Mock Test Paper - Series I: March 2025

Date of Paper: 19th March, 2025

Time of Paper: 10 A.M. – 1 P.M.

INTERMEDIATE: GROUP – II

PAPER – 6: FINANCIAL MANAGEMENT & STRATEGIC MANAGEMENT

PAPER 6A : FINANCIAL MANAGEMENT

Suggested Answers/ Hints

DIVISION A

1. (b) 2.33 times

Liquid Ratio $= \frac{\text{Liquid assets}}{\text{Current liabilities}}$

Liquid Assets = Current Assets – Inventories

$= \frac{77,000}{33,000}$ = 2.33 times

2. (a) 0.5 : 1 and 6 times

Sales to Proprietary Ratio $= \frac{\text{Sales}}{\text{Proprietary fund}}$

$= \frac{1,00,000}{2,00,000} = 0.5 : 1$

Proprietor's fund or Shareholder's fund

= Equity share capital + Preference share capital + Reserve and surplus

= 1,00,000 + 20,000 + 80,000 = 2,00,000

Interest Coverage Ratio $= \frac{\text{Earnings before interest and taxes(EBIT)}}{\text{Interest}}$

= 24,000/4000 = 6 times

EBIT = 20,000 + 4,000 = 24,000

Fixed interest charges = 8% on debentures of ₹ 50,000 = ₹ 4,000

3. (c) 3.33 times and 6 times

Debtors Turnover Ratio $= \frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$

= 1,00,000/30,000 = 3.33 times

In the absence of credit sales and opening debtors, total sales is considered as credit sales and closing debtors as average debtors.

Creditors Turnover Ratio $= \frac{\text{Annual Net Credit Purchases}}{\text{Average Accounts Payables}}$

= 60,000/10,000 = 6 times

In the absence of opening creditors, closing creditors are treated as average creditors.

Credit Purchase = Creditors x 360 / 60

= 10,000 x 360/60 = 60,000

4. (a) 1.06 times

Working Capital Turnover Ratio $= \frac{\text{Sales}}{\text{Working Capital}}$

= 1,00,000/94,000 = 1.06 times

Net Working Capital = Current assets – Current liabilities

= 1,27,000 – 33,000 = 94,000

5. (d) 7%

Return on Investment $= \frac{\text{Net Profit after taxes}}{\text{Shareholders' Funds}} \times 100$

= 14,000/ 2,00,000 x 100

= 7%

Proprietor's fund or Shareholder's fund

= Equity share capital + Preference share capital + Reserve and surplus

= 1,00,000 + 20,000 + 80,000 = 2,00,000

6. (a) 13.3%

Calculation of Cost of Equity

Calculation of value of firm (v) = $\frac{\text{EBIT}}{\text{Overall cost of capital } (K_o)}$

$= \frac{9,00,000}{0.12} = \text{Rs.}75,00,000$

Market value of equity (S) = V – Debts

= 75,00,000 – 30,00,000 = ₹. 45,00,000

Market value of debts (D) = 30,00,000

$K_e \text{ (Cost of equity)} = K_o\left(\frac{V}{S}\right) - K_d\left(\frac{D}{S}\right)$

$= 0.12\left(\frac{75,00,000}{45,00,000}\right) - 0.10\left(\frac{30,00,000}{45,00,000}\right)$

$= 0.20 - 0.067 = 0.133 \times 100$

K_e = 13.3%.

7. (b) ₹1,750

Computation of Earnings after tax

Contribution = ₹ 60 × 1,000 = ₹ 60,000

Operating Leverage (OL) × Financial Leverage (FL) = Combined Leverage (CL)

6 × Financial Leverage = 24

∴ Financial Leverage = 4

Operating Leverage = $\frac{\text{Contribution}}{\text{EBIT}} = \frac{₹60,000}{\text{EBIT}} = 6$

EBIT = $\frac{60,000}{6} = ₹10,000$

Financial Leverage = $\frac{\text{EBIT}}{\text{EBT}} = 4$

∴ EBT = $\frac{\text{EBIT}}{4} = \frac{10,000}{4} = ₹2,500$

EBIT- Earnings before Interest and tax.

EBT- Earnings before tax.

