep-rooted principles** which **guides decisions & actions**.
- As per Collins & Porras core values → **inherent & sacrosanct**
- Values **sets tone** for how people will think & behave, in dilemma.
- Creates a sense of **shared purpose** → build strong foundation and focus on **longevity**.
- **Employees** → work with employers whose values **resonate** with them
- **Consumers** → buy products from cos. that have a **purpose** that **reflects their own value & belief system**.
- Hence, values have both **internal** as well as **external** implications.
- For eg- HP Way, etc

Strategic Levels of Org.

Corporate Level Managers

- CLM consists of CEO & other senior executives, BOD, & corporate staff.
- **Participate in strategic decision making & oversee devp of strategies**
- **Role of CLM** includes
 - 1) **formulating & impl. strategies** that span individual businesses,
 - 2) defining **mission & goals**
 - 3) determining **what businesses** it should be in,
 - 4) **allocating resources**
 - 5) providing **leadership**

MT: Formulating & Implementing MBA Leadership



CHAPTER 1 - INTRODUCTION TO STRATEGIC MANAGEMENT

Business Level Managers (BLM)

- Development of **strategies** for competing in **individual business areas**, (like FMCQ, hotel, financial services etc) → responsibility of BLM
- The **principal general manager** at business level, or BLM, is the **head of the division (SBU)**.
- BLM's strategic role is to **translate general statements of direction & intent** that come from the corporate level **into concrete strategies** for individual businesses.

Functional Level Managers (FLM)

- FLMs → responsible for **specific business functions** (HR, sales, etc) → **develop functional strategies**
- FLM's sphere of responsibility is confined to **one organizational activity**, whereas general managers (BLM) **oversee operation of whole company/division**.
- FLM **provide information** → helps BLM & CLM to **formulate realistic & attainable strategies**.
- They are **closer to the customers, suppliers & operations** than general manager is.
- FLM **themselves may generate important ideas** that may become major strategies
- Also responsible for → **strategy implementation, i.e. execution** of CLM & BLM plans.

3 major types of networks of relationship

1) Functional & Divisional Relationship

- **Independent relationship**, where **each function** or a division is run **independently headed** by the **function/division head**, who is a **BLM**, reporting to **business head**, who is CLM.

2) Horizontal Relationship (Flat Structure) → More suitable for **startups**

- All positions, from top mgt to employees, are in **same hierarchical position**.
- This leads to - **openness & transparency** & more **idea sharing & innovation**.

3) Matrix Relationship

- **Grid-like structure** of levels in an org., with **teams formed with people from various departments** that are built for **temporary task-based projects**.
- Helps to manage huge **conglomerates** (large org.) → **impossible to track every single team independently**.
- **More than one BLMs** for each functional teams. (**Dual-reporting**)

Top Down Approach or Bottom-Up Approach?

- **Top-down approach** to decision making → **decision made solely by leadership at top (CLM)**,
- **Bottom-up approach** → gives **all teams across the levels a voice** in decision making

Benefit of proactive strategy over reactive strategy

MT: BCCE

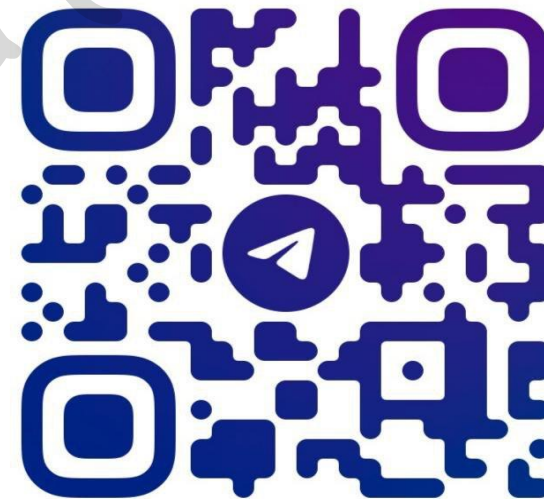
- 1) Allows for **better risk management** by identifying potential challenges in advance, enabling organizations to **develop contingency plans**.
- 2) Result in **cost savings** as **preventive measures** can be more **efficient** than addressing crises retroactively.
- 3) Organizations can **maintain a competitive edge** by **staying ahead** of industry trends and changes.
- 4) It **enhances organizational strength** and **responsiveness** in navigating uncertainties.

Mission Vs Vision

- 1) Mission statement tells **fundamental purpose** & concentrates on **present**. It defines **customer** & **critical processes** & informs you of **desired level of performance**. On the other hand, a vision statement outlines what the organization **wants to be**. It concentrates on the **future**. It is a source of **inspiration**. It provides **clear decision - making criteria**.
- 2) The **vision** describes a **future identity** while the **mission** serves as an **on-going** and **time-independent guide**.
- 3) The **vision** statement can galvanize the people to **achieve defined objectives**. A **mission** statement provides a **path to realize the vision** in line with its values.
- 4) A **vision** statement defines the **purpose or broader goal for being in existence** & **can remain the same for decades**, while a **mission** statement is **more specific** in terms of both **future state** & **time frame**. Mission describes **what will be achieved** if the organization is **successful**.

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SM Chapter 2

Strategic Analysis : External Environment

By CA Mohnish Vora (MVSIR)

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CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

➤ The process of strategic formulation **begins with a strategic analysis.**

➤ Its **objective** is to **compile information** about **internal & external environments** → to assess possibilities while formulating strategic objectives & contemplating strategic activities.

➤ Strategy formulation **cannot** be done just by intuition, instincts, or creative thinking. Judgments about what strategies to pursue need to flow directly from

➤ analysis of a firm's **external environment** and

➤ its **internal resources and capabilities.**

❖ **Environmental scanning** is a **natural & continuous activity** for every business

✓ **Informal structure**- learn about changes in tax or laws through **T.V. news**

✓ **Formal structure**- learn about changes in tax or laws through a **well-established reading material from experts.**

➤ Using just informal techniques can lead to **missed opportunities.**

➤ Thus, a **systematic approach** to environmental assessment is **essential** for **managing risk and uncertainty.**

Strategic analysis is a component of business planning that-

➤ has a **methodical approach,**

➤ makes the **right resource investments, &**

➤ may **assist** business in **achieving its objective.**

➤ forces to **think about rivals** & aids in staying ahead of competition.

The **two important situational considerations** regarding strategic analysis are:

1) **industry** and **competitive conditions,** and

2) an organisation's **own capabilities,** resources, internal strengths, weaknesses, and market position.

Accurate diagnosis of business situation is necessary to-

1) Decide on **sound long-term direction,**

2) **Setting appropriate objectives,** and

3) **crafting a winning strategy.**

Without strategic analysis, managers will finalize a strategic game plan that

1) **doesn't fit** the situation well,

2) that holds **little prospect** for building **competitive advantage,** &

3) is **unlikely to boost** co. performance.

Two major limitations of strategic analysis-

1) It gives a **lot of innovative options but doesn't tell which one to pick.** The options can be overlapping, confusing or difficult to implement.

2) It can be **time-consuming** at times, hurting overall organisational functioning & also strain other innovations such as developing new product.

Issues to consider for Strategic Analysis

1) **Strategy evolves over a period of time:**

➤ A current strategy is **result of several little choices** taken over a long period of time.

➤ Strategy is **influenced by experience,** & is to be **updated** when results become clear.

2) **Balance of external and internal factors:**

➤ Strat. analysis requires **balance** between **challenges**

➤ There are factors

✓ driving a decision, like **entering a new market.**

✓ **limit the option,** like **presence of large opponent.**

➤ While **some** of these aspects are **under our control,** while some are not.

3) **Risk:**

➤ **Complexity** & **intermingling** of variables in the environment **reduces strategic balance** in org.

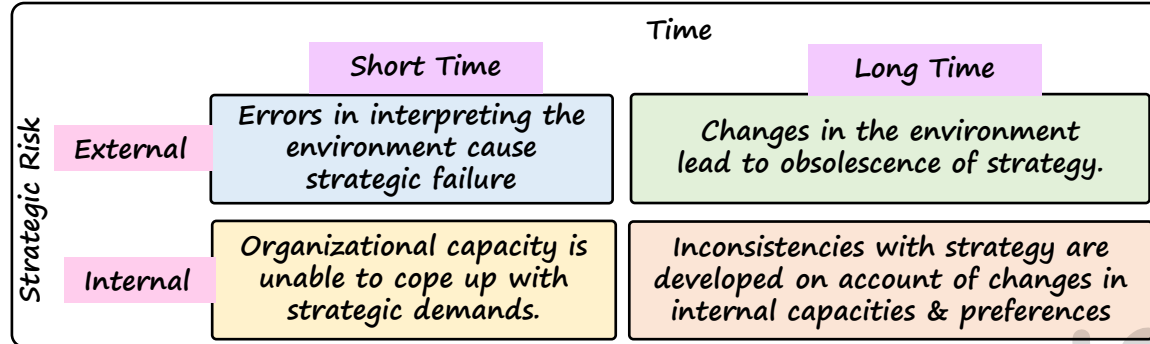
➤ **Competitive markets, globalization, booms, tech advancements etc** affect business & pose risk.

➤ It is important to **identify potential imbalances** or risks and **assess their consequences.**



CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

- ❖ **External risk** - **inconsistencies** between **strategies** & **forces in the environment**.
- ❖ **Internal risk** - Occurs on account of forces that are either **within** the organization or are **directly interacting** with the organization on a **routine basis**.



Business Environment refers to all **external factors**, influences, or situations that in some way **affect business decisions, plans, and operations**. It is **highly dynamic** and **continuously evolving**.

Importance of Business Environment

MT: COLD Image

1) Meeting Competition

- **Analyse competitors' strategies** & formulate own strategies accordingly.
- Thus helping business to **flourish** & **beat competition**

2) Determine opportunities and threats

- It helps to find **new wants** of consumers, **changes in laws**, changes in **social behaviours**, and tells what new products competitors are bringing.

3) Continuous Learning

- The managers are **motivated** to **continuously update their knowledge**, understanding and **skills** to meet changes in environment.

4) Give direction for growth

- It helps to **identify areas** for growth & expansion.

4) Image Building

- Helps organizations to **improve their image** by showing their **sensitivity** to the environment.
- For eg, in view of **shortage of power**, many companies have set up **captive power plants** within their factories to meet their own requirement of power as well as extend surplus capacities.
- Understanding needs of environment → showcase that organization is **aware & responsive** to needs of people & it creates a **positive image** & win over competitors.

- ❖ To flourish, a business must be aware of, assess, & respond to opportunities & threats in its environment & also be able to handle and adapt to them.

- ❖ Two crucial aspects for success include-

- 1) **function of top management**, &
- 2) **method of formulating strategic decisions**.

- ❖ **Business Environment** can be classified as-

- I. External Environment
- II. Internal Environment (Will discuss in Chp 3)

- Classification of environment into components helps an organization to-

- ✓ cope with its **complexity**,
- ✓ **comprehend** the different influences operating, &
- ✓ **relating** the environmental **changes** to its **strategic management process**.



CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

❖ The external environment can be categorised in two major types as follows:

- 1) Micro environment
- 2) Macro environment

Micro Environment

- Related to small area or immediate periphery of an organization.
- It consists of **consumers, market, intermediaries, competitors, suppliers**, etc. These are **specific** to the business & affect its working on a **direct & regular** basis.
- Within micro or immediate or task environment → we need to address the following issues: **MT: Competitors supply LEEF**
 - ✓ The **direct competition** and their comparative performance.
 - ✓ Who are **suppliers** & how are the links between the two being developed?
 - ✓ The **local community** within which the firm operates.
 - ✓ The **employees**, their characteristics and how they are organised.
 - ✓ The **existing customer base** on which the firm relies for business.
 - ✓ The ways in which the firm can raise its **finance**.
 - ✓ The **factors in micro environment** relate an **organization to the macro issues** influencing the way a firm reacts in the market place.

Macro Environment

It is the portion of environment that **affects** how organisation operates & is **beyond its direct control** and influence. It has broader dimensions as it consists of **economic, socio-cultural, technological, political and legal factors**.

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| Element of Macro Env. | Important Points |
|-----------------------|---|
| Political-Legal | <ul style="list-style-type: none"> ➤ It consists elements like- <ul style="list-style-type: none"> ✓ general level of political development, ✓ degree to which business & economic issues have been politicised, ✓ degree of political morality, ✓ state of law and order, ✓ political stability & ideology etc ➤ It is partly general to all similar enterprises & partly specific to an individual enterprise. ➤ A business has to consider changes in regulatory framework & their impact on business. Taxes and duties are also critical areas ➤ Businesses prefer a country with sound legal system. They must have a good working knowledge & understand the major relevant laws. ➤ Nationalism supports measures aimed at enhancing the position of a country in International business. Eg- Make in India and Aatmanirbhar Bharat. |



CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

| Element of Macro Env. | Important Points | | |
|-----------------------|---|----------------|---|
| Economic | <ul style="list-style-type: none"> ➤ Economic environment refers to the overall economic situation around the business. ➤ It determines strength and size of the market. ➤ The purchasing power in an economy depends on current income, prices, savings, credit availability etc. ➤ Here we find out effect of economic prospect, growth and inflation on operations of business. ➤ Higher interest rates are detrimental for businesses. In real estate market, they reduce ability of buyers to avail loan, thus lower the demand. ➤ The economic conditions of a nation refer to a set of economic factors that influence business. These include GDP, per capita income, markets, availability of capital, forex reserve, interest rates, disposable income, unemployment, inflation, etc. | Socio-Cultural | <ul style="list-style-type: none"> ➤ It includes factors such as social traditions, values and beliefs, level and standards of literacy, ethical standards & state of society, the extent of social stratification etc. ➤ It differs from demographics → it is not characteristics of population, but it behaviour & belief system of population. ➤ Socio-cultural environment consists of factors related to human relationships & impact of social attitudes and cultural values affecting operations of the organization. ➤ The core beliefs of a particular society tend to be persistent, which are difficult to change. Thus org. have to adjust to social norms and beliefs to operate successfully. |
| Demographic | <ul style="list-style-type: none"> ➤ Demographics are characteristics of a population in an area like- age, gender, income etc. ➤ It includes factors such as race, age, income, education, possession of assets, house ownership, etc. ➤ Marketers divide up populations based on their demographic makeup. Like- India has relatively younger population ➤ Org. need to address following issues related to demographic env: <ul style="list-style-type: none"> ✓ What demographic trends will affect market size? ✓ What demographic trends represent opp or threats? | Technological | <ul style="list-style-type: none"> ➤ Technology has changed the way people communicate, do things & ways of how businesses operate now. ➤ Technology and business are inter-linked and inter-dependent on one another. ➤ Technology has impacted on how businesses are conducted. <ul style="list-style-type: none"> ✓ reduce paperwork, ✓ schedule payments more efficiently, ✓ are able to coordinate inventories efficiently and effectively. ➤ This helps to reduce costs & shrink time and distance. ➤ The technological advancements require a business to drastically alter its operational, prod & marketing strategy ➤ Technology leads to new business opportunities & makes most of the existing business obsolete. ➤ Technology can act as opportunity → when business is able to adopt technological innovations ➤ Technology can also act as a threat → when business is not able to adopt new tech. |



CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

PESTLE Analysis

- Used for analysis of **macro** environmental factors.
- Advantage - encourages management into **proactive & structured thinking** in its decision making.
- PESTLE stands for-
 - ❑ P- Political → (how & to what extent government intervenes in economy & activities of business firms.)
 - ❑ E- Economic → (**interest rates, exchange rate, money supply, inflation, etc** have a bearing on business decisions)
 - ❑ S- Social → (affect **demand** of products & **how company operates**)
 - ❑ T- Technological → (can determine **barriers to entry, minimum efficient production level** and influence **outsourcing decisions**. It also includes **Intellectual property rights & copyrights**)
 - ❑ L- Legal → (affect **how a company operates**, its **costs**, and the **demand** for its products, **ease of business**)
 - ❑ E- Environmental → (affects industries such as **tourism, farming & insurance**. Growing awareness to **climate change** affects how org. operate - it is **creating new markets & destroying existing ones**)

Internationalization of Business

- Act of designing goods/services in a way **that facilitates expansion into international market**.
- It enables a business to **enter new markets** for **greater earnings & cheap resources**.
- Also, expanding internationally enables a business to **achieve greater economies of scale** and **extend the lifespan** of its products.

Characteristics of a global business

MT: ORS

- 1) **Conglomerate** of multiple units → **all linked by common ownership**.
- 2) Multiple units draw on a **common pool of resources**.
- 3) The units respond to some **common strategy**. Besides, its **managers and shareholders** are also based in **different nations**.

❖ The steps in international strategic planning are as follows-

MT: Reverse DOSE

- 1) **Evaluate global opp. & threats** → **rate them** with internal capabilities.
- 2) Describe the **scope** of the firm's global commercial operations.
- 3) Create firm's global business **objectives**.
- 4) Develop **distinct corporate strategies** for global business & whole org

❖ Why do businesses go global?

MT: DR ne CA SE GST ka Cost pucha

- 1) When **domestic** markets are no longer adequate.
- 2) Need for **reliable** or cheaper source of raw-materials.
- 3) The **collapse** of international trade barriers redefines the roles of state & industry → **increased privatization & less govt interference**.
- 4) Globalization has made cos. in different countries to form **strategic alliances** to **ward off** economic & technological **threats**.
- 5) The rise of **services** to constitute largest single sector in world.
- 6) When **exporting** organisations find foreign markets to **open up** → they open **overseas plants & branches** for **higher sales & cash flow**.
- 7) The need to **grow** is basic need of every org. **Finding opportunities** in **other parts of globe**.
- 8) There is rapid **shrinking** of time & distance across globe, because of **faster communication, speedier transportation** etc
- 9) Companies set up overseas plants to **reduce high transportation costs** → cheaper to produce near market.



CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

International Environment

- An **assessment of the external environment** is the first step toward internationalisation. It allows org. to **discover opportunities in the global market** and evaluate its feasibility.
- Assessments of international enviro. can be done at three levels:
 - 1) Multinational environmental analysis
 - ❑ It involves **identifying, anticipating, & monitoring** significant components of the global environment on a large scale.
 - ❑ **Governments** may have **free** or **interventionist tendencies**.
 - 2) Country environmental analysis
 - ❑ Study of **economic, legal, political, & cultural dimensions**
 - ❑ The analysis must be **customized** for each country to develop effective **market entrance strategies**.
 - 3) Regional environmental analysis
 - ❑ It emphasizes on **discovering market opportunities** for goods, or services in **chosen location (specific geographical area)**.

