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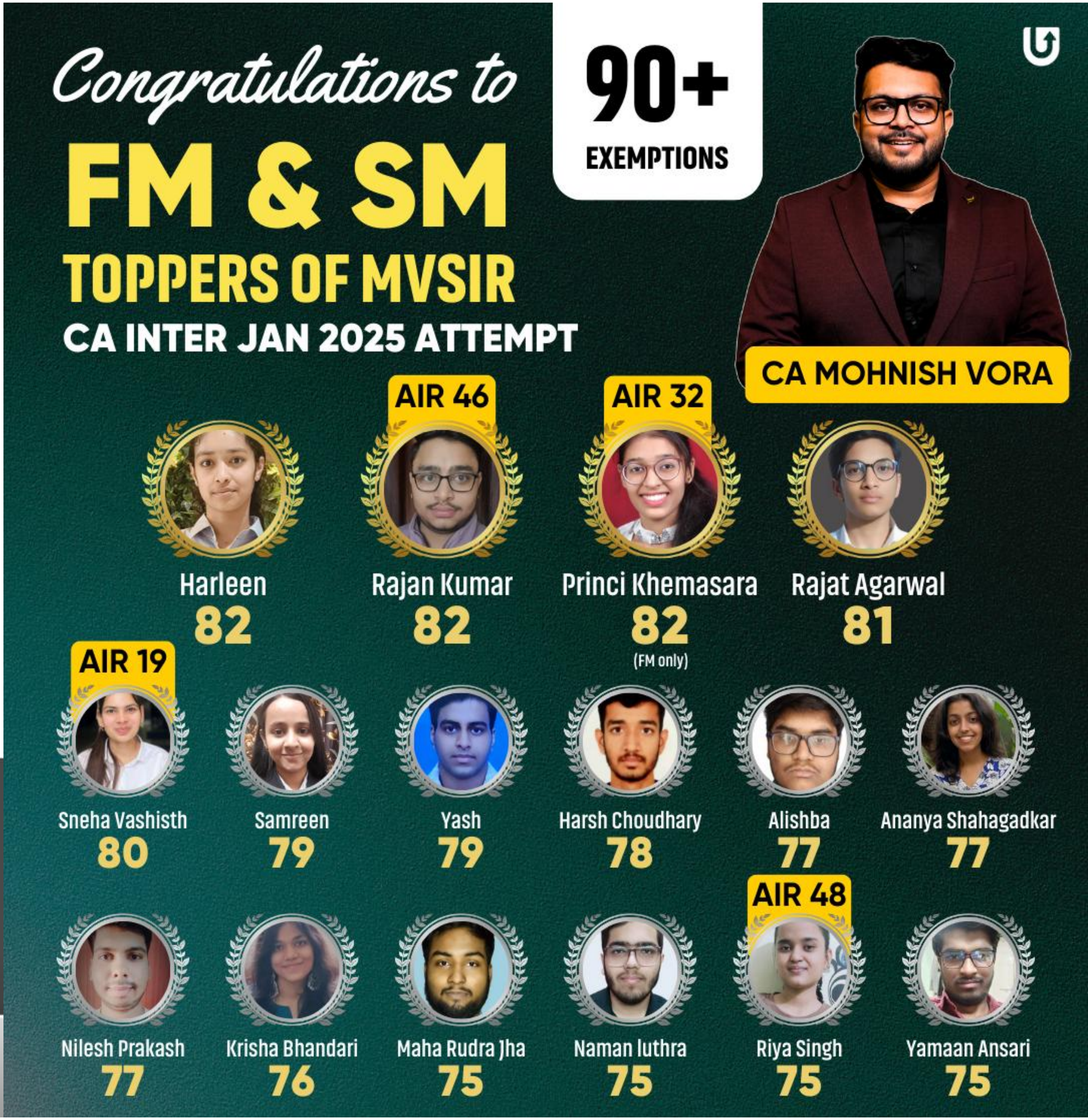

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CA Intermediate (New Syllabus)

FM Super Chart Book

INDEX

Note- Index of SM is given separately

CA Intermediate – New Syllabus

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

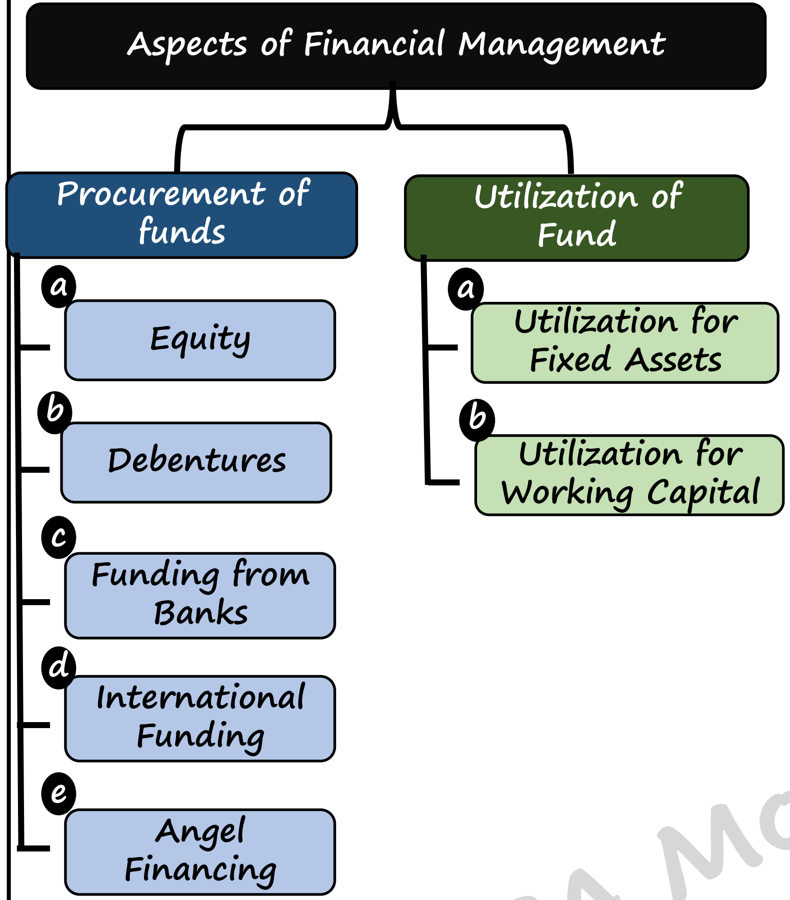
  with an **objective to-**
  - ✓ **Maximisation** of **profits**, &
  - ✓ **Maximisation** of **wealth** (value) of shareholders.

- ➢ 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

- Procurement of funds
  - a Equity
  - b Debentures
  - c Funding from Banks
  - d International Funding
  - e Angel Financing
- Utilization of Fund
  - a Utilization for Fixed Assets
  - b Utilization for Working Capital

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	➢ 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- ✓ 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	➢ 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 ✓ 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	➢ 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:- Lending Services Fund Based: Cash Credit; Overdraft; Term Loans; Working Capital Term; Bill Purchase / Discounting Non – Fund Based: Guarantee; Letters of Credit

D) International Funding	➢ 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	➢ 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	➢ 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	➢ 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:

1 Traditional Phase

During this phase, financial management was considered necessary **only during occasional events such as takeovers, mergers, expansion, liquidation**, etc. Also, when taking financial decisions in the organisation, the **needs of outsiders** (investment bankers, people who lend money to the business and other such people) to the business was **kept in mind.**

2 Transitional Phase

During this phase, the **day-to-day problems** that financial managers faced were **given importance**. The general problems related to **funds analysis, planning and control** were given **more attention** in this phase.

3 Modern Phase

Modern phase is still going on. The scope of financial management has greatly increased now. It is important to **carry out financial analysis for a company**. This analysis helps in **decision making**.

During this phase, many **theories** have been developed regarding **efficient markets, capital budgeting, option pricing, valuation models** and also in several other important fields in financial management.

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

1 Investment decisions (I)

- ➢ These decisions relate to **selection of assets** in which funds will be invested by a firm.
- ➢ Long term funds are used in a project for various **fixed assets** and also for **current assets**.

2 Financing decisions (F)

- ➢ These decisions relate to **acquiring the optimum finance** to meet financial objectives and seeing that **fixed** and **working capital** are effectively managed.
- ➢ Finance manager needs to have knowledge of sources of available funds & their respective **costs** and needs to ensure that company has a **sound capital structure**, i.e. a proper **balance between equity capital and debt**.

3 Dividend decisions (D)

- ➢ These decisions relate to determination as to **how much & how frequently cash can be paid out of profits** of organisation as income for equity shareholders
- ➢ The dividend decision thus has **two elements-**
  1) **amount to be paid out** &
  2) **amount to be retained** to support growth of org.

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, societyetc. 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.

Wealth = Present value of benefits – 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."

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.

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?	What a CFO now does?
1) Budgeting	1) Budgeting
2) Forecasting	2) Forecasting
3) Accounting	3) Managing M&As
4) Treasury (cash management)	4) Profitability analysis (for example, by customer or product)
5) Preparing internal financial reports for management.	5) Pricing analysis
6) Preparing quarterly, annual filings for investors.	6) Decisions about outsourcing
7) Tax filing	7) Overseeing the IT function.
8) Tracking accounts payable and accounts receivable.	8) Overseeing the HR function.
9) Travel and entertainment expense management.	9) Strategic planning (sometimes overseeing this function)
	10) Regulatory compliance.
	11) Risk management.

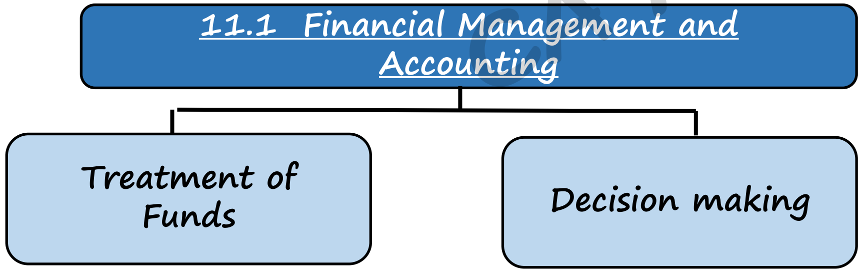
Financial Distress And Insolvency

- 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.

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.

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.**
- <u>Agency cost</u> 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

By CA Mohnish Vora (MVSIR)

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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 ***exceeding 5-10 years***. 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 ***exceeding one year but not exceeding 5 years***. 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 ***not exceeding*** the accounting period. i.e., ***one year***.

Basic Principle for Funding Various Needs

Stage	Type of Borrowing	Borrower nature
Early stage	High Uncertainty	• Equity; mainly Angel fund
	High to moderate Uncertainty	• Equity; • Venture capital; • Debt
Growth Stage	Moderate to Low Uncertainty	• Debt; • Venture Capital; • Private Equity
Stable stage	Low Uncertainty	• Debt

Classification Of Financial Sources

- Based on Basic Sources
- Based on Maturity of repayment period
- Based on Ownership & Control

Sources of finance based on Basic Sources

- External Sources
  - Share Capital
    - Equity Shares
    - Preference Shares
  - Debt or Borrowed Capital
    - Debentures
    - Loan from Financial Institutions & Banks
- Internal Sources
  - Retained Earnings

Sources of finance based on Ownership and Control

- Owner's Fund
  - Equity Share Capital
  - Retained Earnings
- Borrowed Fund
  - Debentures
  - Loan from Financial Institutions & Banks

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.