Since tax rate = 30%

Earnings after Tax (EAT) = EBT (1 − 0.30) [30% is tax rate]

= ₹2,500 (0.70)

∴ Earnings after Tax (EAT) = ₹1,750

8. (d) 6.07%

Calculation of Cost of Debt after tax:

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

Cost of 12% Debentures, if issued at 10% Premium:

$$K_d = \frac{₹1,20,000(1-0.35)+\frac{₹10,00,000-₹11,00,000}{7\text{ years}}}{\frac{₹10,00,000+₹11,00,000}{2}} = \frac{₹78,000-₹14,286}{₹10,50,000}$$

= 0.0607 or 6.07%

Division B: Descriptive Question

1. (a) Given,

Cost of Equity (K_e)	12%
Number of shares in the beginning (n)	40,000
Current Market Price (P_0)	₹200
Net Profit (E)	₹5,00,000
Expected Dividend (D_1)	₹10 per share
Investment (I)	₹10,00,000

Situation 1 – When dividends are paid	**Situation 2 – When dividends are not paid**
(i) $P_0 = \frac{P1+D1}{1+Ke}$	(i) $P_0 = \frac{P1+D1}{1+Ke}$
$200 = \frac{P1+10}{1+0.12}$	$200 = \frac{P1+0}{1+0.12}$
$P_1 + 10 = 200 \times 1.12$	

$P_1 = 224 – 10 = 214$ (ii) Calculation of funds required = Total Investment - (Net profit - Dividend) = 10,00,000 - (5,00,000 – 4,00,000) = 9,00,000 (iii) No. of shares required to be issued for balance fund No. of shares = $\frac{\text{Funds Required}}{\text{Price at end (P1)}}$ $\Delta n = \frac{9,00,000}{214} = 4,205.61$ (iv) Calculation of value of firm $V_f = \frac{(n+\Delta n)P1-I+E}{1+Ke}$ $= \frac{(40,000+\frac{9,00,000}{214})214-10,00,000+5,00,000}{1+0.12}$ $= \frac{94,60,000 - 5,00,000}{1.12} = 80,00,000$	$P_1 + 0 = 200 \times 1.12$ $P_1 = 224 – 0 = 224$ (ii) Calculation of funds required = Total Investment - (Net profit - Dividend) = 10,00,000 – (5,00,000 - 0) = 5,00,000 (iii) No. of shares required to be issued for balance fund No. of shares = $\frac{\text{Funds Required}}{\text{Price at end (P1)}}$ $\Delta n = \frac{5,00,000}{224} = 2,232.14$ (iv) Calculation of value of firm $V_f = \frac{(n+\Delta n)P1-I+E}{1+Ke}$ $= \frac{(40,000+\frac{5,00,000}{224})224-10,00,000+5,00,000}{1+0.12}$ $= \frac{94,60,000 - 5,00,000}{1.12} = 80,00,000$

(b) Income Statement Punyakalash Limited

Particulars	**Amount (₹)**
Sales **(WN 4)**	4,50,000
(-) VC	3,15,000
Contribution **(WN 4)**	1,35,000
(-) Fixed Cost	81,000
EBIT **(WN 3)**	54,000
(-) Interest **(WN 2)**	18,000

EBT	36,000
(-) Tax	9,000
EAT / Net profit available to equity shareholders	27,000

No of Equity shares = $\frac{\text{Net profit available to equity shareholders}}{\text{EPS}}$

= 27,000 / 15

= 1,800 shares

WN 1 Calculation of EPS using Earnings yield ratio

Earnings yield ratio = EPS / MPS X 100

Therefore, EPS = 15

WN 2 Calculation of Interest cost

Interest rate (pre-tax) = $\frac{\text{Interest rate } (\text{post tax})}{1-t}$

Therefore, Int Rate (pre-tax) = 9 / 0.75 = 12%

Interest Cost = 1,50,000 X 12% = 18,000

WN 3 Calculation of EBIT using FL

FL = $\frac{\text{EBIT}}{\text{EBIT}-\text{Int}}$

1.5 = $\frac{\text{EBIT}}{\text{EBIT}-18,000}$

Therefore EBIT = 54,000

WN 4 Calculation of Operating Leverage (OL), Contribution & Sales

OL = $\frac{1}{\text{MOS}} = \frac{1}{0.4} = 2.5$

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

2.5 $= \frac{\text{Contribution}}{54,000}$

Therefore Contribution = 1,35,000

Sales $= \frac{\text{Contribution}}{\text{PV Ratio}}$ = 1,35,000 / 0.3 = 4,50,000

(c) WN1 – Calculation of EBIT using Financial Leverage

$FL = \frac{EBIT}{(EBIT\text{-}Int.) - \frac{D_P}{1-t}}$

Let EBIT be 'X'

Preference Dividend (Dp) = 0.15X

4 $= \frac{X}{(X\text{-}57,400) - \frac{0.15X}{1-0.3}}$

3.16X – 2,29,600 = X

X = EBIT = ₹ 1,06,296

Preference Dividend = 1,06,296 x 0.15 = ₹ 15,944

WN2 – Calculation of Total Fixed Cost

Cash Fixed Cost = Cash Breakeven sales x PV Ratio

= 2,25,000 x 0.40

= ₹ 90,000

Total Fixed Cost = 90,000 + 10,000 (Depreciation)

