

## **PAPER – 6:**

# **FINANCIAL MANAGEMENT AND STRATEGIC MANAGEMENT**

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### **6A: FINANCIAL MANAGEMENT**



#### **QUESTIONS**

##### **Division A: Case Scenario**

##### **Working Capital**

1. ArMore LLP is a newly established startup dealing in manufacture of a revolutionary product HDHMR which is a substitute to conventional wood and plywood. It is an economical substitute for manufacture of furniture and home furnishing. It has been asked by a venture capitalist for an estimated amount of funds required for setting up plant and also the amount of circulating capital required. A consultant hired by the entity has advised that the cost of setting up the plant would be ₹ 5 Crores and it will require 1 year to make the plant operational. The anticipated revenue and associated cost numbers are as follows:

Units to be sold = 3 lakh sq metres p.a.

Sale Price of each sq mtr = ₹ 1000

Raw Material cost = ₹ 200 per sq mtr

Labour cost = ₹ 50 per hour

Labour hours per sq mtr = 3 hours

Cash Manufacturing Overheads = ₹ 75 per machine hour

Machine hours per sq mtr = 2 hours

Selling and credit administration Overheads = ₹ 250 per sq mtr

Being a new product in the industry, the firm will have to give a longer credit period of 3 months to its customers. It will maintain a stock of raw material equal to 15% of annual consumption. Based on negotiation with the creditors, the payment period has been agreed to be 1 month from the date of purchase. The entity will hold finished goods equal to 2 months of units to be sold. All other expenses are to be paid one month in arrears. Cash and Bank balance to the tune of ₹ 25,00,000 is required to be maintained.

The entity is also considering reducing the working capital requirement by either of the two options: a) reducing the credit period to customers by a month which will lead to reduction in sales by 5%. b) Engaging with a factor for managing the receivables, who will charge a commission of 2% of invoice value and will also advance 65% of receivables @ 12% p.a. This will lead to savings in administration and bad debts cost to the extent of ₹ 20 lakhs and 16 lakhs respectively.

The entity is also considering funding a part of working capital by bank loan. For this purpose, bank has stipulated that it will grant 75% of net current assets as advance against working capital. The bank has quoted 16.5% rate of interest with a condition of opening a current account with it, which will require 10% of loan amount to be minimum average balance.

You being an finance manager, has been asked the following questions:

- (i) The anticipated profit before tax per annum after the plant is operational is .....
  - (A) 750 Lakhs
  - (B) 570 Lakhs
  - (C) 370 Lakhs
  - (D) 525 Lakhs
- (ii) The estimated current assets requirement in the first year of operation (debtors calculated at cost) is .....

- (A) 9,42,50,000
  - (B) 2,17,08,333
  - (C) 7,25,41,667
  - (D) 67,08,333
- (iii) The net working capital requirement for the first year of operation is .....
- (A) 9,42,50,000
  - (B) 2,17,08,333
  - (C) 7,25,41,667
  - (D) 67,08,333
- (iv) The annualised % cost of two options for reducing the working capital is .....
- (A) 18.18% and 16.92%
  - (B) 18.33% and 16.92%
  - (C) 18.59% and 18.33%
  - (D) 16.92% and 19.05%
- (v) What will be the Maximum Permissible Bank Finance by the bank and annualised % cost of the same?
- (A) 4,55,03,630 and 18.33%
  - (B) 5,44,06,250 and 18.33%
  - (C) 4,45,86,025 and 18.59%
  - (D) 3,45,89,020 and 19.85%

**Division B: Descriptive Questions****Ratio Analysis**

1. From the following information and ratios, PREPARE the Balance Sheet as on 31<sup>st</sup> March 2023 and Income Statement for the year ended on that date for Limelite & Co.

|                                             |            |
|---------------------------------------------|------------|
| Gross Profit                                | ₹ 1,20,000 |
| Shareholders' Funds                         | ₹ 5,00,000 |
| Gross Profit margin                         | 40%        |
| Net Profit Margin                           | 10%        |
| PBIT to PBT                                 | 2:1        |
| Credit sales to Total sales                 | 80%        |
| Total Assets turnover                       | 0.4 times  |
| Inventory turnover (Use sales as turnover)  | 5 times    |
| Average collection period (a 360 days year) | 30 days    |
| Current ratio                               | 2          |
| Operating expenses (excluding interest)     | ₹ 60,000   |
| Long-term Debt to Equity                    | 40%        |
| Tax                                         | Nil        |

### Cost of Capital

2. Tutto Ltd. has following capital structure as on 31<sup>st</sup> December 2023, which is considered to be optimum:

|                                         | (₹)       |
|-----------------------------------------|-----------|
| 12% Debenture                           | 4,50,000  |
| 10% Preference share capital            | 1,50,000  |
| Equity shares capital (2,00,000 shares) | 24,00,000 |

The company's share has a current market price of ₹ 30.25 per share. The expected dividend per share in next year is 50 percent of the 2023 EPS. The EPS of last 10 years is as follows. The past trends are expected to continue:

| Year    | 2014  | 2015  | 2016  | 2017  | 2018  | 2019 | 2020  | 2021  | 2022  | 2023  |
|---------|-------|-------|-------|-------|-------|------|-------|-------|-------|-------|
| EPS (₹) | 1.180 | 1.311 | 1.456 | 1.616 | 1.794 | 1.99 | 2.209 | 2.452 | 2.723 | 3.023 |

The company can issue 14 percent new debenture and 12 percent new preference share. The company's debenture is currently selling at ₹ 99.

The new preference issue can be sold at a net price of ₹ 9.90, paying a dividend of ₹ 1.25 per share. The company's marginal tax rate is 50%.

- (i) CALCULATE the after-tax cost (a) of new debts and new preference share capital, (b) of ordinary equity, assuming new equity comes from retained earnings.
- (ii) CALCULATE the marginal cost of capital for the new funds raised.
- (iii) How much can be spent for capital investment before new ordinary share must be sold? Marginal cost of capital remains to be constant. (Assuming that retained earnings available for next year's investment is 50% of 2023 earnings.)
- (iv) What will be marginal cost of capital (cost of fund raised in excess of the amount calculated in part (iii) if the company can sell new ordinary shares of ₹ 22 per share? Assuming both the cost of debt and of preference share capital to be constant.

### Capital Structure

3. Following data is available in respect of two companies having same business risk:

Capital employed = ₹ 3,00,000, EBIT = ₹ 45,000 and  $K_e = 12.5\%$

| Sources     | A Ltd               | B Ltd                 |
|-------------|---------------------|-----------------------|
|             | Levered Company (₹) | Unlevered Company (₹) |
| Debt (@10%) | 1,50,000            | Nil                   |
| Equity      | 1,50,000            | 3,00,000              |

An investor is holding 20% shares in levered company. CALCULATE the increase in annual earnings of investor if he switches his holding from Levered to Unlevered company.

### Leverage

4. From the following financial data of Company A and Company B, PREPARE their Income Statements.

|               | Company A (₹) | Company B (₹) |
|---------------|---------------|---------------|
| Variable Cost | 88,000        | 50% of sales  |

|                    |        |        |
|--------------------|--------|--------|
| Fixed Cost         | 26,500 | -      |
| Interest Expenses  | 14,000 | 11,000 |
| Financial Leverage | 5 : 1  | -      |
| Margin of Safety   | -      | 0.25   |
| Income Tax Rate    | 30%    | 30%    |
| EBIT               | -      | 14,000 |

### Investment Decisions

5. HMR Ltd. is considering replacing a manually operated old machine with a fully automatic new machine. The old machine had been fully depreciated for tax purpose but has a book value of ₹ 2,50,000 on 31<sup>st</sup> March. The machine has begun causing problems with breakdowns and it cannot fetch more than ₹ 40,000 if sold in the market at present. It will have no realizable value after 10 years. The company has been offered ₹ 1,50,000 for the old machine as a trade in on the new machine which has a price (before allowance for trade in) of ₹ 6,00,000. The expected life of new machine is 10 years with salvage value of ₹ 35,000.

Further, the company follows written down value method depreciation @ 10% but for tax purpose, straight line method depreciation is used considering that this is the only machine in the block of assets. A working capital of ₹ 50,000 will be needed and it will be released at the end of tenth year.