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

1) Debentures are issued in different denominations ranging from ₹100 to ₹1,000 & carry different rates of interest.
2) They are issued on basis of debenture trust deed which lists terms & conditions on which debentures are floated.
3) They are used for raising long-term debt capital.
4) The period of maturity varies from 3 to 10 years & may increase for high gestation projects.
5) Debentures are either secured or unsecured.
6) They may or may not be listed on stock exchange.
7) The cost of using debentures is quite low since interest is a tax-deductible expense.
8) 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	Repair after a certain period
6.	Non-Redeemable	Not repayable

Advantages of Debentures

1) 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.
2) Debenture financing does not result in dilution of control.
3) 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.

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 Bond

Based 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

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)	➢ 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	➢ 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.
3.	Convertible Floating Rate Notes (FRN)	➢ 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	➢ 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	➢ 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)	➢ 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	➢ 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	➢ 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	➢ 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	➢ 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	➢ 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-

a) 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.

b) 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.

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.

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

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:

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 requirements 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.

Types of Bank Advances

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.

Notes:

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 <u>without</u> **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.

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.

Instagram Channel of MVSIR
@ca_mohnishvora

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.

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 Depository Receipts (ADRs)
    b) Global Depository Receipts (GDRs)
    c) Indian Depository 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.

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 Instruments

a) 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**.

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 Frances** 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.

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.

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 depositary 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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CA Intermediate – New Syllabus

FM & SM

SUPER CHART BOOK

FM Chapter 3

Ratio Analysis

By CA Mohnish Vora (MVSIR)

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

CHAPTER 3 – Ratio Analysis

Liquidity Ratios

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

Long-term Solvency Ratios / Leverage Ratios

Capital Structure Ratios

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

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

Net Assets Or Net Worth = Total Assets – Total Liabilities

= [FA + CA] – [LTD + CL]

Capital Employed = FA + [CA – CL

= FA + WC]

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)	$\frac{\text{Earnings available for debt services}}{\text{Interest + Instalments}}$ OR $\frac{\text{EBITDA}}{\text{Interest + Instalments}}$

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	$\frac{\text{Sales}}{\text{Total Assets}}$	OR	$\frac{\text{Cost of Goods Sold}}{\text{Total Assets}}$
Fixed Assets Turnover Ratio	$\frac{\text{Sales}}{\text{Fixed Assets}}$	OR	$\frac{\text{Cost of Goods Sold}}{\text{Fixed Assets}}$
Capital Turnover Ratio	$\frac{\text{Sales}}{\text{Capital Employed}}$	OR	$\frac{\text{Cost of Goods Sold}}{\text{Capital Employed}}$
Current Assets Turnover Ratio	$\frac{\text{Sales}}{\text{Current Assets}}$	OR	$\frac{\text{Cost of Goods Sold}}{\text{Current Assets}}$
Working Capital Turnover Ratio	$\frac{\text{Sales}}{\text{Working Capital}}$	OR	$\frac{\text{Cost of Goods Sold}}{\text{Working Capital}}$
Inventory/ Stock Turnover Ratio	$\frac{\text{Sales}}{\text{Average Inventory}}$ Where, Average Inventory	OR =	$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$ $\frac{\text{Op. Stock + Cl. Stock}}{2}$
Inventory Holding period Or Inventory Velocity	$\frac{\text{12 mts/365 days/52 weeks}}{\text{Inventory T/O ratio}}$	OR	$\frac{\text{Average Inventory}}{\text{Daily/Monthly/weekly COGS}}$
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	$\frac{\text{Average Accounts Receivable}}{\text{Average Daily Credit Sales}}$ Average Daily Credit Sales	OR =	$\frac{\text{12 months/52 weeks/360 day}}{\text{Receivable Turnover Ratio}}$ $\frac{\text{Credit Sales}}{\text{No. of days in year (say360)}}$

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	$\frac{\text{Average Accounts Payable}}{\text{Average Daily Credit Purchases}}$ OR $\frac{\text{12 months/52 weeks/360 day}}{\text{Payables Turnover Ratio}}$

Profitability Ratios

Profitability Ratios Related to Sales

a) Gross Profit Ratio	$\frac{\text{Gross Profit}}{\text{Sales}} \times 100$
b) Net Profit Ratio	$\left[\frac{\text{Net Profit}}{\text{Sales}} \times 100\right]$ 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	$\left[\frac{\text{Operating Profit}}{\text{Sales}} \times 100\right]$ 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	$\frac{\text{COGS + Operating Exp.}}{\text{Sales}} \times 100$
Financial Exp Ratio	$\frac{\text{Financial Exp}}{\text{Sales}} \times 100$ Financial Exp = Interest + Equity & Pref Dividend

Operating Profit

- Sales (–) COGS (–) Operating Exp
- Sales (–) [COGS + Operating Exp]
- Sales (–) Op. cost
- Gross Profit (–) Op.Exp
- Net profit (–) Non Operating income (+) Non Op Exp

COGS Ratio + GP Ratio = 100%
Op. cost ratio + 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 Profitability Ratio x Investment Turnover Ratio

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

i) Return on Capital Employed (ROCE)	ROCE (Pre-tax) = $\frac{\text{EBIT}}{\text{Capital Employed}} \times 100$ ROCE (Post-tax) = $\frac{\text{EBIT (1-t)}}{\text{Capital Employed}} \times 100$ 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 $\frac{\text{Net Profit after taxes}}{\text{Average Fixed Assets}}$

ii) Return on Assets (ROA)	As Assets are also financed by lenders, hence ROA can be calculated as- ROA = $\frac{\text{Net Profit after taxes + Interest}}{\text{Average Total Assets or Average Tangible Assets or Average Fixed Assets}}$ Return on Total Assets (ROTA) = $\frac{\text{EBIT (1-t)}}{\text{Average Total Assets}}$ 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

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

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

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)	$\frac{\text{Total Eq. Dividend}}{\text{Earning per Eq Share}}$ OR $\frac{\text{DPS}}{\text{EPS}}$
Dividend Rate	$\frac{\text{Total Eq. Dividend}}{\text{FV of ESC}}$ OR $\frac{\text{DPS}}{\text{FVPS}}$
Retention ratio [b]	$\frac{\text{Retained Earnings}}{\text{EFES}}$ 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)	$\frac{\text{Average share price}}{\text{Equity} \div \text{No. of equity shares}}$ 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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FM Chapter 4
Cost of Capital

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CHAPTER 4 – Cost of Capital

Cost of Long Term Debt (Kd)

Cost of Irredeemable Debt

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

- 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

$$Kd = \frac{I(1-t) + \left[\frac{(RV - NP)}{n}\right]}{\left[\frac{(RV + NP)}{2}\right]}$$

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

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

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.

CHAPTER 4 – Cost of Capital

COST OF EQUITY SHARE CAPITAL (Ke)

Dividend Price Approach

$$Ke = \frac{D1}{PO}$$

Earnings Price Approach

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

Growth Approach or Gordon's Model

$$Ke = \frac{D1}{PO} + g$$

Capital Asset pricing model

$$Ke = Rf + \beta\,(Rm - Rf)$$

- D1 = Expected Dividend
- Po = Current Market Price (Ex Dividend)
- Ex Div Price = Cum Div Price (-) DPS
- If Floatation Cost is given, then subtract it in denominator→ [PO – FC]
- g = b (x) r

Rm – Rf = Market Risk Premium

β (Rm – Rf) = Security Risk Premium

Generally, Ke = Cost of Retained Earnings (Kr)
However, difference comes when floatation cost & personal tax exists

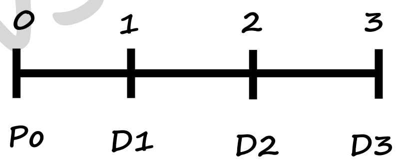
- If personal tax [tp] is given in ques
Kr = Ke (1-FC) (1-tp)

- If we have to calculate both Ke & Kr & Ques mentions → issue price, FC, & CMP {illu. 13}
  - For Ke (assuming new issue of equity shares) → Po = Issue Price – F.C
  - For Kr → Po = C.M.P

Realised Yield approach

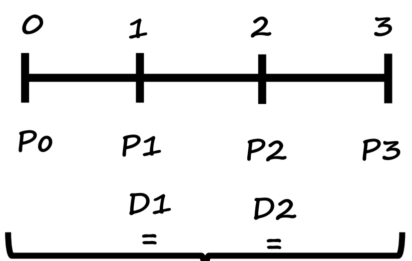
2 ways to calculate Ke as per above method

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



Calculate Ke 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 →

$$(1 + r1) = \frac{P1+D1}{Po}$$

$$(1 + r2) = \frac{P2+D2}{P1}$$

$$Ke = \left[\sqrt[n]{(1+r1) \times (1+r2) \ldots\ldots \times (1+rn)}\right] - 1$$

CHAPTER 4 – Cost of Capital

Cost Of Preference Share Capital (Kp)

Cost of Irredeemable Preference Shares

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

- 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

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

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)

WEIGHTED AVERAGE COST OF CAPITAL (WACC)

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

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. id 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

Data Given in Question			FC to be calculated on
Face Value	Issue Price	Current Market Price (CMP)	
✓	✗	✗	**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

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

    - MV of R&S

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

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

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**.

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FM Chapter 5

Capital Structure

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CHAPTER 5 – Capital Structure

Value of the firm

Before Tax

$$\boxed{\frac{NOI}{Ko}}$$

After Tax

$$\boxed{\frac{NOI\ (1-t)}{Ko}}$$

OR

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

$$= \frac{\text{Net income}}{Ke} + \frac{\text{Interest}}{Kd}$$

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

Cost of Capital

Ko = (Cost of debt x weight of debt)
+ (Cost of equity x weight of equity)

Ko = [{Kd x D/ (D+S)} + {Ke x S/(D+S)}]

Ko = [{Kd x Wd} + {Ke x We }]

OR

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

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

NOI
(–) Interest

EBT
(–) Tax

Net Income [EAT = EFES]

Or

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

No taxes

NOI
(–) Interest

Net Income [EBT = EAT = EFES]

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

Notes:

CHAPTER 5 – Capital Structure

Capital Structure Theories		
Relevance Theory (capital structure decision is <u>relevant</u> 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 Ko & thereby maximizing Vf
	Traditional Approach	A firm should increase leverage (debt) only upto **Optimum point**, where Ko is **minimum** & Vf is **maximum**
	Modigliani-Miller (MM) Approach-1958 (With Tax)	As per this approach, $\boxed{V_L > V_{UL}}$ $V_L = V_{UL}$ + Tax Advantage ...OR $V_L = V_{UL}$ + [Debt x Tax Rate] <u>Steps to solve Ques of MM Approach (with tax)</u> **Step 1** $V_{uL} = \frac{NOI\ (1-t)}{K_{ouL}}$ **Step 2** $V_L = V_{uL}$ + Tax Advantage [Debt x t] **Step 3** Ko of levered co. $= \frac{NOI\ (1-t)}{V_L}$ **Step 4** Ko of levered co. $= \frac{NI}{S} = \frac{(NOI - Int)\ (1-t)}{V_L - D}$

Irrelevance Theory (capital structure is <u>irrelevant</u> to the value of the firm)	**Net Operating Income (NOI) Approach**	The increase in debt in the capital structure leads to increase in Ke such that Ko remains constant. Thus, Vf 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) Vf [Levered or unlevered] = NOI/Ko $\boxed{\text{Value of Lev Co. = Value of Unlev Co.}}$ 2) Ke of Levered Co [KeL] > Ke of Unlevered Co [Keul] $\boxed{K_{eL} = K_o + [K_o - K_d]\ D/S}$ 3) Capital Structure does **NOT** affect Ko or value of firm

Arbitrage

<u>Case I: When Value of Levered > Value of Unlevered</u>

- <u>**Step 1:**</u> Sell (assuming we have 10% equity) Shares of Levered Co. & receive cash
- <u>**Step 2:**</u> Personally Borrow an amount equal to 10% of (Debt of Levered Co.) at the same interest rate of levered cos. debt.
- <u>**Step 3:**</u> Buy 10% Equity of Unlevered Co.

