

JAN 2025



FM-SM

LIST OF IMPORTANT QUESTIONS

**CHAPTER-WISE WITH SOLUTION
AND INTERPRETATION VIDEO**



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FINANCIAL MANAGEMENT

LIST of Important Questions

January 2025

Chapter - 1

Ratio Analysis

Chapter - 2

Cost of Capital

Chapter - 3

EBIT-EPs Analysis

Chapter - 4

Leverages

Chapter - 5

Capital Structure

Chapter - 6

Capital Budgeting

Chapter - 7

Dividend Decisions

Chapter - 8

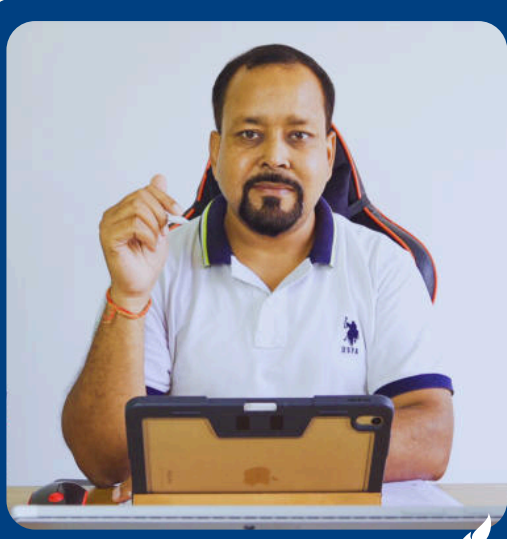
Working Capital Management

Video Interpretation of List:
<https://youtu.be/dVq9NF7s874>



PROF. OM TRIVEDI
ICAI Visiting Faculty at LVC,
NIRC, WIRC & MCS

About Prof. Om Trivedi



Prof. Om Trivedi



An Edupreneur, Visiting Faculty Member of #NIRC and #WIRC of ICAI, Guest Faculty of LVC and External Subject Expert at the BOS of #ICAI, IIM-C Alumnus, Author, Publisher, Educationist, Management Consultant, and Corporate Speaker.

Synopsis:

- Over **11 years of teaching experience** in various CA, CS, CMA and MBA courses.
- Guided more than **1,00,000 CA, CS, and CMA** students through Face to Face Classes and more than **2,00,000** students through LIVE Virtual & Online Classes.
- Students scored **All India 'Highest Marks, AIR 20, 22, 23, 36, 37, 40 & 47 with 1000s of exemptions.**

- His student scored **"Highest Marks"** in this subject.
- Done research and projects in areas like competition studies, Financial Modelling, Data Analytics, value creation, and competitive advantages, MIS, and Process Improvement Techniques, etc.
- **Author** of books on **Financial Management, Strategic Management, CMA, Strategic Financial Management, Strategic Cost Management & Performance Evaluation, Risk Management, Mercantile Law, Generic Skills & Ethics, and Communication.** Case Study Developer and Content writer on Management subjects for different Distance Learning Programmer (DLPs) of eminent universities of India.
- Over **17 years of industry experience in Publishing, Content Development and Editing, Instructional Design, Instructor's Resource Development, Acquisitions of Businesses, Authors and Imprints, Sales and Marketing, Publishing solution, and operations.**
- Worked with **Thomson Learning** as **Regional Head**, with **Tata McGraw-Hills** as **Acquisition Head**, with **Macmillan** as **Acquisition Editor** and **Partner with LexisNexis India** (A Reed Elsevier Company).
- Worked as a **Consultant Business Head - HEP of Trinity Press** (Formerly Macmillan India's Higher Education Programme) in 2013-14 and played an instrumental role in the acquisition of Macmillan India's Higher Education Programme by LPPL under the brand name Trinity Press.
- Worked as a **consultant and business advisor** on book publishing, content development, instructional design, case study development, instructor's resources, and copyright matters to several companies like **Macmillan, Taxmann, LexisNexis India, Vikas Publishing, Excel Books, Firewall Media, Biztantra, etc.**

1

CHAPTER

RATIO ANALYSIS

"The secret of success in battle lies often not so much in the use of one's own strength but in the exploitation of the other side's weaknesses"
-Jhon Christopher

Important Questions

January 2025

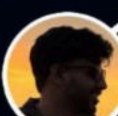
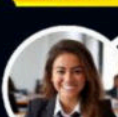
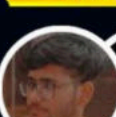
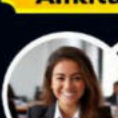


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 75 Marks Sanskar Jain	 75 Marks Shushobit Verma	 75 Marks Mayank Gupta
 74 Marks Vasudev	 72 Marks Preeti Aggarwal	 69 Marks Sandeep Shaw
 69 Marks Shashank	 69 Marks Riya Bansal	 68 Marks Akansha
 68 Marks Arsalan Ali	 67 Marks Abhay Nahar	 67 Marks Harsh
 66 Marks Ankita Rani	 66 Marks Anshu Kumar	 65 Marks Pulkit Luthra
 65 Marks Seerat Sharma	 65 Marks Ayush Sharma	 65 Marks Shubham

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 BHARAT GAUTAM 80 MARKS	 PRADEEP ROHILLA 79 MARKS				
 ANUSHKA SHARMA 78 MARKS	 KSHITIZ TAYAL 78 MARKS				
 SAIKAT GHOSH 77 MARKS	 NILESH JAISWAL 76 MARKS				
 NUZAIF AKHTAR 76 MARKS	 KOMAL SANWAL 75 MARKS				
 SHALINI SONI 75 MARKS	 ASHUTOSH KUMAR 74 MARKS				
 NANDA CHATURVEDI 74 MARKS	 ARYAN MERATWAL 73 MARKS				
 DEEPANSHI JAIN 73 MARKS	 KAUSHAL ARORA 73 MARKS				
 PREETHAM BHAT 73 MARKS	 SONALI VIJ 73 MARKS				
 ANKIT JAIN 72 MARKS	 MAYURI PRAMOD 72 MARKS				
 SANCHIT 72 MARKS	 SONU AGRAWAL 72 MARKS				
 TANYA BANSAL 72 MARKS	 ANURAG AGGRAWAL 71 MARKS				
 CHIRAG JAIN 70 MARKS	 NITESH LAHU 70 MARKS				
 PARAS BANSAL 70 MARKS	 RAJSHREE 70 MARKS				
 RAJVI DILIP 70 MARKS	 YASH JAIN 70 MARKS				

OTC CHAMPIONS

CHAPTER ONE

Video for Interpretation of the List:
<https://youtu.be/dVq9NF7s8I4>



RATIO ANALYSIS

LIST OF IMPORTANT QUESTIONS JANUARY 2025



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Problem 1: In a meeting held at Solan towards the end of 2018, the Directors of M/s HPCL Ltd. Have taken a decision to diversify. At present HPCL Ltd. Sells all finished goods from its own warehouse.



The Company issued debentures on 01.01.2019 and purchased fixed assets on the same day. The purchase prices have remained stable during the concerned period. Following information is provided to you:

Income Statement

Particulars	2018		2019	
Cash Sales	30,000		32,000	
Credit Sales	2,70,000	3,00,000	3,42,000	3,74,000
Less: Cost of Goods Sold		2,36,000		2,98,000
Gross profit		64,000		76,000
Less: Operating Expenses:				
Warehousing	13,000		14,000	
Transport	6,000		10,000	
Administrative	19,000		19,000	
Selling	11,000		14,000	
Non Operating Expenses		49,000		59,000
Net Profit		15,000		17,000

Balance Sheet

Particulars	2018		2019	
Fixed Assets (Net Block)	-	30,000	-	40,000
Receivables	50,000		82,000	
Cash at Bank	10,000		7,000	
Stock	60,000		94,000	
Total Current Assets (CA)	1,20,000		1,83,000	
Payables	50,000		76,000	
Total Current Liabilities (CL)	50,000		76,000	
Working Capital (CA-CL)		70,000		1,07,000
Total Assets		1,00,000		1,47,000
Represented by:				
Share Capital		75,000		75,000
Reserve and Surplus		25,000		42,000
Debentures		-		30,000
		1,00,000		1,47,000

You are required to calculate the following ratios for the years 2018 and 2019.

- Gross Profit Ratio
- Operating Expenses to Sales Ratio
- Capital Turnover ratio
- Stock Turnover ratio
- Net Profit to Net worth Ratio, and
- Receivables Collection Period.

Ratio relating to capital employed should be based on the capital at the end of the year. Give the reasons for change in the ratios for 2 years. Assume opening stock of ₹ 40,000 for the year 2018. Ignore Taxation.

Solution:

	Particulars	2018	2019
(1)	Gross Profit ratio Gross Profit Sales	$\frac{64,000}{3,00,000} \times 100 = 21.3\%$	$\frac{76,000}{3,74,000} \times 100 = 20.3\%$
(2)	Operating Expenses to Sales Operating Expenses Sales	$\frac{49,000}{3,00,000} \times 100 = 16.3\%$	$\frac{57,000}{3,74,000} \times 100 = 15.2\%$
(3)	Operating Profit Ratio Operating Profit Sales	$\frac{15,000}{3,00,000} \times 100 = 5\%$	$\frac{19,000}{3,74,000} \times 100 = 5.08\%$
(4)	Capital Turnover Ratio Sales Capital employed	$\frac{3,00,000}{1,00,000} = 3\%$	$\frac{3,74,000}{1,47,000} = 2.54\%$
(5)	Stock Turnover Ratio COGS Average Stock	$\frac{2,36,000}{50,000} = 4.7\%$	$\frac{2,98,000}{77,000} = 3.9\%$
(6)	Net profit to Net worth Net Profit Net worth	$\frac{15,000}{1,00,000} \times 100 = 15\%$	$\frac{17,000}{1,17,000} \times 100 = 14.53\%$
(7)	Receivable Collection Period Average Receivables Average Daily Credit Sales	$\frac{50,000}{2,70,000} \times 365 = 67.6 \text{ days}$	$\frac{82,000}{3,42,000} \times 365 = 87.5 \text{ days}$

Analysis: The decline in the Gross profit ratio could be either due to a reduction in the selling price or increase in the direct expenses (since the purchase price has remained the same). Similarly, there is a decline in the ratio of operating expenses to sales. However, since operating expenses have little bearing with sales, a decline in this ratio cannot be necessarily be interpreted as an increase in operational efficiency. An in-depth analysis reveals that the decline in the warehousing and the administrative expenses has been partly set off by an increase in the transport and the selling expenses. The operating profit ratio has remained the same in spite of a decline in the Gross profit margin ratio. In fact, the company has not benefited at all in terms of operational performance because of the increased sales. The company has not been able to deploy its capital efficiently. This is indicated by a decline in the Capital turnover from 3 times in case the capital turnover would have remained at 3 the company would have increased sales and profits by ₹ 67,000 and ₹ 3,350 respectively. The decline in the stock turnover ratio implies that the company has increased its investment in stock. Return on Net worth has declined indicating that the additional capital employed has failed to increase the volume of sales proportionately. The increase in the Average collection period indicates that the company has become liberal in extending credit on sales. However, there is a corresponding increase in the current assets due to such a policy. It appears as if the decision to expand the business has not shown the desired results.

Problem 2: JKL Limited has the following Balance Sheets as on March 31, 2006 and March 31, 2005:

**Balance Sheet (₹ in Lakh)**

Particulars	31.03.2006	31.06.2005
Sources of Funds:		
Shareholder's Fund	2,377	1,472
Loan Funds	3,570	3,038
	5,947	4,555
Applications of Funds:		
Fixed Assets	3,466	2,900
Cash and Bank	489	470
Debtors	1,495	1,168

Stock	2,867	2,407
Other Current Assets	1,567	1,404
Less: Current Liabilities	(3,937)	(3,794)
	5,947	4,555

The Income Statement of the JKL Ltd. For the year ended is as follows (₹ in Lakh):

<i>Particulars</i>	<i>31.03.2006</i>	<i>31.06.2005</i>
Sales	22,165	13,882
Less: Cost of Goods Sold	20,860	12,544
Gross profit	1,305	1,338
Less Selling, General and Administration Expenses	1,135	752
EBIT	170	586
Less: Interest Expenses	113	105
PBT	57	481
Less: Tax	23	192
PAT	34	289

Required:

1. Calculate for the years 2005 and 2006:
 - a. Inventory turnover ratio
 - b. Financial Leverage
 - c. Return on Investment (ROI)
 - d. Return on Equity (ROE)
 - e. Average Collection period.
2. Give a brief comment on the financial position of JKL Limited.

Solution:



1. Computation of Ratios

	<i>Particulars</i>	<i>31.03.2006</i>	<i>31.03.2005</i>
(a)	Inventory turnover ratio		
(b)	Financial Leverage		
(c)	Return on investment		
(d)	Return on equity		
(e)	Average collection period		

2. Brief comment on the financial position of JKL Ltd:

- The inventory turnover ratio is increased from 5.21 times to 7.28 times. This indicates the reduction in investment of stock and increase in sale turnover with reduced stocks.
- The financial leverage of the company is increased from 1.22 times to 2.98 times, which indicates the lower the cushion for paying interest on borrowings. The increase in ratio warns the increase in risk as to over gearing, which constitutes a strain on profits.
- There is a steep fall in ROI from 12.86% to 2.86%, this may be due to increase in finances from fresh issue of share and loan funds for expansion, modernization or new investment proposals, and increase in sales has not resulted in increase of company's profitability.
- The return on equity has also fallen from 19.63% to 1.43%. The current year may not be sufficient for declaration of dividends to shareholders.
- Increase in sale and reduction in investment in debtor's balances has resulted in reduction of average collection period from 30.7 days to 24.6 days.

Problem 3: ABC Company sells plumbing fixtures on terms of 2/10, net 30. Its financial statements over the last 3 years are as follows:

Particulars	2020-21	2021-22	2022-23
	₹	₹	₹
Cash	30,000	20,000	5,000
Accounts receivable	2,00,000	2,60,000	2,90,000
Inventory	4,00,000	4,80,000	6,00,000
	6,30,000	7,60,000	8,95,000
Net fixed assets	8,00,000	8,00,000	8,00,000
	14,30,000	15,60,000	16,95,000

	₹	₹	₹
Accounts payable	2,30,000	3,00,000	3,80,000
Accruals	2,00,000	2,10,000	2,25,000
Bank loan (short-term)	1,00,000	1,00,000	1,40,000
	5,30,000	6,10,000	7,45,000
Long-term debt	3,00,000	3,00,000	3,00,000
Common stock	1,00,000	1,00,000	1,00,000
Retained earnings	5,00,000	5,50,000	5,50,000
	14,30,000	15,60,000	16,95,000

	₹	₹	₹
Sales	40,00,000	43,00,000	38,00,000
Cost of goods sold	32,00,000	36,00,000	33,00,000
Net profit	3,00,000	2,00,000	1,00,000

Considering opening balance of Accounts Receivable and Inventory as 2,00,000 and 4,00,000 respectively as on 01.04.2020, ANALYSE the company's financial condition and performance over the last 3 years. Are there any problems?

Solution:

Ratios	2020-21	2021-22	2022-23
Current ratio (Current Assets / Current Liabilities)	1.19 ₹6,30,000/₹5,30,000	1.25 ₹7,60,000/₹6,10,000	1.20 ₹8,95,000/₹7,45,000
Acid-test ratio (Quick Assets / Current Liabilities)	0.43 ₹2,30,000/₹5,30,000	0.46 ₹2,80,000/₹6,10,000	0.40 ₹2,95,000/₹7,45,000
Receivables turnover ratio (Sales/ Average Receivables) (Refer Working Notes)	20 ₹40,00,000/₹2,00,000	18.70 ₹43,00,000/₹2,30,000	13.82 ₹38,00,000/₹2,75,000
Average collection period (365 / Receivables turnover ratio)	18.25 (365 / 20)	19.52 (365/18.70)	26.41 (365/13.82)
Inventory turnover ratio (COGS / Average Inventory) (Refer Working Notes)	8 ₹ 32,00,000/₹ 4,00,000)	8.18 (₹ 36,00,000 / ₹ 4,40,000)	6.11 (₹ 33,00,000/₹ 5,40,000)

Total debt to net worth (Short term + Long term Debt) / (Common stock + Retained earnings)	1.38 (₹ 8,30,000/₹ 6,00,000)	1.40 (₹ 9,10,000/₹ 6,50,000)	1.61 (₹ 10,45,000/₹ 6,50,000)
Long-term debt to total capitalization	0.33 (₹3,00,000/₹9,00,000)	0.32 (₹3,00,000 /₹9,50,000)	0.32 (₹3,00,000/₹9,50,000)
Gross profit margin (Gross Profit / Sales) {Gross profit = Sales – Cost of Goods sold}	0.20 (₹8,00,000/₹40,00,000)	0.16 (₹7,00,000/₹43,00,000)	0.13 (₹5,00,000/₹38,00,000)
Net profit margin (Net Profit / Sales)	0.075 (₹3,00,000/₹40,00,000)	0.047 (₹2,00,000/₹43,00,000)	0.026 (₹1,00,000/₹38,00,000)
Total Asset turnover (Sales / Total Assets)	2.80 ₹40,00,000/₹14,30,000	2.76 ₹43,00,000/₹15,60,000	2.24 (₹38,00,000/₹16,95,000)
Return on assets (Net profit/ Total Assets)	0.21 (₹3,00,000/₹14,30,000)	0.13 (₹2,00,000/₹15,60,000)	0.06 (₹1,00,000/₹16,95,000)
Working Notes			
Average receivables {(Opening + closing)/2}	₹ 2,00,000 + ₹ 2,00,000)/2 = ₹ 2,00,000	₹ 2,00,000 + ₹ 2,60,000)/2 = ₹ 2,30,000	₹ 2,60,000 + ₹ 2,90,000)/2 = ₹ 2,75,000
Average Inventory {(Opening + closing)/2}	₹ 4,00,000 + ₹ 4,00,000)/2 = ₹ 4,00,000	₹ 4,00,000 + ₹ 4,80,000)/2 = ₹ 4,40,000	₹ 4,80,000 + ₹ 6,00,000)/2 = ₹ 5,40,000

Analysis:

The current ratio and quick ratio are less than the ideal ratio (2:1 and 1:1 respectively) indicating that the company is not having enough resources to meet its current obligations.

Receivables are growing slower, although the average collection period is still very reasonable relative to the terms given. Inventory turnover is slowing as well, indicating a relative build-up in inventories. The increase in receivables and inventories, coupled with the fact that net worth has increased very little, has resulted in the total debt-to-net worth ratio increasing to what would have to be regarded on an absolute basis as a high level.

Long-term debt to total capitalization has not changed relatively coupled with the fact that retained earnings of only ₹ 50,000 is made in year 2019-20, and there is no issuance of new long-term debt in year 2019-20 and 2020-21. Both the gross profit and net profit margins have declined substantially.

The relationship between the two suggests that the company has incurred more relative expenses. The build-up in inventories and receivables has resulted in a decline in the asset turnover ratio, and this, coupled with the decline in profitability, has resulted in a sharp decrease in the return on assets ratio.

decline in profitability, has resulted in a sharp decrease in the return on assets ratio.

Problem 4: (ICAI Study Material): Following information are available for Navya Ltd. along with various ratios relevant to the particular industry it belongs to. APPRAISE your comments on strength and weakness of Navya Ltd. comparing its ratios with the given industry norms.



Navya Ltd.

Balance Sheet as at 31.3.2023

Liabilities	(₹)	Assets	(₹)
Equity Share Capital	48,00,000	Fixed Assets	24,20,000
10% Debentures	9,20,000	Cash	8,80,000
Sundry Creditors	6,60,000	Sundry debtors	11,00,000
Bills Payable	8,80,000	Stock	33,00,000
Other current Liabilities	4,40,000		-
Total	77,00,000	Total	77,00,000

Statement of Profitability For the year ending 31.3.2023

Particulars	(₹)	(₹)
Sales		1,10,00,000
Less: Cost of goods sold:		
Material	41,80,000	
Wages	26,40,000	
Factory Overhead	12,98,000	
Gross Profit		81,18,000
		28,82,000
Less: Selling and Distribution Cost	11,00,000	
Administrative Cost	12,28,000	23,28,000
Earnings before Interest and Taxes		5,54,000
Less: Interest Charges		92,000
Earning before Tax		4,62,000
Less: Taxes @ 50%		2,31,000
Net Profit (PAT)		2,31,000

Industry Norms

Ratios	Norm
Current Ratio	2.5
Receivables Turnover Ratio	8.0
Inventory Turnover Ratio (based on Sales)	9.0
Total Assets Turnover Ratio	2.0
Net Profit Ratio	3.5%
Return on Total Assets (on EBIT)	7.0%
Return on Net worth (Based on Net profit)	10.5%
Total Debt/Total Assets	60.0%

Solution:

Ratios	Navya Ltd.	Industry Norms
1. Current Ratio = Current Assets/Current Liabilities	₹52,80,000/₹19,80,000 = 2.67	2.50
2 Receivable Turnover Ratio = Sales/Debtors	₹1,10,00,000/₹11,00,000 = 10.0	8.00
3. Inventory turnover ratio = Sales/Stock	₹1,10,00,000/₹33,00,000 = 3.33	9.00
4. Total Asset Turnover ratio = Sales/Total Assets	₹1,10,00,000/₹77,00,000 = 1.43	2.00
5 Net Profit Ratio = Net Profit/Sales	₹2,31,000/₹1,10,00,000 = 2.10%	3.50%
6. Return on Total Asset = EBIT/Total Assets	₹5,54,000/₹77,00,000 = 7.19%	7%
7. Return on Net worth = Net Profit/Net Worth	₹2,31,000/₹48,00,000 = 4.81%	
8. Total Debt/Total Assets	₹29,00,000/₹77,00,000 = 37.66%	60%

Comments:

1. The position of Navya Ltd. is better than the industry norm with respect to Current Ratio and Receivables Turnover Ratio.
2. However, the Inventory turnover ratio and Total Asset Turnover ratio is poor comparing to industry norm indicating that company is inefficient to utilize its inventory and assets.
3. The firm also has its net profit ratio and return on net worth ratio much lower than the industry norm.
4. Total debt to total assets ratio is lower than the industry standard which suggests that the firm is less levered by debt and more by equity resulting in less risky company.

Problem 5: The following information was taken from the financial statements of Gamma Limited (amount in thousands of rupees).



Particulars	Year 1	Year 2	Year 3
Total Assets	750	850	860
Credit Sales	420	520	550
Cost of goods sold	450	595	645
Cash	50	60	55
Debtors	150	165	180
Inventory	130	160	170
Net Fixed Assets	120	250	250
Creditors	75	85	100
Short term debt	125	175	170
Long-term Debt	125	185	175
Equity	200	210	-

You are required to calculate those ratios which indicate the efficient use of assets and discuss potential sources of trouble.

Solution:

The efficient use of assets is indicated by the following key ratios:

(a) Current assets turnover, (b) Debtors' turnover, (c) Inventory turnover, (d) Fixed assets turnover, and (e) Total assets turnover.

Computation of Ratios:

	Year 1	Year 2	Year 3
a. Computation of Ratios: (Cost of goods sold / Total current assets)	1.36	1.55	1.59
b. Debtor's turnover (Credit sales / Average debtors)	2.8*	3.30	3.19
c. Inventory turnover (Cost of goods sold/ Average inventory)	3.46*	4.10	3.91
d. Fixed assets turnover (Cost of goods sold/ Fixed Assets)	3.75	2.38	2.58
e. Total assets turnover (Cost of goods sold/ Total assets)	1.00	0.93	0.98

* Based on Debtors and Inventory at the end, as their opening balances are not available.

Comments: The first three ratios indicate the efficiency of Current Assets usage, and the latter two, namely, Fixed assets turnover and Total assets turnover ratio, show the efficiency of utilisation of these. Current assets utilisation appears to be very satisfactory as reflected in the first three types of ratios. No major change is noticeable in their values over a period of time, which is presumably indicative of consistency in Debtors collection period and inventory turnover. There does not seem to be any significant problem regarding utilisation of Current assets.

However, it appears that fixed assets are not being fully utilised. Investments in fixed assets have more than doubled during years 2 and 3. The Fixed assets turnover ratio has sharply fallen to 2.58 in year 3 from 3.75 in year 1. Thus, investment in fixed assets are either excessive, or the capacity of the additional plant is under utilised. This is corroborated by the fact that sales in the latter 2-year have increased by around 15%. Therefore, the remedy lies in utilising the plant capacity by increasing production and sales.

Working Capital Efficiency Related Ratios

Problem 6: Following figures are available from the accounts of a large industrial unit. Compute relevant ratios assess the efficiency of working capital management for 2012-13 and 2013-2014

Particulars	2011-12	2012-13	2013-14
Inventories	50	52.5	65
Debtors	67	57	77
Other current assets	5	15	20
Cash and bank balance	30	10	15
Total	152.0	134.5	177
Current liabilities	52	54.5	72
Net working capital	100	80	105
Sales	300	300	340
Total assets	220	200	240

Solution:

Working Notes:

1. Average Inventory		(₹ crores)
(Opening Stock + Closing Stock) ÷ 2		
2012-13	(50 + 52.5) ÷ 2	51.25
2013-14	(52.5 + 65) ÷ 2	58.75
2. Average Debtors Turnover		
(Opening Balance + Closing Balance) ÷ 2		
2012-13	(67 + 57) ÷ 2	62
2013-14	(57 + 77) ÷ 2	67
3. Average Working Capital		
(Opening Balance + Closing Balance) ÷ 2		
2012-13	(100 + 80) ÷ 2	90
2013-14	(80 + 105) ÷ 2	92.5
4. Average Current Assets		
(Opening Balance + Closing Balance) ÷ 2		
2011-13	(152 + 134.5) ÷ 2	143.25
2013-14	(134.5 + 177) ÷ 2	155.75

Computation of Ratios for assessment of Working Capital

(₹ crores)

Particulars	2012-13	2013-14
1. Current Ratio: $\left(\frac{\text{Current assets}}{\text{Current liabilities}} \right)$	$\frac{134.5}{54.5} = 2.47$	$\frac{177}{72} = 2.46$
2. Liquid Ratio: $\left(\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}} \right)$	$\frac{(134.5-52.5)}{54.5} = 1.50$	$\frac{(177-65)}{72} = 1.56$
3. Current Assets to Total Assets: $\left(\frac{\text{Current assets}}{\text{Total assets}} \right)$	$\frac{134.5}{200} = 0.67$	$\frac{177}{240} = 0.74$
4. Inventory turnover ratio: $\frac{\text{Sales}}{\text{Average inventory}}$	$\frac{300}{51.25} = 5.85$	$\frac{340}{58.75} = 5.79$
5. Debtors Turnover ratio: $\left(\frac{\text{Sales}}{\text{Average debtors}} \right)$	$\frac{300}{62} = 4.84$	$\frac{340}{67} = 5.076$
6. Current Assets/Turnover Ratio: $\frac{\text{Sales}}{\text{Average current assets}}$	$\frac{300}{143.25} = 2.09$	$\frac{340}{155.75} = 2.18$
7. Working Capital Turnover Ratio: $\frac{\text{Sales}}{\text{Average net working capital}}$	$\frac{300}{90} = 3.33$	$\frac{340}{92.5} = 3.68$

Problem 7: Based on the following information of the financial ratios prepare Balance Sheet of Achievers Ltd. as of December 31, 2024. Explain your working and assumptions:



Current ratio	2.5
Liquidity ratio	1.5
Net Working capital	₹ 6,00,000
Stock turnover ratio	5
Ratio of gross profit to sales	20%
Turnover ratio to net fixed assets	2
Average debt collection period	2.4 months
Fixed assets to net worth	0.80
Long term debt to capital and reserve	7/25

Solution:**Balance Sheet of Achievers Ltd. as on December 31, 2024**

Particulars	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
Capital and Reserve		Fixed Assets		
Share Capital:		Cost less Depreciation		10,00,000
Reserve and Surplus	12,50,000	Current Assets:		
Long Term Debts	3,50,000	Stock-in-Trade	4,00,000	
Current Liabilities	4,00,000	Sundry Debtors	5,00,000	
		Cash	1,00,000	10,00,000
	20,00,000			20,00,000

Working Notes:

- Current Ratio = 2.5
Suppose if Current Liabilities = x, Current Assets = 2.5x
Therefore, Net Working Capital = Current Assets – Current Liabilities = 2.5x – x = 1.5x
- Working Capital = ₹ 6,00,000
Or 1.5x = ₹ 6,00,000

$$x = \frac{₹ 6,00,000}{1.5} = ₹ 4,00,000$$

$$\text{Current liabilities} = x = ₹ 4,00,000$$

$$3. \quad \text{Current assets} = 2.5x = 2.5 \times ₹ 4,00,000 = ₹ 10,00,000$$

$$4. \quad \text{Liquidity Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}} = 1.5$$

$$\frac{\text{Liquid Assets}}{4,00,000} = 1.5 \quad \text{or} \quad \text{Liquid Assets} = ₹ 6,00,000$$

$$5. \text{ Stock:} \quad \text{Current Assets} - \text{Liquid Assets} = \text{Stock}$$

$$\text{Or} \quad ₹ 10,00,000 - ₹ 6,00,000 = \text{Stock} \quad \text{Or} \quad \text{Stock} = ₹ 4,00,000$$

$$6. \text{ Turnover Ratio} = 5$$

$$\text{Stock} = ₹ 4,00,000$$

$$\text{Cost of Sales} = 5 \times 4,00,000 = ₹ 20,00,000$$

$$7. \text{ Fixed Assets (Net) Turnover Ratio} = 2$$

$$\text{Cost of Sales} = ₹ 20,00,000$$

$$\therefore \text{Fixed Assets (Net)} = ₹ 10,00,000$$

$$8. \text{ Ratio of gross profit to sales} = 20\% \text{ on sales means } 25\% \text{ on cost of sales. Cost of sales being } ₹ 20,00,000, \text{ Gross Profit will be } ₹ 5,00,000 \text{ making total sales or turnover of } ₹ 25,00,000.$$

$$9. \quad \text{Book Debts} = 2.4 \text{ months}$$

$$\text{Hence, Book Debts} = \frac{25,00,000 \times 2.4}{12} = ₹ 5,00,000$$

$$10. \text{ Cash Balance} = \text{Liquid Assets} - \text{Debtors} = ₹ 6,00,000 - ₹ 5,00,000 = ₹ 1,00,000$$

$$11. \text{ Fixed Assets to Net Worth} = 0.80$$

$$\therefore \text{Net Worth} = \text{Fixed Assets} \times \frac{100}{80} = ₹ 10,00,000 \times \frac{100}{80} = ₹ 12,50,000$$

$$12. \text{ Long Term Debts} = \frac{(\text{Net worth} \times 7)}{25} = \frac{(₹ 12,50,000 \times 7)}{25} = ₹ 3,50,000. \text{ It has been assumed that stock turnover ratio is on the basis of cost of sales, a candidate may work out this on the assumption that turnover stands for sales.}$$

Problem 8: From the following information, prepare Balance Sheet of a firm:

	Stock Turnover Ratio (based on cost of goods sold) -	7 times
	Rate of Gross Profit to Sales	25%
	Sales to Fixed Assets	2 times
	Average debt collection period	1.5 months
	Current Ratio	2
	Liquidity Ratio	1.25
	Net Working Capital	₹8,00,000
	Net Worth to Fixed Assets	0.9 times
	Reserve and Surplus to Capital	0.25 times
	Long Term Debts	Nil
	All Sales are on credit basis.	

(Nov 2014)

Solution: Working Notes:



$$1. \text{ Net Working Capital} = \text{Current Assets} - \text{Current Liabilities} \\ = 2 - 1 = 1$$

$$\text{Current Assets} = \frac{8,00,000 \times 2}{1}$$

$$= \frac{\text{Net Working Capital} \times 2}{1}$$

Current Assets = 16,00,000

Current Liabilities = 16,00,000 - 8,00,000 = 8,00,000

2. Liquid Ratio = $\frac{\text{Liquid Assets}}{\text{Current Liabilities}}$

1.25 = $\frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$

1.25 = $\frac{16,00,000 - \text{Stock}}{8,00,000}$

$1.25 \times 8,00,000$ = 16,00,000 - Stock

10,00,000 = 16,00,000 - Stock

Stock = 6,00,000

Liquid Assets = $1.25 \times 8,00,000 = 10,00,000$

3. Stock Turnover Ratio = $\frac{\text{COGS}}{\text{Stock}}$

7 = $\frac{\text{COGS}}{6,00,000}$

COGS = 42,00,000

4. Sales - Gross Profit = COGS

$\frac{\text{Gross Profit}}{\text{Sales}} = 25\%$

Gross Profit = 25% Sales

Sales - 25% Sales = COGS

Sales = $\frac{42,00,000}{0.75} = 56,00,000$

5. Debtors turnover Ratio = $\frac{12}{1.5} = 8$

Debtors = $\frac{\text{Credit Sales}}{\text{Debtors Turnover}}$

= $\frac{56,00,000}{8} = 7,00,000$

6. $\frac{\text{Sales}}{\text{Fixed Assets}} = 2$

Fixed Assets = $\frac{56,00,000}{2} = 28,00,000$

7. Net worth = Fixed Assets + Current Assets - Long-term Debt - Current Liabilities

= 28,00,000 + 16,00,000 - 0 - 8,00,000

= 36,00,000

$$\begin{aligned}
 8. \quad \frac{\text{Reserves \& Surplus}}{\text{Capital}} &= 0.25 \\
 \text{Net worth} &= \text{Reserves and Surplus} + \text{Capital} \\
 \text{Capital} &= \frac{36,00,000}{1.25} = 28,80,000 \\
 \text{Reserves and Surplus} &= 0.25 \times 28,80,000 \\
 &= 7,20,000 \\
 9. \text{ Cash} &= \text{Liquid Assets} - \text{Debtors} \\
 &= 10,00,000 - 7,00,000 = 3,00,000 \\
 10. \text{ Long Term Debts} &= \text{Nil}
 \end{aligned}$$

Draft Balance Sheet

<i>Liabilities</i>	<i>Amount (₹)</i>	<i>Assets</i>	<i>Liabilities (₹)</i>
Share Capital	28,80,000	Fixed Assets	28,00,000
Reserves and Surplus	7,20,000	Current Assets:	
Long Term Debts	-	Stock	6,00,000
Current Liabilities	8,00,000	Debtors	7,00,000
	-	Cash	3,00,000
	44,00,000		44,00,000

(Note: The above solution has been worked out by ignoring the Net worth to Fixed assets ratio given in the question in order to match the total of assets and liabilities in the Balance Sheet).

Problem 9: SSR Ltd. Has furnished the following ratios and information relating to the year ended 31st march, 2015.



Sales	₹60 Lacs
Return on Net worth	25%
Rate of Income tax	50%
Share Capital to reserves	7:3
Current Ratio	2
Net-profit to Sales (after tax)	6.25%
Inventory Turnover (Based on cost of goods sold and closing stock)	12
Cost of goods sold	₹18 Lacs
Interest on Debentures (@ 15%)	₹60,000
Sundry Debtors	₹2 Lacs
Sundry Creditors	₹2 Lacs

You are required to:

- Calculate the operating expenses for the year ended 31st March, 2015
- Prepare a Balance Sheet as on 31st March, 2015.

(May 2015)

Solution: Workings:

1. Net Profit = 6.25% of ₹60,00,000 = ₹3,75,000

2. Net worth = ₹3,75,000 × $\frac{100}{25}$ = ₹15,00,000

Share Capital = ₹15,00,000 × $\frac{7}{10}$ = ₹10,50,000

Reserve = ₹15,00,000 × $\frac{3}{10}$ = ₹4,50,000

Debentures = ₹60,000 × $\frac{100}{15}$ = ₹4,00,000

3. Sundry Creditors = ₹2,00,000

Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ = 2

Current Assets = 2 Current Liabilities

= 2 × ₹2,00,000 (assumed creditors is the only current liabilities) = ₹4,00,000

4. Inventory Turnover = $\frac{\text{Cost of Goods Sold}}{\text{Closing Stock}}$ = 12

Hence, Closing Stock = $\frac{₹18,00,000}{12}$ = ₹1,50,000

Calculation of Earnings Before Interest and Tax (EBIT)

Particulars	Amount (₹)
Net Profit	3,75,000
Tax @ 50%	3,75,000
Profit Before Tax	7,50,000
Add: Interest on Debentures	60,000
Earnings Before Interest and Tax (EBIT)	8,10,000

(i) Calculation of Operating Expenses for the year ended 31st March 2015

Particulars	Amount (₹)	Amount (₹)
Sales		60,00,000
Less: Cost of Goods Sold	18,00,000	
EBIT	8,10,000	26,10,000
Operating Expenses		33,90,000

(ii) Balance Sheet as on 31st March, 2015

Liabilities	Amount (₹)	Amount (₹)	Assets	Amount (₹)	Amount (₹)
Share capital		10,50,000	Fixed Assets (balancing figure)		17,00,000
Reserve		4,50,000	Current Assets:		
Debentures 15%		4,00,000	Closing stock	1,50,000	
Sundry Creditors		2,00,000	Debtors	2,00,000	
			Cash	50,000	4,00,000
		21,00,000			21,00,000

Problem 10: Following is the abridged balance sheet of the Trivedi Co. Ltd.



Paid up share capital	5,00,000	Free hold property	4,00,000
Profit and loss account	85,000	Plant and machinery	2,50,000
Current liabilities	2,00,000	Less: Depreciation	50,000
		Stocks	1,05,000
		Debtors	1,00,000
			5,000
	7,85,000		7,85,000

From the following information you are required to prepare profit and loss account and balance sheet as at 31st March 2025:

- The composition of the total of the Liabilities side of the company's balance sheet as 31st March 2025 (the paid up share capital remaining the same as at 31st March 2024) was:

Share capital	50 percent	profit and loss A/c	15 percent
7 percent debentures	10 percent	creditors	25 per cent

 The debenture were issued on 1st April 2024, interest being paid on 30th September 2024 and 31st March 2025.
- During the year ended on 31st March, 2025. Additional plant and machinery had been bought and a further ₹ 25,000 depreciation written off. Freehold property remained unchanged. The total fixed assets then constituted 60 percent of total fixed and current assets.
- The current ratio was 1.6:1. The quick assets ratio was 1:1
- The debtors (four -fifths of the quick assets) to sales ratio revealed a credit period of two months.
- Gross profit was at the rate of 15 percent of selling price and return on net worth as at 31st March, 2025 was 10 percent. Ignore taxation.

Solution:



Balance Sheet as at 31 March, 2025

Liabilities	Amount (₹)	Assets	Amount (₹)
Share Capital	5,00,000	Fixed Assets:	
Reserve and Surplus:		Freehold property	4,00,000
Profit and Loss A/c	1,50,000	Plant and Machinery	3,00,000
7% Debentures	1,00,000	Less: Depreciation	1,00,000
Creditors	2,50,000	Current Assets:	
		Stock	1,50,000
		Debtors	2,00,000
		Bank	50,000
	10,00,000		10,00,000

Profit and Loss Account for the year ended March 31, 2025

Dr.

Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening Stock	1,05,000	By Sales	12,00,000
To Purchases (Balance figure)	10,65,000	By Closing Stock	1,50,000
To Gross Profit	1,80,000		
	13,50,000		13,50,000
To Expenses (Balance figure)	83,000	By Gross Profit b/d	1,80,000
To Debentures Interest	7,000		
To Depreciation	25,000		
To Net Profit	65,000		
	1,80,000		1,80,000

- (i) Total of Liabilities Side = $\frac{₹ 5,00,000}{0.50} = ₹ 10,00,000$.
- (ii) Profit and Loss A/c (Cr. Balance) = 15% of ₹ 10,00,000 = ₹ 1,50,000.
- (iii) 7% Debentures = 10% of ₹ 10,00,000 = ₹ 1,00,000
- (iv) Creditors = 25% of ₹ 10,00,000 = ₹ 2,50,000.
- (v) Net fixed Assets = 60% of ₹ 10,00,000 = ₹ 6,00,000.
- (vi) Net Plant and Machinery = ₹ 6,00,000 - ₹ 4,00,000 = ₹ 2,00,000.
- (vii) Gross Plant and Machinery = ₹ 2,00,000 + (₹ 75,000 + ₹ 25,000) = ₹ 3,00,000
- (viii) Current Assets = ₹ 2,50,000 × 1.6 = ₹ 4,00,000.
- (ix) Liquid Assets = ₹ 2,50,000 × 1 = ₹ 2,50,000
- (x) Stock = ₹ 4,00,000 - ₹ 2,50,000 = ₹ 1,50,000.
- (xi) Debtors = $\frac{₹ 2,50,000}{4} \times 5 = ₹ 2,00,000$
- (xii) Sales = ₹ 2,00,000 × $\frac{12}{2} = ₹ 12,00,000$.
- (xiii) Gross profit = 15% of ₹ 12,00,000 = ₹ 1,80,000
- (xiv) Net Worth = ₹ 5,00,000 + ₹ 1,50,000 = ₹ 6,50,000.
- (xv) Net Profit = 10% of ₹ 6,50,000 = ₹ 65,000.

Problem 11: Equity share capital G Ltd. Has furnished the following information relating to the year ended 31st March 2017 and 31st March, 2018:

Particulars	31st March, 2017	31st March, 2018
Share Capital	40,00,000	40,00,000
Reserve and Surplus	20,00,000	25,00,000
Long term loan	30,00,000	30,00,000

- Net profit ratio: 8%
- Gross profit ratio: 20%
- Long-term loan has been used to finance 40% of the fixed assets.
- Stock turnover with respect to cost of goods sold is 4.
- Debtors represent 90 days sales.
- The company holds cash equivalent to 1 months cost of goods sold.
- Ignore taxation and assume 360 days in year.

You are required to prepare Balance Sheet as on 31st March, 2018 in following format:

Liabilities	₹	Assets	₹
Share Capital	-	Fixed Assets	-
Reserve and Surplus	-	Sundry Debtors	-
Long-Term Loan	-	Closing Stock	-
Sundry Creditors	-	Cash in hand	-

Solution:**Balance Sheet**

Liabilities	₹	Assets	₹
Share Capital	40,00,000	Fixed Assets	75,00,000
Reserve and Surplus	25,00,000	Sundry Debtors	15,62,500
Long-Term Loan	30,00,000	Closing Stock	12,50,000
Sundry Creditors	14,37,500	Cash in hand	6,25,000

Working Notes:

- Net Profit = Change in Reserve and Surplus
 $= 25,00,000 - 20,00,000 = ₹ 5,00,000$
- Sales:
 Net Profit ratio = 8% of sales
 $\therefore \text{Sales} = \text{Net Profit} \div \text{Net Profit ratio} = 5,00,000 \div 8\% = ₹ 62,50,000$
- Cost of Goods Sold = Sales - Gross Profit (20% of Sales)
 $= ₹ 62,50,000 - 20\% \text{ of } ₹ 62,50,000 = ₹ 50,00,000$
- Fixed Assets = Long term loan $\div$ 40%
 $= ₹ 30,00,000 \div 40\% = ₹ 75,00,000$
- Closing Stock = Cost of Goods Sold $\div$ Stock Turnover
 $= ₹ 50,00,000 \div 4 = ₹ 12,50,000$
- Debtors = Sales $\times$ Debtors Collection Period (days) $\div$ 360 days
 $= ₹ 62,50,000 \times 90/360 = ₹ 15,62,500$
- Cash Equivalent = **COGS $\times$ 1.5/12**
 $= ₹ 50,00,000 \times 1.5/12 = ₹ 6,25,000$

Problem 12: The following figures and ratios are related to a company:



Sales for the year (all credit)	₹ 30,00,000
Gross profit ratio	25%
Fixed assets turnover (basis on cost of goods sold)	1.5
Stock turnover (basis on cost of goods sold)	6
Liquid ratio	1:1
Current ratio	1.5:1
Debtors collection period	2 months
Reserve and surplus to Share Capital	0.6:1
Capital gearing ratio	0.5
Fixed assets to net worth	1.20:1

You are required to prepare:

- Balance Sheet of the company on the basis of above details.
- The statement showing working capital requirement, if the company wants to make a provision for contingencies @ 10% of net working capital including such provision.

(1) Projected Balance Sheet

Liabilities	₹	Assets	₹
Share Capital	7,81,250	Fixed Assets	15,00,000
Reserve & Surplus	4,68,750	Stock	3,75,000
Debt	6,25,000	Debtors	5,00,000
Current Liabilities	7,50,000	Cash	2,50,000
	26,25,000		26,25,000

a. Cost of Goods Sold = 30,00,000 - 25% = **22,50,000**

b. Fixed Assets Turnover Ratio = $\frac{\text{COGS}}{\text{Fixed Assets}} = 1.5 \text{ times}$

Fixed Assets = $\frac{22,50,000}{1.5} = \mathbf{15,00,000}$

c. Fixed Assets to Net Worth = $\frac{\text{Fixed Assets}}{\text{Net Worth}} = 1.2 \text{ Times}$

Net Worth = $\frac{15,00,000}{1.2} = \mathbf{12,50,000}$

d. Capital Gearing = $\frac{\text{Debt+Preference}}{\text{Equity}} = \frac{\text{Debt+Nil}}{12,50,000}$

Debt = 0.5 x ₹ 12,50,000 = **₹ 6,25,000**

Assumption: Preference Share capital is zero

e. Reserve & Surplus = 12,50,000 x 0.6/1.6 = **₹ 4,68,750**

f. Share capital = 12,50,000 x 1/1.6 = **₹ 7,81,250**

g. Stock Turn over = $\frac{\text{COGS}}{\text{Stock}} = 6 \text{ times}$

Stock = $\frac{22,50,000}{6} = \mathbf{₹ 3,75,000}$

h. Debtors = Sales x $\frac{\text{Collection Period}}{12} = 30,00,000 \times \frac{2}{12} = \mathbf{₹ 5,00,000}$

i. Stock = CL(Current ratio - Liquid ratio)

Current Liabilities = $\frac{\text{Stock}}{\text{CR} - \text{LR}} = \frac{3,75,000}{1.5 - 1} = \mathbf{₹ 7,50,000}$

j. **Current Ratio** = $\frac{\text{CA}}{\text{CL}} = 1.5 \text{ Times}$

Current Assets = 1.5 x 7,50,000 = **₹ 11,25,000**

k. Cash in Hand = 11,25,000 - 3,75,000 - 5,00,000 = **₹ 2,50,000**

(2) Statement of Working Capital Requirement

Particulars	₹
Current Assets: Stock	3,65,000
Debtors	5,00,000
Cash	2,50,000
	11,25,000
Less: Current Liabilities	(7,50,000)
Working Capital Before Provision	3,75,000
Add: Provision for Contingencies @ 10% of WC (including provision)	41,667
Working Capital Including Provision 3,75,000 x	4,16,667

2

CHAPTER

COST OF CAPITAL

Hope is the belief in the probability of the possible rather than the necessity of the probable.

Important Questions

January 2025

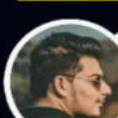
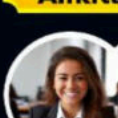


Congratulations!

The league of Champions

FM-SM



 75 Marks	 75 Marks	 75 Marks
Sanskar Jain	Shushobit Verma	Mayank Gupta
 74 Marks	 72 Marks	 69 Marks
Vasudev	Preeti Aggarwal	Sandeep Shaw
 69 Marks	 69 Marks	 68 Marks
Shashank	Riya Bansal	Akansha
 68 Marks	 67 Marks	 67 Marks
Arsalan Ali	Abhay Nahar	Harsh
 66 Marks	 66 Marks	 65 Marks
Ankita Rani	Anshu Kumar	Pulkit Luthra
 65 Marks	 65 Marks	 65 Marks
Seerat Sharma	Ayush Sharma	Shubham

3000+ Exemptions
3500+ Above 50 Marks



Congratulations!

The League of Champions

 MEENAKSHI AIR 20	 ROHIT AIR 22	 SHUBHAM AIR 23	 ANUSHKA AIR 36	 CHERRY AIR 37	 SANJEEV AIR 47
 SATYAM KUMAR 87 MARKS	 SUSHANT ARORA 83 MARKS				
 BHARAT GAUTAM 80 MARKS	 PRADEEP ROHILLA 79 MARKS				
 ANUSHKA SHARMA 78 MARKS	 KSHITIZ TAYAL 78 MARKS				
 SAIKAT GHOSH 77 MARKS	 NILESH JAISWAL 76 MARKS				
 NUZAIF AKTHAR 76 MARKS	 KOMAL SANWAL 75 MARKS				
 SHALINI SONI 75 MARKS	 ASHUTOSH KUMAR 74 MARKS				
 NANDA CHATURVEDI 74 MARKS	 ARYAN MERATWAL 73 MARKS				
 DEEPANSHI JAIN 73 MARKS	 KAUSHAL ARORA 73 MARKS				
 PREETHAM BHAT 73 MARKS	 SONALI VIJ 73 MARKS				
 ANKIT JAIN 72 MARKS	 MAYURI PRAMOD 72 MARKS				
 SANCHIT 72 MARKS	 SONU AGRAWAL 72 MARKS				
 TANYA BANSAL 72 MARKS	 ANURAG AGGRAWAL 71 MARKS				
 CHIRAG JAIN 70 MARKS	 NITESH LAHU 70 MARKS				
 PARAS BANSAL 70 MARKS	 RAJSHREE 70 MARKS				
 RAJVI DILIP 70 MARKS	 YASH JAIN 70 MARKS				

OTC CHAMPIONS

CHAPTER TWO

Video for Interpretation of the List:
<https://youtu.be/dVq9NF7s814>



COST OF CAPITAL

LIST OF IMPORTANT QUESTIONS JANUARY 2025



**FM-SM
REGULAR** Batch
JAN/MAY/SEPT 2025



**FM-SM
EXAM-ORIENTED** Batch
JAN/MAY/SEPT 2025



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Problem 1:

Suppose number of existing shares = 5,20,000

Existing capital structure	Percentage
Equity Share Capital	65%
Preference Share Capital	15%
Debenture	20%
	100%

This same percentage will continue in future. This best earnings per share (EPS).

Year	2003	2004	2005	2006
EPS	2.00	2.40	2.88	3.456

Next dividend per share will be equal to 50% of EPS of year 2006.

Current price per share = ₹ 21.60

15% new Debentures will be issued at market price ₹ 75 (Face value = ₹ 100)

New 13.8% Preference share will be allotted at ₹ 115 (Face value = ₹ 100)

Tax rate 50%. Find average cost of capital if the retained earnings will be used in a project.

Solution:

Based on past earnings we can get growth rate.

Year	EPS	Growth rate
2003	2	
2004	2.4	$\frac{E_{2004}}{E_{2003}} - 1 = \frac{2.4}{2} - 1 = 20\%$
2005	2.88	$\frac{E_{2005}}{E_{2004}} - 1 = \frac{2.88}{2.4} - 1 = 20\%$
2006	3.456	$\frac{E_{2006}}{E_{2005}} - 1 = \frac{3.456}{2.88} - 1 = 20\%$

The growth rate will be 20% p.a.

Next Dividend Per share (D_1) = 50% of EPS of 2006 = 50% of 3.456 = 1.728

Current Price (P_0) = 21.60

$$K_e = \frac{D_1}{P_0} + g = \frac{1.728}{21.60} + 0.20 = 0.28 = 28\%$$

Interest on Debenture = Face value × Interest rate

$$= 100 \times 15\% = ₹ 15$$

$$\text{Cost of debts} = \frac{\text{Amount of Interest (1-tax)}}{\text{Market Price}} = \frac{15 (1-0.50)}{75} \times 100 = 10\% \text{ p.a.}$$

$$\text{Cost of preference share} = \frac{\text{Amount of Preference Dividend}}{\text{Market value of Preference Share}} \times 100$$

$$= \frac{13.8\% \text{ of face value (₹ 100)}}{₹ 115} \times 100 = \frac{13.8}{115} \times 100 = 12\%$$

If the given capital structure is maintained the cost of retained earnings will be equal to cost of existing equity i.e. 28%.

Overall cost for capital in new project

$$= W_e k_e + W_p K_p + W_d K_d$$

$$= (0.65 \times 28) + (0.15 \times 12) + (0.20 \times 10) = 18.2 + 1.80 + 2 = 22\%$$

Now, calculate the cost of project if the retained earnings of 2006 is used.

No. of equity shares	= 5,20,000 shares
EPS of 2006	= ₹ 3.456
DPS of 2006	= ₹ 1.728
Retained earnings per share	= ₹ 1.728
Total retained earnings	= ₹ 1.728 × 5,20,000 = ₹ 8,98,560
Proportion of equity invested in Project	= Project cost × 65%
₹ 8,98,560	= Project cost × 65%
Project cost	= $\frac{₹ 8,98,560}{65\%} = ₹ 13,82,400$

Example 2: Adani Wilmar wished to raise additional finance of ₹ 10 lakhs for meeting its investment plans it has ₹ 2,10,000 in the form of retained earnings available for investment purposes. Further details are as following: (1) Debt/equity mix 30%/70% (2) Cost of debt: Up to ₹ 1,80,000 10% (before tax); Beyond ₹ 1,80,000 16% (before tax) (3) Earnings per share ₹ 4 (4) Dividend payout 50% of earnings is paid (5) Expected growth rate in dividend 10% (6) Current market price per share ₹ 44 (7) Tax rate 50%.

Required:

- To determine the pattern for raising the additional finance.
- To determine the post-tax average cost of additional debt.
- To determine the cost of retained earnings and cost of equity, and
- Compute the overall weighted average after tax cost of additional finance.

Solution:

(a) Pattern of raising additional finance.

Equity 70% of ₹ 10,00,000 = ₹ 7,00,000; Debt 30% of ₹ 10,00,000 = ₹ 3,00,000

The capital structure after raising additional finance:

<i>The capital structure after raising additional finance:</i>	(₹)
Equity Capital (7,00,000-2,10,000)	4,90,000
Retained earnings	2,10,000
Debt (Interest @ 10% p.a.)	1,80,000
(Interest @ 16% p.a.) (3,00,000 – 1,80,000)	1,20,000
Total Funds	10,00,000

(b) Determination of post-tax average cost of additional debt

$K_d = I(1-t)$ Where, I = Interest Rate; T = Corporate tax-rate

On ₹ 1,80,000 = 10%(1-0.5) = 5% of 0.05; On ₹ 1,20,000 = 16%(1-0.5)=8% or 0.08

$$\text{Average Cost of Debt} = \frac{1,80,000 \times .05 + 1,20,000 \times .08}{3,00,000} = 6.2\%$$

(c) Determination of cost of retained earnings and cost of equity applying Dividend growth model:

$$K_e = ₹ 2(1+.10) / ₹ 44 + 10\% = 15\%$$

(d) Computation of overall weighted average after tax cost of additional finance

Particular	₹	Weights	Cost of funds
Equity (including retained earnings)	7,00,000	0.70	15%
Debt	3,00,000	0.30	6.2%

$$WACC = (\text{Cost of Equity} \times \% \text{ Equity}) + (\text{Cost of debt} \times \% \text{ Debt})$$

$$= (15\% \times 0.70) + (6.2\% \times 0.30) = 10.5\% + 1.86\% = 12.36\%$$

Note: Retained Earnings & Equity and 10% & 16% Debt can be shown separately. Answer will be same.

Problem 3: Concepts Ltd. Issued 20,000 10% convertible debentures of ₹ 100 each with a maturity period of 5 years.

At maturity the debentures holders will have the option to convert debentures into equity shares of the company in ratio of 1:5 (5 shares for each debenture). The current market price of the equity share is ₹ 20 each and historically the growth rate of the share is 4% per annum. Assuming tax rate is 25%. **Compute the cost of 10% convertible debenture using Approximation Method and Internal Rate of Return Method. PV Factor are as under:**

Year	1	2	3	4	5
PV Factor @ 10%	0.909	0.826	0.751	0.683	0.621
PV Factor @ 15%	0.870	0.756	0.658	0.572	0.497

Solution:

Determination of Redemption value: Higher of –

(i) The cash value of debentures = ₹ 100

(ii) Value of equity shares = 5 shares $\times$ ₹ 20 $(1+0.04)^5$ = 5 shares $\times$ ₹ 24.333 = ₹ 121.665 rounded to ₹ 121.67
₹ 121.67 will be taken as redemption value as it is higher than the cash option and attractive to the investors.

Calculation of Cost of 10% Convertible debenture

$$(i) \text{ Using Approximation Method: } K_d = \frac{I(1-t) + \frac{(RV - NP)}{n}}{\frac{(RV + NP)}{2}} = \frac{10(1-0.25) + \frac{(121.67 - 100)}{5}}{\frac{(121.67 + 100)}{5}} = 10.676\%$$

(ii) Using Internal Rate of Return Method

Year	Cash flows (₹)	Discount Factor @ 10%	Present Value	Discount factor @ 15%	Present Value (₹)
0	100	1.000	(100.00)	1.000	(100.00)
1 to 5	7.5	3.790	28.425	3.353	25.148
5	121.67	0.621	75.557	0.497	60.470
NPV			+3.982		-14.382

$$IRR = L + \frac{NPV_L}{NPV_L - NPV_H} (H - L) = 10\% + \frac{3.982}{3.982 - (-14.382)} (15\% - 10\%) = 0.11084 \text{ or } 11.084\% (\text{approx.})$$

Problem 4: ABC Company's Equity Share is quoted in the market at ₹ 25 per Share currently. The Company pays a dividend of ₹ 2 per Share and the Investor's Market expects a growth rate of 6% per year.

You are required to:

- Calculate the Company's Cost of Equity Capital.
- If the anticipated Growth Rate is 8% per annum, calculate the indicated Market Price per Share.
- If the Company issues 10% Debentures of Face Value of ₹ 100 each and realizes ₹ 96 per Debenture while the Debentures are redeemable after 12 years at a premium of 12%, what will be the Cost of Debentures? [Tax = 50%]

[Nov -2016]

Solution:

(a) Cost of Equity Capital (K_e):

$$K_e = \frac{\text{Expected dividend per share}(D_1)}{\text{Market price per share}(P_0)} + \text{Growth rate}(g) = \frac{₹ 2 \times 1.06}{₹ 25} + 0.06 = \mathbf{0.1448 \text{ or } 14.48\%}$$

Note: The cost of equity can be calculated without taking the effect of growth on dividend.

(b) Indicated market price per share when growth rate is 8% p.a.:

$$K_e = \frac{\text{Expected dividend per share}(D_1)}{\text{Market price per share}(P_0)} + \text{Growth rate}(g)$$

$$P_0 = \frac{\text{Expected dividend per share}(D_1)}{\text{Cost of equity}(K_e) - \text{Growth rate}(g)} = \frac{₹ 2 \times 1.08}{0.1448 - 0.08} \text{ Or, } P_0 = \frac{₹ 2.16}{0.0648} = \mathbf{₹ 33.33}$$

(c) Cost of Debenture (K_d) (Using approximation method)

$$K_d = \frac{\text{Interest}(1 - \text{tax rate}) + \left(\frac{RV - NP}{12 \text{ Year}} \right)}{\left(\frac{RV + NP}{2} \right)}$$

Where, Tax Rate = 50%

Net Proceeds (NP) = ₹ 96

Redeemable Value (RV) = ₹ 100 (1.12) = ₹ 112

$$K_d = \frac{10\% \text{ of } ₹ 100 (1 - 0.5) + \left(\frac{₹ 112 - ₹ 96}{12 \text{ Year}} \right)}{\left(\frac{₹ 112 + ₹ 96}{2} \right)} = \frac{₹ 5.33}{₹ 104} = \mathbf{0.0608 \text{ or } 6.08\%}$$

OR

(Using Present value method or YTM)

Identification of relevant cash flows

Year	Cash flows
0	Current market price (P_0) = ₹ 96
1 to 12	Interest net of tax $[I(1-t)] = 10\% \text{ of } ₹ 100 (1 - 0.5) = ₹ 5$
12	Redemption value (RV) = ₹ 100 (1.12) = ₹ 112

Calculation of Net Present Values (NPV) at two discount rates

Year	Cash flows	Discount factor @ 5%(L)	Present Value	Discount factor @ 10% (H)	Present Value
0	96	1.000	(96.00)	1.000	(96.00)
1 to 12	5	8.863	44.32	6.814	34.07
12	112	0.557	62.38	0.319	35.73
NPV			+10.7		-26.2

Calculation of IPR

$$IPR = L + \frac{NPV_L}{NPV_L - NPV_H} (H - L) = 9\% + \frac{10.7}{10.7 - (-26.2)} (10\% - 9\%) = 9\% + \frac{53.5}{369} = 6.45\%$$

Therefore, $K_d = 6.45\%$

[Any other low and high rate as discount factor may also be used.]

Problem 5: The following is the Capital Structure of RBT Limited as on 31st March, 2016:



Source of Capital	Book Value	Market Value
Equity Shares at ₹ 10 each	₹ 50,00,000	₹ 1,05,00,000
Retained Earnings	₹ 13,00,000	Nil
11% Preference Shares of ₹ 100 each	₹ 7,00,000	₹ 9,00,000
14% Debentures of ₹ 100 each	₹ 30,00,000	₹ 36,00,000

Market Price of Equity Shares is ₹ 40 per Share and it is expected that a Dividend of ₹ 4 per Share would be declared. The Dividend per Share is expected to grow at the rate of 8% every year. Income Tax Rate applicable to the Company is 40% and Shareholder's Personal Income Tax Rate is 20%.