Given below are the expected sales and costs from both old and new machine:

|                              | Old machine  | New machine  |
|------------------------------|--------------|--------------|
| Annual output                | 60,000 units | 80,000 units |
| Selling price per unit       | ₹ 18         | ₹ 18         |
| Annual operating hours       | 2,800        | 2,800        |
| Material cost per unit       | ₹ 5          | ₹ 5          |
| Labour cost per hour         | ₹ 50         | ₹ 75         |
| Indirect cash cost per annum | ₹ 1,00,000   | ₹ 1,75,000   |

From the above information, ANALYSE whether the old machine should be replaced or not if the opportunity cost of capital of the Company is 10%?

The Income tax rate is 30%. Further assume that book profit is treated as ordinary income for tax purpose.

Also ESTIMATE the internal rate of return of the replacement decision.

All calculations to be calculated to 3 decimal places.

### Dividend Decision

6. MCO Ltd. has a paid-up share capital of ₹ 10,00,000, face value of ₹ 10 each. The current market price of the shares is ₹20 each. The Board of Directors of the company has an agenda of meeting to pay a dividend of 25% to its shareholders. The company expects a net income of ₹ 5,20,000 at the end of the current financial year. Company also plans for a capital expenditure for the next financial year for a cost of ₹ 7,50,000, which can be financed through retained earnings and issue of new equity shares.

Company's desired rate of investment is 15%.

#### Required:

Following the Modigliani- Miller (MM) Hypothesis, DETERMINE value of the company when:

- (i) It does not pay dividend and
- (ii) It does pay dividend

### Working Capital

7. PQ Ltd. has commenced new business segment in 2023-24. The following information has been ascertained for annual production of 25,000 units which is the full capacity.

|                                       | Cost per unit (₹) |
|---------------------------------------|-------------------|
| Material                              | 100               |
| Labour and variable overhead expenses | 50                |
| Fixed manufacturing expenses          | 35                |
| Depreciation                          | 15                |
| Selling expenses (80% variable)       | 10                |

In the first two years of operations, production and sales are expected to be as follows:

| Year | Production (No. of units) | Sales (No. of units) |
|------|---------------------------|----------------------|
| 1    | 12,000                    | 10,000               |
| 2    | 18,000                    | 19,000               |

The selling price is expected to be ₹ 250 .

To assess the working capital requirements, the following additional information is available:

- (a) Stock of materials                      2 months' average consumption
- (b) Debtors                                      1.5 month's average sales.
- (c) Cash balance                              ₹ 50,000
- (d) Creditors for supply of materials      1 month's average purchase during the year.
- (e) Expenses                                      All expenses will be paid 1 month in advance during the year.

Goods equal to 15% of the year's production (in terms of physical units) will be in process on the average requiring full materials but only 40% of the other expenses.

The management is also of the opinion to make 10% margin for contingencies on computed figure and value the closing stock at cost of production.

PREPARE, for the two years:

- (i) A projected statement of Profit/Loss (Ignoring taxation); and
- (ii) A projected statement of working capital requirements on a cash cost basis.

### Miscellaneous

8. (i) EXPLAIN as to how the wealth maximisation objective is superior to the profit maximisation objective
- (ii) EXPLAIN the importance of trade credit and accruals as source of working capital. What is the cost of these sources?



**SUGGESTED ANSWERS/HINTS****Division A: Case Scenario**

1. (i) (A) 750 Lakhs

|                          | Units           | Per unit<br>(₹) | Amount<br>(₹)       |
|--------------------------|-----------------|-----------------|---------------------|
| Raw Material consumption | 3,50,000        | 200             | 7,00,00,000         |
| labour cost              | 3,50,000        | 150             | 5,25,00,000         |
| Production Overheads     | 3,50,000        | 150             | 5,25,00,000         |
| Cost of Production       | <b>3,50,000</b> | <b>500</b>      | <b>17,50,00,000</b> |
| Less: Stock of FG        | 50,000          | 500             | 2,50,00,000         |
| COGS                     | <b>3,00,000</b> | <b>500</b>      | <b>15,00,00,000</b> |
| Selling and admin exp    | 3,00,000        | 250             | 7,50,00,000         |
| Cost of Sales            | <b>3,00,000</b> | <b>750</b>      | <b>22,50,00,000</b> |
| Sales                    | 3,00,000        | 1000            | 30,00,00,000        |
| Profit                   | <b>3,00,000</b> | <b>250</b>      | <b>7,50,00,000</b>  |

Stock of FG (sq. mtr.) =  $30,00,000 \times 2/12 = 50,000$

Units sold = 3,00,000

Raw material consumed (sq. mtr.) = 3,50,000

Raw Material Purchases = Consumption + RM stock (15%)  
 $= 7,00,00,000 + 1,05,00,000$   
 $= ₹ 8,05,00,000$

(ii) (A) **9,42,50,000**

Stock of Raw Material (15% of 7,00,00,000) = 1,05,00,000

Stock of finished goods = 2,50,00,000

|                                        |                      |
|----------------------------------------|----------------------|
| Debtors ( $22,50,00,000 \times 3/12$ ) | = 5,62,50,000        |
| Cash                                   | = 25,00,000          |
| <b>Total Current Assets</b>            | <b>= 9,42,50,000</b> |

(iii) (C) **7,25,41,667**

**Working Capital Statement**

|                                            | <b>Amount (₹)</b>  |
|--------------------------------------------|--------------------|
| Stock of Raw Material (15% of 7,00,00,000) | 1,05,00,000        |
| Stock of finished goods                    | 2,50,00,000        |
| Debtors ( $22,50,00,000 \times 3/12$ )     | 5,62,50,000        |
| Cash                                       | 25,00,000          |
| <b>Total Current Assets</b>                | <b>9,42,50,000</b> |
| Creditors ( $8,05,00,000 \times 1/12$ )    | 67,08,333          |
| O/s Exp ( $18,00,00,000 \times 1/12$ )     | 1,50,00,000        |
| <b>Total Current Liabilities</b>           | <b>2,17,08,333</b> |
| <b>Net Working Capital</b>                 | <b>7,25,41,667</b> |

(iv) (A) **18.18% and 16.92%**

**Cost reducing debtors credit period**

|                       |                                                                     |
|-----------------------|---------------------------------------------------------------------|
| Debtors credit period | = 2 months                                                          |
| Debtors balance       | = $21,37,50,000(2,85,000 \text{ units}) \times 2/12 = ₹3,56,25,000$ |

|                       |                                              |
|-----------------------|----------------------------------------------|
| Debtors credit period | = 3 months                                   |
| Debtors balance       | = $22,50,00,000 \times 3/12 = ₹ 5,62,50,000$ |

Amount released from debtors = ₹ 2,06,25,000

reduction in profit ( $15,000 \text{ units} \times ₹ 250$ ) = ₹ 37,50,000

% p.a. cost ( $37,50,000/2,06,25,000$ ) = **18.18%**

**Costs of factoring**

Commission (2% of 30 crores) = ₹ 60,00,000

$$\begin{aligned}
 \text{Interest} &= ₹ 58,50,000 \\
 (30\text{cr} \times 65\% \times 12\% \times 3/12) \\
 \text{savings} &= ₹ 36,00,000 \\
 \text{Net cost of factoring} &= \frac{82,50,000}{65\% \text{ of } 30\text{cr. i.e. } 19,50,00,000} \times \frac{12}{3} \\
 &= ₹ 82,50,000 \\
 \% \text{ p.a. cost} &= \mathbf{16.92\%}
 \end{aligned}$$