✓ Now balance cash left will be →

(Amt recd from shares + Debt Taken) – Value of Unlev Co. 10% sh.

- <u>**Step 4:**</u> Calculate Return due to arbitrage (which will be "0") & you will be left with **balance cash**

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

$$\boxed{V_L = V_{uL} + \text{Tax Advantage} - \text{Cost of Financial Distress}}$$

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 x PE 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 I the amount of EBIT where, value of EPS is equal in two alternative options of financing.**

$$\frac{(EBIT_1 - Int)(1-t) - P_D}{\text{No. of Equity shares}} = \frac{(EBIT_2 - Int)(1-t) - P_D}{\text{No. of Equity shares}}$$

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

No Indifference Point Or **Many (infinite) Indifference points**

No Indifference Point → If after tax cost of source [other than ESC] is **NOT SAME** under both plans

Many (infinite) Indifference points → 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, **EPS = 0** of a particular alternative of financing.

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

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

Sales BEP

At what level (amt) of sales

↓

EBIT = 0

Sales
(-) VC
Contribution
(-) FC
EBIT → 0

Financial BEP

At what level (amt) of EBIT

↓

EPS = 0

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

↓

We find out this EBIT, where EPS = 0

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FM Chapter 6

Leverage Analysis

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CHAPTER 5 – Leverage Analysis

Formula of Leverages

Degree of Operating Leverage	$DOL = \frac{\% \Delta \text{ EBIT}}{\% \Delta \text{ Sales}}$
Degree of Financial Leverage	$DFL = \frac{\% \Delta \text{ EPS}}{\% \Delta \text{ EBIT}}$
Degree of Combined Leverage	$DCL = \frac{\% \Delta \text{ EPS}}{\% \Delta \text{ Sales}}$

Alternative Formula

When Pref Div does not exist	When P_D exists
$DOL = \frac{\text{Contribution}}{\text{EBIT}}$	$DOL = \frac{\text{Contribution}}{\text{EBIT}}$
$DFL = \frac{\text{EBIT}}{\text{EBT}}$	$DFL = \frac{\text{EBIT}}{\text{EBT} - \left[\frac{P_D}{1 - t}\right]}$
$DCL = \frac{\text{Contribution}}{\text{EBT}}$	$DCL = \frac{\text{Contribution}}{\text{EBT} - \left[\frac{P_D}{1 - t}\right]}$

Margin of Safety and Operating Leverage

$$MOS = \frac{\text{Sales} - \text{BEP Sales}}{\text{Sales}} \times 100$$

$$MOS = \frac{\text{Sales}-\text{BEP Sales}}{\text{Sales}} \times \frac{\text{PV Ratio}}{\text{PV Ratio}}$$

$$MOS = \frac{\text{EBIT}}{\text{Contribution}}$$

$$\text{Degree of Operating leverage} = \frac{1}{\text{Margin of safety (in \%)}}$$

Formula of BEP Sales

- In Units → $\frac{\text{Fixed Cost}}{\text{Contribution per unit}}$
- In Amount → $\frac{\text{Fixed Cost}}{\text{PV Ratio}}$
- In % → $\frac{\text{Fixed Cost}}{\text{Contribution}}$

Formula of MOS Sales

- In Units → $\frac{\text{EBIT}}{\text{Contribution per unit}}$
- In Amount → $\frac{\text{EBIT}}{\text{PV Ratio}}$
- In % → $\frac{\text{EBIT}}{\text{Contribution}}$ Or $\frac{1}{\text{DOL}}$

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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FM Chapter 7

Investment Decisions

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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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Buy books & classes of MVSIR- www.mvsir.in
Enroll in FM/SM classes from- www.ultimateca.com

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

Net Present Value (NPV) method

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

Or

$$= \left[\frac{C1}{(1+Ko)^1} + \frac{C2}{(1+Ko)^2} + ... + \frac{Cn}{(1+Ko)^n}\right] (-) \text{ Initial Investment}$$

Year	Particulars	Cf	Df	Dcf

How to take decision as per NPV Method?

$\underbrace{NPV > 0}_{Accept}$ $\underbrace{NPV = 0}_{Accept/\ Reject}$ $\underbrace{NPV < 0}_{Reject}$

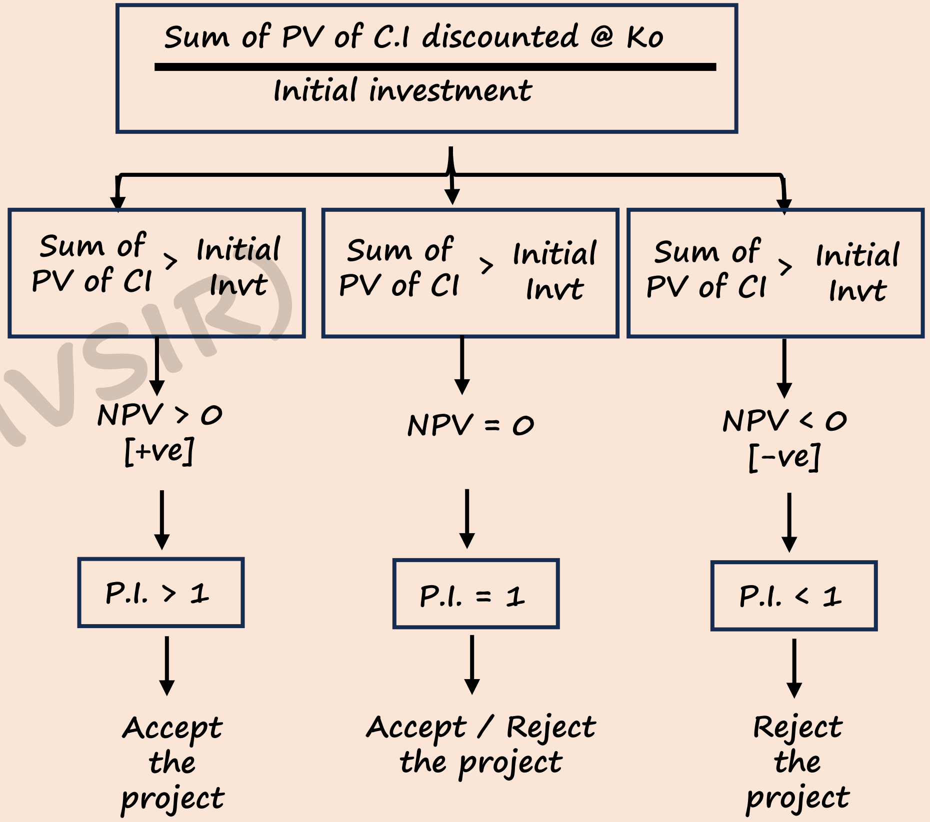
$\boxed{NPV \neq Profit}$

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]

Time Adjusted OR Discounting Techniques

Profitability Index (PI)



$$\frac{\text{Sum of PV of C.I discounted @ Ko}}{\text{Initial investment}}$$

Sum of PV of CI > Initial Invt → NPV > 0 [+ve] → P.I. > 1 → Accept the project

Sum of PV of CI > Initial Invt → NPV = 0 → P.I. = 1 → Accept / Reject the project

Sum of PV of CI > Initial Invt → NPV < 0 [-ve] → P.I. < 1 → Reject the project

CHAPTER 7 – Investment Decisions

Time Adjusted OR Discounting Techniques

Internal Rate of return (IRR) method

IRR is the discounting rate at which

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

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

$$\boxed{\text{Lower Rate} + \frac{NPV_{LR}}{NPV_{LR} - NPV_{HR}} \quad (HR - LR)}$$

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

$NPV_{LR} \rightarrow +ve$

& $NPV_{HR} \rightarrow -ve$

- ➢ *How to take decision as per IRR method ?*

IRR > Ko	IRR = Ko	IRR < Ko
↓	↓	↓
Accept the project	Accept / Reject the project	Reject the project

Time Adjusted OR Discounting Techniques

Modified IRR

- *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

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

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

- ➢ *How to take decision as per MIRR ?*

MIRR > Ko	MIRR = Ko	MIRR < Ko
↓	↓	↓
Accept the project	Accept / Reject the project	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	▪ 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. [Eg → Tax saving due to Depn, Rent saved due to Purchase of a factory]
Cash Outflow	▪ 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. [Jo income mil rahi thi, vo ab nahi mil rahi, new aseet ke wajah se Eg → Hospital - Commission]

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

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)
- <u>Project A</u>

0	1	2	3	4	5	6
(40L)	8L	14L	13L	12L	11L	10L

- <u>Project B</u>

0	1	2	3	4	5	6
(20L)	7L	13L	12L (20L)	12L	11L	10L

Equivalent Annualised criterion [EAC]

- <u>Step 1</u> : Compute NPV of all projects.
- <u>Step 2</u> : Compute PVAF of projects as per the respective life.
- <u>Step 3</u> : Compute

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

& compare the same

EAC net inflows (NPV) ↓ Choose the project with Higher EAC

EAC net outflows (NPV) ↓ Choose the project with Lower EAC

CHAPTER 7 – Investment Decisions

ADJUSTED PRESENT VALUE [APV]

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

Adjusted PV = Base case NPV + PV of tax shield on Int. (–) Issue cost

ADJUSTED DISCOUNT RATE [ADR]

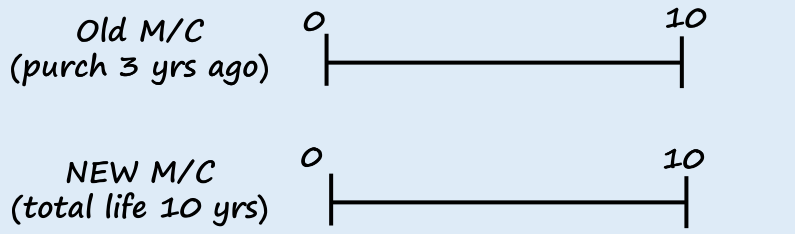
$$ADR = \frac{\text{Annual C. I. where APV = 0}}{\text{Total funds Raised as DEBT}}$$

REPLACEMENT OF MACHINERY

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

Yr.	Incr. PBDT	Incr. Depr.	Incr. PBT	Incr. PAT	Incr. CFAT	Df	DCF
	(1)	(2)	(3) = (1)-(2)	(4) = (3) x (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