Understanding Product & Industry

Business products have certain characteristics as follows:

MT: P²UT Features

- 1) Product has a price
 - ✓ Org. determine **cost** of their products & charge a **price** for them.
 - ✓ **Demand & supply** and influence market price.
 - ✓ The market price is the price at which **quantity provided equals quantity desired**.
 - ✓ Price is determined by **market, quality, marketing** etc.

- 2) Product is **pivotal** for business.
 - ✓ Product → **centre** of business around which all activities revolve.
 - ✓ Product enables production, quality, sales, & other processes.
 - ✓ Product → **driving force behind business activities**.
- 3) A product has a **useful life**.
 - ✓ Every product has a **usable life after which** it must be **replaced**, & a **life cycle** after which it is to be **reinvented** or may cease to exist.
 - ✓ Eg- **fixed line telephone instruments** → **replaced by mobile phones**.
- 4) Products are either **tangible** or **intangible**.
 - ✓ **Tangible** product → **handled, seen, & physically felt** → car, book etc.
 - ✓ **Intangible** product → **not a physical good** → telecom service, banking, insurance etc
- 5) Products have certain **features** that deliver satisfaction.
 - ✓ A product feature is a **component** of a product that **satisfies a consumer need**.
 - ✓ Features determine product pricing, and businesses **alter features** during development process to **optimise the user experience**.
 - ✓ Products should **provide value satisfaction** to customers.
 - ✓ Features of the product will **distinguish** it in terms of its **function, design, quality** and **experience**.
 - ✓ A customer's **cumulative experience** from purchase to end is imp.

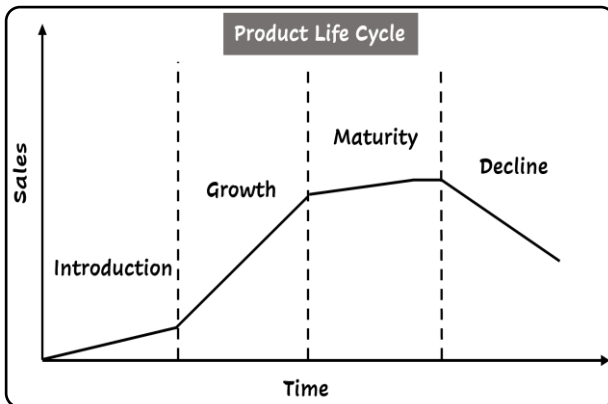
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CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

Product Life Cycle (PLC)

PLC is an **S-shaped curve** → shows **relationship** of **sales** with respect of **time**.
A product passes through **four successive stages**.

1st PhaseIntroduction Stage
(slow sales growth)

- competition → negligible,
- prices → high, and
- markets → limited.
- Growth in sales → lower rate because of lack of awareness of customers.

❑ The main advantage of PLC approach → used to **diagnose a portfolio of products/businesses** → to **establish stage** at which each of them exists.

For eg-

- ✓ **Expansion** → for businesses in the introductory & growth stages.
- ✓ **Mature businesses** → **used as sources of cash** for invt in other businesses
- ✓ A **combination** of strategies like **selective harvesting**, **retrenchment**, etc. may be adopted for declining businesses.

❖ Value Chain Analysis (Given by Michael Porter)

- Value chain analysis is a method of **examining each activity** in value chain of a business in order to **identify areas** for **improvements**.
- When you do a value chain analysis, you must analyse how each stage in the process **adds or subtracts value** from the end product or service.

| 2 nd Phase | 3 rd Phase | 4 th Phase |
|---|---|---|
| Growth Stage (rapid market acceptance) | Maturity Stage (slowdown in growth rate) | Decline Stage (sharp downward drift in sales) |
| <ul style="list-style-type: none"> ➤ demand expands rapidly, ➤ prices fall, ➤ competition increases, ➤ market expands. ➤ Customer has knowledge about the product and shows interest in purchasing it. | <ul style="list-style-type: none"> ➤ the competition gets tough, ➤ market gets stabilised. ➤ Profit comes down because of stiff competition. ➤ Organisations have to work for maintaining stability | <ul style="list-style-type: none"> ➤ Sales & profits fall down sharply due to some new product replaces existing product. ➤ Combination of strategies can be implemented to stay in market either by diversification or retrenchment. |





CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

- Value chain analysis is used to **improve the sequence of operations**, **enhancing efficiency** and **create a competitive advantage**.
- Originally introduced as an **accounting analysis**
- The two basic steps of-
 - **identifying** separate **activities**, and
 - assessing the **value added** from each were **linked** to an analysis of an org.'s **competitive advantage**.

Primary Activities

| Inbound logistics | Operations | Outbound logistics | Marketing and sales | Services |
|---|---|---|---|--|
| <p>These are the activities concerned with</p> <ul style="list-style-type: none"> • receiving, • storing and • distributing <p>the inputs to product/service</p> <p>This includes materials handling, stock control, transport etc.</p> <p>Like, transportation and warehousing.</p> | <p>Operations transform these inputs into the final product-</p> <ul style="list-style-type: none"> • machining, • packaging, • assembly, • testing, etc. <p>Convert raw materials in finished goods.</p> | <p>It involves-</p> <ul style="list-style-type: none"> • collecting, • storing & • distributing <p>the product to customers.</p> <p>For tangible products→</p> <ul style="list-style-type: none"> • warehousing, • materials • handling, • transport, etc. <p>For services → arrangements for bringing customers to service, if it is a fixed location (eg- sports event)</p> | <p>It provides the means whereby consumers are made aware of the product & are able to purchase it.</p> <p>This would include</p> <ul style="list-style-type: none"> • sales • administration, • advertising, • selling etc. <p>In public services, communication networks which help users' access a particular service are often important.</p> | <p>Services are all those activities, which</p> <ul style="list-style-type: none"> • enhance or • maintain <p>the value of a product,</p> <p>Such as-</p> <ul style="list-style-type: none"> • installation, • repair, • training • spares. |

Support Activities

| Procurement | Technology development | Human resource management | Infrastructure |
|--|---|--|--|
| <p>Refers to processes for acquiring the various resource inputs to primary activities.</p> <p>As such, it occurs in many parts of the organization</p> | <p>All value activities have a 'technology', even if it is simply know-how. The key technologies are concerned with-</p> <ul style="list-style-type: none"> • product (R&D product design) • processes (process development) • particular resource (raw materials improvements) | <p>It is an area which transcends all primary activities.</p> <p>It involves activities like</p> <ul style="list-style-type: none"> • recruiting, • managing, • training, • developing • rewarding people | <p>The systems of</p> <ul style="list-style-type: none"> • planning, • finance, • quality control, • information mgt <p>are important to an org's performance in its primary activities.</p> <p>It also consists of structures & routines of org. which sustain its culture.</p> |



CHAPTER 2 – STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

Industry Environment Analysis

Porter's Five Forces Model

- It is a way for-
 - ✓ determining **key sources of competition**.
 - ✓ diagnosing **competitive pressures** & **assess strength & importance**.
- Understanding the variables that affect industry helps to **adapt strategy**, **boost profitability**, and **stay ahead of competition**.
- The model holds that the **state of competition** in an industry is a **composite** of competitive pressures operating in **five areas**-
Competitive pressures associated with-
 - 1) market manoeuvring & jockeying for buyers → **among rival sellers**.
 - 2) **threat of new entrants** into the market.
 - 3) attempts of companies in other industries to win buyers over to their own **substitute products**.
 - 4) **supplier bargaining power** & **supplier-seller collaboration**.
 - 5) **buyer bargaining power** & **seller-buyer Collaboration**.
- Steps to determine what how competition is like, using 5 forces:
 - ✓ **Step 1:** Identify **specific competitive pressures** associated with each of five forces.
 - ✓ **Step 2:** Evaluate **how strong the pressures are** (fierce, strong, moderate to normal, or weak).
 - ✓ **Step 3:** Determine whether the **collective strength** of 5 forces is **conducive to earning attractive profits**.

I. The Threat of New Entrants

- New entrants can **reduce industry profitability** because they **add new production capacity** leading to an **increase supply** even at a **lower price** and can erode existing firm's market share position & profitability.
- **Bigger the new entrant**, the **more severe the competitive effect**.
- ❑ To discourage new entrants, existing firms can try to **raise barriers to entry**. Common barriers to entry include-
MT: BAD SPEC
 - 1) **Brand Identity**
 - New entrants often find difficulties in building up brand identity → **require substantial resources over a long period**.
 - 2) **Access to distribution channels**
 - The **unavailability of distribution channels** → **entry barrier**.
 - Existing firms have **influence over their distribution channels** & can **impede their use by new firms**.
 - 3) **Product differentiation**
 - **Physical or perceptual differences**, that makes a **product unique** in eyes of customers. Entry barriers as **cost** of creating **genuine differences** may be **too high**.
 - 4) **Switching costs**
 - To succeed → new entrant must **persuade existing customers** of other companies to **switch to its products**.
 - To make a switch, buyers may need to-
 - ✓ **Test, negotiate, train personnel, modify facilities**.
 - Buyers incur **substantial financial & psychological costs**.
 - When **switching costs** are **high** → **buyers reluctant to change**.



CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

5) Possibility of aggressive retaliation by existing players

- Sometimes mere **threat of retaliation** → **deter entry** of new entrants. **Incumbents firms** may **reduce product prices** & **increase their advertising budgets**.

6) Economies of scale

- Large firm enjoys economies of scale can produce **high volumes** at **lower costs** → **discouraging new entrant**.

7) Capital requirements

- When a large amount of capital is required to enter an industry, new **firms lacking funds** are **barred** from entering.

II. Bargaining Power of Buyers

- This force becomes heavier → if **buyers form groups**.
- Users of **industrial products come together** & exert pressure on producer
- The bargaining power of the buyers influences-
 - ✓ the **prices** that producer can charge &
 - ✓ **costs** & **investments** of producer
- This force is particularly evident when:
 - a) Buyers have **full knowledge** of **sources of products** & **their substitutes**.
 - b) They spend a **lot of money** → they are **big buyers**.
 - c) The industry's product is **not perceived as critical** to the buyer's needs & **buyers are more concentrated** than sellers. They can **easily switch** to the **substitutes available**.

III. Bargaining Power of Suppliers

- The **more specialised the offering** from supplier, **greater is his clout**.
- This force **determines the cost of raw materials** and **other inputs** & thus, the industry's **attractiveness and profitability**.
- ❑ Suppliers can command bargaining power over a firm when:
 - a) Their **products are crucial to buyer** & **substitutes are not available**.
 - b) They can **erect high switching costs**.
 - c) They are **more concentrated than their buyers**.

IV. The Nature of Rivalry in the Industry (Existing Competitors)

- This force affects **industry's attractiveness** and **profitability**.
- It influences **costs of suppliers, distribution, attracting customers** & **profitability**.
- The **more intensive the rivalry**, the **less attractive is industry**.
- ❑ Rivalry tends to be **cutthroat** & **industry profitability low** when:
 - 1) **Fixed Costs**: When **rivals operate** with **high fixed costs**, they feel strong motivation to **utilize their capacity** and thus **cut prices** when they have **excess capacity**.
 - 2) **Industry Leader**: can **discourage price wars** by **disciplining initiators**.
 - 3) **Number of Competitors**: Ability to exert **pricing discipline diminishes** with **increased number of rivals**
 - 4) **Exit Barriers**: Rivalry declines if some competitors leave industry. **Profitability is higher** in industries with **few exit barriers**. **Assets** of a firm considering exit may be **highly specialized** & of little value to others → thus find **no buyer for its assets**. This **discourages exit**.



CHAPTER 2 – STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

- 3) **Product Differentiation**: Firms sometimes **insulate themselves from price wars** by **differentiating** their products. **Profitability** is **lower** in industries involving **undifferentiated products**.
- 4) **Slow Growth**: As industry growth slows, rivals **fight harder to grow** or keep existing market share → leading to **reducing profitability for all**.

V. Threat of Substitutes

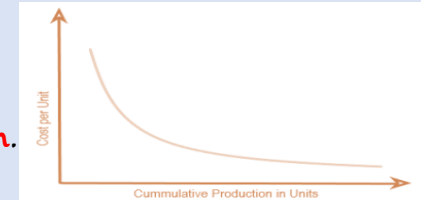
- Substitute products are a **latent source of competition**.
- Substitute products offering a **price advantage** or **performance improvement** can **drastically increase competition**.
- For eg- **coir suffered at the hands of synthetic fibre**.
- Wherever substantial **investment in R&D** is taking place, threats from substitute products can be expected.
- Substitutes, usually **limit the prices & profits**.
- **To predict profit pressure** from this source, firms must **search for products** that **perform the same function** as their **existing products**.
- For eg- **Real estate, insurance, bonds & bank deposits** are substitutes for **common stocks** → alternate ways to invest funds.

Attractiveness of Industry

- If an industry's **overall profit prospects** are **above average**, the industry can be considered **attractive** & vice-versa.
- However, **attractiveness is relative, not absolute**.
 - ✓ Industry is **unattractive** to **weak competitors**, &
 - ✓ may be **attractive** to **strong competitors**.

Experience Curve (EC)

- Experience curve is **similar to learning curve** which explains the **efficiency gained by workers through repetitive productive work**.
- EC is based on phenomenon that **unit costs decline** as firm **accumulates experience** in terms of **cumulative volume of production**. It is based on the concept, "**we learn as we grow**".
- The implication is that **larger firms** in an industry would tend to have **lower unit costs** as compared to those for smaller companies, thereby gaining a **competitive cost advantage**.
- Experience curve results from a variety of factors such as-
 - ✓ **learning effects**,
 - ✓ **economies of scale**,
 - ✓ **product redesign** and
 - ✓ **technological improvements in production**.
- Experience curve has following features:
 - ✓ As business organisation **grow**, they **gain experience**.
 - ✓ Experience provides **advantage over competition**.
 - ✓ Experience is a **key barrier to entry**.
 - ✓ **Large & successful org.** possess **stronger "experience effect"**.

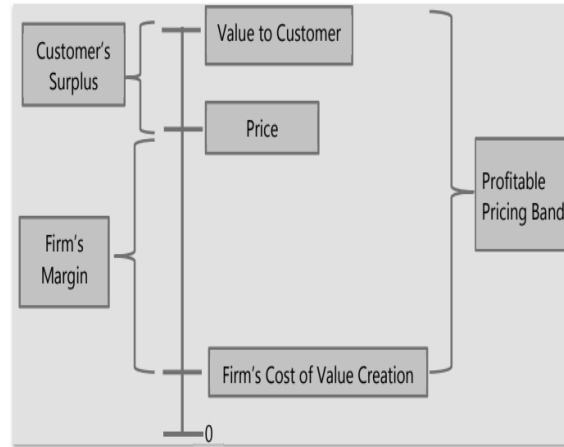


Value Creation

- Value creation is an **activity or performance** by which a firm tries to **create value** that **increases the worth of goods & services**.
- Value is measured by a **product's features, quality, availability, durability, performance & services** for which customers are **willing to pay**.

CHAPTER 2 – STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

- Many businesses focus on value creation both in the context of-
 - 1) **creating better value for customers**, &
 - 2) for **stakeholders** → want their investment to appreciate in value.
- Thus, value consumer **wants to pay**, over & above **price that business wants to charge**. This excess amount is value creation.



Business Orientation

- The orientation of product marketing has evolved and acquired different dimensions. Businesses that have-
 - 1) **Product orientation** → buyers will **choose those products** that have the **best quality, performance, design, or features**.
 - 2) **Production oriented businesses** → believe that **customers choose low price products**.
 - 3) **Sales-oriented businesses** → believe that if they spend **enough money on advertisement, sales and promotion**, customers can be persuaded to make a purchase.
 - 4) In a **customer or market-oriented approach** strategists **prioritise efforts on their customers**. A customer-centric business is one that **continuously learn from its customers' needs and market dynamics**.

Customer

- **Customers** are the people who **actually pay** money to buy products. Customers **may or may not** be a **consumer**.
- **Consumer** is the one who **ultimately consumes** or uses the product. Eg- A father buys a chocolate (as a customer) for his daughter who will be a consumer.

❖ Consumer behaviour may be influenced by a number of things. These elements are in following **three conceptual domains**:

- 1) **External Influences**: Like **advertisement, peer recommendations** have **direct impact** on **psychological & internal processes**. These aspects are divided into **two groups** –
 - ✓ the **company's marketing efforts** and
 - ✓ the **numerous environmental elements**.
 - 2) **Internal Influences**: **Psychological factors internal to customer**.
 - 3) **Decision Making**: A rational consumer takes in the following way.
 - ✓ **Problem recognition**, i.e., identify an existing need or desire that is unfulfilled
 - ✓ **Search for desirable alternative** and list them
 - ✓ **Seeking information** on available alternatives and **weighing their pros and cons**.
 - ✓ **Make a final choice**
- The above mostly applies during **significant purchases** → like when product has a significant influence on their **health or self-image**. Eg car, television or refrigerator in contrast to purchase of ice creams or soft drinks.



CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

Post-decision Processes

- After making a decision & purchasing a product → **final phase** in decision-making process is **evaluating the outcome**.
- The **consumer's reaction** may vary depending upon the **satisfaction**.
- A **happy customer** may make **repeat purchase & recommend to others**, while
- A customer with **dissonance** will **neither purchase product again nor recommend to others**

Competitive Landscape

- Competitive landscape is about-
 - ✓ **identifying & understanding the competitors** and
 - ✓ it **involves understanding of their vision, mission**, values, strengths & weaknesses.
- Understanding of competitive landscape requires an application of "**competitive intelligence**"

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Steps to understand the competitive landscape

- 1) Identify the competitor
& **have actual data** about their **respective market share**.
- 2) Understand the competitors
Once the competitors have been identified, the strategist can use **market research report, internet, newspapers, social media**, industry reports, and various other sources to understand the products and services offered by them in different markets
- 3) Determine the strengths of the competitors
What is the **strength** of the competitors?
What do they **do well**? Do they offer **great products**?
Do they utilize **marketing** in a way that comparatively reaches out to more consumers?
Why do **customers give them their business**?
- 4) Determine the weaknesses of the competitors
Weaknesses (and strengths) can be identified by going through **consumer reports** and **reviews** appearing in various media.
Consumers are often willing to give their opinions, when the products are either **great** or **very poor**.
- 5) Put all of the information together
Strategist should put together all information about competitors and **draw inference** about-
 - ✓ what they are **not offering** and
 - ✓ what the **firm can do to fill in the gaps**.
 The strategist can also know **areas** which need to be **strengthen**.