**(v) (B) 5,44,06,250 and 18.33%**

$$\begin{aligned}
 \text{Maximum Permissible Bank Finance} &= 75\% \text{ of } 7,25,41,667 \\
 &= ₹ 5,44,06,250
 \end{aligned}$$

$$\text{Annualised cost of bank loan} = 16.5/90\% = 18.33\%$$

#### Division A: Descriptive Questions

$$\begin{aligned}
 1. \quad \text{Gross Profit} &= ₹ 1,20,000 \\
 \text{Gross Profit Margin} &= 40\% \\
 \therefore \text{Sales} &= \frac{\text{Gross Profit}}{\text{Gross Profit Margin}} = ₹ 1,20,000 / 0.40 = ₹ 3,00,000 \\
 \text{Net profit (PBT)} &= 3,00,000 \times 10\% = ₹ 30,000 \\
 \text{PBIT/PBT} &= 2 \\
 \text{PBIT} &= 2 \times 30,000 \\
 \text{PBIT} &= 60,000 \\
 \text{Interest} &= 60,000 - 30,000 = ₹ 30,000 \\
 \text{Credit Sales to Total Sales} &= 80\% \\
 \therefore \text{Credit Sales} &= ₹ 3,00,000 \times 0.80 = ₹ 2,40,000 \\
 \text{Total Assets Turnover} &= 0.4 \text{ times} \\
 \therefore \text{Total Assets} &= \frac{\text{Sales}}{\text{Total Assets Turnover}} \\
 &= \frac{₹ 3,00,000}{0.4} = ₹ 7,50,000
 \end{aligned}$$

$$\begin{aligned}
 \text{Inventory turnover} &= 5 \text{ times} \\
 \text{Inventory} &= \frac{\text{Sales}}{\text{Inventory turnover}} = \frac{3,00,000}{5} = ₹ 60,000 \\
 \text{Average Collection Period} &= 30 \text{ days} \\
 \therefore \text{Debtors turnover} &= \frac{360}{\text{Average Collection Period}} = 360/30 = 12 \\
 \therefore \text{Debtors} &= \frac{\text{Credit Sales}}{\text{Debtors turnover}} = \frac{₹ 2,40,000}{12} = ₹ 20,000 \\
 \text{Current ratio} &= 2 \\
 2 &= \frac{\text{Debtors} + \text{Inventory} + \text{Cash (Current Assets)}}{\text{Creditors (Current Liabilities)}} \\
 2 \text{ Creditors} &= (₹ 20,000 + ₹ 60,000 + \text{Cash}) \\
 2 \text{ Creditors} &= ₹ 80,000 + \text{Cash} \text{ ----- (i)} \\
 \text{Long-term Debt to Equity} &= 40\% \\
 \text{Shareholders' Funds (Equity)} &= ₹ 5,00,000 \\
 \therefore \text{Long-term Debt} &= ₹ 5,00,000 \times 40\% = ₹ 2,00,000 \\
 \text{Creditors} &= \text{Total Assets} - (\text{Shareholder's fund} + \text{Long term debt}) \\
 &= ₹ 7,50,000 - (5,00,000 + 2,00,000) = ₹ 50,000 \\
 \therefore \text{Cash} &= (₹ 50,000 \times 2) - ₹ 80,000 = ₹ 20,000 \text{ [From equation (i)]}
 \end{aligned}$$

**Income Statement**

|                          | (₹)      |
|--------------------------|----------|
| Sales                    | 3,00,000 |
| Less: Cost of Goods Sold | 1,80,000 |
| Gross Profit             | 1,20,000 |
| Less: Operating Expenses | 60,000   |
| PBIT                     | 60,000   |
| Less: Interest           | 30,000   |
| Net Profit               | 30,000   |

Balance Sheet

| Liabilities          | ₹        | Assets                  | ₹        |
|----------------------|----------|-------------------------|----------|
| Equity share capital | 5,00,000 | Fixed asset (bal. fig.) | 6,50,000 |
| Long term debt       | 2,00,000 | Current assets:         |          |
| Current liability    | 50,000   | Stock 60,000            |          |
|                      |          | Receivables 20,000      |          |
|                      |          | Cash 20,000             | 1,00,000 |
|                      | 7,50,000 |                         | 7,50,000 |

## 2. (i) Calculation of after-tax cost of the followings:

$$(a) \quad \text{New 14\% Debentures } (K_d) = \frac{I(1-t)}{NP} = \frac{₹14(1-0.5)}{₹99} = 0.0707 \text{ or } 7.07\%$$

$$\text{New 12\% Preference Shares } (K_p) = \frac{PD}{NP} = \frac{₹1.25}{₹9.90} = 0.1263 \text{ or } 12.63\%$$

Where,

I = Interest

t = Tax rate

PD = Preference dividend

NP = Net proceeds

$$(b) \quad \text{Equity Shares (Retained Earnings) } (K_e) = \frac{\text{Expected dividend } (D_1)}{\text{Current market price } (P_0)} + \text{Growth rate } (G)$$

$$= \frac{50\% \text{ of } ₹3.023}{₹30.25} + 0.11^* = 0.16 \text{ or } 16\%$$

\* Growth rate (on the basis of EPS) is calculated as below :

$$\frac{\text{EPS}_{\text{in current year}} - \text{EPS}_{\text{in previous year}}}{\text{EPS}_{\text{in previous year}}} = \frac{\text{₹ } 3.023 - \text{₹ } 2.723}{\text{₹ } 2.723} = 0.11$$

(Students may verify the growth trend by applying the above formula to last three or four years. Growth Rate is rounded off)

**(ii) Calculation of marginal cost of capital (on the basis of existing capital structure):**

| Source of capital        | Weight<br>(a) | After tax Cost<br>of capital (%)<br>(b) | WACC<br>(%)<br>(a) × (b) |
|--------------------------|---------------|-----------------------------------------|--------------------------|
| 14% Debenture            | 0.15          | 7.07                                    | 1.0605                   |
| 12% Preference shares    | 0.05          | 12.63                                   | 0.6315                   |
| Equity shares            | 0.80          | 16.00                                   | 12.800                   |
| Marginal cost of capital |               |                                         | 14.492                   |

**(iii)** The company can spend for capital investment before issuing new equity shares and without increasing its marginal cost of capital:

Retained earnings can be available for capital investment

= 50% of 2023 EPS × equity shares outstanding

= 50% of ₹ 3.023 × 2,00,000 shares = ₹3,02,300

Since, marginal cost of capital is to be maintained at the current level i.e. 14.492%, the retained earnings should be equal to 80% of total additional capital for investment.

Thus, investment before issuing equity  $\left( \frac{\text{₹ } 3,02,300}{80} \times 100 \right)$   
= ₹ 3,77,875

The remaining capital of ₹ 75,575 i.e. ₹ 3,77,875 – ₹ 3,02,300 shall be financed by issuing 14% Debenture and 12% preference shares in the ratio of 3 : 1 respectively.

**(iv)** If the company spends more than ₹ 3,77,875 as calculated in part (iii) above, it will have to issue new shares at ₹ 22 per share.

The cost of new issue of equity shares will be:

$$K_e = \frac{\text{Expected dividend}(D_1)}{\text{Current market price}(P_0)} + \text{Growth rate}(g) = \frac{50\% \text{ of } ₹ 3.023}{₹ 22} + 0.11$$

$$= 0.1787 \text{ or } 17.87\%$$

Calculation of marginal cost of capital (assuming the existing capital structure will be maintained):

| Source of capital        | Weight<br>(a) | Cost (%)<br>(b) | WACC (%)<br>(a) × (b) |
|--------------------------|---------------|-----------------|-----------------------|
| 14% Debenture            | 0.15          | 7.07            | 1.0605                |
| 12% Preference shares    | 0.05          | 12.63           | 0.6315                |
| Equity shares            | 0.80          | 17.87           | 14.296                |
| Marginal cost of capital |               |                 | 15.988                |

**3. (i) Valuation of firms**

| Particulars                                                           | A Ltd            | B Ltd              |
|-----------------------------------------------------------------------|------------------|--------------------|
|                                                                       | Levered Firm (₹) | Unlevered Firm (₹) |
| EBIT                                                                  | 45,000           | 45,000             |
| Less: Interest on debt (10% × ₹ 1,50,000)                             | 15,000           | Nil                |
| Earnings available to Equity shareholders                             | 30,000           | 45,000             |
| Ke                                                                    | 12.5%            | 12.5%              |
| Value of Equity (S)<br>(Earnings available to Equity shareholders/Ke) | 2,40,000         | 3,60,000           |
| Debt (D)                                                              | 1,50,000         | Nil                |
| Value of Firm (V) = S + D                                             | 3,90,000         | 3,60,000           |

Value of Levered company is more than that of unlevered company. Therefore, investor will sell his shares in levered company and buy shares in unlevered company. To maintain the

level of risk he will borrow proportionate amount and invest that amount also in shares of unlevered company.