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

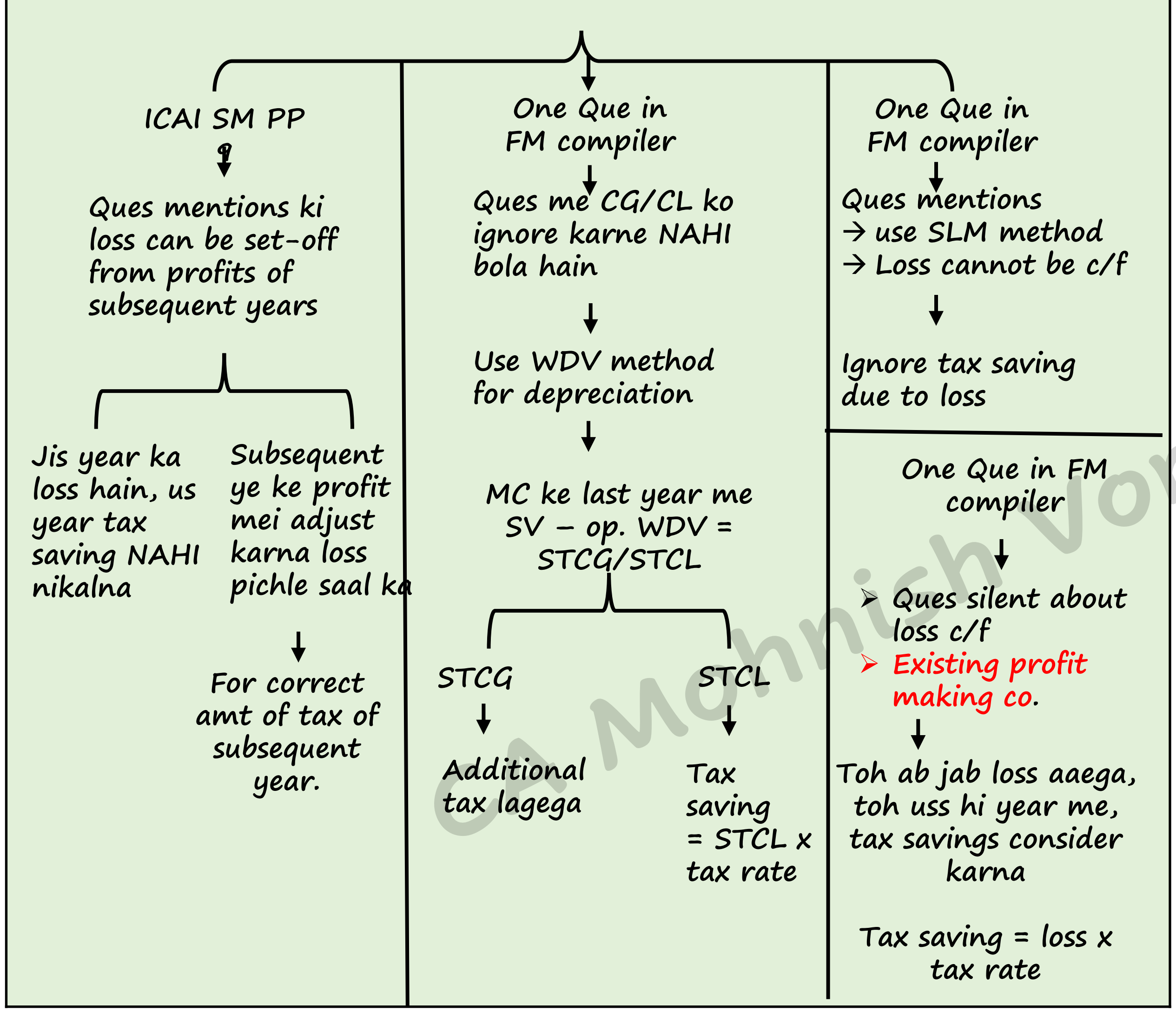
Incremental Approach (follow this in exams)

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.

Kya tax calculate karna hain loss pe ?



ICAI SM PP
↓
Ques mentions ki loss can be set-off from profits of subsequent years

- Jis year ka loss hain, us year tax saving NAHI nikalna
- Subsequent ye ke profit mei adjust karna loss pichle saal ka
  ↓
  For correct amt of tax of subsequent year.

One Que in FM compiler
↓
Ques me CG/CL ko ignore karne NAHI bola hain
↓
Use WDV method for depreciation
↓
MC ke last year me SV – op. WDV = STCG/STCL

- STCG
  ↓
  Additional tax lagega
- STCL
  ↓
  Tax saving = STCL x tax rate

One Que in FM compiler
↓
Ques mentions
→ use SLM method
→ Loss cannot be c/f
↓
Ignore tax saving due to loss

One Que in FM compiler
↓
- Ques silent about loss c/f
- Existing profit making co.

↓
Toh ab jab loss aaega, toh uss hi year me, tax savings consider karna

Tax saving = loss x tax rate

Notes:

CA Intermediate – New Syllabus

FM & SM
SUPER CHART BOOK

FM Chapter 8
Dividend Decisions

By CA Mohnish Vora (MVSIR)

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

CHAPTER 8 – Divident Decisions

THEORIES OF DIVIDEND

IRRELEVANCE THEORY

- Dividend decisions are irrelevant.
- Whether a co. pays dividend or not → value of MPS remains SAME [No charge]

↓

M. M. Approach

RELEVANCE THEORY

Dividend decisions are relevant.

MPS will change according to the amount of dividend paid

Walter's Model

Gordon's Model

TRADITIONAL THEORY

- Linter's Model
- Graham & Dodd Model

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 1^{st} year [P.]

$$P1 = P0\ (1 + Ke\ ) - D1$$

ii. Calculation of funds required for investment

Particular	Amount
Earning Less : Dividend	Xx (xx)
Retained earnings Total amount required for investment	xx 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]

$$n1 = \frac{\text{Bal funds read. for investment}}{P1}$$

iv. Calculation of value of firm

$$Vf = \frac{(n + n1)\ P1 + E - I}{(1 + Ke)}$$

❖ Formula of theoretical MPS [walter's model]

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

❖ Proposition of Walter

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

CHAPTER 8 – Divident Decisions

Proposition of Gordon

- r > Ke → share price will increase → DPR decrease

Or

- r < Ke → share price will decrease → DPR increase

Situation	Type of co.	Optimum DPR
r > Ke	Growth co.	0%
r < Ke	Declining co.	100%
r = Ke	Normal co.	0 – 100%

a. Zero growth

$$\text{Theoretical MPS} = \boxed{P0 = \frac{D1}{Ke}}$$

b. Constant Growth Model [Gordon]

$$\boxed{P0 = \frac{D0\,(1+g)}{Ke\ -g} \quad \text{or} \quad \frac{D1}{Ke - g} \quad \text{or} \quad \frac{E1\,(1-b)}{Ke - b.r}}$$

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

c. Variable Growth model [not part of Gordon]

$$\text{Intrinsic value} = \frac{D1}{(1+Ke)^1} + \frac{D2}{(1+Ke)^2} + \ldots\ldots\ldots + \frac{Dn}{(1+Ke)^n} + \frac{Sv}{(1+Ke)^n}$$

IMPORTANT POINTS

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

= 100% - DPR

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

$Ke = \frac{1}{PER} = \frac{EPS}{MPS}$ [Earnings price approach]

3)

- Current dividend
- Last year dividend
- Had paid dividend

} D0

- Expected to pay div.
- Div at end of 1st year
- Next year div.

} D1

❑ Expected to pay dividend → assuming dividends are expected to grow by __% → then consider DPS it "D0"

Traditional Theories of Dividend

a) Graham & Dodd Model

$$P0 = m\left[DPS + \frac{EPS}{3}\right]$$

Note:
Value of multiplier "m" will be given in Question

b) Linter's model

$$D1 = D0 + [(EPS \times \text{target DPR}) - Do] \times Af$$

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

CHAPTER 8 – Divident Decisions

Dividend Discount Model

- Zero Growth → $Po = \frac{D1}{Ke}$
- Constant Growth → $Po = \frac{D1}{Ke - g}$
- Variable Growth → $Po = \frac{D1}{1 + Ke} + \frac{D2}{(1 + Ke)^2} + ... + \frac{RVn}{(1 + Ke)^n}$

Dividend

- Dividend Rate
  - %
    - Total wala data use karke → $\frac{\text{Equity Div}}{\text{Face value of equity shares}}$
    - Per share wala data use karke → $\frac{\text{DPS}}{\text{FVPS}}$
- DPS
  - ₹ per share
    - $\frac{\text{Total Equity Div}}{\text{No. of equity shares}}$
    - FVPS x Div rate
    - EPS x DPR
- DPR
  - %
    - $\frac{\text{Total Equity Div}}{\text{EFES}}$
    - [100% – b]
    - $\frac{\text{DPS}}{\text{EPS}}$

CA Intermediate – New Syllabus

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SUPER CHART BOOK

FM Chapter 9
Working Capital Management

By CA Mohnish Vora (MVSIR)

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

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.

ON BASIS OF VALUE

Gross WC
↓
Current assets

Net WC
↓
Current Assets (–) Current liabilities

ON BASIS OF TIME

Permanent WC

- Aka. Base WC
- Min. amount invested in CA at all times
- Can be financed using long – term sources of finance

Fluctuation WC

- Aka. Temporary WC
- Arises due to fluctuation in sales, in order to meet seasonal demand.

Approaches of WC Investment

AGGRESSIVE

- WC is kept at **minimum level**
- Adv. → **lower** financial cost
- Disadv. → stock out situation

↓
High risk & poor liquidity
↓
Higher
Return on total assets

MODERATE

- In between these two approaches
- Balance between risk & return, due to efficient use of funds.

CONSERVATIVE

- WC → high level
- Adv. → higher sales due to liberal credit policies, increase in goodwill among suppliers.
- Disadv. → cost of Capital ↑, Bad debt ↑, Inventory obsolete, Shortage of liquidity in long run.

↓
Low risk
&
Greater liquidity
(in short. term)
↓
Lower return on Total Assets

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 charges in sales
[WC → % of sales]

3) RATIO OF FIXED INVESTMENTS

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

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

RM consumed = RM Purchase + Opening RM – Closing RM

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

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

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

Receivables = Estimated Cr. Sales (×) Estimated cost (×) Avg Rec.
(Debtors) 12 mts / 365d/ 52w of sales P. V. Collection period

↓

<u>If cash cost Basis</u>
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 is constant PER UNIT → VC total value charges.
- 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,
   Sales – GP = 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 debitors 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 debitors 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**

Chp 9 – Unit 2

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

Cash budget [format]

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

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

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

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]**

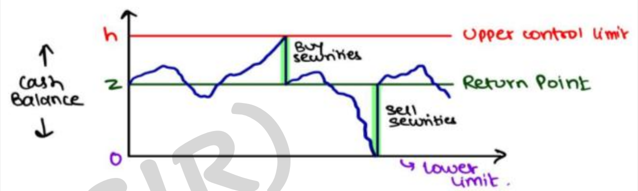
Transfer of cash equal to "h – z" is invested in metastable securities account. [Buy securities]

- **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.

Chp 9 – Unit 3

I. Economic order Quantity (EOQ)

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

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 Wherehouse.

