SUGGESTED SOLUTION

FINAL NOVEMBER 2019 EXAM

SUBJECT- SFM

Test Code – FNJ 7070 M

BRANCH - () (Date :)

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Answer 1:
(A)

Financial planning is the backbone of the business planning and corporate planning. It helps in defining the feasible area of operation for all types of activities and thereby defines the overall planning framework. Financial planning is a systematic approach whereby the financial planner helps the customer to maximize his existing financial resources by utilizing financial tools to achieve his financial goals.

There are 3 major components of Financial planning:

- Financial Resources (FR)
- Financial Tools (FT)
- Financial Goals (FG)

Financial Planning: FR + FT = FG

For an individual, financial planning is the process of meeting one's life goals through proper management of the finances. These goals may include buying a house, saving for children's education or planning for retirement. It is a process that consists of specific steps that helps in taking a big-picture look at where you financially are. Using these steps you can work out where you are now, what you may need in the future and what you must do to reach your goals.

Financial objectives are to be decided at the very outset so that rest of the decisions can be taken accordingly. The objectives need to be consistent with the corporate mission and corporate objectives. Financial decision making helps in analyzing the financial problems that are being faced by the corporate and accordingly deciding the course of action to be taken by it. The financial measures like ratio analysis, analysis of cash flow statement are used to evaluate the performance of the Company.

(6 marks)

(B)

(1) Counter Party Risk

This risk occurs due to non-honoring of obligations by the counter party which can be failure to deliver the goods for the payment already made or vice-versa or repayment of borrowings and interest etc. Thus, this risk also covers the credit risk i.e. default by the counter party.

(2) Political Risk

Generally this type of risk is faced by and overseas investors, as the adverse action by the government of host country may lead to huge loses. This can be on any of the following form.

- Confiscation or destruction of overseas properties.
- Rationing of remittance to home country.

- Restriction on conversion of local currency of host country into foreign currency.
- Restriction as borrowings.
- Invalidation of Patents
- Price control of products

(3) Interest Rate Risk

This risk occurs due to change in interest rate resulting in change in asset and liabilities. This risk is more important for banking companies as their balance sheet's items are more interest sensitive and their base of earning is spread between borrowing and lending rates.

Here interest rates are two types i.e. fixed and floating. The risk in both of these types is inherent. If any company has borrowed money at floating rate then with increase in floating the liability under fixed rate shall remain the same. This fixed rate, with falling floating rate the liability of company to pay interest under fixed rate shall comparatively be higher.

(4) Currency Risk

This risk mainly affects the organization dealing with foreign exchange as their cash flows changes with the movement in the currency exchange rates. This risk can be affected by cash flow adversely or favorably. For example, if rupee depreciates vis-à-vis US$ receivables will stand to gain vis-à- vis to the importer who has the liability to pay bill in US$. The best case we can quote Infosys (Exporter) and Indian Oil Corporation Ltd. (Importer).

(4*1 = 4 marks)

Answer 2:

(A) Misconception about Efficient Market Theory

(a) Out performing the market : Efficient Market Theory implies that market prices factor in all available information and as such it is not possible for any investor to earn consistent long term returns from market operations.

(b) Fair value : Although price tends to fluctuate they cannot reflect fair value. This is because the future is uncertain. The market springs surprises continually and as prices reflect the surprises they fluctuate.

(c) Inadequate Information : Inability of institutional portfolio managers to achieve superior investment performance implies that they lack competence in an efficient market. It is not possible to achieve superior investment performance since market efficiency exists due to portfolio mangers doing this job well in a competitive setting.

(d) Irrational Behaviour : The random movement of stock prices suggests that stock market is irrational. Randomness and irrationality are two different things, if investors are rational and competitive, price changes are bound to be random.

(5 marks)

(B)

An individual is said to be boot strapping when he or she attempts to found and build a company from personal finances or from the operating revenues of the new company.

A common mistake made by most founders is that they make unnecessary expenses towards marketing, offices and equipment they cannot really afford. So, it is true that more money at the inception of a business leads to complacency and wasteful expenditure. On the other hand, investment by startups from their own savings leads to cautious approach. It curbs wasteful expenditures and enable the promoter to be on their toes all the time.

Here are some of the methods in which a startup firm can bootstrap:

(a) Trade Credit :

It represents Credit Granted by Supplier of Goods. It can be in form of running account, Bill by Bill Settlement, Bills Payable etc.

The owner or the financial officer has to be explained about the business and the need to get the first order on credit in order to launch the venture. The owner or financial officer may give half the order on credit and balance on delivery. The trick here is to get the goods shipped and sell them before paying to them. One can also borrow to pay for the good sold. But there is interest cost also. So trade credit is one of the most important ways to reduce the amount of working capital one needs. This is especially true in retail operations.