Required:

1. Cost of Capital for each source of Capital.
2. Weighted Average Cost of Capital on the basis of Book Value Weights.
3. Weighted Average Cost of Capital of on the basis of Market Value Weights.

[Nov -2016]

Solution:**(i) Calculation of Cost of Capital for each source of capital:**

(a) Cost of Equity share capital:

$$K_e = \frac{D_0(1+g)}{\text{Market Price per share}(P_0)} + g = \frac{4(1+0.08)}{₹ 40} + 0.08 = 18.8\%$$

(b) Cost of Preference share capital (K_p) = 11%

(c) Cost of Debentures (K_d) = $r(1 - t) = 14\%(1 - 0.4) = 8.4\%$.

(d) Cost of Retained Earnings (K_s) = $K_e(1 - tp) = 18.8(1 - 0.2) = 15.04\%$

(ii) Weighted Average Cost of Capital (WACC) on the basis of book value weights

Source	Amount (₹)	Weights (a)	After tax Cost of Capital (%) (b)	WACC (%) (c) = (a) × (b)
Equity share	50,00,000	0.50	18.80	9.40
Retained earnings	13,00,000	0.13	15.04	1.96
11% Preference share	7,00,000	0.07	11.00	0.77
14% Debentures	30,00,000	0.30	8.40	2.52
	1,00,00,000	1.00		14.65

(iii) Weighted Average Cost of Capital (WACC) on the basis of market value weights

Source	Amount (₹)	Weights (a)	After tax Cost of Capital (%) (b)	WACC (%) (c) = (a) × (b)
Equity share	1,05,00,000	0.70	18.80	13.16
11% Preference share	9,00,000	0.06	11.00	0.66
14% Debentures	36,00,000	0.24	8.40	2.016
	1,50,00,000	1.000		15.836

- Note:**
- The cost of equity can be calculated without taking the effect of growth on dividend.
 - Accordingly WACC can be calculated.

Problem 6: The X Company has following Capital Structure at 31st March 2015, which is considered to be optimum.



14% Debentures	₹ 3,00,000
11% Preference Shares	₹ 1,00,000
Equity (1,00,000 Shares)	₹ 16,00,000
Total	₹ 20,00,000

The Company's Share has a current Market Price of ₹ 23.60 per Share. The expected Dividend per Share next year is 50% of 2015 EPS. The following are the Earning Per Share figure for the Company during preceding ten years. The past trends are expected to continue.

Year	EPS (₹)	Year	EPS (₹)
2006	1.00	2011	1.61
2007	1.10	2012	1.82
2008	1.21	2013	1.95
2009	1.33	2014	2.15
2010	1.46	2015	2.36

The Company issued new Debentures carrying 16% Rate of Interest and the Current Market Price of Debenture is ₹ 96. Preference Share ₹ 9.20 (which Dividend of ₹ 1.1 per Share) were also issued. The Company is in 50% tax bracket.

- (i) Calculate after-tax cost of (a) New Debt, (b) New Preference Share (c) New Equity Share (assuming New Equity from Retained Earning)
- (ii) Calculate Marginal Cost of Capital when no New Shares was issued.
- (iii) How much can be spent for Capital Investment before New Ordinary Shares must be sold? Assuming the Retained Earning for next year's investment are 50% of 2015.
- (iv) What will be the Marginal Cost of Capital when the funds exceeds the amount calculated in (iii), assuming New Equity is issued at ₹ 20 per Share?

[May-2016]

Solution:**(i) : Calculation of after tax cost of the followings:**

$$(a) \text{ New Debentures } (K_d) = \frac{I(1-t)}{NP} = \frac{₹16(1-0.05)}{₹96} \times 100 = 8.33\%$$

$$\text{New Preference Shares } (K_d) = \frac{\text{Preference Dividend}}{\text{Net Proceed}} = \frac{₹1.10}{₹9.20} \times 100 = 11.96\%$$

(b) Equity Shares (Consuming New Equity from Retained Earnings) (K_e)

$$= \frac{\text{Expected dividend } (D_1)}{\text{Current market price } (P_0)} + \text{Growth rate } (G) = \frac{50\% \text{ of } ₹ 2.36}{₹ 23.60} \times 100 + 10\% = 5\% + 10\% = 15\%$$

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

$$\frac{\text{EPS in current year} - \text{EPS in previous year}}{\text{EPS in previous year}} = \frac{₹ 2.36 - ₹ 2.15}{₹ 2.15} \times 100 = 10\%$$

(Approximate 10% figure is taken because of decimal figures)

[*Alternative calculation of Growth rate:- Growth rate is calculated on basis average growth of EPS i.e. $10 + 10 + 9.92 + 9.77 + 10.27 + 13.04 + 7.14 + 10.25 + 9.76 = 90.15 / 9 = 10.01$ or 10%]

Or,

The EPS for 2006 is given ₹1 and whereas for 2015 is given at ₹ 2.36. This has resulted in increase of ₹ 1.36 over a period of 9 years.

The growth rate can be calculated by using formula:

$$E_t = E_0 (1 + g)^t$$

$2.36 = 1 (1 + g)^9$, using the CVF table, ₹ 1 becomes ₹ 2.36 at the end of 9th year at the compound interest rate of 10%. Therefore, the growth rate is taken at 10%.]

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

Source of capital	Weight (a)	After Tax Cost of Capital (%) (b)	Weighted Average Cost of Capital (WACC) (%) (a) × (b)
Debenture	0.15	8.33%	1.25
Preference shares	0.15	11.96%	0.60
Equity shares	0.80	15.00%	12.00
Marginal cost of capital			13.85

(iii) The company can spent 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 2015 EPS × equity shares outstanding

= 50% of ₹ 2.36 × 1,00,000 shares = ₹ 1,18,000

Since, marginal cost of capital is to be maintained at the current level i.e. 13.85%, the retained earnings should be equal to 80% of total additional capital for investment.

Thus, investment before issuing equity = $\left(\frac{₹ 1,18,000}{80} \times 100 \right)$ ₹ 1,47,500

The remaining capital of ₹ 29,500 i.e. (₹ 1,47,500 – ₹ 1,18,000) shall be financed by issuing New Debenture and New Preference Shares in the ratio of 3 : 1 (3,00,000 :

1,00,000) respectively.

(iv) If the company spends more than ₹ 1,47,500 as calculated in part (iii) above, it will have to issue new shares at ₹ 20 per share.

The cost of new issue of equity shares will be:

$$\frac{\text{Expected dividend (D}_1\text{)}}{\text{Current market price (P}_0\text{)}} + \text{Growth rate (g)} = \frac{50\% \text{ of } 2.36}{₹ 20} \times 100 + 10\% = 5.9\% + 10\% = \mathbf{15.9\%}$$

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

Source of capital	Weight (a)	Cost (%) (b)	Weighted Average Cost of Capital [WACC (%)] (a) × (b)
Debenture	0.15	8.33	1.25
Preference shares	0.05	11.96	0.60
Equity shares	0.80	15.90	12.72
Marginal cost of capital			14.57

Problem 7: ABC Limited has the following book value capital structure:

Equity Share Capital (150 million shares, ₹ 10 par)	₹ 1,500 million
Reserves and Surplus	₹ 2,250 million
10.5% Preference Share Capital (1 million shares, ₹100 par)	₹ 100 million
9.5% Debentures (1.5 million debentures, ₹ 1000 par)	₹ 1,500 million
8.5% Term Loans from Financial institutions	₹ 500 million

The debentures of ABC Limited are redeemable after three years and are quoting at ₹981.05 per debenture. The applicable income tax rate for the company is 35%.

The current Market Price per equity share is ₹ 60. The prevailing default-risk free interest rate in 10-year GOI Treasury Bonds is 5.5%. The average market risk premium is 8%. The beta of the company is 1.1875. The preferred stock of the company is redeemable after 5 years is currently selling at ₹ 98.15 per preference share.

Required:

- Calculate Weighted Average Cost of Capital of the company using Market Value Weights.**
- Define the marginal cost of capital schedule for the firm if it raises ₹ 750 million for a new project. The firm plans to have a target debt to value ratio (D/D+E) of 20%. The beta of new project is 1.4375. The debt capital will be raised through term loans. It will carry interest rate of 9.5% for the first 100 million and 10% for the next ₹ 50 million.

Solution:**Working Notes:**

$$1. \text{ Computation of Cost of Debentures (K}_d\text{)} = \frac{95(1 - 0.30) + \frac{(1000 - 981.05)}{3}}{\frac{(1000 - 981.05)}{2}} = 6.87\%$$

$$2. \text{ Computation of Cost of Term Loans (K}_t\text{): } 8.5\%(1 - 0.35) = 5.525\%$$

$$10.5 + \frac{(1000 - 98.15)}{5}$$

$$3. \text{ Computation of Cost of Preference Capital (K}_p\text{): } = \frac{10.5 + \frac{(1000 - 98.15)}{5}}{(1000 + 98.15)} = 11\%$$

$$4. \text{ Computation of Cos of Equity (K}_e\text{)} = R_f + \text{Market Risk Premium} \times \text{Beta} = 5.5\% + 8\% \times 1.1875 = 15\%$$

5. Computation of proportion of Equity Capital, Preference Share, Debentures and Term Loans in the Market Value of Capital Structure:

Components of Capital	Market Value of Capital Structure	(₹ in million) Proportion
Equity share capital* (150 million share x ₹60)	9,000	81.3000
10.5% Preference Share capital (1 million shares x 98.15)	98.15	0.889
9.5% Debentures (1.5 million debentures x ₹ 981.05)	1,471.575	13.294
8.5% Term loan	500.000	4.517
	11,069.725	100

*We can bifurcate Equity into Equity Share Capital & Reserve & Surplus. Answer will be same as $K_e = K_r$.

(i) Calculation of WACC using Market Value Weights

Source of capital	Weights	Specific Cost (K%)	Weight x Specific Cost
Equity share capital*	.813	15	.12195
10.5% Preferential share capital	.0089	11	.00097
9.5% Debentures	.1329	6.87	.00913
8.5% Term loans	.04517	5.525	.00250
	1.00		13.46

*We can bifurcate Equity into Equity Share Capital & Reserve & Surplus. Answer will be same as $K_e = K_r$.

(ii) Marginal Cost of Capital (MCC) Schedule:

K_e (New Project) = $5.5\% + 8\% \times 1.4375 = 17\%$; $K_d = 9.5\% \times (1 - 0.35) = 6.175\%$ and $K_d = 10\% \times (1 - 0.35) = 6.5\%$

$$MCC = 17\% \times \frac{600}{750} + 6.175\% \times \frac{100}{750} + 6.5\% \times \frac{50}{750} = 14.86\%$$

$$\text{Note: Debt to Value ratio} = \text{Debt ratio} = \frac{\text{Debt}}{\text{Debt} + \text{Equity}} = 0.20 \rightarrow \text{Debt} = .20 (\text{Debt} + \text{Equity})$$

It means New Debentures Amount will be 20% of Rs 750 = ₹150 and New Equity will be 80% of 750 = ₹600

Note: There may be Alternative Presentation/Solution for the above question. The above solution is as per Institute Recommendation. Hence the same should be preferred for exam.

Problem 8: XYZ Ltd. has the following book value capital structure.

	₹
Equity Capital (in shares of ₹ 10 each, fully paid up-at par)	15 crores
11% Preference capital (in shares of ₹ 100 each, fully paid up-at par)	1crores
Retained earnings	20 crores
Debentures 13.5% (of ₹ 100 each)	10 crores

Term loans 15%

12.5 crores

The next expected dividend on equity shares per share is ₹ 3.60, the dividend per share is expected to grow at the rate of 7%. The market price per equity share is ₹ 40. Preference stock, redeemable after 10 years, is currently selling at ₹ 75 per share. Debentures, redeemable after 6 years, are selling at ₹ 80 per debentures. Applicable corporate income tax rate is 40%.

Required: = 0.20 → Debt = .20 (Debt+Equity)

- (a) Calculate the average cost of capital using
- Book value proportions.
 - Market value proportions.
- (b) Define the marginal cost of capital schedule for the company, if it raises ₹ 10 crores next year, given the following information:
- The amount will be raised by equity and debt in equal proportions;
- The company expects to retain ₹ 1.5 crores earnings next year;
- The additional issue of equity shares will result in the net price per share being fixed at 32.
- The debt capital raised by way of term loans will cost 15% for the first ₹ 2.5 crores and 16% for the next ₹ 2.5 crores.

Solution:



(1) (a) Statement showing computation of weighted average cost of capital by using book value proportions:

Source of finance	Amount (Book values) (₹ in crores)	Weight (Book Value Proportion (a))	Cost of capital (b)	Weighted cost of capital (c) = (a) × (b)
Equity capital	15	0.256	0.16 (W. N. -1)	0.04096
11% Preference capital	1	0.017	0.1543 (W. N. -2)	0.00262
Retained Earnings 13.5%	20	0.342	0.16 (W. N. -1)	0.05472
13.5% Debenture	10	0.171	0.127 (W. N. -3)	0.02171
15% term loans	12.5	0.214	0.09 (W. N. 4)	0.01926
	58.5	1.00		0.13927

(b) Statement showing computation of weighted average cost of capital by using market value proportion:

Source of finance	Amount (₹ in crores)	Weighted (Market value Proportion)	Cost of capital	Weighted cost of capital
		(a)	(b)	(c) = (a) × (b)
Equity capital	60.00 (₹ 1.5 cr × ₹ 40)	0.739	0.16 (W.N.-1)	0.11824
11% Preference capital	0.75 (₹ 1 lacs × ₹ 75)	0.009	0.1543 (W.N.-2)	0.00138
13.5% Debenture	8.00 (₹ 10 lacs × ₹ 80)	0.098	0.127 (W.N.-4)	0.01245
15% term loans	12.50	0.154	0.09 (W.N.-4)	0.01386
Weighted average cost of capital	81.25	1.00		0.14593 Or 14.59%

Note: Since Retained earning are treated as equity capital for purposes of calculation of cost of specific source of finance, the market value of the ordinary shares may be taken to represent the combined market value of equity shares & retained earning. The separate market values of retained earnings & ordinary shares may also be worked out by allocating to each of these a percentage of total market value equal to their percentage share of the total based on book values.

(ii) Statement showing weighted marginal cost of capital schedule for the company, if it raises ₹ 10 crores next year given the following information:

Source of finance	Amount (₹ in crores)	Weight (a)	Cost of capital (b)	Weighted marginal cost of capital (c) = (a) × (b)
1. Retained earnings	1.5	0.5	0.16 (W.N.-1)	0.08
Debt	1.5	0.5	0.09 (W.N.-6)	0.045
Weighted marginal cost of capital				0.125 or 12.5%
2. Equity shares	1	0.5	0.1825 (W.N.-6)	0.09125
Debt	1	0.5	0.09 (W.N.-6)	0.045
Weighted marginal cost of capital				0.13625 or 13.625%
3. Equity shares	2.5	0.5	0.1825 (W.N.-5)	0.09125
Debt	2.5	0.5	0.096 (W.N.-6)	0.048
Weighted marginal cost of capital				0.13925 or 13.92%

Working Notes:

1. Cost of Equity Capital & retained earnings (K_e):

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

Where,

K_e = Cost of equity capital

D_1 = Expected dividend at the end of year 1

P_0 = Current market price of equity shares

g = Growth rate of dividend

Given,

D_1 = ₹ 3.60

P_0 = ₹ 40

g = 7%

$\therefore K_e = \frac{₹ 3.60}{₹ 40} + 0.07 \Rightarrow K_e = 16\%$

$K_v = K_e = 16\%$

2. Cost of Preference capital (k_p):

$$k_p = \frac{D + \left(\frac{F - P}{n}\right)}{\left(\frac{F + P}{2}\right)}$$

Where,

D = Preference dividend

F = Face value of
Preferences share

P = Current market Price
of Preferences shares.

n = Redemption period of
Preference shares.

Given, $D = 11\%$, $F = ₹ 100$, $P = ₹ 75$ & $n = 10$ years.

$$\therefore k_p = \frac{11 + \left(\frac{100 - 75}{10}\right)}{\left(\frac{100 + 75}{2}\right)} \times 100 = 15.43\%$$

3. Cost of Debenture (k_d):

$$k_d = \frac{r(1-t) + \frac{F-P}{n}}{\frac{F+P}{2}}$$

Where,

r = Interest on debenture.

t = Tax rate applicable to the co.

F = Face value of debenture

P = Current Market Price of debenture

n = Redemption Period of debentures.

Given,

R = 13.5%, t = 40%, F = ₹ 100, P = ₹ 80 & n = 6 years.

$$\therefore k_d = \frac{13.5(1-0.40) + \left(\frac{100-80}{6}\right)}{\frac{100+80}{2}} \times 100 = \mathbf{12.70\%}$$

4. Cost of term loans (k_d):

$$K_t = r(1-t)$$

Where,

r = rate of Interest on term loans

t = tax rate applicable to the co.

Given,

r = 15%

t = 40%

$$\therefore K_t = 15\%(1-0.40) = \mathbf{9\%}$$

5. Cost of fresh equity share (k_e):

$$k_e = \frac{D_1}{P} + g$$

Given,

 $D_1 = 3.60$ $P = ₹ 32$ $g = 7\%$

$$\therefore k_e = \frac{3.60}{32} + 0.07 = \mathbf{18.25\%}$$

6. Cost of debt (k_d):

$$k_d = r(1-t)$$

(for first ` 2.5 crores)

r = 15%

$$t = 40\%$$

$$\therefore k_d = 15\% (1 - 0.40) = 9\%$$

(for the next 2.5 crores)

$$r = 16\% \text{ \& } t = 40\%$$

$$\therefore k_d = 16\% (1 - 0.40) = 9.6\%$$

Problem 9: Kashi Ltd. is considering raising of funds of about ₹250 lakhs by any of two alternative methods, viz., 14% institutional term loan and 13% non-convertible debentures. The term loan option would attract no major incidental cost and can be ignored. The debentures would have to be issued at a discount of 2.5% and would involve cost of issue of 2% on face value. Advise Kashi Ltd. as to the better option based on the effective cost of capital in each case. Assume a tax rate of 50%.

Solution:

Calculation of Effective Cost of Capital

Particulars	Option 1 14% Institutional Term Loan (₹ in lakhs)	Option 2 13% Non-convertible Debentures (₹ in lakhs)
(A) Effective capital to be raised Face value	250.00	250.00
Less: Discount	Nil	(6.25)
	250.00	243.75
Less: Cost of issue	Nil	5.00
Effective amount of capital	250.00	238.75
(B) Annual Interest charges on face value of ₹ 250 lakhs	35.0	32.50
Less: Tax benefit on interest @ 50%	17.5	16.25
	17.5	16.25
(C) Effective cost of capital after tax	B/A x 100 = 7.0%	(16.25/238.75) x 100 = 6.81% (approx.)

So, the better option is raising of funds of ₹ 250 lakhs by issue of 13% Non-convertible Debenture

Problem 10: Calculate the WACC using the following data by using (a) Book value weights (b) Market value weights.

The capital structure of the company is as under:

Particulars	(₹)
Debentures (₹ 100 per debentures)	5,00,000
Preference shares (₹ 100 per share)	5,00,000
Equity shares (₹ 10 per share)	10,00,000
	20,00,000

The market prices of these securities are:

Debentures: ₹ 105 per debentures; Preference shares: ₹ 110 per preference share; Equity shares: ₹ 24 each.

Additional Information:

- (i) ₹100 per debentures redeemable at par, 10% coupon rate, 4% flotation costs, 10-year maturity.
- (ii) ₹100 per preference share redeemable at par, 5% coupon rate, 2% flotation cost and 10-year maturity.
- (iii) Equity share has ₹ 4 flotation cost and market price ₹ 24 per share.

The next year expected dividend is ₹ 1 with annual growth of 5%. The firm has practice of paying all earnings in the form of dividend. Corporate tax rate is 30%.

Use YTM method to calculate cost of debentures & preference shares.

Hint: Assume Issue Price is equal to Market Price

Solution:

$$(i) \text{ Cost of Equity (Ke)} = Ke = \frac{D_1}{P_0 - F} + (g) = \frac{1}{24 - 4} + 0.05 = \mathbf{0.1 \text{ or } 10\%}$$

(ii) **Cost of Debt (Kd):** Current market price (P_0)-flotation cost = ₹ 105 - 4% of ₹ 105 = **100.8**

Calculation of NPV at discount rate of 5% and 7%

Year	Cash flows (₹)	Discount factor @ 5%	Present Value	Discount factor @ 7%	Present Value (₹)
0	100.8	1.000	(100.8)	1.000	(100.8)
1 to 10	7	7.722	54.05	7.024	49.17
10	100	0.614	61.40	0.508	50.80
NPV			+14.65		-0.83

Calculation of IRR: IRR =

$$5\% + \frac{14.65}{14.65 - (0.83)} (7\% - 5\%) = 5\% + \frac{14.65}{15.48} (7\% - 5\%) = \mathbf{6.89\%}$$

Cost of Debt (Kd) = 6.89%

(iii) **Cos of Preference shares (Kp):** Current market price (P_0) - flotation cost = ₹ 110 - 2% of 110 = **107.8**

Calculation of NPV at discount rate of 3% and 5%

Year	Cash flows (₹)	Discount factor @ 3%	Present Value	Discount factor @ 5%	Present Value (₹)
0	107.8	1.000	(107.8)	1.000	(107.8)
1 to 10	5	8.530	42.65	7.722	38.61
10	100	0.744	74.40	0.614	61.40
NPV			+9.25		-7.79

$$\text{Calculation of IRR: IRR} = 3\% + \frac{9.25}{9.25 - (-7.79)} (5\% - 3\%) = 3\% + \frac{9.25}{17.04} (5\% - 3\%) = \mathbf{4.08\%}$$

Cost of Preference Shares (Kp) = 4.08%

(a) Calculation of WACC using book value weights.

Source of Capital	Book Value	Weights	After tax cost of capital	WACC (Ko)
	(₹)	(a)	(b)	(c) = (a) x (b)
10% Debentures	5,00,000	0.25	0.0689	0.01723
5% Preference shares	5,00,000	0.25	0.0408	0.0102
Equity shares	10,00,000	0.50	0.10	0.05000
	20,00,000	1.00		0.07743

(b) Calculation of WACC using market value weights

Source of Capital	Market Value	Weights	After tax cost of capital	WACC (Ko)
	(₹)	(a)	(b)	(c) = (a) x (b)
10% Debentures (₹ 105 x 5,000)	5,25,000	0.151	0.0689	0.0104
5% Preference shares (₹ 110 x 5,000)	5,50,000	0.158	0.0408	0.0064
Equity shares (₹ 24 x 1,00,000)	24,00,000	0.691	0.10	0.0691
	34,75,000	1.000		0.0859

WACC (Ko) = 0.0859 or 8.59%

Problem 11: Totto Ltd. has following capital structure as on 31st 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.

Solution:

Calculation of after-tax cost of the followings:

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

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

Where,

I = Interest

t = Tax rate

PD = Preference dividend

NP = Net proceeds

$$\begin{aligned} \text{(b) Equity Shares (Retained Earnings) } K_e &= \frac{\text{Expected dividend } (D_1)}{\text{Current Market price } (P_0)} + (\text{Growth Rate } (g)) \\ &= \frac{50\% \text{ of ₹ } 3.023}{\text{₹ } 30.25} + 0.11^* = \mathbf{0.16 \text{ or } 16\%} \end{aligned}$$

Growth rate (on the basis of EPS) is calculated as Below:

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

(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 (a)	After tax Cost of capital (%) (b)	WACC (%) (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 {₹ 3,02,300 / 80 × 100} = ₹ 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:

= 0.1787 or 17.87%

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

Source of capital	Weight (a)	After tax Cost of capital (%) (b)	WACC (%) (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

Problem 12: Capital structure of D Ltd. as on 31st March, 2023 is given below:

Particulars	₹
Equity share capital (₹ 10 each)	30,00,000
8% Preference share capital (₹ 100 each)	10,00,000
12% Debentures (₹ 100 each)	10,00,000

• Current market price of equity share is ₹ 80 per share. The company has paid dividend of ₹ 14.07 per share. Seven years ago, it paid dividend of ₹ 10 per share. Expected dividend is ₹ 16 per share.
 • 8% Preference shares are redeemable at 6% premium after five years. Current market price per preference share is ₹ 104.
 • 12% debentures are redeemable at 20% premium after 10 years. Flotation cost is ₹ 5 per debenture.
 • The company is in 40% tax bracket.
 • In order to finance an expansion plan, the company intends to borrow 15% Long-term loan of ₹ 30,00,000 from bank. This financial decision is expected to increase dividend on equity share from ₹ 16 per share to ₹ 18 per share. However, the market price of equity share is expected to decline from ₹ 80 to ₹ 72 per share, because investors' required rate of return is based on current market conditions.

Required:

- Determine the existing Weighted Average Cost of Capital (WACC) taking book value weights.
- Compute Weighted Average Cost of Capital (WACC) after the expansion plan taking book value weights.

Interest Rate	1%	2%	3%	4%	5%	6%	7%
FVIF_{i,5}	1.051	1.104	1.159	1.217	1.276	1.338	1.403
FVIF_{i,6}	1.062	1.126	1.194	1.265	1.340	1.419	1.501
FVIF_{i,7}	1.072	1.149	1.230	1.316	1.407	1.504	1.606

[May 2023]

Solution:



(i) (a) Growth rate in Dividends

$$14.07 = 10 \times \text{FVIF}(i, 7 \text{ years})$$

$$\text{FVIF}(i, 7 \text{ years}) = 1.407$$

$$\text{FVIF}(5\%, 7 \text{ years}) = 1.407$$

$$i = 5\%$$

$$\text{Growth rate in dividend} = 5\%$$

(b) Cost of Equity

$$K_e = \frac{D_1}{D_0} + g = \frac{16}{80} + .05 = .25 \text{ or } 25\%$$

$$K_e = 16 / 80 = 0.20$$

$$K_e = 25\%$$

(c) Cost of Preference Shares

$$K_p = \frac{PD + \frac{(RV - NP)}{n}}{\frac{(RV - NP)}{2}}$$

$$K_p = \frac{8 + \frac{(106-104)}{5}}{\frac{(106+104)}{2}}$$

$$K_p = 8.4/105 = 08 = \mathbf{8\%}$$

(d) Cost of Debit

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

$$K_d = \frac{12(1-04) + \frac{(120-95)}{10}}{\frac{(120+95)}{2}}$$

$$K_d = (7.2+2.5)/107.5 = \mathbf{9.02\%}$$

$$K_d = 9.02\%$$

Calculation of existing Weighted Average Cost of Capital (WACC)

Capital	Amount (₹)	Weights	Cost	WACC
Equity Share Capital	30,00,000	0.6	25%	15.00%
Preference Share Capital	10,00,000	0.2	8%	1.60%
Debenture	10,00,000	0.2	9.02%	1.80%
	50,00,000	1		18.40%

(i)**Computation of existing WACC on book value weights**

Source (1)	Book value (₹) (2)	Weight (3)	Cost of capital (%) (4)	Product (2) x (4)
Equity share capital	30,00,000	0.60	25	7,50,000
Preference share capital	10,00,000	0.20	8	80,000
Debentures	10,00,000	0.20	9.02	90,200
Total	50,00,000	1.00		9,20,200

$$\text{WACC} = (\text{Product} / \text{Total book value}) \times 100 = (9,20,200 / 50,00,000) \times 100 = \mathbf{18.4\%}$$

(ii) Cost of Long Term Debt = 15% (1-0.4) = 9%

$$\text{Revised } K_e = 18 / 72 + 0.05 = \mathbf{30\%}$$

Calculation of WACC after expansion taking book value weights

Capital	Amount	Weights	Cost	W.C
Equity Share Capital	30,00,000	0.3750	30%	11.25%
Preference Share Capital	10,00,000	0.1250	8%	1.00%
Debenture	10,00,000	0.1250	9.02%	1.13%
Long Term Debt	30,00,000	0.3750	9.00%	3.38%
	80,00,000	1.0000		16.76%

Alternative presentation**(i)****Computation of WACC on book value weights after expansion**

Source (1)	Book value (₹) (2)	Weight (3)	Cost of capital (%) (4)	Product (2) x (4)
Equity share capital	30,00,000	0.375	30	9,00,000
Preference share capital	10,00,000	0.125	8	80,000
Debentures	10,00,000	0.125	9.02	90,200
Long term loan	30,00,000	0.375	9	2,70,000
Total	80,00,000	1.00		13,40,200

$$\text{WACC} = (\text{Product} / \text{Total book value}) \times 100 = (13,40,200 / 80,00,000) \times 100 = \mathbf{16.76\%}$$

3

CHAPTER

EBIT-EPS ANALYSIS

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Important Questions

January 2025



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NANDA CHATURVED 74 MARKS	ARYAN MERATWAL 73 MARKS	DEEPANSHI JAIN 73 MARKS	KAUSHAL ARORA 73 MARKS	PREETHAM BHAT 73 MARKS	SONALI VIJ 73 MARKS
ANKIT JAIN 72 MARKS	MAYURI PRAMOD 72 MARKS	SANCHIT 72 MARKS	SONU AGRAWAL 72 MARKS	TANYA BANSAL 72 MARKS	ANURAG AGGRAWAL 71 MARKS
CHIRAG JAIN 70 MARKS	NITESH LAHU 70 MARKS	PARAS BANSAL 70 MARKS	RAJSHREE 70 MARKS	RAJVI DILIP 70 MARKS	YASH JAIN 70 MARKS

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CHAPTER THREE



EBIT-EPS ANALYSIS

LIST OF IMPORTANT QUESTIONS JANUARY 2025



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Problem 1: The Sangharsh Ltd. needs ₹ 5,00,000 for construction of a new plant. The following three financial plans are feasible:

- The company may issue 50,000 equity shares at ₹ 10 per share.
- The company may issue 25,000 equity shares at ₹ 10 per share and 2,500 debentures of ₹ 100-denomination bearing 8% rate of interest.
- The company may issue 25,000 equity shares at ₹ 10 per share and 2,500 preference shares at ₹ 100 per share bearing 8% rate of dividend.

If the company's earnings before interest and taxes are ₹ 10,000, ₹ 20,000, ₹ 40,000, ₹ 60,000 and ₹ 1,00,000, what are the earnings per share under each of three financial plans? Which alternative would you recommend and why? Assume corporate tax rate to be 50%.

[Similar May - 2019]

Solution:

Calculation of EPS under the three financial plans for ZBB Ltd.

(i) First alternative financing plan:

Particulars	1 (₹)	2 (₹)	3 (₹)	4 (₹)	5 (₹)
EBIT	10,000	20,000	40,000	60,000	1,00,000
Less: Interest	0	0	0	0	0
PBT	10,000	20,000	40,000	60,000	1,00,000
Less: Taxes @ 50%	(5,000)	(10,000)	(20,000)	(30,000)	(50,000)
PAT	5,000	10,000	20,000	30,000	50,000
No. of equity shares	50,000	50,000	50,000	50,000	50,000
EPS (₹)	0.1	0.2	0.4	0.6	1

(ii) Second alternative financing plan

Particulars	1 (₹)	2 (₹)	3 (₹)	4 (₹)	5 (₹)
EBIT	10,000	20,000	40,000	60,000	1,00,000
Less: Interest	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)
PBT	(10,000)	0	20,000	40,000	80,000
Less: Taxes @ 50%	(5,000)	0	(10,000)	(20,000)	(40,000)
PAT	(5,000)	0	10,000	20,000	40,000
No. of equity shares	25,000	25,000	25,000	25,000	25,000
EPS (₹)	(0.20)	0	0.4	0.8	1.6

On loss the company can get tax credit and it is assumed that the tax credit is given immediately.

(iii) Third alternative financing plan

Particulars	1 (₹)	2 (₹)	3 (₹)	4 (₹)	5 (₹)
EBIT	10,000	20,000	40,000	60,000	1,00,000
Less: Interest	0	0	0	0	0
PBT	10,000	20,000	40,000	60,000	1,00,000
Less: Taxes @ 50%	(5,000)	(10,000)	(20,000)	(30,000)	(50,000)
PAT	5,000	10,000	20,000	30,000	50,000
Less: Preference dividend	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)
Earning for equity Shareholders	(15,000)	(10,000)	0	10,000	30,000
No. of equity shares	25,000	25,000	25,000	25,000	25,000
EPS (₹)	(0.6)	(0.4)	0	-0.4	1.2

Analysis: From the analysis of the above three alternatives of financing, alternative – II gives more EPS when the EBIT is ₹ 1,00,000 and the company issues 25,000 equity shares of ₹ 10 per share and 2,500 debentures of ₹ 100 @ 8% rate of interest.

Problem 2: A company needs ₹ 12,00,000 for the installation of a new factory which would yield an annual EBIT of ₹ 2,00,000. The company has the objective of maximizing the earnings per share. It is considering the possibility of issuing equity shares plus raising a debt of ₹ 2,00,000, ₹ 6,00,000 or ₹ 10,00,000. The current market price of the share is ₹ 40 and will drop to ₹ 25 per share if the market borrowings were to exceed ₹ 7,50,000. Cost of borrowings are indicated as under:

Upto ₹ 2,50,000	...	10% p.a.
Between ₹ 2,50,001 and ₹ 6,25,000	...	14% p.a.
Between ₹ 6,25,001 and ₹ 10,00,000	...	16% p.a.

Assuming the tax rate to be 50%. Work out the EPS.

Solution:



Particulars	Plan I (₹)	Plan II (₹)	Plan III (₹)
Total financing	12,00,000	12,00,000	12,00,000
- Debt financing	2,00,000	6,00,000	10,00,000
Equity financing	10,00,000	6,00,000	2,00,000
Issue price	40	40	25
Number of shares	25,000	15,000	8,000
Computation of interest:			
10% of ₹ 2,00,000	20,000	—	—
10% of ₹ 2,50,000	—	25,000	25,000
14% of ₹ 3,50,000	—	49,000	—
14% of ₹ 3,75,000	—	—	52,500
14% of ₹ 3,75,000	—	—	60,000
Total interest	20,000	74,000	1,37,500
Calculation of EPS:			
EBIT	2,00,000	2,00,000	2,00,000
Less: Interest	20,000	74,000	1,37,500
Profit before tax	1,80,000	1,26,000	62,500
Less: Tax @ 50%	90,000	63,000	31,250
Profit after tax	90,000	63,000	31,250
Number of shares	25,000	15,000	8,000
EPS (₹) $\left(\frac{\text{Profit after tax}}{\text{No. of shares}} \right)$	3.6	4.2	3.91

The EPS is highest (i.e. ₹ 4.20) under the plan II. The borrowings under this plan i.e. ₹ 6,00,000 is also within limits and the market price would be maintained at ₹ 40.

Problem 3: Ummeed Software Ltd. has appointed you as its finance manager. The company wants to implement a project for which ₹ 30 lakhs is required to be raised from the market as a means of financing the project. The following financing plans and options are at hand:

Particulars	Plan A	Plan B	Plan C
	(No. in thousands)		
Option 1:			
Equity shares	30	30	30
Option 2:			
Equity shares	15	20	10
12% Preference Shares	Nil	10	10
10% Non-Convertible debentures	15	Nil	10

Assuming corporate tax to be 55% and the face value of all the shares and debentures to be ₹ 100 each, calculate the indifference points and earning per share (EPS) of each of the financing plans.

Solution:**Plan A**

$$\frac{\text{EBIT} (1 - t)}{N_1} = \frac{(\text{EBIT} - \text{Int.}) (1 - t)}{N_2}$$

$$\frac{\text{EBIT} (1 - 0.55)}{30,000} = \frac{\text{EBIT} (1 - 1,50,000) (1 - 0.55)}{15,000}$$

⇒ By solving the above the equation, the value of EBIT comes to ₹ 3,00,000

Plan B

$$\frac{\text{EBIT} (1 - t)}{N_1} = \frac{\text{EBIT} (1 - t) - \text{PD}}{N_2}$$

$$\frac{\text{EBIT} (1 - 0.55)}{30,000} = \frac{\text{EBIT} (1 - 0.55) - 1,20,000}{20,000}$$

⇒ By solving the above the equation, the value of EBIT comes to ₹ 8,00,000

Plan C

$$\frac{\text{EBIT} (1 - t)}{N_1} = \frac{(\text{EBIT} - \text{Int.}) (1 - t) - \text{PD}}{N_2}$$

$$\frac{\text{EBIT} (1 - 0.55)}{30,000} = \frac{(\text{EBIT} - 1,00,000) (1 - 0.55) - 1,20,000}{10,000}$$

⇒ By solving the above the equation, the value of EBIT comes to ₹ 5,50,000

Options	Plan - A		Plan - B		Plan - C	
	1	2	1	2	1	2
Earnings before interest on taxes	3,00,000	3,00,000	8,00,000	8,00,000	5,50,000	5,50,000
Less: Interest	—	1,50,000	—	—	—	1,00,000
Earning before tax	3,00,000	1,50,000	8,00,000	8,00,000	5,50,000	4,50,000
Less: Tax (55%)	1,65,000	82,500	4,40,000	4,40,000	3,02,500	2,47,500
Earning after tax	1,35,000	67,500	3,60,000	3,60,000	2,47,500	2,02,500
Less: preference dividend	—	—	—	1,20,000	—	1,20,000
Earning to equity shares	1,35,000	67,500	3,60,000	2,40,000	2,47,500	82,500
No. of equity shares	30,000	15,000	30,000	20,000	30,000	10,000
EPS (₹) $\left(\frac{\text{Earning to equity shares}}{\text{No. of equity shares}} \right)$	4.50	4.5	12	12	8.25	8.25

Recommendation: The company is advised to accept Plan B, where EPS is the highest i.e., ₹ 12.00

Recommendation: The company is advised to accept Plan B, where EPS is the highest i.e., ₹ 12.00

Problem 4: DMC Corporation currently has 100,000 shares of common stock outstanding with a market price of ₹ 50 per share. It also has ₹ 2 million in 7% bonds (currently selling at par). The company is considering a ₹ 4 million expansion program that it can finance with either (I) all common stock at ₹ 50 per share, or (II) all bonds at 9%. The company estimates that if the expansion program is undertaken, it can attain, in the near future, ₹ 1 million in EBIT.

- The company's tax rate is 40%. Calculate the EPS for each plan.
- Draw the EBIT - EPS graph.
- What is indifference point between the alternatives?
- If the expected EBIT for the near future is greater than your answer in (c) what form of financing would you recommend?

Solution:

(a) The EPS is computed as follows:

Particulars	(I) All Stock (₹)	(II) All Bonds (₹)
EBIT	10,00,000	10,00,000
Interest	140,000 ^a	500,000 ^b
EBT	860,000	500,000
Tax (40%)	344,000	200,000
EAT	516,000	300,000
Numbers of shares	180,000 ^c	100,000
EPS	₹ 2.87	₹ 3.00

^a ₹ 2,000,000 × 7% = ₹ 140,000

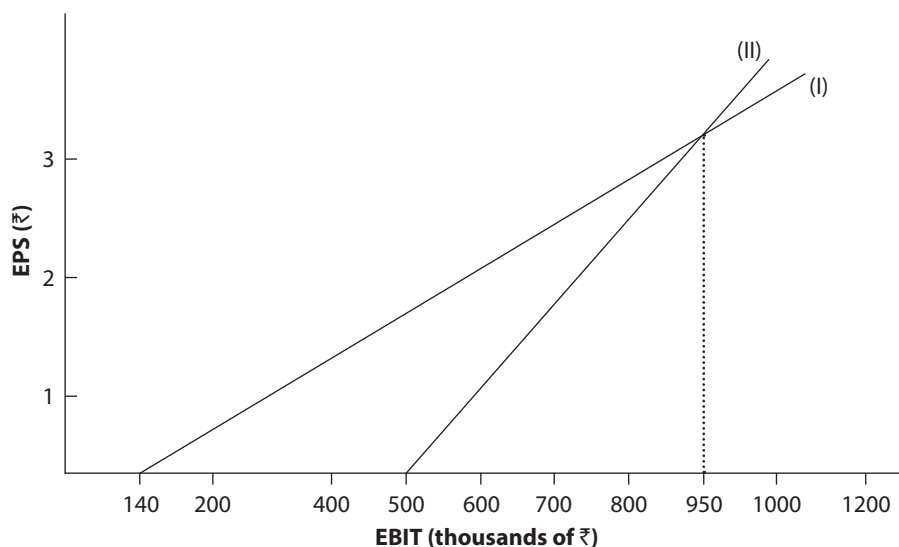
^b ₹ 4,000,000 × 9% = ₹ 360,000

₹ 360,000 + ₹ 140,000 = ₹ 500,000

^c ₹ 4,000,000 ÷ ₹ 50 per share = 80,000 shares.

Therefore, 100,000 + 80,000 = 180,000 shares

(b) The EBIT - EPS graph is shown below



(c)

$$EPS = \frac{(EBIT - I)(1 - t)}{\text{No. of shares outstanding}}$$

The EBIT - EPS indifference points between plans (I) and (II) are calculated as follows:

$$\begin{aligned} \text{EPS under Plant (I)} &= \text{EPS under plan (II)} \\ \frac{(\text{EBIT} - 140,000)(1 - 0.4)}{1,80,000} &= \frac{(\text{EBIT} - 5,00,000)(1 - 0.4)}{1,00,000} \\ (0.6 \text{ EBIT} - 84,000)(100,000) &= (0.6 \text{ EBIT} - 300,000)(180,000) \\ 48,000 \text{ EBIT} &= 45,600,000 \\ \text{EBIT} &= ₹ 950,000 \end{aligned}$$

(d) Plan (II), all bonds, is preferred.

Problem 5: Dream Ltd. is planning an expansion programme which will require ₹ 30 crores and can be funded through one of the three following options:

- (a) Issue further equity shares of ₹ 100 each at par,
- (b) Raise loans at 15% interest,
- (c) Issue preference shares at 12%.

Present paid up capital is ₹ 60 crores and average annual EBIT is ₹ 12 crores. Assume I.T. rate at 50%

After the expansion, EBIT is expected to be ₹ 15 crores p.a.

Calculate EPS under the three financing options indicating the alternative giving the highest return to the equity shareholders.

Determine the point of indifference between Equity Share Capital and Debt (i.e. option (a) and (b) above).

Solution: Calculation of EPS under the following three financing options.

Financing option 1 - issue further equity shares of ₹ 100 each at par.

Financing option 2 - Raise loans @ 15% interest.

Financing option 3 - issue of preference shares at 12%.

Calculation of EPS

(₹ crores)

Particulars	Financing option		
	1	2	3
EBIT	15	15	15
Less: Interest	—	4.5	—
EBT	15	10.5	15
Less: Tax 50%	7.50	5.25	7.50
EAT	7.5	5.25	7.5
Less: Preference dividend	—	—	3.6
Earnings available to equity holders (A)	7.5	5.25	3.9
No. of equity shares (In lakhs)			
Existing	60	60	60
New	30	—	—
Total (B)	90	60	60
EPS (₹) (A) ÷ (B)	8.33	8.75	6.5

Analysis: Financing option 2 i.e., raising of loans @ 15% interest gives the highest EPS of ₹ 8.75.

Determination of Indifference point between equity share capital and debt.

Indifference point represents the point where EBIT at which EPS under two financing options is same. The indifference point is calculated by applying the following formula.

$$\frac{(EBIT - I_1)(1 - T)}{N_1} = \frac{(EBIT - I_2)(1 - T)}{N_2}$$

$$\frac{(EBIT - 0)(1 - 0.5)}{0.90} = \frac{(EBIT - 4.5)(1 - 0.50)}{0.60}$$

or $EBIT (0.5) (0.60) = (EBIT - 4.5) (0.50) 0.90$

or $0.3 EBIT = 0.45 EBIT - 2.025$

or $0.15 EBIT = 2.025$

$$EBIT = 13.5 \text{ crores}$$

Problem 6: The management of Z Company Ltd. wants to raise its funds from market to meet out the financial demands of its long-term projects. The company has various combination of proposals to raise its funds. You are given the following proposals of the company:

(i) Proposals	% of Equity	% of Debts	% of Preference shares
P	100	—	—
Q	50	50	—
R	50	—	50

(ii) Cost of debt – 10%

Cost of preference shares – 10%

(iii) Tax rate – 50%

(iv) Equity shares of the face value of ₹ 10 each will be issued at a premium of ₹ 10 per share.

(v) Total investment to be raised ₹ 40,00,000.

(vi) Expected earning before interest and tax ₹ 18,00,000

From the above proposals the management wants to take advice from you for appropriate plan after computing the following:

- Earning per share
- Financial break-even-point
- Compute the EBIT range among the plans for indifference. Also indicate if any of the plans dominate.

[Similar Nov - 2022] [May-2011] 12 marks

Solution:

(i) Statement showing Earning per share under different proposals

Particulars	Proposal		
	P (₹)	Q (₹)	R (₹)
Expected EBIT	18,00,000	18,00,000	18,00,000
Less: Interest @ 10% of 20,00,000	—	2,00,000	—
EBT	18,00,000	16,00,000	18,00,000
Less: Tax @ 50%	9,00,000	8,00,000	9,00,000
EAT	9,00,000	8,00,000	9,00,000
Less: Pref. dividend	—	—	2,00,000
Earning for equity shareholders	9,00,000	8,00,000	7,00,000
No. of equity shares	2,00,000	1,00,000	1,00,000
EPS = $\left(\frac{\text{Earning for equity shareholders}}{\text{No. of equity shares}} \right)$	₹ 4.5	₹ 8.00	₹ 7.00

Recommendation: Co. should select debt option having highest EPS among different plans.
Calculation of Capital Structure under different proposals.

P

Q

R

Equity share capital	40,00,000	20,00,000	20,00,000
Preference share capital	—	—	20,00,000
Debts	—	20,00,000	—
	<u>40 Lacs</u>	<u>40 Lacs</u>	<u>40 Lacs</u>

Calculation of Equity Shares issued under different plans:

Face Value = ₹ 10

Issue Price = 10 + 10 = ₹ 20

	P	Q	R
Required Fund:	40 Lacs	20 Lacs	20 Lacs
No. of Equity shares	<u>40 Lacs</u>	<u>20 Lacs</u>	<u>20 Lacs</u>
to be issued	20	20	20
	= 2 lacs	= 1 lac	= 1 lac

Note: It is assumed that cost of preference share is after Tax.

(ii) Financial Break even point:- Required EBIT for EPS

Proposal P: No fixed Financial Cost

Hence, EBIT at FBEP will be zero.

Proposal Q:

Financial B.E.P. = Fixed Financial Cost = **2,00,000**

Proposal R:

$$\text{F.B.E.P.} = \frac{\text{Pref. Dividend}}{(1 - \text{Tax})} = \frac{2,00,000}{50} = \mathbf{4,00,000/-}$$

(iii) EBIT at indifference:

EBIT range for indifference between Proposal P & Q:

$$\frac{(E)(1 - t)}{N_1} = \frac{(E - i)(1 - t)}{N_2}$$

$$\frac{E \times .5}{2,00,000} = \frac{(E - 2,00,000) - (1 - .5)}{1,00,000}$$

$$E = 2E - 4,00,000$$

$$\mathbf{EBIT = 4,00,000/-}$$

Proposal P & R:

$$\frac{(E)(1 - t)}{N_1} = \frac{(E - i)(1 - t)}{N_2}$$

$$= \frac{(E)(1 - .5)}{2,00,000} = \frac{[E(1 - .5) - 2,00,000]}{1,00,000}$$

$$.5E = 2E - 2 \quad [.5E - 2,00,000]$$

$$.5E = E - 4,00,000$$

$$\mathbf{EBIT = 8,00,000/-}$$

Proposal Q & R = If number of equity shares between different plans are same then, indifference point can't be calculate.

Problem 7: Yoyo Limited presently has ₹ 36,00,000 in debt outstanding bearing an interest rate of 10%. It wishes to finance a ₹ 40,00,000 expansion programme and is considering three alternatives: -additional debt @ 12% interest, -preference shares with 11% dividend -the issue of equity shares at ₹ 16 per share. The company has 8,00,000 shares outstanding and is in 40 percent tax bracket

- If earnings before interest and taxes are presently ₹ 15,00,000, what would be earnings per share for the three alternatives, assuming no immediate increase in profitability?
- Develop an indifference chart for these alternatives by giving a rough sketch of Graph. What is the indifference point between various plans mathematically.
- Which alternatives do you prefer? How much would EBIT need to increase before the next alternative would be best?

Solution:



(a)Particulars	Alternatives		
	Alternative-I	Alternative-II	Alternative-III
	Take additional Debt	Issue 11% Preference Shares	Equity shares
	₹	₹	₹
EBIT	15,00,000	15,00,000	15,00,000
Interest on Debts:			
-on existing debt @10%	(3,60,000)	(3,60,000)	(3,60,000)
-on new debt @12%	(4,80,000)	-	-
Profit before taxes	6,60,000	11,40,000	11,40,000
Taxes @ 40%	(2,64,000)	(4,56,000)	(4,56,000)
Profit after taxes	3,96,000	6,84,000	6,84,000
Preference shares dividend	---	(4,40,000)	---
Earnings available to equity share holders	3,96,000	2,44,000	6,84,000
Number of shares	8,00,000	8,00,000	10,50,000
Earnings per share	0.495	0.305	0.851

(b) Approximation Indifference Points:

$$\text{Plan 1 \& Plan 2: } \text{EPS}_{\text{Plan 1}} = \text{EPS}_{\text{Plan 2}} \text{ OR } = \frac{(\text{EBIT}-3,60,000-4,80,000)(1-.40)}{8,00,000} = \frac{(\text{EBIT}-3,60,000)(1-.40)-4,40,000}{8,00,000}$$

There is no Indifference Point.

$$\text{Plan 2 \& Plan 3: } \text{EPS}_{\text{Plan 2}} = \text{EPS}_{\text{Plan 3}}$$

$$= \frac{(\text{EBIT}-3,60,000)(1-.40)-4,40,000}{8,00,000} = \frac{(\text{EBIT}-3,60,000)(1-.40)}{10,50,000} = \text{OR EBIT} = ₹ 34,40,000$$

$$\text{Plan 1 \& Plan 3: } \text{EPS}_{\text{Plan 1}} = \text{EPS}_{\text{Plan 3}}$$

$$= \frac{(\text{EBIT}-3,60,000-4,80,000)(1-.40)}{8,00,000} = \frac{(\text{EBIT}-3,60,000)(1-.40)}{10,50,000} = \text{OR EBIT} = ₹ 23,76,000$$

Breakeven Point Calculation For Graph [EBIT at which EPS is Zero]

Plan 1: EBIT = Financial Break Even Point = Interest = ₹ 3,60,000 + ₹ 4,80,000 = ₹ 8,40,000

Plan 2: EBIT = Financial Break Even Point = Interest +

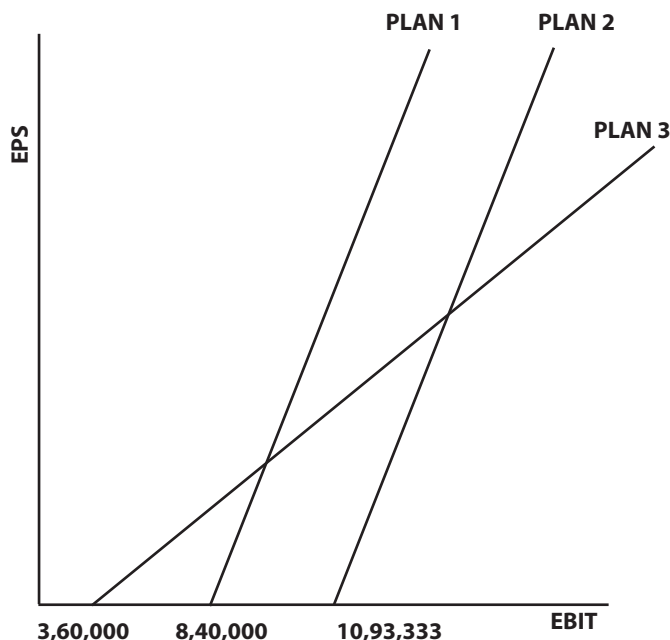
$$\frac{\text{Preference Dividend}}{(1-\text{Tax})} = 3,60,000 + \frac{4,40,000}{(1-.40)} = \text{₹}10,93,333$$

Plan 3: EBIT = Financial Break Even Point = Interest = **₹ 3,60,000**

(c) Equity shares option plan is clearly preferable i.e., Plan No. 3 as EPS Of Plan 3 is maximum.

EBIT should increase by ₹ 23,76,000 – 15,00,000 = ₹ 8,76,000 before any other plan proved to be better.

Graph: Indifference Chart



Problem 8: Best of Luck Ltd., a profit making company, has a paid-up capital of ₹ 100 lakhs consisting of 10 lakhs ordinary shares of ₹ 10 each. Currently, it is earning an annual pre-tax profit of ₹ 60 lakhs. The company's shares are listed and are quoted in the range of ₹ 50 to ₹ 80. The management wants to diversify production and has approved a project which will cost ₹ 50 lakhs and which is expected to yield a pre-tax income of ₹ 40 lakhs per annum. To raise this additional capital, the following options are under consideration of the management:

- To issue equity share capital for the entire additional amount. It is expected that the new shares (face value of ₹ 10) can be sold at a premium of ₹ 15.
- To issue 16% non-convertible debentures of ₹ 100 each for the entire amount.
- To issue equity capital for ₹ 25 lakhs (face value of ₹ 10) and 16% nonconvertible debentures for the balance amount. In this case, the company can issue shares at a premium of ₹ 40 each.

ADVISE which option is the most suitable to raise the additional capital, keeping in mind that the management wants to maximize the earnings per share to maintain its goodwill. The company is paying income tax at 50%.

Solution:**Calculation of Earnings per share under the three options:**

Particulars	Options		
	Option I: Issue Equity shares only	Option II: Issue 16% Debentures only	Options III: Issue Equity Shares and 16% Debentures of equal amount
Number of Equity Shares			
- Existing	10,00,000	10,00,000	10,00,000
- Newly issued	2,00,000	---	50,000
	<u>50,00,000</u> (10+15)		<u>25,00,000</u> (10+40)
Total	12,00,000	10,00,000	10,50,000
16% Debentures (₹)	---	50,00,000	25,00,000
Profit Before Interest and Tax:			
- Existing pre-tax profit	60,00,000	60,00,000	60,00,000
- From new Projects	40,00,000	40,00,000	40,00,000
Less Interest on 15% Debentures	1,00,00,000	1,00,00,000 8,00,000 (16% x ₹ 50,00,000)	1,00,00,000 4,00,000 (16% x ₹ 25,00,000)
Profit Before Tax	1,00,00,000	92,00,000	96,00,000
Less: Tax at 50%	50,00,000	46,00,000	48,00,000
Profit After Tax	50,00,000	46,00,000	48,00,000
Earnings Per Share (EPS)	4.17	4.60	4.57
	<u>PAT</u> No of share)	<u>50,00,000</u> 12,00,000	<u>48,00,000</u> 10,50,000

Advise: Option II i.e., issue of 16% Debentures is most suitable to maximize the earnings per share.

Problem 9: Shahji Steel Limited requires ₹ 25,00,000 for a new plant. This plant is expected to yield earnings before interest and taxes of ₹ 5,00,000. While deciding about the financial plan, the company considers the objective of maximizing earnings per share. It has three alternatives to finance the project - by raising debt of ₹ 2,50,000 or ₹ 10,00,000 or ₹ 15,00,000 and the balance, in each case, by issuing equity shares. The company's share is currently selling at ₹ 150 but is expected to decline to ₹ 125 in case the funds are borrowed in excess of ₹ 10,00,000. The funds can be borrowed at the rate of 10 percent upto ₹ 2,50,000, at 15 percent over ₹ 2,50,000 and upto ₹ 10,00,000 and at 20 percent over ₹ 10,00,000. The tax rate applicable to the company is 50 percent. ANALYSE which form of financing should the company choose?

Solution:

Plan I = Raising Debt of ₹ 2.5 lakh + Equity of ₹ 22.5 lakh

Plan II = Raising Debt of ₹ 10 lakh + Equity of ₹ 15 lakh

Plan III = Raising Debt of ₹ 15 lakh + Equity of ₹ 10 lakh

Calculation of Earnings per share (EPS):

Particulars	Financial Plans		
	Plan I	Plan II	Plan III
	₹	₹	₹
Expected EBIT	5,00,000	5,00,000	5,00,000
Less: Interest (a)	(25,000)	(1,37,500)	(2,37,500)
Earnings before taxes	4,75,000	3,62,500	2,62,500
Less: Taxes @50%	(2,37,500)	(1,81,250)	(1,31,250)
Earnings after taxes (EAT)	2,37,500	1,81,250	1,31,250
Number of shares(b)	15,000	10,000	8,000
Earnings per share (EPS)	15.83	18.13	16.41

Financing Plan II (i.e. Raising debt of ₹ 10 lakh and issue of equity share capital of ₹ 15 lakh) is the option which maximizes the earnings per share.

(a) Calculation of Interest on Debt

Plan		₹	₹
I	(₹ 2,50,000 x 10%)		25,000
II	(₹ 2,50,000 x 10%) (₹ 7,50,000 x 15%)	25,000 1,12,500	1,37,500
III	(₹ 2,50,000 x 10%) (₹ 7,50,000 x 15%) (₹ 5,00,000 x 20%)	25,000 1,12,500 1,00,000	2,37,500

Number of equity shares to be issued

$$\text{Plan I} = \frac{\text{₹ 22,50,000}}{\text{₹ 150 (Market price of share)}} = 15,000 \text{ shares}$$

$$\text{Plan II} = \frac{\text{₹ 15,00,000}}{\text{₹ 150}}$$

$$\text{Plan III} = \frac{\text{₹ 10,00,000}}{\text{₹ 125}}$$

4

CHAPTER

LEVERAGES

*Your time is limited, so don't waste it living someone else's life.
Don't be trapped by dogma which is living with the results of other
people's thinking.*

Important Questions

January 2025

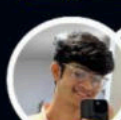
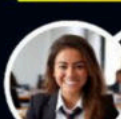
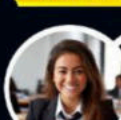


Congratulations

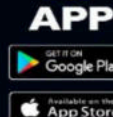
The league of Champions

FM-SM



 75 Marks Sanskar Jain	 75 Marks Shushobit Verma	 75 Marks Mayank Gupta
 74 Marks Vasudev	 72 Marks Preeti Aggarwal	 69 Marks Sandeep Shaw
 69 Marks Shashank	 69 Marks Riya Bansal	 68 Marks Akansha
 68 Marks Arsalan Ali	 67 Marks Abhay Nahar	 67 Marks Harsh
 66 Marks Ankita Rani	 66 Marks Anshu Kumar	 65 Marks Pulkit Luthra
 65 Marks Seerat Sharma	 65 Marks Ayush Sharma	 65 Marks Shubham

3000+ Exemptions
3500+ Above 50 Marks



Congratulations!