III. Lead time consumption

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

IV. Re order stock level (ROL)

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

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

❖ Evaluation of credit policies

Chp 9 – Unit 4

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

Particulars	Present policy	Proposed policy I	Proposed policy II
A) **Expected profit** 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 Invt. 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] (×) no. of units in present policy

→ opportunity cost = $\text{total cost of credit sales} \times \frac{collection\ period}{365\ days} \times \frac{Required\ rate\ if\ return}{100}$

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

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

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

Factoring of receivables

MV foods ltd. —— Transfer the right to collect receivables to factor ——→ factoring agency

- Credit sales = Rs. 360 lac
- Avg collection period = 30 days
- Bad debt loss = 2%
- Debtors admin cost = ₹1,40,000 (annual)

- Commission = 1%
- Advance against receivables @ interest 15% P. a. & after with holding reserve of 10%

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

ii. Calculation of net amount of Advance

Particulars	Amt. (Rs.)
Factoring commission [30L × 1%] Reserve [30L × 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 Less : int on advance @ 15% pa for 30 days (26,70,000 × 15% × $\frac{30}{360}$)	26,70,000 (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 Bad debts [360L × 2%]	 1,40,000 7,20,000
Total saving	8,60,000
B) Costs due to factoring Factoring commission [360L × 1%] or [30,000 × $\frac{360}{30}$] Interest charge [33,375 × $\frac{360}{30}$]	 3,60,000 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

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

2. Compound interest method

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

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 –

Spontaneous Source

Naturally arise in the course of business
a) Trade credit
b) Bill Payable
c) Accrued Expenses

Negotiable Source

They have to specifically negotiated with lenders
a) Inter-Corporate loans & deposits
b) Commercial papers
c) Public Deposits
d) Factoring
e) Bank credit [loans]
   Cash credit , Bank overdraft, Bill Discounting ,Bill Acceptance, Line of credit, Letter of credit, Bank Guarantee

Maximum Permissible Bank Finance [MPBF] By Tandon Committee

Lending Norms

1st Method

Current Assets
(-) Current Liab
WC Gap
(-) 25% from long term sources
MPBF

2nd Method

Current Assets
(-) 25% from long term sources
Bal C.A
(-) Current Liab
MPBF

3rd Method

Current Assets
(-) Core Current Assets
Soft core C.A
(-) 25% from long term sources
Bal C.A
(-) Current Liab
MPBF

NEW SYLLABUS

ULTIMATE CA

CA INTERMEDIATE

FM & SM

FASTRACK OR REGULAR
BATCH

CA Mohnish Vora
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- ☑ 100% CONCEPTUAL CLARITY
- ☑ HANDWRITTEN NOTES: Write concepts in class
- ☑ TESTS WILL BE CONDUCTED
- ☑ AMPLE QUESTION & MCQ PRACTICE
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CA MOHNISH VORA

Harleen		82
Rajan Kumar	AIR 46	82
Princi Khemasara	AIR 32	82 (FM only)
Rajat Agarwal		81
Sneha Vashisth	AIR 19	80
Samreen		79
Yash		79
Harsh Choudhary		78
Alishba		77
Ananya Shahagadkar		77
Nilesh Prakash		77
Krisha Bhandari		76
Maha Rudra Jha		75
Naman luthra		75
Riya Singh	AIR 48	75
Yamaan Ansari		75

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CA Intermediate (New Syllabus)
SM Super Chart Book

INDEX

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– MT: C²OMA

- conduct its operations,
- 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– MT: Utilise M²DH

- to mobilise resources,
- 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.– MT: SWOT

- to use resources & strengths,
- 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

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

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

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.

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

MT: PUB⁴G 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 transalate 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.

MT: 3P 2E CT

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

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

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

MT: Formulating & Implementing MBA Leadership

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

Business Level Managers (BLM)

- Development of **strategies** for competing in **individual business areas**, (like FMCG, 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)

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

CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVRIONMENT

- 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 ENVRIONMENT

- **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.

Time

Strategic Risk	Short Time	Long Time
External	Errors in interpreting the environment cause strategic failure	Changes in the environment lead to obsolescence of strategy.
Internal	Organizational capacity is unable to cope up with strategic demands.	Inconsistencies with strategy are developed on account of changes in internal capacities & preferences

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.

❖ 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.

Element of Macro Env.	Important Points
Political-Legal	➢ It consists elements like- ✓ 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 ENVRIONMENT

Element of Macro Env.	**Important Points**
Economic	➢ **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.
Demographic	➢ 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: ✓ What demographic trends will affect market size? ✓ What demographic trends represent opp or threats?
Socio-Cultural	➢ 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.
Technological	➢ 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.** ✓ 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 ENVRIONMENT

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 ENVRIONMENT

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 envir. 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

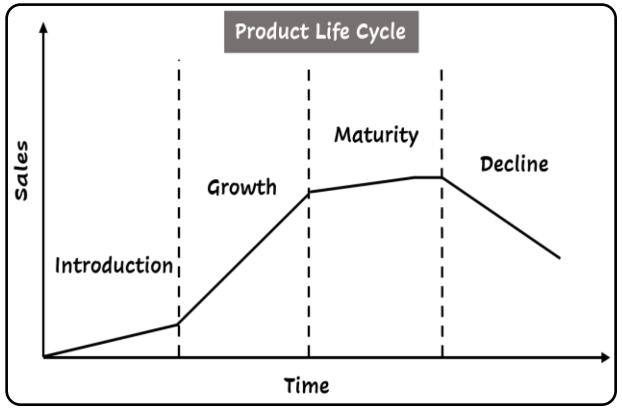
5) Products have certain features that deliver satisfaction.

- ✓ 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.

CHAPTER 2 – STRATEGIC ANALYSIS: EXTERNAL ENVRIONMENT

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 Phase
Introduction Stage (slow sales growth)
➢ competition → negligible, ➢ prices → high, and ➢ markets → limited. ➢ Growth in sales → lower rate because of lack of awareness of customers.

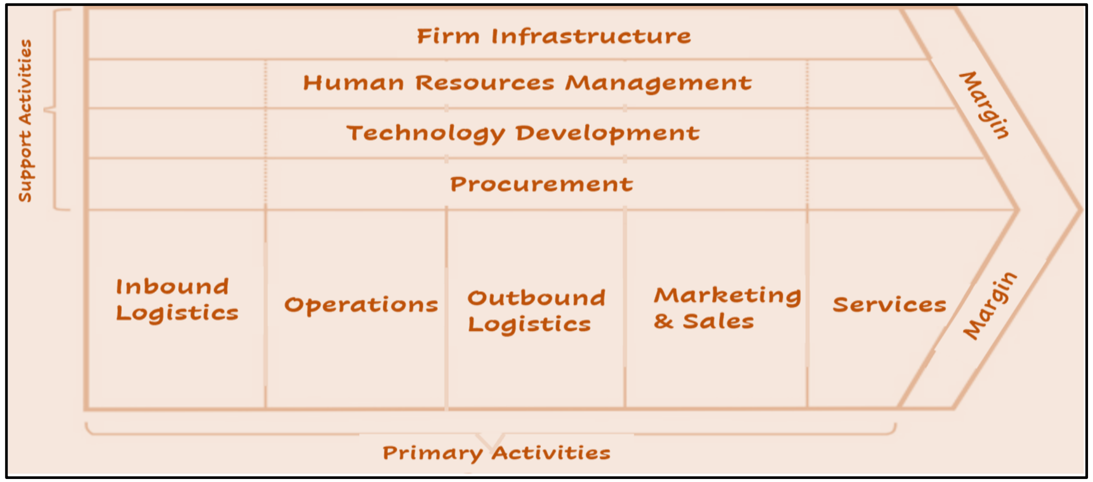
❑ The **main advantage of PLC approach** → used to diagnose a portfolio of products/businesses → to establish stage at which each of them exists.
For eg–
- ✓ Expansion → for businesses in the **introductory & growth** stages.
- ✓ **Mature businesses** → used as sources of cash for invt in other businesses
- ✓ A combination of strategies like selective harvesting, retrenchment, etc. may be adopted for **declining** businesses.

2nd Phase	3rd Phase	4th Phase
Growth Stage (rapid market acceptance)	Maturity Stage (slowdown in growth rate)	Decline Stage (sharp downward drift in sales)
➢ demand expands rapidly, ➢ prices fall, ➢ competition increases, ➢ market expands. ➢ Customer has knowledge about the product and shows interest in purchasing it.	➢ the competition gets tough, ➢ market gets stablised. ➢ Profit comes down because of stiff competition. ➢ Organisations have to work for maintaining stability	➢ 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.

❖ 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.



CHAPTER 2 - STRATEGIC ANALYSIS: EXTERNAL ENVRIONMENT

- **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
These are the activities concerned with • **receiving**, • **storing** and • **distributing** the **inputs** to product/service This includes materials handling, stock control, transport etc. Like, **transportation** and **warehousing**.	Operations **transform** these **inputs** into the **final product-** • machining, • packaging, • assembly, • testing, etc. **Convert raw materials in finished goods**.	It involves- • **collecting**, • **storing &** • **distributing** the **product to customers**. For **tangible products→** • **warehousing**, • **materials** • **handling**, • **transport**, etc. For **services** → **arrangements for bringing customers to service**, if it is a fixed location (eg- sports event)	It provides the means whereby consumers are **made aware of the product** & are able to purchase it. This would include • **sales administration**, • **advertising**, • **selling** etc. In **public services**, **communication networks** which help users' access a particular service are often important.	Services are all those activities, which • **enhance** or • **maintain** the **value of a product**, Such as- • **installation**, • **repair**, • **training** • **spares**.

Support Activities

Procurement	Technology development	Human resource management	Infrastructure
Refers to processes for **acquiring the various resource inputs** to primary activities. As such, it occurs in many parts of the organization. .	All value activities have a 'technology', even if it is simply know-how. The **key technologies** are **concerned** with- • **product** (R&D product design) • **processes** (process development) • **particular resource** (raw materials improvements)	It is an area which **transcends** all primary activities. It involves activities like • **recruiting**, • **managing**, • **training**, • **developing** • **rewarding people**	The systems of • **planning**, • **finance**, • **quality control**, • **information mgt** are important to an org's performance in its primary activities. It also consists of **structures & routines** of org. which **sustain its culture**.

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.

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.

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.

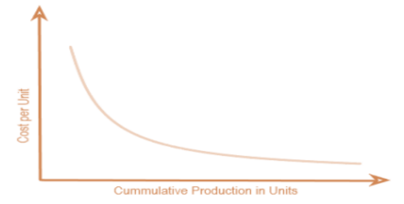
Experience Curve (EC)

- 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

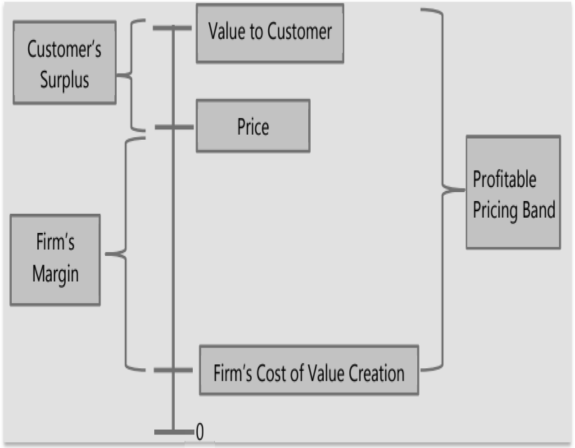
- Value creation is an activity or performance by which a firm tries to create value that increases the worth of goods & services

- Value is measured by a product's features, quality, availability, durability, performance & services for which customers are willing to pay.

- 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 ENVRIONMENT

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"

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 yo achieve a sustainable competitive advantage?

- KSF vary from industry to industry and even from time to time

CA Intermediate – New Syllabus

FM & SM

SUPER CHART BOOK

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 ENVRIONMENT

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)

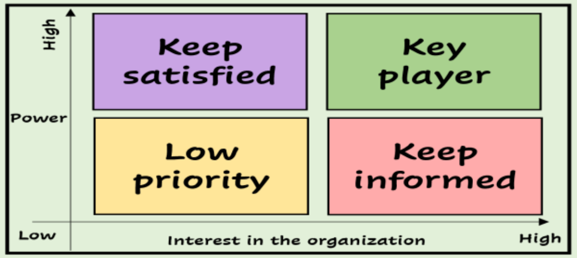
Aka. **Stakeholder Analysis matrix** or **Power-Interest matrix**→ framework to help manage key stakeholders.