Key Success Factors (KSFs)

- An industry's KSFs → things that most **affect industry members' ability to prosper in the market-place**.
- KSFs include, cost structure, technology, distribution system etc.
- KSFs help to shape whether co. will be **financially & competitively successful**
- ❑ The answers to three questions help identify an industry's key success factors:
 - 1) On what **basis** do customers **choose between competing brands**? What **attributes are crucial**?
 - 2) What **resources & competitive capabilities** does a seller need to have?
 - 3) What does it take to achieve a **sustainable competitive advantage**?
- KSF vary from industry to industry and even from time to time

CA Intermediate – New Syllabus



FM & SM
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SM Chapter 3

Strategic Analysis : Internal Environment

By CA Mohnish Vora (MVSIR)

Become a CA not just for yourself, but for your family. You are bound to be successful.



CHAPTER 3 – STRATEGIC ANALYSIS: INTERNAL ENVIRONMENT

Internal environment

➤ It refers to the sum total of-

- 1) people
- 2) processes
- 3) physical infrastructure
- 4) administrative apparatus
- 5) organizational culture

➤ It is **specific to each organization** & is based on its **structure & business model**

Notes

Understanding Key Stakeholders

➤ All those individuals/entities who **have**
 ✓ **a stake (interest) in org.'s success** and/or
 ✓ have **power to influence strategy** or **performance** of organization are stakeholders

➤ It is important to identify the key stakeholders.

Mendelow's Matrix (aka. Stakeholder Analysis matrix or Power-Interest matrix)

Aka. Stakeholder Analysis matrix or Power-Interest matrix → **framework** to help **manage key stakeholders**.

Steps to make Mendelow's Matrix

1. **Identify Stakeholders:** Begin by identifying all relevant stakeholders. Eg- individuals or groups that **may be impacted** by or **have an impact** on your activities.

2. **Assess Power and Interest:** For each stakeholder-

- ✓ Power can be assessed on- **authority resources & expertise**
- ✓ Interest can be assessed on- **level of involvement, expectations & potential benefits/risks**

3. **Plot Stakeholders on the Grid:** Create a grid with

4. Interest on X axis & Power on Y axis

Plot each stakeholder on grid based on your assessment.

4. **Develop Strategies for each Quadrant:**

Based on the placement of stakeholders in the grid, develop strategies for each quadrant:

- **Key Players:** **Fully engage** with them, **seek their input**, and keep them **informed**.
- **Keep Satisfied:** Provide them **regular updates** & **address their concerns** to **prevent** them from becoming **detractors**.
- **Keep Informed:** Keep them informed to ensure they **remain supportive** & to **leverage their insights** and feedback.
- **Low Priority:** **Monitor** them for any **changes** but **allocate minimal resources** to managing their expectations.

5. **Monitor and Adapt:** Continuously monitor power & interest of stakeholders and adjust strategies accordingly. Stakeholders **may move between quadrants** based on changing circumstances, so it's important to remain **flexible** and **responsive**



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Strategic Drivers

- In assessing current performance of business, **strategic drivers** consider what **differentiates** an organisation from its competitors.
- In general, the key strategic drivers of an organisation include:
 - I. Industry and markets
 - II. Products/services MT: IPCC
 - III. Customers
 - IV. Channels

I) Industry and Markets

- Group of companies in **similar type of business** are **grouped together** into **industries**.
- A **market** is defined as the **sum total of all the buyers and sellers** in the area or region under consideration.
 - **Value, cost and price** → determined using **supply & demand** in a market.
 - It may be **physical** or **virtual**.
 - It may be **local** or **global**.

❖ Is market the same for all businesses?

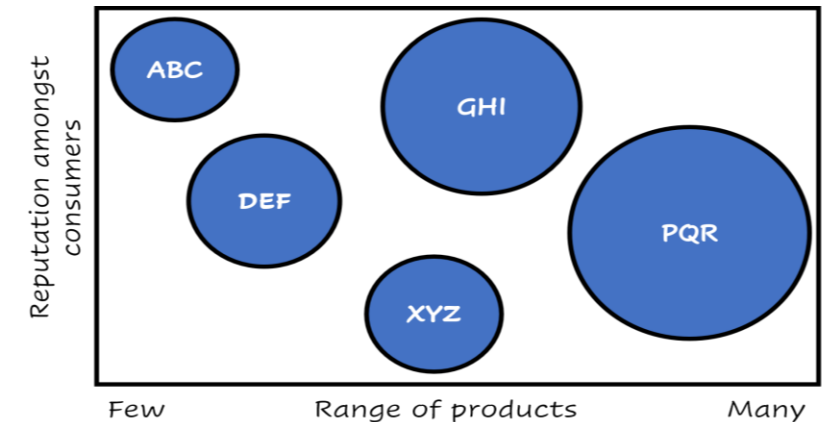
- No, each business has its **own set of customers** i.e. market & **each product within a business** has its **own market**.

Strategic Group Mapping

- A **strategic group** consists of those **rival firms** which have **similar competitive approaches** and positions in the market.
- A tool to study the **market positions of rival companies** by grouping them into like positions is **strategic group mapping**.

Procedure for constructing a SGM-

- 1) **Identify competitive characteristics** that differentiate firms in industry. Variables are-
 - ✓ **price/quality range** (high, medium, low);
 - ✓ **geographic coverage** (local, region, national, global)
 - ✓ degree of **vertical integration** (none, partial, full);
 - ✓ product-line **breadth** (wide, narrow) etc.
- 2) **Plot** the firms on a **two-variable map** using pairs of these differentiating characteristics.
- 3) **Assign** firms that **fall in same strategy**, space to the same strategic group.
- 4) **Draw** circles around **each strategic group**, making circles **proportional to size** of group's **respective share of total industry sales** revenues.



Explanation of Diagram (Strategic Group Mapping)



CHAPTER 3 – STRATEGIC ANALYSIS: INTERNAL ENVIRONMENT

II) Product/Services

For a new product, **pricing strategies** for entering a market need to be designed & at least three objectives must be kept in mind:

- ✓ Have **customer-centric approach** while making a product.
- ✓ Produce **sufficient returns** through a **reasonable margin** over cost.
- ✓ **Increasing market share.**

Marketing is considered to be the activities related to identifying the needs of customers and taking such actions to satisfy them in return of some consideration. The term marketing constitutes different processes, functions, exchanges and activities that create perceived value by satisfying needs of individuals.

| Marketing Strategies | | Meaning | Example |
|----------------------|------------------------|---|--|
| 1 | Social Marketing | Design, implementation, & control of programs → increase acceptability of social idea or practice among a target group to bring in a social change . | Campaign for prohibition of smoking in Delhi . |
| 2 | Augmented Marketing | Additional customer services & benefits → besides core product . Such innovative offerings → elevate customer service | Hi-tech services like movies on demand, online computer repair services etc. |
| 3 | Direct Marketing | Marketing through various media to interact directly with consumers , → calling for direct response . | Catalogue selling, e-mail , telecomputing, electronic marketing, TV shopping etc. |
| 4 | Relationship Marketing | Creating, maintaining, & enhancing strong, value-laden relationships with customers & other stakeholders. Providing special benefits to select customers to strengthen bonds & build relationships . | Airlines offer special lounges at major airports for frequent flyers |
| 5 | Services Marketing | Applying concepts of marketing to services. Services → peculiar characteristics like intangible, inseparability, variability | Hotel - offering free nights to first time guests. |
| 6 | Person Marketing | It consists of activities → create, maintain or change attitudes and behaviour towards particular person . | politicians, sports stars, film stars , etc. i.e., market to get votes, or promote careers. |



CHAPTER 3 – STRATEGIC ANALYSIS: INTERNAL ENVIRONMENT

| Marketing Strategies | | Meaning | Example |
|----------------------|---------------------------------|--|--|
| 7 | Organisation Marketing | It consists of activities → create, maintain or change attitudes and behaviour towards an organization . | Patanjali – chemical free, swadeshi brand Fevicol – The Ultimate Bond |
| 8 | Place Marketing | It consists of activities → create, maintain or change attitudes and behaviour towards particular places say, marketing of business sites, tourism marketing . | Rajasthan – Padharo Maare Des Gujarat Tourism – Amitabh Bacchan Ads |
| 9 | Enlightened Marketing | It is a marketing philosophy holding that a company's marketing should support the best long-run performance of the marketing system that is beyond the prevailing mindset | Its five principles include – 1) value marketing, 2) innovative marketing, 3) customer-oriented marketing, 4) sense-of-mission marketing, 5) societal marketing. <div>MT: VICS²</div> |
| 10 | Differential Marketing | It is a market-coverage strategy in which a firm decides to target several market segments & designs separate offer for each . | HUL has Lifebuoy & Lux in popular segment and Dove & Pears in premium segment |
| 11 | Synchro-marketing | When the demand for a product is irregular due to season, some parts of the day, or on hour basis, causing idle capacity or overworked capacities , synchro-marketing can be used to find ways to alter the pattern of demand through flexible pricing, promotion, and other incentives . | Movie tickets can be sold at lower price over weekdays to generate demand Happy Hours – McDonald |
| 12 | Concentrated Marketing | It is a market-coverage strategy in which a firm goes after a large share of one or few sub-markets . It can also take the form of Niche marketing . | Tesla, Rolls Royce |
| 13 | Demarketing (Reverse Marketing) | Marketing strategies to reduce demand temporarily or permanently . The aim is not to destroy demand, but only to reduce or shift it . This happens when there is overfull demand . | Buses are overloaded in the morning and evening, roads are busy for most of times, Zoological parks are over-crowded on Saturdays, Sundays and holidays. Here demarketing → applied to regulate demand. |



CHAPTER 3 – STRATEGIC ANALYSIS: INTERNAL ENVIRONMENT

III. Customers

- Different customers may have different needs and require different sales models or distribution channels.
- As customers are often responsible for generation of profits obtained by an organisation, it is important to be able to collect and display data in order to show customer trends & profitability.
- Customer is the one who buys a product/service (imp from pricing perspective)
- Consumer is the one who finally uses/consumes it. (imp from value creation & design/usability)

IV. Channels

- Channels are distribution system by which an org. distributes its products/services.
 - The wider and stronger the channel the better position a business has to fight and win over competition. There are typically three channels
- 1) The sales channel
 - ✓ The intermediaries involved in selling product through each channel & ultimately to the end user.
 - 2) The product channel
 - ✓ It focuses on the series of intermediaries who physically handle the product on its path from its producer to the end user.
 - 3) The service channel
 - ✓ It refers to entities that provide necessary services to support the product, as it moves through the sales channel and after purchase by the end user.
 - ✓ Important for complex products → installation or customer assistance.

Role of Resources & Capabilities: Building Core Competency

Core competence

- ✓ unique strength of org. which may not be shared by others.
- ✓ They are capabilities → critical for achieving comp. adv.
- ✓ The competency should differentiate business from other similar businesses.
- As per, C.K. Prahalad & Gary Hamel,
- ✓ Core competency → collective learning in org → coordinating diverse production skills & integrating multiple streams of technologies.
- Competency → combination of skills & techniques
- Core competencies cannot be built on one capability → it has to be integration of many resources → sum of 5- 15 areas of expertise.

As per Prahalad & Hamel, major core competencies are in 3 areas

1) Competitor differentiation

MT: CCM

- A co. has core competence if competence is unique and it is difficult for competitors to imitate.
- It provides co. an edge compared to competitors.
- Co. has to keep on improving these skills in order to sustain
- Although all cos. may have equal skills → but if one co. can perform this significantly better → co. has core competence.
- For eg, difficult to imitate patented innovation → Tesla electric vehicles.



CHAPTER 3 – STRATEGIC ANALYSIS: INTERNAL ENVIRONMENT

2) Customer Value

- When purchasing a product → has to deliver a **fundamental benefit** to end customer.
- It includes all **skills** needed to provide fundamental benefits. The product has to have **real impact** on customer as reason to choose to purchase them.
- Consumer should **value the differentiation offered**.

3) Application of Competencies to other markets

- Core competence must be applicable to **whole** org.; it **cannot be only one particular skill** or specified area of expertise.
- Hence, a core competence is a **unique set of skills & expertise**, which will be used throughout org. to **open up potential markets** to be exploited.

Other Imp Points – Core Competency

- A core competency is whatever a firm does best
- ✓ For eg: **WalMart** focuses on **lowering its operating costs**. Thus able to **price goods lower than most competitors**. Core competency here is co.'s **ability to generate large sales volume**

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Criteria for building a Core Competencies (CC)? **MT: VRCN**

4 specific criteria of sustainable competitive advantage that firms can use to determine those capabilities that are core competencies.

| | | |
|---|-------------------|---|
| 1 | Valuable | Valuable capabilities → allow firms to exploit opportunities or avert threats . A firm creates value by effectively using capabilities to exploit opportunities . Finance companies → placing the right people in the right jobs . |
| 2 | Rare | Core competencies → rare capabilities → few of competitors possess this . Comp. adv. → only when firms develop capabilities that differ from others . |
| 3 | Costly to Imitate | Such capabilities that other firms → unable to develop easily . For eg, Intel has first-mover advantage → rare fast R&D cycle time . |
| 4 | Non substitutable | Capabilities that do not have strategic equivalents are called non-substitutable capabilities. The strategic value of capabilities increases as they become more difficult to substitute . Eg- Tata's low-cost strategy → most were unable to duplicate . |

Sustainability of Competitive Advantage

- Competitive advantage is the position of a firm to maintain & sustain a favorable market position when compared to competitors.
- Comp. adv. → if profitability is higher than average profitability in industry.
- Sustainability of competitive advantage & firm's ability to earn profits from its competitive adv. depends upon 4 characteristics of resources & capabilities: **MT: DATI**

| | | |
|---|------------|--|
| 1 | Durability | <ul style="list-style-type: none"> ➤ The period over which a competitive advantage is sustained depends on the rate at which a firm's resources and capabilities deteriorate. ➤ If rate of product innovation is fast → product patents become obsolete. ➤ Capabilities depending on expertise of CEO → vulnerable to his departure. |
|---|------------|--|



CHAPTER 3 - STRATEGIC ANALYSIS: INTERNAL ENVIRONMENT

| | | |
|---|-----------------|---|
| 2 | Appropriability | <ul style="list-style-type: none"> ➤ Ability of firm's owners to appropriate returns on its resource base. ➤ This means, that rewards are directed to - from where funds were invested. |
| 3 | Transferability | <ul style="list-style-type: none"> ➤ Ability of rival to gain access to necessary res & capabl (R&C) ➤ The easier it is to transfer R & C between cos → the less sustainable will be competitive advantage. |
| 4 | Imitability | <ul style="list-style-type: none"> ➤ If R&C cannot be purchased → then must built from scratch. ➤ How easily & quickly can competitors build R&C? ➤ This is the true test of imitability. ➤ For eg, in financial services, innovations lack legal protection and are easily copied. |

SWOT analysis

- Benefit- identifies complex issues & uses a simple framework.
- Criticism- Does not provide for evaluation of SWOT
- Purpose → enable mgt. to create firm-specific business model that will best align with org. R&C to demands of environment.
- Key reasons for SWOT analyses are: **MT: LIC**
 - 1) It provides a logical framework.
 - 2) It guides the strategist in strategy identification.
 - 3) It presents a comparative account.

Michael Porter's Generic Strategies (Business Level Strategies)

- 1) Cost Leadership- standardized products at low cost for price-sensitive consumers
- 2) Differentiation- unique products for price-insensitive consumers.
- 3) Focus- Products that fulfil needs of small groups of consumers with very specific taste.

- These are termed generic → can be pursued by any type/size of business & even by NPOs.

- ✓ Larger firms with greater resources → use cost leadership &/or diff.
- ✓ Smaller firms compete on a focus basis.

COMPETITIVE SCOPE

Broad Target
Narrow Target

| | |
|--------------------------|--------------------------|
| Cost Leadership | Differentiation |
| Focussed Cost Leadership | Focussed Differentiation |

Low-Cost products/services
Differentiated products/services

COMPETITIVE ADVANTAGE

| SWOT ANALYSIS | Helpful to achieving the objective | Harmful to achieving the objective |
|--|---|--|
| Internal origin (attributes to Organisation) | Strength → inherent capability → use to gain strategic advantage. | Weakness → inherent limitation → creates strategic disadvantage to it. |
| External origin (attributes to Environment) | Opportunity → favourable condition in external env. → strengthen its position | Threat → unfavourable condition in external env → causes risk or damage to org.'s position |

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I. COST LEADERSHIP STRATEGY

Striving to be a low-cost producer in an industry can especially be effective, when

MT: Large PDF

- 1) **Large number of buyers** with **significant bargaining power**.
- 2) market has **many price-sensitive buyers**,
- 3) buyers **do not care much about differences** from brand to brand
- 4) **Few ways to achieve product differentiation**.

The basic idea → **underprice competitors & gain market share** driving competitors out of market.

Advantages of Cost Leadership

- 1) **Rivalry**: Competitors **avoid price war** → low-cost firm will earn profit even after lower price.
- 2) **Buyers**: **Powerful buyers** would **not be able to exploit** cost leader & will continue to buy.
- 3) **Suppliers**: Cost leaders are **able to absorb greater price increases from suppliers**
- 4) **Entrants**: Cost leaders **create barriers to entry** through continuous focus on **efficiency**.
- 5) **Substitutes**: Low-cost leaders are **likely to lower costs** to induce existing customers to stay with their products, **invest in developing substitutes**, and **purchase patents**.

Achieving Cost Leadership Strategy

MT: ROSE FC

- 1) **Resistance to differentiation** till it becomes **essential**.
- 2) **Optimum utilization** of resources.
- 3) **Standardization** of products for **mass production** to yield lower cost per unit.
- 4) Achieving **economies of scale** → **lower per unit cost** of product.
- 5) Prompt **forecasting of demand** of a product
- 6) **Invest in cost saving technologies** & using **advance technology** for efficient working.

Risks of pursuing cost leadership

MT: BIT

- 1) **buyer interests may swing** to other differentiating features besides price.
- 2) competitors may **imitate strategy** → overall industry profits down;
- 3) **technological break throughs** in industry → make strategy **ineffective**

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Disadvantages of Cost Leadership

MT: LEST

- 1) Cost advantage **may not last long** when competitors **imitate cost reduction techniques**.
- 2) Cost leaders keep costs low by **minimizing cost of advertising**, market **research**, R&D → but this can be **expensive in long run**.
- 3) Cost leadership can succeed only if → firm achieve **higher sales volume**.
- 4) **Technological advancement** are a great threat to cost leaders.