The League of Champions

 MEENAKSHI AIR 20	 ROHIT AIR 22	 SHUBHAM AIR 23	 ANUSHKA AIR 36	 CHERRY AIR 37	 SANJEEV AIR 47
 SATYAM KUMAR 87 MARKS	 SUSHANT ARORA 83 MARKS				
 BHARAT GAUTAM 80 MARKS	 PRADEEP ROHILLA 79 MARKS				
 ANUSHKA SHARMA 78 MARKS	 KSHITIZ TAYAL 78 MARKS				
 SAIKAT GHOSH 77 MARKS	 NILESH JAISWAL 76 MARKS				
 NUZAIF AKTHAR 76 MARKS	 KOMAL SANWAL 75 MARKS				
 SHALINI SONI 75 MARKS	 ASHUTOSH KUMAR 74 MARKS				
 NANDA CHATURVEDI 74 MARKS	 ARYAN MERATWAL 73 MARKS				
 DEEPANSHI JAIN 73 MARKS	 KAUSHAL ARORA 73 MARKS				
 PREETHAM BHAT 73 MARKS	 SONALI VIJ 73 MARKS				
 ANKIT JAIN 72 MARKS	 MAYURI PRAMOD 72 MARKS				
 SANCHIT 72 MARKS	 SONU AGRAWAL 72 MARKS				
 TANYA BANSAL 72 MARKS	 ANURAG AGGRAWAL 71 MARKS				
 CHIRAG JAIN 70 MARKS	 NITESH LAHU 70 MARKS				
 PARAS BANSAL 70 MARKS	 RAJSHREE 70 MARKS				
 RAJVI DILIP 70 MARKS	 YASH JAIN 70 MARKS				

OTC CHAMPIONS

CHAPTER FOUR

Video for Interpretation of the List:
<https://youtu.be/dVq9NF7s8l4>



LEVERAGES

LIST OF IMPORTANT QUESTIONS JANUARY 2025



**FM-SM
REGULAR** Batch
JAN/MAY/SEPT 2025



**FM-SM
EXAM-ORIENTED** Batch
JAN/MAY/SEPT 2025



LATEST HD
RECORDING



PROF. OM TRIVEDI



100% ICAI MAT
COVERAGE

STARTING FROM: ₹8,990/- ~~₹10,990/-~~

Guarantee जीत की - अबकी_बार_90_पार

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LATEST HD
RECORDING



PROF. OM TRIVEDI



100% ICAI MAT
COVERAGE

STARTING FROM: ₹4,990/- ~~₹8,990/-~~

Guarantee जीत की - अबकी_बार_90_पार

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NEW CA INTER

FM-SM



100%

ENGLISH BATCH

JAN/MAY-25



Prof. Om Trivedi

ENROLL NOW

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Problem 1:

 EBIT	= ₹ 90,000
Interest	= ₹ 15,000
Income tax rate	= 30%
Preference Dividend	= ₹ 9,000
Corporate Dividend tax (DT)	= ₹ 1,500

Find financial leverage. Suppose, EBIT increases by 20%, then how much the earnings for equity will increase

Solution:

 EBIT	₹ 90,000
Less: Interest	15,000
EBT	75,000
Less: Tax (30%)	22,500
EAT	52,500
Less: Preference Dividend	9,000
Less: Dividend tax (CDT)	1,500
Earnings after tax for equity	42,000

$$\text{Financial leverage} = \frac{\text{EBIT}}{\text{EBT for equity}} = \frac{\text{EBIT}}{\frac{\text{EAT for equity}}{1 - \text{tax}}} = \frac{90,000}{\frac{42,000}{1 - 0.30}} = \frac{90,000}{\frac{42,000}{0.70}} = \frac{90,000}{60,000} = 1.5 \text{ times}$$

Alternatively,

$$\begin{aligned} \text{Financial leverage} &= \frac{\text{EBIT}}{\text{EBIT} - \text{Interest} - \left(\frac{\text{Preference Dividend} + \text{CDT}}{1 - \text{tax rate}} \right)} \\ &= \frac{90,000}{90,000 - 15,000 - \frac{9,000 + 1,500}{1 - 0.3}} = \frac{90,000}{75,000 - 15,000} = \frac{90,000}{60,000} = 1.5 \text{ times} \end{aligned}$$

Suppose EBIT increases by 20% then Earnings for equity will increase by 30% ($20\% \times 1.5 \text{ times}$)

Revised Position	₹
EBIT ($90,000 \times 120\%$)	1,08,000
Less: Interest	15,000
EBT	93,000
Less: Tax (30%)	27,900
EAT	65,100
Less: Preference Dividend	9,000
Less: Dividend Tax	1,500
Earning for equity	54,600

$$\% \text{ increase in Earning for equity} = \frac{54,600 - 42,000}{42,000} \times 100 = 30\%$$

Problem 2: Details of a company for the year ended 31st March, 2022 are given below:

 Sales	₹ 86 lakhs
Profit Volume (P/V) Ratio	35%
Fixed Cost excluding interest expenses	₹ 10 lakhs
10% Debt	₹ 55 lakhs

Equity Share Capital of ₹ 10 each	₹ 75 lakhs
Income Tax Rate	40%

Required:

1. Determine company's Return on Capital Employed (Pre-tax) and EPS.
2. Does the company have a favourable financial leverage?
3. Calculate operating and combined leverages of the company.
4. Calculate percentage change in EBIT, if sales increases by 10%.
5. At what level of sales, the Earning before Tax (EBT) of the company will be equal to zero? [May 2022]

Solution:

Particulars	Amount (₹)
Sales	86,00,000
Less: Variable cost (65% of 86,00,000)	55,90,000
Contribution (35% of 86,00,000)	30,10,000
Less: Fixed costs	10,00,000
Earnings before interest and tax (EBIT)	20,10,000
Less: Interest on debt (@ 10% on ₹ 55 lakhs)	5,50,000
Earnings before tax (EBT)	14,60,000
Tax (40%)	5,84,000
PAT	8,76,000

i. **ROCE (Pre-tax)** = $\frac{\text{EBIT}}{\text{Capital Employed}} \times 100 = \frac{\text{EBIT}}{\text{Equity} + \text{Debt}} \times 100$

$$= \frac{₹ 20,10,000}{₹ (75,00,000 + 55,00,000)} \times 100 = \mathbf{15.46\%}$$

EPS (PAT/No. of equity shares) 1.168 or ₹ 1.17

ii. **ROCE is 15.46% and Interest on debt is 10%. Hence, it has a favourable financial leverage.**

iii. **Calculation of Operating, Financial and Combined leverages:**

$$\text{Operating Leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{₹ 30,10,000}{₹ 20,10,000} = \mathbf{1.497 \text{ (approx)}}$$

$$\text{Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{₹ 20,10,000}{₹ 14,60,000} = \mathbf{1.377 \text{ (approx)}}$$

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBT}} = \frac{₹ 30,10,000}{₹ 14,60,000} = \mathbf{2.062 \text{ (approx)}}$$

Or, = Operating Leverage × Financial Leverage = 1.497 × 1.377 = **2.06 (approx.)**

(iv) Operating leverage is 1.497. So, if sales are increased by 10%

EBIT will be increased by 1.497 × 10% i.e. **14.97% (approx.)**

(v) Since the combined Leverage is 2.062, sales have to drop by 100/2.062 i.e. 48.50% to bring EBT to Zero.

$$\begin{aligned} \text{Accordingly, New Sales} &= ₹ 86,00,000 \times (1 - 0.4850) \\ &= ₹ 86,00,000 \times 0.515 \\ &= ₹ 44,29,000 \text{ (approx.)} \end{aligned}$$

Hence, at ₹ 44,29,000 sales level, EBT of the firm will be equal to Zero.



Problem 3: Information of A Ltd. is given below:



- Earnings after tax: 5% on sales
- Income tax rate: 50%
- Degree of Operating Leverage: 4 times
- 10% Debenture in capital structure: ₹ 3 lakhs
- Variable costs: ₹ 6 lakhs

Required:

(i) From the given data complete following statement:

Sales	XXXX
Less: Variable costs	₹ 6,00,000
Contribution	XXXX
Less: Fixed costs	XXXX
EBIT	XXXX
Less: Interest expenses	XXXX
EBT	XXXX
Less: Income tax	XXXX
EAT	XXXX

(ii) Calculate Financial Leverage and Combined Leverage.

(iii) Calculate the percentage change in earning per share, if sales increased by 5%.

[Dec 2021]

Solution:



(i) **Working Notes:**

Earning after tax (EAT) is 5% of sales

Income tax is 50%

So, EBT is 10% of Sales

Since Interest Expenses is ₹ 30,000

EBIT = 10% of Sales + ₹ 30,000 (Equation i)

Now Degree of operating leverage = 4

So, $\frac{\text{Contribution}}{\text{EBIT}}$

Or, Contribution = 4 EBIT

Or, Sales – Variable Cost = 4

EBIT Or, Sales – ₹ 6,00,000 = 4 EBIT (Equation ii)

Replacing the value of EBIT of equation (i) in Equation (ii)

We get, Sales – ₹ 6,00,000 = 4 (10% of Sales + ₹ 30,000)

Or, Sales – ₹ 6,00,000 = 40% of Sales + ₹ 1,20,000

Or, 60% of Sales = ₹ 7,20,000

So, Sales = $\frac{₹ 7,20,000}{60\%} = ₹ 12,00,000$

Contribution = Sales – Variable Cost = ₹ 12,00,000 – ₹ 6,00,000 = ₹ 6,00,000

EBIT = $\frac{₹ 6,00,000}{4} = ₹ 1,50,000$

Fixed Cost = Contribution – EBIT = ₹ 6,00,000 – ₹ 1,50,000 = ₹ 4,50,000

$$\text{EBT} = \text{EBIT} - \text{Interest} = ₹ 1,50,000 - ₹ 30,000 = ₹ 1,20,000$$

$$\text{EAT} = 50\% \text{ of } ₹ 1,20,000 = ₹ 60,000$$

Income Statement

Particulars	(₹)
Sales	12,00,000
Less: Variable cost	6,00,000
Contribution	6,00,000
Less: Fixed cost	4,50,000
EBIT	1,50,000
Less: Interest	30,000
EBT	1,20,000
Less: Tax (50%)	60,000
EAT	60,000

$$(ii) \text{ Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{₹ 1,50,000}{₹ 1,20,000} = 1.25 \text{ times}$$

$$\text{Combined Leverage} = \text{Operating Leverage} \times \text{Financial Leverage}$$

$$= 4 \times 1.25 = 5 \text{ times}$$

Or,

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{EBT}}$$

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{₹ 6,00,000}{₹ 1,20,000} = 5 \text{ times}$$

(iii) Percentage Change in Earnings per share

$$\text{Combined Leverage} = \frac{\% \text{ Change in EPS}}{\% \text{ change in Sales}} = 5 = \frac{\% \text{ Change in EPS}}{5}$$

$$\therefore \% \text{ Change in EPS} = 25\%$$

Hence, if sales increased by 5 %, EPS will be increased by 25 %.

Problem 4: The capital structures of the progressive Corporation consists of an ordinary share capital of ₹ 10,00,000 (shares of ₹ 100 per value) and ₹ 10,00,000 of 10% debentures. Sales increased by 20% from 1,00,000 units to 1,20,000 units, the selling price is ₹ 10 per unit; variable cost amount to ₹ 6 per unit and fixed expenses amount to ₹ 2,00,000. The income tax rate is assumed to be ₹ 50%.

You are Required to calculate the following :

- the percentage increase in earning per share;
- the degree of financial leverage at 1,00,000 units to 1,20,000 units.
- The degree of operating leverage at 1,00,000 units and 1,20,000 units.
- Comment** on the behavior of operating and financial leverages in relation to increase in production from 1,00,000 units to 1,20,000 units.

[Similar May - 2015]

Solution: Statement showing EPS and operating and financial leverages at two levels of operations.

	1,00,000 units	1,20,000 units
Sales @ ₹ 10	10,00,000	12,00,000
Less: Variable costs	6,00,000	7,20,000
Contribution	4,00,000	4,80,000
Less: Fixed Expenses	2,00,000	2,00,000
Operating profit (EBIT)	2,00,000	2,80,000
Less: Interest	1,00,000	1,00,000
Profit before tax (EBT)	1,00,000	1,80,000
Less: 50% Tax	50,000	90,000
Profit after Tax (EAT)	50,000	90,000
No. of ordinary Share (₹ 10,00,000 ÷ ₹ 100)	10,000	10,000
Earning per share [EAT ÷ No. of ordinary shares]	₹ 5	₹ 9
Percentage increase		80%

$$(ii) \text{ Operating leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{40,00,000}{20,00,000} = 2 \quad \frac{4,80,000}{2,80,000} = 1.71$$

$$(iii) \text{ Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{2,00,000}{1,00,000} = 2 \quad \frac{2,80,000}{1,80,000} = 1.55$$

Comments:

- (i) EPS sale increase from ₹ 1,00,000 to ₹ 1,20,000, following points are distinctly noticed: (a) EPS rises by 80%, (b) Opening leverage comes down from 1.71, and (c) Financial leverage also declines from 2 to 1.55.
- (ii) There is a significant decrease in both business risk and of the company on account of reduction in both the leverage.
- (iii) This is the result, because there is increase in sales without increase in fixed operating or financial costs.

Problem 5: The balance sheet of Alpha Numeric Company is given below:

Liabilities	Amount (₹)	Assets	Amount (₹)
Equity capital (₹ 10 per share)	90,000	Net fixed assets	2,25,000
10% Long term Debt	1,20,000	Current assets	75,000
Retained earnings	30,000		
Current liabilities	60,000		
	3,00,000		3,00,000

The company's total assets turnover ratio is 3, its fixed operating cost is ₹ 1,50,000 and its variable operating cost ratio is 50%. The income-tax rate is 50%.

You are required to:

- (1) Calculate the different type of leverages for the company.
- (2) Determine the likely level of **EBIT if EPS is: (a) ₹ 1 (b) ₹ 2 (c) Re.0.**

[Similar Nov - 2019]

Solution:**Working Notes:** Calculation of Sales

$$\text{Total Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Total assets}} = \frac{\text{Sales}}{₹ 3,00,000} = 3$$

$$\begin{aligned} \text{Sales} &= 3 \times ₹ 3,00,000 \\ &= ₹ 9,00,000 \end{aligned}$$

(i) Calculation of Leverages*Income Statement for the year ended*

Particulars	Amount (₹)
Sales	9,00,000
Less: Variable cost (50% of sales)	4,50,000
Contribution.	4,50,000
Less: Fixed operating cost	1,50,000
EBIT	3,00,000
Less: Interest (₹ 1,20,000 × 10/100)	12,000
EBT	2,88,000
Less: Tax @ 50%	1,44,000
EAT	1,44,000

$$(a) \text{ Operating Leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{₹ 4,50,000}{₹ 3,00,000} = \mathbf{1.50}$$

$$(b) \text{ Financial Leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{₹ 3,00,000}{₹ 2,88,000} = \mathbf{1.04}$$

$$(c) \text{ Combined Leverage} = \text{Operating Leverage} \times \text{Financial Leverage} = 1.50 \times 1.04 = \mathbf{1.56}$$

(ii) Calculation of likely levels of EBIT at different Levels of EPS

$$\text{EPS} = \frac{(\text{EBIT} - 1) (1-T)}{N}$$

(a) Calculation of EBIT If EPS is ₹ 1

$$1 = \frac{(\text{EBIT} - 12,000) (1-0.50)}{9,000}$$

$$9,000 = (\text{EBIT} - 12,000) (0.50)$$

$$9,000 = 0.50 \text{ EBIT} - 6,000$$

$$0.50 \text{ EBIT} = 9,000 + 6,000$$

$$\text{EBIT} = \frac{15,000}{0.50} = \mathbf{₹ 30,000}$$

(b) Calculation of EBIT If EPS is ₹ 2

$$2 = \frac{(\text{EBIT} - 12,000) (1-0.50)}{9,000}$$

$$9,000 \times 2 = (\text{EBIT} - 12,000) (0.50)$$

$$18,000 = 0.50 \text{ EBIT} - 6,000$$

$$0.50 \text{ EBIT} = 18,000 + 6,000$$

$$\text{EBIT} = \frac{24,000}{0.50} = \mathbf{₹ 48,000}$$

(c) Calculation of EBIT If EPS Is ₹ 0

$$0 = \frac{(\text{EBIT} - 12,000) (1-0.50)}{9,000}$$

$$9,000 \times 0 = (\text{EBIT} - 12,000) (0.50)$$

$$0.50 \text{ EBIT} - 6,000 = 0$$

$$0.50 \text{ EBIT} = 6,000$$

$$\text{EBIT} = \frac{12,000}{0.50} = \mathbf{₹ 24,000}$$

Problem 6: A company had the following Balance Sheet as on 31st March, 2014:



Liabilities	(₹) (In crores)	Assets	(₹) (In crores)
Equity Share Capital (50 lakhs shares of ₹10 each)	5	Fixed Assets (Net)	12.5
Reserves and Surplus	1	Current Assets	7.5
15% Debentures	10		
Current Liabilities	4		
	20		20

The additional information given is as under:

Fixed cost per annum (excluding interest)	₹4 crores
Variable operating cost ratio	65%
Total assets turnover ratio	2.5
Income Tax rate	30%

Required: Calculate the following and comment:

(i) Earnings Per Share

(ii) Operating Leverage

(iii) Financial Leverage

(iv) Combined Leverage

(Nov - 2011, May 2014)

[Similar Nov - 2018]

[Similar July - 2021]

Solution:



Total Assets	= ₹20 crores
Total Asset Turnover Ratio	= 2.5
Hence, Total Sales	= 20 × 2.5 = ₹50 crores

Computation of Profit after Tax (PAT)

Particulars	(₹ in crores)
Sales	50.00
Less: Variable Operating Cost @ 65%	32.50
Contribution	17.50
Less: Fixed Cost (other than Interest)	4.00
EBIT	13.50
Less: Interest on Debentures (15% × 10)	1.50
PBT	12.00
Less: Tax @ 30%	3.60
PAT	8.40

(i) Earnings per Share

$$\text{EPS} = \frac{8.40 \text{ crores}}{\text{Number of Equity Shares}} = \frac{8.40 \text{ crores}}{50,00,000} = \text{₹16.80}$$

It indicates the amount the company earns per share. Investors use this as a guide while valuing the share and making investment decisions. It is also an indicator used in comparing firms within an industry or industry segment.

(ii) Operating Leverage

$$\text{Operating Leverage} = \frac{\text{Contribution}}{\text{Ebit}} = \frac{17.50}{13.50} = 1.296$$

It indicates the choice of technology and fixed cost in cost structure. It is level specific. When firm operates beyond operating break-even level, then operating leverage is low. It indicates sensitivity of earnings before interest and tax (EBIT) to change in sales at a particular level.

(iii) **Financial Leverage**

$$\begin{aligned}\text{Financial Leverage} &= \frac{\text{EBIT}}{\text{PBT}} \\ &= \frac{13.50}{12.00} = \mathbf{1.125}\end{aligned}$$

The financial leverage is very comfortable since the debt service obligation is small vis-à-vis EBIT.

(iv) **Combined Leverage**

$$\text{Combined Leverage} = \frac{\text{Contribution}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{PBT}}$$

$$\text{Or,} \quad = \text{Operating Leverage} \times \text{Financial Leverage} = 1.296 \times 1.125 = \mathbf{1.458}$$

The combined leverage studies the choice of fixed cost in cost structure and choice of debt in capital structure. It studies how sensitive the change in EPS is vis-à-vis change in sales. The leverages – operating, financial and combined are measures of risk.

Problem 7: The following details of RST Limited for the year ended 31 March, 2006 are given below:

	Operating leverage	1.4
	Combined leverage	2.8
	Fixed Cost (Excluding interest)	₹ 2.04 lakhs
	Sales	₹ 30.00 lakhs
	12% Debentures of ₹ 100 each	₹ 21.25 lakhs
	Equity Share Capital of ₹ 10 each	₹ 17.00 lakhs
	Income tax rate	30 per cent

Required:

- Calculate Financial leverage
- Calculate P/V ratio and Earning per Share (EPS)
- If the company belongs to an industry, whose assets turnover is 1.5, does it have a high or low assets leverage?
- At what **level of sales** the **Earning before Tax (EBT)** of the company will **be equal to zero?**

[May-2007] [Similar Nov - 2017]

Solution:



(i) **Financial leverage**

$$\text{Combined Leverage} = \text{Operating Leverage (OL)} \times \text{Financial Leverage (FL)}$$

$$2.8 = 1.4 \times \text{FL}$$

$$\text{FL} = 2$$

$$\text{Financial Leverage} = 2$$

(ii) **P/V Ratio and EPS**

$$\text{P/V Ratio} = \frac{\text{Contribution}}{\text{Sales}} \times 100$$

$$\text{Operating leverage} = \frac{\text{Contribution}}{\text{Contribution} - \text{Fixed cost}} \times 100$$

$$1.4 = \frac{\text{Contribution}}{\text{Contribution} - 2,04,000}$$

$$1.4 (\text{Contribution} - 2,04,000) = \text{Contribution}$$

$$1.4 \text{ Contribution} - 2,85,600 = \text{Contribution}$$

$$\text{Contribution} = \frac{2,85,600}{0.4} = 7,14,000$$

$$\text{P/V Ratio} = \frac{7,14,000}{30,00,000} \times 100$$

Therefore, **P/V Ratio = 23.8%**

$$\text{EPS} = \frac{\text{Profit after tax}}{\text{No. of equity shares}}$$

$$\begin{aligned} \text{EBT} &= \text{Sales} - \text{*Variable cost} - \text{FC} - \text{Interest} \\ &= 30,00,000 - 22,86,000 - 2,04,000 - 2,55,000 \\ &= \mathbf{2,55,000} \end{aligned}$$

$$\begin{aligned} \text{PAT} &= \text{EBT} - \text{Tax} \\ &= 2,55,000 - 76,500 = \mathbf{1,78,500} \end{aligned}$$

$$\text{EPS} = \frac{1,78,500}{1,70,000} = \mathbf{1.05}$$

$$\begin{aligned} * &= 100\% - \text{PV Ratio} \\ &= 100\% - 23.8\% \\ &= 76.2\% \text{ of sales} \\ &= 76.2\% \text{ of } 30 \text{ lacs} \\ &= 22,86,000/- \end{aligned}$$

(iii) Assets turnover

$$\text{Assets turnover} = \frac{\text{Sales}}{\text{Total Assets}} = \frac{30,00,000}{38,25,000} = 0.784$$

0.784 < 1.5 means lower than industry turnover.

(iv) EBT zero means 100% reduction in EBT.

Since combined leverage is 2.8, sales have to be dropped by $\frac{100}{2.8} = 35.7143\%$.

Hence, new sales will be $30,00,000 \times (100 - 35.7143)\% = \mathbf{₹19,28,571}$.

Therefore, at ₹19,28,700 level of sales, the Earnings before Tax of the company will be equal to zero.

Problem 8: A firm has sales of ₹ 75,00,000 variable cost of ₹ 42,00,000 and fixed cost of ₹ 6,00,000. It has a debt of ₹ 45,00,000 at 9% and equity of ₹ 55,00,000.

- What are the operating, financial and combined leverages of the firm?
- What is the firm's ROI?
- Does it have favourable financial leverage?
- If the firm belongs to an industry whose asset turnover is 3, does it have a high or low asset leverage?
- If the sales drop to ₹ 50,00,000, what will be the new EBIT?
- At what level of sales the EBT of the firm will be equal to zero?

Solution:



$$(i) \text{ ROI} = \frac{\text{EBIT}}{\text{Capital employed}} \times 100 = \frac{\text{EBIT}}{\text{Equity} + \text{Debt}} \times 100 = \frac{₹ 27,00,000}{₹ 55,00,000 + ₹ 45,00,000} = \mathbf{27\%}$$

- The return on investment of firm is 27% whereas the firm is only paying 9% rate of interest on its debt and hence the firm is enjoying favourable financial leverage.

$$(iii) \text{ Asset turnover} = \frac{\text{Net Sales}}{\text{Total assets}}$$

$$\text{Or,} \quad = \frac{\text{Net Sales}}{\text{Total investment}} = \frac{₹ 75,00,000}{₹ 1,00,00,000} = \mathbf{0.75}$$

As compared to the industry's normal asset turnover of 3 times, the firm's asset turnover ratio is only 0.75, and the investment level of the firm is highly abnormal.

(iv) Calculation of operating, Financial and combined leverages

$$(a) \text{ Operating leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{\text{₹ } 33,00,000}{\text{₹ } 27,00,000} = 1.22$$

$$(b) \text{ Financial leverage} = \frac{\text{EBIT}}{\text{EBT}} = \frac{\text{₹ } 27,00,000}{\text{₹ } 22,95,000} = 1.18$$

$$(c) \text{ Combined leverage} = \frac{\text{Contribution}}{\text{EBT}} = \frac{\text{₹ } 33,00,000}{\text{₹ } 22,95,000} = 1.44$$

$$\text{Or Operating leverage} \times \text{Financial leverage} = 1.22 \times 1.18 = 1.44$$

(v) New EBIT when sales drop to ₹ 50,00,000

(₹)

New sales (after 33.33% drop) 50,00,000

Less: Variable cost (₹ 42 lakh – 33.33%)

28,00,000

Contribution 22,00,000

Less: Fixed cost 6,00,000

New EBIT 16,00,000

(vi) Sales level at which EBT of the firm will be equal to zero.

Since the combined leverage is 1.44, sales have to drop by $100/1.44$ i.e., 69.44%.

Hence, the new sales will as follows:

$$= \text{₹ } 75,00,000 \times (1 - 69.44\%) = \text{₹ } 22,92,000 \text{ (approx.)}$$

Working Notes:

Calculations of EBIT and EBT

Particulars	(₹)
Sales	75,00,000
Less: Variable costs	42,00,000
Contribution	33,00,000
Less: Fixed costs	6,00,000
EBIT	27,00,000
Less: Interest on debt @ 9% on ₹ 45 lakhs	4,05,000
EBT	22,95,000

Problem 9: The Capital structure of RST Ltd. is as follows:



Particulars	Amount (₹)
Equity Share of ₹10 each	8,00,000
10% Preference Share of ₹100 each	5,00,000
12% Debentures of ₹100 each	7,00,000
	20,00,000

Additional Information:

- Profit after tax (Tax Rate 30%) are ₹2,80,000
- Operating Expenses (including Depreciation ₹96,800) are 1.5 times of EBIT
- Equity Dividend paid is 15% - Market price of Equity Share is ₹23

Calculate:

- (i) Operating and Financial Leverage (iii) The Earning Yield Ratio and Price Earning Ratio
 (ii) Cover for preference and equity dividend (iv) The Net Fund Flow

Note: All operating expenses (excluding depreciation) are variable.

(May 2012, Nov 2014) [Similar Jan - 2021]

Solution:**Working Notes:**

Particulars	Amount (₹)
Net Profit after Tax	2,80,000
Tax @ 30%	1,20,000
EBT	4,00,000
Interest on Debentures	84,000
EBIT	4,84,000
Operating Expenses (1.5 times of EBIT)	7,26,000
Sales	12,10,000

(i) Operating Leverage

$$= \frac{\text{Contribution}}{\text{EBIT}} = \frac{(12,10,000 - 6,29,200)}{4,84,000}$$

$$= \frac{5,80,800}{4,84,000} = \mathbf{1.2 \text{ times}}$$

Financial Leverage

$$= \frac{\text{EBIT}}{\text{EBT}} = \frac{4,84,800}{4,00,000}$$

$$= \mathbf{1.21 \text{ times}}$$

OR

Financial Leverage

$$= \frac{\text{EBIT}}{\text{EBT} - \left(\frac{\text{Preference Dividend}}{1 - t} \right)}$$

times

$$= \frac{4,84,000}{4,00,000 - \left(\frac{50,000}{1 - 0.30} \right)} = \frac{4,84,000}{4,00,000 - 71,428.58} = \frac{4,84,000}{3,28,571} = \mathbf{1.47}$$

$$\text{(ii) Cover for Preference Dividend} = \frac{\text{PAT}}{\text{Preference Share Dividend}} = \frac{2,80,000}{50,000} = \mathbf{5.6 \text{ times}}$$

Cover for Equity Dividend

$$= \frac{(\text{PAT} - \text{Preference Dividend})}{\text{Equity Share Dividend}} = \frac{(2,80,000 - 50,000)}{1,20,000}$$

$$= \frac{(2,80,000 - 50,000)}{1,20,000} = \mathbf{1.92 \text{ times}}$$

(iii) Earning Yield Ratio

$$= \frac{\text{EPS}}{\text{Market Price}} \times 100$$

$$= \frac{230.00}{80.00} \times 100 = \frac{2.875}{23} \times 100 = \mathbf{12.5\%}$$

$$\text{Price - Earnings Ratio (PE Ratio)} = \frac{\text{Market Price}}{\text{EPS}} = \frac{23}{2.875} = \mathbf{8 \text{ times}}$$

(iv) **Net Funds Flow**

$$\begin{aligned} &= \text{Net PAT} + \text{Depreciation} - \text{Total Dividend} \\ &= 2,80,000 + 96,800 - (50,000 + 1,20,000) \\ &= 3,76,800 - 1,70,000 = \mathbf{2,06,800} \end{aligned}$$

Problem 10:

The following data is available for Stone Ltd. :

	₹
Sales	5,00,000
(-) Variable cost @ 40%	2,00,000
Contribution	3,00,000
(-) Fixed cost	2,00,000
EBIT	1,00,000
(-) Interest	25,000
Profit before tax	75,000

Using the concept of leverage, find out

- The percentage change in taxable income if EBIT increases by 10%.
- The percentage change in EBIT if sales increases by 10%.
- The percentage change in taxable income if sales increases by 10%.

Also verify the results in each of the above case.

Solution:

$$\mathbf{1. \text{ Degree of Financial Leverage}} = \frac{\text{EBIT}}{\text{EBT}} = \frac{\text{₹ } 1,00,000}{\text{₹ } 75,000} = \mathbf{1.333 \text{ times}}$$

So, If EBIT increase by 10% then Taxable Income (EBT) will increased by $1.333 \times 10 = \mathbf{13.33\% \text{ (approx.)}}$ **Verification**

Particulars	Amounts (₹)
New EBIT after 10% increase (₹ 1,00,000 + 10%)	1,00,000
Less: Interest	25,000
Earnings before Tax after change (EBT)	85,000

$$\text{Increase in Earning before Tax} = \text{₹ } 85,000 - \text{₹ } 75,000 = \text{₹ } 10,000$$

$$\text{So, percentage change in Taxable Income (EBT)} = \frac{\text{₹ } 10,000}{\text{₹ } 75,000} \times 100 = \mathbf{13.333, \text{ hence verified}}$$

$$\mathbf{2. \text{ Degree Operating Leverage}} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{\text{₹ } 3,00,000}{\text{₹ } 1,00,000} = \mathbf{3 \text{ times}}$$

So, If sale is increased by 10% then EBIT will be increased by $3 \times 10 = \mathbf{30\%}$

Verification

Particulars	Amount (₹)
New Sales after 10% increase (₹ 5,00,000 + 10%)	5,00,000
Less: Variable cost (40% of ₹ 5,50,000)	2,20,000
Contribution	3,30,000
Less: Fixed costs	2,00,000
Earnings before interest and tax after change (EBIT)	1,30,000

Increase in Earnings before interest and tax (EBIT) = ₹ 1,30,000 - ₹ 1,00,000 = ₹ 30,000

So, percentage change in EBIT = $\frac{₹ 3,000}{₹ 1,00,000} \times 100 = 30\%$, **hence Verified.**

$$3. \text{ Degree of Combined Leverage} = \frac{\text{Contribution}}{\text{EBIT}} = \frac{₹ 3,00,000}{₹ 75,000} = 4 \text{ times}$$

So, If sale is increased by 10% then Taxable Income (EBT) will be increased by $4 \times 10 = 40\%$.

Verification

Particulars	Amount (₹)
New Sales after 10% increase (₹ 5,00,000 + 10%)	5,50,000
Less: Variable Cost (40% of 5,50,000)	2,20,000
Contribution	3,30,000
Less: Fixed Costs	2,00,000
Earning before interest and tax (EBIT)	1,30,000
Less: Interest	25,000
Earning before tax after change (EBT)	1,05,000

Increase in Earning before tax (EBT) = ₹ 1,05,000 - ₹ 75,000 = ₹ 30,000

So, Percentage change in Taxable income (EBT) = $\frac{₹ 30,000}{₹ 75,000} \times 100 = 40\%$, **Hence verified.**

Problem 11: Following are the data in respect of ABC Industries for the year ended 31 st March, 2021:

	Debt to Total assets ratio	0.40
	Long-term debts to equity ratio	30%
	Gross profit margin on sales	20%
	Accounts receivables period	36 days
	Quick ratio	0.9
	Inventory holding period	55 days
	Cost of goods sold	₹ 64,00,000

Liabilities	₹	Assets	₹
Equity Share Capital	20,00,000	Fixed assets	
Reserve & Surplus		Inventories	

Long-term debts		Accounts receivables	
Accounts payable		Cash	
Total	50,00,000	Total	

Required:

Complete the Balance Sheet of ABC Industries as on 31st March, 2021. All calculations should be in nearest Rupee. Assume 360 days in a year. **[NOV 2022]**

Solution:**Working Notes:**

1. Total liability = Total Assets = ₹ 50,00,000

Debt to Total Asset Ratio = 0.40

$$\frac{\text{Debt}}{\text{Total Assets}} = 0.40$$

$$\text{Or, } \frac{\text{Debt}}{50,00,000} = 0.40$$

So, Debt = **₹ 20,00,000**

2. Total Liabilities = ₹ 50,00,000

Equity share Capital + Reserves + Debt = ₹ 50,00,000

So, Reserves = ₹ 50,00,000 - ₹ 20,00,000 - ₹ 20,00,000

So, Reserves & Surplus = **₹ 10,00,000**

3. $\frac{\text{Long term Debt}}{\text{Equity Shareholder's Fund}} = 30\%^*$

Long Term Debt = **₹ 9,00,000**

4. So, Accounts Payable = ₹ 20,00,000 - ₹ 9,00,000

Accounts Payable = **₹ 11,00,000**

5. Gross Profit to sales = 20%

Cost of Goods Sold = 80% of Sales = ₹ 64,00,000

Sales = $(100/80) \times 64,00,000 = \mathbf{₹ 80,00,000}$

6. Inventory Turnover = $\frac{360}{\frac{\text{COGS}}{\text{Closing inventory}}}$

$$= \frac{360}{\frac{64,00,000}{55}}$$

Closing inventory = 9,77,778

7. Accounts Receivable period = 36 days

$$\frac{\text{Accounts Receivable}}{\text{Credit Sales}} \times 360 = 36$$

$$\text{Accounts Receivable} = \frac{36}{360} \times \text{Credit Sales}$$

$$= \frac{36}{360} \times 80,00,00 \text{ (assumed all sales are on credit)}$$

Accounts Receivable = ₹ 8,00,000

8. Quick Ratio = 0.9

$$\frac{\text{Quick Assets}}{\text{Current liabilities}} = 0.9$$

$$\frac{\text{Cash+Debetors}}{11,00,000} = 0.9$$

$$\text{Cash} + 8,00,000 = ₹ 9,90,000$$

$$\text{Cash} = ₹ 1,90,000$$

9. Fixed Assets = Total Assets - Current Assets = 50,00,000 - (9,77,778 + 8,00,000 + 1,90,000) = **30,32,222**

Balance Sheet of ABC Industries as on 31st March 2021

Liabilities	(₹)	Assets	(₹)
Share Capital	20,00,000	Fixed Assets	30,32,222
Reserved surplus	10,00,000	Current Assets:	
Long Term Debt	9,00,000	Inventory	9,77,778
Accounts Payable	11,00,000	Accounts Receivables	8,00,000
		Cash	1,90,000
Total	50,00,000	Total	50,00,000

(*Note: Equity shareholders' fund represent equity in 'Long term debts to equity ratio'. The question can be solved assuming only share capital as 'equity')

5

CHAPTER

CAPITAL STRUCTURE

Learn from yesterday, live for today, hope for tomorrow. The important thing is not to stop questioning.

Important Questions

January 2025



Congratulations!

The league of Champions

FM-SM

 75 Marks	 75 Marks	 75 Marks
 74 Marks	 72 Marks	 69 Marks
 69 Marks	 69 Marks	 68 Marks
 68 Marks	 67 Marks	 67 Marks
 66 Marks	 66 Marks	 65 Marks
 65 Marks	 65 Marks	 65 Marks

3000+ Exemptions
3500+ Above 50 Marks



Congratulations!

The League of Champions

 MEENAKSHI AIR 20	 ROHIT AIR 22	 SHUBHAM AIR 23	 ANUSHKA AIR 36	 CHERRY AIR 37	 SANJEEV AIR 47
 SATYAM KUMAR 87 MARKS	 SUSHANT ARORA 83 MARKS				
 BHARAT GAUTAM 80 MARKS	 PRADEEP ROHILLA 79 MARKS				
 ANUSHKA SHARMA 78 MARKS	 KSHITIZ TAYAL 78 MARKS				
 SAIKAT GHOSH 77 MARKS	 NILESH JAISWAL 76 MARKS				
 NUZAIF AKTHAR 76 MARKS	 KOMAL SANWAL 75 MARKS				
 SHALINI SONI 75 MARKS	 ASHUTOSH KUMAR 74 MARKS				
 NANDA CHATURVEDI 74 MARKS	 ARYAN MERATWAL 73 MARKS				
 DEEPANSHI JAIN 73 MARKS	 KAUSHAL ARORA 73 MARKS				
 PREETHAM BHAT 73 MARKS	 SONALI VIJ 73 MARKS				
 ANKIT JAIN 72 MARKS	 MAYURI PRAMOD 72 MARKS				
 SANCHIT 72 MARKS	 SONU AGRAWAL 72 MARKS				
 TANYA BANSAL 72 MARKS	 ANURAG AGRAWAL 71 MARKS				
 CHIRAG JAIN 70 MARKS	 NITESH LAHU 70 MARKS				
 PARAS BANSAL 70 MARKS	 RAJSHREE 70 MARKS				
 RAJVI DILIP 70 MARKS	 YASH JAIN 70 MARKS				

OTC CHAMPIONS

CHAPTER FIVE

Video for Interpretation of the List: <https://youtu.be/dVq9NF7s8I4>



CAPITAL STRUCTURE

LIST OF IMPORTANT QUESTIONS JANUARY 2025



**FM-SM
REGULAR** Batch
JAN/MAY/SEPT 2025



**FM-SM
EXAM-ORIENTED** Batch
JAN/MAY/SEPT 2025



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Problem 1: Companies X and Y are identical in all respects including risk factors except for debt/equity, X having issued 10% debentures of ₹ 18 lakhs while Y has issued only equity. Both the companies earn 20% before interest and taxes on their total assets of ₹ 30 lakhs.

Assuming a tax rate of 50% and capitalization rate of 15% for and all equity company, compute the value of companies X and Y using

- Net income approach and
- Net operating income approach.

Solution:

(i) Valuation of companies under net income approach.

Particulars	X (₹)	Y (₹)
EBIT @ 20% on ₹ 30,00,000	6,00,000	6,00,000
Less: Interest	1,80,000	—
EBT	4,20,000	6,00,000
Less: Tax @ 50%	2,10,000	3,00,000
EAT (available to equity holders)	2,10,000	3,00,000
Value of equity (capitalized @ 15%)	14,00,000	20,00,000
$X = (2,10,000 \times \frac{100}{15})$ $Y = (3,00,000 \times \frac{100}{15})$		
Value of debt	18,00,000	—
Total value of company	32,00,000	20,00,000

(ii) Valuation of companies under net operating income approach

Particulars	X (₹)	Y (₹)
Capitalization of earnings at 15% $\left[6,00,000 \frac{(1 - 0.5)}{0.15} \right]$	20,00,000	20,00,000
Less: Value of debt [18,00,000 (1-0.5)]	9,00,000	—
Value of equity	11,00,000	20,00,000
Add: Value of debt	18,00,000	—
Total value of company	29,00,000	20,00,000

Problem 2: From the following selected data, determine the value of the firms, P and Q belonging homogeneous risk class under (a) the net income (NI) approach, and (b) The net operating income approach.

	Firm P ₹	Firm Q ₹
EBIT	2,75,000	2,25,000
Interest at 15%	75,000	
Equity capitalization rate, K_e	20%	
Corporate tax rate	50%	

Which of the two firms has an optimal capital structure under the (i) NI approach, and (ii) NOI approach?

Solution:**Valuation of the firm (Net income approach)**

Particulars	Firm P ₹	Firm Q ₹
EBIT	2,25,000	2,25,000
Less: Interest	75,000	—
Profit before tax	1,50,000	2,25,000
Less: Taxes @ 50%	75,000	1,12,500
PAT (available for equity holders)	75,000	1,12,500
K_e (equity capitalization rate)	0.2	0.2
Market value of equity, (E) (PAT ÷ K_e)	3,75,000	5,62,500
Market value of debt (Interest ÷ K_d)	5,00,000	—
Total market value, (V) = (E) + (D)	8,75,000	5,62,500

$$\begin{aligned}
 K_o (\text{Firm P}) &= \left[K_d \left(\frac{D}{D+E} \right) + K_e \left(\frac{E}{D+E} \right) \right] \\
 &= 7.5\% \times \frac{₹ 5,00,000}{₹ 8,75,000} + 20\% \times \frac{3,75,000}{8,75,000} \\
 &= 4.29\% + 8.5\% = 12.86\%
 \end{aligned}$$

$$K_o (\text{Firm Q}) = 20\% = K_e \text{ as it is not having any debt fund.}$$

Valuation of the firm (Net operating income approach):

Under the NOI approach the value of levered firm is taken as equal to the value of unlevered firm plus the premium for interest tax shield on debt financing. Thus,

Valuation of Firm Q (Unlevered Firm):

$$V_u = \frac{\text{EBIT} (1 - t)}{K_e} = \frac{₹ 2,25,000 (.5)}{.20} = ₹ 5,62,500$$

Now, the valuation of firm P (Levered Firm) is:

$$V_L = V_u + \text{Debt} (t) = ₹ 5,62,500 + 5,00,000 (.50) = ₹ 8,12,500$$

Now the value of equity = ₹ 8,12,500 - 5,00,000 = ₹ 3,12,500, and

$$\text{The equity capitalization rate } K_e = \frac{₹ 75,000}{3,12,500} = 24\%.$$

The overall capitalization rate, K_o , may be found as follows:

$$= 7.5\% \times \frac{₹ 5,00,000}{₹ 8,12,500} + 24\% \times \frac{₹ 3,12,500}{₹ 8,12,500} = 4.26\% + 9.23\% = 13.85\%$$

So, the WACC of firm P is 13.85%. Under both the NI approach and NOI approach, the firm P seems to have the optimal capital structure as it is having higher total value than the value of the firm Q.

Problem 3: There are two firms P and Q which are identical except P does not use any debt in its capital structure while Q has ₹ 8,00,000, 9% debentures in its capital structure. Both the firms have earning before interest and tax of ₹ 2,60,000 p.a. and the capitalization rate is 10%. Assuming the corporate tax of 30%, calculate the value of these firms according to MM Hypothesis. [Nov-2009] 3 Marks

Solution:**(i) Calculation of Value of Firm P and Q according to MM Hypothesis****Market Value of Firm P (Unlevered)**

$$V_u = \frac{\text{EBIT} (1 - t)}{K_e} = \frac{2,60,000 (1 - 0.30)}{10\%} = \frac{₹ 1,82,000}{10\%} = ₹ 18,20,000$$

Market Value of Firm Q (Levered)

$$\begin{aligned}
 V_E &= V_u + D(t) \\
 &= ₹ 18,20,000 + (8,00,000 \times 0.30) \\
 &= ₹ 18,20,000 + 2,40,000 = ₹ 20,60,000
 \end{aligned}$$

Problem 4: Following is the information relating to U Ltd. and L Ltd. having same level of risk but different capital structures



Particulars	U Ltd. (₹)	L Ltd. (₹)
Equity	90,000	50,000
Debt	—	50,000
Total value	90,000	1,00,000
Earnings	20,000	20,000
Interest	—	5,000
Net profit	20,000	15,000
K_e (NP + Equity)	22.2%	30%
K_d	—	10%
K_o (Earnings + value)	22.2%	20%

The above values show that the two firms not in equilibrium. Show by different methods, how an investor could profit from the arbitrage process.

Solution: In the given case, L Ltd. is an over valued firm. So, an investor having 5% holding of equity in L. Ltd. decides to make profit by indulging in the arbitrage process. He may be benefited and this can be demonstrated in two ways as follows:



(i) By maintaining his income from a smaller investment:

The current income of the investor is 5% of ₹ 15,000 i.e., 750 p.a. He undertakes the arbitrage process and replace his holding by purchasing equity capital in U Ltd., the effect can be demonstrated as follows:

	₹
Selling price of 5% holding in L Ltd.,	2,500
+ Borrowing @ 10% Interest of an amount 5% of 50,000 Debt.	2,500
Total funds	5,000
Less: Purchase price of 5% equity of U Ltd.,	4,500
Savings of funds	500
Net income from U Ltd.:	
Dividend Income (5% of ₹ 20,000)	1,000
Interest on loan (10% of 2,500)	250
Net income position	750

As far as income is concerned, he is getting the same income level of ₹ 750 but he has been benefited in terms of capital funds of ₹ 500 available with him.

(ii) By earning higher income from same level of investment:

Out of the total funds of ₹ 5,000 (as shown above), he can buy 5,000/90,000 of U Ltd. i.e., 5.555%. He will not be having any capital fund with him. His income position would be as follows:

	₹
Dividend from U Ltd. (5.555% of ₹ 20,000)	1,111
Less: Interest on loan (10% of ₹ 2,500)	250
Net income	861

So, his income has increased from ₹ 750 to ₹ 861, and he is benefited in terms of receiving higher income.

Problem 5: Equipment Company has earnings before interest and taxes (EBIT) of ₹ 10 million. The company currently has outstanding debt of ₹ 20 million at a cost of 7%.

- (a) using the net income (N1) approach and a cost of equity of 12.5%; (1) compute the total value of the firm and firm's overall weighted average cost of capital (K_o) and (2) determine the firm's market debt/equity ratio.
- (b) Assume that the firm issues an additional ₹ 10 million in debt and uses the proceeds to retire stock; the interest rate and the cost of equity remain the same. (1) Compute the new total value of firm and the firm's overall cost of capital and (2) determine the firm's market debt/equity ratio.

Solution:



- (a) EBIT = ₹ 10,000,000

$$I = ₹ 2,00,00,000 \times 7\% = ₹ 14,00,000$$

$$K_e = 12.5\%$$

- (1) The total value of the firm, V_F can be found as follows:

$$EAE = EBIT - I = ₹ 1,00,00,000 - ₹ 14,00,000 = ₹ 86,00,000$$

$$V_E = \frac{EAE}{K_e} = \frac{₹ 86,00,000}{0.125} = ₹ 6,88,00,000$$

$$V_F = V_E + V_D = ₹ 6,88,00,000 + ₹ 2,00,00,000 = ₹ 8,88,00,000$$

Therefore,

$$K_o = \frac{EBIT}{V_F} = \frac{₹ 1,00,00,000}{8,88,00,000} = ₹ 11.26\%$$

- (2) The firm's market Debt/Equity ratio is

$$\frac{V_D}{V_E} = \frac{₹ 2,00,00,000}{6,88,00,000} = 0.29$$

- (b)

- (1) $I = ₹ 30,000,000 \times 7\% = ₹ 2,100,000$

$$EAE = EBIT - I = ₹ 1,00,00,000 - ₹ 21,00,000 = ₹ 79,00,000$$

$$V_E = \frac{EAE}{K_e} = \frac{₹ 79,00,000}{0.125} = ₹ 6,32,00,000$$

$$V_F = V_E + V_D = ₹ 6,32,00,000 + ₹ 3,00,00,000 = ₹ 9,32,00,000$$

Therefore,

$$K_o = \frac{EBIT}{V_F} = \frac{₹ 1,00,00,000}{9,32,00,000} = 10.75\%$$

- (2) The Debt/Equity ratio = $\frac{V_D}{V_E} = \frac{₹ 3,00,00,000}{6,32,00,000} = 0.47$

Problem 6: There are two companies U Ltd. and L Ltd., having same NOI of ₹ 20,000 except that L Ltd. is a levered company having a debt of ₹ 1,00,000 @ 7% and cost of equity of U Ltd. & L Ltd. are 10% and 18% respectively.



COMPUTE how arbitrage process will work.

Solution:

Particulars	Company	
	U Ltd.	L Ltd.
NOI (EBIT)	₹ 20,000	₹ 20,000
Debt (D)	-	₹ 1,00,000
K_d	-	7%
K_e	10%	18%
Value of equity capital (S)	₹ 2,00,000	₹ 72,222
$\left(\frac{\text{EBIT} - \text{Interest}}{K_e} \right)$	$\left(\frac{20,000}{0.10} \right)$	$\left(\frac{20,000 - 7,000}{0.18} \right)$
Total value of the firm (V) = S+D	₹ 2,00,000	₹ 1,72,222
		(₹ 72,222 + ₹ 1,00,000)

Arbitrage Process:

If you have 10% shares of unlevered firm i.e. investment of 10% of ₹ 2,00,000 = ₹ 20,000 and Return @ 10% on ₹ 20,000. Investment will be 10% of earnings available for equity i.e. $10\% \times ₹ 20,000 = ₹ 2,000$.

Alternative strategy will be:

Sell your shares in unlevered firm for ₹ 20,000 and buy 10% shares of levered firm's equity plus debt.

10% equity of levered firm ₹ 7,222

10% debt of levered firm ₹ 10,000

Total investment in levered firm **₹ 17,222**

Surplus cash available = Surplus - Investment = ₹ 20,000 - ₹ 17,222 = ₹ 2,778

Your return on investment is:

7% on debt of ₹ 10,000	₹ 700
10% on equity i.e. 10% of earnings available for equity holders ($10\% \times ₹ 13,000$)	₹ 1,300
Total return	₹ 2,000

In both the cases the return received is ₹ 2,000 and still you have excess cash of ₹ 2,778

Hence, you are better off by doing arbitrage i.e. you will start selling unlevered company shares and buy levered company's shares thereby pushing down the value of shares of unlevered firm and increasing the value of levered firm till equilibrium is reached.

In the above example we have not invested entire amount received from "sale of shares of Unlevered company". We also have the same level of earning along with reduced investment. Alternatively, we could have invested entire amount in Levered company. In that case annual earnings would have increased. An example for the same is as follows:

Problem 7: The following data relates to two companies belonging to the same risk class:



Particulars	A Ltd.	B Ltd.
Expected Net Operating Income	₹ 18,00,000	₹ 18,00,000
12% Debt	₹ 54,00,000	-
Equity Capitalization Rate	-	18

Required:

- Determine the total market value, Equity capitalization rate and weighted average cost of capital for each company assuming no taxes as per M.M. Approach.
- Determine the total market value, Equity capitalization rate and weighted average cost of capital for each company assuming 40% taxes as per M.M. Approach.

Solution:

- (a) Assuming no tax as per MM Approach

Calculation of Value of Firms 'A Ltd.' and 'B Ltd.' according to MM Hypothesis

Market Value of 'B Ltd.' [Unlevered(u)]

Total Value of Unlevered Firm (V_u) = $[NOI/K_e] = 18,00,000/0.18 = ₹ 1,00,00,000$ K_e of Unlevered Firm (given) = 0.18 K_o of Unlevered Firm (Same as above = K_e as there is no debt) = 0.18**Market Value of 'A Ltd.' [Levered Firm (I)]**Total Value of Levered Firm (V_L) = $V_u + (\text{Debt} \times \text{Nil})$

= ₹ 1,00,00,000 + (54,00,000 × nil)

= ₹ 1,00,00,000

Computation of Equity Capitalization Rate and Weighted Average Cost of Capital (WACC)

	Particulars	A Ltd.	B Ltd.
A.	Net Operating Income (NOI)	₹ 18,00,000	₹ 18,00,000
B.	Less: Interest on Deb (I)	₹ 6,48,000	-
C.	Earnings of Equity Shareholders (NI)	₹ 11,52,000	₹ 18,00,000
D.	Overall Capitalization Rate (K_e)	0.18	0.18
E.	Total Value of Firm ($V = NOI/K_e$)	₹ 1,00,00,000	₹ 1,00,00,000
F.	Less: Market Value of Equity	₹ 54,00,000	-
G.	Market Value of Equity (S)	₹ 46,00,000	₹ 1,00,00,000
H.	Equity Capitalization Rate [$K_e = NI/S$]	0.2504	0.18
I.	Weighted Average Cost of Capital [WACC (K_o)]* $K_o = (K_e \times S/V) + (K_d \times D/V)$	0.18	0.18

***Computation of WACC A Ltd**

Component of Capital	Amount	Weight	Cost of Capital	WACC
Equity	₹ 46,00,00	0.46	0.2504	0.1152
Debt	₹ 54,00,000	0.54	0.12*	0.0648
Total	₹ 1,00,00,000			0.18

* $K_d = 1$ (since there is no tax)

WACC = 18%

- (a) Assuming 40% taxes as per MM Approach

Calculation of Value of Firms 'A Ltd.' and 'B Ltd.' according to MM Hypothesis

Market Value of 'B Ltd.' [Unlevered(u)]

Total Value of unlevered Firm (V_u) = $[NOI (1 - t)/k_e] = 18,00,000 (1 - 0.40) / 0.18$
= ₹ 60,00,000 K_e of unlevered Firm (given) = 0.18 K_o of unlevered Firm (Same as above = k_e as there is no debt) = 0.18**Market Value of 'A Ltd.' [Levered Firm (I)]**Total Value of Levered Firm (V_L) = $V_u + (\text{Debt} \times \text{Tax})$

= ₹ 60,00,000 + (₹ 54,00,000 × 0.4)

= ₹ 81,60,000

Computation of Weighted Average Cost of Capital (WACC) of 'B Ltd.= 18% (i.e. $K_e = K_o$)

Computation of Equity Capitalization Rate and Weighted Average Cost of Capital (WACC) of A Ltd

Particulars	A Ltd. (₹)
Net Operating Income (NOI)	18,00,000
Less: Interest on Debt (I)	6,48,000
Earnings Before Tax (EBT)	11,52,000
Less: Tax @ 40%	4,60,800
Earnings for equity shareholders (NI)	6,91,200
Total Value of Firm (V) as calculated above	81,60,000
Less: Market Value of Debt	54,00,000
Market Value of Equity (S)	27,60,000
Equity Capitalization Rate [$k_e = NI/S$]	0.2504
Weighted Average Cost of Capital (k_o)* $k_o = (k_e \times S/V) + (k_d \times D/V)$	13.23

*Computation of WACC A Ltd

Component of Capital	₹	Weight	Cost of Capital	WACC
Equity	27,60,000	0.338	0.2504	0.0846
Debt	54,00,000	0.662	0.072*	0.0477
Total	81,60,000			0.1323

$$*K_d = 12\% (1 - 0.4) = 12\% \times 0.6 = 7.2\%$$

$$WACC = 13.23\%$$

Problem 8: Leo Ltd. has a net operating income of ₹ 21,60,000 and the total capitalisation of ₹ 120 lakhs. The company is evaluating the options to introduce debt financing in the capital structure and the following information is available at various levels of debt value.

Debt value (₹)	Interest rate (%)	Equity Capitalisation rate (%)
0	N.A.	12.00
10,00,000	7.00	12.50
20,00,000	7.00	13.00
30,00,000	7.50	13.50
40,00,000	7.50	14.00
50,00,000	8.00	15.00
60,00,000	8.50	16.00
70,00,000	9.00	17.00
80,00,000	10.00	20.00

You are required to COMPUTE the equity capitalization rate if MM approach is followed. Assume that the firm operates in zero tax regime and calculations to be based on book values.

Solution:

$$\text{Value of a Firm} = \frac{\text{NOI}}{K_0}$$

$$\therefore 1,20,00,000 = \frac{21,60,000}{K_0}$$

$$\therefore K_0 = \frac{21,60,000}{1,20,00,000} = 18\%$$

$$\text{Under MM approach, } K_e = K_0 + \frac{D}{E} (K_0 - K_d)$$

Statement of equity capitalization under MM approach

Debt Value (₹)	Equity Value (₹)	Debt/ Equity	$K_d(\%)$	$K_0(\%)$	$K_0 - K_d(\%)$	$K_e = K_0 + (K_0 - K_d) (D/E)$
-	1,20,00,000	0.0000	NA	18.00	18.00	18.00
10,00,000	1,10,00,000	0.0909	7.00	18.00	11.00	19.00
20,00,000	1,00,00,000	0.2000	7.00	18.00	11.00	20.20
30,00,000	90,00,000	0.3333	7.50	18.00	10.50	21.50
40,00,000	80,00,000	0.5000	7.50	18.00	10.50	23.25
50,00,000	70,00,000	0.7143	8.00	18.00	10.00	25.14
60,00,000	60,00,000	1.0000	8.50	18.00	9.50	27.50
70,00,000	50,00,000	1.4000	9.00	18.00	9.00	30.60
80,00,000	40,00,000	2.0000	10.00	18.00	8.00	34.00

Problem 9: The financial advisor of Sun Ltd. is confronted with following two alternative financing plans for raising ₹ 10 lakhs that is needed for plant expansion and modernization



Alternative I: Issue 80% of funds with 14% Debenture [Face value (FV) ₹ 100] at par and redeem at a premium of 10% after 10 years and balance by issuing equity shares at premium.

Alternative II: Raise 10% of funds required by issuing 8% Irredeemable Debentures [Face value (FV) ₹ 100] at par and the remaining by issuing equity shares at current market price of ₹125.

Currently, the firm has an Earnings per share (EPS) of ₹ 21

The modernization and expansion programme is expected to increase the firm's Earnings before Interest and Taxation (EBIT) by ₹ 200,000 annually

The firm's condensed Balance Sheet for the current year is given below:

Liabilities	(₹)	Assets	(₹)
Current Liabilities	5,00,000	Current Assets	16,00,000
10% Long Term Loan	15,00,000	Plan & Equipment (Net)	34,00,000
Reserves & Surplus	10,00,000		
Equity Share Capital (FV: ₹ 100 each)	20,00,000		
TOTAL	50,00,000	TOTAL	50,00,000

However, the finance advisor is concerned about the effect that issuing of debt might have on the firm. The average debt ratio for firms in industry is 35%. He believes if this ratio is exceeded, the P/E ratio of the company will be 7 because of the potentially greater risk.

If the firm increases its equity capital by more than 10 %, he expects the P/E ratio of the company will increase to 8.5 irrespective of the debt ratio.

Assume Tax Rate of 25%. Assume target dividend pay-out under each alternative to be 60% for the next year and growth rate to be 10% for the purpose of calculating Cost of Equity.

SUGGEST with reason which alternative is better on the basis of each of the below given criteria:

- Earnings per share (EPS) & Market Price per share (MPS)
- Financial Leverage
- Weighted Average Cost of Capital & Marginal Cost of Capital (using Book Value weights)

Solution:



Calculation of Equity Share capital and Reserves and surplus:

Alternative 1:

$$\text{Equity Share capital} = ₹ 20,00,000 + \frac{₹ 2,00,000 \times 100}{133.3333} = ₹ 21,50,000$$

$$\text{Reserves} = ₹ 10,00,000 + \frac{₹ 2,00,000 \times 33.3333}{133.3333} = ₹ 10,50,000$$

Alternative 2:

$$\text{Equity Share capital} = ₹ 20,00,000 + \frac{₹ 2,00,000 \times 100}{125} = ₹ 27,20,000$$

$$\text{Reserves} = ₹ 10,00,000 + \frac{₹ 2,00,000 \times 25}{125} = ₹ 11,80,000$$

Capital Structure Plans

Capital	Alternative 1 ₹	Alternative 2 ₹
Equity Share capital	21,50,000	27,20,000
Reserves and surplus	10,50,000	11,80,000
10% long term debt	15,00,000	15,00,000
14% Debentures	8,00,000	-
8% Irredeemable Debentures	-	1,00,000
Total Capital Employed	55,00,000	55,00,000

Computation of Present Earnings before interest and tax (EBIT)

EPS (₹)	21
No. of equity shares	20,000
Earnings for equity shareholders (I x II) (₹)	4,20,000
Profit Before Tax (III/75%) (₹)	5,60,000
Interest on long term loan (1500000 x 10%) (₹)	1,50,000
EBIT (IV + V) (₹)	7,10,000

$$\text{EBIT after expansion} = ₹ 7,10,000 + ₹ 2,00,000 = ₹ 9,10,000$$

Evaluation of Financial Plans on the basis of EPS, MPS and Financial Leverage

Particulars	(Amount in ₹)	
	Alternative I	Alternative II
EBIT	9,10,000	9,10,000
Less: Interest: 10% on long term loan	(1,50,000)	(1,50,000)
14% on Debentures	(1,12,000)	Nil
8% on Irredeemable Debentures	Nil	(8000)
PBT	6,48,000	7,52,000
Less: Tax @25%	(1,62,000)	(1,88,000)
PAT	4,86,000	5,64,000
No. of equity shares	21,500	27,200
EPS	22.60	20.74
Applicable P/E ratio (Working Note 1)	7	8.5
MPS (EPS X P/E ratio)	158.2	176.29
Financial Leverage EBIT/PBT	1.40	1.21

Working Note 1

Debt:	Alternative I	Alternative II
₹ 15,00,000 + ₹ 8,00,000	23,00,000	-
₹ 15,00,000 + ₹ 1,00,000	-	16,00,000
Total capital Employed (₹)	55,00,000	55,00,000
Debt Ratio (Debt/Capital employed)	=0.4182	=0.2909
	=41.82%	=29.09%
Change in Equity: ₹ 21,50,000-₹ 20,00,000 ₹ 27,20,000-₹ 20,00,000	1,50,000	7,20,000
Percentage change in equity	7.5%	36%
Applicable P/E ratio	7	8.5
A) Cost of equity		
EPS ₹	22.60	20.74
DPS (EPS X 60%) ₹	13.56	12.44
Growth (g)	10%	10%
Po (MPS)	158.2	176.29
Ke= Do (1 + g)/ Po		
	= 9.43%	= 7.76%
B) Cost of Debt:		
10% long term debt	10% + (1- 0.25)	10% + (1- 0.25)
	7.5%	7.5%
14% redeemable debentures		Nil
	= 10.5 + 1/10.5	
	= 10.95%	
8% irredeemable debenture	NA	8000 (1- 0.25)/1,00,00 = 6%

Calculation of Weighted Average cost of capital (WACC)

Capital	Alternative 1			Alternative 2		
	(weight)	Cost (%)	MACC	(weight)	Cost (%)	MACC
Equity Share Capital	₹ 1,50,000 (0.15)	9.43	1.41%	₹ 7,20,000 (0.72)	7.76	5.59%
Reserve and Surplus	₹ 50,000 (0.05)	9.43	0.47%	₹ 1,80,000 (0.18)	7.76	1.40%
14% Debenture	₹ 8,00,000 (0.80)	10.95	8.76%	-		0.00%
8% Irredeemable Debentures	-			₹ 1,00,000 (0.10)	6	0.60%
Total Capital Employed	₹ 10,00,000		10.65%	₹ 10,00,000		7.58%

Summary of solution:

	Alternate I	Alternate II
Earnings per share (EPS) ₹	22.60	20.74
Market price per share (MPS) ₹	158.20	176.29
Financial leverage	1.4043	1.2101
Weighted Average cost of capital (WACC)	9.12%	7.66%
Marginal cost of capital (MACC)	10.65%	7.58%

Alternative I of financing will be preferred under the criteria of EPS, whereas Alternative II of financing will be preferred under the criteria of MPS, Financial leverage, WACC and marginal cost of capital.