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

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?**

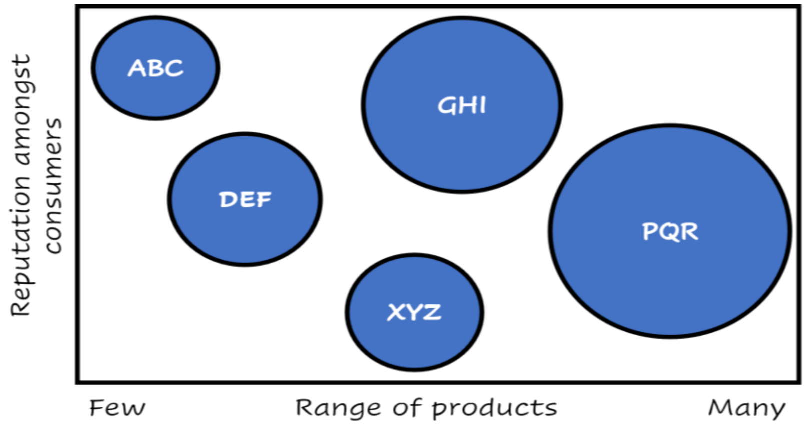
- No, each business has its own set of customers i.e. market & each product within a business has its own market.

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)

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 ENVRIONMENT

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- MT: VICS² 1) value marketing, 2) innovative marketing, 3) customer-oriented marketing, 4) sense-of-mission marketing, 5) societal marketing.
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 ENVRIONMENT

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.

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**

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**	- 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 ENVRIONMENT

2	Approp riability	➢ 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	Transfe rability	➢ 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	Imitabil ity	➢ 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	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 Enviroment)	Opportunity→ favourable condition in external env. → strengthen its position	Threat→ unfavourable condition in external env→ causes risk or damage to org.'s position

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

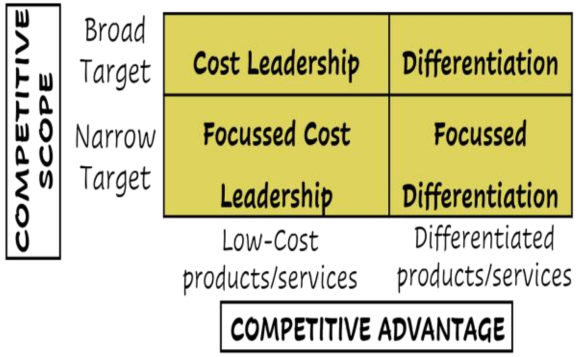
1) It provides a logical framework.
2) It guides the strategist in strategy identification.
3) It presents a comparative account.

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	Cost Leadership	Differentiation
Narrow Target	Focussed Cost Leadership	Focussed Differentiation
	Low-Cost products/services	Differentiated products/services
	COMPETITIVE ADVANTAGE	

CHAPTER 3 - STRATEGIC ANALYSIS: INTERNAL ENVRIONMENT

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.

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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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.**

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

CHAPTER 3 - STRATEGIC ANALYSIS: INTERNAL ENVRIONMENT

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.

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.

CA Intermediate – New Syllabus

FM & SM
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SM Chapter 4

Strategic Choices

By CA Mohnish Vora (MVSIR)

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

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 Strategy

MT: 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

CHAPTER 4 – STRATEGIC CHOICES

Growth/Expansion Strategy (Corporate Level Strategy)

Characteristics of Growth Strategy

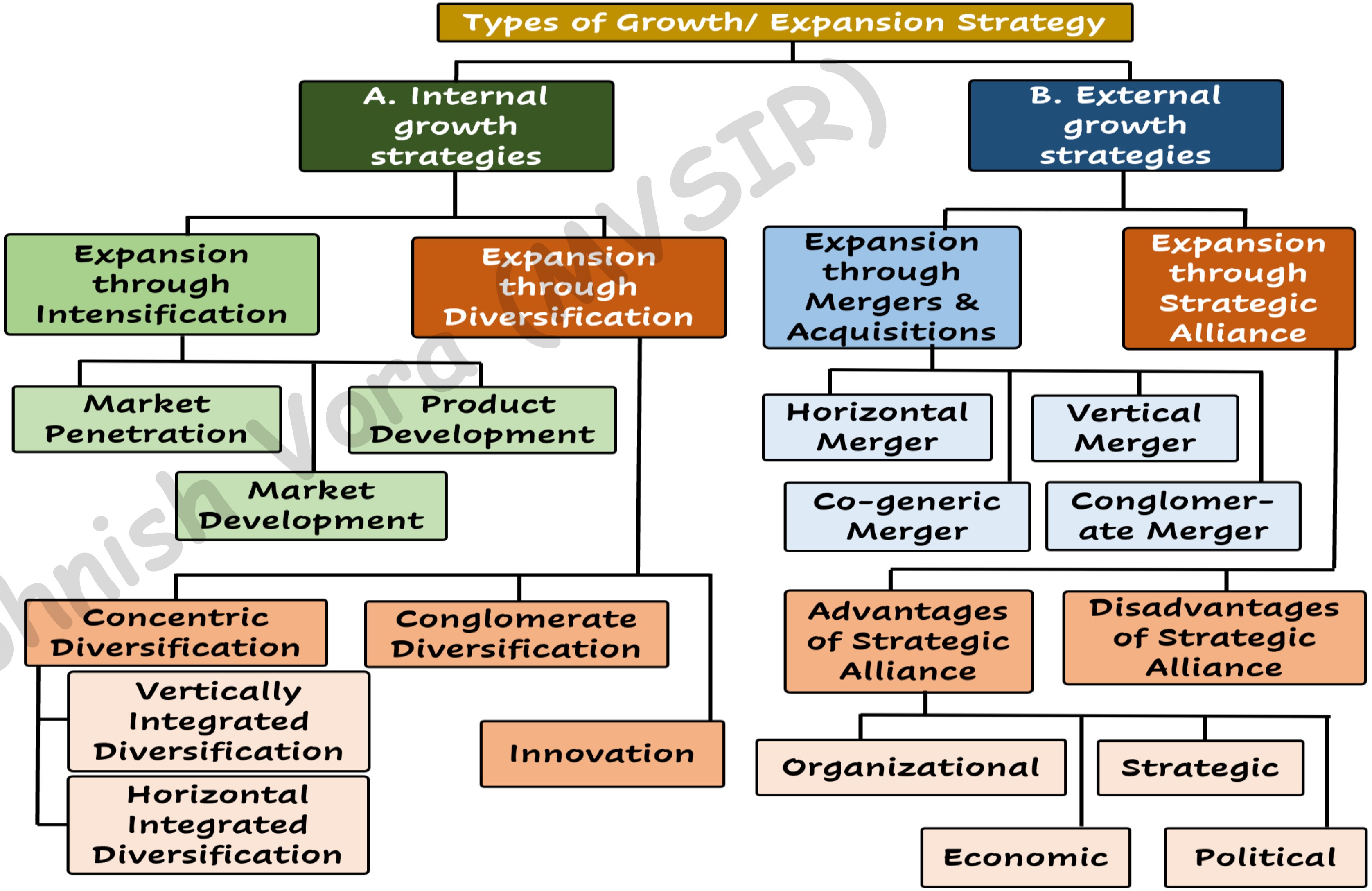
MT: VIGOuR²

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

- A. Internal growth strategies
  - Expansion through Intensification
    - Market Penetration
    - Product Development
    - Market Development
  - Expansion through Diversification
    - Concentric Diversification
      - Vertically Integrated Diversification
      - Horizontal Integrated Diversification
    - Conglomerate Diversification
    - Innovation
- B. External growth strategies
  - Expansion through Mergers & Acquisitions
    - Horizontal Merger
    - Vertical Merger
    - Co-generic Merger
    - Conglomerate Merger
  - Expansion through Strategic Alliance
    - Advantages of Strategic Alliance
      - Organizational
      - Strategic
      - Economic
      - Political
    - Disadvantages of Strategic Alliance

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→ utlise **excess capacity**, funds, marketing channels, R&D
2) It gives synergistic advantage→ improve sales of existing products by adding related or new products.

Summary of concepts

Related Diversification

Vertical Integration

When firms start businesses that are related to existing business of firm, while remaining vertically within the same product-process chain → moves forward or backward in chain-

Forward Integration

- Moving forward in value chain & entering business lines that use existing products.
- May also involve entering→ business of distribution channels.
- But, risk of lack of continued focus on original business.
- For eg, A coffee bean manufacture starts its own coffee cafe.

Backward Integration

- When a firm enters into business of input providers.
- It leads to-

✓ expanding profits and
✓ greater control over production/supply,
✓ Incr. own supply capability
✓ lessen its cost of production.

- For eg, A supermarket chain → purchase farms that provide fresh produce.

Horizontal Integration

A firm gets horizontally diversified by integrating through ~~acquisition of one or more~~ **entering** into similar businesses operating at same stage of production-marketing chain.

They can also ~~integrate with firms~~ start producing complementary product or by-product.

Concentric Diversification

- It takes place when products are **related**.
- New business that a firm diversifies into is linked to existing businesses through process, technology or marketing (PTM).
- New product is a spin-off from existing facilities & products.
- Here there are benefits of synergy
- New product is connected in a loop-like manner at one or more points in the firm's existing PTM.

Unrelated Diversification

Conglomerate Diversification

- Established firm launches new product→ with little or no affinity (relation) with its present product line & is for new class of customers.
- No linkages in PTM
- New businesses are disjointed.
- No common thread.

Is it really worth expanding in unrelated products? MT: Easy FAN

1) It eases management of losses→ profits in one can be used to keep loss making business afloat.
2) Despite its complexity→ it financially makes lot of sense.
3) It allows access to markets & cross-selling → increases revenue.
4) It creates access to new pool of customers→

CHAPTER 4 – STRATEGIC CHOICES

Summary of Questions Asked by ICAI

Related Diversification

Vertical Integration

Forward Integration

1) Siddhartha is the owner of a cloth manufacturing → desires to start another unit to produce readymade garments (Q 45)
2) Acquisition of another organisation that was using your product in their manufacturing (RTP Nov 19 – MCQ)
3) A tea farm owners plan to open tea cafes in tourist spots and to sell their own premium tea to build a brand (RTP May 22 – MCQ)
4) Stylish Fabric Ltd., a clothes manufacturer is buying up a chain of retail outlets to differentiate its clothes from those of its competitors through branding.