**(ii) Investment & Borrowings**

|                                                             | ₹             |
|-------------------------------------------------------------|---------------|
| Sell shares in Levered company ( $₹ 2,40,000 \times 20\%$ ) | 48,000        |
| Borrow money ( $₹ 1,50,000 \times 20\%$ )                   | <u>30,000</u> |
| Buy shares in Unlevered company                             | <u>78,000</u> |

**(iii) Change in Return**

|                                                                         | ₹            |
|-------------------------------------------------------------------------|--------------|
| Income from shares in Unlevered company<br>( $₹ 78,000 \times 12.5\%$ ) | 9,750        |
| Less: Interest on loan ( $₹ 30,000 \times 10\%$ )                       | <u>3,000</u> |
| Net Income from unlevered firm                                          | 6,750        |
| Less: Income from Levered firm ( $₹ 48,000 \times 12.5\%$ )             | <u>6,000</u> |
| Incremental Income due to arbitrage                                     | <u>750</u>   |

**4. Income Statements of Company A and Company B**

|                                         | Company A<br>(₹) | Company B<br>(₹) |
|-----------------------------------------|------------------|------------------|
| Sales                                   | 1,32,000         | 1,12,000         |
| Less: Variable cost                     | 88,000           | 56,000           |
| Contribution                            | 44,000           | 56,000           |
| Less: Fixed Cost                        | 26,500           | 42,000           |
| Earnings before interest and tax (EBIT) | 17,500           | 14,000           |
| Less: Interest                          | 14,000           | 11,000           |
| Earnings before tax (EBT)               | 3,500            | 3,000            |
| Less: Tax @ 30%                         | 1,050            | 900              |
| Earnings after tax (EAT)                | 2,450            | 2,100            |



**Working Notes:**
**Company A**

$$(i) \quad \text{Financial Leverage} = \frac{\text{EBIT}}{\text{EBT i.e EBIT - Interest}}$$

$$\text{So, } 5 = \frac{\text{EBIT}}{\text{EBIT} - 14,000}$$

$$\text{Or, } 5 (\text{EBIT} - 14,000) = \text{EBIT}$$

$$\text{Or, } 4 \text{ EBIT} = 70,000$$

$$\text{Or, } \text{EBIT} = ₹17,500$$

$$(ii) \quad \begin{aligned} \text{Contribution} &= \text{EBIT} + \text{Fixed Cost} \\ &= ₹17,500 + ₹26,500 = ₹44,000 \end{aligned}$$

$$(iii) \quad \begin{aligned} \text{Sales} &= \text{Contribution} + \text{Variable cost} \\ &= ₹44,000 + ₹88,000 \\ &= ₹1,32,000 \end{aligned}$$

**Company B**

$$(i) \quad \text{Operating Leverage} = 1/\text{Margin of Safety} = \frac{\text{Contribution}}{\text{EBIT}}$$

$$1/0.25 = \frac{\text{Contribution}}{₹14,000}$$

$$4 = \frac{\text{Contribution}}{₹14,000}$$

$$\text{Contribution} = ₹14,000 \times 4 = ₹56,000$$

$$(ii) \quad \text{Fixed Cost} = \text{Contribution} - \text{EBIT} = 56,000 - 14,000 = ₹42,000$$

$$(iii) \quad \begin{aligned} \text{Contribution} &= 50\% \text{ of Sales (as Variable Cost is 50\% of Sales)} \\ \text{Sales} &= 56,000 \times 2 = ₹1,12,000 \end{aligned}$$

**5. Workings:**
**(i) Initial Cash Outflow:**

|                                      | <b>Amount (₹)</b> |
|--------------------------------------|-------------------|
| Cost of new machine                  | 6,00,000          |
| Less: Sale Price of existing machine | 1,05,000          |
| Net of Tax (₹ 1,50,000 × 0.70)       |                   |
|                                      | 4,95,000          |

**(ii) Terminal Cash Flows:**
**New Machine**

|                                                               | <b>Amount (₹)</b> |
|---------------------------------------------------------------|-------------------|
| Salvage value of Machine                                      | 35,000            |
| Less: Depreciated WDV<br>{₹ 6,00,000 - (₹ 56,500 × 10 years)} | 35,000            |
| Short Term Capital Gain (STCG)                                | Nil               |
| Tax                                                           | Nil               |
| Net Salvage Value (cash flows)                                | 35,000            |

**(iii) Computation of additional cash flows (yearly)**

| <b>Particulars</b>                   | <b>Existing machine</b> | <b>New Machine</b> | <b>Incremental</b> |
|--------------------------------------|-------------------------|--------------------|--------------------|
| (1)                                  | (2)                     | (3)                | (4)=(3)–(2)        |
| Annual output                        | 60,000 units            | 80,000 units       | 20,000 units       |
|                                      | ₹                       | ₹                  | ₹                  |
| (A) Sales revenue<br>@ ₹ 18 per unit | 10,80,000               | 14,40,000          | 3,60,000           |
| (B) Less: Cost of<br>Operation       |                         |                    |                    |
| Material @ ₹ 5 per unit              | 3,00,000                | 4,00,000           | 1,00,000           |
| Labour                               |                         |                    |                    |
| Old = 2,800 × ₹ 50                   | 1,40,000                |                    | 70,000             |

|                                                          |          |          |          |
|----------------------------------------------------------|----------|----------|----------|
| New = 2,800 x ₹ 75                                       |          | 2,10,000 |          |
| Indirect cash cost                                       | 1,00,000 | 1,75,000 | 75,000   |
| Total Cost (B)                                           | 5,40,000 | 7,85,000 | 2,45,000 |
| Profit Before Tax and depreciation (PBTd) (A – B)        | 5,40,000 | 6,55,000 | 1,15,000 |
| Less: Depreciation<br>( $\frac{6,00,000 - 35,000}{10}$ ) |          |          | 56,500   |
| Earning after depreciation before Tax                    |          |          | 58,500   |
| Less: Tax @30%                                           |          |          | 17,550   |
| Earning after depreciation and Tax                       |          |          | 40,950   |
| Add: Depreciation                                        |          |          | 56,500   |
| Net Cash inflow                                          |          |          | 97,450   |

**Analysis:** Since the Incremental Cash flow is positive, the old machine should be replaced.

**Note:** As mentioned in the question WDV of Machine is zero for tax purpose hence no depreciation shall be provided in existing machine.

**(iv) Calculation of IRR**

**Computation of NPV @ 10%**

|                                 | Period | Cash flow (₹) | PVF @ 10% | PV (₹)   |
|---------------------------------|--------|---------------|-----------|----------|
| Incremental cash flows          | 1-10   | 97,450        | 6.144     | 5,98,733 |
| Add: Release of Working Capital | 10     | 50,000        | 0.386     | 19,300   |
| Add: Terminal year cash         | 10     | 35,000        | 0.386     | 13,510   |
|                                 |        |               |           | 6,31,543 |

|                            |   |          |     |          |
|----------------------------|---|----------|-----|----------|
| Less: Initial cash outflow | 0 | 4,95,000 | 1   | 4,95,000 |
| Less: Working capital      | 0 | 50,000   | 1   | 50,000   |
|                            |   |          | NPV | 86,543   |

Since NPV computed in Part (i) is positive. Let us discount cash flows at higher rate say at 20%

|                                 | Period | Cash flow (₹) | PVF @ 20% | PV (₹)     |
|---------------------------------|--------|---------------|-----------|------------|
| Incremental cash flows          | 1-10   | 97,450        | 4.192     | 4,08,510   |
| Add: Release of Working Capital | 10     | 50,000        | 0.162     | 8,100      |
| Add: Terminal year cash         | 10     | 35,000        | 0.162     | 5,670      |
|                                 |        |               |           | 4,22,280   |
| Less: Initial cash outflow      | 0      | 4,95,000      | 1         | 4,95,000   |
| Less: Working capital           | 0      | 50,000        | 1         | 50,000     |
|                                 |        |               | NPV       | (1,22,720) |

Now we use interpolation formula:

$$10\% + \frac{86,543}{86,543 - (-1,22,720)} \times 10\%$$

$$10\% + \frac{86,543}{2,09,263} \times 10\%$$

$$\text{IRR} = 10\% + 4.14\% = 14.14\%$$

### Summary of Results

|                       |                                | Decision |
|-----------------------|--------------------------------|----------|
| Incremental Cash Flow | ₹ 97,450                       | Accept   |
| IRR                   | 14.14% > Cost of Capital (10%) | Accept   |