= ₹ 1,00,000

Therefore Contribution = 1,06,296 + 1,00,000 = 2,06,296

i. Income Statement for FY 2023-24:

Particulars		**Amount (₹)**
Sales	(2,06,296 / 0.40)	**5,15,740**
(-) Variable Cost		(3,09,444)
Contribution		**2,06,296**

(-) Fixed Cost **(See Wn 2)**	(1,00,000)
EBIT **(See Wn 1)**	**1,06,296**
(-) Interest Exp	(57,400)
EBT	**48,896**
(-) Tax	(14,669)
EAT	**34,227**
(-) Preference Dividend (1,06,296 X 15%)	**(15,944)**
Earnings For Equity Shareholders	**18,283**

ii. Operating Leverage = $\frac{\text{Contribution}}{\text{EBIT}}$

= 2,06,296 / 1,06,296

= 1.94 times

Combined Leverage = OL x FL

= 4 x 1.94

= 7.76 times

iii. Combined leverage is the study from Sales to Eps, where combined leverage measures the % change in EPS due to increase/decrease in % change in sales

CL = % Change in EPS / % Change in sales

7.76 = % Change in EPS / 7

Therefore, % Change in EPS = 54.32%

If sales increase by 7%, then EPS will rise by 54.32% and on the contrary if sales decrease by 7%, then EPS will fall by 54.32%.

iv. Return on Equity shareholders' funds

$= \frac{\text{Earnings for Equity holders}}{\text{Total Eq. Shareholders' funds}}$

= 18,283 / 1,53,920

= 11.88%

v. Calculation of Amount of Debt

$$\text{Pre-tax Interest \%} = \frac{\text{Interest rate (post tax)}}{1-t}$$

$$= 6.65/0.70$$

$$= 9.5\%$$

$$\text{Debt Amount} = \frac{\text{Interest(Rs.)}}{\text{Interest(\%)}}$$

$$= 57,400 / 0.095$$

$$= ₹\ 6,04,210$$

2. (a) (i) Computation of Weighted Average Cost of Capital based on existing capital structure

Source of Capital	Existing Capital structure (₹)	Weights (a)	After tax cost of capital (%) (b)	WACC (%) (a) × (b)
Equity share capital (W.N.1)	4,00,00,000	0.588	10.00	5.88
12% Preference share capital	80,00,000	0.118	12.00	1.42
11% Debentures (W.N.2)	2,00,00,000	0.294	7.70	2.26
Total	6,80,00,000	1.000		9.56

Working Notes:

1. Cost of Equity Capital:

$$K_e = \frac{\text{Expected dividend}(D_1)}{\text{Current Market Price}(P_0)} + \text{Growth}(g)$$

$$= \frac{20}{400} + 0.05$$

$$= 10\%$$

2. Cost of 10% Debentures

$$K_d = \frac{\text{Interest}(1-t)}{\text{Net proceeds}}$$

$$= \frac{22,00,000\,(1-0.30)}{2,00,00,000}$$

= 0.077 or 7.7%

(ii) Computation of Weighted Average Cost of Capital based on new capital structure

Source of Capital	New Capital structure (₹)	Weights (a)	After tax cost of capital (%) (b)	WACC (%) (a) x (b)
Equity share capital (W.N.3)	4,00,00,000	0.548	13.33	7.30
12% Preference share capital	80,00,000	0.110	12.00	1.32
11% Debentures (W.N.2)	2,00,00,000	0.274	7.70	2.11
12% Debentures (W.N.4)	50,00,000	0.068	8.40	0.57
Total	7,30,00,000	1.000		11.30

Working Notes:

3. Cost of Equity Capital:

$$K_e = \frac{25}{300} + 0.05$$

= 13.33%

4. Cost of 12% Debentures

$$K_d = \frac{6,00,000\,(1-0.30)}{50,00,000}$$

= 0.084 or 8.4%

(b) Statement showing the Evaluation of Accounts Receivable Policies

(Amount in ₹)

	Particulars	Present Policy	Proposed Policy 1	Proposed Policy 2
A	**Expected Profit:**			
	(a) Credit Sales	50,00,000	60,00,000	67,50,000
	(b) Total Cost other than Bad Debts:			

	(i) Variable Costs (70%)	35,00,000	42,00,000	47,25,000
	(c) Bad Debts	1,50,000	3,00,000	4,50,000
	(d) Expected Profit [(a) – (b) – (c)]	13,50,000	15,00,000	15,75,000
B	**Opportunity Cost of Investments in Accounts Receivable** (Working Note)	1,75,000	2,80,000	3,93,750
C	**Net Benefits (A – B)**	11,75,000	12,20,000	11,81,250

Recommendation: The Proposed Policy 1 should be adopted since the net benefits under this policy are higher as compared to other policies.