Backward Integration

1) If suppliers are unreliable or too costly, then this strategy is applied. (RTP May 21, MTP Oct 19 – MCQ)
2) An organization acquires its supplier (RTP May 19 – MCQ)
3) Beta Company, a car manufacturer is buying up a supplier so that it gets a dedicated supplier with both guaranteed quality and price. (MTP Mar 21 – MCQ)
4) Organo is a large supermarket chain. It purchases a number of farms that provides fresh produce (RTP May 20)

Horizontal Integration

1) Horizontal integration is concerned with "Production" – (MCQ)
2) Strategy of seeking ownership of taking over competitor's product
3) A company that produces and sells athletic shoes may acquire or merge with another athletic shoe manufacturer in order to increase their market share and reduce competition (MTP Apr 23 – MCQ)

Concentric Diversification

1) Hupo a honey brand decided to start a new brand for making honey ginger candies to meet the rising demand. (RTP Nov 22 – MCQ)
2) A rubber manufacturer starts making shoe soles and gum (MTP Oct 21)
3) Leatherite Ltd., a manufacturer of leather footwear. To expand they decided to manufacture leather bags for males and females (MTP Aug 18, Nov 24, RTP Nov 18, Nov 21)
4) FlyBee is a notebook and diary brand → to take up competition with Gecko in pens segment and thereby launched, Fly Pens (MTP Mar 22)

Unrelated Diversification

Conglomerate Diversification

1) Gautam is the owner of a cloth manufacturing → later acquires another industrial unit manufacturing stationery items
2) Jynklo Ltd. is an online gaming company → they start a premium sports drink named JynX for athletes (MTP Sep 22, RTP Nov 23)

Co-generic Merger	TechNova, a leading software development firm known for its cutting-edge operating systems, is developing a groundbreaking new platform. ElectroWave, an emerging player in the electronics and hardware industry, specializes in manufacturing advanced devices. TechNova and ElectroWave have decided to join forces to design innovative laptops and smartphones, aiming to tap into new markets and broaden their business horizons. (MTP Aug 24)

CHAPTER 4 - STRATEGIC CHOICES

RELATED DIVERSIFICATION	UNRELATED DIVERSIFICATION
➢ Exchange or share assets or competencies by exploiting. ➢ Brand name. ➢ Marketing skills. ➢ Sales & distribution capacity ➢ Manufacturing skills. ➢ R&D and new product capability. ➢ Economies of scale.	➢ Investment in new product portfolios. ➢ Employ new technology ➢ Focus on multiple products. ➢ Reduce risk by operating in multiple product markets. ➢ Defend against takeover bids. ➢ Provide executive interest.

Notes

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Innovation

- ➢ Innovation drives upgradation of existing product lines or processes→ increased market share, revenues, profitability & customer satisfaction.
- ➢ For business to grow long term, **innovation offers the following benefits-**

MT: CPC

1) **Helps to solve complex problems**
   - ✓ By developing customer centric sustainable solutions.

2) **Increases productivity**
   - ✓ By automating repetitive tasks, & simplifying the long chain of processes.

3) **Gives Competitive Advantage**
   - ✓ The faster a business innovates, the farther it goes from its competitor's reach.
   - ✓ Innovative products need less marketing & helps retain existing customers & acquire new ones

External growth strategies

When organization diversifies by making alliances with external org.

MERGER	ACQUISITION
➢ When two or more companies come together to expand their business operations. ➢ Deal gets finalized on friendly terms & both org. share profits in the newly created entity. ➢ Here, two organizations combine to increase their strength & financial gains along with breaking trade barriers.	➢ When one org. takes over the other org. & controls all its business operations. ➢ Here, one financially strong org. overpowers weaker one. ➢ Combined operations then run under name of powerful entity. ➢ Acquisitions often happen during recession or declining profit margins. ➢ Here, deal is done in an unfriendly manner→ kind of a forced association where powerful organization acquires operations of co. in a weaker position & is forced to sell its entity.

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**):

MT: MUD²TOP

- ✓ Mismanagement
- ✓ 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**.

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

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

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.

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

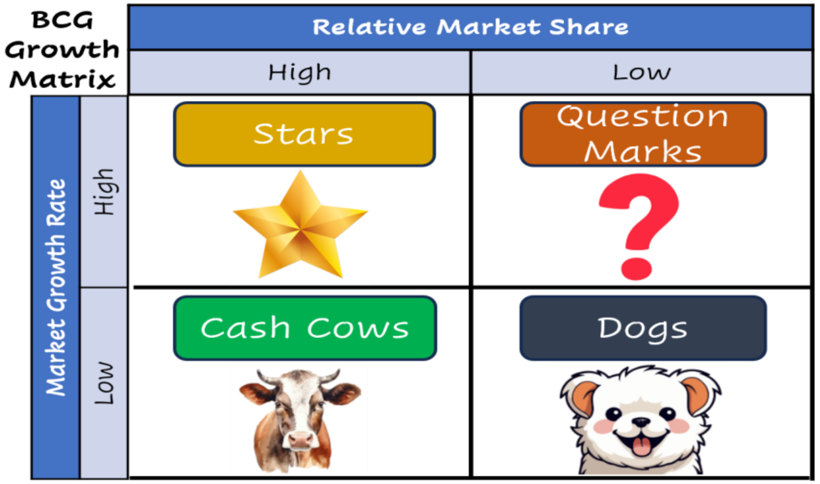
- Developed in early 1970s by BCG,
- Also known for its **cow & dog metaphors**
- Co. classifies businesses on 2-dimensional growth-share matrix.
- In the matrix:
  - ✓ **Vertical axis** → Market growth rate→ measure of market attractiveness.
  - ✓ **Horizontal axis** → Market share → measure of company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



4 Post Identification strategies of BCG

a) **Build** with the aim for long-term growth and strong future. (Stars)

b) **Hold** or preserve the existing market share. (Question Mark)

c) **Harvest** or maximize short-term cash flows. (Cash Cow)

d) **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.

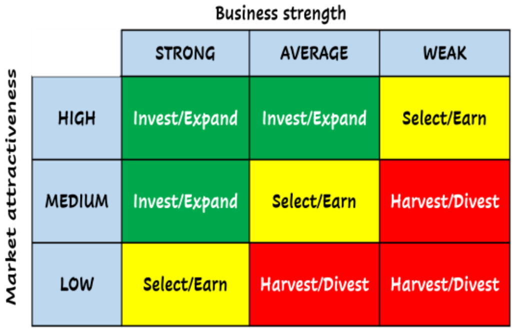
2) Difficult to define SBUs & measure market share & growth.

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

Market attractiveness	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.

CA Intermediate – New Syllabus

FM & SM

SUPER CHART BOOK

SM Chapter 5

Strategic Implementation & Evaluation

By CA Mohnish Vora (MVSIR)

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

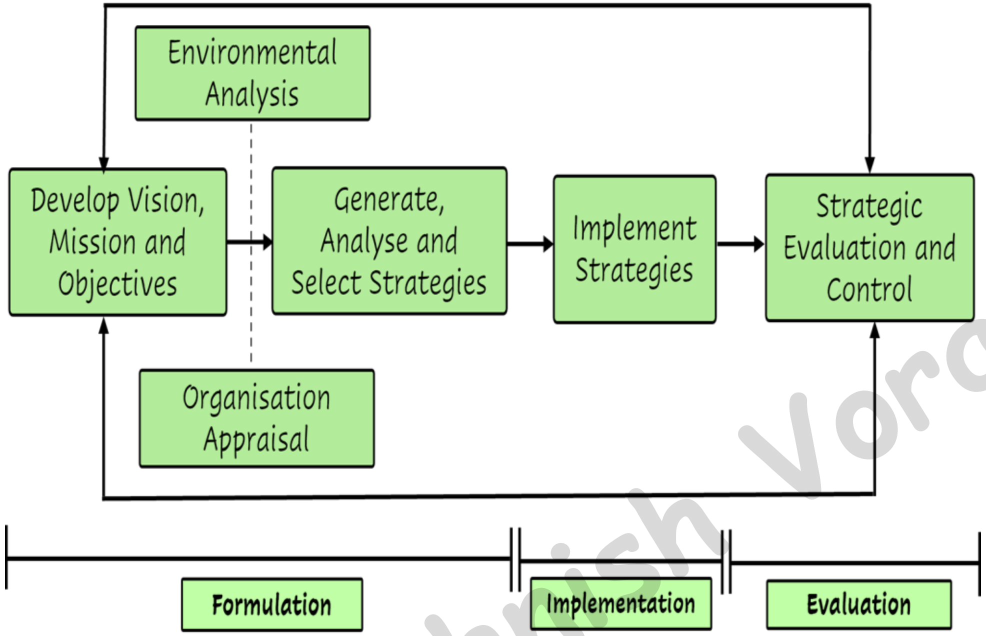
CHAPTER 5 – STRATEGIC IMPLEMENTATION & EVALUATION

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

Strategic Management Model (Fred R David)



Environmental Analysis

Develop Vision, Mission and Objectives

Generate, Analyse and Select Strategies

Implement Strategies

Strategic Evaluation and Control

Organisation Appraisal

Formulation

Implementation

Evaluation

- ➢ 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

<u>**Stage 1:**</u> (Already covered all points in Chapter 1)

<u>Stage 2: Environmental and Organisational Analysis</u>

- ▪ 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
Senior management develops strategic plans for entire organization after evaluating strengths and weaknesses.	Operational plans are made at middle and lower-level mgt. They provide specifics on how resources are to be used effectively to achieve goals
Characteristics of Strategic planning MT: HOLIS^2~~tie~~ 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.	**Characteristics of Operational planning** MT: FM CTC 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.

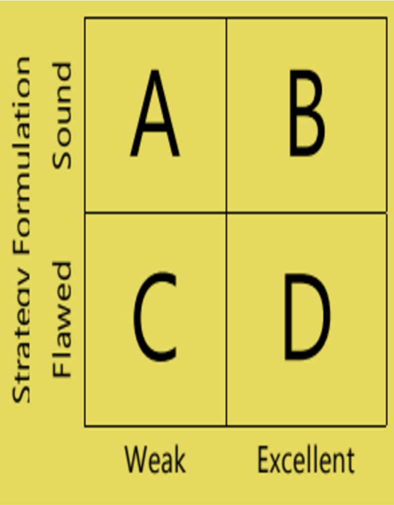
☐ **How to deal with strategic uncertainty?**

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.

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**

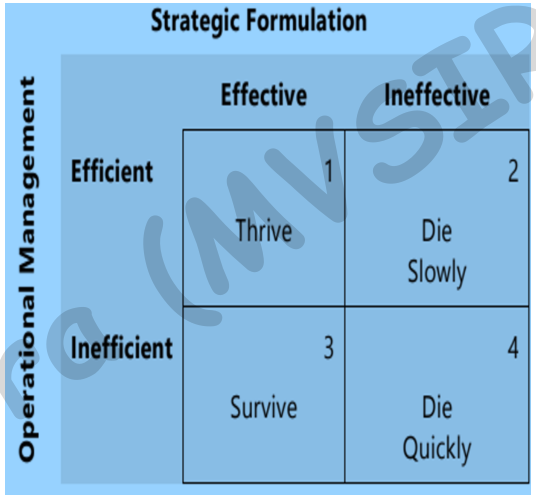


		Weak	Excellent
Strategy Formulation	Sound	A	B
	Flawed	C	D

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 Operational Management	Effective	Ineffective
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**.