6. As per MM Hypothesis, value of firm/ company is calculated as below:

$$V_f \text{ or } nP_0 = \frac{(n + \Delta n)P_1 - I + E}{(1 + K_e)}$$

Where,

- $V_f$  = Value of firm in the beginning of the period  
 $n$  = number of shares in the beginning of the period  
 $\Delta n$  = number of shares issued to raise the funds required  
 $I$  = Amount required for investment  
 $E$  = total earnings during the period

- (i) Value of the ZX Ltd. when dividends are not paid.

$$\begin{aligned} nP_0 &= \frac{(n + \Delta n)P_1 - I + E}{1 + K_e} \\ nP_0 &= \frac{\left(1,00,000 + \frac{2,30,000}{23}\right) \times ₹23 - ₹7,50,000 + ₹5,20,000}{(1 + 0.15)} \\ &= \frac{₹25,30,000 - ₹7,50,000 + ₹5,20,000}{(1 + 0.15)} = ₹20,00,000 \end{aligned}$$

**Working notes:**

1. Price of share at the end of the period ( $P_1$ )

$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$

$$20 = \frac{P_1 + 0}{1 + 0.15} \quad \text{or, } P_1 = ₹23$$

2. Calculation of funds required for investment

|                      |            |
|----------------------|------------|
| Earnings             | ₹ 5,20,000 |
| Dividend distributed | Nil        |

|                               |           |
|-------------------------------|-----------|
| Fund available for investment | ₹5,20,000 |
| Total Investment              | ₹7,50,000 |
| Balance Funds required        | ₹2,30,000 |

3. Calculation of no. of shares required to be issued for balance fund

$$\begin{aligned} \text{No. of shares } (\Delta n) &= \frac{\text{Funds required}}{\text{Price at end } (P_1)} = \frac{2,30,000}{23} \text{ shares} \\ &= 10,000 \text{ shares} \end{aligned}$$

(ii) **Value of the ZX Ltd. when dividends are paid.**

$$\begin{aligned} nP_0 &= \frac{(n + \Delta n)P_1 - I + E}{1 + K_e} \\ nP_0 &= \frac{\left(1,00,000 + \frac{4,80,000}{20.5}\right) \times ₹20.5 - ₹7,50,000 + ₹5,20,000}{(1 + 0.15)} \\ &= \frac{₹25,30,000 - ₹7,50,000 + ₹5,20,000}{(1 + 0.15)} = ₹20,00,000 \end{aligned}$$

**Working notes:**

4. Price of share at the end of the period ( $P_1$ )

$$\begin{aligned} P_0 &= \frac{P_1 + D_1}{1 + K_e} \\ 20 &= \frac{P_1 + 2.5}{1 + 0.15} \quad \text{or, } P_1 = ₹20.5 \end{aligned}$$

5. Calculation of funds required for investment

|                               |           |
|-------------------------------|-----------|
| Earnings                      | ₹5,20,000 |
| Dividend distributed          | ₹2,50,000 |
| Fund available for investment | ₹2,70,000 |
| Total Investment              | ₹7,50,000 |
| Balance Funds required        | ₹4,80,000 |

6. Calculation of no. of shares required to be issued for balance fund

$$\text{No. of shares } (\Delta n) = \frac{\text{Funds required}}{\text{Price at end } (P_1)} = \frac{4,80,000}{20.5}$$

$$= 23,415 \text{ shares (approx.)}$$

**Note- As per MM-hypothesis of dividend irrelevance, value of firm remains same irrespective of dividend paid. In the solution, there may be variation in value, which is due to rounding off error.**

7. (i)

**PQ Limited**

**Projected Statement of Profit / Loss  
(Ignoring Taxation)**

|                                                                            | <b>Year 1</b>    | <b>Year 2</b>    |
|----------------------------------------------------------------------------|------------------|------------------|
| Production (Units)                                                         | 12,000           | 18,000           |
| Sales (Units)                                                              | 10,000           | 19,000           |
|                                                                            | <b>(₹)</b>       | <b>(₹)</b>       |
| Sales revenue (A) (Sales unit × ₹ 250)                                     | 25,00,000        | 47,50,000        |
| <b>Cost of production:</b>                                                 |                  |                  |
| Materials cost<br>(Units produced × ₹ 100)                                 | 12,00,000        | 18,00,000        |
| Direct labour and variable expenses<br>(Units produced × ₹ 50)             | 6,00,000         | 9,00,000         |
| Fixed manufacturing expenses<br>(Production Capacity: 25,000 units × ₹ 35) | 8,75,000         | 8,75,000         |
| Depreciation<br>(Production Capacity: 25,000 units × ₹ 15)                 | 3,75,000         | 3,75,000         |
| <b>Gross Factory Cost</b>                                                  | <b>30,50,000</b> | <b>39,50,000</b> |

|                                                                                                                                                               |                  |                  |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|------------------|
| Add: Opening W.I.P.                                                                                                                                           | -                | 2,91,000         |
| Less: Closing W.I.P.                                                                                                                                          | 2,91,000         | 3,99,000         |
| <b>Cost of goods produced</b>                                                                                                                                 | <b>27,59,000</b> | <b>38,42,000</b> |
| Add: Opening stock of finished goods<br>(Year 1 : Nil; Year 2 : 2,000 units)                                                                                  | -                | 4,59,833         |
| Cost of Goods available for sale<br>(Year 1: 12,000 units; Year 2: 20,000 units)                                                                              | 27,59,000        | 43,01,833        |
| Less: Closing stock of finished goods at average cost<br>(year 1: 2000 units, year 2 : 1000 units)<br>(Cost of Production × Closing stock/<br>units produced) | 4,59,833         | 2,13,444         |
| <b>Cost of Goods Sold</b>                                                                                                                                     | <b>22,99,167</b> | <b>40,88,389</b> |
| Add: Selling expenses – Variable (Sales unit × ₹ 8)                                                                                                           | 80,000           | 1,52,000         |
| Add: Selling expenses -Fixed (25,000 units × ₹ 2)                                                                                                             | 50,000           | 50,000           |
| Cost of Sales : (B)                                                                                                                                           | 24,29,167        | 42,90,389        |
| <b>Profit (+) / Loss (-): (A - B)</b>                                                                                                                         | <b>70,833</b>    | <b>4,59,611</b>  |

**Working Notes:**
**Calculation of Stock of Work-in-progress**

| Particulars                                                 | Year 1   | Year 2   |
|-------------------------------------------------------------|----------|----------|
|                                                             | (₹)      | (₹)      |
| Raw Material (material cost × 15%)                          | 1,80,000 | 2,70,000 |
| Labour & Mfg. Expenses (Labour & mfg. expenses × 15% × 40%) | 88,500   | 1,06,500 |
| Depreciation (Depreciation × 15% × 40%)                     | 22,500   | 22,500   |
| Total                                                       | 2,91,000 | 3,99,000 |



1. Calculation of creditors for supply of materials:

|                                                    | Year 1 (₹)      | Year 2 (₹)      |
|----------------------------------------------------|-----------------|-----------------|
| Materials consumed during the year                 | 12,00,000       | 18,00,000       |
| Add: Closing stock (2 month's average consumption) | <u>2,00,000</u> | <u>3,00,000</u> |
|                                                    | 14,00,000       | 21,00,000       |
| Less: Opening Stock                                | -               | 2,00,000        |
| Purchases during the year                          | 14,00,000       | 19,00,000       |
| Average purchases per month (Creditors)            | 1,16,667        | 1,58,333        |

2. Prepayment for expenses:

|                                     | Year 1 (₹)      | Year 2 (₹)      |
|-------------------------------------|-----------------|-----------------|
| Direct labour and variable expenses | 6,00,000        | 9,00,000        |
| Fixed manufacturing expenses        | 8,75,000        | 8,75,000        |
| Selling expenses (variable + fixed) | <u>1,30,000</u> | <u>2,02,000</u> |
| Total                               | 16,05,000       | 19,77,000       |
| Average per month                   | 1,33,750        | 1,64,750        |