6

CHAPTER

CAPITAL BUDGETING

Education is the passport to the future, for tomorrow belongs to those who prepare for it today.

Important Questions

January 2025



Congratulations!

The league of Champions

FM-SM

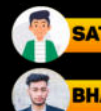
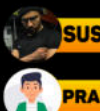
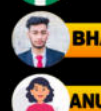
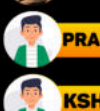
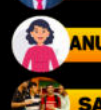
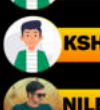
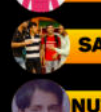
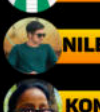
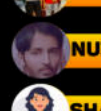
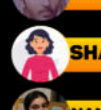
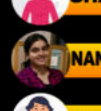
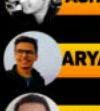
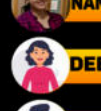
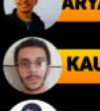
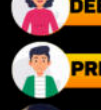
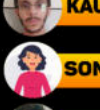
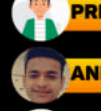
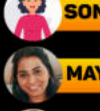
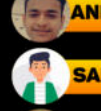
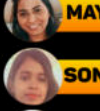
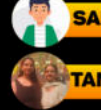
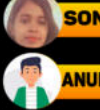
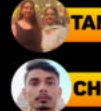
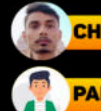
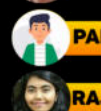
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 74 Marks	 72 Marks	 69 Marks
 69 Marks	 69 Marks	 68 Marks
 68 Marks	 67 Marks	 67 Marks
 66 Marks	 66 Marks	 65 Marks
 65 Marks	 65 Marks	 65 Marks

3000+ Exemptions
3500+ Above 50 Marks



Congratulations!

The League of Champions

 MEENAKSHI AIR 20	 ROHIT AIR 22	 SHUBHAM AIR 23	 ANUSHKA AIR 36	 CHERRY AIR 37	 SANJEEV AIR 47
 SATYAM KUMAR 87 MARKS	 SUSHANT ARORA 83 MARKS				
 BHARAT GAUTAM 80 MARKS	 PRADEEP ROHILLA 79 MARKS				
 ANUSHKA SHARMA 78 MARKS	 KSHITIZ TAYAL 78 MARKS				
 SAIKAT GHOSH 77 MARKS	 NILESH JAISWAL 76 MARKS				
 NUZAIF AKTHAR 76 MARKS	 KOMAL SANWAL 75 MARKS				
 SHALINI SONI 75 MARKS	 ASHUTOSH KUMAR 74 MARKS				
 NANDA CHATURVEDI 74 MARKS	 ARYAN MERATWAL 73 MARKS				
 DEEPANSHI JAIN 73 MARKS	 KAUSHAL ARORA 73 MARKS				
 PREETHAM BHAT 73 MARKS	 SONALI VIJ 73 MARKS				
 ANKIT JAIN 72 MARKS	 MAYURI PRAMOD 72 MARKS				
 SANCHIT 72 MARKS	 SONU AGRAWAL 72 MARKS				
 TANYA BANSAL 72 MARKS	 ANURAG AGGRAWAL 71 MARKS				
 CHIRAG JAIN 70 MARKS	 NITESH LAHU 70 MARKS				
 PARAS BANSAL 70 MARKS	 RAJSHREE 70 MARKS				
 RAJVI DILIP 70 MARKS	 YASH JAIN 70 MARKS				

OTC CHAMPIONS

CHAPTER SIX

Video for Interpretation of the List: <https://youtu.be/dVq9NF7s8l4>



CAPITAL BUDGETING

LIST OF IMPORTANT QUESTIONS JANUARY 2025



**FM-SM
REGULAR** Batch
JAN/MAY/SEPT 2025



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Problem 1: A hospital is considering to purchase a diagnostic machine costing ₹ 80,000. The projected life of the machine is 8 years and has an expected salvage value of ₹ 6,000 at the end of 8 years. The annual operating cost of the machine is ₹ 7,500. It is expected to generate revenues of ₹ 40,000 per year for eight years. Presently, the hospital is outsourcing the diagnostic work and is earning commission income is ₹ 12,000 per annum; net of taxes.

Required: Whether it would be profitable for the hospital to purchase machine. Give your recommendation under:

- Net Present Value method
- Profitability Index method.
- PV factors at 10% are given below:

[Nov-2009]

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
0.909	0.826	0.751	0.683	0.621	0.564	0.513	0.467

Solution: Advise to the Hospital Management

Determination of Cash inflows

Particulars	₹
Sales Revenue	40,000
Less: Operating Cost	7,500
	32,500
Less: Depreciation $\frac{(80,000 - 6,000)}{8}$	9,250
Net Income	23,250
Tax @ 30%	6,975
Earnings after Tax (EAT)	16,275
Add: Depreciation	9,250
Cash inflow after tax per annum	25,525
Less: Loss of Commission Income	12,000
Net Cash inflow after tax per annum	13,525
In 8th Year:	
New Cash inflow after tax	13,525
Add: Salvage Value of Machine	6,000
Net Cash inflow in year 8	19,525

Calculation of Net Present Value (NPV)

Year	CFAT (E)	PV Factor @ 10%	Present Value of Cash inflows
1 to 7	13,525	4.867	65,826.18
8	19,525	0.467	9,118.18
			74,944.36
Less: Cash Outflows			80,000.00
NPV			(5,055.64)

$$\text{Profitability Index} = \frac{\text{Sum of discounted cash inflows}}{\text{Initial Cash Outlay or Total Discounted Cash outflows}}$$

$$= \frac{74,944.36}{80,000} = 0.937$$

Advise: Since the net present value is negative and profitability index is also less than 1, Therefore, the hospital should not purchase the diagnostic machine.

Note: Since the tax rate is not mentioned in the question, therefore, it is assumed to be 30 percent in the given solution.

Problem 2: Following are the data on a capital project being evaluated by the management of X Ltd.:



Project M

Annual cost saving	₹ 40,000
Useful life	4 years
I.R.R.	15%
Profitability Index (P.I.)	1.064
NPV	?
Cost of capital	?
Cost of project	?
Payback	?
Salvage value	0

Find the missing values considering the following table of discount factor only:

Discount factor	15%	14%	13%	12%
1 year	0.869	0.877	0.885	0.893
2 year	0.756	0.769	0.783	0.797
3 year	0.658	0.675	0.693	0.712
4 year	0.572	0.592	0.613	0.636
	<u>2.855</u>	<u>2.913</u>	<u>2.974</u>	<u>3.038</u>

Solution:



At IRR, Present Value of Cash Outflows = Present Value of Cash Inflows

Hence, cost of Project = ₹ 40,000 × 2.855 = ₹ 1,14,200

Profitability Index at cost of capital = 1.064

$$1.064 = \frac{\text{Present Value of Cash Inflows at cost of capital}}{1,14,200}$$

Present Value of Cash Inflows at cost of capital = ₹ 1,21,509

Net Present Value at cost of capital = ₹ 1,21,509 - ₹ 1,14,200 = ₹ 7,309

$$\text{Annuity factor at cost of capital (1-4)} = \frac{\text{Present Value of Cash Inflows}}{\text{Annual Cash Inflows}} = \frac{1,21,509}{40,000} = 3.038$$

Reference to cumulative annuity table gives us the cost of capital 12%.

$$\text{Payback Period} = \frac{1,14,200}{40,000} = 2.855 \text{ years}$$

Problem 3: Strong Enterprises Ltd. is a manufacturer of high quality running shoes. Mr. Dazlling, President, is considering the company's ordering, inventory and billing procedures. He estimates that annual savings from computerization include a reduction of ten clerical employees with annual salaries of ₹ 15,000 each, ₹ 8,000 from reduced production delays caused by raw materials inventory problems ₹ 12,000 from lost sales due to inventory stock outs and ₹ 3,000 associated with timely billing procedure. The purchase price of the system is ₹ 2,00,000 and installation costs are ₹ 50,000. These outlays will be capitalized (depreciated) on a straight-line basis to a zero book salvage value which is also its market value at the end of the end of five years. Operation of the new system requires two computer specialists with annual salaries of ₹ 40,000 per person. Also annual maintenance and operating (cash) expenses of ₹ 12,000 are estimated to be required. The company's tax rate is 40% and its required rate of return (cost of capital) for this project is 12%.

You are required to-

- Find the project's initial net cash outlay.
- Find the project's operating and terminal value cash flows over its 5-year life.

- (c) evaluate the project using NPV method.
- (d) evaluate the project using PI method.
- (e) calculate the project's payback period.
- (f) Find the project's cash flows and NPV [parts (a) through (c)] assuming that the system can be sold for ₹ 25,000 at the end of five years even though the book salvage value will be zero and that capital gain is subject to tax.
- (g) Find the project's cash flows and NPV [parts (a) though (c)] assuming that the book salvage value for depreciation purposes is ₹ 20,000 even though the machine is worthless in terms of its resale value, and that such loss of ₹ 20,000 (book value) is allowed for tax purposes.

Solution:**(a) Project's initial cash outlay:**

Cost	₹ 2,00,000
Installation Expenses	50,000
Total net Cash outlay	<u>2,50,000</u>
Depreciation per year = ₹ 2,50,000 ÷ 5 = ₹ 50,000	

(b) Project's operating cash flows its 5-year life:

	₹
Savings	1,50,000
Reduction in clerks salaries	8,000
Reduction in production delays	12,000
Reduction in lost sales	3,000
Gains due to timely billing	<u>1,73,000</u>
Less: Depreciation	50,000
Less: Additional people cost	80,000
Less: Maintenance cost	<u>12,000</u>
Profit before tax	<u>1,42,000</u>
Less tax @ 40%	31,000
Profit after tax	<u>18,600</u>

Cash flow = PAT + Depreciation = ₹ 18,600 + ₹ 50,000 = ₹ 68,600

(b) Evaluation of the project by using NPV Method:

Year	Cash flow	PVAF (12%, 5y)	Total AV (₹)
1- 5	₹ 68,600	3.605	2,47,303
Less: Total initial Cash outlay			<u>(2,50,000)</u>
		NPV =	<u>(2,697)</u>

Since NPV is negative therefore the project is unviable.

(c) Evaluation of the project by using PI Method:

$$\text{Profitability Index (PI)} = \frac{\text{PV of cash inflows}}{\text{PV of cash outflows}}$$

$$= \frac{₹ 2,47,303}{₹ 2,50,000} = 0.989$$

Since PI is less than 1.0, the project is unviable

(d) Calculation of the Project's Payback Period:

Year	Net Cash flow (₹)	Cumulative cash flow (₹)
1	68,600	68,600
2	68,600	1,37,200
3	68,600	2,05,800
4	68,600	3,74,400

5

68,600

3,43,000

Here, the payback period is 3 years plus a fraction of the 4th year as under:

$$\text{Payback period} = 3 \text{ years} + \frac{44,200}{68,600} = 3.64 \text{ years}$$

Therefore, the payback period is 3.64 years.

- (e) **Calculation of cash flows and NPV assuming when the system can be sold for ₹ 25,000 at the end of 5- years:** In case the project has a salvage of ₹ 25,000 (book value nil) at the end of five years, the whole of ₹ 25,000 is capital gain and subject to tax at the rate of 40%. The present value of the tax salvage amount is to be added to the current NPV.

Post tax salvage value in year 5 = ₹ 15,000 (i.e. ₹ 25,000 × .60)

Present value of ₹ 15,000 discounted at 12% is (₹ 15,000 × 0.566) = ₹ 8,505.

New NPV is ₹ 8,505 – ₹ 2,697 = ₹ 5,808. Since NPV > 0, the project is viable.

- (f) **Project's cash flows and NPV assuming that the book salvage value for depreciation purposes is ₹ 20,000:**

$$\text{Depreciation} = \frac{(\text{₹ } 2,50,000 - \text{₹ } 20,000)}{5} = \text{₹ } 46,000 \text{ per year} \quad \text{₹}$$

Cash inflow for the years 1 to 5 are Savings (Calculated as earlier)	1,73,000
Less: Depreciation	(46,000)
Less: Additional people cost	(80,000)
Less: Maintenance cost	(12,000)
Profit before tax	35,000
Tax @ 40%	14,000
Profit after tax	21,000
Cash inflow (21,000 + 46,000)	67,000

Calculation of NPV: It may be noted that at the end of year 5, the book value of the project would be ₹ 20,000 but realizable value nil. So, the capital loss of ₹ 20,000 will result in tax savings of ₹ 8,000 (i.e. ₹ 20,000 × 40%), as the capital loss is available for tax purpose in view of the information given. So, at the end of year 5, there would be an additional inflow of ₹ 8,000. The NPV may now be calculated as follows:

Years	Cash flows	PVF (12%, n)	PV
1-5	₹ 67,000	3.605	₹ 2,41,535
5	8,000	.567	4,536
PV of inflows			2,46,071
Outflows			2,50,000
NPV			(3,929)

As the NPV of the project is negative, the project is not viable.

Problem 4: Royal Industries is considering the replacement of one of its moulding machines. The existing machine is in good operating condition, but is smaller than required if the firm is to expand its operations. The old machine is 5 years old, has a current salvage value of ₹ 30,000 and a remaining depreciable life of 10 Years. The machine was originally purchased for ₹ 75,000 and is being depreciated on a straight line basis over 10 years, with no salvage value. Cost of new machine is ₹ 1,50,000. The management anticipates that with the expended operations, there will be need for an additional net working capital of ₹ 30,000. The new machine will allow the firm to expand current operations, and thereby increase revenues of ₹ 40,000, and variable operating costs from ₹ 2,00,000 to ₹ 2,10,000. The company's tax rate is 50% and its cost of capital is 10%. Should the company replace its existing machine, given that capital gain taxable at the same rate of tax ?

Solution:**Calculation of Initial Outflow:**

	₹
Cost of Machine	1,50,000
Add: Additional Working Capital required	30,000
Less: Sale value of existing machine	30,000
	1,50,000
Less: Tax saving @ 50% on Loss on sale i.e. 50% of (₹ 50,000 — 30,000)	10,000
Net Cash outflow	1,40,000

Calculation of annual Inflows:

	₹
Increase in Sales Revenues	40,000
Less: Increase in Variable Cost	10,000
Increase in Contribution	30,000
Less: Tax @ 50%	15,000
Add: Tax shield @ 50% on additional Depreciation (i.e. 50% of (15,000— 5,000))	5,000
	20,000

Calculation of Terminal Inflow:

Working capital Released	₹ 30,000

Calculation of Net Present value:

Years	Cash Flow	PV factor @ 10%	PV(₹)
1-10	₹ 20,000	6.145	1,22,900
10	30,000	.386	11,580
			1,34,480
Less: Cash outflow			1,40,000
Net Present Value			(5,520)

As the NPV of buying the new machine is negative, the firm need not replace the existing machine.

Problem 5: The project cash flows from two mutually exclusive Projects A and B are as under:



Period	Project A	Project B
0 (outflow)	₹ 22,000	₹ 27,000
1 to 7 (inflow)	₹ 6,000 each year	₹ 7,000 each year
Project life	7 years	7 years

- Advice on project selection with reference to internal rate of return.
- Will it make any difference in project selection, if the cash flow from project B is for 8 years instead of 7 years @ ₹ 7,000 each year?

Solution:

- Project selection based on internal rate of return.

The present values of Project A and Project B is calculated as follows:

Discount Rate	P.V. Factor for 7 years	Project A		Project B	
		Cash inflow p.a. (₹)	P.V. (₹)	Cash inflow p.a. (₹)	P.V. (₹)

15%	4.16	6,000	24,960	7,000	29,120
16%	4.04	6,000	24,240	7,000	28,280
17%	3.92	6,000	23,520	7,000	27,440
18%	3.81	6,000	22,860	7,000	26,670
19%	3.71	6,000	22,260	7,000	25,970
20%	3.60	6,000	21,600	7,000	25,200

(a) Project A

Since the original investment in Project A is ₹ 22,000, its IRR will fall between 19% and 20%.

Now, IRR of Project A is calculated as follows, by applying formula for interpretation:

$$\text{Actual IRR} = 19 + \frac{260}{660} \times 1 = 19.4\% \text{ (approx)}$$

(b) Project B

Since the original investment in project is ₹ 27,000, its IRR will fall between 17% to 18%.

PV. of cash inflows at 17% 27,440

PV. of cash inflows at 18% 26,670

Difference 770

Now, IRR of Project B is ascertained as below:

$$\text{Actual IRR} = 17 + \frac{27,440 - 27,000}{770} \times 1 = 17.57\% \text{ (approx)}$$

Selection of Project: The IRR of Project A and Project B are 19.4% and 17.6% respectively. A project can be selected based on its higher IRR over the other projects. Hence project A is preferred to which is having a higher IRR of 19.4%.

(ii) Calculation of IRR of Project B whose cash flow from the project is for 8 years instead of 7 years

Discount Factor	P.V. factor for 8 years	Cash inflow each year	P.V. of cash inflows
15%	4.49	7,000	31,340
16%	4.34	7,000	30,380
17%	4.21	7,000	29,470
18%	4.08	7,000	28,560
19%	3.95	7,000	27,650
20%	3.84	7,000	26,880

Since the original investment in Project B is ₹ 27,000, its IRR will fall between 19% to 20%.

(₹)

PV. of cash inflows @ 19% 27,650

PV. of cash inflows @ 20% 26,880

Difference 770

Now, IRR of Project B is calculated as follows:

$$\text{Actual IRR} = 19 + \frac{27,650 - 27,000}{770} \times 1 = 19.8\% \text{ (approx)}$$

Selection of Project: With the change in cash inflow of project B from 7 years to 8 years its IRR is also improved from 17.6% to 19.8% and it is also higher than the IRR of Project A (i.e. 19.4%). Hence, Project B can be selected (based on its 8 years of cash inflows).

Problem 6: Pioneer Steels Ltd., is considering two mutually exclusive projects. Both required an initial cash outlay of ₹ 10,000 each and have a life of five years. The company's required rate of return is 10% and pays tax at a 50% rate. The projects will be depreciated on a straight line basis. The net cash flow expected to be generated by the projects are as follows:

Year	1	2	3	4	5
Project 1	₹ 4,000	4,000	4,000	4,000	4,000
Project 2	₹ 6,000	3,000	2,000	5,000	5,000

You are required to calculate:

- The pay back of each project.
- The Average rate of return for each project.
- The Net present value and Profitability index for each project.
- The Internal rate of returns for each project.

Which project should be accepted and why ?

Solution:

Calculation of Cash flows: In the question, it has been mentioned that the depreciation will be provided on straight line basis. It appears that the net cash flows given in the question are the profit before depreciation and tax. These are to be adjusted to find out the cash flows as follows:

Project 1

Year	PBDT	Dep.	PBT	Tax	PAT	CF	Cumulative
	(₹)	(₹)	(₹)	(₹)	(₹)	(₹)	CF (₹)
1	₹ 4,000	₹ 2,000	₹ 2,000	₹ 1,000	₹ 1,000	₹ 3,000	₹ 3,000
2	4,000	2,000	2,000	1,000	1,000	3,000	6,000
3	4,000	2,000	2,000	1,000	1,000	3,000	9,000
4	4,000	2,000	2,000	1,000	1,000	3,000	12,000
5	4,000	2,000	2,000	1,000	1,000	3,000	15,000

*PBDT – Profit before depreciation and tax

Project 2

	₹	₹	₹	₹	₹	₹	₹
1	6,000	2,000	4,000	2,000	2,000	4,000	4,000
2	3,000	2,000	1,000	5,00	5,00	2,500	6,500
3	2,000	2,000	—	—	—	2,000	8,500
4	5,000	2,000	3,000	1,500	1,500	3,500	12,000
5	5,000	2,000	3,000	1,500	1,500	3,500	15,000

Project 1

Calculation of Payback Period:

$$3 + \frac{1,000}{3,000} \text{ years}$$

$$= 3 \frac{1}{3} \text{ years}$$

Calculation of Accounting Rate of Return:

Average Cost	₹ 5,000
Average Profit After Tax	₹ 1,000
ARR	20%

Project 2

$$3 + \frac{1,500}{3,500} \text{ years}$$

$$= 3 \frac{3}{7} \text{ years}$$

₹ 5,000
₹ 1,100
22%

Calculation of NPV (Cost of Capital 10%):

Project 1: Annuity of Cash inflows for 5 years	=	₹ 3,000
PVAF _(10%,5y)	=	3.791
PV of Annuity (₹ 3,000 × 3.791)	=	₹ 11,373
Less: Cash outflow	=	₹ 10,000
Net Present Value	=	<u>₹ 1,373</u>

Project 2:

Year	Cash flow	PVF _(10%,n)	PV
0	(10,000)	1.000	(10,000)
1	4,000	0.909	3,636
2	2,500	0.826	2,065
3	2,000	0.751	1,502
4	3,500	0.683	2,391
5	3,500	0.621	2,173
Net Present Value			1,767

Calculation of Profitability Index:

$$PI = \frac{\text{PV of Inflows}}{\text{PV of outflows}}$$

Project 1 $PI = \frac{₹ 11,373}{₹ 10,000} = 1.137$

Project 2 $PI = \frac{₹ 11,767}{₹ 10,000} = 1.177$

Calculation of Internal Rate of Return: The IRR of a project is the rate at which the NPV of the project comes to zero. In the above calculation of NPV (at 10%), both projects were found to be having positive NPV. So, the IRR for both the projects are more than 10%. The exact IRR may be ascertained as follows:

Project 1: In these case, the cash inflows are equal for 5 years, therefore the situation can be presented like this:-

$$\begin{aligned} ₹ 10,000 &= ₹ 3,000 \times PVAF_{(r,5y)} \\ PVAF_{(r,5y)} &= 10,000 \div 3,000 \\ &= 3.333 \end{aligned}$$

In the PVAF table, the value of 3.333 in 5 years row may be found between 15% and 16%.

$$\begin{aligned} \text{At 15\% NPV} &= (₹ 3,000 \times PVAF_{15\%,5y}) - ₹ 10,000 \\ &= (₹ 3,000 \times 3.352) - ₹ 10,000 \\ &= ₹ 56 \end{aligned}$$

$$\begin{aligned} \text{At 16\% NPV} &= (₹ 3,000 \times PVAF_{16\%,5y}) - ₹ 10,000 \\ &= (₹ 3,000 \times 3.274) - ₹ 10,000 \\ &= ₹ -178 \end{aligned}$$

The exact IRR may be found by interpolating between 15% & 16%,

$$IRR = 15\% + \frac{56}{(56 + 178)}\% = 15.24\%$$

Project 2: As the project 2 is having higher NPV and the Inflows are scattered, the NPV may be found at 16% and 17%.

Year	CF (₹)	PVF _(16%,n) (₹)	PV (₹)	PVF _(17%,n) (₹)	PV (₹)
0	(10,000)	1.000	(10,000)	1.000	(10,000)
1	4,000	0.862	3,448	.855	3,420
2	2,500	0.743	1,858	.731	1,828

3	2,000	0.641	1,282	.624	1,248
4	3,500	0.552	1,932	.534	1,869
5	3,500	0.476	1,666	.456	1,596
			186		-39

Now, the IRR is $= 16\% + \frac{186}{186 + 39}\% = 16.83\%$

Problem 7: Company X is forced to choose between two machines A and B. The two machines are designed differently, but have identical capacity and do exactly the same job. Machine A costs ₹ 1,50,000 and will last for 3 years. It costs ₹ 40,000 per year to run. Machine B is an 'economy' model costing only ₹ 1,00,000, but will last only for 2 years, and costs ₹ 60,000 per year to run. These are real cash flows. The costs are forecasted in rupees of constant purchasing power. Ignore tax. Opportunity cost of capital is 10 per cent. Which machine company X should buy?

Solution:

Statement showing the evaluation of two machines

Machines	A	B
Purchase cost (₹): (i)	1,50,000	1,00,000
Life of machines (years)	3	2
Running cost of machine per year (₹): (ii)	40,000	60,000
Cumulative present value factor for 1-3 years @ 10% (iii)	2.486	–
Cumulative present value factor for 1-2 years @ 10% (iv)	–	1.735
Present value of running cost of machines (₹): (v)	99,440	1,04,100
	[(ii) × (iii)]	[(ii) × (iv)]
Cash outflow of machines (₹): (vi) = (i) + (v)	2,49,440	2,04,100
Equivalent present value of annual cash outflow	1,00,338	1,17,637
	[(vi) ÷ (iii)]	[(vi) ÷ (iv)]

Decision: Company X should buy machine A since its equivalent cash outflow is less than machine B.

Problem 8: A firm is considering the introduction of a new product which will have a life of five years. Two alternative of promoting the product have been identified:

Alternative 1: This will involve employing a number of agents. An immediate expenditure of ₹ 5,00,000 will be required to advertise the product. This will produce net annual cash inflows of ₹ 3,00,000 at the end of the each of the subsequent five years. However, the agents will have to be paid ₹ 50,000 each years. On termination of the contract the agent will have to be paid a lump sum of ₹ 1,00,000 at the end of the fifth years.

Alternative 2: Under this alternative, the firm will not employ agent but will sell directly to the consumers. The initial expenditure on advertising will be ₹ 2,50,000. This will bring in cash at the end of each year of ₹ 1,50,000. However this alternative will involve out-of-pocket cost for sales administration to the extent of ₹ 50,000. The firm also proposes to allocate fixed costs worth ₹ 20,000 per year to this product if this alternative is pursued.

Required:

- Advice the management as to the method of promotion to be adopted. You may assume that the firm's cost of capital is 20%
- Calculate the internal rate of return for alternative 2.

Solution:

Calculation of NPV:

Alternative 1

Outflows: Initial Expenditure (A)		(₹ 5,00,000)
Inflows: Annual cash inflow	₹ 3,00,000	
Less: payment to Agent	50,000	
Net cash inflow	2,50,000	
PVAF (20%, 5Y)	2.991	
Present value of inflows (2,50,000 × 2.991) (B)		7,47,750
Outflow: at the end of year 5 (Payment to agents)	1,80,000	
PVF (20%, 5Y)	402	
Present Value (C)	40,200	(40,200)
Net present value (B) - [(A) + (C)]		₹ 2,07,550

Alternative 2

Outflow: Initial Expenditure (A)		₹ -2,50,000
Inflows: Annual Cash inflow	₹ 1,50,000	
Less: Out of pocket expenses	50,000	
Net inflow	1,00,000	
PVAF (20%, 5Y)	2.991	
Present value of inflows (2.991 × 1,00,000) (B)		2,99,100
Net present value (2,99,100 - 2,50,000) (B) - (A)		49,100

Calculation of Internal rate of return for alternative 2:

$$₹ 2,50,000 = ₹ 1,00,000 \times \text{PVAF}(r, 5Y)$$

$$\text{PVAF}(r, 5Y) = 2,50,000 \div 1,00,000 = 2.5$$

For 5 years in the PVAF table, the value of 2.5 may be traced between 28% and 29%.

$$\text{At } 28\% \text{ NPV} = (1,00,000 \times 2.532) - 2,50,000 = ₹ 3,200$$

$$\text{At } 29\% \text{ NPV} = (1,00,000 \times 2.483) - 2,50,000 = ₹ -1,700$$

The exact IRR may be found by interpolating between 28% and 29% as follows:

$$\text{IRR} = 28 + \frac{3,200}{(3,200 + 1,700)} = 28.65\%$$

Note: The allocated fixed costs in case of Alternative 2 have been ignored because these do not involve any incremental cash outflow.

Problem 9: SS Limited is considering the purchase of a new automatic machine which will carry out some operations which are at present performed by manual labour. NM-A1 and NM-A2, two alternative models are available in the market. The following details are collected:



	Machine	
	NM-A1	NM-A2
Cost of Machine (₹)	20,00,000	25,00,000
Estimated working life 5 Years 5 Years	5 Years	5 Years
Estimated saving in direct wages per annum (₹)	7,00,000	9,00,000
Estimated saving in scrap per annum (₹)	60,000	1,00,000
Estimated additional cost of indirect material per annum (₹)	30,000	90,000
Estimated additional cost of indirect labour per annum (₹)	40,000	50,000
Estimated additional cost of repairs and maintenance per annum (₹)	45,000	85,000

Depreciation will be charged on a straight line method. Corporate tax rate is 30 percent and expected rate of return may be 12 percent.

Required: To evaluate the alternatives by calculating the

- (i) Pay-back Period
- (ii) Accounting (Average) Rate of Return; and
- (iii) Profitability Index or P.V. Index (P.V. factor for ₹ 1 @ 12% 0.893; 0.797; 0.712; 0.636; 0.567; 0.507)

[Nov. 2012]

Solution: Evaluation of Alternatives**Working Notes:**Depreciation on Machine NM-A1 = $20,00,000/5 = 4,00,000$ Depreciation on Machine NM-A2 = $25,00,000/5 = 5,00,000$

Particulars	Machine NM-A1 (₹)	Machine NM-A2 (₹)
Annual Savings:		
Direct Wages	7,00,000	9,00,000
Scraps	60,000	1,00,000
Total Savings (A)	7,60,000	10,00,000
Annual Estimated Cash Cost :		
Indirect Material	30,000	90,000
Indirect Labour	40,000	50,000
Repairs and Maintenance	45,000	85,000
Total Cost (B)	1,15,000	2,25,000
Annual Cash Savings (A-B)	6,45,000	7,75,000
Less: Depreciation	4,00,000	5,00,000
Annual Savings before Tax	2,45,000	2,75,000
Less: Tax @ 30%	73,500	82,500
Annual Savings /Profits after tax	1,71,500	1,92,500
Add: Depreciation	4,00,000	5,00,000
Annual Cash Inflows	5,71,500	6,92,500

(i) Payback Period

Machine NM-A1 = Total Initial Capital Investment/Annual expected after tax net cash flow

$$= 20,00,000/5,71,500$$

$$= 3.50 \text{ Years}$$

Machine NM- A2 = $25,00,000/6,92,500$

$$= 3.61 \text{ Years}$$

Decision: Machine NM-A1 is better.**(ii) Accounting (Average) Rate of Return (ARR)**

ARR = Average Annual Net Savings/Average investment x 100

Machine NM-A1 = $1,71,500/10,00,000 \times 100$

$$= 17.15\%$$

Machine NM-A2 = $1,92,500/12,50,000 \times 100$

$$= 15.4\%$$

Decision: Machine NM-A1 is better.

(Note: ARR may be computed alternatively by taking initial investment in the denominator.)

(iii) Profitability Index or P V Index

Present Value Cash Inflow = Annual Cash Inflow x PV factor at 12%

Machine NM-A1 = 5, 71,500 x 3.605 = ₹ 20, 60,258

Machine NM-A2 = 6, 92,500 x 3.605 = ₹ 24, 96,463

PV Index = Present Value of Cash Inflow/Investment

Machine NM-A1 = 20,60,258/20,00,000 = 1.03

Machine NM-A2 = 24,96,463/25,00,000 = 0.9

Decision: Machine NM-A1 is better

Problem 10: ANP Ltd. is providing the following information:



Annual cost of saving	₹ 96,000
Useful life	5 years
Salvage value	zero
Internal rate of return	15%
Profitability index	1.05

Table of discount factor

Discount factor	Years					
	1	2	3	4	5	Total
15%	0.870	0.756	0.658	0.572	0.497	3.353
14%	0.877	0.769	0.675	0.592	0.519	3.432
13%	0.886	0.783	0.693	0.614	0.544	3.52

Required:

- Cost of the project
- Payback period
- Net present value of cash inflow
- Cost of capital.

[May 2012]

Solution:



(i) **Cost of Project**

At 15% internal rate of return (IRR), the sum of total cash inflows = cost of the project i.e initial cash outlay

Annual cost savings = ₹ 96,000

Useful life = 5 years

Considering the discount factor table @ 15%, cumulative present value of cash inflows for 5 years is 3.353

Hence, Total Cash inflows for 5 years for the Project is 96,000 x 3.353 = ₹ 3,21,888

Hence, Cost of the Project = ₹ 3,21,888

(ii) **Payback Period**

$$\text{Payback period} = \frac{\text{Cost of the Project}}{\text{Annual Cost Savings}} = \frac{\text{₹ 3,21,888}}{96,000}$$

Payback Period = 3.353 years

(iii) **Net Present Value (NPV)**

NPV = Sum of Present Values of Cash inflows – Cost of the Project

= ₹ 3,37,982.40 – 3,21,888 = ₹ 16,094.40

Net Present Value = ₹ 16,094.40

(iv) **Cost of Capital**

$$\text{Profitability index} = \frac{\text{Sum of Discounted Cash inflows}}{\text{Cost of the Project}}$$

$$1.05 = \frac{\text{Sum of Discounted Cash inflows}}{3,21,888}$$

∴ Sum of Discounted Cash inflows = ₹ 3,37,982.40

Since, Annual Cost Saving = ₹ 96,000

$$\text{Hence, cumulative discount factor for 5 years} = \frac{₹ 3,37,982.40}{96,000}$$

From the discount factor table, at discount rate of 13%, the cumulative discount factor for 5 years is 3.52

Hence, Cost of Capital = 13%

Problem 11: Given below are the data on a capital project 'M'



Annual cash inflows ₹60,000

Useful life 4 years

Internal rate of return 15%

Profitability index 1.064

Salvage value 0

You are required to calculate for this project M:

(i) Cost of project

(ii) Payback period

(iii) Cost of capital

(iv) Net present value

PV factors at different rates are given below:

(May 2015)

Discount factor	15%	14%	13%	12%
1 year	0.869	0.877	0.885	0.893
2 year	0.756	0.769	0.783	0.797
3 year	0.658	0.675	0.693	0.712
4 year	0.572	0.592	0.613	0.636

Solution:



(i) Cost of Project 'M'

At 15% internal rate of return (IRR), the sum of total cash inflows = cost of the project i.e initial cash outlay

Annual cash inflows = ₹60,000

Useful life = 4 years

Considering the discount factor table @ 15%, cumulative present value of cash inflows for 4 years is 2.855 (0.869 + 0.756 + 0.658 + 0.572)

Hence, Total Cash inflows for 4 years for Project M is

₹60,000 × 2.855 = ₹1,71,300

Hence, Cost of the Project = ₹1,71,300

(ii) Payback Period

$$\text{Payback period} = \frac{\text{Cost of the Project}}{\text{Annual Cash Inflows}} = \frac{₹1,71,300}{₹60,000} = 2.855 \text{ years}$$

(iii) Cost of Capital

$$\text{Profitability index} = \frac{\text{Sum of Discounted Cash inflows}}{\text{Cost of the Project}}$$

$$1.064 = \frac{\text{Sum of Discounted Cash inflows}}{₹1,71,300}$$

∴ Sum of Discounted Cash inflows = ₹1,82,263.20

Since, Annual Cash Inflows = ₹60,000

$$\text{Hence, cumulative discount factor for 4 years} = \frac{₹1,82,263.20}{₹60,000}$$

From the discount factor table, at discount rate of 12%, the cumulative discount factor for 4 years is
3.038 (0.893 + 0.797 + 0.712 + 0.636)

Hence, Cost of Capital = 12%

(iv) Net Present Value (NPV)

NPV = Sum of Present Values of Cash inflows – Cost of the Project
= ₹1,82,263.20 – ₹1,71,300 = ₹10,963.20

Net Present Value = ₹10,963.20

Problem 12: Elite Cooker Company is evaluating three investment situations: (1) Produce a new line of aluminium skillets, (2) Expand its existing cooker line to include several new sizes, and (3) Develop a new, higher-quality line of cookers. If only the project in question is undertaken, the expected present values and the amounts of investment required are:

Project	Investment required	Present value of Future Cash-Flows
	₹	₹
1	2,00,000	2,90,000
2	1,15,000	1,85,000
3	2,70,000	4,00,000

If projects 1 and 2 are jointly undertaken, there will be no economies; the investments required and present values will simply be the sum of the parts. With projects 1 and 3, economies are possible in investment because one of the machines acquired can be used in both production processes. The total investment required for projects 1 and 3 combined is ₹ 4,40,000. If projects 2 and 3 are undertaken, there are economies to be achieved in marketing and producing the products but not in investment. The expected present value of future cash flows for projects 2 and 3 is ₹ 6,20,000. If all three projects are undertaken simultaneously, the economies noted will still hold. However, a ₹ 1,25,000 extension on the plant will be necessary, as space is not available for all three projects. CALCULATE NPV of the projects and STATE which project or projects should be chosen?

Solution:



Calculation of NPV

Project	Investment Required	Present value of Future Cash Flows	Net Present value
	₹	₹	₹
1	2,00,000	2,90,000	90,000
2	1,15,000	1,85,000	70,000
3	2,70,000	4,00,000	1,30,000
1 and 2	3,15,000	4,75,000	1,60,000
1 and 3	4,40,000	6,90,000	2,50,000
2 and 3	3,85,000	6,20,000	2,35,000
1, 2 and 3 (Refer Working note)	6,80,000*	9,10,000	2,30,000

Working Note:**(i) Total Investment required if all the three projects are undertaken simultaneously:**

	(₹)
Project 1 & 3	4,40,000
Project 2	1,15,000
Plant extension cost	1,25,000
Total	6,80,000

(ii) Total of Present value of Cash flows if all the three projects are undertaken simultaneously:

	(₹)
Project 2 & 3	6,20,000
Project 1	2,90,000
Total	9,10,000

Projects 1 and 3 should be chosen, as they provide the highest net present value.

Problem 13: Ae Bee Cee Ltd. is planning to invest in machinery, for which it has to make a choice between the two identical machines, in terms of Capacity, 'X' and 'Y'. Despite being designed differently, both machines do the same job. Further, details regarding both the machines are given below:

Particulars	Machine 'X'	Machine 'Y'
Purchase Cost of the Machine (₹)	15,00,000	10,00,000
Life (years)	3	2
Running cost per year (₹)	4,00,000	6,00,000

The opportunity cost of capital is 9%.

You are required to IDENTIFY the machine which the company should buy?

The present value (PV) factors at 9% are:

Year	t_1	t_2	t_3
$PVIF_{0.09,t}$	0.917	0.842	0.772

Solution:

Statement Showing the Evaluation of Two Machines

	Particulars	Machine 'X'	Machine 'Y'
(i)	Purchase Cost	₹ 15,00,000	₹ 10,00,000
(ii)	Life of Machine	3 years	2 years
(iii)	Running Cost of Machine per year	₹ 4,00,000	₹ 6,00,000
(iv)	PVIFA (0.09, 3)	2.531	
	PVIFA (0.09, 2)		1.759
(v)	PV of Running Cost of Machine {(iii) × (iv)}	₹ 10,12,400	₹ 10,55,400
(vi)	Cash outflows of Machine {(i) + (v)}	₹ 25,12,400	₹ 20,55,400
(vii)	Equivalent PV of Annual Cash outflow {(vi)/(iv)}	₹ 9,92,651	₹ 11,68,505

Recommendation: Ae Bee Cee Ltd. should buy Machine 'X' since equivalent annual cash outflow is less than that of Machine 'Y'.

Problem 14: XYZ Ltd. is planning to introduce a new product with a project life of 8 years. Initial equipment cost will be ₹ 3.5 crores. Additional equipment costing ₹ 25,00,000 will be purchased at the end of the third year from the cash inflow of this year. At the end of 8 years, the original equipment will have no resale value, but additional equipment can be sold for ₹ 2,50,000. A working capital of ₹ 40,00,000 will be needed and it will be released at the end of eighth year. The project will be financed with sufficient amount of equity capital.

The sales volumes over eight years have been estimated as follows:

Year	1	2	3	4-5	6-8
Units per year	72,000	1,08,000	2,60,000	2,70,000	1,80,000

A sales price of ₹ 240 per unit is expected and variable expenses will amount to 60% of sales revenue. Fixed cash operating costs will amount ₹ 36,00,000 per year. The loss of any year will be set off from the profits of subsequent two years. The company is subject to 30 per cent tax rate and considers 12 per cent to be an appropriate after-tax cost of capital for this project. The company follows straight line method of depreciation.

CALCULATE the net present value of the project and advise the management to take appropriate decision.

The PV factors at 12% are

Year	1	2	3	4	5	6	7	8
PV Factor	0.893	0.797	0.712	0.636	0.567	0.507	0.452	0.404

Solution:



(a) Calculation of annual cash flows

(₹ in lakh)

Year	Sales	VC	FC	Dep.	Profit	Tax	PAT	Dep.	Cash inflow
1	172.80	103.68	36	43.75	(10.63)	-	-	43.75	33.12
2	259.20	155.52	36	43.75	23.93	3.99*	19.94	43.75	63.69
3	624.00	374.40	36	43.75	169.85	50.955	118.895	43.75	162.645
4-5	648.00	388.80	36	48.25	174.95	52.485	122.465	48.25	170.715
6-8	432.00	259.20	36	48.25	88.55	26.565	61.985	48.25	110.235

(b) Calculation of Depreciation:

$$\text{- On Initial equipment} = \frac{350 \text{ lakh}}{8 \text{ years}} = 43.75 \text{ lakh}$$

$$\text{- On additional equipment} = \frac{(\text{₹}25 - \text{₹}2.5) \text{ lakh}}{8 \text{ years}} = 4.5 \text{ lakh}$$

(c) *Calculation of tax in 2nd Year:

	₹ in lakh
Profit for the year	23.93
Less: Set off of unabsorbed depreciation in 1st year	(10.63)
Taxable profit	13.30
Tax @30%	3.99

(d) Calculation of Initial cash outflow

	₹ in lakh
Cost of New Equipment	350
Add: Working Capital	40
Outflow	390

Calculation of NPV

(₹ in lakh)

Year	Cash flows	PV factor @12%	PV of cash- flows	Remark
0	(390)	1	(390)	Initial equipment cost
1	33.12	0.893	29.57	
2	63.69	0.797	50.76	
3	162.645	0.712	115.8	
3	(25)	0.712	(17.8)	Additional equipment cost
4	170.715	0.636	108.57	
5	170.715	0.567	96.79	
6	110.235	0.507	55.89	
7	110.235	0.452	49.83	
8	110.235	0.404	44.53	
8	40	0.404	16.16	Release of working capital
8	2.5	0.404	1.01	Additional equipment salvage value
Net Present Value			161.11	

Advise: Since the project has a positive NPV, therefore, it should be accepted.

Problem 15: A large profit making company is considering the installation of a machine to process the waste produced by one of its existing manufacturing process to be converted into a marketable product. At present, the waste is removed by a contractor for disposal on payment by the company of ₹ 150 lakh per annum for the next four years. The contract can be terminated upon installation of the aforesaid machine on payment of a compensation of ₹ 90 lakh before the processing operation starts. This compensation is not allowed as deduction for tax purposes.

The machine required for carrying out the processing will cost ₹ 600 lakh. At the end of the 4th year, the machine can be sold for ₹ 60 lakh and the cost of dismantling and removal will be ₹ 45 lakh.

Sales and direct costs of the product emerging from waste processing for 4 years are estimated as under:

(₹ in lakh)

Year	1	2	3	4
Sales	966	966	1,254	1,254
Material consumption	90	120	255	255
Wages	225	225	255	300
Other expenses	120	135	162	210
Factory overheads	165	180	330	435
Depreciation (as per income tax rules)	150	114	84	63

Initial stock of materials required before commencement of the processing operations is ₹ 60 lakh at the start of year 1. The stock levels of materials to be maintained at the end of year 1, 2 and 3 will be ₹ 165 lakh and the stocks at the end of year 4 will be nil. The storage of materials will utilise space which would otherwise have been rented out for ₹ 30 lakh per annum. Labour costs include wages of 40 workers, whose transfer to this process will reduce idle time payments of ₹ 45 lakh in the year- 1 and ₹ 30 lakh in the year- 2. Factory overheads include apportionment of general factory overheads except to the extent of insurance charges of ₹ 90 lakh per annum payable on this venture. The company's tax rate is 30%.

Consider cost of capital @ 14%, the present value factors of which is given below for four years:

Year	1	2	3	4
PV factors @14%	0.877	0.769	0.674	0.592

ADVISE the management on the desirability of installing the machine for processing the waste. All calculations should form part of the answer.

Solution:**Statement of Operating Profit from processing of waste****(₹ in lakhs)**

Year	1	2	3	4
Sales (A)	966	966	1,254	1,254
Material consumption	90	120	255	255
Wages	180	195	255	300
Other expenses	120	135	162	210
Factory overheads (insurance only)	90	90	90	90
Loss of rent on storage space (opportunity cost)	30	30	30	30
Depreciation (as per income tax rules)	150	114	84	63
Total cost (B)	660	684	876	948
Profit {(C)=(A) - (B)}	306	282	378	306
Less: Tax (30%)	91.8	84.6	113.4	91.8
Profit after Tax (PAT)	214.2	197.4	264.6	214.2

Statement of Incremental Cash Flows**(₹ in lakhs)**

Year	0	1	2	3	4
Cost of Machine	(600)				
Material stock	(60)	(105)	-	-	165
Compensation for contract	(90)	-	-	-	-
Contract payment saved	-	150	150	150	150
Tax on contract payment	-	(45)	(45)	(45)	(45)
Incremental profit	-	306	282	378	306
Depreciation added back	-	150	114	84	63
Tax on profits	-	(91.8)	(84.6)	(113.4)	(91.8)
Profit on sale of machinery (net)	-	-	-	-	15
Total incremental cash flows Present value factor	(750)	364.2	416.4	453.6	562.2
Present value of cash flows	1.00	0.877	0.769	0.674	0.592
	(750)	319.40	320.21	305.73	332.82
Net present value		528.16			

Advice: Since the net present value of cash flows is ₹ 528.16 lakh which is positive the management should install the machine for processing the waste.

Notes:

1. Material stock increases are taken in cash flows.
2. Idle time wages have also been considered.
3. Apportioned factory overheads are not relevant only insurance charges of this project are relevant.
4. Sale of machinery - Net income after deducting removal expenses taken. Tax on Capital gains is ignored.
5. Saving in contract payment and income tax thereon is considered in the cash flows.

Problem 16: Xavly Ltd. has a machine which has been in operation for 3 years. The machine has a remaining estimated useful life of 5 years with no salvage value in the end. Its current market value is ₹ 2,00,000. The company is considering a proposal to purchase a new model of machine to replace the existing machine. The relevant information is as follows:

	Existing Machine	New Machine
Cost of machine	₹ 3,30,000	₹ 10,00,000
Estimated life	8 years	5 years
Salvage value	Nil	₹ 40,000
Annual output	30,000 units	75,000 units
Selling price per unit	₹ 15	₹ 15
Annual operating hours	3,000	3,000
Material cost per unit	₹ 4	₹ 4
Labour cost per hour	₹ 40	₹ 70
Indirect cash cost per annum	₹ 50,000	₹ 65,000

The company uses written down value of depreciation @ 20% and it has several other machines in the block of assets. The Income tax rate is 30 per cent and Xavly Ltd. does not make any investment, if it yields less than 12 per cent.

ADVISE Xavly Ltd. whether the existing machine should be replaced or not.

PV factors @12%:

Year	1	2	3	4	5
PVF	0.893	0.797	0.712	0.636	0.567

Solution:



(i) Calculation of Net Initial Cash Outflows:

	₹
Cost of new machine	10,00,000
Less: Sale proceeds of existing machine	2,00,000
Net initial cash outflows	8,00,000

(ii) Calculation of Base for depreciation

Particulars	₹
WDV of Existing Machine	
Cost of existing machine	3,30,000
Less: Depreciation for year 1	66,000
Depreciation for Year 2	52,800
Depreciation for Year 3	42,240
WDV of Existing Machine (i)	1,68,960
Depreciation base of New Machine	

Cost of new machine	10,00,000
Add: WDV of existing machine	1,68,960
Less: Sales value of existing machine	2,00,000
Depreciation base of New Machine (ii)	9,68,960
Base for incremental depreciation [(ii) – (i)]	8,00,000

(iii) Calculation of annual Profit Before Tax and depreciation

Particulars	Existing machine	New Machine	Differential
(1)	(2)	(3)	(4)=(3)–(2)
Annual output	30,000 units	75,000 units	45,000 units
	₹	₹	₹
(A) Sales revenue @ ₹ 15 per unit	4,50,000	11,25,000	6,75,000
(B) Less: Cost of Operation			
Material @ ₹ 4 per unit	1,20,000	3,00,000	1,80,000
Labour			
Old = 3,000 x ₹ 40	1,20,000		90,000
New = 3,000 x ₹ 70		2,10,000	
Indirect cash cost	50,000	65,000	15,000
Total Cost (B)	2,90,000	5,75,000	2,85,000
Profit Before Tax and depreciation (PBTd) (A – B)	1,60,000	5,50,000	3,90,000

(iv) Calculation of Incremental Net Present Value:

Year	PBTd	Dep. @ 20%	PBT	Tax @ 30%	Net cash flow	PVF @ 12%	PV
(1)	(2)	(3)	(4)=2-3	(5)	(6)=4-5+3	(7)	(8)=6 x 7
1	3,90,000	1,60,000	2,30,000	69,000.00	3,21,000.00	0.893	2,86,653.00
2	3,90,000	1,28,000	2,62,000	78,600.00	3,11,400.00	0.797	2,48,185.80
3	3,90,000	1,02,400	2,87,600	86,280.00	3,03,720.00	0.712	2,16,248.64
4	3,90,000	81,920	3,08,080	92,424.00	2,97,576.00	0.636	1,89,258.34
5	3,90,000	65,536	3,24,464	97,339.20	2,92,660.80	0.567	1,65,938.67
							11,06,284.45
	Add: PV of Salvage Value of new machine (₹ 40,000 x 0.567)						22,680.00
	Less: Initial Cash Outflow						8,00,000.00
	NPV						3,28,964.45

Advice: Since the incremental NPV is positive, existing machine should be replaced.

Problem 17: Manoranjan Ltd is a News broadcasting channel having its broadcasting Centre in Mumbai. There are total 200 employees in the organisation including top management. As a part of employee benefit expenses, the company serves tea or coffee to its employees, which is outsourced from a third-party. The company offers tea or coffee three times a day to each of its employees. 120 employees prefer tea all three times, 40 employees prefer

coffee all three times and remaining prefer tea only once in a day. The third-party charges ₹ 10 for each cup of tea and ₹ 15 for each cup of coffee. The company works for 200 days in a year.

Looking at the substantial amount of expenditure on tea and coffee, the finance department has proposed to the management an installation of a master tea and coffee vending machine which will cost ₹ 10,00,000 with a useful life of five years. Upon purchasing the machine, the company will have to enter into an annual maintenance contract with the vendor, which will require a payment of ₹ 75,000 every year. The machine would require electricity consumption of 500 units p.m. and current incremental cost of electricity for the company is ₹ 12 per unit. Apart from these running costs, the company will have to incur the following consumables expenditure also:

1. Packets of Coffee beans at a cost of ₹ 90 per packet.
2. Packet of tea powder at a cost of ₹ 70 per packet.
3. Sugar at a cost of ₹ 50 per Kg.
4. Milk at a cost of ₹ 50 per litre.
5. Paper cup at a cost of 20 paise per cup

Each packet of coffee beans would produce 200 cups of coffee and same goes for tea powder packet. Each cup of tea or coffee would consist of 10g of sugar on an average and 100 ml of milk.

The company anticipate that due to ready availability of tea and coffee through vending machines its employees would end up consuming more tea and coffee.

It estimates that the consumption will increase by on an average 20% for all class of employees. Also, the paper cups consumption will be 10% more than the actual cups served due to leakages in them.

The company is in the 25% tax bracket and has a current cost of capital at 12% per annum. Straight line method of depreciation is allowed for the purpose of taxation. You as a financial consultant is required to ADVISE on the feasibility of acquiring the vending machine.

PV factors @ 12%:

Year	1	2	3	4	5
PVF	0.8929	0.7972	0.7118	0.6355	0.5674

Solution:



(A) Computation of CFAT (Year 1 to 5)

Particulars		Amount (₹)
(a) Savings in existing Tea & Coffee charges	$(120 \times 10 \times 3) + (40 \times 15 \times 3) + (40 \times 10 \times 1) \times 200 \text{ days}$	11,60,000
(b) AMC of machine		(75,000)
(c) Electricity charges	$500 \times 12 \times 12$	(72,000)
(d) Coffee Beans	(W.N.) 144×90	(12,960)
(e) Tea Powder	(W.N.) 480×70	(33,600)
(f) Sugar	(W.N.) 1248×50	(62,400)
(g) Milk	(W.N.) 12480×50	(6,24,000)
(h) Paper Cup	(W.N.) $1,37,280 \times 0.2$	(27,456)
(i) Depreciation	$10,00,000/5$	(2,00,000)
Profit before Tax		52,584
(-) Tax @ 25%		(13,146)
Profit after Tax		39,438
Depreciation		2,00,000
CFAT		2,39,438

(B) Computation of NPV

Year	Particulars	CF	PVF @ 12%	PV
0	Cost of machine	(10,00,00)	1	(10,00,000)
1-5	CFAT	2,39,438	3.6048	8,63,126
Net Present Value				(1,36,874)

Since NPV of the machine is negative, it should not be purchased.

Working Note:

Computation of Qty of consumable

No. of Tea Cups = $[(120 \times 3 \times 200 \text{ days}) + (40 \times 1 \times 200 \text{ days})] \times 1.2 = 96,000$

No. of Coffee cups = $40 \times 3 \times 200 \text{ days} \times 1.2 = 28,800$

No. of coffee beans packet = $\frac{28,800}{200} = 144$

No. of Tea Powder Packets = $\frac{96,000}{200} = 480$

Qty of Sugar = $\frac{(96,000+28,800) 6,000}{1,000 \text{ g}} = 1248 \text{ kgs}$

Qty of Milk = $\frac{(96,000+28,800) 6,000}{1,000 \text{ ml}} = 12,480 \text{ liters}$

No. of paper cups = $(96,000 + 28,800) \times 1.1 = \mathbf{1,37,280}$

7 CHAPTER

DIVIDEND DECISIONS

An investment in knowledge pays the best interest.

Important Questions January 2025

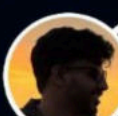
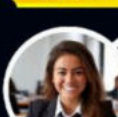
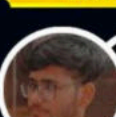
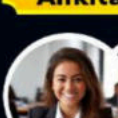


Congratulations!

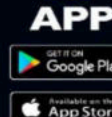
The league of Champions

FM-SM



 75 Marks Sanskar Jain	 75 Marks Shushobit Verma	 75 Marks Mayank Gupta
 74 Marks Vasudev	 72 Marks Preeti Aggarwal	 69 Marks Sandeep Shaw
 69 Marks Shashank	 69 Marks Riya Bansal	 68 Marks Akansha
 68 Marks Arsalan Ali	 67 Marks Abhay Nahar	 67 Marks Harsh
 66 Marks Ankita Rani	 66 Marks Anshu Kumar	 65 Marks Pulkit Luthra
 65 Marks Seerat Sharma	 65 Marks Ayush Sharma	 65 Marks Shubham

3000+ Exemptions
3500+ Above 50 Marks



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The League of Champions

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 BHARAT GAUTAM 80 MARKS	 PRADEEP ROHILLA 79 MARKS				
 ANUSHKA SHARMA 78 MARKS	 KSHITIZ TAYAL 78 MARKS				
 SAIKAT GHOSH 77 MARKS	 NILESH JAISWAL 76 MARKS				
 NUZAIF AKHTAR 76 MARKS	 KOMAL SANWAL 75 MARKS				
 SHALINI SONI 75 MARKS	 ASHUTOSH KUMAR 74 MARKS				
 NANDA CHATURVEDI 74 MARKS	 ARYAN MERATWAL 73 MARKS				
 DEEPANSHI JAIN 73 MARKS	 KAUSHAL ARORA 73 MARKS				
 PREETHAM BHAT 73 MARKS	 SONALI VIJ 73 MARKS				
 ANKIT JAIN 72 MARKS	 MAYURI PRAMOD 72 MARKS				
 SANCHIT 72 MARKS	 SONU AGRAWAL 72 MARKS				
 TANYA BANSAL 72 MARKS	 ANURAG AGGRAWAL 71 MARKS				
 CHIRAG JAIN 70 MARKS	 NITESH LAHU 70 MARKS				
 PARAS BANSAL 70 MARKS	 RAJSHREE 70 MARKS				
 RAJVI DILIP 70 MARKS	 YASH JAIN 70 MARKS				

OTC CHAMPIONS

CHAPTER SEVEN

Video for Interpretation of the List: <https://youtu.be/dVq9NF7s8l4>



DIVIDEND DECISIONS

LIST OF IMPORTANT QUESTIONS JANUARY 2025



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Problem 1: In December, 2011 AB Co.'s share was sold for ₹ 146 per share. A long term earnings growth rate of 7.5% is anticipated. AB Co. is expected to pay dividend of ₹ 3.36 per share.

Required:

- What rate of return an investor can expect to earn assuming that dividends are expected to grow along with earnings at 7.5% per year in perpetuity?
- It is expected that AB Co. will earn about 10% on book Equity and shall retain 60% of earnings. In this case, whether, there would be any change in growth rate and cost of Equity?

Solution:

- According to Dividend Discount Model approach the firm's expected or required return on equity is computed as follows:

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

Where,

K_e = Cost of equity share capital

D_1 = Expected dividend at the end of year 1

P_0 = Current market price of the share.

g = Expected growth rate of dividend.

$$\text{Therefore, } K_e = \frac{3.36}{146} + 7.5\% = 0.0230 + 0.075 = 0.098$$

$$\text{Or, } K_e = 9.80\%$$

- With rate of return on retained earnings (r) 10% and retention ratio (b) 60%, new growth rate will be as follows:

$$g = br \text{ i.e. } = 0.10 \times 0.60 = 0.06$$

Accordingly dividend will also get changed and to calculate this, first we shall calculate previous retention ratio (b_1) and then EPS assuming that rate of return on retained earnings (r) is same.

With previous Growth Rate of 7.5% and $r = 10\%$ the retention ratio comes out to be:

$$0.075 = b_1 \times 0.10$$

$$b_1 = 0.75 \text{ and payout ratio} = 0.25$$

With 0.25 payout ratio the EPS will be as follows:

$$\frac{3.36}{0.25} = 13.44$$

With new 0.40 (1 - 0.60) payout ratio the new dividend will be $D_1 = 13.44 \times 0.40 = 5.376$

Accordingly new K_e will be

$$K_e = \frac{5.376}{146} + 6.0\%$$

or,

$$K_e = 9.68\%$$

Problem 2: Valuation based on dividend

The following information are available for XYZ CO.

- No of shares outstanding is 1 lakh
- EPS is ₹ 4
- DPS is ₹ 2.4
- Equity capitalization rate : 12%
- Rate of return on investment : 15%

- As per Walter's model, what will be Market value per Share ?
- To keep Share price at ₹ 40, what should be payout ratio ?
- As per Walter's model, what is optimum payout ratio?

(iv) Market Value at that payout ratio?

Solution:



(i) According to Walter's model,

$$P = \frac{D + (E - D) \left(\frac{r}{K_e} \right)}{K_e}$$

$$= \frac{\left[2.4 + (4 - 2.4) \times \left(\frac{0.15}{0.12} \right) \right]}{0.12} = \frac{4.4}{0.12} = ₹ 36.67$$

(ii) Let Payout ratio is x

$$\text{Then, } 40 = \frac{\left\{ 4X + (4 - 4X) \times \left(\frac{0.15}{0.12} \right) \right\}}{0.12}$$

$$\text{Or } 4.8 = 4X + 5 - 5X$$

$$\text{Or } X = 0.2$$

Thus, required Payout ratio is 20%.

(iii) According to Walter's model, when return on investment is more than the cost of equity price of share increases as dividend pay out ratio decreases. Hence, optimum pay out ratio in the present case should be nil.

$$(iv) \text{ At nil payout ratio, } P = \frac{\left(4 \times \frac{0.15}{0.12} \right)}{0.12} = ₹ 41.66$$

Problem 3: The following figures are collected from the annual report of XYZ Ltd.:



Particulars	Amount (₹)
Net Profit	30 lakhs
Outstanding 12% preference shares	100 lakhs
No. of equity shares	3 lakhs
Return on Investment	20%

What should be the approximate dividend pay-out ratio so as to keep the share price at ₹ 42 by using Walter model?