Working Note:

Calculation of Opportunity Cost of Average Investments

Opportunity Cost = Total Cost × Collection period/12 × Rate of Return/100

Present Policy = ₹ 35,00,000 × 3/12 × 20% = ₹ 1,75,000

Proposed Policy 1 = ₹ 42,00,000 × 4/12 × 20% = ₹ 2,80,000

Proposed Policy 2 = ₹ 47,25,000 × 5/12 × 20% = ₹ 3,93,750

3. (a) At Indifference Point, EPS of Plan (i) = EPS of Plan (ii)

Plan (i) **Plan (ii)**

$$\frac{(EBIT - I_1)(1-T)}{E_1} = \frac{(EBIT - I_2)(1-T) - PD}{E_2}$$

$$\frac{(EBIT - 1,26,000)(1-0.25)}{1,80,000} = \frac{(EBIT - 98,000)(1-0.25) - 80,000}{1,50,000}$$

0.75 EBIT = 4,48,500

EBIT = Indifference point = 5,98,000

A) Financial BEP = Int + (Pref Div / 1-t)

Plan (i) = 1,26,000 + 0

FBEP for Plan (i) = 1,26,000

Plan (ii) = 98,000 + {80,000/ (1 - 0.25)}

FBEP for Plan (ii) = 2,04,666

(b) Evaluation of option A – buying brand new vehicles

The cash inflows would be in the form of 'cash flows from operations', government subsidy, scrap value and tax savings on capital loss if any.

A] Calculation of PV Cash Inflows from Operations -

Year	1	2	3	4	5	6	7	8	9	10
Revenue	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000
Less: Cash Exp	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000
NPBDT	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000
Less: Depre	1,26,000	1,00,800	80,640	64,512	51,610	41,288	33,030	26,424	21,139	16,911
NPBT	3,74,000	3,99,200	4,19,360	4,35,488	4,48,390	4,58,712	4,66,970	4,73,576	4,78,861	4,83,089
Less: Tax @ 15%	56,100	59,880	62,904	65,323	67,259	68,807	70,046	71,036	71,829	72,463
NPAT	3,17,900	3,39,320	3,56,456	3,70,165	3,81,132	3,89,905	3,96,925	4,02,540	4,07,032	4,10,626
Add: Depre	1,26,000	1,00,800	80,640	64,512	51,610	41,288	33,030	26,424	21,139	16,911
Cash flow after tax from operation	4,43,900	4,40,120	4,37,096	4,34,677	4,32,742	4,31,193	4,29,955	4,28,964	4,28,171	4,27,537
PVAF @ 15%	0.870	0.757	0.658	0.572	0.497	0.432	0.376	0.327	0.284	0.247
PV of Cash flows	3,86,193	3,33,171	2,87,609	2,48,635	2,15,073	1,86,275	1,61,663	1,40,271	1,21,601	1,05,602

PV = ₹ 21,86,092

Since GST on purchase of electric vehicle is not eligible for set off, it would be added to the cost of vehicle

Initial Outflow = 1,50,000 x 4 = ₹ 6,00,000

(+) 5% GST = ₹ 30,000

Purchase price / Gross Cost = ₹ 6,30,000

B] Calculation of PV on Government subsidy –

Government subsidy received at the end of Year 1 = 20,000 x 4 = ₹ 80,000

PVIF at 15%, Year 1 = 0.870

Therefore, PV on Government subsidy = ₹ 69,600

C] Calculation of PV of Scrap value

Scrap value received at the end of Year 10 = 10% on Gross Cost

= 6,30,000 x 0.1

= 63,000

Therefore, PV of scrap = 63,000 x 0.247 = ₹ 15,561

D] Calculation of PV on Tax savings due to Capital Loss at the end of 10th year

WDV of assets at the end of 10th year = 6,30,000 - 5,62,354 = ₹ 67,646

Less : Sale Value = ₹ 63,000

Capital Loss = ₹ 4,646

Tax savings at 15% on above loss = ₹ 697

PV on Tax savings due to Capital Loss = 697 x 0.247 = ₹ 172

NPV of Net Outflow = PV on Cash Inflows from Operations + PV on govt subsidy + PV on Scrap + PV on Tax Savings due to Capital Loss - Initial Outflow