(b) Factoring

This is a financing method where accounts receivable of a business organization is sold to a commercial finance company to raise capital.The factor then got hold of the accounts receivable of a business organization and assumes the task of collecting the receivables as well as doing what would've been the paperwork. Factoring can be performed on a non-notification basis. It means customers may not be told that their accounts have been sold.

However, there are merits and demerits to factoring. The process of factoring may actually reduce costs for a business organization. It can actually reduce costs associated with maintaining accounts receivable such as bookkeeping, collections and credit verifications. If comparison can be made between these costs and fee payable to the factor, in many cases it has been observed that it even proved fruitful to utilize this financing method.

In addition to reducing internal costs of a business, factoring also frees up money that would otherwise be tied to receivables. This money can be used to generate profit through other avenues of the company. Factoring can be a very useful tool for raising money and keeping cash flowing.

(c) Leasing

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

There are advantages for both the startup businessman using the property or equipment (i.e. the lessee) and the owner of that property or equipment (i.e. the lessor.) The lessor enjoys tax benefits in the form of depreciation on the fixed asset leased and may gain from capital appreciation on the property, as well as making a profit from the lease. The lessee benefits by making smaller payments retain the ability to walk away from the equipment at the end of the lease term. The lessee may also claim tax benefit in the form of lease rentals paid by him.

(5 marks)

Answer 3:

(A)

Steps in securitization mechanism:

(1) Creation of Pool of Assets

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

(2) Transfer to SPV

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

(3) Sale of Securitized Papers

SPV designs the instruments based on nature of interest, risk, tenure etc. based on pool of assets. These instruments can be Pass Through Security or Pay Through Certificates.

(4) Administration of assets

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

(5) Recourse to Originator

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

(6) Repayment of funds

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

(7) Credit Rating to Instruments

Sometime before the sale of securitized instruments credit rating can be done to assess the risk of the issuer.

(5 marks)

(B)

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

(A) From the angle of originator

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

(i) Off – Balance Sheet Financing: When loan/receivables are securitized it release a portion of capital tied up in these assets resulting in off Balance Sheet financing leading to improved liquidity position which helps expanding the business of the company.

(ii) More specialization in main business: By transferring the assets the entity could concentrate more on core business as servicing of loan is transferred to SPV.

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

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

(B) <u>From the angle of investor</u>

Following benefits accrues to the investors of securitized securities.

1. Diversification of Risk: Purchase of securities backed by different types of assets provides the diversification of portfolio resulting in reduction of risk.

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

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

(5 marks)

Answer 4:

(A)

1. <u>Breadth Index:</u>

a) Concept: Breadth Index covers all securities traded and also the volume of transactions to give a view of the direction of the Stock Market Movements. It is an addition to the Dow Theory and the movement of the Dow Jones Averages.

(b) Measurement: It is computed by dividing the Net Advances or Declines in the market, by the number of issues traded.

(c) Application and Inference:

- The Breadth Index can either support or contradict the movement of the Dow Jones Averages.
- If it supports the movement of the Dow Jones Averages, this is considered sign of technical strength, and if it does not support the averages, it is a sign of technical weakness, i.e. a sign that the market will move in a direction opposite to the Dow Jones Averages.

2. <u>Volume of Transactions:</u>

(a) Meaning: Volume represents quantities purchased and also the number of transactions entered into in the market in a given period. These provide useful clues on how the market would behave in the near future.

(b) Application / Inference:

Situation	Inference
Rising Price, and Increasing Volume	Signals “Buy” behaviour, since the situation reflects an unsatisfied demand in the market.
Falling Price, and Increasing Volume	Signals a “Bear Market”, i.e. “Sell Behaviour”, and the prices would be expected to fall further.
Rising Market, and Decreasing Volume	Indicates a Bull Market.
Falling Price, and Decreasing Volume	Indicates a Bearish Market.

3. <u>Confidence Index:</u>

(a) Meaning: Confidence Index is the ratio of high-grade bond yields to low-grade bond yields. It indicates the willingness of the Investors to take a chance in the market.

(b) Application: Market Analysts use Confidence Index as a method of trading or timing the purchase and sale of stock. They are also used as a forecasting device to determine the turning points of the market.

(c) Application / Inference:

- Rising Confidence Index is expected to precede a rising Stock Market, and a fall in the Index is expected to precede a drop in Stock Prices.
- A fall in the Confidence Index represents the fact that low-grade bond yields are rising faster or falling more slowly than high grade yields.