Solution:



Particulars	₹ in lakhs
Net Profit	30
Less: Preference dividend	12
Earning for equity shareholders	18
Therefore earning per share	$\frac{₹ 18 \text{ lakhs}}{3 \text{ lakhs}} = ₹ 6.00$

Cost of capital i.e. (k_e) **(Assumed) 16%***

Let, the dividend payout ratio be X and so the share price will be:

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

Here $D = 6X$; $E = ₹ 6$; $r = 0.20$ and $K_e = 0.16$ and $P = ₹ 42$

$$\text{Hence } ₹ 42 = \frac{6X}{0.16} + \frac{0.2(6 - 6X)}{0.16 \times 0.16}$$

$$\text{Or, } ₹ 42 = 37.50X + 46.875(1 - X)$$

$$9.375X = 4.875$$

$$X = 0.52$$

So, the required dividend payout ratio will be = 52%

*Students can assume any percentage other than 16%.

Problem 4: The earnings per share of a company is ₹ 10 and the rate of capitalisation applicable to it is 10 per cent. The company has three options of paying dividend i.e. (i) 50%, (ii) 75% and (iii) 100%. Calculate the market price of the share as per Walter's model if it can earn a return of (a) 15, (b) 10 and (c) 5 per cent on its retained earnings.

Solution:

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

Where

P = Price of Share

R = Rate of Earning

K_e = Rate of Capitalisation or Cost of Equity

	(i) DP ratio 50%	(ii) DP ratio 75%	(iii) DP ratio 100%
(a) Price of Share if $r = 15\%$	$\frac{5 + \left(\frac{0.15}{0.10}\right)(10 - 5)}{0.10}$ $= \frac{12.5}{0.10} = ₹ 125$	$\frac{7.5 + \left(\frac{0.15}{0.10}\right)(10 - 7.5)}{0.10}$ $= \frac{11.25}{0.10} = ₹ 112.5$	$\frac{10 + \left(\frac{0.15}{0.10}\right)(10 - 10)}{0.10}$ $= \frac{10}{0.10} = ₹ 100$
(b) Price of Share if $r = 10\%$	$\frac{5 + \left(\frac{0.10}{0.10}\right)(10 - 5)}{0.10}$ $= \frac{10}{0.10} = ₹ 100$	$\frac{7.5 + \left(\frac{0.10}{0.10}\right)(10 - 7.5)}{0.10}$ $= \frac{10}{0.1} = ₹ 100$	$\frac{10 + \left(\frac{0.10}{0.10}\right)(10 - 10)}{0.10}$ $= \frac{10}{0.1} = ₹ 100$
(c) Price of Share if $r = 5\%$	$\frac{5 + \left(\frac{0.05}{0.10}\right)(10 - 5)}{0.10}$ $= \frac{7.5}{0.10} = ₹ 75$	$\frac{7.5 + \left(\frac{0.05}{0.10}\right)(10 - 7.5)}{0.10}$ $= \frac{8.75}{0.10} = ₹ 87.5$	$\frac{10 + \left(\frac{0.05}{0.10}\right)(10 - 10)}{0.10}$ $= \frac{10}{0.1} = ₹ 100$

Problem 5: Following are details regarding three companies A Ltd., B Ltd. and C Ltd.:

Details	A Ltd.	B Ltd.	C Ltd.
Internal Rate of Return (r)	15%	5%	10%
Cost of Equity Capital (K_e)	10%	10%	10%
Earning Per Share (EPS)	₹ 8	₹ 8	₹ 8

Calculate the value or price of an equity share of each of these companies applying Walter's formulae when (D/P ratio) is (i) 25% (ii) 50% and (iii) 75% What conclusions do you draw?

Solution:



DP Ratio Company	25%	50%	75%
	As per walter: $P_o = \frac{DPS}{K_e} + \frac{\frac{r}{K_e} (EPS - DPS)}{K_e}$		
A Ltd.	$P_o = \frac{2}{0.10} + \frac{\frac{0.15}{0.10} (8 - 2)}{0.10} = ₹ 110$	$P_o = \frac{4}{0.10} + \frac{\frac{0.15}{0.10} (8 - 4)}{0.10} = ₹ 100$	$P_o = \frac{6}{0.10} + \frac{\frac{0.15}{0.10} (8 - 6)}{0.10} = ₹ 90$
B Ltd.	$P_o = \frac{2}{0.10} + \frac{\frac{0.05}{0.10} (8 - 2)}{0.10} = ₹ 50$	$P_o = \frac{4}{0.10} + \frac{\frac{0.05}{0.10} (8 - 4)}{0.10} = ₹ 60$	$P_o = \frac{6}{0.10} + \frac{\frac{0.05}{0.10} (8 - 6)}{0.10} = ₹ 70$
C Ltd.	$P_o = \frac{2}{0.10} + \frac{\frac{0.10}{0.10} (8 - 2)}{0.10} = ₹ 80$	$P_o = \frac{4}{0.10} + \frac{\frac{0.10}{0.10} (8 - 4)}{0.10} = ₹ 80$	$P_o = \frac{6}{0.10} + \frac{\frac{0.10}{0.10} (8 - 6)}{0.10} = ₹ 80$

Conclusion

	r	Ke	Nature	25%	50%	75%
A	15%	10%	Growth	110	100	90
B	5%	10%	Decline	50	60	70
C	10%	10%	Normal	80	80	80

Problem 5: Zumo & Co. is a watch manufacturing company and is all equity financed and has paid up capital ₹10,00,000 (₹10 per shares)



The other data related to the company is as follows:

Year	EPS (₹)	Net Dividend per share (₹)	Share Price (₹)
2004	4.20	1.70	25.20
2005	4.60	1.80	18.40
2006	5.10	2.00	25.50
2007	5.50	2.20	27.50
2008	6.20	2.50	37.20

Zumo & Co. has hired one management consultant, Vidal Consultants to analyze the future earnings and other related item for the forthcoming years.

As per Vidal Consultants's report

- (1) The earnings and dividend will grow at 25% for the next two years.
- (2) Earnings are likely at rate of 10% from 3rd year and onwards.
- (3) Further if there is reduction in earnings growth occurs dividend payout ratio will increase to 50%

Assuming the tax rate as 33% (not expected to change in the foreseeable future) calculate the estimated share price and P/E Ratio which analysts now expect for Zumo & Co., using the dividend valuation model.

You may further assume that post tax cost of capital is 18%.

Solution:

(a) The formula for the Dividend valuation Model is

$$P_0 = \frac{D_1}{K_e - g} \quad \text{where, } K_e = \text{Cost of Capital, } g = \text{Growth rate, } D_1 = \text{Dividend at the end of year 1}$$

On the basis of the information given, the following projection can be made:

Year	DPS (₹)	PVF @18%	PV of DPS (₹)
2009	3.13	0.847	2.65
2010	3.91	0.718	2.81
2011	5.33*	0.609	3.25
			8.71

* Payout Ratio changed to 50%.

After 2011, the perpetuity value assuming 10% constant annual growth, is:

$$D_1 = ₹ 5.33 \times 110\% = ₹ 5.863$$

Therefore P_0 from the end of 2011

$$\frac{₹ 5.863}{0.18 - 0.10} = ₹ 73.29$$

This must be discounted back to the present value, using the 3 year discount factor after 18%.

₹

Present Value of P_0 (₹ 73.29 × 0.609)

44.63

Add: Dividends 2009 to 2011 8.71

Expected Market Price of Share 53.34

(b) P/E Ratio

$$\begin{aligned} \text{PE Ratio} &= \frac{\text{Expected Market Price of Share (P}_1\text{)}}{\text{Earning Per Share}} \\ &= \frac{₹ 53.34}{₹ 6.20} = 8.60 \end{aligned}$$

Problem 6: The MNC Ltd.'s available information is:

$K_e = 15\%$; $\text{EPS} = ₹ 30$; Productivity of Retained Earnings (r) = (i) 14%; (ii) 15% and (iii) 16%

You are required to calculate market price of a share of the MNC Ltd., as per Gordon Model if:

(i) $b = 40\%$ (ii) $b = 60\%$ and (iii) $b = 80\%$

What conclusion can you draw?

Solution:

As per growth model-

$$P_0 = \left[\frac{\text{EPS} (1 - b)}{K_e - b \times r} \right]$$

(i) $r = 14\%$

$b = 40\%$

$$P_0 = \frac{30(1 - 0.40)}{0.15 - 0.40 \times 0.14} = \mathbf{191.4}$$

$b = 60\%$

$$P_0 = \frac{30(1 - 0.60)}{0.15 - 0.60 \times 0.14} = 181.81$$

$b = 80\%$

$$P_0 = \frac{30(1 - 0.80)}{0.15 - 0.80 \times 0.14} = 157.89$$

(ii) **r = 15%****b = 40%**

$$P_0 = \frac{30(1 - 0.40)}{0.15 - 0.40 \times 0.15} = ₹ 200$$

b = 60%

$$P_0 = \frac{30(1 - 0.60)}{0.15 - 0.60 \times 0.15} = ₹ 200$$

b = 80%

$$P_0 = \frac{30(1 - 0.80)}{0.15 - 0.80 \times 0.15} = ₹ 200$$

(iii) **r = 16%****b = 40%**

$$P_0 = \frac{30(1 - 0.40)}{0.15 - 0.40 \times 0.16} = 209.30$$

b = 60%

$$P_0 = \frac{30(1 - 0.60)}{0.15 - 0.60 \times 0.16} = 222.22$$

b = 80%

$$P_0 = \frac{30(1 - 0.80)}{0.15 - 0.80 \times 0.16} = 272.72$$

Conclusion

Case	r	Ke	Nature	40%	60%	80%
(i)	14%	15%	Decline	191.49	181.82	157.80
(ii)	15%	15%	Normal	200	200	200
(iii)	16%	15%	Growth	209.30	222.22	272.72

Problem 7: X Ltd., has 8 lakhs equity shares outstanding at the beginning of the year 2003. The current market price per share is ₹ 120. The Board of Directors of the company is contemplating ₹ 6.4 per share as dividend. The rate of capitalisation, appropriate to the risk-class to which the company belongs, is 9.6%:

- Based on M-M Approach, calculate the market price of the share of the company, when the dividend is – (a) declared; and (b) not declared.
- How many new shares are to be issued by the company, if the company desires to fund an investment budget of ₹ 3.20 crores by the end of the year assuming net income for the year will be ₹ 1.60 crores?

Solution: Modigliani and Miller (M-M) – Dividend Irrelevancy Model:

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

Where,

P_0 = Existing market price per share i.e. ₹ 120

P_1 = Market price of share at the year-end (to be determined)

D_1 = Contemplated dividend per share i.e. ₹ 6.4

K_e = Capitalisation rate i.e. 9.6%.

(i) (a) Calculation of share price when dividend is declared:

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

$$120 = \frac{P_1 + 6.4}{1 + 0.096}$$

$$120 \times 1.096 = P_1 + 6.4$$

$$P_1 = 120 \times 1.096 - 6.4$$

$$= 125.12$$

(b) Calculation of share price when dividend is not declared:

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

$$120 = \frac{P_1 + 0}{1 + 0.096}$$

$$120 \times 1.096 = P_1 + 0$$

$$P_1 = 131.52$$

(ii) Calculation of No. of shares to be issued:

(₹ in lakhs)

Particulars	If dividend declared	If dividend not declared
Net Income	160.00	160.00
Less: Dividend paid	51.20	—
Retained earnings	108.80	160.00
Investment budget	320.00	320.00
Amount to be raised by issue of new shares (i)	211.20	160.00
Market price per share (ii)	125.12	131.52
No. of new shares to be issued (ii)	1,68,797.95	1,21,654.50
Or say	1,68,798.00	1,21,655.00

Problem 8: RST Ltd. has a capital of ₹ 10,00,000 in equity shares of ₹ 100 each. The shares are currently quoted at ₹ 100 par. The company proposes to declare a dividend of ₹ 10 per share at the end of the current financial year. The capitalization rate for the risk class of which the company belongs is 12%. What will be the market price of the share at the end of the year, if

- a dividend is not declared ?
- a dividend is declared ?
- assuming that the company pays the dividend and has net profits of ₹ 5,00,000 and makes new investments of ₹ 10,00,000 during the period, how many new shares must be issued? Use the MM model.

Solution: As per MM model, the current market price of equity share is:

$$P_0 = \frac{1}{1 + k_e} \times (D_1 + P_1)$$

- (i) If the dividend is not declared:

$$100 = \frac{1}{1 + 0.12} (0 + P_1)$$

$$100 = \frac{P_1}{1.12}$$

$$P_1 = ₹ 112$$

The Market price of the equity share at the end of the year would be ₹ 112.

- (ii) If the dividend is declared:

$$100 = \frac{1}{1 + 0.12} (10 + P_1)$$

$$100 = \frac{10 + P_1}{1.12}$$

The market price of the equity share at the end of the year would be ₹ 102.

- (iii) In case the firm pays dividend of ₹ 10 per share out of total profits of ₹ 5,00,000 and plans to make new investment of ₹ 10,00,000, the number of shares to be issued may be found as follows:

Total Earnings	₹ 5,00,000
- Dividends paid	1,00,000
Retained earnings	4,00,000
Total funds required	10,00,000
Fresh funds to be raised	6,00,000
Market price of the share	102

$$\text{Number of shares to be issued} \left(\frac{₹ 6,00,000}{102} \right) = 5,882.35$$

or, the firm would issue 5,883 shares at the rate of ₹ 102

Problem 9:



The following information pertains to M/s XY Ltd.

Earnings of the Company	₹ 5,00,000
Dividend Payout ratio	60%
No. of shares outstanding	1,00,000
Equity capitalization rate	12%
Rate of return on investment	15%

CALCULATE:

- Market value per share as per Walter's model.
- Optimum dividend payout ratio according to Walter's model and the market value of Company's share at that payout ratio.

Solution:



i. As per Walter's model:

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

$$P = \frac{\quad}{K_e}$$

Where,

P = Market price per share.

E = Earnings per share = ₹ 5

D = Dividend per share = ₹ 3

R = Return earned on investment = 15%

K_e = Cost of equity capital = 12%

$$P = \frac{3 + \frac{0.15}{0.12} (5 - 3)}{0.12} = ₹ 45.83$$

$$P = \frac{3 + \frac{0.15}{0.12} (5 - 0)}{0.12} = ₹ 52.08$$

- ii. According to Walter's model, when the return on investment is more than the cost of equity capital, the price per share increases as the dividend pay-out ratio decreases. Hence, the optimum dividend pay-out ratio in this case is nil. So, at a pay-out ratio of zero, the market value of the company's share will be:

Problem 10:

 Aakash Ltd. has 10 lakh equity shares outstanding at the start of the accounting year. The existing market price per share is ₹ 150. Expected dividend is ₹ 8 per share. The rate of capitalization appropriate to the risk class to which the company belongs is 10%.

- CALCULATE the market price per share when expected dividends are: (a) declared, and (b) not declared, based on the Miller – Modigliani approach.
- CALCULATE number of shares to be issued by the company at the end of the accounting year on the assumption that the net income for the year is ₹ 3 crore, investment budget is ₹ 6 crores, when (a) Dividends are declared, and (b) Dividends are not declared.
- PROOF that the market value of the shares at the end of the accounting year will remain unchanged irrespective of whether (a) Dividends are declared, or (ii) Dividends are not declared.

Solution:



i. Calculation of market price per share

According to Miller – Modigliani (MM) Approach:

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

Where,

Existing market price (P_0) = ₹ 150

Expected dividend per share (D_1) = ₹ 8

Capitalization rate (k_e) = 0.10

Market price at year end (P_1) = to be determined

(a) If expected dividends are declared, then

$$₹ 150 = \frac{P_1 + 8}{1 + 0.10}$$

$$\therefore P_1 = ₹ 157$$

(b) If expected dividends are not declared, then

$$₹ 150 = \frac{P_1 + 0}{1 + 0.10}$$

$$\therefore P_1 = ₹ 165$$

ii. Calculation of number of shares to be issued

	(a) Dividends are declared (₹ lakh)	(b) Dividends are not Declared (₹ lakh)
Net income	300	300
Total dividends	(80)	-
Retained earnings	220	300
Investment budget	600	600
Amount to be raised by new issues	380	300
Relevant market price (₹ per share)	157	165

No. of new shares to be issued (in lakh)(₹ 380 ÷ 157; ₹ 300 ÷ 165)	2.42	1.82

iii. Calculation of market value of the shares

	(a) Dividends are declared	(b) Dividends are not Declared
Existing shares (in lakhs)	10.00	10.00
New shares (in lakhs)	2.42	1.82
Total shares (in lakhs)	12.42	11.82
Market price per share (₹)	157	165
Total market value of shares at the end of the year (₹ in lakh)	12.42 × 157 = 1,950 (approx.)	11.82 × 165 = 1,950 (approx.)

Hence, it is proved that the total market value of shares remains unchanged irrespective of whether dividends are declared, or not declared.

8 CHAPTER

WORKING CAPITAL MANAGEMENT

The function of education is to teach one to think intensively and to think critically. Intelligence plus character - that is the goal of true education.

Important Questions January 2025



Congratulations!

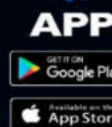
The league of Champions

FM-SM



75 Marks Sanskar Jain	75 Marks Shushobit Verma	75 Marks Mayank Gupta
74 Marks Vasudev	72 Marks Preeti Aggarwal	69 Marks Sandeep Shaw
69 Marks Shashank	69 Marks Riya Bansal	68 Marks Akansha
68 Marks Arsalan Ali	67 Marks Abhay Nahar	67 Marks Harsh
66 Marks Ankita Rani	66 Marks Anshu Kumar	65 Marks Pulkit Luthra
65 Marks Seerat Sharma	65 Marks Ayush Sharma	65 Marks Shubham

3000+ Exemptions
3500+ Above 50 Marks



Congratulations!

The League of Champions

MEENAKSHI AIR 20	ROHIT AIR 22	SHUBHAM AIR 23	ANUSHKA AIR 36	CHERRY AIR 37	SANJEEV AIR 47
SATYAM KUMAR 87 MARKS	SUSHANT ARORA 83 MARKS	BHARAT GAUTAM 80 MARKS	PRADEEP ROHILLA 79 MARKS	ANUSHKA SHARMA 78 MARKS	KSHITIZ TAYAL 78 MARKS
SAIKAT GHOSH 77 MARKS	NUZAIF AKTHAR 76 MARKS	SHALINI SONI 75 MARKS	ASHUTOSH KUMAR 74 MARKS	NANDA CHATURVEDI 74 MARKS	NILESH JAISWAL 76 MARKS
DEEPANSHI JAIN 73 MARKS	PREETHAM BHAT 73 MARKS	ARYAN MERATWAL 73 MARKS	KAUSHAL ARORA 73 MARKS	SONALI VIJ 73 MARKS	KOMAL SANWAL 75 MARKS
ANKIT JAIN 72 MARKS	SANCHIT 72 MARKS	MAYURI PRAMOD 72 MARKS	SONU AGRAWAL 72 MARKS	TANYA BANSAL 72 MARKS	ANURAG AGGRAWAL 71 MARKS
CHIRAG JAIN 70 MARKS	PARAS BANSAL 70 MARKS	NITESH LAHU 70 MARKS	RAJSHREE 70 MARKS	RAJVI DILIP 70 MARKS	YASH JAIN 70 MARKS

OTC CHAMPIONS



CHAPTER EIGHT

WORKING CAPITAL MANAGEMENT

UNIT 1: MANAGEMENT OF WORKING CAPITAL

LIST OF IMPORTANT QUESTIONS JANUARY 2025



**FM-SM
REGULAR** Batch
JAN/MAY/SEPT 2025



**FM-SM
EXAM-ORIENTED** Batch
JAN/MAY/SEPT 2025



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RECORDING



PROF. OM TRIVEDI



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COVERAGE

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JAN/MAY-25



Prof. Om Trivedi

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Problem 1: AB Ltd. provides the following particulars relating to its working:



	Amount in ₹ (Per unit)
Cost/Profit per unit:	
Raw material cost	84
Direct labour cost	36
Overheads (All variable)	36
Total cost	156
Profit	44
Selling price	200
(i) Average amount of back up stock:	
Raw material	1 month
Work-in-progress (50% complete)	½ month
Finished goods	1 month
(ii) Average allowed by suppliers	1 month
(iii) Credit allowed to customers	2 months
(iv) Average time lag in the payment of:	
Wages	½ month
Overhead expenses	1-½ months
(v) d cash in hand and at bank ₹ 3,00,000.	
(vi) 25% of the output is sold for cash.	

For an expected sale of 1,00,000 units, work out the working capital requirement assuming that production is carried on evenly throughout the year and wages and overheads accrue similarly.

Solution:



Statement of Working Capital requirement

	Amount (₹)	Amount (₹)
I. Current Assets:		
Cash		3,00,000
Raw material $(1,00,000 \times 84) \div 24$		7,00,000
Work in progress:		
Raw material $(1,00,000 \times 84) \div 24$	3,50,000	
Labour $[(1,00,000 \times 36) \div 24] \times 50\%$	75,000	
Overhead $[(1,00,000 \times 36) \div 24] \times 50\%$	75,000	5,00,000
Finished goods $(1,00,000 \times 156) \div 12$		13,00,000
Debtors $(1,00,000 \times 75\% \times 156) \div 6$		19,50,000
Total current assets (CA)		47,50,000
II. Current liabilities:		
Creditors $(1,00,000 \times 84) \div 12$		7,00,000
O/S Wages $(1,00,000 \times 36) \div 24$		1,50,000
O/S Overheads $(1,00,000 \times 36) \div 12] \times 1.5$		4,50,000
Total current liabilities (CL)		13,00,000
Net working capital requirement (CA-CL)		34,50,000

Problem 2: Prepare an estimate of net working capital requirement for the CNP Ltd. adding 10% for contingencies from the information given below:

Estimated cost per unit of production ₹ 170, includes raw materials ₹ 80, direct labour ₹ 30 and overheads (exclusive of depreciation) ₹60. Selling price is ₹ 200 per unit.

Level of activity per annum 1,04,000 units. Raw material in stock: average 4 weeks; work-in-progress (assume 50% completion stage): average 2 weeks; finished goods in stock; average 4 weeks; credit allowed by suppliers; average 4 weeks; credit allowed to debtors: average 8 weeks; lag in payment of wage: average 1.5 weeks, and cash at bank is expected to be ₹ 25,000.

Required

You may assume that production is carried on evenly throughout the year (52 weeks) and wages and overheads accrue similarly. All sales are on credit basis only. You may state your assumptions, if any.

Solution:

Working Notes:

Particulars			Amount (₹)
1. Raw material stock	4 weeks	$1,04,000 \text{ units} \times ₹ 80 \times 4/52$	6,40,000
2. Work-in-progress –	2 weeks (50% completion stage)		
Raw materials		$(1,04,000 \times ₹ 80 \times 2/52)$	3,20,000
Direct Labour		$(1,04,000 \times ₹ 15 \times 2/52)$	60,000
Overheads	(50% of ₹ 60)	$(1,04,000 \times ₹ 30 \times 2/52)$	1,20,000
		Total	5,00,000
3. Finished stock	4 weeks	$1,04,000 \text{ units} \times ₹ 170 \times 4/52$	13,60,000
4. Debtors	8 weeks	$1,04,000 \text{ units} \times ₹ 200 \times 8/52$	32,00,000
5. Creditors for raw materials	4 weeks	$1,04,000 \text{ units} \times ₹ 80 \times 4/52$	6,40,000
6. Creditors for wages	1.5 weeks	$1,04,000 \text{ units} \times ₹ 30 \times 1.5/52$	90,000

Estimation of Net Working Capital requirement

Particulars		Amount (₹)
Current Assets		
Inventory		
Raw material		6,40,000
Work-in-progress		5,00,000
Finished goods		13,60,000
Sundry Debtors		32,00,000
Cash at Bank		25,000
	(A)	57,25,000
Current Liabilities		
Creditors for Raw Materials		6,40,000
Creditors for wages		90,000
	(B)	7,30,000
Net Working Capital	(A) – (B)	49,95,000
Add: 10% Contingencies		4,99,000
Total Working Capital requirement		54,94,500

Assumption: Debtors balance is calculated based on selling price not on cost price.

Problem 3: A company newly commencing business in 1991 has the under mentioned projected Profit & Loss A/c:-



	₹	₹
Sales		42,00,000
Cost of goods sold		30,60,000
Gross profit		11,40,000
Administrative expenses	2,80,000	
Selling expenses	<u>2,60,000</u>	<u>5,40,000</u>
Profit before tax		6,00,000
Provision for taxation		<u>2,00,000</u>
		<u>4,00,000</u>
Profit after tax		
The cost of goods sold has been arrived at as under:-		
Material used	16,80,000	
Wages and manufacturing expenses	12,50,000	
Depreciation	<u>4,70,000</u>	34,00,000
Less: Stock of finished goods (10% of goods produced not yet sold)		3,40,000
	<u>30,60,000</u>	

The figures given above relate only to finished goods and not to work-in progress. 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 company believes in keeping material equal to two months consumption in stock.

All expenses will be paid one month in arrear; Suppliers of material will extend $1\frac{1}{2}$ month's credit; Sales will be 20% for cash and the rest at two months' credit; 90% of the income-tax will be paid in advance in quarterly installments. The company wishes to keep ₹ 1,00,000 in cash.

Prepare an estimate of the requirement of

- working capital and
- cash cost of working capital.

Solution:



Working Notes:

(i) Work-in-progress

Particulars		Amount (₹)
Raw material	(15% of 16,80,000)	2,52,000
Wages and manufacturing expenses	(15% of 12,50,000) × 40%	75,000
Depreciation	(15% of 4,70,000) × 40%	28,200
		<u>3,55,200</u>

(ii) Raw Material Stock (1/6th of Material consumption)

Particulars		Amount (₹)
Finished goods		16,80,000
Work - in - progress		2,52,000
		<u>19,32,000</u>
1/6th of ₹ 19,32,000		<u>3,22,000</u>

(iii) Sundry Debtors

80% of two months sales = $42,00,000 \times 80/100 \times 2/12 = ₹ 5,60,000$

(iv) Creditors for raw material

$\left(1 \frac{1}{2} \text{ month of total purchase of raw material for the year}\right)$

Particulars	Amount (₹)
Finished goods	16,80,000
Work - in - progress	2,52,000
Raw material stock	3,22,000
	22,54,000

(v) Creditors for Wages and Manufacturing expenses) (1 month arrear)

Particulars	Amount (₹)
For cost of goods sold	12,50,000
For work - in - progress	75,000
	13,25,000

$= 13,25,000 \times 1/12 = ₹ 1,10,416$

(v) Creditors for administrative and selling expenses = $5,40,000 \times \frac{1}{12} = ₹ 45,000$ **1. Estimate of requirement of Working Capital**

Particulars	Amount (₹)	Amount (₹)
Current Assets		
1. Finished Stock		
Raw Materials	1,68,000	
Wages & Manufacturing expenses	1,25,000	
Depreciation	47,000	3,40,000
2. Work - in - progress		
Raw materials	2,52,000	
Wages & Manufacturing expenses	75,000	
Depreciation	28,200	3,55,200
3. Raw Material Stock		3,22,000
4. Sundry Debtors:		
Material	2,01,600	
Wages & Manufacturing expenses	1,50,000	
Depreciation	56,400	
Administrative & Selling expenses	72,000	
Profit	80,000	5,60,000
5. Cash in hand		1,00,000
Total		16,77,000
Less: Current Liabilities		
Creditors for Purchases	2,81,750	

Wages & Manufacturing expenses	1,10,416	
Administrative & Selling expenses	45,000	
Provision for Taxation	20,000	4,57,166
Working Capital requirement		12,20,034

2. Estimate of requirement of Cash Cost of Working Capital

Particulars	Amount (₹)	Amount (₹)	Amount (₹)
Working Capital requirement (as per statement (i) above)			12,20,034
Less: Cash not required for depreciation and profit included in the cost of current assets:			
(i) Depreciation			
Finished Stock	47,000		
Work-in-progress	28,200		
Sundry debtors	56,400	1,31,600	
(ii) Profit included in debtors		80,000	2,11,600
Cash Cost of Working Capital			10,08,434

Problem 4: A newly formed company has applied to the Commercial Bank for the first time for Financing its working capital requirements. The following information is available about the projections for the current year:



Elements of cost:	Per unit ₹
Raw material	40
Direct labour	15
Overhead	30
Total cost	85
Profit	15
Sales	100

Other information: Raw material in stock: average 4 weeks consumption, Work - in progress (completion stage, 50 percent), on an average half a month. Finished goods in stock: on an average, one month. Credit allowed by suppliers is one month. Credit allowed to debtors is two months.

Average time lag in payment of wages is 1.5 weeks and 4 weeks in overhead expenses. Cash in hand and at bank is desired to be maintained at ₹ 50,000. All Sales are on credit basis only.

Required:

- Prepare statement showing estimate of working capital needed to finance an activity level of 96,000 units of production. Assume that production is carried on evenly throughout the year, and wages and overhead accrue similarly. For the calculation purpose 4 weeks may be taken as equivalent to a month and 52 weeks in a year.
- From the above information calculate the maximum permissible bank finance by all the three methods for working capital as per Tondon Committee norms; assume the core current assets constitute 25% of the current assets. **[Nov-2007]**

Solution:**Calculation of Working Capital Requirement****(A) Current Assets**

S.No.	Particulars	₹
(i)	Stock of material for 4 weeks $\left(96,000 \times 40 \times \frac{4}{52}\right)$	2,95,385
(ii)	Work in progress for $\frac{1}{2}$ month	
	Raw Material $\left(96,000 \times 40 \times \frac{2}{52} \times 0.50\right)$	73,846
	Labour $\left(96,000 \times 15 \times \frac{2}{52} \times 0.50\right)$	27,692
	Overhead $\left(96,000 \times 30 \times \frac{2}{52} \times 0.50\right)$	55,385
(iii)	Finished stock $\left(96,000 \times 85 \times \frac{4}{52}\right)$	6,27,692
(iv)	Debtors for 2 months $\left(96,000 \times 85 \times \frac{8}{52}\right)$	12,55,385
	Cash in hand or at bank	50,000
	Investment in Current Assets	23,85,385
(B)	Current Liabilities	
(i)	Creditors for one month $\left(96,000 \times 40 \times \frac{4}{52}\right)$	2,95,385
(ii)	Lag in payment of wages $\left(96,000 \times 15 \times \frac{1.5}{52}\right)$	41,538
(ii)	Lag in payment of wages $\left(96,000 \times 30 \times \frac{4}{52}\right)$	2,21,538
	Total Current Liabilities	5,58,461

(B) Current Liabilities

S.No.	Particulars	₹
(i)	Creditors for one month $\left(96,000 \times 40 \times \frac{4}{52}\right)$	2,95,385
(ii)	Lag in payment of wages $\left(96,000 \times 15 \times \frac{1.5}{52}\right)$	41,538
(ii)	Lag in payment of wages $\left(96,000 \times 30 \times \frac{4}{52}\right)$	2,21,538
	Total Current Liabilities	5,58,461

(ii) Maximum Permissible bank Finance

(i) Method I:

$$0.75 (CA - CL) = 0.75 (23,85,385 - 5,58,461) = 0.75 (18,26,924) = ₹ 13,70,193$$

(ii) Method II:

$$(.75 CA) - CL = (.75 \times 23,85,385) - 5,58,461 = 17,89,039 - 5,58,461 = ₹ 12,30,578$$

(iii) Method III:

$$[.75 \text{ of soft core current assets}] - CL = [.75 (23,85,385 - 5,96,346) - 5,58,461] \\ = .75 (17,89,039) - 5,58,461 = 13,41,779 - 5,58,461 = ₹ 7,83,318$$

Problem 5: The management of MNP Company Ltd. is planning to expand its business and consult you to prepare an estimated working capital statement. The records of the company reveals the following annual information:

₹	
Sales – Domestic at one month's credit	24,00,000
Export at three month's credit (Sales price 10% below Domestic price)	10,80,000
Material used (suppliers extend two months credit)	9,00,000
Lag in payment of wages – ½ month	7,20,000
Lag in payment of manufacturing expenses (cash) -1 month	10,80,000
Lag in payment of Adm. expenses – 1 month	2,40,000
Sales promotion expenses payable quarterly in advance	1,50,000
Income tax payable in four installments of which one falls in the	2,25,000

Next financial year

Rate of gross profit is 20%

Ignore work-in-progress and depreciation

The company keeps one month's stock of raw materials and finished goods (each) and believes in keeping ₹ 2,50,000 available to it including the overdraft limit of ₹ 75,000 not yet utilized by the company.

The management is also of the option to make 12% margin for contingencies on computed figure.

Required:

Prepare the estimated working capital statement for next year.

[May-2011]

Solution:

 **Statement Showing estimated working Capital Requirement (cash cost basis)**

Particulars		(₹)
(A) Current Assets:		
Raw Material	$9,00,000 \times \frac{1}{12}$	75,000
Finished goods	$27,00,000 \times \frac{1}{12}$	2,25,000
Sales promotion	$1,50,000 \times \frac{1}{4}$	37,500
Debtors:		
Domestic	$20,60,000 \times \frac{1}{12}$	1,71,667
Export	$10,30,000 \times \frac{3}{12}$	2,57,500
Cash:	2,50,000 – 75,000	1,75,000
Total (A)		9,41,667
(B) Current Liabilities:		
Wages	$7,20,000 \times \frac{1}{12}$	30,000
Miscellaneous		
Expenses.	$10,80,000 \times \frac{1}{12}$	90,000

Administrative Expenses	$2,40,000 \times \frac{1}{12}$	20,000
Income Tax	$2,25,000 \times \frac{1}{4}$	56,250
Overdraft		Nil
Creditors	$9,00,000 \times \frac{2}{12}$	1,50,000
Total (b)		3,46,250
Net working capital A-B		5,95,417
Add: Margin for contingencies @ 12%		71,450
Total W.C.		6,66,867

Working Notes:**(i) Calculation of Cash cost of production:**

Raw material 9,00,000
Wages 7,20,000
Miscellaneous expenses 10,80,000
Cash cost of Production 27,00,000

(ii) Calculation of Cash cost of production:

Cost of Production 27,00,000
Add: Administrative Expenses 2,40,000
Sales Promotion Expenses 1,50,000
Cash cost of sales 30,90,000

(iii) Calculation of Cash cost of Debtors:

Export sales = 10,80,000 (10% below domestic sales price)

Export sales equivalent to Domestic sales:- $10,80,000 \times \frac{100}{90} = 12,00,000$

(iv) Apportionment of cash cost of sales between Domestic foreign Debtors:

Domestic Debtors = $30,90,000 \times \frac{24,00,000}{36,00,000} = 20,60,000$

Foreign Debtors = $30,90,000 \times \frac{12,00,000}{36,00,000} = 10,30,000$

Problem 6: From the following information of XYZ Ltd., calculate:

(i) Net operating cycle period.

(ii) Number of operating cycles in a year:

1. Raw material inventory consumed during the year	6,00,000
2. Average stock of raw material	50,000
3. Work-in-progress inventory	500,000
4. Average work-in-progress inventory	30,000
5. Finished goods inventory	8,00,000
6. Average finished goods stock held	40,000
7. Average collection period from debtors	45 days
8. Average credit period availed	30 days
9. No of days in a year	360 days

Solution:**(i) Statement Showing Computation of Net Operating Cycle Period**

Particulars	Days
I. Raw Material conversion period $\left(\frac{50,000}{6,00,000} \times 360 \right)$	30
II. Work-in-Progress Conversion period $\left(\frac{30,000}{5,00,000} \times 360 \right)$	22
III. Finished goods conversion period $\left(\frac{40,000}{8,00,000} \times 360 \right)$	18
IV. Average collection period from debtors	45
Less: V. Average credit period awaited	(30)
Operating Cycle	85

(ii) No. of operating cycle in a year $= \frac{360}{85} = 4.24$ cycle in a year

Problem 7: An engineering company is considering its working capital investment for the year end 2003-04. The estimated fixed assets and current liabilities for the next year are ₹ 6.63 crore and ₹ 5.967 crore respectively. The sales and earnings before interest and taxes (EBIT) depend on investment in its current assets- particularly inventory and receivables. The company is examining the following alternative working capital policies:

(₹ in crore)

Working capital policy	Investment in C.Assets	Estimated sales	EBIT
Conservative	11.475	31.365	3.1365
Moderate	9.945	29.325	2.9325
Aggressive	6.63	25.5	2.55

You are required to calculate the following for each policy:

- Rate of return on total assets.
- Net working capital position.
- Current assets to fixed assets ratio.
- Discuss the risk- return trade off of each working capital policy.

Solution:

(i) Return on total Assets $= \frac{\text{EBIT}}{\text{Total Assets}} \times 100$

Conservative	Moderate	Aggressive
$= \frac{3.1365}{(6.63 + 11.475)} \times 100$ $= 17.32\%$	$\frac{2.9325}{6.63 + 9.945} \times 100 = 17.69\%$	$\frac{2.55}{6.63 + 6.63} \times 100 = 19.23\%$

(ii) Net Working Capital = CA - CL

	Conservative	Moderate	Aggressive
Current Assets	11.475	9.945	6.63
Less: Current Liabilities	(5.967)	(5.967)	(5.967)
Net Working Capital	5.508	3.978	0.663

(iii) Current Assets to fixed Assets ratio = $\frac{C.A}{FA}$

Conservative	Moderate	Aggressive
11.475	9.945	6.63
6.63	6.63	6.63
1.73 : 1	1.5 : 1	1:1

(iv) The current ratio is a measure of short term solvency of an entity and hence a measure of risk. Rate of return on total assets is a measure of return. Lower current ratio implies higher risk. Higher the risk higher the return. The expected risk and return are minimum in case of conservative investment policy and maximum in case of aggressive investment policy. The firm can improve profitability by reducing investment in working capital.

investment in working capital.

Problem 8: The following information is provided by the DPS Limited for the year ending 31st March, 2013.



Raw material storage period	55 days	
Work-in Progress conversion period		18 days
Finished Goods storage period	22 days	
Debt collection period	45 days	
Creditors payment period	60 days	
Annual Operating cost (including depreciation of ₹ 2,10,000)		₹ 2,10,000
[1 year = 360 days]		

Required:

- Operating Cycle period.
- Number of Operating Cycle in a year.
- Amount of working capital required for the company on a cash cost basis.
- The company is a market leader in its product, there is virtually no competitor in the market. Based on a market research it is planning to discontinue sales on credit and deliver products based on pre-payments. Thereby, it can reduce its working capital requirement substantially. What would be the reduction in working capital requirement due to such decision? [May 2013]

Solution:



(i) Calculation of Operating Cycle Period

$$\text{Operating Cycle Period} = R + W + F + D - C = 55 + 18 + 22 + 45 - 60 = 80 \text{ days}$$

(ii) Number of Operating Cycle in a Year

$$= 360 / \text{Operating Cycle Period} = 360 / 80 = 4.5$$

(iii) Amount of Working Capital Required

$$= \text{Annual Operating Cost} / \text{Number of Operating Cycle}$$

$$= 18,90,000 / 4.5 = 4,20,000$$

(iv) Reduction in Working Capital

$$\text{Operating Cycle Period} = R + W + F - C = 55 + 18 + 22 - 60 = 35$$

$$\text{Amount of Working Capital Required} = 18,90,000 / 360 \times 35 = 1,83,750$$

$$\text{Reduction in Working Capital} = 4,20,000 - 1,83,750 = 2,36,250$$

Problem 9: STN Ltd. is a readymade garment manufacturing company. Its production cycle indicates that materials are introduced in the beginning of the production phase; wages and overhead accrue evenly throughout the period of cycle. The following figures for the 12 months ending 31st December 2011 are given.



Production of shirts	54,000 units
Selling price per unit	₹ 200
Duration of the production cycle	1 month

Raw material inventory held 2 month's consumption

Finished goods stock held for 1 month

Credit allowed to debtors is 1.5 months and credit allowed by creditors is 1 month.

Wages are paid in the next month following the month of accrual.

In the work-in-progress 50% of wages and overheads are supposed to be conversion costs.

The ratios of cost to sales price are—raw materials 60% direct wages 10% and overheads 20%. Cash is to be held to the extent of 40% of current liabilities and safety margin of 15% will be maintained.

Calculate amount of working capital required for the company on a cash cost basis.

[May 2012]

Solution: Computation of Amount of Working Capital required on a Cash Cost basis



Working Notes:

1. **Raw material inventory:** The cost of materials for the whole year is 60% of the Sales value.

Hence it is $54,000 \text{ units} \times ₹ 200 \times \frac{60}{100} = ₹ 64,80,000$. The monthly consumption of raw material would be ₹ 5,40,000. Raw material requirements would be for two months; hence raw materials in stock would be ₹ 10,80,000.

2. **Debtors:** Total Cash Cost of Sales = $97,20,000 \times \frac{1.5}{12} = ₹ 12,15,000$

3. **Work-in-process:** (Each unit of production is expected to be in process for one month).

	₹
(a) Raw materials in work-in-process (being one month's raw material requirements)	5,40,000
(b) Labour costs in work-in-process (It is stated that it accrues evenly during the month. Thus, on the first day of each month it would be zero and on the last day of month the work-in-process would include one month's labour costs. On an average therefore, it would be equivalent to $\frac{1}{2}$ of the month's labour costs)	45,000
(c) Overheads	90,000
(For $\frac{1}{2}$ month as explained above) Total work-in-process	6,75,000

4. **Finished goods inventory:**

(1 month's cost of production)	
Raw materials	5,40,000
Labour	90,000
Overheads	1,80,000
	8,10,000

5. **Creditors:** Suppliers allow a one month's credit period. Hence, the average amount of creditors would be ₹ 5,40,000 being one month's purchase of raw materials.

6. **Direct Wages payable:** The direct wages for the whole year is $54,000 \text{ units} \times ₹ 200 \times 10\% = 10,80,000$. The monthly direct wages would be 90,000 ($10,80,000 \div 12$). Hence, wages payable would be ₹ 90,000.

Statement of Working Capital Required

	Amount (₹)	Amount (₹)
Current Assets		
Raw materials inventory (Refer to working note 1)	10,80,000	
Debtors (Refer to working note 2)	12,15,000	
Working-in-process (Refer to working note 3)	6,75,000	
Finished goods inventory (Refer to working note 4)	8,10,000	
Cash	2,52,000	40,32,000

<i>Current Liabilities</i>		
Creditors (Refer to working note 5)	5,40,000	
Direct wages payable (Refer to working note 6)	90,000	6,30,000
Estimated working capital requirements (before safety margin of 15%)		34,02,000
Add: Safety margin of 15%		5,10,300
Estimated Working Capital Requirements		39,12,300

Problem 10:

 Samreen Enterprises has been operating its manufacturing facilities till 31.3.2022 on a single shift working with the following cost structure:

	Per unit (₹)
Cost of Materials	6.00
Wages (out of which 40% fixed)	5.00
Overheads (out of which 80% fixed)	5.00
Profit	2.00
Selling Price	18.00
Sales during 2020-21 – ₹ 4,32,000	

As at 31.3.2022 the company held:

	(₹)
Stock of raw materials (at cost)	36,000
Work-in-progress (valued at prime cost)	22,000
Finished goods (valued at total cost)	72,000
Sundry debtors	1,08,000

In view of increased market demand, it is proposed to double production by working an extra shift. It is expected that a 10% discount will be available from suppliers of raw materials in view of increased volume of business. Selling price will remain the same. The credit period allowed to customers will remain unaltered. Credit availed of from suppliers will continue to remain at the present level i.e., 2 months. Lag in payment of wages and expenses will continue to remain half a month.

You are required to PREPARE the additional working capital requirements, if the policy to increase output is implemented.

Solution:

 This question can be solved using two approaches:

- To assess the impact of double shift for long term as a matter of production policy.
- To assess the impact of double shift to mitigate the immediate demand for next year only.

The first approach is more appropriate and fulfilling the requirement of the question

i. Assessment of impact of double shift for long term as a matter of production policy:

Comparative Statement of Working Capital Requirement

	Single Shift (24,000)			Double Shift (48,000)		
	Unit	Rate (₹)	Amount (₹)	Unit	Rate (₹)	Amount (₹)
Current Assets						
Inventories:						
Raw Materials	6,000	6	36,000	12,000	5.4	64,800
Work-in-Progress	2,000	11	22,000	2,000	9.4	18,800
Finished Goods	4,500	16	72,000	9,000	12.4	1,11,600
Sundry Debtors	6,000	16	96,000	12,000	12.4	1,48,800
Total Current Assets: (A)			2,26,000			3,44,000
Current Liabilities						
Creditors for Materials	4,000	6	24,000	8,000	5.4	43,200
Creditors for Wages	1,000	5	5,000	2,000	4	8,000
Creditors for Expenses	1,000	5	5,000	2,000	3	6,000
Total Current Liabilities: (B)			34,000			57,200
Working Capital: (A) – (B)			1,92,000			2,86,800

Additional Working Capital requirement = ₹ 2,86,800 – ₹ 1,92,000 = ₹ 94,800

Workings:**1. Statement of cost at single shift and double shift working**

	24,000 units		48,000 Units	
	Per unit (₹)	Total (₹)	Per unit (₹)	Total (₹)
Raw materials	6.00	1,44,000	5.40	2,59,200
1. Wages - Variable	3.00	72,000	3.00	1,44,000
Fixed	2.00	48,000	1.00	48,000
Overheads - Variable	1.00	24,000	1.00	48,000
Fixed	4.00	96,000	2.00	96,000
Total cost	16.00	3,84,000	12.40	5,95,200
Profit	2.00	48,000	5.60	2,68,800
	18.00	4,32,000	18.00	8,64,000

2. Sales in units 2020-21

$$= \frac{\text{Sales}}{\text{Unit selling price}} = \frac{\text{₹ } 4,32,000}{\text{₹ } 18} = 24,000 \text{ units}$$

3. Stock of Raw Materials in units on 31.3.2021

$$= \frac{\text{Value of Stock}}{\text{cost per unit}} = \frac{\text{₹ } 36,000}{6} = 6,000 \text{ units}$$

4. Stock work-in-progress in units on 31.3.2021

$$= \frac{\text{Value of work-in-progress}}{\text{Prime Cost per unit}} = \frac{\text{₹ } 22,000}{\text{₹ } 6 + \text{₹ } 5} = 2,000 \text{ units}$$

5. Stock of finished goods in units 2020-21

$$= \frac{\text{Value of Stock}}{\text{cost per unit}} = \frac{\text{₹ 36,000}}{6} = 6,000 \text{ units}$$

ii. Assessment of the impact of double shift to mitigate the immediate demand for next year only & not as part of policy implementation.

In this approach, working capital shall be computed as if we are calculating the same for the next / second year with double production. Whereas, in the first approach to implement double-shift as part of policy implementation, we calculated comparative analysis of working capital requirement for single & double shift within the same year.

Workings:**6. Calculation of no. of units to be sold:**

No. of units to be Produced	48,000
Add: Opening stock of finished goods	4,500
Less: Closing stock of finished goods	(9,000)
No. of units to be Sold	43,500

7. Calculation of Material to be consumed and materials to be purchased in units:

No. of units Produced	48,000
Add: Closing stock of WIP	2,000
Less: Opening stock of WIP	(2,000)
Raw Materials to be consumed in units	48,000
Add: Closing stock of Raw material	12,000
Less: Opening stock of Raw material	(6,000)
Raw Materials to be purchased (in units)	54,000

8. Credit allowed by suppliers:

$$= \frac{\text{No. of units of purchased} \times \text{Cost per unit}}{12 \text{ month}} \times \frac{54,000 \times \text{₹ 5.40}}{12 \text{ month}} \times 2 \text{ months} = \text{₹ 48,600}$$

Comparative Statement of Working Capital Requirement

	Single Shift (Current Year – 24,000 units)			Double Shift (Next Year – 48,000 units)		
	Unit	Rate (₹)	Amount (₹)	Unit	Rate (₹)	Amount (₹)
Current Assets						
Inventories:						
Raw Materials	6,000	6.00	36,000	12,000	5.40	64,800
Work-in-Progress	2,000	11.00	22,000	2,000	9.40	18,800
Finished Goods	4,500	16.00	72,000	9,000	12.40	1,11,600
Sundry Debtors	6,000	16.00	96,000	12,000	12.40	1,48,800
Total Current Assets: (A)			2,26,000			3,44,000
Current Liabilities						
Creditors for Materials	4,000	6.00	24,000	9,000	5.40	48,600
Creditors for Wages	1,000	5.00	5,000	2,000	4.00	8,000
Creditors for Expenses	1,000	5.00	5,000	2,000	3.00	6,000
Total Current Liabilities: (B)			34,000			62,600
Working Capital: (A) – (B)			1,92,000			2,81,400

Additional Working Capital requirement = ₹ 2,81,400 – ₹ 1,92,000 = ₹ 89,400



CHAPTER EIGHT

WORKING CAPITAL MANAGEMENT UNIT 2: TREASURY AND CASH MANAGEMENT

LIST OF IMPORTANT QUESTIONS JANUARY 2025



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Problem 1: Gold stone Ltd. has given the following particulars. You are required to prepare a cash budget for three months 31st December 2011.



(i) Months	Sales	Materials	Wages	Overheads
August	40,000	20,400	7,600	3,800
September	42,000	20,000	7,600	4,200
October	46,000	19,600	8,000	4,600
November	50,000	20,000	8,400	4,800
December	60,000	21,600	9,000	5,000

Credit terms are:

- (ii) Sales/debtors – 10% sales are on cash basis. 50% of the credit sales are collected next month and the balance following months:
 - Creditors – Materials 2 months
 - Wages 1/5 month.
 - Overheads ½ month.
- (iii) Cash balance on 1st October 2011 is expected to be ₹ 8,000
- (iv) A machinery will be installed in August 2011 at a cost of ₹ 1,00,000 the monthly installment of ₹ 5,000 is payable from October onwards.
- (v) Dividend at 10% on preference share capital of ₹ 3,00,000 will be paid on 1st December 2011
- (vi) Advance to be received for sale of vehicle ₹ 20,000 in December, 2011.
- (vii) Income tax (advance) to be paid in December ₹ 5,000.

Solution:



Cash budget for three months – October to December 2011

Particulars	October (₹)	November (₹)	December (₹)
Opening cash balance	8,000	11,780	18,360
Receipts			
Cash sales	4,600	5,000	6,000
Collection from debtors	36,900	39,600	43,200
Advance from sale of vehicle			20,000
Total	49,500	56,380	87,560
Payments			
Materials (creditors)	20,400	20,000	19,600
Wages	7,920	8,320	8,880
Overheads	4,400	4,700	4,900
Machinery (monthly installment)	5,000	5,000	5,000
Preference dividend			30,000
Income tax advance			5,000
Total	37,720	38,020	73,380
Closing balance	11,780	18,360	14,180

Working Notes:

(i) Cash collected from debtors:

Particulars		August (₹)	September (₹)	October (₹)	November (₹)	December (₹)
Cash sales	10%	4,000	4,200	4,600	5,000	6,000
Credit sales	90%	36,000	37,800	41,400	45,000	54,000
Collections (debtors)						
1 st Month	50%			18,900	20,700	22,500
2 nd Month	50%			18,000	18,900	20,700
Total				36,900	39,600	43,200

- (ii) Since the period of credit allowed by suppliers is two months the payment for purchase of August will be October and so on.
- (iii) $\frac{4}{5}$ th of the wages is paid in the month itself and $\frac{1}{5}$ th will be paid in the next month and so on.
- (iv) $\frac{1}{2}$ of the overheads is paid in the month itself and $\frac{1}{2}$ will be paid in next month and so on.

Problem 2: Prepare monthly cash budgets for six months beginning from April, 2004, on the basis of the following information:



(i) Estimated monthly sales are as follows:

₹			₹
January	1,00,000	June	80,000
February	1,20,000	July	1,00,000
March	1,40,000	August	80,000
April	80,000	September	60,000
May	60,000	October	1,00,000

(ii) Wages and salaries are estimated to be payable as follows:

April	9,000	July	10,000
May	8,000	August	9,000
June	10,000	September	9,000

- (iii) Of the sales 80% is on credit and 20% for cash. 75% of credit sales are collected within one month and the balance in two months. There are no bad debt losses.
- (iv) Purchase amount of 80% of sales and are made & paid for in the month preceding the sales.
- (v) The firm has 10% Debentures of ₹ 1,20,000. Interest on these has to be paid quarterly in January, April and so on.
- (vi) The firm is to make an advance payment of tax of ₹ 5,000 in July, 2004.
- (vii) The firm had a cash balance of ₹ 20,000 on April 1, 2004, which is the minimum desired level of cash balance. Any cash surplus/deficit above/below this level is made up by temporary investments/liquidation of temporary investments or temporary borrowings at the end of each month (interest on these to be ignored).

Solution:**Cash budget for Apr. to Sep. 2004**

	Jan.	Feb.	Mar.	Apr.	May	June
Receipts						
Cash sales	16,000	12,000	16,000	20,000	16,000	12,000
From Debtors	1,08,000	76,000	52,000	60,000	76,000	68,000
(A)	1,24,000	88,000	68,000	80,000	92,000	80,000
Payments						
Purchases	48,000	64,000	80,000	64,000	48,000	80,000
Wages & Salaries	9,000	8,000	10,000	10,000	9,000	9,000
Deb. interest	3,000	–	–	3,000	–	–
Adv. Tax	–	–	–	5,000	–	–
(B)	60,000	72,000	90,000	82,000	57,000	89,000
Net Receipts (A – B)	64,000	16,000	(22,000)	(2,000)	35,000	(9,000)
Op. Cash Bal.	20,000	20,000	20,000	20,000	20,000	20,000
	84,000	36,000	(2,000)	18,000	55,000	11,000
Invest. In Securities	(64,000)	(16,000)	–	–	(35,000)	–
Temporary borrowings	–	–	22,000	2,000	–	9,000
Closing Cash bal.	20,000	20,000	20,000	22,000	20,000	20,000

Problem 3: Prepare Cash budget for July-December from the following information:



(i) **The estimated sales, expenses etc. are as follows:**

(₹ lakhs)

	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Sales	35	40	40	50	50	60	65
Purchases	14	16	17	20	20	25	28
Wages & Salaries	12	14	14	18	18	20	22
Miscellaneous Expenses	5	6	6	6	7	7	7
Interest Received	2	–	–	2	–	–	2
Sales of Shares	–	–	20	–	–	–	–

- (ii) 20% of the sales are on cash and the balance on credit.
- (iii) 1% of the credit sales are returned by customers, 2% of the total accounts receivable constitute bad debt losses. 50% of the good accounts receivable are collected in the month of the sales, and the rest in the next month.
- (iv) The time lag in the payment of miscellaneous expenses and purchases is one month. Wages and salaries are paid fortnightly with a time lag of 15 days.
- (v) The company keeps a minimum cash balance of ₹ 5 lakhs. Cash in excess of ₹ 7 lakhs is invested in Government securities in the multiple of ₹ 1 lakh. Shortfalls in the minimum cash balance are made good by borrowings from banks. Ignore interest received and paid.

Solution:**Cash Budget for July to December**

(₹ in lakhs)

	July	Aug.	Sept.	Oct.	Nov.	Dec.
Receipts						
Cash in hand	5.00	7.10	7.14	7.06	7.86	7.54
Collection from Debtors (Note 1)	29.10	31.04	34.92	38.80	42.68	48.50
Interest received	–	–	2.00	–	–	2.00
Sale of shares	–	20.00	–	–	–	–
(A)	42.10	66.14	54.06	55.86	62.54	71.04
Payments						
Creditors for supply (Time lag 1 month)	14.00	16.00	17.00	20.00	20.00	25.00
Wages and Salaries	13.00	14.00	16.00	18.00	19.00	21.00
Misc. Exp. (Time lag 1 month)	5.00	6.00	6.00	6.00	7.00	7.00
Total Payments (B)	32.00	36.00	39.00	44.00	46.00	53.00
Minimum Cash Balance (B1)	5.00	5.00	5.00	5.00	5.00	5.00
Total Cash needed	37.00	41.00	44.00	49.00	51.00	58.00
Surplus/Deficiency (B2)	5.10	25.14	10.06	6.86	11.54	13.04
Financing & Investment (B1 + B2 – 7.00)(D)	(3.00)	(23.00)	(8.00)	(4.00)	(9.00)	(11.00)
Closing Cash Balance (A-B-D)	7.10	7.14	7.06	7.86	7.54	7.04

Working Notes:**1. Collection from Debtors**

Particulars	(₹ In lakhs)						
	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Sales	35.00	40.00	40.00	50.00	50.00	60.00	65.00
Cash Sales (20%)	7.00	8.00	8.00	10.00	10.00	12.00	13.00
Credit Sales (80%)	28.00	32.00	32.00	40.00	40.00	48.00	62.00
Returns	0.28	0.32	0.32	0.40	0.40	0.48	0.52
Bad Debt (2%)*	0.56	0.64	0.64	0.80	0.80	0.96	1.04
Debts recoverable	27.16	31.04	31.04	38.80	38.80	46.56	50.44
Collection 50% in the month of sales	13.58	15.52	15.52	19.40	19.40	23.28	25.22
		13.58	15.52	15.52	19.40	19.40	23.28
Total collection in a month		29.10	31.04	34.92	38.80	42.68	48.50

2. Payment of Wages and Salaries (Fortnightly with a lag of 15 days)

Particulars	(₹ in lakhs)					
	July	Aug.	Sept.	Oct.	Nov.	Dec.
½ to be paid same month	7	7	9	9	10	11
½ relating to previous month	6	7	7	9	9	10
Total Wages and Salaries paid	13	14	16	18	19	21

Problem 4: The following particulars have been obtained in respect of retail business of Lucky Ltd., for the three months ending March, 2018:

1. Working capital as on 1st January, 2018 has been estimated as follows:

	₹
Cash and bank balances	10,900
Debtors	51,400
Creditors	42,200
Outstanding expenses	4,000
Dividend due	9,700
Tax due	6,400
Stock	26,000

2. Budgeted Profit Statement at the end of each month:

	2018		
	January	February	March
	₹	₹	₹
Sales	42,000	36,000	34,000
Cost of Sales	32,700	28,100	26,600
Gross Profit	9,300	7,900	7,400
Administrative, Selling & Distribution Expenses	6,300	5,400	5,100
Net Profit before tax	3,000	2,500	2,300

3. Budgeted balances at the end of each month:

	2018		
	January	February	March
	₹	₹	₹
Stock	24,000	22,000	20,000
Debtors	52,000	50,000	47,000
Creditors	40,000	39,000	38,000
Outstanding Expenses	4,000	4,000	4,000
Dividend Due	9,700	–	–
Tax due	6,400	6,400	6,400

Note: Depreciation amounting to ₹ 1,700 has been included in the budgeted expenditure of each month.

You are required to prepare a cash budget on receipts and payments basis by months upto March, 2000. Workings should form part of the answer.

Solution:

Statement showing Cash Budget for Jan., Feb. & March 2018

	January	February	March
Cash and Bank balance (opening)	10,900	14,800	12,300
Add: Receipt from debtors (Note 1)	41,400	38,000	37,000
Total (A)	52,300	52,800	49,300
Payment			
Account payable for materials & expenses (Note 2)	37,500	30,800	29,000
Dividend	–	9,700	–
Total (B)	37,500	40,500	29,000
Closing Cash and Bank balance (A) – (B)	14,800	12,300	20,300

Working Notes:

Particulars		January (₹)	February (₹)	March (₹)
1. Receipt from debtors				
Opening balance		51,400	52,000	50,000
Add: Credit sales during this month		42,000	36,000	34,000
		93,400	88,000	84,000
Less: Closing balance		52,000	50,000	47,000
Receipt from debtors		41,400	38,000	37,000
2. Payment to creditors for material and expenses				
Opening Balance:				
Creditors		42,200	40,000	39,000
Expenses		4,000	4,000	4,000
Total		46,200	44,000	43,000
Add: Cost of sales (Note 3)		29,000	24,400	22,900
Adm. S & D expenses		6,300	5,400	5,100
		81,500	73,800	71,000
Less: Closing balance:				
Creditors		40,000	39,000	38,000
Expenses		4,000	4,000	4,000
Payment during this month		37,500	30,800	29,000
3. Cost of sales				
Cost of sales (given)		32,700	28,100	26,600
Add: Closing stock		24,000	22,000	20,000
		56,700	50,100	46,600
Less: Opening stock		26,000	24,000	22,000
		30,700	26,100	24,600
Less: Depreciation (being non-cash item)		1,700	1,700	1,700
Expenses for the month		29,000	24,400	22,900

Problem 5:

 Prachi Ltd is a manufacturing company producing and selling a range of cleaning products to wholesale customers. It has three suppliers and two customers. Prachi Ltd relies on its cleared funds forecast to manage its cash.