(ii) **Projected Statement of Working Capital Requirement  
(Cash Cost Basis)**

|                                                                              | Year 1 (₹) | Year 2 (₹) |
|------------------------------------------------------------------------------|------------|------------|
| <b>(A) Current Assets</b>                                                    |            |            |
| Inventories:                                                                 |            |            |
| - Stock of Raw Material (12,000 units ₹ 100 2/12); (18,000 units ₹ 100 2/12) | 2,00,000   | 3,00,000   |
| - Finished Goods (Refer working note 3)                                      | 4,01,083   | 1,92,611   |
| - Work In Process (Refer working note 5)                                     | 2,68,500   | 3,76,500   |

|                                                   |                  |                  |
|---------------------------------------------------|------------------|------------------|
| Receivables (Debtors) (Refer working note 4)      | 2,66,927         | 4,84,684         |
| Prepayment for Expenses (Refer working note 2)    | 1,33,750         | 1,64,750         |
| Minimum Cash balance                              | 50,000           | 50,000           |
| Total Current Assets/ Gross working capital (A)   | 13,20,260        | 15,68,545        |
| <b>(B) Current Liabilities</b>                    |                  |                  |
| Creditors for raw material (Refer working note 1) | 1,16,667         | 1,58,333         |
| Total Current Liabilities                         | 1,16,667         | 1,58,333         |
| Net Working Capital (A – B)                       | 12,03,594        | 14,10,212        |
| Add: 10% contingency margin                       | 1,20,359         | 1,41,021         |
| Total Working capital required                    | <b>13,23,953</b> | <b>15,51,233</b> |

**Working Note:**

## 3. Cash Cost of Production:

|                                                      | Year 1 (₹) | Year 2 (₹) |
|------------------------------------------------------|------------|------------|
| Gross Factory Cost as per projected Statement of P&L | 30,50,000  | 39,50,000  |
| Add: Opening W.I.P                                   | -          | 2,68,500   |
| Less: Closing W.I.P                                  | 2,68,500   | 3,76,500   |
| Cost of goods produced                               | 27,81,500  | 38,42,000  |
| Less: Depreciation                                   | (3,75,000) | (3,75,000) |
| Cash Cost of Production                              | 24,06,500  | 34,67,000  |
| Add: Opening Stock at Average Cost:                  | -          | 4,01,083   |
| Cash Cost of Goods Available for sale                | 24,06,500  | 38,68,083  |
| Less: Closing Stock at Avg. Cost                     | 4,01,083   | 1,92,611   |

|                                                                                                                   |           |           |
|-------------------------------------------------------------------------------------------------------------------|-----------|-----------|
| $\left( \frac{₹ 24,06,500 \times 2,000}{12,000} \right)$ $\left( \frac{₹ 34,67,000 \times 1,000}{18,000} \right)$ |           |           |
| Cash Cost of Goods Sold                                                                                           | 20,05,417 | 36,75,472 |

4. Receivables (Debtors)

|                                                        | Year 1 (₹) | Year 2 (₹) |
|--------------------------------------------------------|------------|------------|
| Cash Cost of Goods Sold                                | 20,05,417  | 36,75,472  |
| Add: Selling expenses – Variable<br>(Sales unit × ₹ 8) | 80,000     | 1,52,000   |
| Add: Selling expenses -Fixed<br>(25,000 units × ₹ 2)   | 50,000     | 50,000     |
| Cash Cost of Debtors                                   | 21,35,417  | 38,77,472  |
| Average Debtors                                        | 2,66,927   | 4,84,684   |

**Calculation of Stock of Work-in-progress (Cash Cost Basis)**

| Particulars                                                 |          | (₹)      |
|-------------------------------------------------------------|----------|----------|
| Raw Material (material cost × 15%)                          | 1,80,000 | 2,70,000 |
| Labour & Mfg. Expenses (Labour & mfg. expenses × 15% × 40%) | 88,500   | 1,06,500 |
| Total                                                       | 2,68,500 | 3,76,500 |

8. (i) A firm's financial management may often have the following as their objectives:

- The maximisation of firm's profit.
- The maximisation of firm's value / wealth.

The maximisation of profit is often considered as an implied objective of a firm. To achieve the aforesaid objective various type of financing decisions may be taken. Options resulting into maximisation of profit may be selected by the firm's decision makers. They even sometime may adopt policies yielding

exorbitant profits in short run which may prove to be unhealthy for the growth, survival and overall interests of the firm. The profit of the firm in this case is measured in terms of its total accounting profit available to its shareholders.

The value/wealth of a firm is defined as the market price of the firm's stock. The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock.

The value maximisation objective of a firm is superior to its profit maximisation objective due to following reasons.

1. The value maximisation objective of a firm considers all future cash flows, dividends, earning per share, risk of a decision etc. whereas profit maximisation objective does not consider the effect of EPS, dividend paid or any other returns to shareholders or the wealth of the shareholder.
2. A firm that wishes to maximise the shareholders wealth may pay regular dividends whereas a firm with the objective of profit maximisation may refrain from dividend payment to its shareholders.
3. Shareholders would prefer an increase in the firm's wealth against its generation of increasing flow of profits.
4. The market price of a share reflects the shareholders expected return, considering the long-term prospects of the firm, reflects the differences in timings of the returns, considers risk and recognizes the importance of distribution of returns.

The maximisation of a firm's value as reflected in the market price of a share is viewed as a proper goal of a firm. The profit maximisation can be considered as a part of the wealth maximisation strategy.

- (ii) Trade credit and accruals as source of working capital refers to credit facility given by suppliers of goods during the normal course of trade. It is a short-term source of finance. SSI firms in particular are heavily dependent on this source for financing their working capital needs. The major advantages of trade credit are – easy availability, flexibility and informality.

There can be an argument that trade credit is a cost-free source of finance. But it is not. It involves implicit cost. The supplier extending trade credit incurs cost in the form of opportunity cost of funds invested in trade receivables. Generally, the supplier passes on these costs to the buyer by increasing the price of the goods or alternatively by not extending cash discount facility.

## 6B: STRATEGIC MANAGEMENT



### QUESTIONS

#### Multiple Choice Questions

1. Swasthya, a rising star in India's dynamic healthcare sector, stands out as a prime example of smart strategic management.

At Swasthya, the compass guiding their endeavors is a compelling thought: to emerge as the finest healthcare provider renowned for delivering accessible, top-notch healthcare services. This overarching goal is not an isolated vision, but a thread woven into the very fabric of the organization, driving every facet of their operations. The people of the organization play a pivotal role in this journey. They are entrusted with translating this vision into tangible outcomes at the grassroots level, ensuring that local operations are aligned with the grand aspiration of becoming a healthcare leader.

Swasthya works meticulously towards optimizing each link of the patient experience. From streamlining appointment scheduling to expediting test result delivery, every facet of the healthcare journey is scrutinized. Swasthya's strategy is not merely about being a player in the market but about strategically positioning themselves as leaders. They proactively recognize the constant innovations that could disrupt their areas of expertise. To counter this, they introduced value-added offerings such as telemedicine and wellness programs. This addition not only mitigates the risk but also fortifies their long-term viability.

Beyond competition, ensuring the quality and safety of patient care is paramount at Swasthya. Stringent hygiene protocols, equipment maintenance regimens, and adherence to healthcare regulations form the cornerstone of their business. In parallel, the organization meticulously undertakes regular assessment as a central element of its decision-making apparatus. This forward-looking exercise encompasses

identifying and assessing potential risks such as regulatory changes, medical malpractice vulnerabilities, or shifts in market dynamics, all of which could have far-reaching consequences for their long-term objectives.

The implementation of Swasthya's strategy is steered by the McKinsey 7S model, which ensures a harmonious alignment of seven critical elements: strategy, structure, systems, shared values, skills, style, and staff. It emphasizes that the success of a long-term objective is contingent on the synchronization of these seven elements, reinforcing the idea that strategic management is not a compartmentalized process but a comprehensive activity.

Swasthya's strategic journey through India's healthcare landscape is a testament to the seamless integration of core management concepts, guiding its actions and strategies, while keeping the vision and intent at the core.