(d) Limitations: Confidence Index is not always a leading indicator of the market. Hence, it should be used in conjunction with other market indicators.

4. <u>Relative Strength Analysis:</u>

(a) Relatively Strong Securities: Securities with historically high average returns as compared to other securities, are securities with high relative strength.

(b) Principle I Concept:

- Some Securities are stronger than the other securities, due to which they rise relatively faster in the Bull Market, or decline more slowly in a Bear Market, than the others.
- Investors can earn higher returns by investing in such Securities, because the relative strength of a security tends to remain undiminished over time.

(c) Measurement: Relative Strength can be measured in several ways. Ratios like security relative to its industry, and security relative to the entire market, can also be used to detect relative strength in a security or an industry.

5. <u>Gap:</u>

(a) Meaning: Gap = Opening Price on a trading day less Closing Price of the previous trading day.

(b) Inference: Wider the gap, the stronger the signal for a continuation of the observed trend. In a rising market, if the Opening Price is considerably higher than the previous Closing Price, it indicates that Investors are willing to pay a much higher price to acquire the scrip. Similarly, a gap in a falling market is an indicator of extreme selling pressure.

6. **Odd-Lot Theory**:

(a) Meaning: This Theory is a contrary-opinion theory. It assumes that the average person is usually wrong and that a wise course of action is to pursue strategies contrary to popular opinion.

(b) Application: The Odd-Lot Theory is used primarily to predict tops in bull markets, but also to predict reversals in individual securities.

(6 marks)

(B)

Angel investors invest in small startups or entrepreneurs. Often, angel investors are among an entrepreneur's family and friends. The capital angel investors provide may be a one-time investment to help the business propel or an ongoing injection of money to support and carry the company through its difficult early stages.

- Angel investors provide more favorable terms compared to other lenders, since they usually invest in the entrepreneur starting the business rather than the viability of the business. Angel investors are focused on helping startups take their first steps, rather than the possible profit they may get from the business. Essentially, angel investors are the opposite of venture capitalists.
- Angel investors are also called informal investors, angel funders, private investors, seed investors or business angels. These are affluent individuals who inject capital for startups in exchange for ownership equity or convertible debt. Some angel investors invest through crowd funding platforms online or build angel investor networks to pool in capital.
- Though angel investors usually represent individuals, the entity that actually provides the fund may be a limited liability company, a business, a trust or an investment fund, among many other kinds of vehicles.
- Angel investors who seed startups that fail during their early stages lose their investments completely. This is why professional angel investors look for opportunities for a defined exit strategy, acquisitions or initial public offerings (IPOs).

(4 marks)

Answer 5:

(A)

In any business, financial policies are guiding forces behind strategic financial decision. Such policies should be based on corporate vision and values. It should be

- Flexible
- Reviewed frequently
- Be framed after due consideration and
- Provide their exceptions.

The interface of strategic management and financial policy will be clearly understood if we appreciate the fact that the starting point of an organization is money and the end point of that organization is also money. No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both i.e. internally and externally mobilized financial base.

- The generation of funds may arise out of ownership capital and or borrowed capital. A company may issue equity shares and/or preference shares for mobilizing ownership capital and debentures to raise borrowed capital. Public deposits, for a fixed time period, have also become a major source of short and medium term finance. The overdraft, cash credits, bill discounting, bank loan and trade credit are the other sources of short term finance.
- Along with the mobilization of funds, policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital.
- Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions.
- Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company.
- Thus, the financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth. These policies being related to external awareness about the firm, especially the awareness of the investors about the firm, in respect of its internal performance. Hence, attention of the corporate planners must be drawn while framing the financial policies not at a later stage but during the stage of corporate planning itself. The nature of interdependence is the crucial factor to be studied and modelled by using an in depth analytical approach. This is a very difficult task compared to usual cause and effect study because corporate strategy is the cause and financial

policy is the effect and sometimes financial policy is the cause and corporate strategy is the effect.

(6 marks)

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

(a) From stakeholder's point of view: Major stakeholders of a business are equity shareholders and they view financial gearing i.e. ratio of debt in capital structure of company as risk since in event of winding up of a company they will be least prioritized.

Even for a lender, existing gearing is also a risk since company having high gearing faces more risk in default of payment of interest and principal repayment.

(b) From Company's point of view: From company's point of view if a company borrows excessively or lend to someone who defaults, then it can be forced to go into liquidation.

(c) From Government's point of view: From Government's point of view, the financial risk can be viewed as failure of any bank or (like Lehman Brothers) down grading of any financial institution leading to spread of distrust among society at large. Even this risk also includes willful defaulters.

(4 marks)