Notes



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II. DIFFERENTIATION STRATEGY

- It is aimed at **broad mass market** & involves **creation of a product** that is **perceived** by customers as **unique**.
- It allows firm to **charge higher price** & **gain customer loyalty** → consumers become **strongly attached**
- Pursued only after **careful study of buyers' needs** to determine **feasibility**

Differentiation does not guarantee competitive advantage, if-

- ✓ **standard products** sufficiently **meet customer needs** or
- ✓ if **rapid imitation** by competitors is possible.

Basis of Differentiation

1) Product

MT: POP

Innovative products lead to competitive advantage. But, it can be **costly** - **R&D, production & marketing costs**. But can have big **payoff** → if customer's flock to **first to have new product**.

For eg, Apple iPhone → invested huge money in R&D, & customers' value that.

2) Organisation

- **Maximizing power of a brand** or
 - Using **specific advantages**-
 - ✓ **Location adv., name recognition, customer loyalty**
- can provide additional ways for differentiation
For eg, Apple → building customer loyalty & has a fanbase → "Apple Fanboys/Fangirls".

3) Pricing

It **fluctuates** based on **supply & demand**; & also influenced by customer's **ideal value** of product. Cos. that differentiate based on price can either-

- ✓ **offer lowest price** or
- ✓ **establish superiority** through higher prices.

For eg, Apple dominates smart phone segment by charging **higher prices** for its products.

Risks associated with pursuing a differentiation strategy

- 1) Unique product **may not be valued high enough** to justify high price.
- 2) **Competitors** may **copy** differentiating features quickly. Firms must find **durable sources** of uniqueness.

Achieving Differentiation Strategy

MT: EQUIP²

- 1) Taking steps for **enhancing brand image & value**.
- 2) Offer **high-quality** product.
- 3) Offer **utility** to customers & **match products with tastes**.
- 4) **Improve performance**.
- 5) **Fixing prices** based on **unique features & buying capacity**.
- 6) **Rapid product innovation** to keep up with dynamic env.

Disadvantages of Differentiation

- 1) In long term, **uniqueness** is **difficult to sustain**.
- 2) Charging too high price → customer may **switch**.
- 3) Differentiation fails to work if its basis is something that is **not valued** by customers.

Advantages of Differentiation

- 1) **Rivalry** - **Brand loyalty** acts as a **safeguard** against competitors → customers will be **less sensitive to price increase**.
- 2) **Buyers** - They **do not negotiate for price** → get **special features** & have **fewer options**.
- 3) **Supplier** - Differentiators charge a premium price → **can absorb higher costs of supplies**.
- 4) **Entrants** - Innovative features are an **expensive** offer. So, **new entrants generally avoid these**.
- 5) **Substitutes** - Substitute products **can't replace differentiated products** which have **high brand value** and enjoy **customer loyalty**.



CHAPTER 3 - STRATEGIC ANALYSIS: INTERNAL ENVIRONMENT

III. FOCUSSED STRATEGY

Successful focus strategy depends on industry segment that -

- ✓ is of **sufficient size**,
- ✓ has good **growth potential**, and
- ✓ is **not crucial to success** of other major competitors.

Focused cost leadership

- Competing based on **price** to **target a narrow market**.
- Here, a firm **does not charge lowest prices** → Instead, it charges **low prices relative to other firms**.

Focused differentiation

- Compete based on **uniqueness** - **target narrow market**.
- Some firms focus on **particular sales channel**, like **selling over internet only**. Others may target particular **demographic group**.
- For eg, Rolls-Royce → limited high-end, custom-built cars.

Risks of pursuing Focus

- 1) Possibility of **competitors recognizing** successful focus strategy & **imitating it**,
- 2) Consumer **preferences may drift** towards attributes **desired by market** as a whole.

Achieving Focused Strategy

MT: NEWS

- 1) **Selecting specific niches** which are not covered by cost leaders and differentiators.
- 2) **Generating high efficiencies** for serving such niche markets.
- 3) **Developing innovative ways** in managing the **value chain**.
- 4) **Creating superior skills** for catering such niche markets.

Advantages of Focused Strategy

- 1) **Premium prices** can be charged
- 2) Due to tremendous expertise → **rivals & new entrants** may find it **difficult to compete**.

Disadvantages of Focused Strategy

MT: 3D

- 1) Firms **lacking distinctive competencies** may **not** be able to pursue this.
- 2) Due to **limited demand** of product, **costs are high** → can cause problems.
- 3) In **long run** → **niche could disappear** or be **taken over** by larger competitors

Best-Cost Provider (BCP) Strategy
(further development of above 3 generic strategies)

- BCP involves providing customers **more value for money** by emphasizing on
 - ✓ **lower cost** &
 - ✓ **better-quality differences**.
- BCP strategy can be done through 2 **sub-strategies**-
 - 1) offering products at **lower price** than rivals having products with **comparable quality** and features (low price → same quality) or
 - 2) charging **similar price** as by the rivals for products with **much higher quality** and better features (same price → high quality)

For eg, android flagship phones from **OnePlus, Xiaomi, Oppo, Vivo**, etc, are all rooting for giving **better quality at lowest prices** to the customers.

They are following BCP strategy to penetrate market.

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SM Chapter 4

Strategic Choices

By CA Mohnish Vora (MVSIR)

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CHAPTER 4 – STRATEGIC CHOICES

Stability Strategy (Corporate Level Strategy)

- Strategy where a firm **stays with-**
- ✓ its **current businesses** & product markets;
- ✓ **maintains existing level** of effort; &
- ✓ satisfied with **incremental growth**.

Stabilization may be opted to

MT: Consolidate ROPES

- 1) to **consolidate** commanding position already reached,
- 2) to **optimise returns** on resources committed in business.
- 3) to **pursue** well established & tested **objectives**,
- 4) to **continue** in the chosen business path,
- 5) to maintain **operational efficiency** on a sustained basis,
- 6) **safeguard** its existing **interests & strengths**

Whether stability is a 'do nothing' strategy ?

- This strategy is for firms whose product reached **maturity stage** or those who **have a sufficient market share** & need to retain it.
- Have to **remain updated** & have to **pace with dynamic & volatile business world** to preserve their market share.

Hence→ stability is **not** a 'do nothing' strategy.

Major Reasons for Stability Strategy

MT: Rapid MSN

- 1) After **rapid expansion**, a firm might want to **stabilize & consolidate itself**.
- 2) Product has reached **maturity** stage, staff feels **comfortable with status quo**
- 3) Firm's **environment** is relatively **stable**.
- 4) Where it is **not advisable to expand** as it may be perceived as **threatening (risky)**.

Characteristics of Stability StrategyMT: R²EC SMS

- 1) It does **not** involve a **redefinition** of business
- 2) The **risk** involved is **less**.
- 3) Endeavour is to **enhance functional efficiencies** in **incremental way**, through **better utilization of resources**.
- 4) Firms **concentrate on its resources** & existing bness→ leading to **building of core competencies**.
- 5) Firm stays with **same business, same product** & maintaining **same level of effort**
- 6) Firms with **modest growth objective** choose this strategy.
- 7) It is a **safe strategy** that **maintains status quo**. It does **not** require **fresh investments**.

Why don't Startups aim for stability?

Startup→ **early stages of ideation & development**. For it, important factors are **speed & agility**→ being in **nascent stage**.

Whereas, **Stability** strategy applied when **size** of operations is **expanded to full capacity** & business is at a **mature stage**.

Notes

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CHAPTER 4 - STRATEGIC CHOICES

Growth/Expansion Strategy (Corporate Level Strategy)

Characteristics of Growth Strategy

MT: VIGOUR²

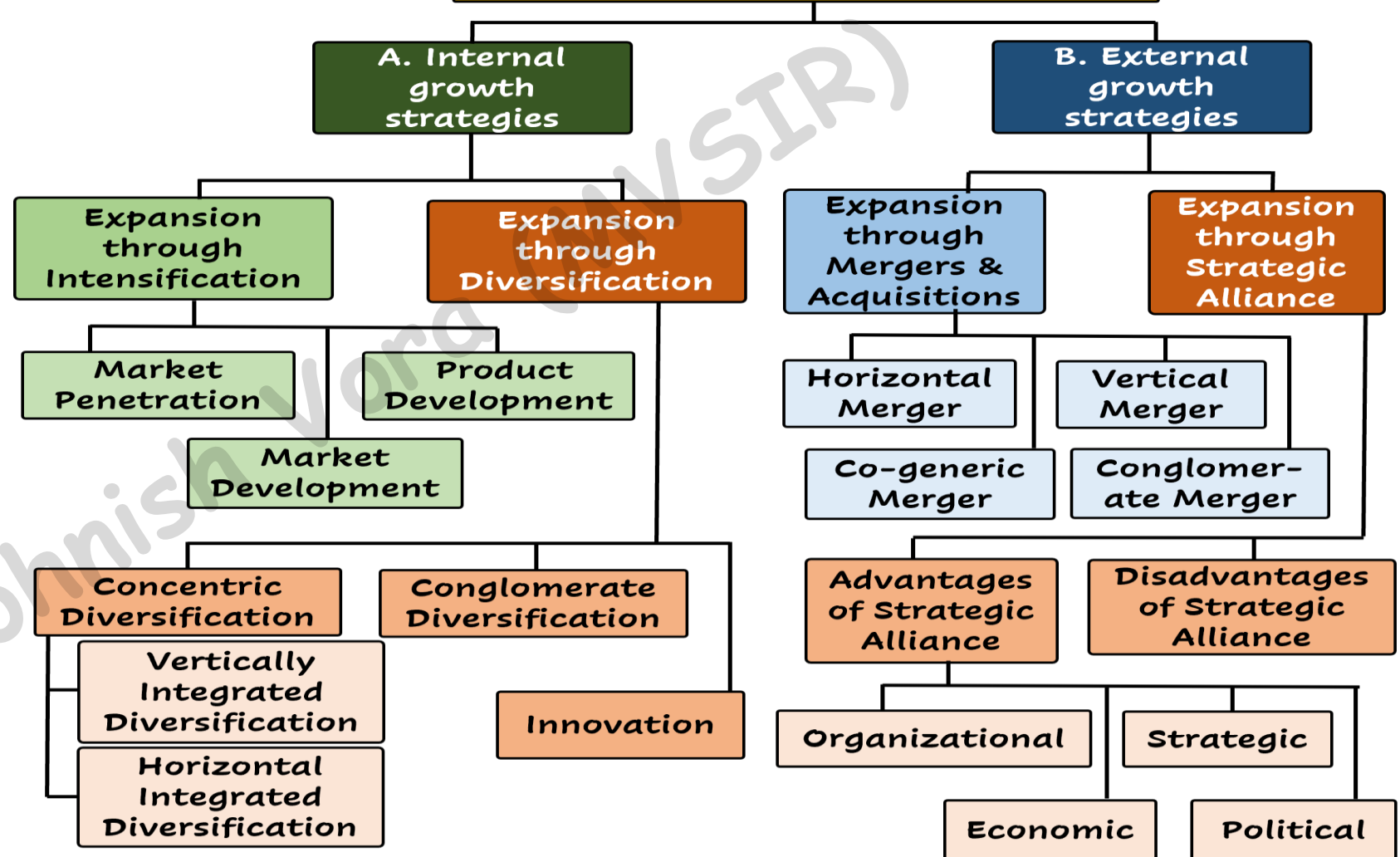
- 1) **Highly versatile** strategy → offers many combinations for growth.
- 2) Process of **renewal** of firm through **fresh investments** and **new businesses**.
- 3) A firm with **mammoth growth ambition** can meet its objective only through expansion.
- 4) It is **opposite of stability** strategy → in expansion rewards are **very high** since **risk is high**.
- 5) It involves a **redefinition of business**.
- 6) Further divided in two major strategy routes: **Intensification & Diversification**.

Major Reasons for Growth Strategy

MT: CAPS

- 1) Expansion may lead to **greater control over the market**.
- 2) **Advantages** from **experience curve** & **scale** of operations may accrue.
- 3) It may become **imperative** when **environment demands increase in pace** of activity.
- 4) Strategists may **feel more satisfied** → chief executives may **take pride**.

Types of Growth/ Expansion Strategy



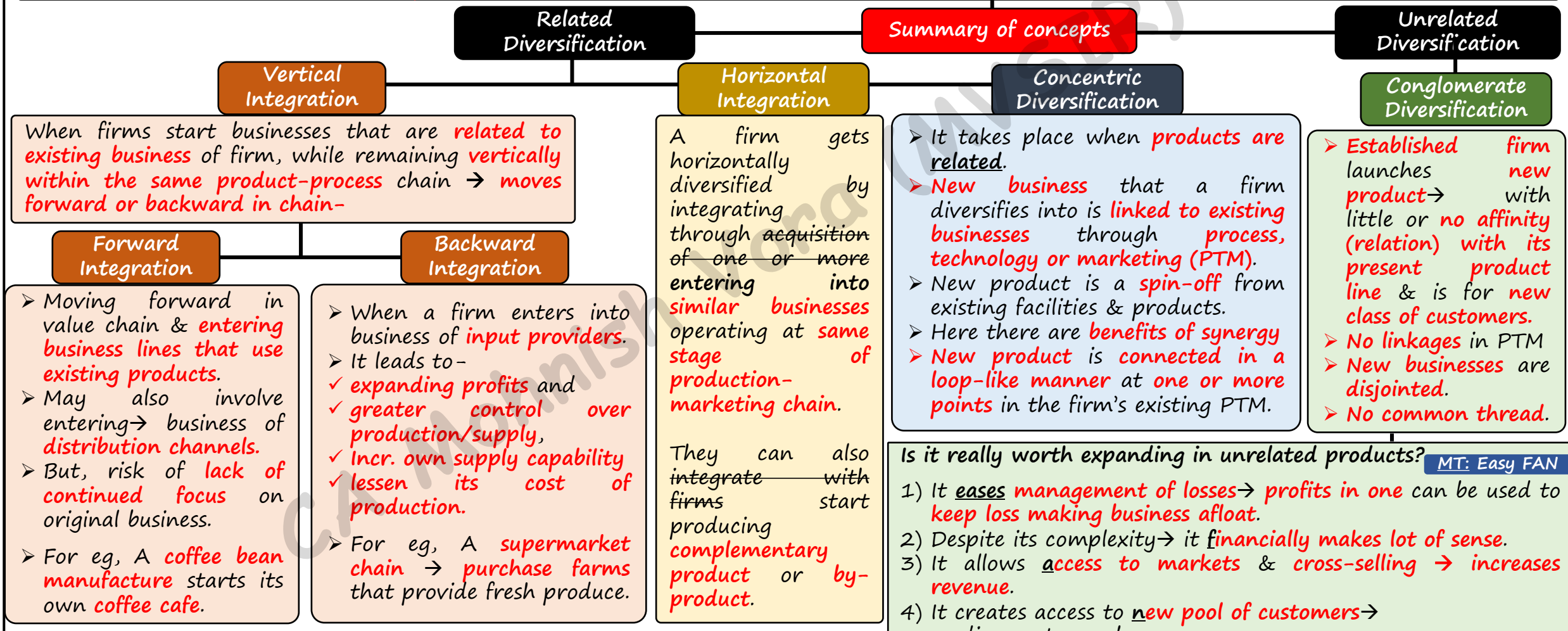


CHAPTER 4 - STRATEGIC CHOICES

➤ **Diversification** → entry into **new products or markets**, involving **different skills, technology & knowledge**.

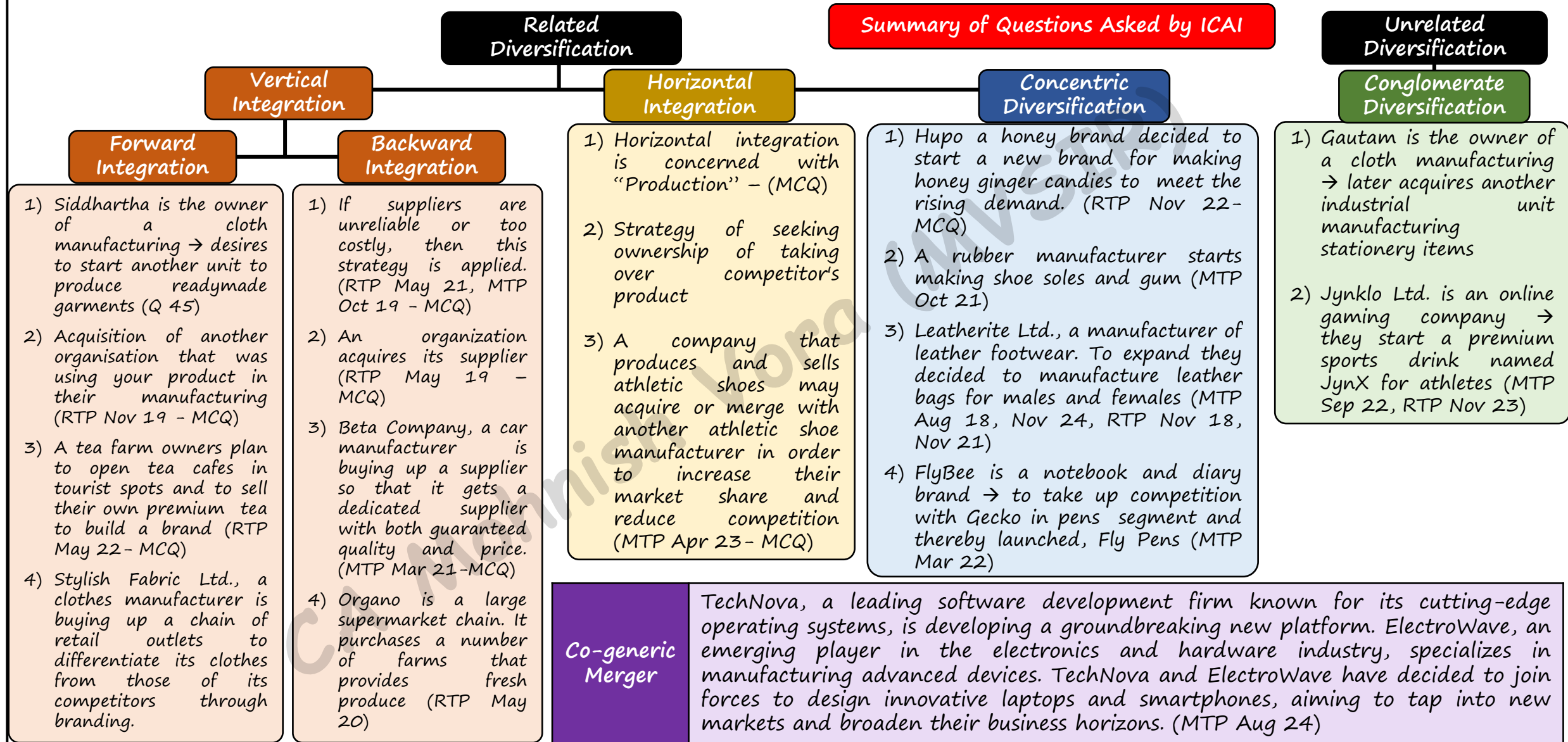
➤ **Why diversification?**

- 1) Means of **utilising existing facility & capability** in **more effective & efficient manner** → utilise **excess capacity**, funds, marketing channels, R&D
- 2) It gives **synergistic advantage** → **improve sales** of existing products by adding related or new products.