You are an accounting technician for the company and have been asked to prepare a cleared funds forecast for the period Saturday 9 August to Wednesday 13 August 20X2 inclusive. You have been provided with the following information:

1. Receipts from customers

	Credit terms	Payment method	9 Aug 20X2 sales	9 Jul 20X2 sales
W Ltd	1 calendar month	BACS	₹ 150,000	₹ 130,000
X Ltd	None	Cheque	₹ 180,000	₹ 160,000

- (a) Receipt of money by BACS (**Bankers' Automated Clearing Services**) is instantaneous.
- (b) X Ltd's cheque will be paid into Prachi Ltd's bank account on the same day as the sale is made and will clear on the third day following this (excluding day of payment).

2. Payments to suppliers

Supplier name	Credit terms	Payment method	9 Aug 20X2 purchases	9 Jul 20X2 purchases	9 Jun 20X2 purchases
A Ltd	1 calendar month	Standing order	₹ 65,000	₹ 55,000	₹ 45,000
B Ltd	2 calendar months	Cheque	₹ 85,000	₹ 80,000	₹ 75,000
C Ltd	None	Cheque	₹ 95,000	₹ 90,000	₹ 85,000

- (a) Prachi Ltd has set up a standing order for ₹ 45,000 a month to pay for supplies from A Ltd. This will leave Prachi's bank account on 9 August. Every few months, an adjustment is made to reflect the actual cost of supplies purchased (you do NOT need to make this adjustment).
- (b) Prachi Ltd will send out, by post, cheques to B Ltd and C Ltd on 9 August. The amounts will leave its bank account on the second day following this (excluding the day of posting).

3. Wages and salaries

	July 20X2	August 20X2
Weekly wages	₹ 12,000	₹ 13,000
Monthly salaries	₹ 56,000	₹ 59,000

- (a) Factory workers are paid cash wages (weekly). They will be paid one week's wages, on 13 August, for the last week's work done in July (i.e. they work a week in hand).
- (b) All the office workers are paid salaries (monthly) by BACS. Salaries for July will be paid on 9 August.

4. Other miscellaneous payments

- (a) Every Saturday morning, the petty cashier withdraws ₹ 200 from the company bank account for the petty cash. The money leaves Prachi's bank account straight away.
- (b) The room cleaner is paid ₹ 30 from petty cash every Monday morning.
- (c) Office stationery will be ordered by telephone on Sunday 10 August to the value of ₹ 300. This is paid for by company debit card. Such payments are generally seen to leave the company account on the next working day.
- (d) Five new softwares will be ordered over the Internet on 12 August at a total cost of ₹ 6,500. A cheque will be sent out on the same day. The amount will leave Prachi Ltd's bank account on the second day following this (excluding the day of posting).

5. Other information

The balance on Prachi's bank account will be ₹ 200,000 on 9 August 20X2. This represents both the book balance and the cleared funds.

PREPARE a cleared funds forecast for the period Saturday 7th August to Wednesday 13th August 20X2 inclusive using the information provided. Show clearly the uncleared funds float each day.

Solution:**Cleared Funds Forecast**

	9 Aug (Saturday)	10 Aug (Sunday)	11 Aug (Monday)	12 Aug (Tuesday)	13 Aug (Wednesday)
Receipts	₹	₹	₹	₹	₹
W Ltd	1,30,000	0	0	0	0
X Ltd	0	0	0	1,80,000	0
(a)	1,30,000	0	0	1,80,000	0
Payments					
A Ltd	45,000	0	0	0	0

B Ltd	0	0	75,000	0	0
C Ltd	0	0	95,000	0	0
Wages	0	0	0	0	12,000
Salaries	56,000	0	0	0	0
Petty Cash	200	0	0	0	0
Stationery	0	0	300	0	0
(b)	1,01,200	0	1,70,300	0	12,000
Cleared excess Receipts					
over payments (a) – (b)	28,800	0	(1,70,300)	1,80,000	(12,000)
Cleared balance b/f	2,00,000	2,28,800	2,28,800	58,500	2,38,500
Cleared balance c/f (c)	2,28,800	2,28,800	58,500	2,38,500	2,26,500
Uncleared funds float					
Receipts	1,80,000	1,80,000	1,80,000	0	0
Payments	(1,70,000)	(1,70,300)	0	(6,500)	(6,500)
(d)	10,000	9,700	180,000	(6,500)	(6,500)
Total book balance c/f	2,38,800	2,38,500	2,38,500	2,32,000	2,20,000
(c)+ (d)					

Problem 6:

From the following information relating to a departmental store, you are required to PREPARE for the three months ending 31st March, 2022:

- Month-wise cash budget on receipts and payments basis; and
- Statement of Sources and uses of funds for the three months period.

It is anticipated that the working capital & other account balances at 1st January, 2022 will be as follows:

	₹ in '000
Cash in hand and at bank	545
Short term investments	300
Debtors	2,570
Stock	1,300
Trade creditors	2,110
Other creditors	200
Dividends payable	485
Tax due	320
Plant	800

Budgeted Profit Statement:	₹ in '000		
	January	February	March
Sales	2,100	1,800	1,700
Cost of goods sold	1,635	1,405	1,330
Gross Profit	465	395	370
Administrative, Selling and Distribution Expenses	315	270	255
Net Profit before tax	150	125	115

Budgeted balances at the end of each months	₹ in '000		
	31st Jan.	28th Feb.	31st March
Short term investments	700	---	200
Debtors	2,600	2,500	2,350
Stock	1,200	1,100	1,000
Trade creditors	2,000	1,950	1,900
Other creditors	200	200	200
Dividends payable	485	--	--
Tax due	320	320	320
Plant (depreciation ignored)	800	1,600	1,550

Depreciation amount to ₹ 60,000 is included in the budgeted expenditure for each month.

Solution:



WORKING

		₹ in '000		
		Jan.	Feb.	March
(1)	Payments to creditors:			
	Cost of goods sold	1,635	1,405	1,330
	Add: Closing Stocks	1,200	1,100	1,000
		2,835	2,505	2,330
	Less: Opening Stocks	1,300	1,200	1,100
	Purchases	1,535	1,305	1,230
	Add: Trade Creditors, Opening balance	2,110	2,000	1,950
		3,645	3,305	3,180
	Less: Trade Creditors, closing balance	2,000	1,950	1,900
	Payment	1,645	1,355	1,280
(2)	Receipts from debtors:			
	Debtors, Opening balances	2,570	2,600	2,500
	Add: Sales	2,100	1,800	1,700
		4,670	4,400	4,200
	Less: Debtors, closing balance	2,600	2,500	2,350
	Receipt	2,070	1,900	1,850

Cash Budget

(a) 3 months ending 31st March, 2022

(₹ in 000)			
	January, 2022	February, 2022	March, 2022
Opening cash balances	545	315	65
Add: Receipts:			
From Debtors	2,070	1,900	1,850
Sale of Investments	---	700	---
Sale of Plant	---	---	50
Total (A)	2,615	2,915	1,965
Deduct: Payments			

Creditors	1,645	1,355	1,280
Expenses	255	210	195
Capital Expenditure	---	800	---
Payment of dividend	---	485	---
Purchase of investments	400	---	200
Total payments (B)	2,300	2,850	1,675
Closing cash balance (A-B)	315	65	290

Statement of Sources and uses of Funds for the three month period ending 31st March, 2022

	₹ '000	₹ '000
Sources:		
Funds from operation:		
Net profit (150+125+115)	390	
Add: Depreciation (60×3)	180	570
Sale of plant		50
		620
Decrease in Working Capital (Refer Statement of changes in working capital)		665
Total		1,285
Uses:		
Purchase of plant		800
Payment by dividends		485
Total		1,285

Statement of Changes in Working Capital

	January,22	March,22	Increase	Decrease
	₹' 000	₹' 000	₹' 000	₹' 000
Current Assets				
Cash in hand and at Bank	545	290		255
Short term Investments	300	200		100
Debtors	2,570	2,350		220
Stock	1,300	1,000		300
	4,715	3,840		
Current Liabilities				
Trade Creditors	2,110	1,900	210	---
Other Creditors	200	200	---	---
Tax Due	320	320	---	---
	2,630	2,420		
Working Capital	2,085	1,420		
Decrease	-	665	665	
	2,085	2,085	875	875

Since there is our incremental net revenue of ₹ 7,00,000 therefore extension of credit should be accepted



CHAPTER EIGHT

WORKING CAPITAL MANAGEMENT

UNIT 4: MANAGEMENT OF RECEIVABLES

LIST OF IMPORTANT QUESTIONS JANUARY 2025



**FM-SM
REGULAR** Batch
JAN/MAY/SEPT 2025



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Problem 1: The present credit terms of P Company are 1/10 net 30. Its annual sales are ₹ 80 lakhs, its average collection period is 20 days. Its variable costs and average total costs to sales are 0.85 and 0.95 respectively and its cost of capital is 10%. The proportion of sales on which customers currently take discount is 0.5. P Company is considering relaxing its discount terms to 2/10 net 30. Such relaxation is expected to increase sales by ₹ 5 lakhs, reduce the average collection period to 14 days and increase the proportion of discount sales to 0.8.

What will be the effect of relaxing the discount policy on company's profit? Take year as 360 days.

Solution:

Working Notes:

Calculation reduction in investment in receivables

(₹)

Present investment in receivables	$\left(₹ 80 \text{ lakhs} \times 0.95 \times \frac{20 \text{ days}}{360 \text{ days}} \right)$	4,22,222

Proposed investment in receivables

$[(₹ 80 \text{ lakhs} \times 0.95) + (₹ 5 \text{ lakhs} \times 0.85)] \times \left(\frac{14 \text{ days}}{360 \text{ days}} \right)$	3,12,083

Reduction in investment in receivables

1,10,139

Calculations of increase in discount

(₹)

Present discount	$\left(₹ 80 \text{ lakhs} \times \frac{1}{100} \times 0.5 \right)$	40,000

Proposed discount	$\left(₹ 85 \text{ lakhs} \times \frac{2}{100} \times 0.8 \right)$	1,36,000

Net increase in amount	<u>96,000</u>

Statement showing evaluation of effect of relaxing the discount policy on company's profit

(₹)

Increase in contribution	$\left(₹ 5 \text{ lakhs} \times \frac{15}{100} \right)$	75,000

Cost of savings on investment in receivables	$\left(₹ 1,10,139 \times \frac{10}{100} \right)$	11,014

Total incremental cost	<u>86,014</u>

Less: Net increase in discount	<u>96,000</u>

Incremental loss	<u>9,986</u>

Analysis: These will be an incremental loss by relaxing the discount policy. Hence, it is not suggested to release

Problem 2: As a part of the strategy to increase sales and profits, the sales manager of a company proposes to sell goods to a group of new customers with 10% risk of non-payment. This group would require one and a half months credit and is likely to increase sales by ₹ 1,00,000 p.a. production and selling expenses amount to 80% of sales and the income-tax rate is 50%. The company's minimum required rate of return (after tax) is 25%.

Should the sales manager's proposal be accepted?

Solution:

Extension of credit to group of new customer; profitability of additional sales

Particulars	(₹)
Increase in sales per annum	1,00,000
Less: Bad debts @ 10%	<u>10,000</u>
Net sales revenue	90,000
Less: Production and selling expenses (80% of sales)	80,000
Profit before tax	10,000
Less: Income tax @ 50%	<u>5,000</u>
Profit after tax	5,000

Average investment in additional receivables

Period of credit = 1 ½ month

Receivable turn over = $\frac{12}{1\frac{1}{2}}$ = 8

Average amount of receivable = $\frac{₹ 1,00,000}{8}$ = ₹ 12,500

Average investment in receivable (at cost) = ₹ 12,500 × $\left(\frac{80}{100}\right)$ = ₹ 10,000

Available rate of return = $\frac{₹ 5,000}{₹ 10,000} \times 100$ = 50%

Since the rate of return is higher than the desired rate of return of 25%, the proposal is to be accepted.
Acceptable degree of risk of non-payment

(a) When rate of return is 30% (after tax)

Required profit after tax on investment = ₹ 10,000 × 30% = ₹ 3,000

Required amount of PBT = $\frac{3,000}{50} \times 100$ = ₹ 6,000

Net sales revenue required = ₹ 80,000 + 6,000 = ₹ 86,000

Acceptable amount of bad debts losses = ₹ 1,00,000 – ₹ 86,000 = ₹ 14,000

Acceptable degree of risk of non- payment = $\frac{₹ 14,000}{₹ 1,00,000} \times 100$ = 14%

(b) When rate of return is 40% (after tax)

Required amount of profit after tax on Investment = ₹ 10,000 × 40% = ₹ 4,000

Required amount of PBT = $\left(\frac{₹ 4,000}{50}\right) \times 100$ = ₹ 8,000

Sales required = ₹ 80,000 + ₹ 8,000 = ₹ 88,000

Acceptable amount of bad debts = ₹ 1,00,000 – ₹ 88,000 = ₹ 12,000

Acceptable degree of risk of non-payment = 12% (calculation as above)

(c) When rate of return is 60% (after tax)

Required amount of profit after tax on Investment = ₹ 10,000 × 60% = ₹ 6,000

Required amount of PBT = $\left(\frac{₹ 6,000}{50}\right) \times 100$ = ₹ 12,000

Sales required = ₹ 80,000 + ₹ 12,000 = ₹ 92,000

Acceptable bad debts losses = ₹ 1,00,000 – ₹ 92,000 = ₹ 8,000

Acceptable degree of risk of non – payment = 8% (calculation as above)

Problem 3: The Sales Manager of AB Limited suggests that if credit period is given for 1.5 months then sales may likely to increase by ₹ 1,20,000 per annum. Cost of sales amounted to 90% of sales. The risk of non-payment is 5%. Income tax rate is 30%. The expected return on investment is ₹ 3,375 (after tax).

Should the company accept. The suggestion of sales manager?

[May-2008]

Solution:

	Credit period	=	1.5 Months
	Increase in Sales	=	1,20,000
	Less: Cost of Production		1,08,000
	Contribution		12,000
	Less: Bad Debts		6,000
			6,000
	Less: Tax @ 30%		1,800
	Profit after tax		4,200

Working Notes:

Turnover (credit)	90,00,000
Less: Factor Reserve 12% of 90 lacs	10,80,000
	79,20,000
Less: Commission 4% of 90 lacs	3,60,000
	75,60,000

Conclusion: Since, Net Profit is ₹ 4,200 & expected return is 3,375, therefore as PAT is positive hence, the suggestion of the sales manager may be accepted.

Problem 4: The Marketing Manager of XY Ltd. is giving a proposal to the Board of Directors of the company that an increase in credit period allowed to customers from the present one month to two months will bring a 25% increase in sales volume in the next year.

The following operational data of the company for the current year are taken from the records of the company:

	₹
Selling price	21 p.u.
Variable cost	14 p.u.
Total cost	18 p.u.
Sales value	18,90,000

Required:

The Board, by forwarding the above proposal and data requests you to give your expert opinion on the adoption of the new credit policy in next year subject to a condition that the company's required rate of return on investments is 40%. [May-2011]

Solution: Alternative 1: Total Approach**Evaluation of Credit Policy**

Particulars	Existing 1 Month Credit (₹)	Proposed 2 Month Credit (₹)
No. of units sold (WN'1')	90,000	1,12,500
Sales @ 21 p.u.	18,90,000	23,62,500
Less: V.C. @ 14 P.U.	12,60,000	15,75,000
Less: F.C. [WN'2']	3,60,000	3,60,000
Profit	2,70,000	4,27,500
Less: Cost of Investment [W.N. '3']	54,000	1,29,000
Net Benefit	2,16,000	2,98,500

Recommendation:

Company should adopt new credit policy having higher profit than profit under existing credit policy.

Working Note:

1. Calculation of No. of units sold in existing and proposed credit policy = S.V. ÷ S.P.P.U.

$$\text{Existing} = 18,90,000 \div 21 = 90,000 \text{ units}$$

$$\text{Proposed} = 90,000 + 25\% \text{ of } 90,000 = 1,12,500 \text{ units}$$

2. Calculation of Fixed Cost:-

$$\text{Total Cost} - \text{V.C.} = \text{F.C. per unit}$$

$$18 - 14 = \text{Rs. 4 P.U.}$$

$$\text{Total Fixed Cost} = 4 \times 90,000 \text{ (Existing)} = 3,60,000$$

Fixed Cost will remain same in proposed credit policy

3. Calculation of cost of investment in debtors:

$$\text{Existing} = [\text{V.C.} + \text{F.C.}] \times \frac{\text{Credit Period}}{12} \times 40\%$$

$$= [12,60,000 + 3,60,000] \times \frac{1}{12} = 54,000$$

$$\text{Proposed:} = [15,75,000 + 3,60,000] + \frac{1}{12} \times 40\% = 1,29,000$$

Alternative 2:**Incremental Approach**

Particulars	Amount (₹)
Incremental contribution @ ₹ 7 of 22,500 units [WN:1]	1,57,500
Less: incremental cost of investment [WN ii]	75,000
Incremental profit	82,500

Company have incremental benefit on proposed policy, Hence, proposed credit policy should be adopted.

Working Note:

1. Calculation of incremental

$$\text{Existing units} = 18,90,000 \div 21$$

$$= 90,000 \text{ units}$$

$$\text{Incremental units} = 90,000 \times 25\%$$

$$= 22,500 \text{ units}$$

$$\text{Contribution per unit} = \text{S.P.} - \text{V.C.}$$

$$= 21 - 14$$

$$= 7 \text{ per unit}$$

$$\text{Contribution on Incremental Units} = 22,500 \times 7$$

$$= 1,57,500$$

2. Incremental Cost of investment

$$\text{Existing Cost} = 90,000 \text{ units @ } 18 \text{ p.u.} = 16,20,000$$

$$\text{Incremental Cost} = 22,500 \text{ units @ } 14 \text{ p.u. (only V.C.)} = 3,15,000$$

$$\text{Existing credit period} = 1 \text{ month}$$

$$\text{Proposed credit period} = 2 \text{ months}$$

3. Incremental cost of investment:

$$(a) \text{ On existing debtors} = 16,20,000 \times \frac{2-1}{12} \times 40\%$$

$$(b) \text{ On incremental debtors} = 3,15,000 \times \frac{2}{12} \times 40\% = 21,000$$

$$a + b = 54,000 + 21,000 = 75,000/-$$

Problem 5: Under an advance factoring arrangement Bharat Factors Ltd. (BFL) has advanced a sum of ₹ 14 lakh against the receivables purchased from ABC Ltd. The Factoring agreement provides for an advance payment of 80% (maintaining 'factor reserve of 20% to provide for disputes and deduction relating to the bills assigned) of the value of factored receivables and for guaranteed payment after three months from the date of purchasing the receivables. The advance carries a rate of interest of 20% per annum compounded quarterly and the factoring commission is 1.5% of the value of factored receivables. Both the interest and commission are collected up-front.

Required:

- (i) Compute the amount of advance payable to ABC Ltd.
- (ii) Calculator per annum the effective cost of funds made available to ABC Ltd.
- (iii) Calculate the effective cost of funds made available to ABC Ltd. assuming that the interest is collected in arrear and commission is collected in advance.

Solution:

	(i) Computation of advance payable to ABC Ltd:	(₹ in lacs)
	Value of factored receivable (i.e. 14/0.8)	17.50
	Maximum permissible advance	14.00
	Less: commission @ 1.5 per cent (i.e. 17.50×0.015)	0.26
	Less: discount charge ($14 \times 0.2 \times 90/360$)	0.70
	Funds made available to ABC Ltd.	<u>13.04</u>
	(ii) Effective Cost:	
	Total charge	$= 0.7 + 0.26 = ₹ 0.96 \text{ lacs}$
	Total charge expressed as a percentage of funds made available to ABC Ltd. (i.e. $0.96/13.04$)	$= 7.36\% \text{ per quarter}$
	The annualized rate of interest	$= [(1 + .0736)]^4 - 1 = 32.85$
	Hence cost of funds	$= 32.85\%$
	(iii) Effective cost when interest in arrears and commission in advance:	(₹ in lacs)
	Maximum Permissible advance	14.00
	Less: commission payable up- front (17.00×0.015)	0.26
	Funds available to ABC Ltd.	<u>13.74</u>
	Interest charges collected in arrears (i.e. $14 \times 0.20 \times 90/360$)	0.70
	Total charge expressed as a percentage of funds made available	
	$\frac{.96}{13.74} \times 100 = 6.99\% \text{ per quarter}$	
	Annualized interest cost $= [(1 + .0699)^4 - 1] \times 100 = 31.03\%$	

Problem 6: The turnover of PQR Ltd. is ₹ 120 lakhs of which 75 per cent is on credit. The variable cost ratio is 80 per cent. The credit terms are 2/10, net 30. On the current level of sales, the bad debts are 1 per cent. The company spends ₹ 1,20,000 per annum on administering its credit sales. The cost includes salaries of staff who handle credit checking, collection etc. These are avoidable costs. The past experience indicates that 60 per cent of the customers avail of the cash discount, the remaining customers pay on an average 60 days after the date of sale.

The Book debts (receivable) of the company are presently being financed in the ratio of 1 : 1 by a mix of bank borrowings and owned funds which cost per annum 15 per cent and 14 per cent respectively.

A factoring firm has offered to buy the firm's receivables. The main elements of such deal structured by the factor are:

- (i) Factor reserve, 12 per cent
- (ii) Guaranteed payment, 25 days
- (iii) Interest charges, 15 per cent, and
- (iv) Commission 4 per cent of the value of receivables.

Assume 360 days in a year.

Required:

What advise would you give to PQR Ltd. - whether to continue with the in house management of receivables or accept the factoring firm's offer? [May-2007]

Solution: In-house Decision

	₹
Cash discount ($₹ 90 \text{ lakhs} \times .60 \times .02$)	1,08,000
Bad debts losses ($90,00,000 \times .01$)	90,000
Administration cost	1,20,000
Cost of funds in receivables*	1,08,750
	<u>4,26,750</u>

*Average collection period $[(10 \times .6) + (60 \text{ days} \times .40)] = 30 \text{ days}$

Average investments in debtors $= \frac{90}{12} \times \frac{30}{360} = 7.5 \text{ lakhs}$

Cost of Bank funds $\left(₹ 7.5 \times \frac{1}{2} \times .15 \right)$ 56,250

Cost of Owned funds $\left(₹ 7.5 \times \frac{1}{2} \times 1.4 \right)$ 52,500

1,08,750

Offer Alternative

Factoring commission ($₹ 90 \text{ lakhs} \times .04$) 3,60,000

Interest charges $75,60,000 \times 15\% \times \frac{25}{360}$ 78,750

Cost of owned funds invested in receivables

$(90,00,000 - 75,60,000) \times .14 \times \frac{25}{360}$ 14,000

4,52,750

Decision: PQR should not go for the factoring alternative as the cost of factoring is more.

Cost of In-house Decision 4,26,750

Cost of Factoring Firm 4,52,750

Net loss (26,000)

Problem 7: A firm has a total sales of ₹ 12,00,000 and its average collection period is 90 days. The past experience indicates that bad debt losses are 1.5% on sale. The expenditure incurred by the firm in administering receivable collection effort are ₹ 50,000. A factor is prepared to buy the firm's receivables by charging 2% commission. The factor will pay advance on receivables to this firm at an interest rate of 16% p.a. after withholding 10% as reserve.

Calculate effective cost of factoring to the firm. Assume 360 days in a year.

[May-2009]

Solution: Computation of Effective Cost of factoring

Average level of Receivable = $12,00,000 \times \frac{90}{360}$

= 3,00,000

Factoring commission = $3,00,000 \times \frac{2}{100}$

= 6,000

Factoring Reserve = $3,00,000 \times \frac{10}{100}$

= 30,000

Amount available for

$$\begin{aligned} \text{Advance} &= ₹ 3,00,000 - (6,000 + 30,0000) \\ \text{Factor will deduct his interest @ 16\%:-} \\ \text{Interest} &= \frac{₹ 2,64,000 \times 16 \times 90}{360 \times 100} = ₹ 10,560 \\ \text{Advance to be paid} &= ₹ 2,64,000 - ₹ 10,560 = ₹ 2,53,440 \end{aligned}$$

Effective cost of factoring to the firm:

Total commission (6,000 × 4)	24,000
Total interest (10,560 × 4)	42,240
Total cost	66,240
less: Existing cost	50,000
Elective cost	16,240
Effective cost	$\frac{16,240}{2,53,440} \times 100 = 6.4078\%$

Problem 8: Pollock Co. Pvt. Ltd., which is operating for the last 5 years, has approached Sudershan Industries for grant of credit limit on account of goods bought from the latter, annexing Balance Sheet and Income Statement for the last 2 years as below:

Pollock Co. Pvt. Ltd. – Balance Sheet (₹ '000)

Particulars	Current Year (₹)	Last Year (₹)	Particulars	Current Year (₹)	Last Year (₹)
Share Capital Equity (₹ 10)	600	600	Plant and Equipment (less Depr.)	1,500	1,400
Share Premium	400	400	Land	750	750
Retained Earnings	900	700	Total Fixed Assets	2,250	2,150
Total Equity	1,900	1,700	Inventories	580	300
First Mortgage	200	300	Account Receivables	350	200
Second Mortgage	—	200	Marketable Securities	120	120
Bonds	300	300	Cash	100	80
Long-term Liabilities	500	800	Total Current Assets	1,150	700
Account Payable	300	60			
Notes Payable	600	220			
Secured Liabilities	100	70			
Total Current Liabilities	1,000	350			
Total	3,400	2,850	Total	3,400	2,850

Pollock Co. Pvt. Ltd. – Income Statement (₹ '000)

Particulars	Current Year (₹)		Last Year (₹)	
Sales	5,980		5,780	
Income from Investments	20	6,000	20	5,800
Opening inventory	300		400	
Total Manufacturing Costs	4,200		3,200	
Ending Inventory	– 580	3,920	– 300	3,300
		2,080		2,500
General and Admin. Expenses		950		750

Operating Income		1,130		1,750
Interest Expenses.		60		62
Earnings before Taxes		1,070		1,688
Income Tax		480		674
Net income after Taxes		590		1,014
Dividend declared and paid				250

Sudershan Industries has established the following broad guidelines for granting credit limits to its customers:

- Limit credit limit to 10% of net worth and 20% of the net working capital.
- Not to give credit in excess of ₹ 1,00,000 to any single customer.

Required:

You are required to detail the steps required for establishing credit limits to Pollock Co. Pvt. Ltd. In this case, what you consider to be reasonable credit limit ?

Solution:



Working Notes:

(₹ 000)

I. Liquidity Ratios:

Particulars	Current Year	Last Year
1. Current Ratio $\frac{\text{Current assets}}{\text{current liabilities}}$	$\frac{1150}{1000} = 11.5$	$\frac{700}{350} = 2.00$
2. Acid Test Ratio $\frac{\text{Current assets} - \text{Inven.}}{\text{current Liabilities}}$	$\frac{570}{1000} = 0.57$	$\frac{400}{350} = 1.14$
3. Inventory turnover $\frac{\text{Cost of goods sold}}{\text{Inventories}}$	$\frac{3920}{580} = 6.758$	$\frac{3300}{300} = 11$
4. Debtors turnover $\frac{\text{Sales}}{\text{Receivables}}$	$\frac{5980}{350} = 17.09$	$\frac{5780}{200} = 28.9$

II. Profitability Ratios:

Particulars	Current Year	Last Year
1. Profit margin $\left(\frac{\text{EBIT}}{\text{Sales}}\right) \times 100$	$\left(\frac{1130}{5980}\right) \times 100 = 18.9\%$	$\left(\frac{1750}{5780}\right) \times 100 = 30.28\%$
2. Return on investment $\left(\frac{\text{EBIT}}{\text{Total assets}}\right) \times 100$	$\left(\frac{1130}{3400}\right) \times 100 = 33.24\%$	$\left(\frac{1750}{2850}\right) \times 100 = 61.40\%$
3. Return on equity $\left(\frac{\text{EAT}}{\text{Equity}}\right) \times 100$	$\left(\frac{590}{1900}\right) \times 100 = 31.05\%$	$\left(\frac{1014}{1700}\right) \times 100 = 59.65\%$

III. Composition of current assets:

Particular	Current year		Last year	
	₹ 000	%	₹ 000	%
Inventories	580	50.43	300	42.86
Accounts receivable	350	30.43	200	28.57
Market securities	120	10.44	120	17.14
Cash	100	8.7	80	11.43
Total	1,150	100	700	100

IV. Working Capital:

Particulars	Current year ₹ 000	Last year ₹ 000
Current assets	1150	700
Less: Current liabilities	1000	350
Working capital	150	350

Less: Analysis to Pollock Co. Pvt. Ltd. on credit worthiness:

- The cost of goods sold has increased by ₹ 6,20,000 (i.e. ₹ 39,20,000 – ₹ 33,00,000) but the corresponding sales increase amounted to ₹ 2,00,000 only.
- Current ratio and quick ratio gives an indication of adverse liquidity position.
- Inventory turnover ratio has slipped from 11 times to 6.76 times, is an indication of poor sales and inefficient inventory control system.
- Debtors turnover ratio has declined from 28.9 to 17.09 indicates liberal credit policy extended to customers and amounting of debtors balances.
- Profit margin has declined from 30.28% to 18.9%.
- Return on investment has declined from 61.40% to 33.24%.
- Return on equity has also drastically declined from 59.65% to 31.05%.
- Current liabilities have substantially been increased by ₹ 6,50,000 (i.e., ₹ 10,00,000 – ₹ 3,50,000) during the current year.
- The composition of current assets gives an indication of locking up of working capital in inventories.
- The quick assets viz. Marketable securities and cash balances have declined during the current year.
- The long-term liabilities have reduced from ₹ 8,00,000 to ₹ 5,00,000, short-term funds might have used for (a), repayment of long-term liabilities.
- The company has skipped the payment of dividend for the current year.
- General and administration expenses have increased by ₹ 2,00,000 (i.e. 9,50,000 – ₹ 7,50,000) during the, current year.

Board guidelines of Sudarshan Industries for granting credit limits to its customers:

- Credit limit to 10% of net worth and 20% of the net working capital.
- Not to give credit in excess of ₹ 1,00,000 to any single customer.

Credit limits to Pollock Co. Pvt. Ltd.	Amount (₹)
I. Net worth of Pollock Co. Pvt. Ltd.	19,00,000
Credit limit – 10% of net worth $\left(\frac{₹ 19,00,000 \times 10}{100} \right)$	1,90,000
II. Net working capital of Pollock Co. Pvt. Ltd.	1,50,000
Credit limit – 20% of networking capital $\left(\frac{₹ 1,50,000 \times 20}{100} \right)$	30,000
III. Maximum credit limit to any single customer	1,00,000

Analysis: Pollock Co. Pvt. Ltd. may be allowed a credit limit of ₹ 30,000, with constant appraisal of its performance and financial position.

Problem 9: PTX Limited is considering a change in its present credit policy. Currently it is evaluating two policies. The company is required to give a return of 20% on the investment in new accounts receivables. The company's variable costs are 70% of the selling price. Information regarding present and proposed policies is as follows:

Particulars	Present Policy	Policy Option 1	Policy Option 2
Annual Credit Sales (₹)	30,00,000	42,00,000	45,00,000
Debtors turnover ratio	4 times	3 times	2.4 times
Loss due to bad debts	3% of sales	5% of sales	6% of sales

Note: Return on investment in new accounts receivable is based on cost of investment in debtors.

Which option would you recommend?

(Nov. 2013)

Solution: Statement of Evaluation of Credit Policies of PTX Limited (based on Total Cost Approach)



Particulars	Present Policy	Policy Option I	Policy Option II
Sales Revenue	30,00,000	42,00,000	45,00,000
Less: Variable Cost @70% Contribution	21,00,000	29,40,000	31,50,000
	9,00,000	12,60,000	13,50,000
Less: Other Relevant Costs			
Bad Debt Losses	(90,000)	(2,10,000)	(2,70,000)
Investment Cost	(1,05,000)	(1,96,000)	(2,62,500)
(VC ÷ DTR) × 20%			
Profit	7,05,000	8,54,000	8,17,500

Recommendation: PTX Limited is advised to adopt Policy Option I.

(Note: In the above solution, investment in accounts receivable is based on total cost of goods sold on credit. Since fixed costs are not given in the problem, therefore, it is assumed that there are no fixed costs and investment in receivables is determined with reference to variable costs only. The above solution may alternatively be worked out on the basis of incremental approach. However, the recommendation would remain the same.)

Problem 10: PQR Ltd. having an annual sales of ₹30 lakhs, is re-considering its present collection policy. At present, the average collection period is 50 days and the bad debt losses are 5% of sales. The company is incurring an expenditure of ₹30,000 on account of collection of receivables.

The alternative policies are as under:

Particulars	Alternative I	Alternative II
Average Collection Period	40 days	30 days
Bad Debt Losses	4% of sales	3% of sales
Collection Expenses	₹60,000	₹95,000

Required:

Evaluate the alternatives on the basis of incremental approach and state which alternative is more beneficial. (Nov 2014)

Solution: Evaluation of Alternative Collection Programmes

Particulars	Present Policy	Alternative I	Alternative II
	(₹)	(₹)	(₹)
Sales Revenues	30,00,000	30,00,000	30,00,000
Average Collection Period (ACP) (days)	50	40	30
Receivables (₹) $\left(\text{Sales} \times \frac{\text{ACP}}{360} \right)$	4,16,667	3,33,333	2,50,000
Reduction in Receivables from Present Level (₹)	—	83,334	1,66,667
Savings in Interest @ 10% p.a. (A)	—	₹8,333	₹16,667
% of Bad Debt Loss	5%	4%	3%
Amount (₹)	1,50,000	1,20,000	90,000
Reduction in Bad Debts from Present Level (B)	—	30,000	60,000
Incremental Benefits from Present Level (C) = (A) + (B)	—	38,333	76,667
Collection Expenses (₹)	30,000	60,000	95,000
Incremental Collection Expenses from Present Level (D)	—	30,000	65,000
Incremental Net Benefit (C – D)	—	₹8,333	₹11,667

Conclusion: From the analysis it is apparent that Alternative I has a benefit of ₹8,333 and Alternative II has a benefit of ₹11,667 over present level. Alternative II has a benefit of ₹3,334 more than Alternative I. Hence Alternative II is more viable.

(Note: In absence of Cost of Sales, sales has been taken for purpose of calculating investment in receivables. Cost of Funds has been assumed to be 10%. 1 year = 360 days.)

Problem 11:

A trader whose current sales are in the region of ₹ 6 lakhs per annum and an average collection period of 30 days wants to pursue a more liberal policy to improve sales. A study made by a management consultant reveals the following information:

Credit Policy	Increase in collection period	Increase in sales	Present default anticipated
A	10 days	` 30,000	1.5%
B	20 days	` 48,000	2%
C	30 days	` 75,000	3%
D	45 days	` 90,000	4%

The selling price per unit is ₹ 3. Average cost per unit is ₹ 2.25 and variable costs per unit are ₹ 2. The current bad debt loss is 1%. Required return on additional investment is 20%. Assume a 360 days year.

ANALYSE which of the above policies would you recommend for adoption?

Solution:**(a) Statement showing the Evaluation of Debtors Policies (Total Approach)**

Particulars	Present Policy 30 days	Proposed Policy A 40 days	Proposed Policy B 50 days	Proposed Policy C 60 days	Proposed Policy D 75 days
				₹	₹
A. Expected Profit:					
(a) Credit Sales	6,00,000	6,30,000	6,48,000	6,75,000	6,90,000

	(b) Total Cost other than Bad Debts					
	(i) Variable Costs [Sales × 2/3]	4,00,000	4,20,000	4,32,000	4,50,000	4,60,000
	(ii) Fixed Costs	50,000	50,000	50,000	50,000	50,000
		4,50,000	4,70,000	4,82,000	5,00,000	5,10,000
	(c) Bad Debts	6,000	9,450	12,960	20,250	27,600
	(d) Expected Profit [(a) – (b) – (c)]	1,44,000	1,50,550	1,53,040	1,54,750	1,52,400
B.	Opportunity Cost of Investments in Receivables	7,500	10,444	13,389	16,667	21,250
C.	Net Benefits (A – B)	1,36,500	1,40,106	1,39,651	1,38,083	1,31,150

Recommendation: The Proposed Policy A (i.e. increase in collection period by 10 days or total 40 days) should be adopted since the net benefits under this policy are higher as compared to other policies.

Working Notes:

i. Calculation of Fixed Cost = [Average Cost per unit – Variable Cost per unit] × No. of Units sold
= [₹ 2.25 – ₹ 2.00] × (₹ 6,00,000/3)
= ₹ 0.25 × 2,00,000 = ₹ 50,000

ii. Calculation of Opportunity Cost of Average Investments

$$\text{Opportunity Cost} = \text{Total Cost} \times \frac{\text{Collection period}}{360} \times \frac{\text{Rate of Return}}{100}$$

Present Policy = 4,50,000 × $\frac{30}{360}$ × $\frac{20}{100}$ = 7,500

Policy A = 4,70,000 × $\frac{40}{360}$ × $\frac{20}{100}$ = 10,444

Policy B = 4,82,000 × $\frac{50}{360}$ × $\frac{20}{100}$ = 13,389

Policy C = 5,00,000 × $\frac{60}{360}$ × $\frac{20}{100}$ = 16,667

Policy D = 5,10,000 × $\frac{75}{360}$ × $\frac{20}{100}$ = 21,250

B. Another method of solving the problem is **Incremental Approach**. Here we assume that sales are all credit sales.

Particulars	Present Policy 30 days	Proposed Policy A 40 days	Proposed Policy B 50 days	Proposed Policy C 60 days	Proposed Policy D 75 days
	₹	₹	₹	₹	₹
A. Incremental Expected Profit:					
(a) Incremental Credit Sales	---	30,000	48,000	75,000	90,000
(b) Incremental Costs					
(i) Variable Costs	---	20,000	32,000	50,000	60,000
(ii) Fixed Costs	---	-	-	-	-
(c) Incremental Bad Debt Losses	---	3,450	6,960	14,250	21,600

(d) Incremental Expected Profit (a – b – c)]		6,550	9,040	10,750	8,400
B. Required Return on Incremental Investments:					
(a) Cost of Credit Sales	4,50,000	4,70,000	4,82,000	5,00,000	5,10,000
(b) Collection period	30	40	50	60	75
(c) Investment in Receivable (a × b/360)	37,500	52,222	66,944	83,333	1,06,250
(d) Incremental Investment in Receivables	---	14,722	29,444	45,833	68,750
(e) Required Rate of Return (in %)		20	20	20	20
(f) Required Return on Incremental Investments (d × e)	---	2,944	5,889	9,167	13,750
C. Net Benefits (A – B)	---	3,606	3,151	1,583	-5,350

Recommendation: The Proposed Policy A should be adopted since the net benefits under this policy are higher than those under other policies.

C. Another method of solving the problem is by computing the **Expected Rate of Return**.

$$\text{Policy A} = 4,70,000 \times \frac{\text{₹}6,550}{\text{₹}14,722} \times 100 = 44.49\%$$

$$\text{Policy B} = 4,82,000 \times \frac{\text{₹}9,040}{\text{₹}29,444} \times 100 = 30.70\%$$

$$\text{Policy C} = 5,00,000 \times \frac{\text{₹}10,750}{\text{₹}45,833} \times 100 = 23.45\%$$

$$\text{Policy D} = 5,10,000 \times \frac{\text{₹}8,400}{\text{₹}68,750} \times 100 = 12.22\%$$

Recommendation: The Proposed Policy A should be adopted since the Expected Rate of Return (44.49%) is more than the Required Rate of Return (20%) and is highest among the given policies compared.

Problem 12:

 A Factoring firm has credit sales of ₹ 360 lakhs and its average collection period is 30 days. The financial controller estimates, bad debt losses are around 2% of credit sales. The firm spends ₹ 1,40,000 annually on debtor's administration. This cost comprises of telephonic and fax bills along with salaries of staff members. These are the avoidable costs. A Factoring firm has offered to buy the firm's receivables. The factor will charge 1% commission and will pay an advance against receivables on an interest @15% p.a. after withholding 10% as reserve. ANALYSE what should the firm do?

Assume 360 days in a year.

Solution:

Working notes:

$$\text{Average level of receivables} = \text{₹} 360 \text{ lakhs} \times \frac{30}{360} = \text{₹} 30 \text{ lakhs}$$

$$\text{Factoring Commission} = 1\% \text{ of } \text{₹} 30,00,000 = \text{₹} 30,000$$

$$\text{Reserve} = 10\% \text{ of } \text{₹} 30,00,000 = \text{₹} 3,00,000$$

$$\text{Total (i)} = \text{₹} 3,30,000$$

Thus, the amount available for advance is

$$\text{Average level of receivables} = \text{₹} 30,00,000$$

$$\text{Less: Total (i) from above} = \text{₹} 3,30,000$$

$$\text{(ii)} = \text{₹} 26,70,000$$

$$\text{Less: Interest @ 15\% p.a. for 30 days} = \text{₹} 33,375$$

Net Amount of Advance available. ₹ 26,36,625

Evaluation of Factoring Proposal

	Particulars		
A.	Savings (Benefit) to the firm		
	Cost of Credit administration	₹ 1,40,000	₹ 1,40,000
	Cost of bad-debt losses	(0.02 × 360 lakhs)	₹ 7,20,000
	Total		₹ 8,60,000
B.	Cost to the Firm:		
	Factoring Commission [Annual credit Sales × % of Commission (or calculated annually)]	₹ 30,000 × $\frac{360}{30}$	₹ 3,60,000
	Interest Charges	₹ 33,375 × $\frac{360}{30}$	₹ 4,00,500
	Total		₹ 7,60,500
C.	Net Benefits to the Firm: (A-B)		₹ 99,500

Advice: Since the savings to the firm exceeds the cost to the firm on account of factoring, therefore, the proposal is acceptable.

Video for Interpretation of the List: <https://youtu.be/dVq9NF7s8I4>



CHAPTER EIGHT

WORKING CAPITAL MANAGEMENT UNIT 5: MANAGEMENT OF PAYABLES (CREDITORS)

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Problem 1: Suppose ABC Ltd. has been offered credit terms from its major supplier of 2/10, net 45. Hence the company has the choice of paying ₹ 10 per ₹ 100 or to invest ₹ 98 for an additional 35 days and eventually pay the supplier ₹ 100 per ₹ 100. The decision as to whether the discount should be accepted depends on the opportunity cost of investing ₹ 98 for 35 days. ANALYSE what should the company do?

Solution:

If the company does not avail the cash discount and pays the amount after 45 days, the implied cost of interest per annum would be approximately:

$$\left(\frac{100}{100 - d} \right)^{\frac{365}{t}} - 1 = 23.5\%$$

Now let us assume that ABC Ltd. can invest the additional cash and can obtain an annual return of 25% and if the amount of invoice is ₹ 10,000. The alternatives are as follows:

	Refuse discount	Accept discount
	₹	₹
Payment to supplier	10,000	9,800
Return from investing ₹ 9,800 between day 10 and day 45: $\frac{35}{365} \times ₹9,800 \times 25\%$		
Net Cost	9,765	9,800

Advise: Thus, it is better for the company to refuse the discount, as return on cash retained is more than the saving on account of discount.

Problem 2: The Dolce Company purchases raw materials on terms of 2/10, net 30. A review of the company's records by the owner, Mr. Gautam, revealed that payments are usually made 15 days after purchases are made. When asked why the firm did not take advantage of its discounts, the accountant, Mr. Rohit, replied that it cost only 2 per cent for these funds, whereas a bank loan would cost the company 12 per cent.

- ANALYSE what mistake is Rohit making?
- If the firm could not borrow from the bank and was forced to resort to the use of trade credit funds, what suggestion might be made to Rohit that would reduce the annual interest cost? IDENTIFY.

Solution:

(a) Rohit's argument of comparing 2% discount with 12% bank loan rate is not rational as 2% discount can be earned by making payment 5 days in advance i.e. within 10 days rather 15 days as payments are made presently. Whereas 12% bank loan rate is for a year.

Assume that the purchase value is ₹100, the discount can be earned by making payment within 10 days is ₹2, therefore, net payment would be ₹98 only. Annualized benefit

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

This means cost of not taking cash discount is 149%.

- If the bank loan facility could not be available, then in this case the company should resort to utilise maximum credit period as possible.

Therefore, payment should be made in 30 days to reduce the interest cost.



STRATEGIC MANAGEMENT

LIST of Important Questions

January 2025

Video for Interpretation of the List: <https://youtu.be/dVq9NF7s874>

Chapter - 1

Introduction to SM

Chapter - 2

*Strategic Analysis:
External Environment*

Chapter - 3

*Strategic Analysis:
Internal Environment*

Chapter - 4

Strategic Choices

Chapter - 5

*Strategy Implementation
and Control*

*Video for Interpretation of the List:
<https://youtu.be/dVq9NF7s874>*



PROF. OM TRIVEDI
ICAI Visiting Faculty at LVC,
NIRC, WIRC & MCS

About Prof. Om Trivedi



An Edupreneur, Visiting Faculty Member of #NIRC and #WIRC of ICAI, Guest Faculty of LVC and External Subject Expert at the BOS of #ICAI, IIM-C Alumnus, Author, Publisher, Educationist, Management Consultant, and Corporate Speaker.

Synopsis:

- Over **11 years of teaching experience** in various CA, CS, CMA and MBA courses.
- Guided more than **1,00,000 CA, CS, and CMA** students through Face to Face Classes and more than **2,00,000** students through LIVE Virtual & Online Classes.
- Students scored **All India 'Highest Marks, AIR 20, 22, 23, 36, 37, 40 & 47 with 1000s of exemptions.**

- His student scored **"Highest Marks"** in this subject.
- Done research and projects in areas like competition studies, Financial Modelling, Data Analytics, value creation, and competitive advantages, MIS, and Process Improvement Techniques, etc.
- **Author** of books on **Financial Management, Strategic Management, CMA, Strategic Financial Management, Strategic Cost Management & Performance Evaluation, Risk Management, Mercantile Law, Generic Skills & Ethics, and Communication.** Case Study Developer and Content writer on Management subjects for different Distance Learning Programmer (DLPs) of eminent universities of India.
- Over **17 years of industry experience in Publishing, Content Development and Editing,** Instructional Design, Instructor's Resource Development, Acquisitions of Businesses, Authors and Imprints, Sales and Marketing, Publishing solution, and operations.
- Worked with **Thomson Learning** as **Regional Head**, with **Tata McGraw-Hills** as **Acquisition Head**, with **Macmillan** as **Acquisition Editor** and **Partner with LexisNexis India** (A Reed Elsevier Company).
- Worked as a **Consultant Business Head - HEP of Trinity Press** (Formerly Macmillan India's Higher Education Programme) in 2013-14 and played an instrumental role in the acquisition of Macmillan India's Higher Education Programme by LPPL under the brand name Trinity Press.
- Worked as a **consultant and business advisor** on book publishing, content development, instructional design, case study development, instructor's resources, and copyright matters to several companies like **Macmillan, Taxmann, LexisNexis India, Vikas Publishing, Excel Books, Firewall Media, Biztantra, etc.**

1 CHAPTER

INTRODUCTION TO STRATEGIC MANAGEMENT

The function of education is to teach one to think intensively and to think critically. Intelligence plus character - that is the goal of true education.

Important Questions January 2025



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78 MARKS	77 MARKS	76 MARKS	75 MARKS	74 MARKS	73 MARKS
75 MARKS	74 MARKS	73 MARKS	73 MARKS	73 MARKS	72 MARKS
73 MARKS	72 MARKS	72 MARKS	72 MARKS	71 MARKS	70 MARKS
72 MARKS	70 MARKS	70 MARKS	70 MARKS	70 MARKS	70 MARKS

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INTRODUCTION TO STRATEGIC MANAGEMENT

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LEARNING

After studying this chapter, you will be able to

- ◆ Identify strategic decisions and behaviours and their relevance thereof in the modern business world.
- ◆ Acknowledge and appreciate the limitations of strategic decisions and accept that all decisions need not be strategic.
- ◆ Formulate Strategic Intent - Vision, Mission, Goals. Each of these plays an important role in the development of an overall business strategy.
- ◆ Describe strategic levels in organizations (Corporate, Business, Functional and Network of relation between three levels); and discuss the role each plays in final decision making and real execution of plans.

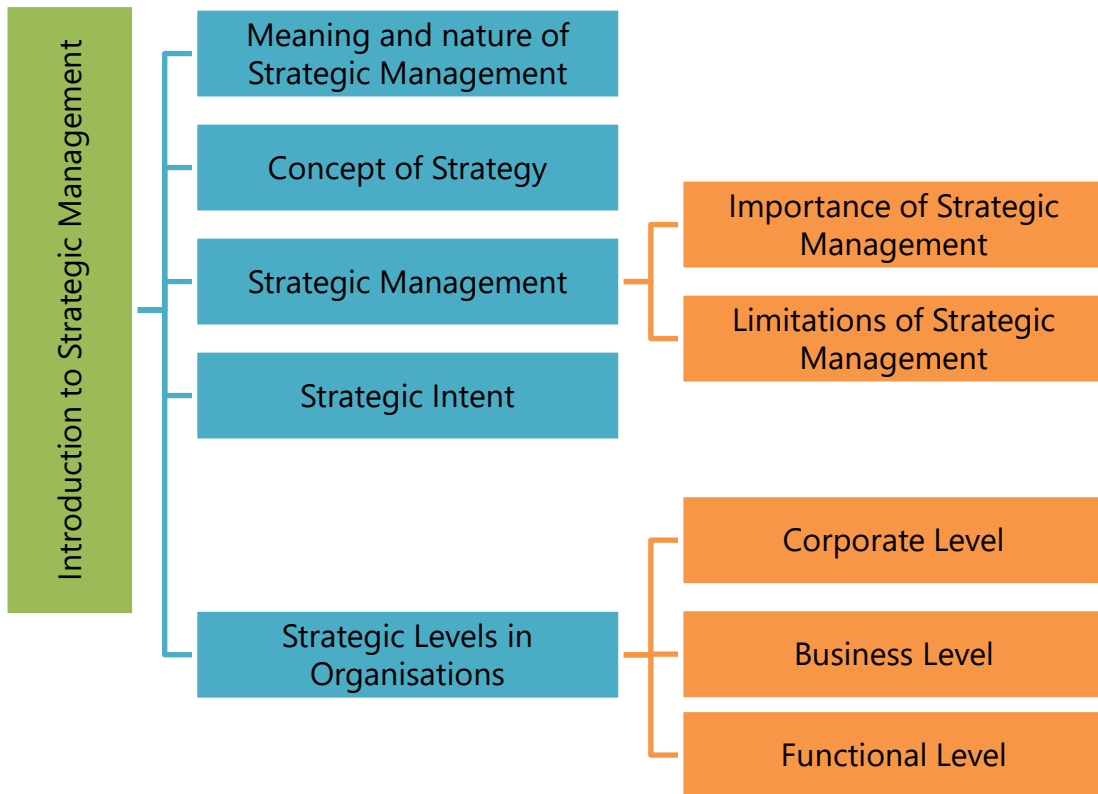
"The company without a strategy is willing to try anything."

Michael Porter

"Strategy is not the consequence of planning, but the opposite: it's the starting point."

Henry Mintzberg

CHAPTER OVERVIEW

 1.1 INTRODUCTION

This chapter is an attempt to highlight the concepts and significance of 'strategic management'. With increased competition, business management has acquired a strategic dimension. All executives and professionals, including Chartered Accountants, working towards growth of businesses, must possess sound knowledge of concepts of strategic management.



1.2 MEANING AND NATURE OF STRATEGIC MANAGEMENT

To understand the concept of strategic management, we need to have a basic understanding of the term management. The term 'management' is used in two senses, such as:

- (a) It is used with reference to a **key group in an organisation in-charge of its affairs**. In relation to an organisation, management is the chief organ entrusted with the task of making it a purposeful and productive entity, by undertaking the task of bringing together and integrating the disorganised resources of manpower, money, material, and technology, which are then combined into a functioning whole.

An organisation becomes a unified functioning system when management systematically mobilises and utilises the diverse resources efficiently and effectively. The survival and success of an organisation depends to a large extent on the competence and character of its management. Management has to also facilitate organisational change and adaptation for effective interaction with the environment.

- (b) The term 'Management' is also used with reference to a set of interrelated functions and processes carried out by the management of an organisation (the key group of individuals mentioned in point (a) to attain its objectives). These functions include Planning, Organising, Directing, Staffing and Control. The functions or sub-processes of management are wide-ranging but closely interrelated. They range all the way from determination of the goals, design of the organisation, mobilisation and acquisition of resources, allocation of tasks and resources among the personnel and activity units and installation of control system to ensure that what is planned is achieved.

Management is an influence process to make things happen, to gain command over phenomena, to induce and direct events and people in a particular manner. Influence is backed by power, competence, knowledge and resources. Managers formulate organisational goals, values and strategies, to cope with, to adapt and to adjust themselves with the behaviour and changes in the environment.

The strategic management process is the set of activities that firm managers undertake to put their firms in the best possible position to compete successfully in the marketplace. Strategic management is made up of several distinct activities: developing the firm's vision and mission; strategic analysis; developing objectives; creating, choosing, and implementing strategies; and measuring and evaluating performance.

1.3 CONCEPT OF STRATEGY

In the context of business, the application of the term 'Strategy' relates to the ways, the business decides to respond to dynamic and often hostile external forces while pursuing their vision, mission and ultimate objectives.

The very incorporation of the idea of strategy into business organizations is intended to unravel complexity and to reduce uncertainty caused by changes in the environment. Strategy seeks to relate the goals of the organization to the means of achieving them. Strategy is the game plan that the management of a business uses to take market position, conduct its operations, attract and satisfy customers, compete successfully, and achieve organizational objectives.

To the extent, the term strategy is associated with unified design and action for achieving major goals, gaining command over the situation with a long-range perspective and securing a critically advantageous position, its implications for corporate functioning are obvious.

We may define the term 'strategy' as a long-range blueprint of an organization's desired image, direction and destination, i.e., what it wants to be, what it wants to do, how it wants to do things, and where it wants to go. Following are also important other definitions are to understand the term:

Igor H. Ansoff	:	The common thread among the organization's activities and product-markets that defines the essential nature of business that the organization has or planned to be in future.
William F. Glueck	:	A unified, comprehensive and integrated plan designed to assure that the basic objectives of the enterprise are achieved.

Strategy is consciously considered and flexibly designed scheme of corporate intent and action to mobilise resources, to direct human effort and behaviour, to handle events and problems, to perceive and utilise opportunities, and to meet challenges and threats for corporate survival and success.

Strategy is meant to fill in the need of organizations for a sense of dynamic direction, focus and cohesiveness. Objectives and goals are essential to give a direction to business, but they do not fill in the need alone. Strategy provides an integrated framework for the top management to search for, evaluate and exploit beneficial opportunities, to perceive and meet potential threats and crisis, to make full use of resources and strengths, and to offset corporate weaknesses. 

Important to note that strategy is no substitute for sound, alert and responsible management. It must be recognised that strategy can never be perfect, flawless and optimal. It is in the very nature of strategy that it is flexible and pragmatic to take care of sudden emergencies, pressures, and avoid failures and frustrations. In a sound strategy, allowances are made for possible miscalculations and unanticipated events.

In large organisations, strategies are formulated at:

- ◆ the corporate,
- ◆ divisional, and
- ◆ functional levels

Corporate strategies are formulated by the top managers. Such strategies include the determination of the plans for expansion and growth, vertical and horizontal integration, diversification, takeovers and mergers, new investment and divestment areas, R & D projects, and so on. These corporate wide strategies need to be operationalized by divisional and functional strategies regarding product lines, production volumes, quality ranges, prices, product promotion, market penetration, purchasing sources, personnel development and like. This is discussed in detail in further separate topics.

Strategy is partly proactive and partly reactive: A company's strategy is typically a blend of:

- ◆ Proactive actions on the part of managers to improve the company's market position and financial performance.

MCQs
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- ◆ Reactions to unanticipated developments and fresh market conditions in the dynamic business environment.

In other words, a company uses both proactive and reactive strategies to cope up the uncertain business environment. Proactive strategy is planned strategy whereas reactive strategy is adaptive reaction to changing circumstances.

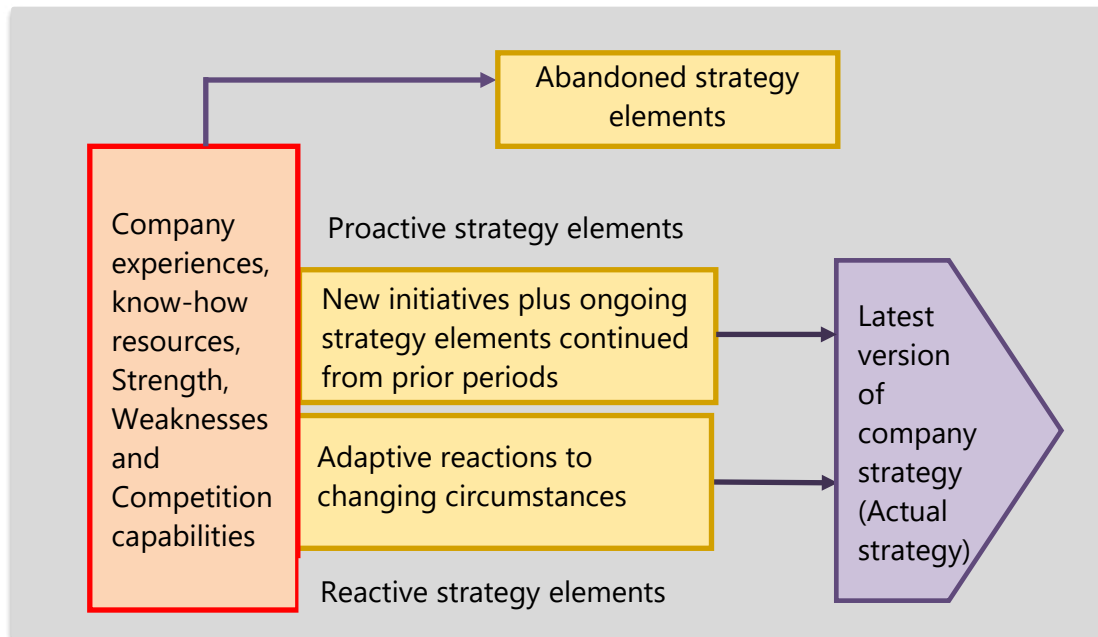


Figure: A company's actual strategy is partly planned & partly reactive

As is evident from the figure, a company's current strategy flows from both previously initiated actions and business approaches that are working well enough to merit continuation, as well as newly initiated managerial decisions and actions that strengthen the company's overall position and performance. Thus, strategy partly is deliberate and proactive, standing as the product of management's analysis and strategic thinking about the company's situation and its conclusions about how to position the company in the marketplace and tackle the task of competing for buyer's patronage.

However, not every strategic move is the result of proactive planning and deliberate management design. Things happen that cannot be fully anticipated or planned for. When market and competitive conditions take an unexpected turn or some aspect of a company's strategy hits a stone wall, some kind of strategic reaction or adjustment is required. Hence, partially, a company's strategy is always developed

as a reasoned response to unforeseen developments in the business environment as well as the situations within the firm.

Crafting a strategy thus involves stitching together a proactive/intended strategy based on prior successful experience and then adapting pieces of successful reactions as circumstances surrounding the company's situation change or better options emerge - a reactive/adaptive strategy.

Strategy helps unravel complexity and reduce uncertainty caused by changes in the environment. It also means to identify existing problems and solving them by executing revolutionary ideas. It would be pertinent to mention one such **example** in the recent times, that is UPI, Unified Payments Interface. UPI has changed the entire digital payments landscape in India and has now even gone global. A true example of Made in India for the world. It was all because of a well-planned identification of existing problem statement, formulating a strategy putting it to perfect execution.

Now that we have understood about strategy as a concept, the chapters to follow would focus more on how organisations plan and execute their strategies via Strategic Management.

Is this a Strategy?

A ketchup brand making a healthier ketchup with less sugar and preservatives to attract more customers by letting parents feel safe about their kid's consuming ketchup. Can this be called a strategy?

Yes, it is a business strategy to fight competition and to adapt with changing external environment (people becoming health conscious is external environment factor)

1.4 STRATEGIC MANAGEMENT - IMPORTANCE AND LIMITATIONS

The importance of Strategic Management essentially lies in enabling an organisation to perform better than its competitors and its own past and present performance. That is, delivering superior returns to the investors, superior value to the customers and superior performance *vis-à-vis* expectations of the employees,

suppliers, government and society. The overall objectives of strategic management are two-fold:

- ◆ To create competitive advantage (something unique and valued by the customer), so that the company can outperform the competitors in all aspects of organisational performance.
- ◆ To guide the company successfully through all changes in the environment. That is to react in the right manner.

The organizational operations are highly influenced by the increasing rate of change in the environment and the ripple effect created on the organization. Changes can be external to the firm, or they may be introduced in the firm by the managers. It may manifest in the blurring of industry and firm boundaries, driven by technology, deregulation, or, through globalization. The tasks of crafting, implementing and executing company strategies are the heart and soul of managing a business enterprise.