**Based on the above Case Scenario, answer the Multiple Choice Questions.**

- (i) How does Swasthya's approach to premise control, including stringent hygiene protocols and equipment maintenance, contribute to their long-term objectives and which concept does it align with?
  - (a) It reduces immediate costs and aligns with strategic risk assessment.
  - (b) It safeguards quality and aligns with strategic risk assessment.
  - (c) It enhances immediate profitability and aligns with shared values.
  - (d) It streamlines administrative processes and aligns with value chain analysis.
- (ii) How does Swasthya counter the risk posed by constant innovations and disruptions in their areas of expertise?
  - (a) By aggressively acquiring innovative startups.

- (b) By introducing value-added services like telemedicine and wellness programs.
  - (c) By downsizing their operations.
  - (d) By focusing exclusively on urban healthcare markets.
- (iii) Why is the McKinsey 7S model significant in Swasthya's strategic management approach, and which elements of the model ensure a holistic alignment of their strategy?
  - (a) It facilitates short-term profit maximization, with a focus on structure and style.
  - (b) It emphasizes a compartmentalized approach to strategy, focusing on shared values and skills.
  - (c) It ensures a comprehensive alignment of strategy, structure, systems, shared values, skills, style, and staff.
  - (d) It prioritizes immediate cost reduction by aligning systems and strategy.
- (iv) Why is the focus on local operations essential for Swasthya in the context of their long-term objective, and how does it contribute to their overall strategy?
  - (a) It reduces strategic risk by minimizing the need for strategic risk assessment.
  - (b) It aligns with their commitment to immediate profitability.
  - (c) It translates the organization's vision into tangible outcomes and aligns with their long-term objective.
  - (d) It diversifies their portfolio and aligns with competitive landscape analysis.
- (v) The case talks about scrutiny of every facet of the healthcare journey and also emphasizes the fact that people of the organization play a pivotal role in this journey. Based on your reading, which level of management has the most crucial part to play here to ensure the sense of customer-first is imbibed in the organization?



- (a) Top Management (C-Suite) which sets the tone and strategy of the organization
  - (b) Middle Management (Divisional Managers) who have the responsibility of translating strategy to real-time objectives
  - (c) Functional Managers who actually do the work on the field
  - (d) Board of Directors who are responsible for wealth creation of the shareholders
2. ABC Foundation envisages a world where every individual, regardless of background, has access to quality education, eradicating illiteracy globally. ABC Foundation is committed to establishing 1000 learning centers, with a target to reach 1 million learners in the next five years. Their core values emphasize equality, empowerment, and knowledge-sharing. What represents the fundamental purpose and long-term aspirations of ABC Foundation?
- (a) Vision
  - (b) Values
  - (c) Mission
  - (d) Goals and Objectives
3. Kanika, known as "Desi Taylor Swift," launched the lipstick brand Kolor among intense global and domestic competition. Despite a lack of groundwork, her substantial 45 million social media following gained significant attention. Which aspect of Michael Porter's force multiplier is working in favour of Kolor?
- (a) Social Media Influence
  - (b) Threat of New Entrants
  - (c) Supplier Bargaining Power
  - (d) Buyer Bargaining Power
4. Mukul faced intense competition in an undifferentiated industry. To address this, he opted for a cost-cutting strategy to attract customers

with lower pricing. Which factor could pose a risk to Mukul's cost-cutting strategy?

- (a) Prompt forecasting of demand for the product or service
  - (b) Investing in cost-saving technologies and using advanced technology for smart, efficient working
  - (c) Technological breakthroughs in the industry
  - (d) Resistance to differentiation until it becomes essential
5. Quntik operates in the software industry and enjoys a strong position in the market. They have identified an opportunity to acquire a smaller company to expand their product offerings. Which quadrant of Medelow's Matrix would the CEO of a smaller company fall into?
- (a) Keep Satisfied
  - (b) Key Player
  - (c) Low Priority
  - (d) Keep Informed
6. What organizational structure is best suited for House of Jani's strategic need for dynamic allocation of resources, ensuring each project and department is mentored, monitored, and maximized via multiple leaders?
- (a) Functional Structure
  - (b) Matrix Structure
  - (c) Hourglass Structure
  - (d) Network Structure

### Descriptive Questions

#### Chapter 1-Introduction to Strategic Management

7. ABC Pharmaceuticals, a leading pharmaceutical company, is in the process of formulating its strategic intent. The top management of ABC Pharmaceuticals wants to define the company's future direction, objectives, and goals. Their aim is to create a vision that sets the

organization apart and provides a roadmap for future growth. ABC Pharmaceuticals aspires to enrich the lives of people by producing high-quality pharmaceutical products at competitive prices and wants to become the world's leading pharmaceutical company by 2030." Based on this context, draft a vision and mission statement that could be formulated by the top management of ABC Pharmaceuticals.

8. Define Strategic Management. Also discuss the limitations of Strategic Management.

### **Chapter 2-Strategic Analysis: External Environment**

9. Riya Sharma owns a confectionery business in Jaipur, specializing in homemade chocolates and candies. Despite holding a substantial market share in the central region, her business has experienced declining sales of these products over the last few years. Concerned about the market dynamics, Riya consults a management expert for guidance. The consultant recommends a comprehensive understanding of the competitive landscape. Explain the steps to be followed by Riya Sharma to understand the competitive landscape to address the sales decline.
10. Explain the concept of Experience Curve and highlight its relevance in strategic management.

### **Chapter 3-Strategic Analysis: Internal Environment**

11. ABC Ltd. is a beverage manufacturing company. It chiefly manufactures soft drinks. The products are priced on the lower side, which has made the company a leader in the business. Currently it holds 35 percent of the market share. The R & D of the company developed a formula for manufacturing sugar-free beverages. On successful trial and approval by the competent authorities, the company was granted to manufacture sugar free beverages. This company is the pioneer to launch sugar free beverages which are sold at a relatively higher price. This new product has been accepted widely by a class of customers. These products have proved profitable for the company. Identify the strategy employed by the company ABC Ltd. and mention what measures could be adopted by the company to achieve the employed strategy.

12. There are four specific criteria of sustainable competitive advantage that firms can use to determine those capabilities that are known as core competencies. Explain.

#### Chapter 4-Strategic Choices

13. XYZ Corporation is a multinational conglomerate operating in various industries. They have a diverse portfolio of businesses, including a leading consumer electronics division, a growing e-commerce platform, a mature industrial machinery division, and a newly established software development unit. Which division of XYZ Corporation would most likely be classified as a "Star" in the BCG Growth-Share Matrix?
14. Justify the statement "Stability strategy is opposite of Expansion strategy".

#### Chapter 5-Strategy Implementation and Evaluation

15. York Investors, recognizing the importance of aligning its organizational elements with strategic objectives, has strategically invested in training programs, technology, and communication systems. The company aims to enhance the skills and capabilities of its workforce through comprehensive training initiatives. Simultaneously, York Investors leverages cutting-edge technology to streamline its operations and improve overall efficiency. The investment in communication systems ensures seamless collaboration and information flow across various departments. Identify and explain the model used by York Investors to achieve its strategic objectives.
16. Why is change management crucial during digital transformation, and what are some key strategies for navigating change effectively?



#### SUGGESTED ANSWERS/HINTS

1. (i) (b) (ii) (b) (iii) (c) (iv) (c) (v) (b)

2. (a)
3. (b)
4. (c)
5. (b)
6. (b)

7. ABC Pharmaceuticals may have following vision and mission:

**Vision:** Vision implies the blueprint of the company's future position. It describes where the organisation wants to land. ABC Pharmaceuticals may have vision "To be the globally recognized leader in pharmaceutical innovation and enriching the lives of people worldwide by providing high-quality, affordable, and accessible pharmaceutical products."

**Mission:** Mission delineates the firm's business, its goals and ways to reach the goals. It explains the reason for the existence of the firm in society. It is designed to help potential shareholders and investors understand the purpose of the company.

ABC Pharmaceuticals may identify mission in the following lines:

- To improve the well-being of individuals and communities by relentlessly pursuing excellence in pharmaceutical research, development, and manufacturing.
  - Committed to producing safe, effective, and sustainable medicines that address unmet medical needs and enhance the quality of life for patients.
  - Through innovation, collaboration, and ethical practices, we aim to make a positive impact on global healthcare and become the trusted partner of healthcare providers and patients alike.
8. The term '**strategic management**' refers to the managerial process of developing a strategic vision, setting objectives, crafting a strategy, implementing and evaluating the strategy, and initiating corrective adjustments were deemed appropriate.