CHAPTER 4 - STRATEGIC CHOICES



Notes



CHAPTER 4 – STRATEGIC CHOICES

Types of Merger

Horizontal Merger

- Combination of firms in **same industry**.
- Merger with **direct competitor**. (Eg **Lipton India & Brook Bond**)
- Objective here is to **achieve economies of scale** in production by-
 - ✓ **shedding duplication** of functions,
 - ✓ **widening line** of products,
 - ✓ **decrease in working capital** and fixed assets investment,
 - ✓ getting **rid of competition**
- For eg, formation of Brook Bond Lipton India Ltd. through the.

Vertical Merger

- Merger of cos. operating in **same industry** but at **different stages of production** or distribution system. (leading to **increased synergies**)
- If an **org. takes over its supplier/producers of RM** → **backward intg.**
- If an **org. takes over its buyer organizations or distribution channels** → **forward integration**
- Vertical mergers help to **create an advantageous position** by-
 - ✓ **restricting supply** of inputs to other players, or
 - ✓ by providing inputs at **higher cost**.

Conglomerate Merger

- Combination of org. that are **unrelated** to each other.
- There are **no linkages** with respect to customer groups, customer functions and technologies being used.
- There are **no important common factors**.

Co-generic Merger

- When 2 or more org. are **associated in some way** or related to- (PTM)
 - ✓ **production processes**, **business markets**, or basic required **technologies**.
- Such merger includes-
 - ✓ **extension of product line**, or
 - ✓ **acquiring components** required in daily operations.
- For eg, org. in white goods category like **refrigerators** can merge with another org. in **kitchen appliances**.

Expansion through Strategic Alliance

- **Strategic alliance** → relationship between 2 or more org that enables each to **achieve certain strategic objectives** which **neither would be able to achieve on its own**. (formed between cos. **based in different regions**)
- The **strategic partners maintain their status as independent** and separate entities, share the **benefits & control & contribute to alliance until it is terminated**.

Advantages of Strategic Alliance

| Political | Organizational | Strategic | Economic |
|---|---|---|--|
| Formed with a local foreign business to gain entry into a foreign market either because of local prejudices or legal barriers to entry. | It helps to learn necessary skills & obtain certain capabilities from strategic partners. Well-known & respected partner-add legitimacy & credibility. | Rivals can join together to cooperate instead of competing with each other. | Reduction in costs & risks. Greater economies of scale → take advantage of co-specialization. |



CHAPTER 4 – STRATEGIC CHOICES

Disadvantages of Strategic Alliance (SA)

- **Sharing**- SA require **sharing of resources, profits, knowledge & skills** that otherwise org. may not like to share.
- Sharing → **problematic** → if involve **trade secrets**.
- **Agreements** can be executed to **protect** trade secrets, but they are only as good as **willingness of parties to abide by it**.

Strategic Exits

Strategic Exits are followed when an organization **substantially reduces scope of its activity**. This is done by-

- ✓ **finding the problem areas & diagnosing causes** of problems.
- ✓ Next, steps are taken to **solve** the problems.
- These steps lead to various **retrenchment strategies**-
 - 1) **Turnaround strategy**- **Focus on ways & means to reverse process of decline**.
 - 2) **Divestment (or Divestiture) strategy**- If it **cuts off loss-making units**, curtails its product line, or reduces functions.
 - 3) If none of above actions work → then **abandon activities totally**, resulting in a **liquidation strategy**.

Turnaround Strategy

Need for Turnaround strategy (Reasons to adopt turnaround)

- Needed when co.'s **performance deteriorates** → needs **radical change of direction in strategy, structure & culture**
- Effort to **return an organization to profitability & incr. positive cash flows**
- Used when both **threats & weaknesses adversely affect health** of co. → so much that its **basic survival is difficult**
- Overall goal → **return an underperforming co. to normalcy**.

MT: R²OAR

- To **achieve its objectives, turnaround strategy must**-
 - ✓ **reverse** causes of distress,
 - ✓ **resolve** the financial crisis,
 - ✓ **overcome** internal constraints and unfavourable industry characteristics.
 - ✓ **achieve** a rapid improvement in financial performance,
 - ✓ **regain** stakeholder support.

Indicators which point out that a turnaround is needed (danger signals requiring turnaround):

- ✓ **Mismanagement** MT: MUD²TOP
- ✓ **Uncompetitive** products or services
- ✓ **Declining market share**
- ✓ **Deterioration** in physical facilities
- ✓ **high turnover of employees**- low morale
- ✓ **Over-staffing**,
- ✓ **Persistent negative cash flow**

Workable action plan for turnaround

- ❑ **Stage 1** – Assessment of current prob.: Get to **root causes & extent of damage**.
- ❑ **Stage 2** – Analyze the situation and develop a strategic plan: Determine **chances of business's survival**, Identify appropriate strategies, & develop a **preliminary action plan**
- ❑ **Stage 3** – Implementing an emergency action plan: If org. is in critical stage, develop action plan to **stop the bleeding** & enable org to **survive**
- ❑ **Stage 4** – Restructuring the business: If **core business is irreparably damaged** → then future is **bleak**. Efforts to position org for **rapid improvement**
- ❑ **Stage Five** – Returning to normal: Org. **should show signs of profitability**, ROI etc. Take **strategic efforts** carefully adding new products, improving customer service, creating alliances with other organizations, increasing the market share, etc.



CHAPTER 4 - STRATEGIC CHOICES

Important elements of turnaround strategy

MT: Neutralising C⁴RAQ

- 1) **Neutralising** external pressures
- 2) **Change** in **top management**
- 3) Initial **credibility-building actions**
- 4) Quick **cost reductions**
- 5) Better **internal coordination**
- 6) **Revenue** generation
- 7) **Asset liquidation** for generating cash
- 8) Identifying **quick pay-off activities**

Is Turnaround strategy only relevant to loss making business?

When co. is experiencing **period of poor performance** → does not always mean losses, it may mean-

- ✓ **lower than expected growth**,
- ✓ **no future clarity**, or
- ✓ **lesser than target profits**.

Major Reasons for Retrenchment Strategy

MT: Persian CAT is NOT Most Viable

- 1) **Persistent negative cash flows** → create financial problems for whole company.
- 2) **Severity of competition** & inability to cope with it.
- 3) A **better alternative may be available for investment**.
- 4) **Technological upgradation** is required for survival, but **not possible** for firm to invest in it.
- 5) Mgt. **no longer wishes to remain in business** due to **continuous losses & unviability**.
- 6) **Business** that had been acquired proves to be a **mismatch** & **cannot be integrated** within co.
- 7) Mgt. feels → business **could be made viable** by **divesting some of activities**.

(Points 1, 2, 3, 4 & 6 - Reasons to adopt Divestment)

Notes

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Turnaround

- **Internal Retrenchment**
- Transform firm into a **leaner structure**
- Focus on ways to **reverse the process of decline**
- Try to- **Reduce cost, generate revenue**, improve co-ordination, better control etc.
- Danger Signals- **MUD²TOP**
- Applied when co. experiencing problems due to **internal factors**

Divestment

- **External Retrenchment**
- **Sale/Liquidation** of a **portion** of business
- It is **integral part** of strategy **without any stigma attached**.
- Applied when-
 - 1) **Turnaround** is **attempted** but was **unsuccessful**, or
 - 2) **Turnaround** was **not possible**, or
 - 3) **Losses** or business become **unviable** because of **external factors**

Liquidation

- Most **extreme** & **unattractive**
- **Closing down** a firm and **selling its assets**. **turnaround or divestment** are **not seen as solution** or have been **attempted but failed**
- When **dead business** is **worth more than alive**
- **Last Resort- serious consequences**
 - termination of future opp.
 - loss of employment &
 - stigma of failure



CHAPTER 4 – STRATEGIC CHOICES

Strategic Options

Strategic Options

I) Ansoff's Product Market Growth Matrix

II) ADL Matrix

III) BCG Growth-Share Matrix

IV) General Electric Matrix

I) Ansoff's Product Market Growth Matrix

- Given by **Igor Ansoff**- It is a useful tool that helps businesses **decide** their **product & market growth strategy**.
- The product/market growth matrix is a **portfolio-planning tool** for **identifying growth opportunities** for the company

Existing Products

New Products

Existing Markets

Market Penetration

- Selling existing products into existing markets.
- Making more sales to present customers **without changing products** in any major way.
- Require **advertising or personal selling** on **increasing usage by existing customers**.

Product Development

- Introduce new products into existing markets.
- It requires-
✓ **development of new competencies** &
✓ **develop modified products** which can appeal to existing markets.

New Markets

Market Development

- Sell its existing products into new markets.
- Achieved through-
✓ **new geographical markets**,
✓ **new product packaging**,
✓ **new distribution channels** or
✓ **different pricing policies**

Diversification

- When a business markets new products in new markets.
- Starting up or acquiring cos. **outside co.'s current products & markets** (little/no experience)
- It is **risky** → does not rely on co.'s existing product or market.

Strategy

Questions asked by ICAI

Market Penetration

- 1) A leading producer of toothpaste, advises its customers to brush teeth twice a day to keep breath fresh.
- 2) Advertisement says, 'Have Romanza with milk and lassi too'

Product Development

- 1) A women's clothing brand introduced a new clothing line, received positive feedback from initial trials, and grew through strategic partnerships and targeted advertising.
- 2) A renowned auto manufacturing company launches ungeared scooters in the market.

Market Development

- 1) Fresh Delight, renowned for its organic fruit juices- launches targeted marketing campaigns and partners with local distributors to introduce its juices to new regions.
- 2) One of India's premier utility vehicles manufacturing company ventures to foray into foreign markets. It refers to a growth strategy where the business seeks to sell its existing products into new markets
- 3) Spark Pvt. Ltd., an automobile seat manufacturing company has superior growth compared to competitors due to emphasis on quality of production. To expand the existing business, CEO will be travelling to south-east Asia & Africa for identifying new geographical places and new product dimensions and will try to establish new distribution channels to attract new customers abroad.

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CHAPTER 4 - STRATEGIC CHOICES

II. ADL Matrix (by Arthur D. Little)

Portfolio analysis method based on **product life cycle**.

2 dimensional matrix based on

- ✓ **stage of industry maturity** &
- ✓ **firm's competitive position**

➤ The **role** of ADL matrix is to **assess the competitive position of a firm** based on following criteria:

- 1) **Dominant:** **Rare position** → attributable either to a **monopoly** or strong & **protected technological leadership**
- 2) **Strong:** Firm has considerable degree of **freedom** over its **choice of strategies** & is able to **act without its market position being unduly threatened** by its competitors.
- 3) **Favorable:** This happens when **industry is fragmented** & **no one competitor stand out clearly**, results in the market leaders a reasonable degree of freedom.
- 4) **Tenable:** Although firms here are able to perform satisfactorily & can justify staying, but they are **vulnerable in face of increased competition** from stronger and more proactive cos.
- 5) **Weak:** The performance of firms in this category is **unsatisfactory** although opportunities for improvement do exist.

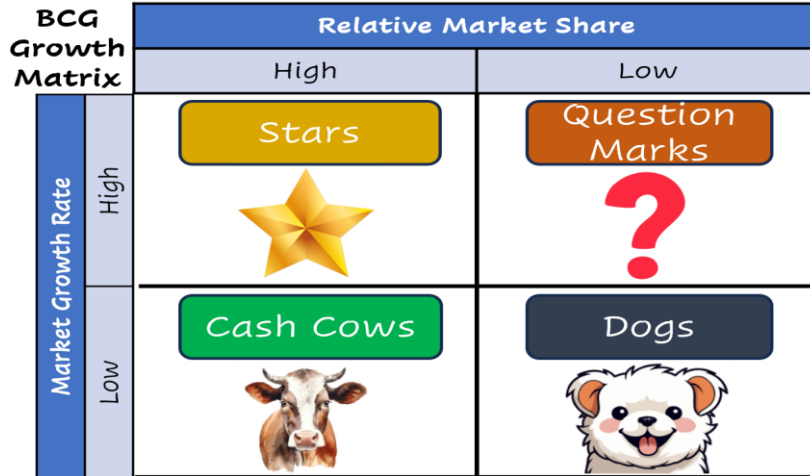
Boston Consulting Group (BCG) Growth-Share Matrix

- Developed in early 1970s by BCG,
- Also known for its **cow & dog metaphors**
- Co. classifies businesses on **2-dimensional growth-share matrix**.
- In the matrix:
 - ✓ **Vertical axis** → **Market growth rate** → measure of **market attractiveness**.
 - ✓ **Horizontal axis** → **Market share** → measure of **company strength**

- 1) **Stars** → products **growing rapidly**. Also need **heavy investment** to maintain their position. Represent **best opportunities for expansion**.
- 2) **Cash Cows** are **low-growth, high market share** products. They **generate cash** and have **low costs**. They are **established, successful**, & need **less investment** to maintain their market share. In **long run** when **growth rate slows down**, **stars become cash cows**.
- 3) **Question Marks** (aka. **problem children** or **wildcats**) → **low market share** business in **high-growth markets**. They **require a lot of cash** to hold their share. They need **heavy investments** with **low potential to generate cash**. Question marks if left **unattended** can become **cash traps**. Since **growth rate is high**, increasing it should be relatively easier. It is for business org. to **turn them into stars** & then to **cash cows** when the growth rate reduces.
- 4) **Dogs** are **low-growth, low-share businesses**. They may generate enough cash to maintain themselves, but **do not have much future**. Sometimes they **may need cash to survive**. Dogs should be **minimised** by means of **divestment** or **liquidation**.

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CHAPTER 4 – STRATEGIC CHOICES

**4 Post Identification strategies of BCG**

- Build with the aim for long-term growth and strong future. (**Stars**)
- Hold or preserve the existing market share. (**Question Mark**)
- Harvest or maximize short-term cash flows. (**Cash Cow**)
- Divest, sell/liquidate and ensure better utilization of resources elsewhere. (**Dogs**)

Notes

Is BCG Matrix really helpful?**Problems/Limitations of BCG Matrix–**

- 1) **Difficult, time-consuming, & costly** to implement.
- 2) **Difficult to define SBUs** & measure market share & growth.
- 3) It focuses on classifying current businesses but provide **little advice for future planning**.
- 4) It may lead to **placing too much emphasis** on market-share growth or growth through entry into attractive new markets. This can cause **unwise expansion** into hot, new, **risky ventures** or **divesting established units too quickly**.

III. General Electric Matrix [“Stop-Light” Strategy Model]

- This model was used by General Electric Company (developed by GE with assistance of McKinsey and Co.).
- Aka. Business Planning Matrix, GE Nine-Cell Matrix, GE Model.
- **Inspired from traffic control lights.**
- The lights that are used at crossings to manage traffic are: **green for go, amber or yellow for caution, and red for stop.**
- This model **uses two factors** while taking strategic decisions–
 - ✓ **Business Strength** (Horizontal Axis)
 - ✓ **Market Attractiveness** (Vertical Axis)

| | Business strength | | |
|--------|-------------------|----------------|----------------|
| | STRONG | AVERAGE | WEAK |
| HIGH | Invest/Expand | Invest/Expand | Select/Earn |
| MEDIUM | Invest/Expand | Select/Earn | Harvest/Divest |
| LOW | Select/Earn | Harvest/Divest | Harvest/Divest |

If a product falls in the–

- **Green zone:** business is at **advantageous position**. To reap benefits, strategic decision can be to **expand, invest & grow**.
- **Amber or Yellow zone:** it needs **caution** and **managerial discretion** is called for making the strategic choices.
- **Red zone:** it will eventually **lead to losses** that would make things difficult for organisations. In such cases, appropriate strategy should be **retrenchment, divestment or liquidation**.



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SM Chapter 5

Strategic Implementation & Evaluation

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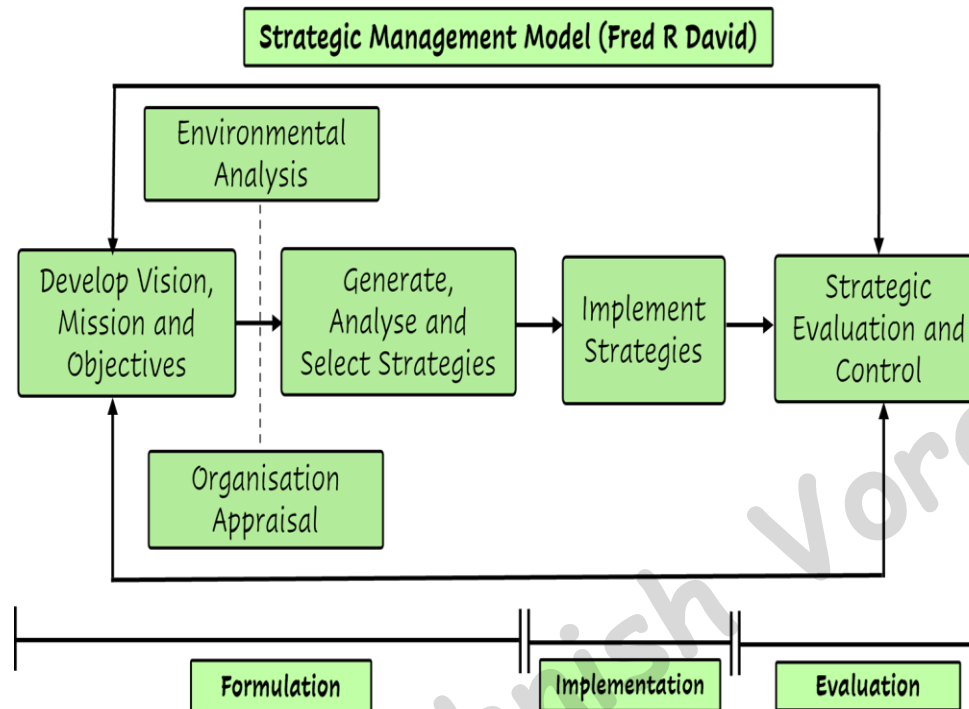


CHAPTER 5 - STRATEGIC IMPLEMENTATION & EVALUATION

Introduction

- ❑ Strategy implementation and evaluation are critical phases of the process of strategic management in an organization.
- **Implementation** → putting plans & initiatives developed as part of the strategy into action,
- **Evaluation** → process of measuring & assessing the effectiveness of these actions.