To put the concept in a few words, 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 finally initiating corrective adjustments were deemed appropriate. The process does not end, it keeps going on in a cyclic manner.

Strategic management involves developing the company's vision, environmental scanning (both external and internal), strategy formulation, strategy implementation and evaluation and control.

Originally called, business policy, strategic management emphasizes the monitoring and evaluation of external opportunities and threats in the light of a company's strengths and weaknesses and designing strategies for the survival and growth of the company.

1.4.1 Importance of Strategic Management

Formulation of strategies and their implementation have become essential for all organizations for their survival and growth in the present turbulent business environment. 'Survival of the fittest' as propagated by Charles Darwin is the only principle of survival for all organizations, where 'fittest' are not the 'largest' or

'strongest' organizations but those who can change and adapt successfully to the changes in business environment.

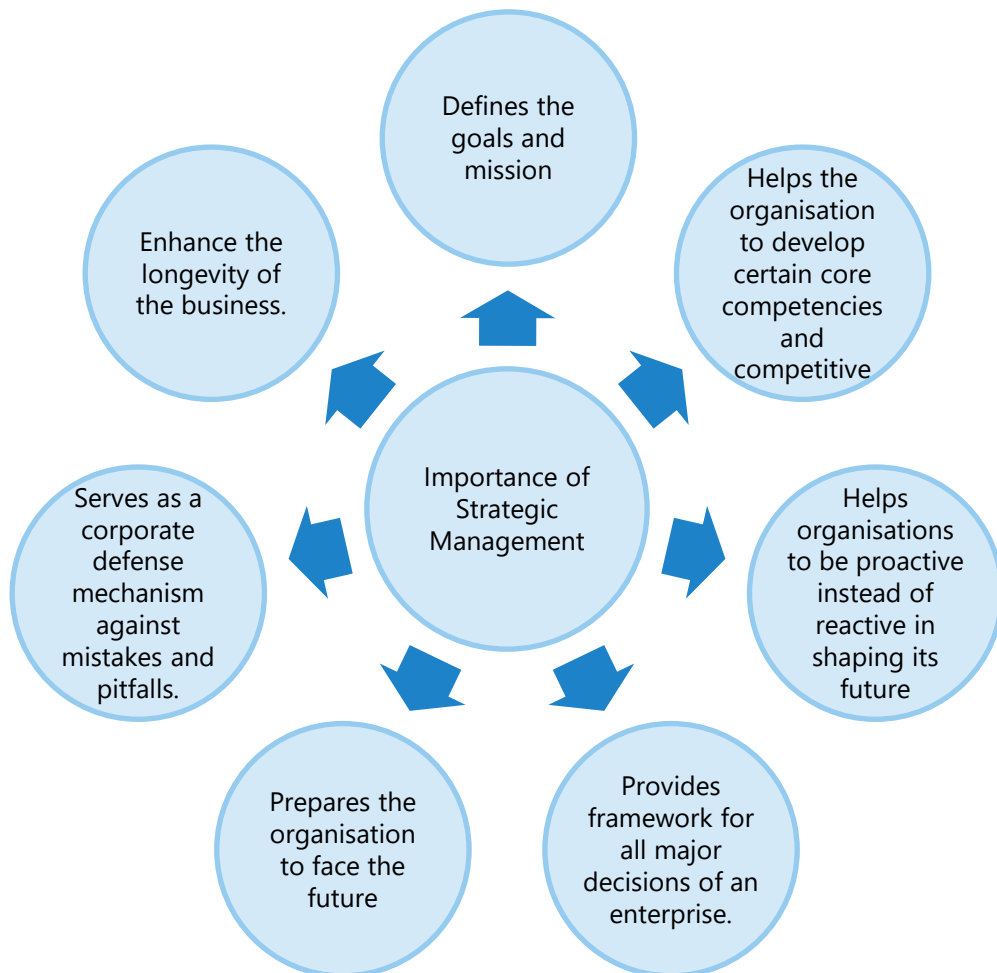
Many business giants have followed the path of extinction failing to manage drastic changes in the business environment. **For example, Bajaj Scooters, LML Scooters, Murphy Radio, BPL Television, Videocon, Nokia, Kodak and so on.** Thus, it becomes imperative to study Business Strategy.

Businesses follow the war principle of 'win or lose', and only in a small number of cases, win-win situation arises. Hence, each organization has to build its competitive advantage over the competitors in the business warfare in order to win. This can be done only by following the process of strategic management - strategic analysis, formulation and implementation, evaluation and control of strategies.

The major benefits of strategic management are:

- ◆ The strategic management gives a direction to the company to move ahead. It helps define the goals and mission. It helps management to define realistic objectives and goals which are in line with the vision of the company.
- ◆ Strategic management helps organisations to be proactive instead of reactive in shaping its future. Organisations are able to analyse and take actions instead of being mere spectators. Thereby they are able to control their own destiny in a better manner. It helps them in working within vagaries of environment and shaping it, instead of getting carried away by its turbulence or uncertainties.
- ◆ Strategic management provides frameworks for all major decisions of an enterprise such as decisions on businesses, products, markets, manufacturing facilities, investments and organisational structure. It provides better guidance to entire organisation on the crucial point - what it is trying to achieve.
- ◆ Strategic management seeks to prepare the organisation to face the future and act as pathfinder to various business opportunities. Organisations are able to identify the available opportunities and identify ways and means to reach them.

- ◆ Strategic management serves as a corporate defence mechanism against mistakes and pitfalls. It helps organisations to avoid costly mistakes in product market choices or investments.
- ◆ Strategic management helps to enhance the longevity of the business. With the state of competition and dynamic environment it may be challenging for organisations to survive in the long run. It helps the organization to take a clear stand in the related industry and makes sure that it is not just surviving on luck. Actions over expectations is what strategic management ensures.
- ◆ Strategic management helps the organisation to develop certain core competencies and competitive advantages that would facilitate assist in its fight for survival and growth.



The importance of strategic management lies in delivering superior organizational performance than that would otherwise obtain. In the competitive context it implies performance superior to that of the competitors or more generally, above average performance.

It must however be realized that in search of meaning and purpose organisations may undertake decisions and activities that may not measure up to being "strategic." Belief in diversity, inclusion & equity; improving availability, affordability and accessibility of products and services to the opportunity deprived sections etc., greater workplace democracy are some of the decisions and behaviours that are worthy on their own count. They may not serve a strategic purpose in the strict sense of the term.

1.4.2 Limitations of Strategic Management

The presence of strategic management cannot counter all hindrances and always achieve success. There are limitations too, attached to strategic management. Let us discuss them briefly:

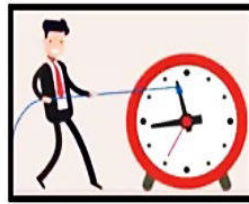
- ◆ Environment is highly complex and turbulent. It is difficult to understand the complex environment and exactly pinpoint how it will shape-up in future. The organisational estimate about its future shape may awfully go wrong and jeopardise all strategic plans. The environment affects as the organisation has to deal with suppliers, customers, governments and other external factors. Thus, relying on a business strategy blindly could go absolutely wrong if the environment is turbulent. **For example**, *Two-Wheeler Electric Vehicles brands counted on strategic benefits they would have because of the huge push from the government for electric mobility. However, customers are getting reluctant to purchase EVs due to the safety concerns amid the frequent incidents of battery's catching fire. So, strategy cannot overcome a turbulent environment.*
- ◆ 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. Planning and strategizing are important but putting them in action is where the actual success lies. Similar to us students, planning and strategizing what to study, from where and at what time of the day to study, consumes so much of our actual study time that by the time we have to study, we are almost exhausted.

Similarly in business if way too much time is spent on planning and formulating, then it might not be as fruitful.

- ♦ 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. Strategic Management requires experts, and these experts are costly resources. Thus, the process as a whole required good amount of funds to be spent.
- ♦ In a competitive scenario, where all organisations are trying to move strategically, it is difficult to clearly estimate the competitive responses to a firm's strategies. It is quite difficult to gauge the strategic planning of competitors because most of these decisions are taken within closed doors by the top management. **For example**, Apple changed the market dynamics of the speaker industry by choosing to remove 3.5mm audio jack from iPhones. Now, to be relevant in the market, all major speaker brands had to put concentrated efforts to develop their own true wireless speakers (TWS) and compete with new entrants.



Complex and Turbulent Environment



Time-consuming Process



Costly Process



Difficult to estimate competitor's response

Why do businesses opt for strategic management even with its limitation?

Strategic Management is a time consuming and costly process, yet all organization's want to do indulge into it? Why?

Because even though it has its limitations, its importance outweighs its shortcomings. A business cannot operate and succeed without proper strategic management.



1.5 STRATEGIC INTENT (VISION, MISSION, GOALS, OBJECTIVES AND VALUES)

Strategic Management is defined as a dynamic process of formulation, implementation, evaluation, and control of strategies to realise the organisation's strategic intent. Strategic intent refers to purposes of what the organisation strives for senior managers must define "what they want to do" and "why they want to do".

"Why they want to do" represents strategic intent of the firm. Clarity in strategic intent is extremely important for the future success and growth of the enterprise, irrespective of its nature and size.

Strategic intent can be understood as the philosophical base of strategic management. It implies the purposes, which an organisation endeavours to achieve. It is a statement that provides a perspective of the means, which will lead the organisation, reach its vision in the long run. Strategic intent gives an idea of what the organisation desires to attain in future. It answers the question what the organisation strives or stands for? It indicates the long-term market position, which the organisation desires to create or occupy and the opportunity for exploring new possibilities.

Strategic intent provides the framework within which the firm would adopt a predetermined direction and would operate to achieve strategic objectives. Strategic intent could be in the form of vision and mission statements for the organisation at the corporate level. It could be expressed as the business definition and business model at the business level of the organisation.

Strategic intent is generally stated in broad terms but when stated in precise terms it is an expression of aims to be achieved operationally, i.e., goals and objectives.

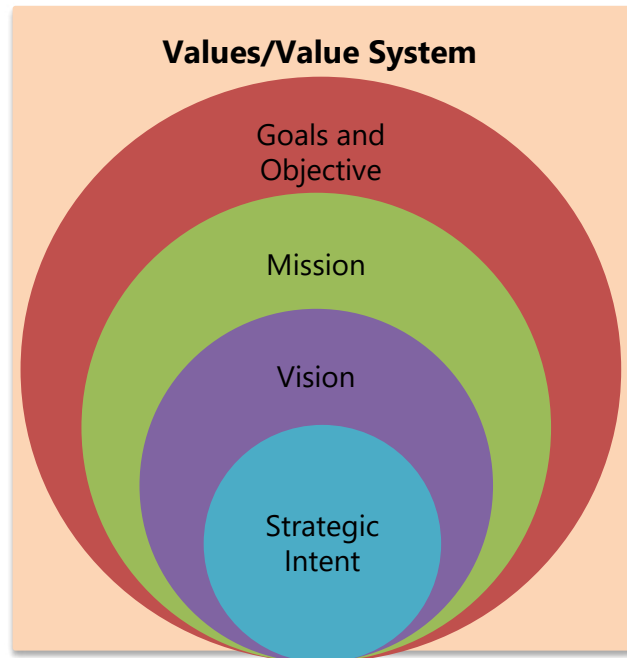
1. **Vision:** Vision implies the blueprint of the company's future position. It describes where the organisation wants to land. It depicts the organisation's aspirations and provides a glimpse of what the organisation would like to become in future. Every sub system of the organisation is required to follow its vision.
2. **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 the society. It is designed to help potential shareholders and investors understand the purpose of the firm. A mission statement helps to identify, 'what business the firm undertakes.' It defines the present capabilities, activities, customer focus and role in society.
3. **Goals and Objectives:** These are the base of measurement. Goals are the end results, that the organisation attempts to achieve. On the other hand, objectives are time-based measurable targets, which help in the accomplishment of goals. These are the end results which are to be attained with the help of an overall plan, over the particular period. However, in practice, no distinction is made between goals and objectives and both the terms are used interchangeably.

The vision, mission, business definition, and business model explain the philosophy of the organisation but the goals and objectives represent the results to be achieved in multiple areas of business.

While **Strategic Intent** is the purpose that an organisation aims to achieve, Values form the omnipresent foundation of each and every decision that the management takes. An organisation without values is like an organisation with no real intent. Let us understand a bit more about values from a business perspective.

4. **Values/ Value System:** Values are the deep-rooted principles which guide an organisation's decisions and actions. Collins and Porras succinctly define core values as being inherent and sacrosanct; they can never be compromised, either for convenience or short-term economic gain. Values often reflect the values of the company's founders—Hewlett-Packard's celebrated "HP Way" is

an example. They are the source of a company's distinctiveness and must be maintained at all costs.



Component of Strategic Intent

1.5.1 Vision

Very early in the strategy making process, a company's senior managers must consider the issue of what directional path the company should take and what changes in the company's product-market-customer-technology focus would improve its current market position and future prospects. Deciding to commit the company to one path versus other pushes managers to draw some carefully reasoned conclusions about how to try to modify the company's business makeup and the market position it should stake out.

Top management's views about the company's direction and the product-customer-market-technology focus constitute the strategic vision for the company. Strategic vision delineates management's aspirations for the business, providing a panoramic view of the "where we are to go" and a convincing rationale for why this makes good business sense for the company. Strategic vision thus points out a particular direction, charts a strategic path to be followed in future, and moulding

organisational identity. A clearly articulated strategic vision communicates management's aspirations to stakeholders and helps steer the energies of company personnel in a common direction. For instance, Henry Ford's vision of a car in every garage had power because it captured the imagination of others, aided internal efforts to mobilize the Ford Motor Company's resources, and served as a reference point for gauging the merits of the company's strategic actions.

- ♦ **HDFC Bank Ltd.**, one of the largest banks in India has clearly defined its Vision of being a world class Indian bank. This vision helps them keep in mind, "where we want to go", as the central thought of their strategic decision making.
- ♦ **LIC Ltd.**, the largest insurance company of India has defined its visions as - A trans-nationally competitive financial conglomerate of significance to societies and Pride of India.
- ♦ **Apple Inc.'s** CEO Tim Cook defined the vision of the company as - "We believe that we are on the face of the earth to make great products, and that's not changing."

Essentials of a strategic vision

- ♦ The entrepreneurial challenge in developing a strategic vision is to think creatively about how to prepare a company for the future.
- ♦ Forming a strategic vision is an exercise in intelligent entrepreneurship.
- ♦ A well-articulated strategic vision creates enthusiasm among the members of the organisation.
- ♦ The best-worded vision statement clearly illuminates the direction in which organisation is headed.

1.5.2 Mission

A mission is an answer to the basic question 'what business are we in and what we do'. It has been observed that many firms fail to conceptualise and articulate the mission and business definition with the required clarity. Such firms are seen to fumble in the identification of opportunities and fail in formulating strategies to make use of opportunities. Firms working to manage their organisation strategically cannot be lax in the matter of mission and business definition, as the two ideas are absolutely central to strategic planning.

Why should an organisation have a mission?

- ◆ To ensure unanimity of purpose within the organisation.
- ◆ To develop a basis, or standard, for allocating organisational resources.
- ◆ To provide a basis for motivating the use of the organisation's resources.
- ◆ To establish a general tone or organisational climate, to suggest a business-like operation.
- ◆ To serve as a focal point for those who can identify with the organisation's purpose and direction.
- ◆ To facilitate the translation of objective and goals into a work structure involving the assignment of tasks to responsible elements within the organisation.
- ◆ To specify organisational purposes and the translation of these purposes into goals in such a way that cost, time, and performance parameters can be assessed and controlled.

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 organisations present capability, customer focus, activities, and business makeup.

- ◆ **HDFC Bank** has two-fold mission: first, to be the preferred provider of banking services for target retail and wholesale customer segments. The second is to achieve healthy growth in profitability, consistent with the bank's risk appetite.
- ◆ **LIC Ltd.'s** Mission is - Ensure and enhance the quality of life of people through financial security by providing products and services of aspired attributes with competitive returns, and by rendering resources for economic development.
- ◆ **Apple's** mission has been defined as - "to bring the best user experience to its customers through innovative hardware, software, and services."

Mission statement should reflect the philosophy of the organisations that is perceived by the senior managers. A good mission statement should be precise, clear, feasible, distinctive and motivating. Following points are useful while writing a mission of a company:

- ♦ One of the roles of a mission statement is to give the organisation its own special identity, business emphasis and path for development – one that typically sets it apart from other similarly positioned companies.
- ♦ A company's business is defined by what needs it is trying to satisfy, which customer groups it is targeting and the technologies and competencies it uses and the activities it performs.
- ♦ Good mission statements are – unique to the organisation for which they are developed.

What is our mission? And what business are we in?

The well-known management experts, Peter Drucker and Theodore Levitt were among the first to agitate this issue through their writings. They emphasised that as the first step in the business planning endeavour, every business firm must clarify the corporate mission and define accurately the business the firm is engaged in. They also explained that towards facilitating this task, the firm should raise and answer certain basic questions concerning its business, such as:

- ♦ What is our mission?
- ♦ What is our ultimate purpose?
- ♦ What do we want to become?
- ♦ What kind of growth do we seek?
- ♦ What business are we in?
- ♦ Do we understand our business correctly and define it accurately in its broadest connotation?
- ♦ Whom do we intend to serve?
- ♦ What human need do we intend to serve through our offer?
- ♦ What brings us to this particular business?
- ♦ What would be the nature of this business in the future?
- ♦ In what business would we like to be in, in the future?

At the time these two experts raised this issue, the business managers of the world did not fully appreciate the importance of these questions; those were the days when business management was still a relatively simple process even in industrially

advanced countries like the US. It was only in subsequent years that captains of industry all over the world understood the significance of the seemingly simple questions raised by Drucker and Levitt.

The corporate mission is an expression of the growth ambition of the firm. It is, in fact, the firm's future visualised. It provides a dramatic picture of what the company wants to become. It is the corporation's dream crystallised. It is a colourful sketch of how the firm wants its future to look, irrespective of the current position. In other words, the mission is a grand design of the firm's future.

Mission amplifies what brings the firm to this business or why it is there, what existence it seeks and what purpose it seeks to achieve as a business firm. In other words, the mission serves as a justification for the firm's very presence and existence; it legitimises the firm's presence.

According to Peter Drucker, every organisation must ask an important question "What business are we in?" and get the correct and meaningful answer. The answer should have marketing or external perspective and should not be restated to the production or generic activities of business. The table given below will clarify and highlight the importance of external perspective.

What business are we in?

Company	Production-oriented answer	Marketing-oriented answer
Indian Oil	We produce oil and gasoline products.	We provide various types of safe and cost-effective energy.
Indian Railways	We run a railroad.	We offer a transportation and material-handling system.
Lakme	In the factory, we make cosmetics.	In the retail outlet, we sell hope.

1.5.3 Goals and Objectives

Business organisation translates their vision and mission into goals and objectives. As such the term objectives are synonymous with goals, however, some authors make an attempt to distinguish the two. Goals are open-ended attributes that denote the future states or outcomes. Objectives are close-ended attributes which are precise and expressed in specific terms. Thus, the Objectives are more specific

and translate the goals to both long term and short-term perspective. However, this distinction is not made by several theorists on the subject. Accordingly, we will also use the term interchangeably.

Objectives are organisation's performance targets – the results and outcomes it wants to achieve. They function as yardsticks for tracking an organisation's performance and progress.

HDFC can have multiple short term and long term objectives which align with the overall vision and mission of the Bank.

All organisations have objectives. The pursuit of objectives is an unending process such that organisations sustain themselves. They provide meaning and sense of direction to organisational endeavour. Organisational structure and activities are designed, and resources are allocated around the objectives to facilitate their achievement. They also act as benchmarks for guiding organisational activity and for evaluating how the organisation is performing.

Objectives with strategic focus relate to outcomes that strengthen an organisation's overall business position and competitive vitality. Objectives, to be meaningful to serve the intended role, must possess the following characteristics:

- ◆ Objectives should define the organisation's relationship with its environment.
- ◆ They should be facilitative towards achievement of mission and purpose.
- ◆ They should provide the basis for strategic decision-making.
- ◆ They should provide standards for performance appraisal.
- ◆ They should be concrete and specific.
- ◆ They should be related to a time frame.
- ◆ They should be measurable and controllable.
- ◆ They should be challenging.
- ◆ Different objectives should correlate with each other.
- ◆ Objectives should be set within the constraints of organisational resources and external environment.

A need for both short-term and long-term objectives: As a rule, a company's set of financial and strategic objectives ought to include both short-term and long-term performance targets. Having quarterly or annual objectives focuses attention on delivering immediate performance improvements. Targets to be achieved within three to five years' prompt considerations of what to do now to put the company in position to perform better down the road. A company that has an objective of doubling its sales within five years can't wait until the third or fourth year to begin growing its sales and customer base. By spelling out annual (or perhaps quarterly) performance targets, management indicates the speed at which longer-range targets are to be approached.

Long-term objectives: To achieve long-term prosperity, strategic planners commonly establish long-term objectives in seven areas.

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

Long-term objectives represent the results expected from pursuing certain strategies. Strategies represent the actions to be taken to accomplish long-term objectives. The time frame for objectives and strategies should be consistent, usually from two to five years.

Short-range objectives can be identical to long-range objectives if an organisation is already performing at the targeted long-term level. For instance, if a company has an ongoing objective of 15 percent profit growth every year and is currently achieving this objective, then the company's long-range and short-range objectives for increasing profits coincide. The most important situation in which short-range objectives differ from long-range objectives occurs when managers are trying to elevate organisational performance and cannot reach the long-range target in just one year. Short-range objectives then serve as steps toward achieving long term objective.

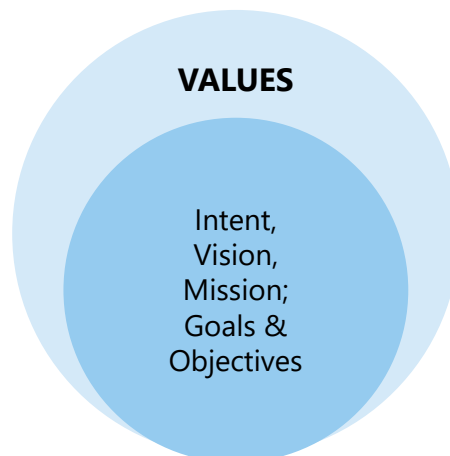
Clearly established objectives offer many benefits. They provide direction, allow synergy, aid in evaluation, establish priorities, reduce uncertainty, minimize conflicts, stimulate exertion, and aid in both the allocation of resources and the design of jobs.

1.5.4 VALUES

"Business, as I have seen it, places one great demand on you: it needs you to self-impose a framework of ethics, values, fairness and objectivity on yourself at all times." - Ratan N Tata, 2006 (Source: TATA Group Website)

A few common examples of values are – Integrity, Trust, Accountability, Humility, Innovation, and Diversity. But why are values so important? A company's value sets the tone for how the people of think and behave, especially in situations of dilemma. It creates a sense of shared purpose to build a strong foundation and focus on longevity of the company's success. Employees prefer to work with employers whose values resonate with them - the ones they can relate to in their daily work and personal life. Interestingly, majority of consumers say that they would prefer to buy products and services from companies that have a purpose that reflects their own value and belief system. Hence, values have both internal as well as external implications.

For reference, a lot of values were put to actions during Covid 19 pandemic when leaders of the organisations put people before everything else. It projected how deep the foundation of the oragnisations' were and how important it was for them to uphold their core values.



The above graphic represents the interconnection of Intent, Vision, Mission, Goals and Values; Values remain the center/core of Vision, Mission, Goals and putting all them to action. Vision is followed by Mission, followed by Goals and finally executing via real actions.

Values of HDFC Bank

HDFC Bank is committed to maintaining the highest level of ethical standards, professional integrity, corporate governance and regulatory compliance. HDFC Bank's business philosophy is based on five core values: Operational Excellence, Customer Focus, Product Leadership, People and Sustainability. (Source: HDFC website)



Excellence



Customer Focus



Product Leadership



People



Sustainability

Can you now go and read about LIC and Apple's values? Try on your own.

Intent vs Values - Which is a broader concept?

Sandeep, a human resource manager thinks that Intent is a bigger concept than Values. Is he right?

Sandeep is not right, as Values and Intent are two different concepts. Intent is the purpose of doing business while values are the principles that guide decision making of business. They both go hand in hand, while the intent is sometimes driven by values. So values more or so is wider than Intent.



1.6 STRATEGIC LEVELS IN ORGANISATIONS

A typical large organization is a multi-divisional organisation that competes in several different businesses. It has separate self-contained divisions to manage each of these businesses. **For example**, Patanjali has healthcare, FMCG, Organic Foods, Medicinal Oils and Herbs, and various different businesses. It has separate divisions which work within themselves to sustain each of these businesses.

Generally, there are three main levels of management:

- ◆ Corporate level
- ◆ Business level
- ◆ Functional level

General managers are found at the first two of these levels, but their strategic roles differ depending on their sphere of responsibility.

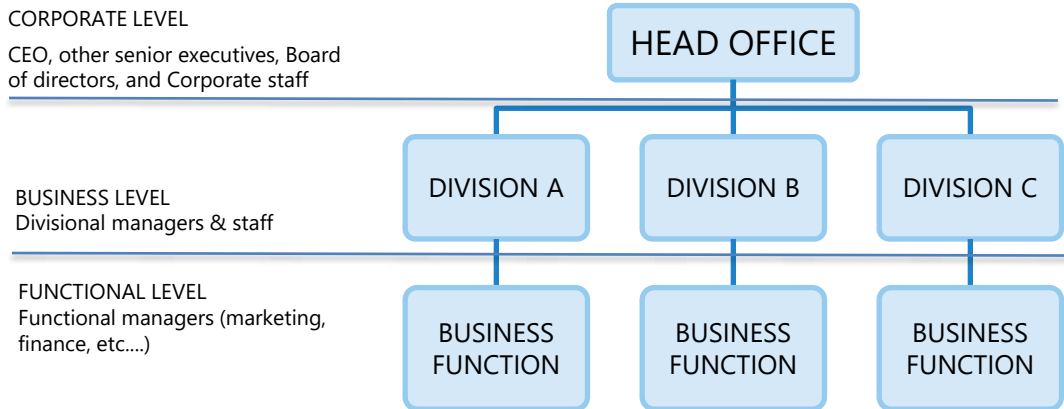


Figure: Levels of strategic management

An organization is divided into a number of segments that work together to bring a particular product or service to the market. If a company provides several and/or different kinds of products or services, it often duplicates these functions and creates a series of self-contained divisions (each of which contain its own set of functions) to manage each different product or service. The general managers of these divisions then become responsible for their particular product line. The overriding concern of the divisional managers is healthy growth of their divisions. They are responsible for deciding how to create a competitive advantage and achieve higher profitability with the resources and capital they have at their disposal. Such divisions are called **Strategic Business Units (SBUs)**.

The **corporate level of management** consists of the Chief Executive Officer (CEO), other senior executives, the board of directors, and corporate staff. These individuals participate in strategic decision making within the organization. The role of **corporate-level managers** is to oversee the development of strategies for the whole organization. This role includes defining the mission and goals of the organization, determining what businesses it should be in, allocating resources

among the different businesses, formulating and implementing strategies that span individual businesses, and providing leadership for the organization as a whole.

For example, Ahmedabad headquartered Adani Group is an Indian multinational conglomerate active in a wide range of businesses, including mining, operating ports and airports, power generation and transmission and cement. The main strategic responsibilities of its Group Chairman, Mr. Gautam Adani, are setting overall strategic objectives, allocating resources among the different business areas, deciding whether the firm should divest itself of any of its businesses, and determining whether it should acquire any new ones. In other words, it is up to Mr. Adani and other senior executives to develop strategies that span individual businesses and building and managing the corporate portfolio of businesses to maximize corporate profitability. However, it is not their specific responsibility to develop strategies for competing in the individual business areas, such as financial services. The development of such strategies is the responsibility of those in charge of different businesses called **business level managers**.

In simple words, corporate level managers provide an organisation level view of strategy and what they want to achieve, but it is on the business level managers to ensure that or their particular business, the one they are responsible for.

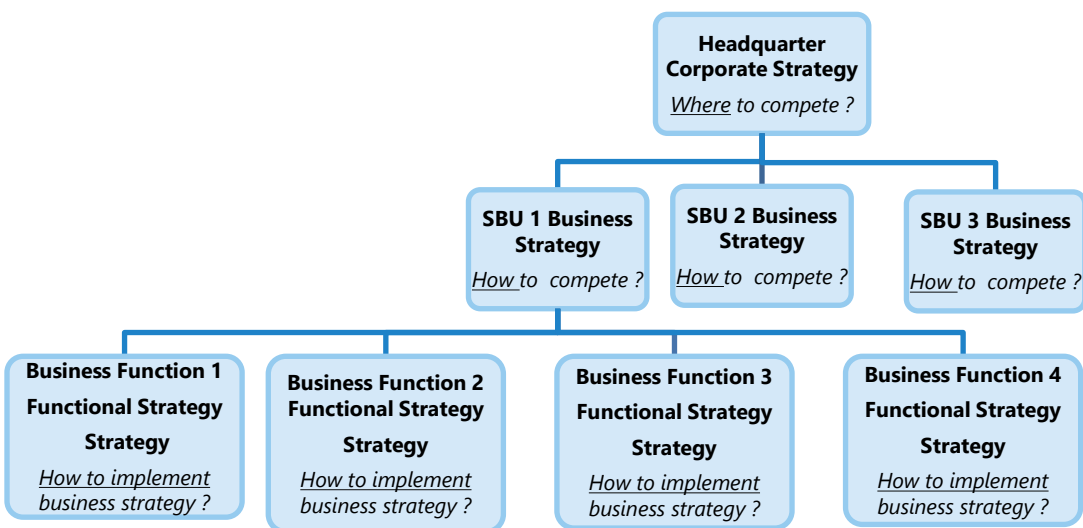
Besides overseeing resource allocation and managing the divestment and acquisition processes, corporate-level managers provide a link between the people who oversee the strategic development of a firm and those who own it (the shareholders). Corporate-level managers, and particularly the CEO, can be viewed as the guardians of shareholders' welfare. It is their responsibility to ensure that the corporate and business strategies of the company are consistent with maximizing shareholders' wealth. If they are not, then ultimately the CEO is likely to be held accountable by the shareholders.

As we now know, a strategic business unit is a self-contained division (with its own functions - **For example**, *finance, purchasing, production, and marketing departments*) that provides a product or service for a particular market. The principal general manager at the business level, or the business-level manager, is the head of the division. The strategic role of these managers is to translate the general statements of direction and intent that come from the corporate level into concrete strategies for individual businesses. Thus, whereas corporate-level managers are

concerned with strategies that span individual businesses, business-level managers are concerned with strategies that are specific to a particular business.

Functional-level managers are responsible for the specific business functions or operations (human resources, purchasing, product development, customer service, and so on) that constitute a company or one of its divisions. Thus, a functional manager's sphere of responsibility is generally confined to one organizational activity, whereas general managers oversee the operation of a whole company or division. Although they are not responsible for the overall performance of the organization, functional managers nevertheless have a major strategic role: to develop functional strategies in their area that help fulfill the strategic objectives set by business- and corporate-level general managers.

Functional managers provide most of the information that makes it possible for business- and corporate-level general managers to formulate realistic and attainable strategies. Indeed, because they are closer to the customer than the typical general manager is, functional managers themselves may generate important ideas that subsequently may become major strategies for the company. Thus, it is important for general managers to listen closely to the ideas of their functional managers. An equally great responsibility for managers at the operational level is strategy implementation: the execution of corporate and business-level plans.



Which is better - Top Down Approach or Bottom-Up Approach?

Do you know the concepts of Top-Down and Bottom-Up approach of decision making?

A top-down approach to decision making is when decisions are made solely by leadership at the top i.e. corporate level of management, while the bottom-up approach gives all teams across the levels a voice in decision making.

1.6.1 Network of relationship between the three levels

The corporate level decides what the business wants to achieve, while the business level draws ideas and plan to execute the same, which eventually flow down to functional level to execute and achieve results. But there are multiple ways in which all the 3 levels of management are interlinked, and interestingly it depends on the organisation as a whole to decide what kind of network of relationship suits their culture and aspirations.

There are 3 major types of networks of relationship between the levels and also amongst the same levels of a business;

- ♦ **Functional and Divisional Relationship:** It is an independent relationship, where each function or a division is run independently headed by the function/division head, who is a business level manager, reporting directly to the business head, who is a corporate level manager. Functions maybe like Finance, Human Resources, Marketing, etc. while Divisions may depend on the products like for a toys manufacturer - kids toys, teenager toys, etc. could be divisions.
- ♦ **Horizontal Relationship:** All positions, from top management to staff-level employees, are in the same hierarchical position. It is a flat structure where everyone is considered at same level. This leads to openness and transparency in work culture and focused more on idea sharing and innovation. This type of relationship between levels is more suitable for startups where the need to share ideas with speed is more desirable.
- ♦ **Matrix Relationship:** It features a grid-like structure of levels in an organisation, with teams formed with people from various departments that are built for temporary task-based projects. This relationship helps manage huge conglomerates with ease where it is nearly impossible to track and

manage every single team independently. In Matrix relationship - there are more than one business level managers for each functional level teams. It is complex for smaller organisations, but extremely useful for large organisations.

SUMMARY

All firms have a strategy, even if it is informal, unstructured, and sporadic. All organizations are heading somewhere, but unfortunately some organizations do not know where they are going. Increased competition and agile business landscape accents the need for organizations to use strategic-management concepts and techniques. The strategic-management process is becoming more widely used by small firms, large companies, nonprofit institutions, governmental organizations, and multinational conglomerates alike. The process of empowering managers and employees has almost limitless benefits. A strategy consists of the combination of competitive moves and business approaches that managers employ to please customer, compete successfully and achieve organizational objectives. This chapter elucidated business policy as a discipline and its transformation to strategic management. It presented a framework for understanding strategic decision making.

The three strategic levels in an organization were discussed: Corporate Level, Business Level and Operational/Functional Level. We further discussed how these managers formulate and implement strategies at their respective levels.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

- 1 *Strategy is a game plan used for which of the following?*
 - (a) *To take market position*
 - (b) *To attract and satisfy customers*
 - (c) *To respond to dynamic and hostile environment*
 - (d) *All of the above*

2. Which of the following is correct?
 - (a) Strategy is always pragmatic and not flexible
 - (b) Strategy is not always perfect, flawless and optimal
 - (c) Strategy is always perfect, flawless and optimal
 - (d) Strategy is always flexible but not pragmatic
3. Strategy is-
 - (a) Proactive in action
 - (b) Reactive in action
 - (c) A blend of proactive and reactive actions
 - (d) None of the above
4. Reactive strategy can also be termed as-
 - (a) Planned strategy
 - (b) Adaptive strategy
 - (c) Sound strategy
 - (d) Dynamic strategy
5. Formulation of strategies and their implementation in a strategic management process is undertaken by-
 - (a) Top level executives
 - (b) Middle level executives
 - (c) Lower level executives
 - (d) All of the above
6. Which of the following are responsible for formulating and developing realistic and attainable strategies?
 - (a) Corporate level and business level managers
 - (b) Corporate level and functional level managers

- (c) *Functional managers and business level managers*
 - (d) *Corporate level managers, business level managers and functional level managers*
7. *Which of the following managers' role is to translate the general statements/ strategies into concrete strategies of their individual businesses-*
- (a) *Supervisor*
 - (b) *Functional Manager*
 - (c) *CEO of the company*
 - (d) *All of the above*
8. *Which statement should be created first and foremost?*
- (a) *Strategy*
 - (b) *Vision*
 - (c) *Objectives*
 - (d) *Mission*
9. *Strategic management enables an organization to _____, instead of companies just responding to threats in their business environment.*
- (a) *be proactive*
 - (b) *determine when the threat will subside*
 - (c) *avoid the threats*
 - (d) *defeat their competitors*
10. *Read the following three statements:*
- (i) *Strategies have short-range implications.*
 - (ii) *Strategies are action oriented.*
 - (iii) *Strategies are rigidly defined.*
- From the combinations given below select an alternative that represents statements that are true:*
- (a) *(i) and (ii)*

- (b) (i) and (iii)
 - (c) (ii) and (iii)
 - (d) (i), (ii) and (iii)
11. What involves formulating, implementing, and evaluating cross-functional decisions that enable an organization to achieve its objectives?
- (a) Strategy formulation
 - (b) Strategy evaluation
 - (c) Strategy implementation
 - (d) Strategic management
12. Strategic management allows an organization to be more
- (a) Authoritative
 - (b) Participative
 - (c) Commanding
 - (d) Proactive

Scenario Based Questions

1. Swati is the marketing manager at a software company. She is responsible for developing and implementing marketing strategies for the company's products. Swati leads a team of marketing professionals and works closely with the product development and sales teams to ensure that the company's products are effectively promoted in the market. She also analyzes market trends and customer feedback to refine the marketing strategies. Which level is she working at, discuss the roles and responsibilities of this level in organization?
2. ABC retail chain regularly monitors consumer trends and supply chain flexibility. The retail chain tracks consumer trends to adjust its offerings, ensuring they meet customer needs. Simultaneously, it maintains a flexible supply chain to respond swiftly to demand fluctuations. This strategy enables ABC retail chain to anticipate market shifts and adapt to them effectively, ensuring its competitiveness and customer satisfaction. Which type of strategy is the retail chain employing?

Am Jivinder

3. *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.*
4. *Imagine you are a strategic consultant advising a retail company that is facing increasing competition from online retailers. The company is considering several strategic options to improve its market position. Using the concept that strategy is partly proactive and partly reactive, explain how the company can develop a strategic approach to address this challenge.*
5. *Tech Innovators Inc., a rapidly expanding technology company, aims to lead in artificial intelligence (AI) and machine learning (ML). With recent growth, the company is evaluating which organizational structure will best support its vision for innovation and leadership in AI technologies. They are considering three options: the Functional and Divisional Relationship for specialization, the Horizontal Relationship for flat, collaborative management, and the Matrix Relationship for cross-functional teams. Which of these relationships—Functional and Divisional, Horizontal, or Matrix—will most effectively achieve Tech Innovators Inc.'s strategic goals, and why?*
6. *Mr. Raj has been hired as a CEO by XYZ Ltd a FMCG company that has diversified into affordable cosmetics. The company intends to launch Feelgood brand of cosmetics. XYZ wishes to enrich the lives of people with its products that are good for skin and are produced in ecologically beneficial manner using herbal ingredients. Draft vision and mission statement that may be formulated by Raj.*
7. *Yummy Foods and Tasty Foods are successfully competing in the business of ready to eat snacks in Patna. Yummy has been pioneer in introducing innovative products. These products will give them good sale. However, Tasty Foods will introduce similar products in reaction to the products introduced by the Yummy Foods taking away the advantage gained by the former.*

Discuss the strategic approach of the two companies. Which is superior?

8. Ramesh Sharma has fifteen stores selling consumer durables in Delhi Region. Four of these stores were opened in last three years. He believes in managing strategically and enjoyed significant sales of refrigerator, televisions, washing machines, air conditioners and like till four years back. With shift to the purchases to online stores, the sales of his stores came down to about seventy per cent in last four years.

Analyse the position of Ramesh Sharma in light of limitations of strategic management.

9. Dharam Singh, the procurement department head of Cyclix, a mountain biking equipment company, was recently promoted to look after sales department along with procurement department. His seniors at the corporate level have always liked his way of leadership and are assured that he would ensure the implementation of policies and strategies to the best of his capacity but have never involved him in decision making for the company.

Do you think this is the right approach? Validate your answer with logical reasoning around management levels and decision making.

10. ABC Limited is in a wide range of businesses which include apparels, lifestyle products, furniture, real estate and electrical products. The company is looking to hire a suitable Chief Executive Officer. Consider yourself as the HR consultant for ABC limited. You have been assigned the task to enlist the activities involved with the role of the Chief Executive Officer. Name the strategic level that this role belongs to and enlist the activities associated with it.

Descriptive Questions

1. What is Strategic Management? What benefits accrue by following a strategic approach to managing?
2. Are there any limitations attached to strategic management in organizations? Discuss.
3. Explain the difference between three levels of strategy formulation.
4. "Strategy is partly proactive and partly reactive." Discuss.

ANSWERS/SOLUTIONS

Answers to Multiple Choice Questions

1	(d)	2	(b)	3	(c)	4	(b)	5	(d)	6	(d)
7	(b)	8	(b)	9	(a)	10	(a)	11	(d)	12	(d)

Answers to Scenario Based Questions

- Swati operates at the functional level of management, specifically as the marketing manager at a software company. Functional managers like Swati oversee specific departments or functions within an organization, such as marketing, finance, or operations. Their primary responsibilities include implementing corporate strategies and policies within their area of expertise and ensuring that daily operations are conducted efficiently and effectively.

In Swati's case, as a marketing manager, her role involves developing and executing marketing strategies for the company's products. This includes leading a team of marketing professionals, collaborating with product development and sales teams, and analyzing market trends and customer feedback to refine strategies. By working closely with these teams, Swati ensures that the company's products are effectively promoted in the market and that marketing efforts align with overall business goals.

Functional managers like Swati play a critical role in the organization by bridging the gap between corporate strategy and daily operations. They are responsible for translating high-level strategic goals into actionable plans for their departments and ensuring that these plans are executed effectively. Additionally, they are often key decision-makers within their areas of responsibility, making strategic choices that impact on the company's success. Overall, Swati's role as a marketing manager exemplifies the importance of functional managers in driving the success of their organizations.

- The retail chain is employing a strategy that combines both proactive and reactive elements. Monitoring consumer trends and adjusting product offerings accordingly demonstrates a proactive approach to anticipate and meet customer needs. On the other hand, maintaining a flexible supply chain

to respond quickly to changes in demand reflects a reactive strategy to address unforeseen shifts in the market.

This combination allows the retail chain to both anticipate future trends and react effectively to immediate market changes, making its strategy partly proactive and partly reactive. This dual strategy of proactive trend monitoring and reactive supply chain flexibility enables the retail chain to anticipate market shifts and adapt to them effectively, ensuring its competitiveness and customer satisfaction.

3. 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.
4. The retail company can develop a strategic approach that is both proactive and reactive to address the challenge of increasing competition from online retailers. To achieve this, the company can:

- ♦ **Proactive Strategy:** The company can proactively analyze market trends and customer preferences to identify opportunities for growth. For example, it can invest in market research to understand what customers value in a retail experience and tailor its offerings to meet those needs. This proactive approach can help the company stay ahead of competitors and attract new customers.
- ♦ **Reactive Strategy:** In addition to proactive measures, the company should also be prepared to react to changes in the market environment. For example, if a competitor launches a new online shopping platform, the company should quickly assess the impact on its business and develop a response. This reactive strategy can help the company adapt to changing market conditions and maintain its competitiveness.

By combining proactive and reactive strategies, the retail company can develop a comprehensive approach to addressing the challenge of increasing competition from online retailers. This approach will allow the company to capitalize on opportunities for growth while also mitigating risks and responding to threats in the market.

5. The Matrix Relationship is the most effective structure for Tech Innovators Inc. to achieve its vision of leadership in AI technologies. This structure promotes cross-functional collaboration, essential for managing complex AI projects and fostering innovation. By integrating expertise from various departments into temporary, task-based teams, the Matrix Relationship supports dynamic project management and aligns well with the company's strategic goals for advancing AI technologies. Despite its complexity, this approach provides the flexibility and collaboration necessary for a leading-edge AI and ML focus.

Relationship	Benefits	Drawbacks	Suitability for AI Leadership
Functional and Divisional	Specialization, clear management of functions and products.	Potential for departmental isolation, limited collaboration.	Less effective for cross-functional AI projects.
Horizontal	Open communication, encourages	Hard to scale, unclear roles and responsibilities.	Suitable for startups, less for large AI initiatives.

	innovation and fast idea sharing.		
Matrix	Facilitates cross-functional collaboration, flexible resource management for complex projects.	Complex reporting structures, potential conflicts.	Ideal for managing diverse, innovative AI projects.

6. Feelgood brand of cosmetics 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. Mr. Raj should aim to position "Feelgood cosmetics" as India's beauty care company. It may have vision to be India's largest beauty care company that improves looks, give extraordinary feeling and bring happiness to people.

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 the society. It is designed to help potential shareholders and investors understand the purpose of the company:

Mr. Raj may identify mission in the following lines:

- ◆ To be in the business of cosmetics to enhance the lives of people, give them confidence to lead.
 - ◆ To protect skin from harmful elements in environment and sun rays.
 - ◆ To produce herbal cosmetics using natural ingredients.
7. Yummy foods is proactive in its approach. On the other hand, Tasty Food is reactive. A proactive strategy is a planned strategy whereas reactive strategy is an adaptive reaction to changing circumstances. A company's strategy is typically a blend of proactive actions on the part of managers to improve the company's market position and financial performance and reactions to unanticipated developments and fresh market conditions.

If organisational resources permit, it is better to be proactive rather than reactive. Being proactive in aspects such as introducing new products will give you an advantage in the mind of customers.

At the same time, crafting a strategy involves stitching together a proactive/intended strategy and then adapting first one piece and then another as circumstances surrounding the company's situation change or better options emerge-a reactive/adaptive strategy. This aspect can be accomplished by Yummy Foods.

8. Ramesh Sharma is facing declining sales on account of large-scale shift of customers to online stores. While he is using the tools of strategic management, they cannot counter all hindrances and always achieve success. There are limitations attached to strategic management as follows:

- ◆ Environment under which strategies are made is highly complex and turbulent. Entry of online stores, a new kind of competitor brought a different dimension to selling consumer durables. Online stores with their size power could control the market and offer stiff competition to traditional stores.
- ◆ Another limitation of strategic management is that it is difficult to predict how things will shape-up in future. Ramesh Sharma, although managing strategically failed to see how online stores will impact the sales.
- ◆ Although, strategic management is a time-consuming process, he should continue to manage strategically. The challenging times require more efforts on his part.
- ◆ Strategic management is costly. Ramesh Sharma may consider engaging experts to find out preferences of the customers and attune his strategies to better serve them in a customized manner. Such customized offerings may be difficult to match by the online stores.
- ◆ The stores owned by Ramesh Sharma are much smaller than online stores. It is very difficult for him to visualize how online stores will be moving strategically.

9. Functional managers provide most of the information that makes it possible for business and corporate level managers to formulate realistic and attainable strategies.

This is so because functional managers like Dharam Singh are closer to the customers/suppliers/ operations than the typical general manager is. A

functional manager may generate important ideas that subsequently may become major strategies for the company. Thus, it is important for general managers to listen closely to the ideas of their functional managers and involve them in decision making.

An equally great responsibility for managers at the operational level is strategy implementation: the execution of corporate and business level plans, and if they are involved in formulation, the clarity of thoughts while implementation can benefit too.

Thus, the approach of Cylcix Corporate management is not right. They should involve Dharam Singh, as well as other functional managers too in strategic management.

10. The role of Chief Executive Officer pertains to corporate level.

The corporate level of management consists of the Chief Executive Officer (CEO) and other top-level executives. These individuals occupy the apex of decision making within the organization.

The role of Chief Executive Officer (Top Management/Corporate Level Managers) is to:

1. oversee the development of strategies for the whole organization;
2. defining the mission and goals of the organization;
3. determining what businesses it should be in;
4. allocating resources among the different businesses;
5. formulating, and implementing strategies that span individual businesses;
6. providing leadership for the organization;
7. ensuring that the corporate and business level strategies which company pursues are consistent with maximizing shareholders wealth; and
8. managing the divestment and acquisition process.

Answer to Descriptive Questions

1. 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 overall objective of strategic management is two-fold:

- ◆ To create competitive advantage, so that the company can outperform the competitors in order to have dominance over the market.
- ◆ To guide the company successfully through all changes in the environment.

The following are the benefits of strategic approach to managing:

- ◆ Strategic management helps organisations to be more proactive instead of reactive in shaping its future. Organisations are able to analyse and take actions instead of being mere spectators. Thereby they are able to control their own destiny in a better manner. It helps them in working within vagaries of environment and shaping it, instead of getting carried away by its turbulence or uncertainties.
- ◆ Strategic management provides frameworks for all the major decisions of an enterprise such as decisions on businesses, products, markets, manufacturing facilities, investments and organisational structure. It provides better guidance to entire organisation on the crucial point - what it is trying to do.
- ◆ Strategic management is concerned with ensuring a good future for the firm. It seeks to prepare the corporation to face the future and act as pathfinder to various business opportunities. Organisations are able to identify the available opportunities and identify ways and means as how to reach them.
- ◆ Strategic management serves as a corporate defence mechanism against mistakes and pitfalls. It helps organisations to avoid costly mistakes in product market choices or investments. Over a period of time strategic management helps organisation to evolve certain core competencies and competitive advantages that assist in its fight for survival and growth.

2. The presence of strategic management cannot counter all hindrances and always achieve success. 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.
 - ◆ 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.
 - ◆ In a competitive scenario, where all organisations are trying to move strategically, it is difficult to clearly estimate the competitive responses to a firm's strategies.
3. A typical large organization is a multidivisional organisation that competes in several different businesses. It has separate self-contained divisions to manage each of these. There are three levels of strategy in management of business - corporate, business, and functional.

The corporate level of management consists of the chief executive officer and other top-level executives. These individuals occupy the apex of decision making within the organization. The role of corporate-level managers is to oversee the development of strategies for the whole organization. This role includes defining the mission and goals of the organization, determining what businesses it should be in, allocating resources among the different businesses and so on rests at the Corporate Level.

The development of strategies for individual business areas is the responsibility of the general managers in these different businesses or business level managers. A business unit is a self-contained division with its own functions - **For example, finance, production, and marketing.** The

strategic role of business-level manager, head of the division, is to translate the general statements of direction and intent that come from the corporate level into concrete strategies for individual businesses.

Functional-level managers are responsible for the specific business functions or operations such as human resources, purchasing, product development, customer service, and so on. Thus, a functional manager's sphere of responsibility is generally confined to one organizational activity, whereas general managers oversee the operation of a whole company or division.

4. Strategy is partly proactive and partly reactive. In proactive strategy, organizations will analyze possible environmental scenarios and create strategic framework after proper planning and set procedures and work on these strategies in a predetermined manner. However, in reality no company can forecast both internal and external environment exactly. Everything cannot be planned in advance. It is not possible to anticipate moves of rival firms, consumer behaviour, evolving technologies and so on.

There can be significant deviations between what was visualized and what actually happens. Strategies need to be attuned or modified in the light of possible environmental changes. There can be significant or major strategic changes when the environment demands. Reactive strategy is triggered by the changes in the environment and provides ways and means to cope with the negative factors or take advantage of emerging opportunities.

2 CHAPTER

STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT

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NANDA CHATURVEDI 74 MARKS	ARYAN MERATWAL 73 MARKS	DEEPANSHI JAIN 73 MARKS	KAUSHAL ARORA 73 MARKS	PREETHAM BHAT 73 MARKS	SONALI VIJ 73 MARKS
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STRATEGIC ANALYSIS: EXTERNAL ENVIRONMENT



LEARNING OUTCOMES

After studying this chapter, you will be able to:

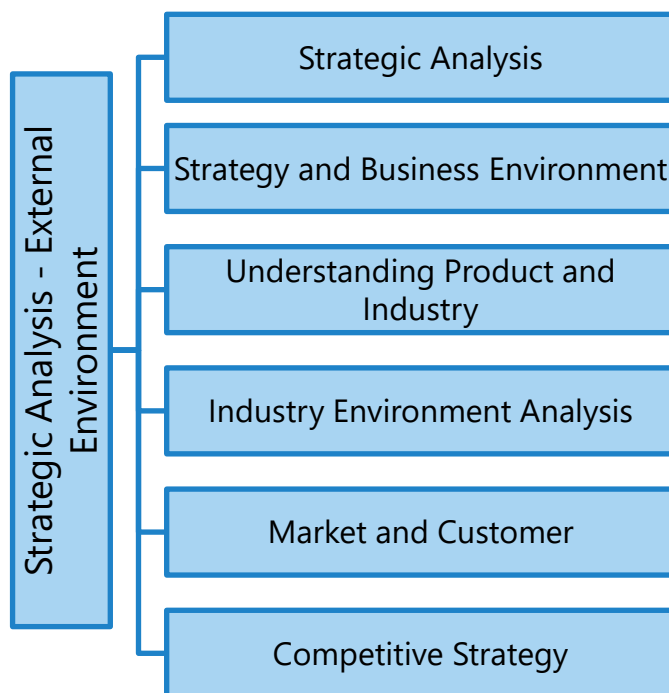
- ◆ Examine the criticality of the business environment in strategic analysis.
- ◆ Describe various elements of the domestic macro environment of business.
- ◆ Utilise PESTLE Analysis as a tool for environmental analysis.
- ◆ Situate a business in an industry and conduct industry analysis.
- ◆ Analyse aspects related to competition in the industry with reference to Porter's five competitive forces.

Environmental analysis is the process by which strategists monitor the economic, governmental/legal, market/ competitive, supplier / technological, geographic and social settings to determine opportunities and threats to their firms.

William F. Glueck

The analysis is the critical starting point of strategic thinking. *Kenichi Ohmae*

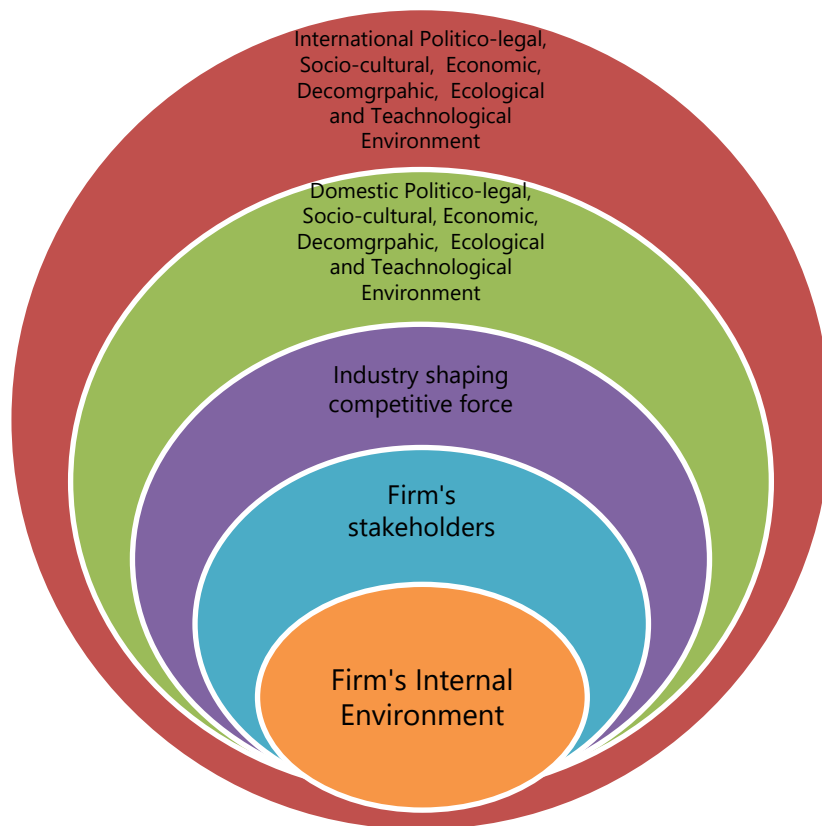
CHAPTER OVERVIEW



2.1 INTRODUCTION

There are different kinds of business activities that take place in an organisational setting, and a cursory look into their world reflects a wide variety of organisations ranging from small local businesses to international or multinational corporations' level. Generally, organisations are distinguished based on their size, type of products, markets, geographical coverage, legal status, and like because of vast organisational diversity.

Whatever their size or other distinguishing feature they do not operate in a vacuum. They continuously act and react to what happens outside their periphery. The factors that are outside the business operations are typically referred to as organisational / business environment. In other words, and in the specific context of business, environment may be defined as a set of all external factors that weigh in the minds of the managers. Drawing an analogy with the term 'atmosphere' one could envision layers of such influences. See Figure-



The process of strategic formulation begins with a strategic analysis. Its objective is to compile information about internal and external environments in order to assess possibilities while formulating strategic objectives and contemplating strategic activities. In this chapter various aspects of external environment are covered with the perspective of strategic analysis. We will also attempt to understand how to identify, and tackle strategies to adapt within complex and turbulent external environment.

2.2 STRATEGIC ANALYSIS

Strategy formulation is not a task in which managers can get by with intuition, opinions, instincts, and creative thinking. Judgments about what strategies to pursue need to flow directly from analysis of a firm's external environment and its internal resources and capabilities. Environmental scanning is a natural and continuous activity for every business and some do it on an informal basis, while

others have a formal structure to collect meaningful information. It is just as important to learn about changes in tax regulations through television news as it is through a well-established reading material from experts. The capacity to collect important information in informal settings usually separates great entrepreneurs and managers. Using just informal techniques, on the other hand, exposes the organisation to missed opportunities and unanticipated hazards. A systematic approach to environmental assessment is essential for managing risk and uncertainty.

The majority of the rapidly expanding organisations use strategic planning throughout various stages of their operations. The strategic analysis is a component of business planning that has a methodical approach, makes the right resource investments, and may assist business in achieving its objective. It forces to think about the rivals and aids in the evaluation of business plans to stay ahead of the competition. The two important situational considerations are:

- (1) industry and competitive conditions, and
- (2) an organisation's own capabilities, resources, internal strengths, weaknesses, and market position.

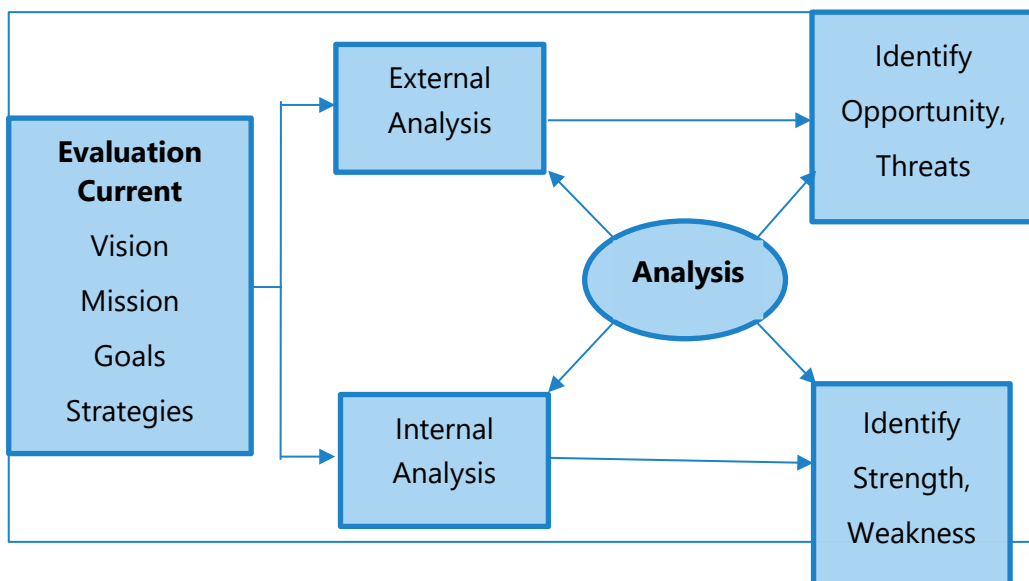


Figure: Strategic Analysis

The analytical sequence is from strategic appraisal of the external and internal situation to evaluation of alternatives of strategies, to the final choice of strategy.

Accurate diagnosis of the business situation is necessary for managerial preparation to decide on a sound long-term direction, setting appropriate objectives, and crafting a winning strategy. Without perceptive understanding of the strategic aspects of a company's external and internal environments, the chances are greatly increased that managers will finalize a strategic game plan that doesn't fit the situation well, that holds little prospect for building competitive advantage, and that is unlikely to boost company performance.

The strategic analysis is a continuous process which is not without limitations. There are two major limitations of strategic analysis that we need to be aware of. First, it gives a lot of innovative options but doesn't tell which one to pick. The options can be overlapping, confusing or difficult to implement. Second, it can be time-consuming at times, hurting overall organisational functioning and also strain other efficient innovations such as developing a new product or a service.

2.2.1 Issues to consider for Strategic Analysis

Strategy evolves over a period of time: Each strategic decision must balance the different factors that impact and constrain strategy. A key element of strategic analysis is the probable outcomes of everyday decisions. A current strategy is the result of several little choices taken over a protracted period of time. A management radically changes strategy when they try to speed up the organisational growth. Strategy is influenced by experience, but it has to be updated when the results become clear. It therefore evolves with time.

Balance of external and internal factors: In practise, strategic analysis necessitates creating a reasonable balance between many and conflicting challenges, because a perfect fit between them is unlikely. Management must consider opportunities, influences, and constraints while taking a strategic decision. There are factors driving a decision, such as entering a new market. Concurrently, there exist constraints that limit the option, such as the presence of a large opponent. These limiting constraints will have various implications on the kind, degree, volume, and significance of the impact. While some of these aspects are under your control, there will be others way beyond the existing capabilities.