= 21,86,092 + 69,600 + 15,561 + 172 - 6,30,000

NPV = ₹ 16,41,425

Evaluation of option B – buying second hand vehicles

A] Calculation of PV of Cash Outflow

Purchase of 4 vehicles at the beginning = 1,00,000 x 4 = ₹ 4,00,000

Rework of 4 vehicles at the end of 5th year = (70,000 x 4) x 0.497

= ₹ 1,39,160

Total Gross Cash Outflow = 4,00,000 + 1,39,160 = ₹ 5,39,160

B] Calculation of PV of Cash Inflows from Operations –

Year	1	2	3	4	5	6	7	8	9	10
Revenue	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000	15,00,000
Less: Cash Exp	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000
NPBDT	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000	5,00,000
Less: Depre	80,000	64,000	51,200	40,960	32,769	75,814	60,652	48,521	38,817	31,054
NPBT	4,20,000	4,36,000	4,48,800	4,59,040	4,67,231	4,24,186	4,39,348	4,51,479	4,61,183	4,68,946

Less: Tax @ 15%	63,000	65,400	67,320	68,856	70,085	63,628	65,902	67,722	69,177	70,342
NPAT	3,57,000	3,70,600	3,81,480	3,90,184	3,97,146	3,60,558	3,73,446	3,83,757	3,92,006	3,98,604
Add: Depre	80,000	64,000	51,200	40,960	32,769	75,814	60,652	48,521	38,817	31,054
Cash flow after tax from operation	4,37,000	4,34,600	4,32,680	4,31,144	4,29,915	4,36,372	4,34,098	4,32,278	4,30,823	4,29,658
PVAF @ 15%	0.870	0.757	0.658	0.572	0.497	0.432	0.376	0.327	0.284	0.247
PV of Cash flows	3,80,190	3,28,992	2,84,703	2,46,614	2,13,668	1,88,513	1,63,221	1,41,355	1,22,354	1,06,126

PV = ₹ 21,75,736

C] Calculation of WDV at the end 5th year (for depreciation purpose)

WDV at the end of 5th Year = ₹ 1,31,072(4,00,000 – 2,68,928)

Add: Rework = ₹ 2,80,000 (70,000 x 4)

Less: Sale Value = (₹ 32,000)

WDV on which Depreciation will be calculated = ₹ 3,79,072

D] Calculation of PV of Scrap

PV of Scrap sale at the end of 5th Year = ₹ (8,000 x 4) x 0.497 = ₹ 15,904

PV of Scrap sale at the end of 10th year = ₹ (4,000 x 4) x 0.247 = ₹ 3,952

Total PV on Scrap Sale = 15,904 + 3,952 = ₹ 19,856

E] Calculation of PV on Tax savings due to Capital Loss (At Year 10)

WDV as per Income tax at the end of 10th Year = ₹ 1,24,214(3,79,072 – 2,54,858)

Less: Sale Value (4,000 x 4) = (₹ 16,000)

Capital Loss = ₹ 1,08,214

Tax @ 15% on Capital Loss = ₹ 16,232

PV on Tax Savings (16,232 x 0.247) = ₹ 4,009

NPV = PV on Cash Inflows from operations + PV on Scrap + PV on Tax Savings due to Capital Loss - Initial Outflow

= 21,75,736 + 19,856 + 4,009 - 5,39,160

NPV = ₹ 16,60,441

Comment - Since NPV for Option B is more, Millenial Limited should go for buying second hand e-delivery vehicles instead every 5 years instead of owning brand new vehicles.

4. (a) 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**.

Agency Problem can be addressed through following efforts:

- Managerial compensation is linked to profit of the company to some extent and also with the long term objectives of the company.
- Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.
- Effecting monitoring can be done.

(b) **Debt Securitisation:** 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.

Process of Debt Securitisation

(i) *The origination function* – A borrower seeks a loan from a finance company, bank, HDFC. The credit worthiness of borrower is evaluated and contract is entered into with repayment schedule structured over the life of the loan.

(ii) *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.

(iii) *The securitisation function* – SPV will structure and issue securities on the basis of asset pool. The securities carry a coupon and 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 the credit risk and issuer is under an obligation to pay to investors only if the cash flows are received by him from the 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.

(c) When the cost of 'fixed cost fund' is less than the return on investment, financial leverage will help to increase return on equity and EPS. The firm will also benefit from the saving of tax on interest on debts etc. However, when cost of debt will be more than the return it will affect return of equity and EPS unfavourably and as a result firm can be under financial distress. Therefore, financial leverage is also known as "**double edged sword".**

Effect on EPS and ROE:

When, ROI > Interest – Favourable – Advantage

When, ROI < Interest – Unfavourable – Disadvantage

When, ROI = Interest – Neutral – Neither advantage nor disadvantage

OR

(c) Objective of financial management is to **maximize wealth**. Therefore, one should choose a capital structure which maximizes wealth. For this purpose, following analysis should be done:

(1) EBIT-EPS-MPS analysis: Chose a capital structure which maximizes market price per share. For that, start with same EBIT for all capital structures and calculate EPS. Thereafter, either multiply EPS by price earning ratio or divide it by cost of equity to arrive at MPS.