Strategic Management Model



- The above SM model **does not guarantee sure-shot success**, but it does **represent a clear and practical approach** for **formulating, implementing, & evaluating strategies**
- SM process is **dynamic, continuous**, & should be performed on a **continual basis**, not just at end of year or semi-annually. It **never really ends**

I. Stages in Strategic Management

- **Crafting & executing strategy** are heart & soul of managing a business enterprise.
- Strategic management involves the following stages:
 - 1) **Developing** a strategic **vision** & formulation of **mission, goals and objectives**.
 - 2) **Environmental** and **organisational analysis**.
 - 3) **Formulation** of strategy.
 - 4) **Implementation** of strategy.
 - 5) Strategic **evaluation** and **control**

Important Points in Stages in Strategic Management

Stage 1: (Already covered all points in Chapter 1)

Stage 2: Environmental and Organisational Analysis

- This stage is **diagnostic phase** of strategic analysis. Two types of analysis:
 - a) **Environmental scanning**
 - ✓ External environment consists **economic, social, technological, market & other forces** which affect its functioning.
 - ✓ External environment is **dynamic** & **uncertain**. So, management must analyse all elements of environment to determine **opportunities & threats** for firm in future.
 - b) **Organisational analysis**
 - ✓ Organisational analysis involves **review** of **financial** resources, **technological** resources, **productive capacity**, **marketing** & **distribution** effectiveness, R&D, HR etc
 - ✓ This would reveal firm's **strengths & weaknesses** which could be **matched** with threats & opportunities in the external environment. (SWOT analysis)



CHAPTER 5 – STRATEGIC IMPLEMENTATION & EVALUATION

Stage 3: Formulating Strategy

- ❑ First step → **developing strategic alternatives** as per firm's SWOT.
- ❑ Second step → **deep analysis** of strategic alternatives for **choosing most appropriate alternative**.
- ✓ A company may have several alternatives such as:
 - i. Should co. **continue in same business**?
 - ii. If it should continue, should it **grow by expanding existing units** or by establishing **new units** or by **acquiring other units**?
 - iii. If it should **diversify**, should it diversify into **related areas** or **unrelated areas**?
 - iv. Should it **get out** of an existing business **fully** or **partially**?

A co. may also follow a **combination** of above called **combination strategy**.

Stage 4: Implementation of Strategy MT: DM BMC

- ❑ It is an **operations-oriented activity** aimed at **shaping performance of core** activities in a strategy-supportive manner.
- ❑ To convert strategic plans into actions and results, a manager must–
 - 1) **direct organisational change**,
 - 2) **motivate people**,
 - 3) **build & strengthen competencies** & competitive capabilities,
 - 4) **meet or beat performance target**, &
 - 5) create a **strategy-supportive work climate**

❑ Strategy-execution process includes following principal aspects: MT: BP²CL SIM

- 1) Developing **budgets** that **steer ample resources** into critical activities.
- 2) Ensuring that **policies** & **operating procedures facilitate** effective execution
- 3) Using **best-known practices** to perform core activities for **continuous improvement**.
- 4) Creating a **culture** & **work climate conducive** to successful strategy impl. & execution.
- 5) **Exerting internal leadership** needed to drive implementation forward.
- 6) **Staffing** the organisation with **needed skills & expertise**, thus building competitive capabilities & organising the work.
- 7) Installing **information** & **operating systems** that enable personnel to **better carry out their strategic roles daily**
- 8) **Motivating** people to pursue the target objectives energetically.

Stage 5: Strategic Evaluation & Control

The final stage of strategic management process involves–

- ✓ **evaluating** the company's **progress**,
- ✓ assessing **impact of new external developments**, and
- ✓ making **corrective adjustments** → trigger point for deciding whether to continue or change.

Strategic evaluation involves **measuring & evaluating performance**. The **goals achieved** are **compared** with the **desired goals** to identify **deviations**,

Reasons why strategy evaluation is more difficult today:

- 1) Dramatic increase in environment's **complexity**.
- 2) Difficulty of **predicting future** with accuracy.
- 3) Increasing number of **variables** in environment.
- 4) Rapid rate of **obsolescence** of even the best plans.
- 5) **Increase** in number of both **domestic and world events** affecting organizations.
- 6) **Decreasing time span** for which planning can be done with any degree of certainty



CHAPTER 5 - STRATEGIC IMPLEMENTATION & EVALUATION

II. Strategy Formulation

| Strategic Planning | Operational Planning |
|---|---|
| <p>Senior management develops strategic plans for entire organization after evaluating strengths and weaknesses.</p> | <p>Operational plans are made at middle and lower-level mgt. They provide specifics on how resources are to be used effectively to achieve goals</p> |
| <p><u>Characteristics of Strategic planning</u></p> <p>MT: HOLIS²tie</p> <ol style="list-style-type: none"> 1) Takes a holistic view of the organization. 2) Develops overall objectives and strategies. 3) Is concerned with the long-term success of the organization. 4) Assesses the impact of environmental variables. 5) Is a senior management responsibility 6) Shapes the organization and its resources. | <p><u>Characteristics of Operational planning</u></p> <p>MT: FM CTC</p> <ol style="list-style-type: none"> 1) Is the responsibility of functional managers. 2) Makes modifications to business functions but not fundamental changes. 3) Deals with current deployment of resources. 4) Develops tactics rather than strategy. 5) Projects current operations into future. |

Strategic planning is the process of: MT: GOOD Resources

- 1) It determines where organization is going in next year & ways for going there.
- 2) Determining objectives of firm,
- 3) The process is organization-wide or focused on a major function or division.
- 4) It involves many interactive & overlapping decisions leading to development of effective strategy.
- 5) Also determines resources required to attain these objectives formulation of policies to govern acquisition, use & disposition of resources.

Strategic Uncertainty

It refers to unpredictability of future events and circumstances that can impact an organization's strategy & goals.

□ How to deal with strategic uncertainty?

- 1) Monitoring & Scenario Planning: Regularly monitor key indicators of change & conduct scenario planning → how different future scenarios might impact strategies.
- 2) Diversification: Diversifying product portfolio, markets, & customer base.
- 3) Building Resilience: Invest in building internal resilience, such as-
 - ✓ strengthening operational processes,
 - ✓ increasing financial flexibility, &
 - ✓ improving risk management capabilities.
- 4) Flexibility: Build flexibility in strategies to quickly adapt to changes.
- 5) Collaboration and Partnerships: Collaborating with other org., suppliers, customers → help org. to pool resources, share risk, & access to new markets & tech.



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III. Strategic Implementation

- Strategy implementation is a managerial exercise of putting-
- ✓ freshly chosen **strategy into action**,
 - ✓ **supervising the ongoing pursuit of strategy**,
 - ✓ **making it work**,
 - ✓ **improving the competence** with which it is executed
 - ✓ showing **measurable progress** in achieving the targeted results.
- It is concerned with **translating a strategic decision into action**
 - A company will be successful only when strategy **formulation is sound** and **implementation is excellent**

| | | | |
|----------------------|--------|------|-----------|
| Strategy Formulation | Sound | A | B |
| | Flawed | C | D |
| | | Weak | Excellent |

Strategy formulation and implementation matrix

- **Square A** - Due to **lack of experience** (e.g. for startups), **resources**, **missing leadership**. Co. will aim at moving from square A to B
- **Square B** - Ideal situation - co. has **succeeded in designing a sound & competitive strategy** and **successful in implementing**
- **Square D** - **formulation is flawed**, but **excellent implementation skills**. First thing to do is to redesign their strategy before readjusting their implementation.
- **Square C** - **business model redesign & implementation readjustment**

- Efficiency is **introspective** (responsibility of Operational managers)
- Effectiveness → **highlights links between org. & its environment**. (responsibility of Top Mgt.)

| | | Strategic Formulation | |
|------------------------|-------------|-----------------------|------------------|
| | | Effective | Ineffective |
| Operational Management | Efficient | 1 Thrive | 2 Die Slowly |
| | Inefficient | 3 Survive | 4 Die Quickly |

Principal combinations of efficiency and effectiveness

- ❑ Org. in **cell 1 is well placed & thrives**, since it is achieving what it aspires with efficient output/input ratio.
- ❑ An org. in **cell 2 or 4 is doomed**, unless it can establish some strategic direction.
- ❑ The **cell 2 is a worse place to be than is cell 3** since, in cell 3 strategic direction is present to ensure effectiveness even if rather too much input is being used to generate outputs.

To be effective is to do the right thing, while
To be efficient is to do the thing right.

An emphasis on efficiency rather than on effectiveness is clearly wrong.

Successful strategy formulation **does not guarantee** successful strategy implementation. (Easier said than done)

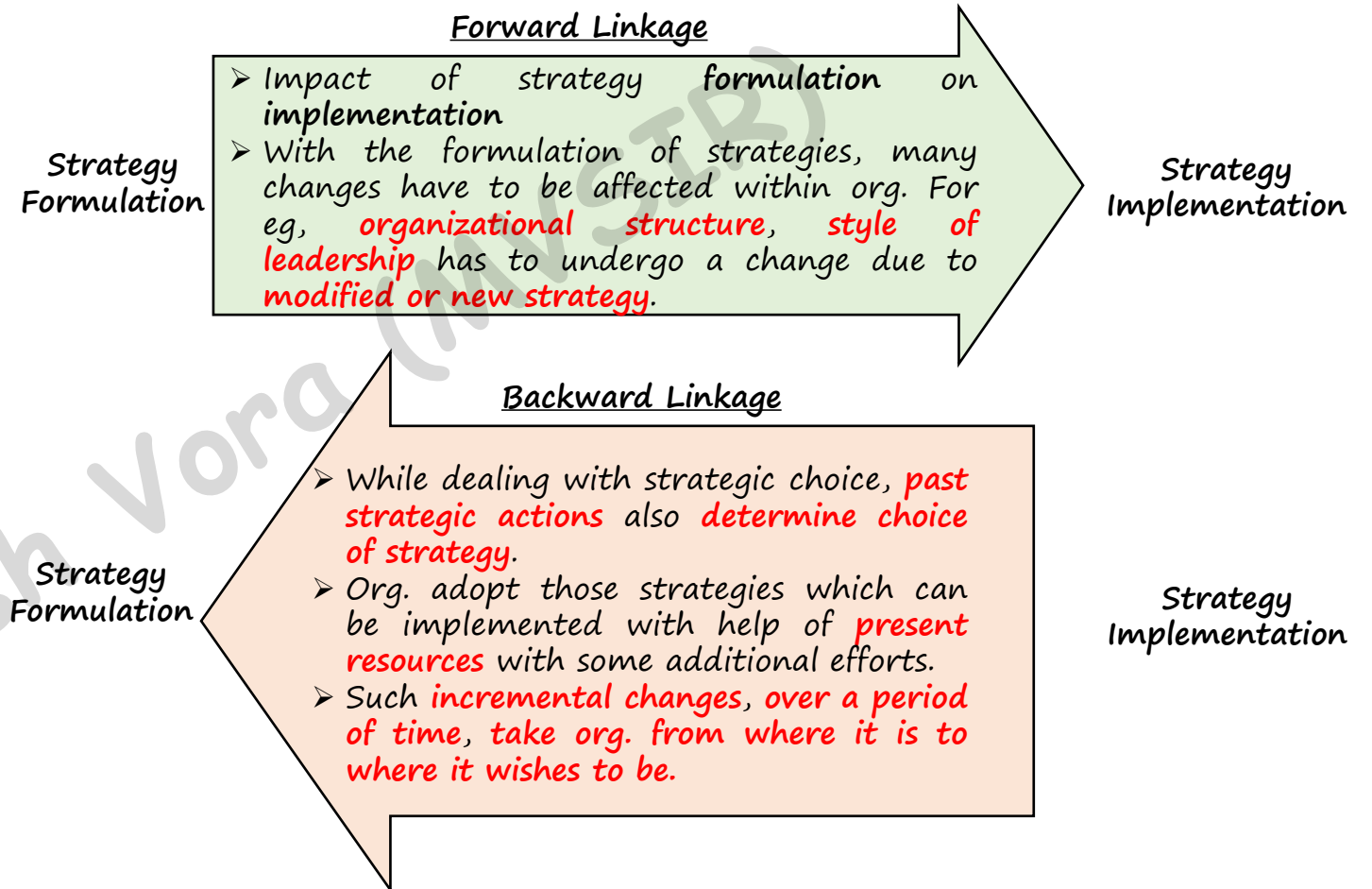


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IV. Strategy Formulation Vs. Strategic Implementation

| Strategy Formulation | Strategy Implementation |
|--|--|
| It includes planning and decision-making involved in developing strategic goals & plans. | It involves all those means related to executing strategic plans . |
| Placing Forces before action. | Managing forces during action. |
| An entrepreneurial activity based on strategic decision-making. | An Administrative Task based on strategic & operational decisions. |
| Emphasizes on effectiveness . | Emphasizes on efficiency . |
| Intellectual & rational process. | Operational process. |
| Requires co-ordination among few individuals at top level . | Co-ordination among many individuals at middle & lower levels. |
| Requires a great deal of initiative, logical skills, conceptual intuitive & analytical skills . | Requires specific motivational and leadership traits . |
| Formulation precedes Implementation. | Implementation follows Formulation. |

V. a) Linkages in Strategy Implementation





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V. b) Issues in Strategy Implementation

- 1) The strategic plan proposes manner in which **strategies** could be **put into action**. Strategies, by themselves, do not lead to action.
 - 2) Strategies should lead to formulation of different kinds of programmes. A programme is a broad term - includes **goals, policies, procedures, rules, & steps** to be taken in **putting a plan into action**. Programmes are supported by **funds** allocated for **plan implementation**.
 - 3) Programmes lead to the formulation of projects. A project is a highly specific programme for which **time schedule & costs** are predetermined. It requires **allocation of funds** based on **capital budgeting**.
- Sequential manner in which issues in strategy implementation are to be considered:
- i. **Project implementation**
 - ii. **Procedural implementation**
 - iii. **Resource allocation**
 - iv. **Structural implementation**
 - v. **Functional implementation**
 - vi. **Behavioural implementation**

VI. Strategic Change through Digital Transformation

Strategic change is a **complex process** that involves a **corporate strategy** focused on new markets, products, services and **new ways of doing business**.

Steps to initiate strategic change

- 1) Recognize the need for change
 - ✓ First step → diagnose which facets of present culture are strategy supportive & which are not.
 - ✓ Doing **environmental scanning** → **appraisal** of both **internal & external capabilities** through **SWOT analysis** & then **determining where lacuna lies & scope for change exists**.
- 2) Create a shared vision to manage change
 - ✓ **Objectives of both individuals & org. should coincide** (no conflict).
 - ✓ **Senior managers** need to constantly **communicate vision** to all **members**. They have to convince → **change in culture is not superficial or cosmetic**.
 - ✓ Actions taken should be credible, **highly visible & indicative** of management's seriousness to new changes.
- 3) Institutionalise the change
 - ✓ This is an **action stage** → **implementation of changed strategy**.
 - ✓ Ensure that firm **does not slip back into old ways** of doing things.
 - ✓ Capacity for **self-renewal** → fundamental anchor of **new culture**.
 - ✓ Also, change process must be **regularly monitored & reviewed to analyse after-effects of change**. Discrepancies, if any, then **necessary corrective actions** are taken.
 - ✓ It **takes time for the changed culture to prevail**.

Kurt Lewin's Model of Change

To make change lasting, Kurt Lewin proposed **three phases** of the **change process** for moving the organization from the present to the future.

i. Unfreezing the situation:

- Make **individuals aware** of **necessity for change** & prepares them.
- Changes should **not come as a surprise**.
- **Sudden & unannounced change** → **socially destructive** & morale lowering
- Unfreezing is process of **breaking down old attitudes & behaviours**, so that **they start with clean slate**.
- Achieved by **making announcements, meetings & promoting new ideas**.

ii. Changing to the new situation:

- After unfreezing, **members** of org. **recognise need for change** & have been fully prepared to accept such. Change, their **behaviour patterns need to be redefined**.



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➤ **H.C. Kellman** has proposed **3 methods** for reassigning **new patterns** of **behaviour** - Compliance, Identification, & Internalization

iii. Refreezing:

➤ When **new behaviour** becomes a **normal way of life**.

➤ New behaviour must replace former behaviour **completely** for successful & permanent change → must be **continuously reinforced**.

➤ Change process is **not a one-time application** but a **continuous process** due to changing env.

Process of unfreezing, changing & refreezing is cyclical & remains **continuously in action**.

3 methods for reassigning new patterns of behaviour by H.C. Kellman

- Compliance:** Strictly enforcing **reward & punishment strategy** for good or bad behaviour. **Fear of punishment, actual punishment, reward** seems to **change behaviour**.
- Identification:** When **members** are **psychologically impressed** with some given **role models** whose behaviour they would like to adopt.
- Internalization:** **Internal changing** of **individual's thought processes** in order to adjust to changes introduced. They have given **freedom to learn & adopt new behaviour**.

VII. How does digital transformation work?

Use of digital technologies to develop **fresh** or **entirely new co. procedures, goods/services** is called "digital transformation."

Change management in the digital transition consists of **four essential elements**: **MT: GCRC**

- Defining the goals & objectives** of transformation
- Assessing current state** of org & **identifying gaps**
- Creating a roadmap** for change that outlines steps needed to reach desired state
- Implementing & managing change** at every level of the organization

VIII. Change Management Strategies for Digital Transformation

5 Best Practices for managing change in small & medium-sized business **MT: Recognize BCDE**

- Begin at the top:** **Leadership team** → **united & committed**. They should **communicate clear vision** for future of co. & **lead by example**.
- Ensure that change is necessary & desired:** Before implementing changes, co. should **assess its current state** & **identify areas** where digital transformation can **add value**. It's imp to **involve employees** in this process to ensure their buy-in.
- Reduce disruption:** **Communicating early** about changes, **providing training & support** for employees, & **empowering change agents** within the org.
- Encourage communication:** Create **channels** for employees to **ask questions** & provide **feedback**. Encourage **collaboration between departments** to **share ideas & innovations**.
- Recognize that change is the norm:** Digital transformation is **not a one-time project** but an **ongoing process**. The company should be **prepared to adapt to new technologies** and market conditions **continuously**.