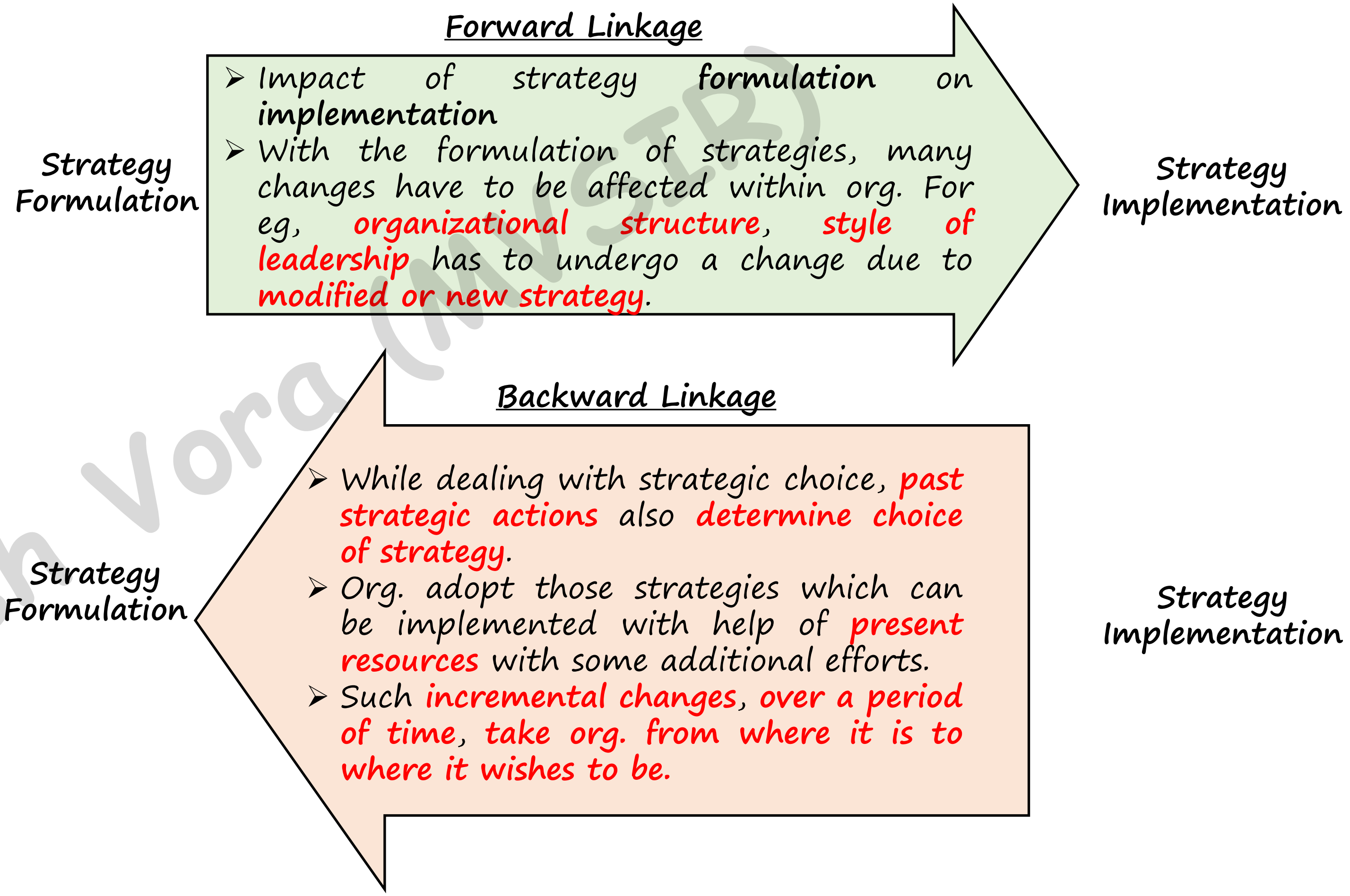
An emphasis on efficiency rather than on effectiveness is clearly **wrong**.

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

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



Forward Linkage

Strategy Formulation → Strategy Implementation

- Impact of strategy **formulation** on **implementation**
- With the formulation of strategies, many changes have to be affected within org. For eg, **organizational structure**, **style of leadership** has to undergo a change due to **modified or new strategy**.

Backward Linkage

Strategy Implementation → Strategy Formulation

- While dealing with strategic choice, **past strategic actions** also **determine choice of strategy**.
- Org. adopt those strategies which can be implemented with help of **present resources** with some additional efforts.
- Such **incremental changes**, **over a period of time, take org. from where it is to where it wishes to be.**

CHAPTER 5 – STRATEGIC IMPLEMENTATION & EVALUATION

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.

CHAPTER 5 – STRATEGIC IMPLEMENTATION & EVALUATION

- 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

a) **Compliance:** Strictly enforcing reward & punishment strategy for good or bad behaviour. Fear of punishment, actual punishment, reward seems to change behaviour.

b) **Identification:** When members are psychologically impressed with some given role models whose behaviour they would like to adopt.

c) **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

1) Defining the goals & objectives of transformation
2) Assessing current state of org & identifying gaps
3) Creating a roadmap for change that outlines steps needed to reach desired state
4) 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

1) **Begin at the top:** Leadership team → united & committed. They should communicate clear vision for future of co. & lead by example.
2) **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.
3) **Reduce disruption:** Communicating early about changes, providing training & support for employees, & empowering change agents within the org.
4) **Encourage communication:** Create channels for employees to ask questions & provide feedback. Encourage collaboration between departments to share ideas & innovations.
5) **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?

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

CHAPTER 5 - STRATEGIC IMPLEMENTATION & EVALUATION

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. Orgranisational Framework (McKinsey 7S Model)

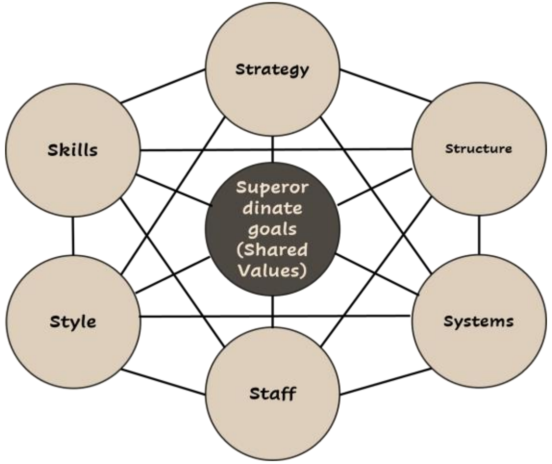
- McKinsey 7S Model → tool to analyze a co.'s "organizational design."
- Goal→ depict how effectiveness can be achieved in an org. through interactions of hard & soft elements.
- Model focuses on how "**Soft S**" & "**Hard S**" elements are **inter-related**→ modifying one aspect might have a ripple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

XI. Orgranisational Structure

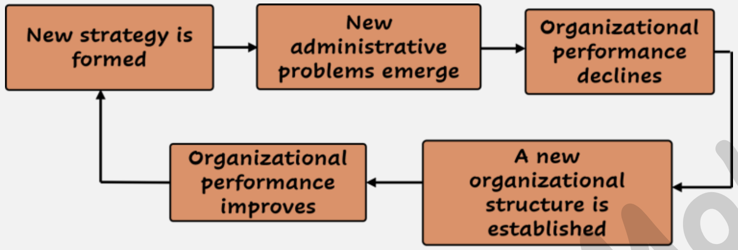
Changes in corporate strategy often **require changes** in way an **org. is structured** for **two reasons**-

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.



Chandler's Strategy-Structure Relationship

- ✓ 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.

- A) Simple Structure
- B) Functional Structure
- C) Divisional Structure
- D) Multi Divisional Structure
- E) SBU Structure
- F) Matrix Structure
- G) Network Structure
- H) Hourglass Structure

Notes

CHAPTER 5 - STRATEGIC IMPLEMENTATION & EVALUATION

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 to 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**.

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.
  - ✓ Arline 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.

CHAPTER 5 – STRATEGIC IMPLEMENTATION & EVALUATION

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.

➢ **<u>Need for M-Form Structure</u>**

- ▪ 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.

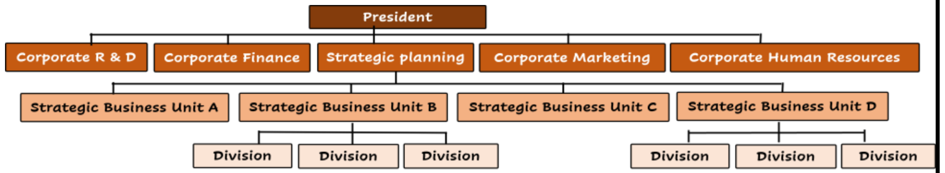
- ➢ **An SBU is a grouping of related businesses**, which is amenable to composite planning treatment.
- ➢ A multi-business ord. groups its multitude of businesses into a few distinct business units in a scientific way.
- ➢ Purpose→ provide effective strategic planning treatment to each one of its products/businesses.

➢ 3 **characteristics of SBU** are:

1) It is a single business or collection of related businesses which offer <u>s</u>cope for independent planning, & which might feasibly standalone from rest of org.
2) It has its own set of <u>c</u>ompetitors.
3) It has a <u>m</u>anager 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.



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 CRA^2P

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.

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.

Notes

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.

XI. G) Hourglass Structure

- 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 shrunken 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 <u>benefit</u> 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.

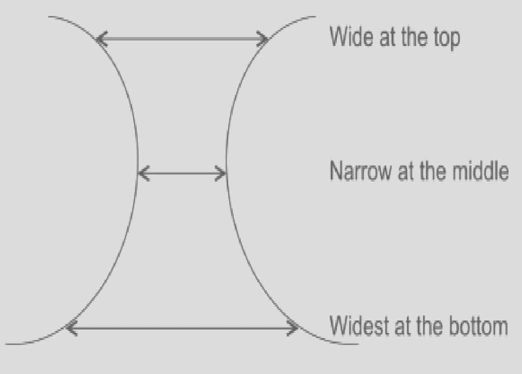


Figure: Hourglass Organisation Structure

<u>Notes</u>

XII. Orgranisational 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

Notes

'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.

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: CR^{2}AKS

Perils 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.

Notes

XIII. Other Important Points

Managers have five leadership roles for good strategy execution:

MT: TERE Corrective Actions

1) Staying on top of what is happening, **closely monitoring progress**, **solving out issues**, and learning **what obstacles lie in the path** of good execution.
2) Promoting a culture of *esprit de corps* that **mobilizes and energizes** organizational members to execute strategy in a competent fashion and **perform at a high level**.
3) Keeping the organization **responsive to changing conditions**, **alert** for **new opportunities**, **bubbling with innovative ideas**, and **ahead of rivals** in developing competitively valuable competencies and capabilities.
4) Exercising **ethical leadership** and insisting that the company **conduct** its **affairs** like a **model corporate citizen**.
5) Pushing **corrective actions** to improve strategy execution and overall strategic performance.

A Strategic leader has several responsibilities-

1) **Making strategic decisions**.
2) **Formulating policies** and action plans to implement strategic decision.
3) **Ensuring effective communication** in the organisation.
4) **Managing human capital** (perhaps the most critical of the strategic leader's skills).
5) **Managing change** in the organisation.
6) **Creating and sustaining strong corporate culture**.
7) **Sustaining high performance** over time.

Transformational leadership style	Transactional leadership style
➢ It uses **charisma** and **enthusiasm** to **inspire people** to exert them for the good of the organization. ➢ It may be appropriate in- 1) **turbulent environments**, 2) industries at **start** or **end** of **life-cycles**, 3) in **poorly performing** org. when there is a **need to inspire** a company to embrace major changes. ➢ Transformational leaders offer **excitement**, **vision**, **intellectual stimulation** and **personal satisfaction**.	➢ It focusses more on **designing systems** & **controlling** the org.'s activities & with **improving the current situation**. ➢ Transactional leaders try to build on **existing culture** & **enhance current practices**. ➢ Transactional leadership style uses the **authority** of its office to exchange **rewards**, such as **pay and status**. ➢ They prefer a more **formalized approach to**

Notes

CHAPTER 5 - STRATEGIC IMPLEMENTATION & EVALUATION

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).

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.

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.

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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