(2) Indifference Point analysis: In above analysis, we have considered value at a given EBIT only. What will happen if EBIT changes? Will it change your decision also? To answer this question, you can do indifference point analysis.

(3) Financial Break-Even Point (BEP) analysis: With change in capital structure, financial risk also changes. Though this risk has already been considered in PE ratio or in cost of equity in point one above, but one may calculate and consider it separately also by calculating Financial BEP.

PAPER 6B: STRATEGIC MANAGEMENT

ANSWERS

PART I

1. (A) (i) (c) (ii) (c) (iii) (d) (iv) (c) (v) (c)

(B) (i) (b) (ii) (b) (iii) (c)

PART II PART II – Descriptive Questions

1. (a) XYZ Enterprises employs different network relationships across its divisions to optimize efficiency and innovation.

- **Automobile Division – Functional and Divisional Relationship:** The automobile division operates independently, with distinct teams handling electric and fuel-based vehicles. Each division is managed by a business-level head who directly reports to the corporate-level management. This structure ensures clear accountability, specialization, and focused decision-making. By maintaining independent divisions, XYZ Enterprises can cater to different market segments effectively.
- **IT Division – Matrix Relationship:** The IT division follows a matrix structure where employees report to both project heads and functional managers. This setup allows for efficient resource utilization, as employees contribute to multiple projects while maintaining alignment with their respective departments. The matrix relationship helps manage complex software development projects that require cross-functional expertise, ensuring seamless collaboration among teams like development, marketing, and finance.
- **Startup Incubator – Horizontal Relationship:** The startup incubator promotes a horizontal structure where all employees, regardless of hierarchy, collaborate and share ideas openly. This nurtures transparency, quick decision-making, and innovation, which are essential for startups. Since speed and adaptability are crucial in early-stage ventures, this relationship structure ensures that creative solutions are implemented without bureaucratic delays.

  By adopting these network relationships, XYZ Enterprises maximizes efficiency, agility, and innovation across its diverse operations.

(b) PQR Ltd. has planned to implement the Strategic Business Unit (SBU) structure. Very large organisations, particularly those running into several products, or operating at distant geographical locations that are extremely diverse in terms of environmental factors, can be better managed by creating strategic business units. SBU structure becomes imperative in an organisation with an increase in number, size and diversity.

The attributes of an SBU and the benefits a firm may derive by using the SBU Structure are as follows:

- A scientific method of grouping the businesses of a multi – business corporation which helps the firm in strategic planning.
- An improvement over the territorial grouping of businesses and strategic planning based on territorial units.
- Strategic planning for SBU is distinct from rest of businesses. Products/ businesses within an SBU receive same strategic planning treatment and priorities.
- Each SBU will have its own distinct set of competitors and its own distinct strategy.
- The CEO of SBU will be responsible for strategic planning for SBU and its profit performance.
- Products/businesses that are related from the standpoint of function are assembled together as a distinct SBU.
- Unrelated products/ businesses in any group are separated into separate SBUs.
- Grouping the businesses on SBU lines helps in strategic planning by removing the vagueness and confusion.
- Each SBU is a separate business and will be distinct from one another on the basis of mission, objectives etc.

(c) ABC Fashion's expansion into international markets, offering different products tailored to the unique preferences of various customer segments, aligns with the **diversification strategy** in Ansoff's Product-Market Growth Matrix. This strategy involves introducing new products to new markets, which represents the highest level of risk and reward in the matrix.

By entering international markets, ABC Fashion is stepping into unfamiliar territories where it must navigate different cultural preferences, market dynamics, and consumer behaviours. The decision to offer a variety of products that cater to the specific needs and tastes of each region demonstrates the company's commitment to localizing its offerings, which is a hallmark of diversification.

This strategy is particularly beneficial for companies like ABC Fashion that seek to maximize their growth potential by not only expanding their geographical footprint but also by innovating and adapting their product lines. It allows the company to tap into new revenue streams and diversify its business risk by not relying solely on its domestic market. However, it also requires significant market research, investment, and adaptation to different regulatory environments.

In summary, ABC Fashion's approach reflects a strategic diversification, enabling the brand to establish a strong international presence while meeting the diverse needs of global customers.

2. **(a)** Businesses sell products. A product can be either a good or a service. It might be physical good or a service, an experience.

Following are the key characteristics of business products:

1. **Products are either tangible or intangible.** A tangible product can be handled, seen, and physically felt, such as a car, book, pen, table, mobile handset and so on. Alternatively, an intangible product is not a physical good, such as telecom services, banking, insurance, or repair services.