How to reduce workplace disruption?

- Getting the word out early** & preparing for some interruption.
- Giving staff members the knowledge & tools**, they need to adjust to change.
- Creating an environment** that **encourages transformation** or change.
- Empowering change agents** to provide **context** and **clarity for changes**, such as project managers or **team leaders**.
- Ensuring that IT dept** is **informed of changes in technology** or **infrastructure** and is prepared to support them.



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IX. How to manage change during digital transformation?

Key strategies to navigate change effectively during digital transformation

MT: SABIT

- 1) Specify digital transformation's aims & objectives: Helps ensure everyone is **aligned** and **working towards same goals**
- 2) Always communicate: **Regular & transparent** communication is crucial to help people **understand goals** of digital transformation & **how it will impact** various stakeholders.
- 3) Be ready for resistance: Change, even if beneficial, can be met with resistance. Having a **strategy** in place to **address resistance** is important **for overcoming challenges** & ensuring a **smooth transition**.
- 4) Implement changes gradually: Instead of making all changes at once, gradual implementation allows individuals to **adapt to new ways** of doing things **without feeling overwhelmed** by too much change.
- 5) Offer assistance and training: Providing **support, guidance, and training** for employees is crucial as they navigate new procedures, software applications etc.

X. Organisational Framework (McKinsey 7S Model)

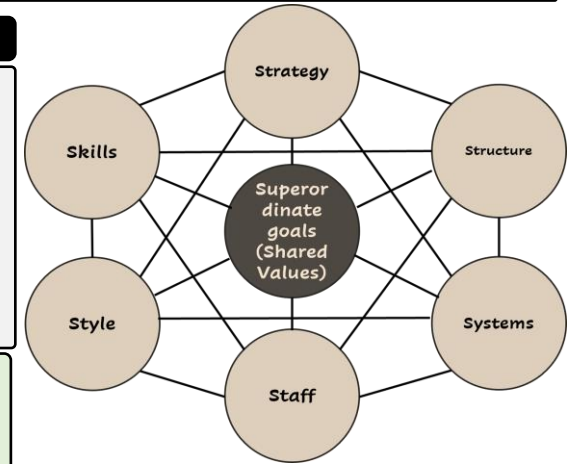
- McKinsey 7S Model → tool to **analyze** a co.'s "**organizational design**."
- Goal → depict **how effectiveness can be achieved** in an org. through interactions of **hard & soft elements**.
- Model focuses on how "Soft S" & "Hard S" elements are **inter-related** → **modifying one aspect** might have a **ripple effect** on **other elements** in order to **maintain an effective balance**.

Hard elements are **directly controlled** by **management**.

- 1) Strategy: direction of org., a **blueprint** to **build on core competency** & **achieve competitive advantage** to drive margins & lead the industry
- 2) Structure: depending on **availability of resources** & degree of **centralisation** or **decentralization** that mgt. desires, it **chooses** from available **alternatives** of org. structures.
- 3) Systems: Development of **daily tasks, operations** & **teams** to **execute goals** & **objectives** in most efficient & effective manner.

Soft elements are **difficult to define** as they are **more governed by culture**.

- 1) Shared Values: **Core values** → reflected within org. culture or **influence code of ethics**.
- 2) Style: This depicts **leadership style** & how it **influences strategic decisions** of org. It also revolves around people motivation & organizational delivery of goals.
- 3) Staff: **Talent pool** of org.
- 4) Skills: The **core competencies** or **key skills** of employees play a vital role in defining organizational success.

Limitations of McKinsey 7S Model

- 1) It **ignores importance of external environment** & depicts only most crucial elements within org.
- 2) It **does not clearly explain** concept of **organizational effectiveness** or **performance**.
- 3) Considered to be **more static & less flexible** for **decision making**.
- 4) It is generally criticized for missing out the **real gaps** in **conceptualization** and **execution** of strategy.



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XI. Organisational Structure

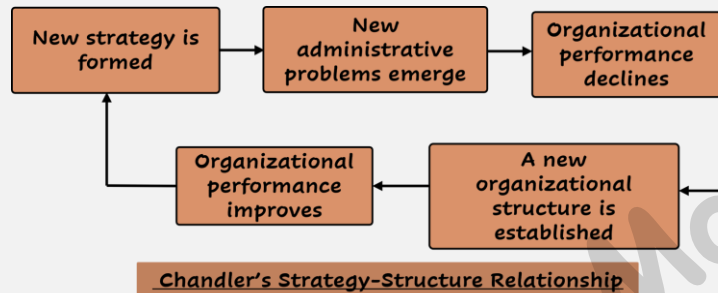
Changes in corporate strategy often require changes in way an org. is structured for two reasons-

1) First, structure dictates how **operational objectives & policies** will be **established** to **achieve strategic objectives**.

2) Second **structure dictates how resources will be allocated** to achieve strategic objectives.

➤ According to Chandler, changes in **strategy** lead to changes in organizational **structure**. (**structure should follow strategy**).

➤ He found a **structure sequence** to be repeated as org. grow & change strategy over time.



✓ **Small firms** → **functionally structured** (centralized)

✓ **Medium-size firms** → **divisionally structured** (decentralized).

✓ **Large firms** → use an **SBU** (strategic business unit) or **matrix structure**.

Symptoms of an ineffective organizational structure

1. too many levels of management,
2. too many meetings attended by too many people,
3. too much attention being directed toward solving interdepartmental conflicts,
4. too large a span of control, &
5. too many unachieved objectives.

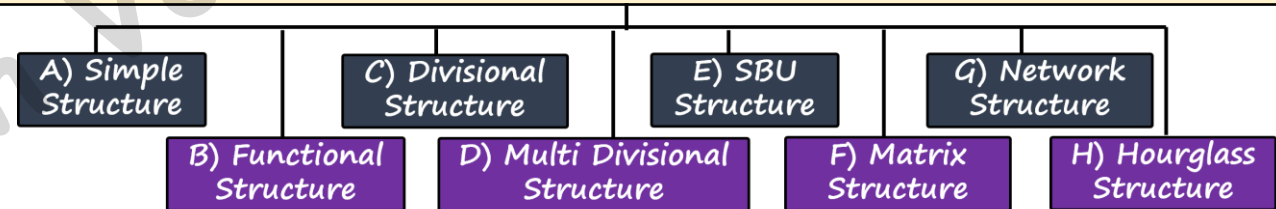
➤ **Changes in structure should not be expected-**

- ✓ to make a **bad strategy good**,
- ✓ to make **bad managers good**, or
- ✓ to make **bad products sell**.

➤ Structure can also influence strategy.

- ✓ If a proposed strategy required massive structural changes, it would not be attractive choice.
- ✓ Thus, **structure can shape choice of strategy**.

Organizational structure is company's formal configuration of its **intended roles, procedures, governance mechanisms, authority, & decision-making processes**.



Notes



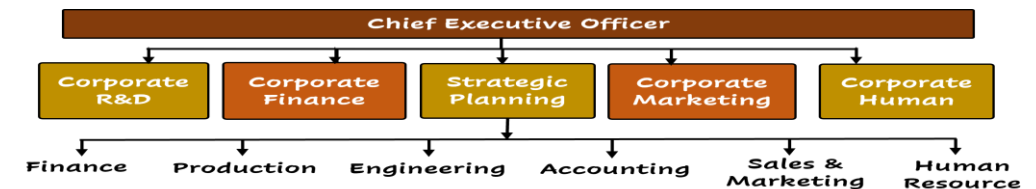
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XI. A) Simple Structure

- Here **owner-manager makes all major decisions** directly & **monitors all activities**, while the **company's staff** merely serves as an **executor**.
- It is **most appropriate** for companies
 - ✓ that follow **single-business strategy** & operate in **single geographic market**. or
 - ✓ implementing **focused cost leadership** or **focused differentiation strategies**.
- Characteristics of Simple Structure
 - 1) **Little specialization** of tasks,
 - 2) **few rules, little formalization**,
 - 3) **unsophisticated information systems**
 - 4) **direct involvement of owner-manager** in day-to-day operations
 - 5) **communication is frequent and direct**, and
 - 6) **new products** tend to be introduced **quickly**, which result in **competitive adv.** (but coordination problems are common)
- This structure result in **competitive advantages** like-
 - a) a **broad-based openness to innovation**,
 - b) **greater structural flexibility**, &
 - c) ability to **respond more rapidly to environmental changes**.
- However, if they are successful, **small companies grow larger**. As a result of this growth, **company outgrows simple structure**.
- **More extensive & complicated information-processing** places pressures on owner-managers (due to lack of organizational skills or experience or time).

XI. A) Functional Structure

- This structure **groups tasks and activities** by business function, such as- **production/operations, marketing, finance/accounting, R&D, HR** etc.
- Besides being **simple and inexpensive**, this structure promotes-
 - 1) **specialization of labour**,
 - 2) **encourages efficiency**,
 - 3) **minimizes need for an elaborate control system**, and
 - 4) **allows rapid decision making**.
- The functional structure consists of-
 - ✓ **CEO/MD** supported by **corporate staff**, with
 - ✓ **functional line managers** in **dominant functions**
- This structure enables to **overcome growth-related constraints** of simple structure, enabling or facilitating **communication & coordination**.
- **CEO** must **integrate functional decision-making & coordinate actions** of the **overall business across functions**.
- Functional specialists often may develop a **myopic perspective**, **losing sight of vision & mission**. This problem can be **overcome** by implementing the **multidivisional structure**.



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XI. C) Divisional Structure

- As a firm, **grows** year after year it faces **difficulty in managing different products** and services in **different markets**. Thus, divisional structure then becomes necessary to –
 - ✓ **motivate employees,**
 - ✓ **control operations,** and
 - ✓ **compete successfully in diverse locations.**
- With a divisional structure, **functional activities** are performed **both-**
 - ✓ **Centrally,** &
 - ✓ **in each division, separately.**
- **Advantages of divisional structure** MT: C²ALM & Easy
 - 1) It **creates career development opportunities** for managers,
 - 2) Leads to a **competitive climate** within an organization,
 - 3) **Accountability is clear.**
 - 4) **Allows local control of local situations,**
 - 5) Employees can easily see **results** of their **good** or **bad** performances. Thus, **employee morale is generally higher** &
 - 6) **Allows new businesses** and products to **be added easily.**
- **Limitation** of divisional structure is that its **costly**, because –
 - 1) **Each division** requires **functional specialists** who must be paid.
 - 2) There exists some **duplication** of **staff services, facilities,** and **personnel;**
 - 3) Managers must be **well qualified** as divisional design forces **delegation of authority better-qualified individuals** requires **higher salaries.**
 - 4) It requires an elaborate, **headquarters-driven control system.**
 - 5) Certain **regions, products,** or **customers** may sometimes **receive special treatment,** & It may be **difficult** to **maintain consistent, companywide practices.**

Divisional structure can be organized in four ways:

1) **By geographic area**

- Appropriate for org. –
 - ✓ strategies are formulated to **fit particular needs of customers** in **different geographic areas,** or
 - ✓ that have **similar branch facilities** located in **widely dispersed areas.**
- It **allows local participation in decision making** & **improved coordination** within a region.

2) **By product or service**

- Effective when specific products/serv. **need special emphasis.**
- Used when **org. offers only a few products,** which **differ substantially.**
- Allows **strict control & attention to product lines** → but require **more skilled mgt. force** & **reduced top mngt control.**

3) **By customer**

- Allows org. to **cater effectively** to **requirements of clearly defined customer groups.**
- For example,
 - ✓ **Book-publishing co.** → colleges, secondary schools, & private schools.
 - ✓ **Airline co.** → **passengers** and **cargo services.**

4) **By process**

- Similar to functional structure, as **activities are organized** according to way **work is actually performed.**
- But, **key difference** is that **divisional process departments** are **accountable for profits or revenues.**



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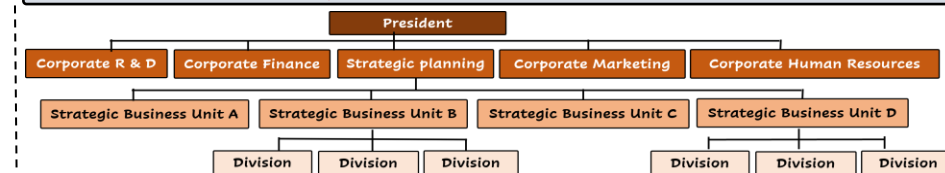
XI. D) Multi Divisional (M-Form) Structure

- ✓ Each division represents a **separate business** to which **top corporate officer** delegates-
 - ✓ day-to-day operations &
 - ✓ business unit strategy to division managers.
- By such delegation, **corporate office** is-
 - ✓ responsible only for **formulating & implementing** overall **corporate strategy**, &
 - ✓ manages divisions through **strategic and financial controls**.
- **Need for M-Form Structure**
 - Developed in **1920s**, due to **coordination & control-related problems** in **large cos**
 - **Functional departments** often had **difficulty** dealing with **distinct product lines** and markets, especially in **coordinating conflicting priorities** among the products.
 - **Costs were not allocated** to individual products, so it was **not possible** to assess an **individual product's profit contribution**.
 - Due to loss of control, **optimal allocation of resources** between products was **difficult**
 - **Top managers** became **over-involved** in solving **short-run problems**.
- Multidivisional structure calls for: (Characteristics)
 - **Creating separate divisions**, each representing a distinct business
 - **Each division** would house its **functional hierarchy**;
 - **Division managers** would be given **responsibility** for **managing day-to-day operations**;
 - **A small corporate office** that would determine the **long-term strategic direction** of the firm and exercise overall **financial control** over the **semi-autonomous divisions**.
- This structure enables the firm to- (Advantages)
 - 1) more **accurately monitor performance** of individual businesses,
 - 2) **simplifying control problems**,
 - 3) **facilitate comparisons** between divisions,
 - 4) **improving the allocation of resources** and
 - 5) **stimulate managers of poorly performing divisions** to seek ways to **improve performance**.

- If firm is less diversified → manage by **strategic controls** → **operational understanding** of strategies.
- An **increase in diversification** → manage by **financial controls** → **manage cash flow** of divisions → **budgets & emphasis on profits**.

XI. E) SBU Structure

- Relevant to **multi-product, multi-business org.**
- An SBU is a grouping of related businesses, which is amenable to **composite planning treatment**.
- A multi-business org. **groups its multitude of businesses** into a **few distinct business units** in a **scientific way**.
- Purpose → provide **effective strategic planning treatment** to **each one of its products/businesses**.
- 3 characteristics of SBU are:
 - 1) It is a single business or collection of related businesses which offer **scope for independent planning**, & which might **feasibly standalone** from rest of org.
 - 2) It has its **own set of competitors**.
 - 3) It has a **manager** who has **responsibility for strategic planning** and **profit performance**, and who has **control of profit-influencing factors**.
- SBU structure consists of at least three levels, with-
 - 1) a **corporate headquarters at the top**,
 - 2) **SBU groups at the second level**, and
 - 3) **divisions grouped by relatedness within each SBU at the third level**.





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Attributes of SBU

- 1) A **scientific method** of grouping businesses of a multi-business org. which helps in **strategic planning**.
- 2) An **improvement over territorial grouping of businesses** and **strategic planning based on territorial units**.
- 3) **Strategic planning** for SBU is **distinct** from rest of businesses. Products/businesses **within an SBU** receive **same** strategic planning treatment and priorities.
- 4) Each SBU will have its **own distinct set of competitors** and its **own distinct strategy**.
- 5) The **CEO of SBU** will be responsible for **strategic planning for SBU** and its **profit performance**.
- 6) Products/businesses that are **related from stand point of function** are **assembled together** as a distinct SBU.
- 7) **Unrelated products/businesses** in any group are separated into **separate SBUs**.
- 8) Grouping the businesses on SBU lines **helps in strategic planning by removing the vagueness and confusion**.
- 9) Each SBU is a **separate business** and will be **distinct from one another** on the basis of mission, objectives etc.

Advantages/Benefits of SBU**MT: Facilitates CRA²P**

- 1) **Facilitates** strategic management and control on large and **diverse organizations**.
- 2) Establishing **coordination between divisions** having **common strategic interests**.
- 3) Makes task of strategic **review** by top executives more **objective & effective**.
- 4) Fixes **accountabilities** at the level of **distinct business units**.
- 5) Helps **allocate corporate resources** to areas with **greatest growth opportunities**.
- 6) Allows strategic **planning** to be done at **most relevant level** in organisation.

XI. F) Matrix Structure

- In matrix structure, functional & product forms are combined simultaneously at same level of org.
 - Employees have **two superiors**, a **product or project manager** and a **functional manager**.
 - The "**home**" department - that is, **engineering, manufacturing, or marketing** - is usually **functional** & is permanent.
 - People from these functional units are often **assigned temporarily** to projects. The projects are usually **temporary** & **act like divisions** in that they are **differentiated** on a **product-market basis**.
 - Matrix structure is **most complex** of all designs because it **depends upon both vertical & horizontal flows** of **authority & communication**.
 - **Higher overhead** because it has **more management positions**.
- **Characteristics of a matrix structure** (leads to complexity)
- 1) **dual lines of budget authority** (violation of unity command principle),
 - 2) **dual sources of reward & punishment**,
 - 3) **shared authority**,
 - 4) **dual reporting channels**, and
 - 5) **need for an extensive and effective communication system**.
- **Advantages of a matrix structure** are that-
- 1) **project objectives are clear**,
 - 2) there are many **channels of communication**,
 - 3) workers can see the **visible results of their work**, and
 - 4) **shutting down a project is accomplished relatively easily**.

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Matrix structure is found in org. when 3 conditions exists:

- 1) Ideas need to be cross-fertilized across projects or products,
- 2) Resources are scarce and
- 3) Abilities to process information & to make decisions need to be improved.

For development of matrix structure Davis & Lawrence, have proposed 3 distinct phases:

- 1) **Cross-functional task forces:** Temporary cross-functional task forces are initially used when a new product line is being introduced. Project manager is in charge → key horizontal link.
- 2) **Product/brand management:** If the cross-functional task forces become more permanent, the project manager becomes a product or brand manager and a second phase begins. In this arrangement, function is still the primary organizational structure, but product or brand managers act as the integrators of semi permanent products or brands.
- 3) **Mature matrix:** The third and final phase of matrix development involves a true dual-authority structure. Both the functional and product structures are permanent. All employees are connected to both a vertical functional superior and a horizontal product manager. Functional and product managers have equal authority and must work well together to resolve disagreements over resources and priorities.