The presence of strategic management cannot counter all hindrances and always achieve success as there are limitations attached to strategic management. These can be explained in the following lines:

- ♦ **Environment is highly complex and turbulent.** It is difficult to understand the complex environment and exactly pinpoint how it will shape-up in future. The organisational estimate about its future shape may awfully go wrong and jeopardise all strategic plans. The environment affects as the organisation has to deal with suppliers, customers, governments and other external factors.
- ♦ **Strategic Management is a time-consuming process.** Organisations spend a lot of time in preparing, communicating the strategies that may impede daily operations and negatively impact the routine business.
- ♦ **Strategic Management is a costly process.** Strategic management adds a lot of expenses to an organization. Expert strategic planners need to be engaged, efforts are made for analysis of external and internal environments, devise strategies and properly implement. These can be really costly for organisations with limited resources particularly when small and medium organisation create strategies to compete.
- ♦ **Competition is unpredictable.** In a competitive scenario, where all organisations are trying to move strategically, it is difficult to clearly estimate the competitive responses to the strategies.

9. Steps to understand the competitive landscape are as follows:

- (i) **Identify the competitor:** The first step to understanding the competitive landscape is to identify the competitors in the firm's industry and have actual data about their respective market share.
- (ii) **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.
- (iii) **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?

- (iv) **Determine the weaknesses of the competitors:** Weaknesses (and strengths) can be identified by going through consumer reports and reviews appearing in various media. After all, consumers are often willing to give their opinions, especially when the products or services are either great or very poor.
- (v) **Put all of the information together:** At this stage, the 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 the areas which need to be strengthened by the firm.

10. Experience curve akin to a learning curve which explains the efficiency increase gained by workers through repetitive productive work. Experience curve is based on the commonly observed phenomenon that unit costs decline as a firm accumulates experience in terms of a cumulative volume of production. It is based on the concept, "we learn as we grow".

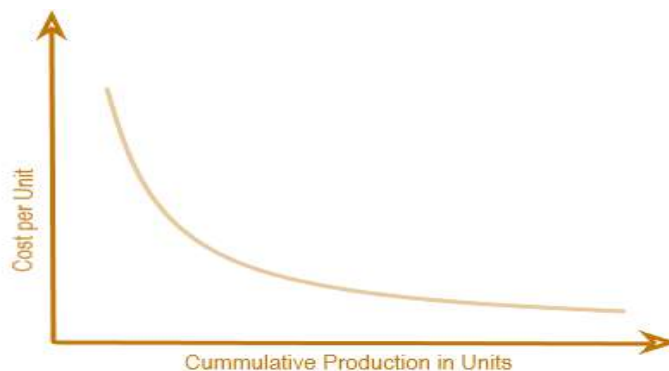
The implication is that larger firms in an industry would tend to have lower unit costs as compared to those for smaller companies, thereby gaining a competitive cost advantage.

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 may provide an advantage over the competition. Experience is a key barrier to entry.
- ◆ Large and successful organisation possess stronger "experience effect".

A typical experience curve may be depicted as follows:



**Figure: Experience curve**

As a business grows, it understands the complexities and benefits from its experiences.

The concept of experience curve is relevant for a number of areas in strategic management. For instance, the experience curve is considered a barrier for new firms contemplating entry in an industry. It is also used to build market share and discourage competition.

11. According to Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Porter called these base generic strategies.

**ABC Ltd. has opted for the Differentiation Strategy.** The company has invested a huge amount in R & D and developed a formula for manufacturing sugar-free beverages to give the customer value and quality. They are **pioneers and serve specific customer needs that are not met by other companies** in the industry. The new product has been accepted by a class of customers. **Differentiated and unique sugar-free beverages** enable ABC Ltd. to charge **relatively higher** for its products, hence making higher profits and maintaining its competitive position in the market.

Sugar free beverage of ABC Ltd. is being accepted widely by a class of customers. Differentiation strategy is aimed at a broad mass market and involves the creation of a product or service that is perceived by the customers as unique. The uniqueness can be associated with product



design, brand image, features, technology, and dealer network or customer service.

### **Achieving Differentiation Strategy**

To achieve differentiation, following strategies are generally adopted by an organization:

1. Offer utility to the customers and match products with their tastes and preferences.
  2. Elevate/Improve performance of the product.
  3. Offer a high-quality product/service for buyer satisfaction.
  4. Rapid product innovation to keep up with dynamic environment.
  5. Taking steps to enhance brand image and brand value.
  6. Fixing product prices based on the unique features of product and buying capacity of the customer.
- 12.** 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.
13. In the BCG Growth-Share Matrix, divisions or business units are classified into four categories: Stars, Cash Cows, Question Marks, and Dogs. These classifications are based on a combination of market share and market growth rate.
- A "Star" in the BCG Matrix represents a business unit with a high market share in a high-growth market. In the scenario, the newly established software development unit would be classified as a "Star." The software development unit is described as "newly established," suggesting that it is operating in a high-growth market. Additionally, the potential for high market share can be inferred if the unit is strategically positioned to become a leader in the software development industry.
- Stars typically require significant investment to fuel their growth, but they have the potential to become future Cash Cows as the market matures. Therefore, the software development unit's high growth potential and the opportunity to capture a substantial market share align with the characteristics of a BCG Matrix "Star."
14. Stability Strategies, as the name suggests, are intended to safeguard the existing interests and strengths of business. It involves organisations pursuing established and tested objectives, continue on the chosen path, maintaining operational efficiency and so on. A stability strategy is pursued when a firm continues to serve in the same or similar markets and deals in the same products and services. In stability strategy, few functional changes are made in the products or markets, however, it is not a 'do nothing' strategy. This strategy is typical for mature business organizations. Some small organizations also frequently use stability as a strategic focus to maintain comfortable market or profit position.

On the other hand, expansion strategy is an aggressive strategy as it involves redefining the business by adding the scope of business substantially, increasing the efforts of the current business. In this sense, it becomes the opposite to stability strategy. Expansion is a promising and popular strategy that tends to be equated with dynamism, vigor, promise and success. Expansion also includes diversifying, acquiring and merging businesses. This strategy may take the enterprise along relatively unknown and risky paths, full of promises and pitfalls.

15. York Investors is employing the McKinsey 7S Model to achieve its strategic objectives. The model focuses on seven interdependent elements within an organization, categorized into "Hard Ss" and "Soft Ss." In this case:
- **Strategy (Hard S):** Investing in training programs and technology aligns with the strategic objective of enhancing workforce skills and operational efficiency.
  - **Structure (Hard S):** The investment suggests a structural alignment to support the strategic initiatives, indicating a deliberate organization of resources.
  - **Systems (Hard S):** The use of cutting-edge technology and communication systems reflects a commitment to optimizing daily tasks and improving overall efficiency, addressing the system component of the model.
  - **Shared Values (Soft S):** The emphasis on comprehensive training initiatives indicates a commitment to shared values, reflecting a focus on developing a skilled and capable workforce.
  - **Style (Soft S):** The leadership style is implied in the strategic decision to invest in technology and training for workforce development and operational efficiency.
  - **Staff (Soft S):** The commitment to enhancing skills and capabilities reflects a focus on the talent pool within the organization.
  - **Skills (Soft S):** The strategic investment in training programs directly addresses the development of key skills within the workforce.

York Investors' approach demonstrates a holistic application of the McKinsey 7S Model, emphasizing the interconnectedness of both hard and soft elements to achieve strategic alignment and organizational effectiveness.

**16.** Change management is essential during digital transformation to ensure the success of the process. Here are some key strategies to navigate change effectively:

- **Specify the digital transformation's aims and objectives:** Clearly defining the intended outcomes and objectives helps ensure everyone is aligned and working towards the same goals.
- **Always communicate:** Regular and transparent communication is crucial to help people understand the goals of digital transformation and how it will impact various stakeholders, including employees, clients, and other parties.
- **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 and ensuring a smooth transition.
- **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 simultaneously.
- **Offer assistance and training:** Providing support, guidance, and training for employees is crucial as they navigate new procedures, software applications, and other aspects of digital transformation.

In conclusion, meticulous planning and effective change management are vital for the successful completion of digital transformation projects. Without proper change management, these efforts are more likely to fail, and organizations can enhance the integration of new digital systems by anticipating and managing the necessary changes.