2. **Product has a price**. Businesses determine the cost of their products and charge a price for them. The dynamics of supply and demand influence the market price of an item or service. The market price is the price at which quantity provided equals quantity desired. The price that may be paid is determined by the market, the quality, the marketing, and the targeted group. In the present competitive world prices are often given by the market and businesses have to work on costs to maintain profitability.

3. **Products have certain features that deliver satisfaction**. A product feature is a component of a product that satisfies a consumer's need. Features determine product pricing, and businesses alter features during the development process to optimize the user experience. Products should be able to provide value satisfaction for the customers for whom they are meant. Features of the product will distinguish between terms of function, design, quality and experience. A customer's cumulative experience with a product from its purchase to the end of its useful life is an important component of a product feature.

4. **Product is pivotal for business**. The product is at the centre of business around which all strategic activities revolve. The product enables production, quality, sales, marketing, logistics and other business processes. Product is the driving force behind business activities.

5. **A product has a useful life**. Every product has a usable life after which it must be replaced, as well as a life cycle after which it is to be reinvented or may cease to exist. We have observed that fixed-line telephone instruments have largely been replaced by mobile phones.

(b) A company's mission statement is typically focused on its present business scope, **who we are and what we do**. Mission statements broadly describe an organization's present capability, customer focus, activities, and business make up. Mission for an organization is significant for the following reasons:

- It ensures **unanimity of purpose** within the organization.
- It develops a basis, or standard, for **allocating organizational resources.**
- It provides a basis for **innovating the use of the organisation's resources.**
- It **establishes** a general tone or **organizational climate**, to suggest a business-like operation.
- It serves as a **focal point** for those who can identify with the **organisation's purpose and direction**.
- It facilitates the **translation of objectives and goals into a work structure** involving the assignment of tasks to responsible elements within the organization.
- It specifies organizational purposes and the **translation of these purposes into goals** in such a way that cost, time, and performance parameters can be assessed and controlled.

3. (a) Any organisation may find the work of digital transformation challenging and overwhelming. To ensure that a digital transition is effective, change management is essential. Here are some pointers for navigating change during the digital transformation:

1. **Specify the digital transformation's aims and objectives:** What is the intended outcome? What are the precise objectives that must be accomplished? It will be easier to make sure that everyone is on the same page and pursuing the same aims if everyone has a clear grasp of their goals.

2. **Always, always, always communicate:** It might be challenging for people to accept change and adjust to it. Ensure that you routinely and honestly discuss the objectives of digital transformation and how they will affect stakeholders, including employees, clients, and other parties.

3. **Be ready for resistance:** Even when a change is for the better, it can be challenging for people to embrace it. Have a strategy in place for dealing with any resistance that may arise.

4. **Implement changes gradually:** Changes should ideally be implemented gradually rather than all at once. In order to avoid overwhelming individuals with too much change at once, this will give people time to become used to the new way of doing things.

5. **Offer assistance and training:** Workers will need guidance in the new procedures, software applications, etc.

In conclusion, effective completion of the massive project known as digital transformation depends on meticulous planning and change management. Digital transformation efforts are more likely to fail without change management. Organizations can successfully integrate a new digital system by planning for and managing the changes that must take place. Any project involving digital transformation must include it.

(b) The following are the principal points of distinction between concentric diversification and conglomerate diversification:

(i) Concentric diversification occurs when a firm adds related products or markets. On the other hand, conglomerate diversification occurs when a firm diversifies into areas that are unrelated to its current line of business.

(ii) In concentric diversification, the new business is linked to the existing businesses through process, technology or marketing. In conglomerate diversification, no such linkages exist; the new business/product is disjointed from the existing businesses/ products.

(iii) The most common reasons for pursuing concentric diversification are that opportunities in a firm's existing line of business are available. However, common reasons for pursuing a conglomerate growth strategy are that opportunities in a firm's current line of business are limited or opportunities outside are highly lucrative.

4. **(a)** The company went through the following stages of the product life cycle (PLC):

Introduction stage: Initially, the company faced slow sales growth, limited markets, and high prices, which are characteristic of the introduction stage. During this stage, competition is almost negligible, and customers have limited knowledge about the product.

Growth stage: Over time, the demand for the product expanded rapidly, prices fell, and competition increased. These are typical features of the growth stage in the PLC. In this stage, the product gains market acceptance, and customers become more aware of the product's benefits and show interest in purchasing it.