XI. G) SBU Structure

- Aka. "non-structure" by its virtual elimination of in-house business functions. Many activities are outsourced.
- A corporation organized in this manner is often called a virtual organization because it is composed of a series of project groups or collaborations linked by constantly changing non-hierarchical, cobweb-like networks.
- This structure is useful when environment is unstable. Under such conditions, there is a need for innovation & quick response. Instead of having salaried employees, it may contract with people for a specific project or length of time.
- Rather than being located in a single building or area, an organization's business functions are scattered at different geographical locations.
- The organization is, in effect, only a shell, with a small headquarters acting as a "broker", electronically connected to some completely/partially owned divisions.
- The network organization structure provides an organization-
 - ✓ With increased flexibility and adaptability to cope with rapid technological change & shifting patterns of international trade and competition.
 - ✓ It allows a company to concentrate on its distinctive competencies, while gathering efficiencies from other firms who are concentrating their efforts in their areas of expertise.

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CHAPTER 5 - STRATEGIC IMPLEMENTATION & EVALUATION

XI. G) Hourglass Structure

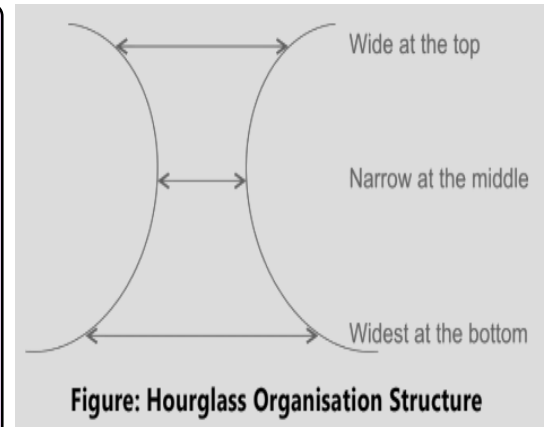
Disadvantages of Network Structure:

- 1) The **availability of numerous potential partners** can be a source of trouble.
- 2) **Contracting out functions to separate suppliers/distributors** may keep the firm from **discovering any synergies** by **combining activities**.
- 3) If a particular firm **over specialises** on only a **few functions**, it runs the **risk of choosing the wrong functions** and thus becoming **non-competitive**.

There are some serious implications:

- 1) **Employees** may **lack the level of confidence** necessary to participate actively in organization-sponsored learning experiences.
- 2) The **flatter** organizational structures that accompany contemporary structures can seem **intrusive** as a result of **their demand for more intense & personal interactions with internal and external stakeholders**.

- In recent year's **IT & communications** have **altered functioning** of org.
- **Role played by middle management is diminishing** as **tasks performed by them** are increasingly being **replaced by technological tools**.
- This structure consists of **three layers with constricted middle layer**. The structure has a short and **narrow middle-management level**.
- **Information technology** links the top and bottom levels in the organization taking away many tasks that are performed by the middle level managers.
- A shrunk middle layer coordinates diverse lower-level activities.
- **Managers** in hourglass structure are **generalists & perform wide variety of tasks**. They would be **handling cross-functional issues** like **marketing, finance or production** etc
- It has **benefit of-**
 - ✓ **reduced costs**
 - ✓ helps in **enhancing responsiveness** by **simplifying decision making**.
- It has problems like-
 - ✓ With reduced size of middle mgt., the **promotion opportunities for lower levels diminish significantly**.
 - ✓ **Continuity at same level** may bring **monotony** and **lack of interest** and it **becomes difficult to keep the motivation levels high**.
- Above problems are **overcome** by **assigning challenging tasks, transferring laterally & having system of proper rewards for performance**.



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XII. Organisational Culture

Corporate culture refers to a **company's values, beliefs, business principles, traditions, ways of operating, & internal work environment.**

How can a corporate culture be both strength and weakness ?

- a) **As a strength:** culture can **facilitate communication** decision-making & control and **create cooperation & commitment**. An organization's culture could be **strong** and cohesive when it conducts its business according to a **clear and explicit set of principles and values** which the management devotes considerable time to **communicating** to employees and which **values are shared widely across** the organization.
- b) **As a weakness:** As a weakness, culture may **obstruct the smooth implementation of strategy** by creating **resistance to change**. An organization's culture could be characterized as **weak** when many **sub-cultures exist**, few values and behavioral norms are shared and **traditions are rare**. In such organizations, **employees do not have a sense of commitment** and **loyalty** with the organization.

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'A strategy-supportive culture promotes good strategy execution.' – Explain

OR

Importance of corporate culture

- A culture where creativity, embracing change, and challenging the status quo are pervasive is very conducive to successful execution of a product innovation and technological leadership strategy.
- Strong cultures promote **good strategy execution** when there's fit and hurt execution when there's negligible fit. A **culture grounded in values, practices, and behavioral norms** that match what is needed for good strategy execution helps energize people throughout the organization to do their jobs in a **strategy-supportive manner**.
- A culture built around such business principles as-
 - ✓ **listening to customers,**
 - ✓ **encouraging employees to take pride** in their work,
 - ✓ **giving employees a high degree of decision-making responsibility.**
 This is very conducive to successful execution of a strategy of delivering superior customer service.
- A **work environment** where the **culture matches the conditions for good strategy** execution provides a system of **informal rules** and **peer pressure** regarding how to conduct business internally and how to go about doing one's job.
- A strong strategy-supportive culture makes **employees feel genuinely better about their jobs and** work environment and the merits of what the company is trying to accomplish.
- Employees are stimulated to take on the challenge of realizing the organizational vision, **do their jobs competently** and with enthusiasm, and **collaborate with others**.



CHAPTER 5 – STRATEGIC IMPLEMENTATION & EVALUATION

Changing a problem culture

- ❑ Changing a company's culture to align it with strategy is among the toughest management tasks – easier to talk about than do.
 - ❑ Changing a problem culture is very difficult because of the heavy anchor of deeply held values and habits.
 - ❑ It takes concerted management action over a period of time to replace an unhealthy culture with a healthy culture or to root out certain unwanted cultural obstacles and instil ones that are more strategy-supportive.
- 1) The first step is to diagnose which facets of the present culture are strategy supportive and which are not.
 - 2) Then, managers have to talk openly and forthrightly to all concerned about those aspects of the culture that have to be changed.
 - 3) The talk has to be followed swiftly by visible, aggressive actions to modify the culture-actions that everyone will understand are intended to establish a new culture more in tune with the strategy.

Management through communication has to create a shared vision to manage changes. The menu of culture-changing actions includes–

- communication on need & benefit to employees
- revising policies and procedures,
- recruiting & hiring new managers & employees,
- altering incentive compensation,
- replacing key executives,
- shifting budgetary allocations for substantial resources to new strategy projects

MT: CR²AKSPerils of Strategy-Culture Conflict

- ❑ When a company's culture is out of sync with what is needed for strategic success, culture has to be changed as rapidly as can be managed – this, of course, presumes that it is one or more aspects of the culture that are out of whack rather than strategy.
- ❑ While correcting a strategy-culture conflict can occasionally mean revamping strategy to produce cultural fit, more usually it means revamping mismatched cultural features to produce strategy fit.
- ❑ The more entrenched the mismatched aspects of culture, greater the difficulty of implementing new or different strategies until better strategy-culture alignment emerges. A sizable and prolonged strategy-culture conflict weakens & may even defeat managerial efforts to make strategy work.

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Strategic Control

- **Control is intended to regulate and check, i.e.,-**
 - ✓ to **structure** and **condition** the **behaviour of events and people**,
 - ✓ to place **restraints** and **curbs** on **undesirable tendencies**,
 - ✓ to make **people conform to certain norms and standards**,
 - ✓ to **measure progress** to keep the system on track,
 - ✓ to ensure that **what is planned is translated into results**,
 - ✓ to keep a watch on **proper use of resources**, on **safeguarding of assets** and so on.
- The controlling function involves-
 - ✓ **monitoring the activity** and **measuring results against pre-established standards**,
 - ✓ **analysing and correcting deviations** as necessary &
 - ✓ **maintaining/adapting the system**.
- ❑ Implementation of plans **cannot assure results** unless strong and sufficient **controls are put in place**. The management of the company should focus diligently on developing controls especially in problem areas.

The process of control has the following elements:

- a) **Objectives of business system** which could be operationalized into measurable & controllable standards.
- b) A mechanism for **monitoring and measuring** the performance of the system.
- c) A mechanism
 - (i) for **comparing the actual results** with reference to the standards
 - (ii) for **detecting deviations** from standards and
 - (iii) for **learning new insights** on standards themselves.
- d) A mechanism for **feeding back corrective & adaptive information** & instructions to system, for **effecting desired changes** to set right system to be on course.
- Above elements of control would ensure-
 - proper check on **improper use of resources**,
 - **undesirable tendencies of the workers**,
 - **non-conformance to norms & standards** and
 - ensure a **result oriented implementation** of plans.

There are three types of organizational control-
operational control, management control and strategic control

- a) **Operational Control**: The thrust of operational control is on **individual tasks or transactions** as against total or more aggregative management functions. For example, **procuring specific items for inventory** is a matter of operational control, in contrast to inventory management as a whole. There should be a **clear-cut** and somewhat **measurable relationship between inputs & outputs** which could be predetermined or **estimated** with **least uncertainty**.

Some of the examples of operational controls can be:

- ❑ **stock control** (maintaining stocks between set limits),
- ❑ **production control** (manufacturing to set programmes),
- ❑ **quality control** (keeping product quality between agreed limits),
- ❑ **cost control** (maintaining expenditure as per standards),
- ❑ **budgetary control** (keeping performance to budget).



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b) **Management Control:** When compared with operational control, management control is **more inclusive** and **more aggregative**, in the sense of embracing the integrated activities of a complete department, division or even entire organisation, instead or mere narrowly circumscribed activities of sub-units.

- ❑ The basic purpose of management control is the achievement of enterprise goals – short range and long range – in a most effective and efficient manner.
- ❑ The term management control is defined by Robert Anthony as 'the process by which managers assure the resources are obtained and used effectively and efficiently in the accomplishment of the organisation's objectives.'

c) **Strategic Control:** According to Schendel and Hofer "Strategic control focuses on the dual questions of whether:

- (1) the strategy is being implemented as planned; and
 - (2) the results produced by the strategy are those intended."
- ❑ There is often a time gap between the stages of strategy formulation and its implementation. A strategy might be affected on account of changes in internal and external environments of organisation. There is a need for warning systems to track a strategy as it is being implemented.
 - ❑ Strategic control is the process of evaluating strategy as it is formulated and implemented. It is directed towards identifying problems and changes in premises and making necessary adjustments.

There are four types of strategic controls, which areas follows:

- 1) Premise control
- 2) Strategic surveillance
- 3) Special alert control
- 4) Implementation control

1) **Premise control:** A strategy is formed on the basis of certain assumptions or premises about complex & turbulent organizational environment. Over a period of time these premises may not remain valid. Premise control is a tool for systematic and continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built. It primarily involves monitoring two types of factors:

(i) **Environmental factors** such as economic (inflation, liquidity, interest rates), technology, social and legal-regulatory.

(ii) **Industry factors** such as competitors, suppliers, substitutes.

It is neither feasible nor desirable to control all types of premises in same manner. Different premises may require different amount of control. Thus, managers are required to select those premises that are likely to change & would severely impact the functioning of the organization and its strategy

2) **Strategic surveillance:**

❑ Contrary to the premise control, the strategic surveillance is unfocussed. It involves general monitoring of various sources of information to uncover unanticipated information having a bearing on the organizational strategy. It involves casual environmental browsing.

❑ Reading financial and other newspapers, business magazines, attending meetings, conferences, discussions & so on can help in strategic surveillance.

❑ Strategic surveillance may be loose form of strategic control but is capable of uncovering information relevant to the strategy.

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3) Special alert control: At times, **unexpected events** may force organizations to **reconsider** their **strategy**. **Sudden changes in government**, natural calamities, terrorist attacks, unexpected merger/acquisition by competitors, industrial disasters & other such events may **trigger** an **immediate & intense review of strategy**.

❑ To cope up with such eventualities, the organisations form **crisis management teams** to handle the situation.

4) Implementation control: Managers implement strategy by **converting major plans** into **concrete, sequential actions** that form incremental steps. Implementation control is directed towards **assessing the need for changes** in the overall strategy in light of unfolding events & results associated with incremental steps & actions.

❑ Strategic implementation control is **not a replacement to operational control**. Unlike operational control, it **continuously monitors basic direction of strategy**.

❑ Two basic forms of implementation control are:

(i) Monitoring strategic thrusts: Monitoring strategic thrusts helps managers to determine whether the **overall strategy is progressing** as desired **or** whether there is **need** for **readjustments**.

(ii) Milestone Reviews: All key activities necessary to implement strategy are **segregated in terms of time, events or major resource allocation**. It normally involves a **complete reassessment of the strategy**. It also assesses the need to continue or refocus the direction of an organization.

Strategic Performance Measures (SPM) is a method that **increases line executives' understanding** of an organization's **strategic goals** & offers a **continuous system for tracking progress** towards these objectives using **clear-cut performance measurements**.

There are various types of strategic performance measures-

1) Employee Measures: Employee measures, such as **employee satisfaction, turnover rate**, and employee **engagement**, provide insight into the organization's ability to **attract and retain talented employees** and **create a positive work environment**.

2) Environmental Measures: Environmental measures, such as **energy consumption, waste reduction**, and **carbon emissions**, provide insight into the organization's **impact on the environment** and its **efforts to operate in a sustainable manner**.

3) Market Measures: Market measures, such as **market share, customer acquisition**, and customer **referrals**, provide information about the organization's **competitiveness** in the **marketplace** and its **ability to attract and retain customers**.

4) Innovation Measures: Innovation measures, such as research and development (R&D) spending, **patent applications**, and **new product launches**, provide insight into the organization's ability to **innovate** and **create new products and services that meet customer needs**.

5) Customer Satisfaction Measures: Customer measures, such as **customer satisfaction**, customer **retention**, and customer **loyalty**, provide insight into the **organization's ability** to meet **customer needs** and provide **high-quality products and services**.

6) Financial Measures: Financial measures, such as **revenue growth**, return on investment (ROI), and **profit margins**, provide an **understanding of the organization's financial performance** and its **ability to generate profit**.



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Strategic performance measures are essential for organizations for several reasons:

- 1) **Resource Allocation:** Strategic performance measures provide organizations with the information they need **to make informed decisions** about resource allocation, enabling them to **prioritize their efforts** and **allocate resources** to the areas that will have the **greatest impact on their performance**.
- 2) **External Accountability:** Strategic performance measures help organizations **demonstrate accountability to stakeholders**, including shareholders, customers, and regulatory bodies, by providing a **clear and transparent picture of their performance**.
- 3) **Goal Alignment:** Strategic performance measures help organizations align their strategies with their goals and objectives, ensuring that they are **on track to achieve their desired outcomes**.
- 4) **Continuous Improvement:** Strategic performance measures provide organizations with a framework for continuous improvement, enabling them to **track their progress** and **make adjustments to improve their performance over time**.

Choosing the Right Strategic Performance Measures

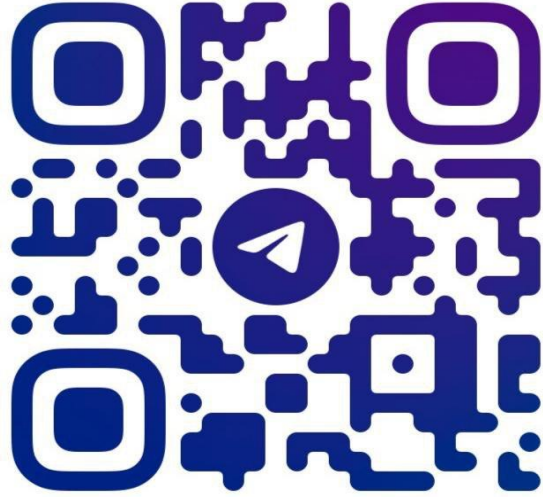
In selecting right measures, organizations should consider the following factors:

- 1) **Relevance:** The measure should be relevant to the organization's goals and objectives and **provide information** that is **actionable** and **meaningful**.
- 2) **Data Availability:** The measure should be based on **data** that is **readily available** and can be **collected** and **analyzed** in a **timely manner**.
- 3) **Data Quality:** The measure should be based on **high-quality data** that is **accurate** and **reliable**.
- 4) **Data Timeliness:** The measure should be based on data that is **current** and **up-to-date**, enabling organizations to make **informed decisions in a timely manner**.

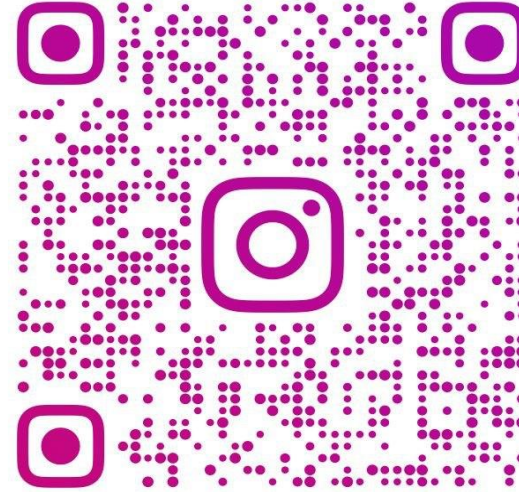


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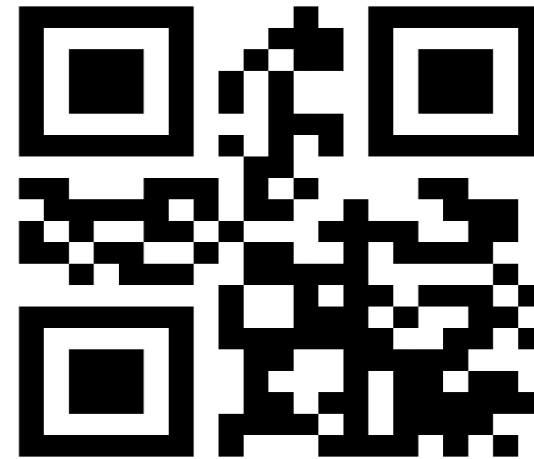
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