(b) Four specific criteria of sustainable competitive advantage that firms can use to determine those capabilities that are core competencies. Capabilities that are valuable, rare, costly to imitate, and non-substitutable are core competencies.

i. **Valuable:** Valuable capabilities are the ones that allow the firm to exploit opportunities or avert the threats in its external environment. A firm created value for customers by effectively using capabilities to exploit opportunities. Finance companies build a valuable competence in financial services. In addition, to make such competencies as financial services highly successful requires placing the right people in the right jobs. Human capital is important in creating value for customers.

ii. **Rare:** Core competencies are very rare capabilities and very few of the competitors possess these. Capabilities possessed by many rivals are unlikely to be sources of competitive advantage for any one of them. Competitive advantage results only when firms develop and exploit valuable capabilities that differ from those shared with competitors.

iii. **Costly to imitate:** Costly to imitate means such capabilities that competing firms are unable to develop easily.

iv. **Non-substitutable:** Capabilities that do not have strategic equivalents are called non-substitutable capabilities. This final criterion for a capability to be a source of competitive advantage is that there must be no strategically equivalent valuable resources that are themselves either not rare or imitable.

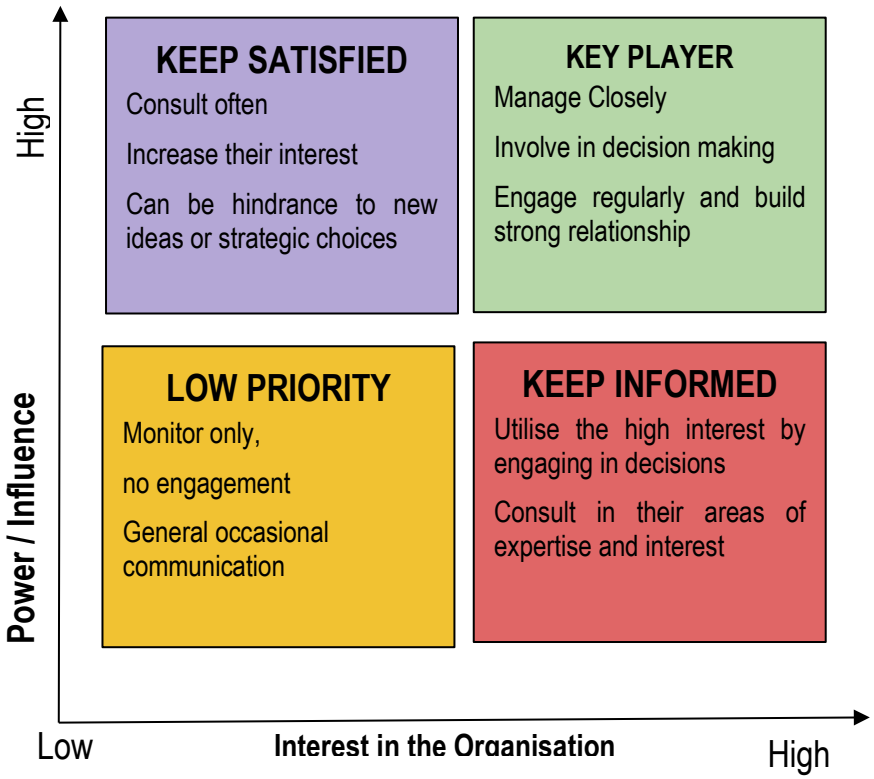
OR

Stakeholders through a grid-based approach by the following steps:

1. **Identify Stakeholders:** Begin by identifying all relevant stakeholders for your project or organization. This includes individuals, groups, or organizations that may be impacted by or have an impact on your activities.

2. **Assess Power and Interest:** For each stakeholder, assess their power to influence your project or organization and their level of interest in its success. Power can be assessed based on factors such as authority, resources, and expertise, while interest can be gauged by their level of involvement, expectations, and potential benefits or risks.

3. **Plot Stakeholders on the Grid:** Create a grid with Power on one axis and Interest on the other. Plot each stakeholder on the grid based on your assessment. Stakeholders with high power and high interest are placed in the "Key Players" quadrant, those with high power but low interest are in the "Keep Satisfied" quadrant, those with low power but high interest are in the "Keep Informed" quadrant, and those with low power and low interest are in the "Low Priority" quadrant.



4. **Develop Strategies for each Quadrant:** Based on the placement of stakeholders in the grid, develop specific strategies for managing each quadrant:

   - **Key Players:** Fully engage with these stakeholders, seek their input, and keep them informed. They are crucial for the success of your project, so their needs and expectations should be a top priority.
   - **Keep Satisfied:** These stakeholders have significant power but may not be as interested in your project. Keep them satisfied by providing regular updates and addressing any concerns they may have to prevent them from becoming detractors.
   - **Keep Informed:** While these stakeholders may not have much power, they are highly interested in your project. Keep them informed to ensure they remain supportive and to leverage their insights and feedback.
   - **Low Priority:** These stakeholders have low power and interest. Monitor them for any changes but allocate minimal resources to managing their expectations.