Risk: In strategic analysis, the principle of maintaining balance is important. However, the complexity and intermingling of variables in the environment reduces the strategic balance in the organisation. Competitive markets, liberalization, globalization, booms, recessions, technological advancements, inter-country relationships all affect businesses and pose risk at varying degrees. An important aspect of strategic analysis is to identify potential imbalances or risks and assess their consequences. A broad classification of the strategic risk that requires consideration in strategic analysis is given below:

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

Figure: Strategic Risk

External risk is on account of inconsistencies between strategies and the forces in the environment. Internal risk occurs on account of forces that are either within the organization or are directly interacting with the organization on a routine basis.

The below given broad list of analysis that a business undertakes to plan a strategy covers both aspects of external analysis and internal analysis. An analysis helps identify opportunities, threats, strengths and weaknesses.

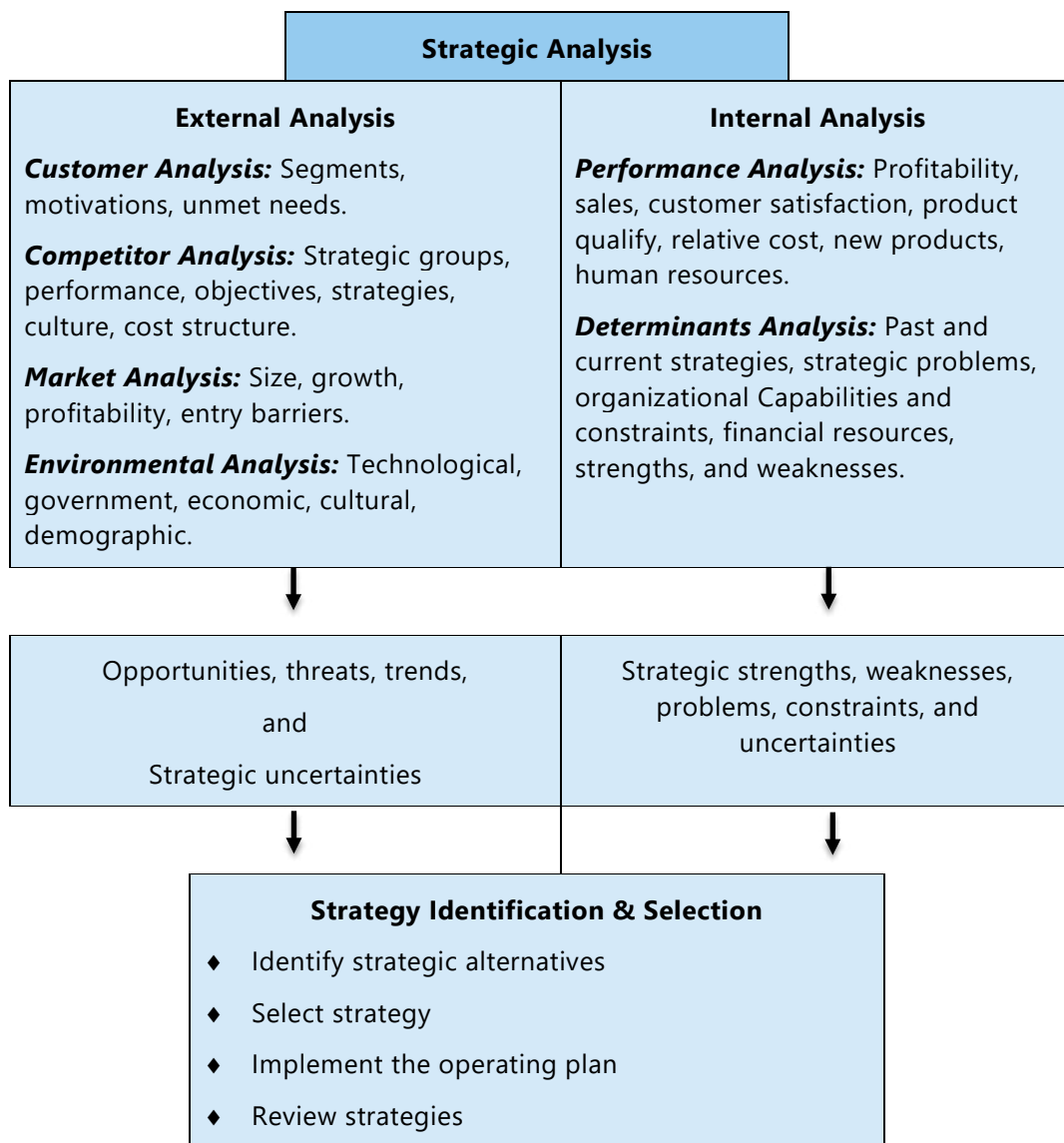


Figure: Framework of Strategic Analysis

It is evident that industries differ widely in their economic characteristics, competitive situations, and future profit prospects. The economic character of industries varies according to such factors as overall size and market growth rate, the pace of technological change, the geographic boundaries of the market (which can extend from local to worldwide), the number and size of buyers and sellers, whether sellers' products are virtually identical or highly differentiated, the extent to which costs are affected by economies of scale, and the types of distribution

channels used to access buyers, marketing opportunities, disposable income of prospective buyers, government support, etc. Competitive forces can be moderate in one industry and fierce, even cutthroat, in another. In some industries competition focuses on who has the best price, while in others competition is centered on quality and reliability (as in monitors for PCs and laptops) or product features and performance (as in mobile phones) or quick service and convenience. (as in online shopping and fast foods) or brand reputation (as in laundry detergents and soft drinks). In other industries, the challenge is for companies to work cooperatively with suppliers, customers, and maybe even select competitors to create the next round of product innovations and open up whole new vistas of market opportunities.

An industry's economic traits and competitive conditions, and how they are expected to change, determine whether its profit prospects are poor, average, or excellent. Industry and competitive conditions differ so much that leading companies in unattractive industries can find it hard to earn respectable profits, while even weak companies in attractive industries can achieve good performance.

2.3 STRATEGY AND BUSINESS ENVIRONMENT

To accomplish the goals and objectives of a business, business strategist creates strategies and formulate policies considering both internal and external factors. A framework for adjusting to the demands of an unpredictable environment and an uncertain future is provided by strategic management.

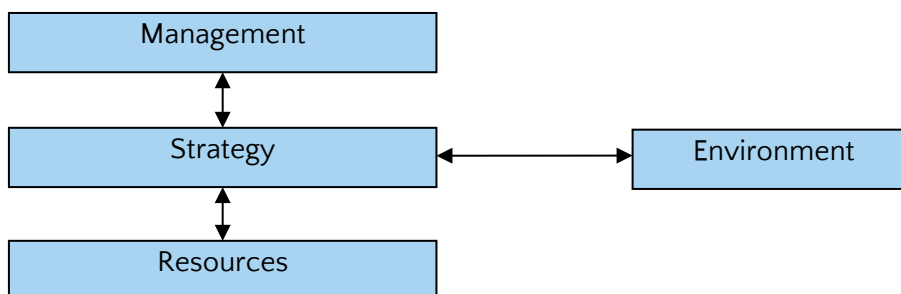


Figure: Strategy and Environment

The business environment is highly dynamic and continuously evolving. Strategists provide an interface between the organizational abilities and the opportunities and challenges it must deal within the larger environment.

The term "business environment" refers to all external factors, influences, or situations that in some way affect business decisions, plans, and operations. Organisational success is determined by its business environment, and even more from its relationship with it.

Strategic management is involved with choosing a long-term direction in relation to these resources and opportunities. There is a close and continuous interaction between a business and its environment. This interaction helps in strengthening the business firm and using its resources more effectively. It helps the business in the following ways:

- i. **Determine opportunities and threats:** The interaction between the business and its environment would explain opportunities and threats to the business. It helps to find new needs and wants of the consumers, changes in laws, changes in social behaviours, and tells what new products the competitors are bringing in the market to attract consumers.
- ii. **Give direction for growth:** The interaction with the environment enables the business to identify the areas for growth and expansion of their activities. Once the business is aware and understands the changes happening around, it can plan and strategise to have successful business.
- iii. **Continuous Learning:** The managers are motivated to continuously update their knowledge, understanding and skills to meet the predicted changes in the realm of business.
- iv. **Image Building:** Environmental understanding helps the business organizations to improve their image by showing their sensitivity to the environment in which they operate. **For example,** in view of the shortage of power, many companies have set up captive power plants with their factories to meet their own requirement of power as well as extend surplus capacities in the vicinity. Understanding the needs of the environment help to showcase that the business is aware and responsive to the needs. It creates a positive image and helps it to prosper and win over the competitors.
- v. **Meeting Competition:** It helps the businesses to analyse the competitors' strategies and formulate their own strategies accordingly. The idea is to flourish and beat competition for its products and services.

Business strategies relate organisational resources to challenges and opportunities in the larger environment. The changes happening in the external environment challenge organisations to find novel and unique strategies to remain in business and succeed. As the world is getting smaller and competition is increasing, organisations have an increasing pressure to develop their businesses and strengthen their competitiveness. Strategic analysis covering internal and external environment is highly relevant and important for the strategists in organisations in order to achieve competitive advantage, as well as ensure high performance for survival and growth.

To flourish, a business must be aware of, assess, and respond to the many opportunities and threats present in its environment. In order to succeed, the business must not only be aware of the numerous aspects of its surroundings but also be able to handle and adapt to them. The business must continuously evaluate its environment and modify its operations in order to thrive and expand.

Strategic decisions are significant aspects of business management and are essential for the success and continued existence. Two crucial aspects for the success include are the function of top management and the method of formulating strategic decisions. Improvement of strategic decisions is constant endeavour for strategist. Due to the contemporary environment's changes and the challenges that managers must overcome when making decisions, there is interest in enhancing strategic decision-making. The environment is far more dynamic and unpredictable than it used to be.

2.3.1 Micro and Macro Environment

The environment in which an organization exists can be described in terms of the opportunities and threats operating in the external environment apart from the strengths and weaknesses existing in the internal environment. Business strategists should always be adequately informed on developments occurring in their company, its industry, and within micro and macro environment of business. For making any strategic decision, they should be able to comprehend the facts available and challenge the underlying assumptions.

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

- ◆ Micro environment
- ◆ Macro environment

Micro-environment is related to small area or immediate periphery of an organization. It influences an organization regularly and directly. Micro environment consists of suppliers, consumers, marketing intermediaries, competitors, etc. These are specific to the said business or firm and affect its working on a direct and regular basis. Within the micro or the immediate environment in which a firm operates we need to address the following issues:

- ◆ The employees of the firm, their characteristics and how they are organised.
- ◆ The existing customer base on which the firm relies for business.
- ◆ The ways in which the firm can raise its finance.
- ◆ Who are the firm suppliers and how are the links between the two being developed?
- ◆ The local community within which the firm operates.
- ◆ The direct competition and their comparative performance.

The factors in micro environment often relate an organization to the macro issues influencing the way a firm reacts in the market place. The macro environment is the portion of the outside world that significantly affects how an organisation operates but is typically much beyond its direct control and influence.

2.3.2 Elements of Macro Environment

Macro environment has broader dimensions as it consists of economic, socio-cultural, technological, political and legal factors. The classification of the relevant environment into components or sectors helps an organization to cope with its complexity, comprehend the different influences operating, and relating the environmental changes to its strategic management process.

"The environment includes factors outside the firm which can lead to opportunities for, or threats to the firm. Although, there are many factors, the most important of the factors are socio-economic, technological, supplier, competitors, and government."
Gluek and Jauch

The external environment of an organisation is made up of all the individuals, teams, organisations, agencies, and factors that it routinely interacts with when conducting business. In addition to carrying out transactions, it develops and puts

into action pertinent plans and policies to address environmental changes. It negotiates its way into the future as well.

Demographic Environment

Demographics are the characteristics of a population that have been classified and explained according to certain criteria, such as age, gender, and income, in order to understand the features of a specific group. Demographical analysis considers factors such as race, age, income, education, possession of assets, house ownership, job position, region, and the degree of education. Data about these qualities across homes and within a demographic variable are of importance to both businesses and economists. Marketers and other social scientists regularly divide up populations based on their demographic makeup. India has relatively younger population as compared to many other countries. Many multinationals are interested in India considering its population size.

Considering demographics is of immense importance for any business. Business Organizations need to study different demographic factors. Particularly, they need to address following issues:

- ◆ What demographic trends will affect the market size of the industry?
- ◆ What demographic trends represent opportunities or threats?

The size, age distribution, geographic dispersion, ethnic mix, and income distribution of a population are all of great importance to the organisation. Identifying the implications of changing demographic characteristics or population components for a future strategic competitiveness is often a challenge for strategists.

Socio-Cultural Environment

A general factor that influences almost all enterprises in a similar manner. It represents a complex group of factors such as social traditions, values and beliefs, level and standards of literacy, the ethical standards and state of society, the extent of social stratification, conflict, cohesiveness and so forth. It differs from demographics in the sense that it is not the characteristics of the population, but it is the behaviour and the belief system of that population.

Socio-cultural environment consists of factors related to human relationships and the impact of social attitudes and cultural values which has bearing on the

operations of the organization. The beliefs, values and norms of a society determine how individuals and organizations should be interrelated. The core beliefs of a particular society tend to be persistent. It is difficult for a business to change these core values, which becomes a determinant of its functioning. This means, that businesses have to adjust to social norms and beliefs to operate successfully. The social environment primarily affects the strategic management process within the organization in the areas of mission and objective setting, and decisions related to products and markets.

Economic Environment

Economic conditions have a direct bearing over the business strategies. The economic environment refers to the overall economic situation around the business and include conditions at the regional, national and global levels. It encompasses conditions in the markets for resources that have an effect on the supply of inputs and outputs of the business, their costs, and the dependability, quality, and availability.

Economic environment determines the strength and size of the market. The purchasing power in an economy depends on current income, prices, savings, circulation of money, debt and credit availability. Income distribution pattern determine the business possibilities. The important point to consider is to find out the effect of economic prospect, growth and inflation on the operations of the business.

Higher interest rates are detrimental for the businesses with high debt. In the real estate market, they reduce the capability of the prospective buyers to avail loan and pay instalments, thus lower the demand.

The economic conditions of a nation refer to a set of economic factors that have great influence on business organizations and their operations. These include gross domestic product, per capita income, markets for goods and services, availability of capital, foreign exchange reserve, growth of foreign trade, strength of capital market, interest rates, disposable income, unemployment, inflation, etc. All these factors generally tell the state of the economy. Whether it is doing good or is it performing poorly.

Political-Legal Environment

Political-legal environment takes into account elements like the general level of political development, the degree to which business and economic issues have been politicised, the degree of political morality, the state of law and order, political stability, the political ideology and practises of the ruling party, the effectiveness and purposefulness of governmental agencies, and the scope and type of governmental intervention in the economy and industry. It is partly general to all similar enterprises and partly specific to an individual enterprise.

Business is highly guided and controlled by government policies. Hence the type of government running a country is a powerful influence on business. A business has to consider the changes in the regulatory framework and their impact on the business. Taxes and duties are other critical areas that may be levied and affect the business.

Businesses prefer to operate in a country where there is a sound legal system. However, in any country businesses must have a good working knowledge of the major laws protecting consumers, competitions and organizations. Businesses must understand the relevant laws relating to companies, competition, intellectual property, foreign exchange, labour and so on.

Nationalism supports measures aimed at enhancing the position of a country in International business. Presently, there is immense thrust on nationalism in Indian business through policies like Make in India and Aatmanirbhar Bharat. Production Linked Incentives scheme, another step in the direction, rewards businesses for increased sales of goods produced domestically. The scheme encourages foreign businesses to open businesses in India, and at the same time incentivises domestic businesses to open or expand their manufacturing facilities, create more jobs, and lessen India's reliance on imports.

Technological Environment

A highly important factor in the present times is technology. Technology has changed the way people communicate and do things. Technology has also changed the ways of how businesses operate now. Technology and business are linked and are interdependent on one another. Businesses help society access the outcomes of technological research and development, raising everyone's standard of living.

As a result, business leverages technology. Businesses use new discoveries to adapt themselves for the advancement of society.

Technology has impacted on how businesses are conducted. With use of technology, many organisations are able to reduce paperwork, schedule payments more efficiently, are able to coordinate inventories efficiently and effectively. This helps to reduce costs of companies, and shrink time and distance, thus, capturing a competitive advantage for the company.

Changes in technology have an effect on how a business runs its operations. The technological advancements might require a business to drastically alter its operational, production and marketing strategies.

Technology is leading to many new business opportunities as well as making obsolete most of the existing business products and services. Technology can act as opportunity, when a business effectively adopts technological innovations to their strategic advantage. However, at the same time technology can act as a threat too. Artificial intelligence, machine learning, robotic process automation is some of the new technological tools that businesses are adopting and can act as both opportunity and threat to a business.

2.3.3 PESTLE– A tool to Analyse Macro Environment

The term PESTLE is often used to describe a framework for analysis of macro environmental factors. PESTEL analysis is frequently used to assess the business environment in which a firm operates. Political, economic, social, and technological (PEST) analysis was the name given to the framework in the past; however, later, the framework has been expanded to include environmental and legal factors as well. PESTLE analysis involves identifying the political, economic, socio-cultural, technological, legal and environmental influences on an organization and providing a way of scanning the environmental influences that have affected or are likely to affect an organization or its policy.

'PESTLE analysis is an increasingly used and recognized analytical tool, and it is an acronym for:

P- political
E- economic
S- socio-cultural
T- technological
L- legal
E- environmental

The PESTLE analysis is simple to understand and quick to implement. The advantage of this tool is that it encourages management into proactive and structured thinking in its decision making.

The Key Factors

- ◆ **Political factors** are how and to what extent the government intervenes in the economy and the activities of business firms. Political factors may also influence goods and services which the government wants to provide or be provided and those that the government does not want to be provided. Furthermore, governments have great influence on the health, education and infrastructure of a nation.
- ◆ **Economic factors** have major impacts on how businesses operate and take decisions. **For example**, interest rates affect a firm's cost of capital and therefore to what extent a business grows and expands. Exchange rates affect the costs of exporting goods and the supply and price of imported goods in an economy. The money supply, inflation, credit flow, per capita income, growth rates have a bearing on the business decisions.
- ◆ **Social factors** affect the demand for a company's products and how that company operates.
- ◆ **Technological factors** can determine barriers to entry, minimum efficient production level and influence outsourcing decisions. Furthermore, technological shifts can affect costs, quality, and lead to innovation.
- ◆ **Legal factors** affect how a company operates, its costs, and the demand for its products, ease of business.

- ◆ **Environmental factors** affect industries such as tourism, farming, and insurance. Growing awareness to climate change is affecting how companies operate and the products they offer--it is both creating new markets and diminishing or destroying existing ones.

On the basis of these, it should be possible to identify a number of key environmental influences, which are in effect, the drivers of change. These are the factors that require to be considered in making meaningful decisions. Take a look at the table given below:

Political	Economic
◆ Political stability ◆ Political principles and ideologies ◆ Current and future taxation policy ◆ Regulatory bodies and processes ◆ Government policies ◆ Government term and change ◆ Thrust areas of political leaders	◆ Economy situation and trends ◆ Market and trade cycles ◆ Specific industry factors ◆ Customer/end-user drivers ◆ Interest and exchange rates ◆ Inflation and unemployment ◆ Strength of consumer spending
Social	Technological
◆ Lifestyle trends ◆ Demographics ◆ Consumer attitudes and opinions ◆ Brand, company, technology image ◆ Consumer buying patterns ◆ Ethnic/religious factors ◆ Media views and perception	◆ Replacement technology/solutions ◆ Maturity of technology ◆ Manufacturing maturity and capacity ◆ Innovation potential ◆ Technology access, licensing, patents, property rights and copyrights
Legal	Environmental
◆ Business and Corporate Laws ◆ Employment Law ◆ Competition Law ◆ Health & Safety Law ◆ International Treaty and Law ◆ Regional Legislation	◆ Ecological/environmental issues ◆ Environmental hazards ◆ Environmental legislation ◆ Energy consumption ◆ Waste disposal

2.3.4 Internationalization of Business

Internationalization has emerged as the dominant commercial trend over the last couple of decades. It enables a business to enter new markets in search of greater earnings and less expensive resources. Additionally, expanding internationally enable a business to achieve greater economies of scale and extend the lifespan of its products.

The strategic-management process is essentially the same for global firms as it is for domestic firms; nevertheless, international processes are much more complicated due to additional variables and linkages. A business can approach internationalisation systemically with the aid of international strategy planning. One method for an organization to identify opportunities and threats in global markets is by scanning the external environment. The development of effective strategies and the formulation of global strategic objectives are made feasible by internationalisation.

Characteristics of a global business

To be specific, a global business has three characteristics:

- ◆ It is a conglomerate of multiple units (located in different parts of the globe) but all linked by common ownership.
- ◆ Multiple units draw on a common pool of resources, such as money, credit, information, patents, trade names and control systems.
- ◆ The units respond to some common strategy. Besides, its managers and shareholders are also based in different nations.

Developing internationally

International development is expensive and challenging. Moving on in a thorough and structured manner is thus the ideal approach to adopt. The steps in international strategic planning are as follows:

- ◆ Evaluate global opportunities and threats and rate them with the internal capabilities.
- ◆ Describe the scope of the firm's global commercial operations.
- ◆ Create the firm's global business objectives.

- ◆ Develop distinct corporate strategies for the global business and whole organisation.

Why do businesses go global?

Technological developments and evolving political views are two important factors in the rapid rise of multinational organisations. Because of technological advances, the process of internationalisation is now simpler than it was previously. Worldwide communication makes it easier to define and implement global strategy by linking corporate headquarters with their abroad operations. In addition, introduction of improved transportation has increased the mobility of money, people, raw materials, and finished items. There are several reasons why companies go global. These are explained as follows:

- ◆ The first and foremost reason is the need to grow. It is basic need of every organisation. Often finding opportunities in the other parts of the globe, organisations extend their businesses and globalise their operations.
- ◆ There is rapid shrinking of time and distance across the globe, because of faster communication, speedier transportation, growing financial flow of funds and rapid technological changes.
- ◆ It is being realised that the domestic markets are no longer adequate. The competition present domestically may not exist in some of the international markets.
- ◆ There can be varied other reasons such as need for reliable or cheaper source of raw-materials, cheap labour, etc. Many foreign businesses shift and set up some of their operations to take advantage of availability of vast pool of talent.
- ◆ Companies often set up overseas plants to reduce high transportation costs. It may be cheaper to produce near the market to reduce the time and costs involved in transportation.
- ◆ When exporting organisations find foreign markets to open up or grow big, they may naturally look at overseas manufacturing plants and sales branches to generate higher sales and better cash flow.
- ◆ The rise of services to constitute the largest single sector in the world economy; and regional economic integration, which has involved both the world's largest economies as well as certain developing economies.

- ◆ The apparent and real collapse of international trade barriers redefines the roles of state and industry. The trend is towards increased privatization of manufacturing and services sectors, less government interference in business decisions and more dependence on the value-added sector to gain marketplace competitiveness. The trade tariffs and custom barriers are getting lowered, resulting in increased flow of business.
- ◆ Globalization has made companies in different countries to form strategic alliances to ward off economic and technological threats and leverage their respective comparative and competitive advantages.

2.3.5 International Environment

The social, cultural, demographic, environmental, political, governmental, legal, technological factors that an international organisation faces are nearly limitless, and the number and complexity of these factors increase manifold as the number of products produced and geographic areas served increase. An assessment of the external environment is the first step toward internationalisation. Analysing international environment is important since it allows organisation to discover opportunities in the global market and evaluate feasibilities of capitalising on these opportunities. Assessments of the international environment can be done at three levels: multinational, regional, and country.

Multinational environmental analysis involves identifying, anticipating, and monitoring significant components of the global environment on a large scale. Understanding global developments covering economic and other macro elements is important. Governments may have free or interventionist tendencies in economies that needs to be carefully considered. These characteristics are evaluated based on their present and expected future impact.

Regional environmental analysis is a more in-depth evaluation of the critical factors in a specific geographical area. The emphasis would be on discovering market opportunities for a goods, services, or innovations in the chosen location.

Country environmental analysis has to take a deeper look at the important environmental factors. Study of economic, legal, political, and cultural dimensions is required in order for planning to be successful. The analysis must be customised for each of the countries to develop effective market entrance strategies.

International environment has become an inherent part of strategic management for businesses of all sizes with global interests. It essentially involves various global aspects like political risks, cultural differences, exchange rate fluctuations, legal compliances and taxation issues. Thus, it becomes more important for the people at the decision-making levels to focus on factors comprising the international environment.



2.4 UNDERSTANDING PRODUCT AND INDUSTRY

Businesses sell products. A product can be either a good or a service. It might be physical good or a service, an experience. Business products have certain characteristics as follows:

- ◆ *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.
- ◆ *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 price is often given by the market and businesses have to work on costs to maintain profitability.

On account of competition, businesses are not able to fix market price by adding profit margin on the costs. Rather, they work on reducing the costs given the prevailing market price.

- ◆ *Products have certain features that deliver satisfaction.* A product feature is a component of a product that satisfies a consumer need. Features determine product pricing, and businesses alter features during the development process to optimise the user experience. Products should be able to provide value satisfaction to the customers for whom they are meant. Features of the product will distinguish it in terms of its 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.

- ◆ *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.
- ◆ *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.

2.4.1 Product Life Cycle

An important concept in strategic choice is that of product life cycle (PLC). It is a useful concept for guiding strategic choice. Essentially, PLC is an S-shaped curve which exhibits the relationship of sales with respect of time for a product that passes through the four successive stages of introduction, growth, maturity and decline. If businesses are substituted for product, the concept of PLC could work just as well.

The first stage of PLC is the introduction stage with slow sales growth, in which competition is almost negligible, prices are relatively high, and markets are limited. The growth in sales is at a lower rate because of lack of awareness on the part of customers.

The second phase of PLC is growth stage with rapid market acceptance. In the growth stage, the demand expands rapidly, prices fall, competition increases, and market expands. The customer has knowledge about the product and shows interest in purchasing it.

The third phase of PLC is maturity stage where there is slowdown in growth rate. In this stage, the competition gets tough, and market gets stabilised. Profit comes down because of stiff competition. At this stage, organisations have to work for maintaining stability.

In the fourth stage of PLC is declines with sharp downward drift in sales. The sales and profits fall down sharply due to some new product replaces the existing

product. So, a combination of strategies can be implemented to stay in the market either by diversification or retrenchment.

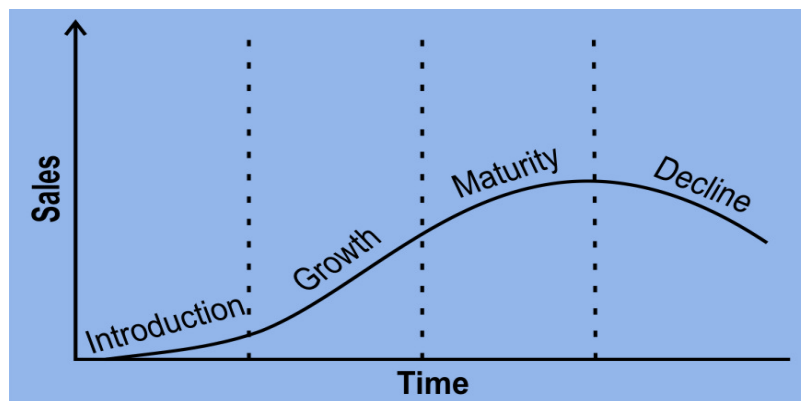


Figure: Product Life Cycle

The main advantage of PLC approach is that it can be used to diagnose a portfolio of products (or businesses) in order to establish the stage at which each of them exists. Particular attention is to be paid on the businesses that are in the declining stage. Depending on the diagnosis, appropriate strategic choice can be made. For instance, expansion may be a feasible alternative for businesses in the introductory and growth stages. Mature businesses may be used as sources of cash for investment in other businesses which need resources. A combination of strategies like selective harvesting, retrenchment, etc. may be adopted for declining businesses. In this way, a balanced portfolio of businesses may be built up by exercising a strategic choice based on the PLC concept.

2.4.2 Value Chain Analysis

With each transaction, successful businesses produce value for their consumers in the form of satisfaction and profits for themselves and their shareholders. Companies that generate more value are more likely to profit than those that generate less value. Understanding value chain of an organisation is critical for evaluating how much value it generates. Value chain analysis is a method used by strategists to break down each process that their business employs. This analysis could be used to improve the sequence of operations, enhancing efficiency and creating a competitive advantage. Value chain analysis can be used by businesses of all sizes, from sole proprietorships to multinational organisations. Each

organisation has a unique set of procedures to perform its duties, and they may all benefit from value chain analysis to evaluate and optimise their processes.

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

Value chain analysis has been widely used as a means of describing the activities within and around an organization and relating them to an assessment of the competitive strength of an organization (or its ability to provide value-for-money products or services). Value chain analysis was originally introduced as an accounting analysis to shed light on the 'value added' of separate steps in complex manufacturing processes, in order to determine where cost improvements could be made and/or value creation improved. The two basic steps of identifying separate activities and assessing the value added from each were linked to an analysis of an organization's competitive advantage by Michael Porter.

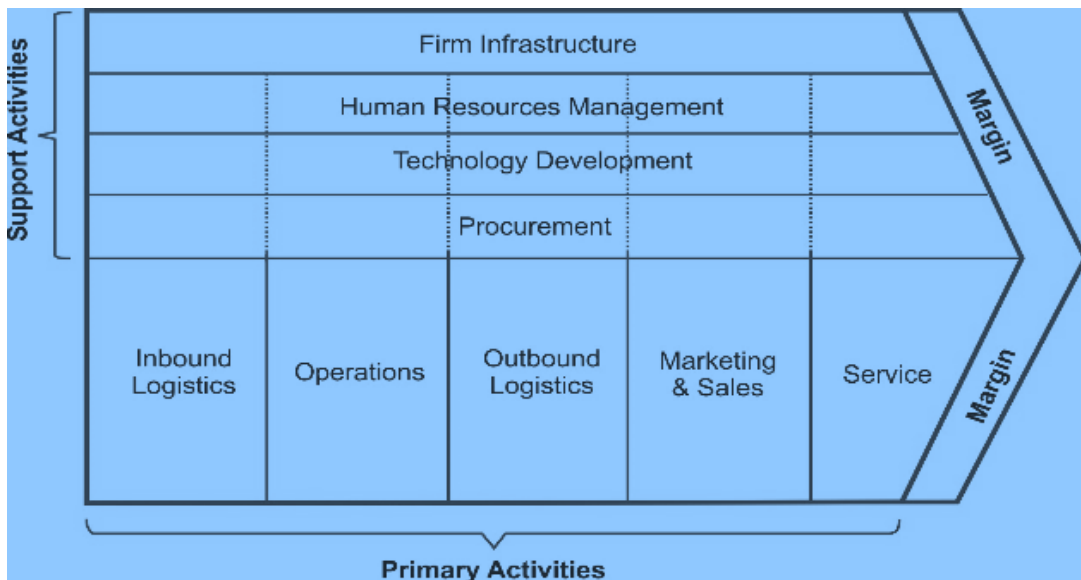


Figure: Value Chain (Michael Porter)

One of the key aspects of value chain analysis is the recognition that organizations are much more than a random collection of machines, material, money and people. These resources are of no value unless deployed into activities and organised into systems and routines which ensure that products or services are produced which

are valued by the final consumer/user. In other words, it is these competences to perform particular activities and the ability to manage linkages between activities which are the source of competitive advantage for organizations. Porter argued that an understanding of strategic capability must start with an identification of these separate value activities.

The primary activities of the organization are grouped into five main areas: inbound logistics, operations, outbound logistics, marketing and sales, and service.

- ◆ **Inbound logistics** are the activities concerned with receiving, storing and distributing the inputs to the product/service. This includes materials handling, stock control, transport etc. Like, transportation and warehousing.
- ◆ **Operations transform these inputs into the final product or service:** machining, packaging, assembly, testing, etc. convert raw materials in finished goods.
- ◆ **Outbound logistics** collect, store and distribute the product to customers. For tangible products this would be warehousing, materials handling, transport, etc. In the case of services, it may be more concerned with arrangements for bringing customers to the service, if it is a fixed location (e.g. sports events).
- ◆ **Marketing and sales** provide the means whereby consumers/users are made aware of the product/service and are able to purchase it. This would include sales administration, advertising, selling and so on. In public services, communication networks which help users' access a particular service are often important.
- ◆ **Service** are all those activities, which enhance or maintain the value of a product/service, such as installation, repair, training and spares.

Each of these groups of primary activities are linked to **support activities**. These can be divided into four areas;

- ◆ **Procurement:** This refers to the processes for acquiring the various resource inputs to the primary activities (not to the resources themselves). As such, it occurs in many parts of the organization.
- ◆ **Technology development:** All value activities have a 'technology', even if it is simply know-how. The key technologies may be concerned directly with the

product (e.g. R&D product design) or with processes (e.g. process development) or with a particular resource (e.g. raw materials improvements).

- ◆ **Human resource management:** This is a particularly important area which transcends all primary activities. It is concerned with those activities involved in recruiting, managing, training, developing and rewarding people within the organization.
- ◆ **Infrastructure:** The systems of planning, finance, quality control, information management, etc. are crucially important to an organization's performance in its primary activities. Infrastructure also consists of the structures and routines of the organization which sustain its culture.



2.5 INDUSTRY ENVIRONMENT ANALYSIS

A combination of ideas and methodologies may be utilised to create a clear picture of key industry traits, competition intensity, industry change drivers, rival firms' market positions and tactics, competitive success, and profit forecasts. Industry analysis enable strategic understanding about the entire state of any industry and make decisions about whether the industry is a lucrative or not.

The goal of the industry environment analysis, which is typically an important step of strategic analysis, is to estimate the amount of competitive pressures the business is presently facing and is expected to face in the near future.

The analysis entails seeing the firm in the context of a bigger framework. The purpose of industrial analysis is to get insight into a wide range of elements within and outside the business. Analysing these elements enhances knowledge of surrounding and serves as the foundation for aligning strategy with changing industry circumstances and realities.

2.5.1 Porter's Five Forces Model

Every business operates in the competitive environment. Competitive state of an industry applies a strong influence on how firms develop their strategies. Porter's Five Forces analysis is a simple but efficient way for determining the key sources of competition in business or industry. It is a powerful and widely used tool to systematically diagnose the significant competitive pressures in a market and assess the strength and importance of each. Understanding the variables that affect

Am Swade!

industry helps to adapt strategy, boost profitability, and stay ahead of the competition. Strategist may use a strong position to organizational advantage or reinforce a weak one to avoid making mistakes in the future.

Michael Porter believes that the basic unit of analysis for understanding is a group of competitors producing goods or services that compete directly with each other. It is the industry where competitive advantage is ultimately won or lost. It is through competitive strategy that the organisation attempts to adopt an approach to compete in the industry.

The character, mix, and intricacies of competitive forces are never the same from one industry to another. The model holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market:

- ◆ Competitive pressures associated with the market manoeuvring and jockeying for buyer patronage that goes on among rival sellers in the industry.
- ◆ Competitive pressures associated with the threat of new entrants into the market.
- ◆ Competitive pressures coming from the attempts of companies in other industries to win buyers over to their own substitute products.
- ◆ Competitive pressures stemming from supplier bargaining power and supplier-seller collaboration.
- ◆ Competitive pressures stemming from buyer bargaining power and seller-buyer Collaboration.

The strategists can use the five-forces model to determine what competition is like in a given industry by undertaking the following steps:

Step 1: Identify the specific competitive pressures associated with each of the five forces.

Step 2: Evaluate how strong the pressures comprising each of the five forces are (fierce, strong, moderate to normal, or weak).

Step 3: Determine whether the collective strength of the five competitive forces is conducive to earning attractive profits.

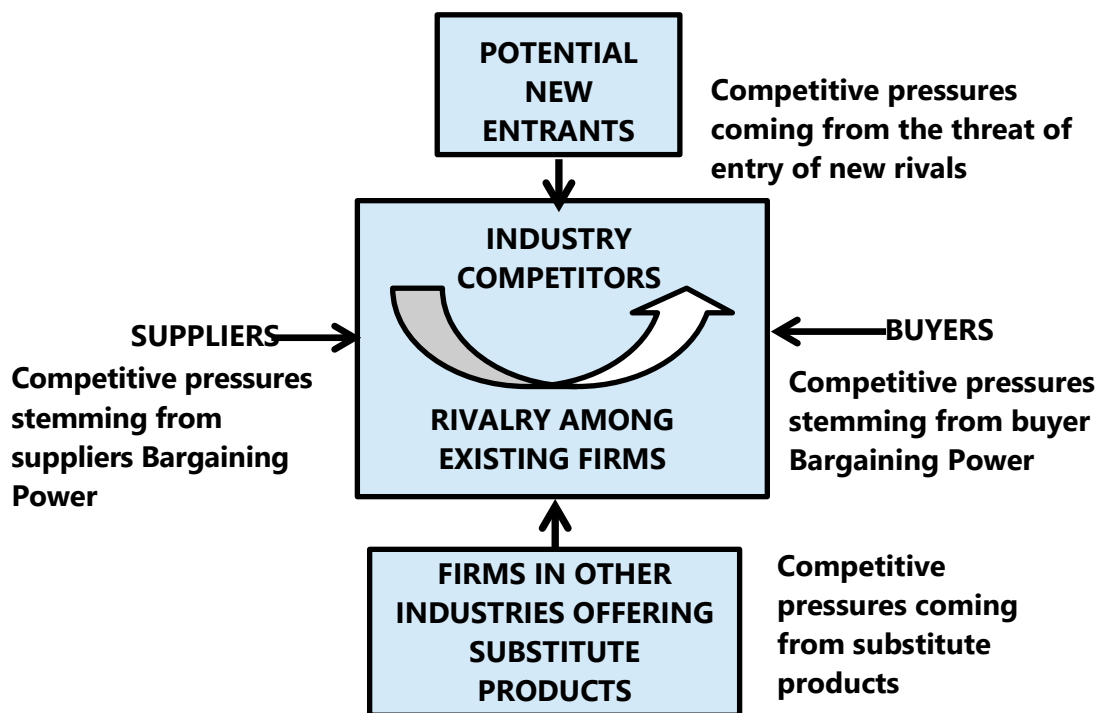


Figure: Porter's Five Force Model of Competition

Porter's five forces model is one of the most effective and enduring conceptual frameworks used to assess the nature of the competitive environment and to describe an industry's structure. The interrelationship among these five forces gives each industry its own particular competitive environment. By applying Porter's five forces model of industry attractiveness to their own industries, the manager can gauge their own firm's strengths, weaknesses, and future opportunities.

I. The Threat of New Entrants

New entrants can reduce industry profitability because they add new production capacity leading to an increase supply of the product even at a lower price and can substantially erode existing firm's market share position. New entrants are always a powerful source of competition. The new capacity and product range they bring in throw up new competitive pressure. And the bigger the new entrant, the more severe the competitive effect. New entrants also place a limit on prices and affect the profitability of existing players. A

firm's profitability tends to be higher when other firms are blocked from entering the industry.

To discourage new entrants, existing firms can try to raise barriers to entry. Barriers to entry represent economic forces (or 'hurdles') that slow down or impede entry by other firms. Common barriers to entry include, capital requirements, economies of scale, product differentiation, switching costs, brand identity, access to distribution channels and possibility of aggressive retaliation by existing players. These are explained as follows:

- (i) **Capital Requirements:** When a large amount of capital is required to enter an industry, firms lacking funds are effectively barred from the industry, thus enhancing the profitability of existing firms in the industry.
- (ii) **Economies of Scale:** Many industries are characterized by economic activities driven by economies of scale. Economies of scale refer to the decline in the per-unit cost of production (or other activity) as volume grows. A large firm that enjoys economies of scale can produce high volumes of goods at successively lower costs. This tends to discourage new entrants.
- (iii) **Product Differentiation:** Product differentiation refers to the physical or perceptual differences, or enhancements, that make a product special or unique in the eyes of customers. Firms in the personal care products and cosmetics industries actively engage in product differentiation to enhance their products' features. Differentiation works to reinforce entry barriers because the cost of creating genuine product differences may be too high for the new entrants.
- (iv) **Switching Costs:** To succeed in an industry, new entrant must be able to persuade existing customers of other companies to switch to its products. To make a switch, buyers may need to test a new firm's product, negotiate new purchase contracts, and train personnel to use the equipment, or modify facilities for product use. Buyers often incur substantial financial (and psychological) costs in switching between firms. When such switching costs are high, buyers are often reluctant to change.

- (v) **Brand Identity:** The brand identity of products or services offered by existing firms can serve as another entry barrier. Brand identity is particularly important for infrequently purchased products that carry a high unit cost to the buyer. New entrants often encounter significant difficulties in building up the brand identity, because to do so they must commit substantial resources over a long period.
- (vi) **Access to Distribution Channels:** The unavailability of distribution channels for new entrants poses another significant entry barrier. Despite the growing power of the internet, many firms may continue to rely on their control of physical distribution channels to sustain a barrier to entry to rivals. Often, existing firms have significant influence over the distribution channels and can retard or impede their use by new firms.
- (vii) **Possibility of Aggressive Retaliation:** Sometimes the mere threat of aggressive retaliation by incumbents can deter entry by other firms into an existing industry. **For example**, introduction of products by a new firm may lead incumbents firms to reduce their product prices and increase their advertising budgets.

II **Bargaining Power of Buyers**

This is another force that influences the competitive condition of the industry. This force will become heavier depending on the possibilities of the buyers forming groups or cartels. Mostly, this is a phenomenon seen in industrial products. Quite often, users of industrial products come together formally or informally and exert pressure on the producer. The bargaining power of the buyers influences not only the prices that the producer can charge but also influences in many cases, costs and investments of the producer because powerful buyers usually bargain for better services which involve costs and investment on the part of the producer.

Buyers of an industry's products or services can sometimes exert considerable pressure on existing firms to secure lower prices or better services. This leverage is particularly evident when:

- (i) Buyers have full knowledge of the sources of products and their substitutes.

- (ii) They spend a lot of money on the industry's products i.e. they are big buyers.
- (iii) The industry's product is not perceived as critical to the buyer's needs and buyers are more concentrated than firms supplying the product. They can easily switch to the substitutes available.

III. Bargaining Power of Suppliers

Quite often suppliers, too, exercise considerable bargaining power over companies. The more specialised the offering from the supplier, greater is his clout. And, if the suppliers are also limited in number, they stand a still better chance to exhibit their bargaining power. The bargaining power of suppliers determines the cost of raw materials and other inputs of the industry and, therefore, industry attractiveness and profitability.

Suppliers can influence the profitability of an industry in a number of ways. Suppliers can command bargaining power over a firm when:

- (i) Their products are crucial to the buyer and substitutes are not available.
- (ii) They can erect high switching costs.
- (iii) They are more concentrated than their buyers.

IV. The Nature of Rivalry in the Industry

The rivalry among existing players is quite obvious. This is what is normally understood as competition. For any player, the competitors influence strategic decisions at different strategic levels. The impact is evident more at functional level in the prices being charged, advertising, and pressures on costs, product and so on.

The intensity of rivalry in an industry is a significant determinant of industry attractiveness and profitability. The intensity of rivalry can influence the costs of suppliers, distribution, and of attracting customers and thus directly affect the profitability. The more intensive the rivalry, the less attractive is the industry. Rivalry among competitors tends to be cutthroat and industry profitability low under various conditions explained as follows:

- (i) **Industry Leader:** A strong industry leader can discourage price wars by disciplining initiators of such activity. Because of its greater financial

resources, a leader can generally outlast smaller rivals in a price war. Knowing this, smaller rivals often avoid initiating such a contest.

- (ii) **Number of Competitors:** Even when an industry leader exists, the leader's ability to exert pricing discipline diminishes with the increased number of rivals in the industry as communicating expectations to players becomes more difficult.
- (iii) **Fixed Costs:** When rivals operate with high fixed costs, they feel strong motivation to utilize their capacity and therefore are inclined to cut prices when they have excess capacity. Price cutting causes profitability to fall for all firms in the industry as firms seek to produce more to cover costs that must be paid regardless of industry demand. For this reason, profitability tends to be lower in industries characterized by high fixed costs.
- (iv) **Exit Barriers:** Rivalry among competitors declines if some competitors leave an industry. Profitability therefore tends to be higher in industries with few exit barriers. Exit barriers come in many forms. Assets of a firm considering exit may be highly specialized and therefore of little value to any other firm. Such a firm can thus find no buyer for its assets. This discourages exit. When barriers to exit are powerful, competitors desiring exit may refrain from leaving. Their continued presence in an industry exerts downward pressure on the profitability of all competitors.
- (v) **Product Differentiation:** Firms can sometimes insulate themselves from price wars by differentiating their products from those of rivals. As a consequence, profitability tends to be higher in industries that offer opportunity for differentiation. Profitability tends to be lower in industries involving undifferentiated commodities such as, memory chips, natural resources, processed metals and railroads.
- (vi) **Slow Growth:** Industries whose growth is slowing down tend to face more intense rivalry. As industry growth slows, rivals must often fight harder to grow or even to keep their existing market share. The resulting intensive rivalry tends to reduce profitability for all.

V. Threat of Substitutes

Substitute products are a latent source of competition in an industry. In many cases they become a major constituent of competition. Substitute products offering a price advantage and/or performance improvement to the consumer can drastically alter the competitive character of an industry. And they can bring it about all of a sudden. **For example**, coir suffered at the hands of synthetic fibre. Wherever substantial investment in R&D is taking place, threats from substitute products can be expected. Substitutes, too, usually limit the prices and profits in an industry.

A final force that can influence industry profitability is the availability of substitutes for an industry's product. To predict profit pressure from this source, firms must search for products that perform the same, or nearly the same, function as their existing products. **For example**, Real estate, insurance, bonds and bank deposits for example are clear substitutes for common stocks, because they represent alternate ways to invest funds.

The five forces together determine industry attractiveness/ profitability. This is so because these forces influence the causes that underlie industry attractiveness/ profitability. **For example**, elements such as cost and investment needed for being a player in the industry decide industry profitability, and all such elements are governed by these forces. The collective strength of these five competitive forces determines the scope to earn attractive profits. The strength of the forces may vary from industry to industry.

2.5.2 Attractiveness of Industry

The industry analysis culminates into identification of various issues and draw conclusions about the relative attractiveness or unattractiveness of the industry, both near-term and long-term. Strategists assess the industry outlook carefully, deciding whether industry and competitive conditions present an attractive business opportunity for the organisation or whether its growth and profit prospects are gloomy. This is important because companies invest capital, either the promoters or from the public and should be inherent careful in choosing an industry. The important factors on which the management may base such conclusions include:

- ◆ The industry's growth potential, is it futuristically viable?

- ◆ Whether competition currently permits adequate profitability and whether competitive forces will become stronger or weaker?
- ◆ Whether industry profitability will be favourably or unfavourably affected by the prevailing driving forces?
- ◆ The competitive position of an organisation in the industry and whether its position is likely to grow stronger or weaker. (Being a well-entrenched leader or strongly positioned contender in an otherwise lackluster industry can still produce good profitability; however, having to fight an uphill battle against much stronger rivals can make an otherwise attractive industry unattractive).
- ◆ The potential to capitalize on the vulnerabilities of weaker rivals (perhaps converting an unattractive industry situation into a potentially rewarding company opportunity).
- ◆ Whether the company is able to defend against or counteract the factors that make the industry unattractive?
- ◆ The degrees of risk and uncertainty in the industry's future.
- ◆ The severity of problems confronting the industry as a whole.
- ◆ Whether continued participation in this industry adds importantly to the firm's ability to be successful in other industries in which it may have business interests?

As a general proposition, if an industry's overall profit prospects are above average, the industry can be considered attractive; if its profit prospects are below average, it is unattractive. However, it is a mistake to think of industries as being attractive or unattractive to all firms in the industry and all potential entrants. Attractiveness is relative, not absolute. Industry environments unattractive to weak competitors may be attractive to strong competitors.

An assessment that the industry is fundamentally attractive typically suggests that current industry participants employ strategies calculated to strengthen their long-term competitive positions in the business, expanding sales efforts and investing in additional facilities and equipment as needed. If the industry and competitive situation is judged relatively unattractive, more successful industry participants may choose to invest cautiously, look for ways to protect their long-term competitiveness and profitability, and perhaps acquire smaller firms if the price is right; over the longer term, strong companies may consider diversification into more attractive businesses. Weak companies in unattractive industries may

consider merging with a rival to bolster market share and profitability or, alternatively, begin looking outside the industry for attractive diversification opportunities.

2.5.3 Experience Curve

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:

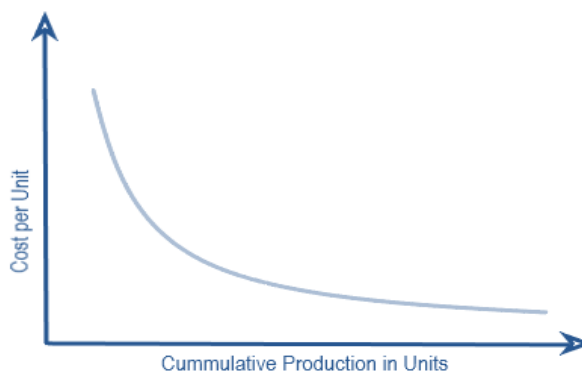


Figure: Experience curve

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, 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. In the contemporary Indian automobile industry, the experience curve phenomenon seems to be working in Maruti Suzuki. The likely strategic choice for competitors can be a market niche approach or segmentation based on demography or geography.

2.5.4 Value Creation

The concept of value creation was introduced primarily for providing products and services to the customers with more worth. Value is measured by a product's features, quality, availability, durability, performance and by its services for which customers are willing to pay. Further, the concept took more space in the business and organizations started discussing about the value creation for stakeholders.

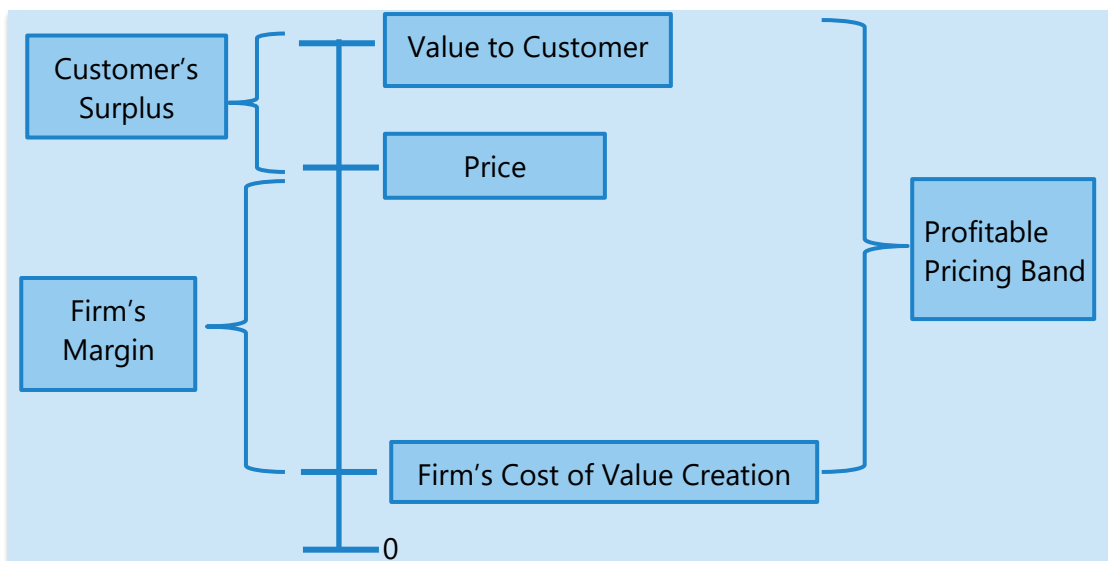


Figure: Value Creation

Thus, we can say that the value creation is an activity or performance by the firm to create value that increases the worth of goods, services, business processes or even the whole business system. Many businesses now focus on value creation both

in the context of creating better value for customers purchasing its products and services, as well as for stakeholders in the business who want to see their investment in business appreciate in value. Ultimately, this concept gives business a competitive advantage in the industry and helps them earn above average profits/returns.

Competitive advantage leads to superior profitability. At the most basic level, how profitable a company becomes depends on three factors:

- (1) the value customers place on the company's products;
- (2) the price that a company charges for its products; and
- (3) the costs of creating those products.

The value customers place on a product reflects the utility they get from a product—the happiness or satisfaction gained from consuming or owning the product. Utility must be distinguished from price. Utility is something that customers get from a product. It is a function of the attributes of the product, such as its performance, design, quality, and point-of-sale and after-sale service.

Companies are ultimately aiming to achieve sustainable competitive advantage, which enables them to succeed in the long run. Michael Porter argues that a company can generate competitive advantage in two different ways, either through differentiation or cost advantage. According to Porter's, differentiation means the capability to provide customers superior and special value in the form of product's special features and quality or in the form of aftersales customer service. As a result of differentiation, a company can demand higher price for its products or services. A company will earn higher profits due to differentiation in case the expenses stay comparable to the costs of competitors.

The above-mentioned differentiation and cost advantage will affect a company's ability to achieve competitive advantage, but there are many different organizational functions that will influence whether a company can achieve cost advantage or differentiation advantage. Michael Porter used the concept of value chain to explore closer different functions of the organisations and mutual interactions among those functions. Value chain analysis provides an excellent tool to examine the origin of competitive advantage. It divides the organisations into two different strategically important group of activities, namely, primary activities

and supporting activities, which can help to comprehend the potential sources for differentiation and to understand an organisation's costs behaviour.

It is basically the value consumer wants to pay, over and above the price that the business wants to charge from the consumer. This excess amount is called value creation, wherein the consumers value the product or service more than it actually costs them.



2.6 MARKET AND CUSTOMER

A market is a place for interested parties, buyers and sellers, where items and services can be exchanged for a price. The market might be physical, such as a departmental store where people engage in person. They may also be virtual, such as an online market where buyers and sellers do not meet in person but tools of technology to strike a deal. In addition to this broad definition, the term market can apply to a wide range of contexts. **For example**, it might be used to describe the stock exchange, where securities are traded. It may also refer to a group of individuals trying to buy a specific commodity or service in a specific place, such as grain or vegetable market where farmers come to sell their produce. It may also be used to define a business or industry, such as the global oil market.

While the market is a place, business strategist work on marketing to improve the chances of success. The term "marketing" encompasses a wide range of operations, including research, designing, pricing, promotion, transportation, and distribution. Often market activities are categorised and explained in terms of four Ps of marketing – product, place, pricing, and promotion. These four kinds of marketing activities help marketers identify customer needs so they may meet their demands and deliver satisfaction. Delivering the best customer experience and establishing, maintaining, and growing relationships with customers are the main goals of marketing.

The orientation of product marketing has evolved and acquired different dimensions centred around product, production, sales and customers. Businesses that have product orientation think that buyers will choose those products that have the best quality, performance, design, or features. Next, there are production-oriented businesses that believe that customers choose low price products. Sales-

oriented businesses believe that if they spend enough money on advertisement, sales and promotion, customers can be persuaded to make a purchase.

In a customer or market-oriented approach strategists prioritise efforts on their customers. In order to create better value propositions for customers, businesses gather, disseminate, and use customer and competitive information. A customer-centric business is one that continuously learn from its customers' needs and market dynamics. In the present times success, many business lies in customer centric approaches.

2.6.1 Customer

A customer is a person or business that buys products or services from another organisation. Customers are important because they provide revenue and organisations cannot exist without them. All businesses vie for customers, either by aggressively marketing their products or by lowering their pricing to boost their customer bases. The terms customer and consumer are practically synonymous and are frequently used interchangeably. There is, however, a thin distinction. Individuals or businesses that consume or utilise products and services are referred to as consumers. Customers are the purchasers of products and services in the economy, and they might exist as consumers or only as customers. In homes groceries are often bought by a parent and consume by all the members of family.

Businesses routinely research the characteristics of their consumers in order to fine-tune their marketing strategies and adjust their inventory to attract the most customers. Customers are frequently categorised based on demographics like as age, race, gender, ethnicity, economic level, and geographic region, which may all assist businesses in developing a profile of a perfect customer.

2.6.2 Customer Analysis

Customer analysis is an essential marketing component of any strategic business plan. It identifies target clients, determines their wants, and then defines how the product meets those needs. Thus, it involves the examination and evaluation of consumer needs, desires, and wants.

Customer analysis includes the administration of customer surveys, the study of consumer data, the evaluation of market positioning strategies, development of

customer profiles, and the selection of the best market segmentation techniques. Using the facts generated by customer analysis, an effective profiling of customers may be established. Customer profiles can reveal demographic information about customers. A number of parties, including buyers, sellers, distributors, salespeople, managers, wholesalers, retailers, suppliers, and creditors, can assist in gathering information to effectively assess the needs and desires of consumers. Successful businesses constantly monitor the behaviour of existing and prospective customers.

2.6.3 Customer Behaviour

Customer behaviour moves beyond the identification of customers to explain how they purchase products. It examines elements like shopping frequency, product preferences, and the perception of your marketing, sales, and service offerings. Understanding these details allows businesses to communicate with customers in an effective manner. Understanding the behaviours of customers enables businesses to establish effective marketing and advertising campaigns, provide products and services that meet their needs, and retain customers for repeat sales.

Consumer behaviour may be influenced by a number of things. These elements can be categorised into the following three conceptual domains:

- ◆ **External Influences:** External influences, like advertisement, peer recommendations or social norms, have a direct impact on the psychological and internal processes that influence various consumer decisions. The focus of external effects is on the numerous elements that have an impact on customers as they choose which needs to satisfy and which products to use to do so. These aspects are divided into two groups – the company's marketing efforts and the numerous environmental elements.
- ◆ **Internal Influences:** Internal processes are psychological factors internal to customer and affect consumer decision making. Consumer behaviour is influenced by a combination of internal and external influences, including motivation and attitudes.

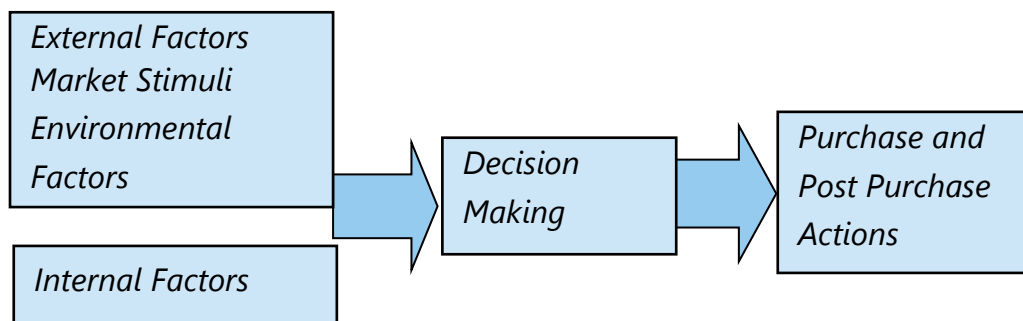


Figure: Process of consumer behaviour

- ◆ **Decision Making:** A rational consumer, as decision maker would seek information about potential decisions and carefully integrate this with the existing knowledge about the product. After weighing the advantages and disadvantages of each option, they would make a decision. The stages of decision making process can be described as:

- Problem recognition, i.e., identify an existing need or desire that is unfulfilled
- Search for desirable alternative and list them
- Seeking information on available alternatives and weighing their pros and cons.
- Make a final choice

This behaviour of making decisions happens very frequently. However, it mostly applies when the purchase is one that is significant to the customer, such as when the product could have a significant influence on their health or self-image. The process is extremely valid when purchasing a car, television or a refrigerator in contrast to purchase of ice creams or soft drinks.

- ◆ **Post-decision Processes:** After making a decision and purchasing a product, the final phase in the decision-making process is evaluating the outcome. The consumer's reaction may vary depending upon the satisfaction. While a happy customer may make repeat purchase and recommend to others, customer with dissonance will neither purchase the product again nor recommend it to others.



2.7 COMPETITIVE STRATEGY

Competition is a fundamental attribute of economic systems and business, and it is frequently connected with small and large organisations. Businesses compete with each other for the same set of resources and customers. Within an industry, competition is frequently encouraged with the wider goal of attaining and achieving higher quality services or superior goods that the firm may manufacture or develop.

The competitive strategy of a business is concerned with how to compete in the business areas in which the organization operates. In other words, competitive strategy defines how a firm expects to create and sustain a competitive advantage over competitors. Having a competitive advantage over competitors means being more profitable in the long run. The competitive strategy of a firm within a certain business field is analysed using two criteria: **the creation of competitive advantage and the protection of competitive advantage.**

An important component of industry and competitive analysis involves delving into the industry's competitive process to discover what the main sources of competitive pressure are and how strong each competitive force is. This analytical step is essential because managers cannot devise a successful strategy without in-depth understanding of the industry's competitive character. Even though competitive pressures in various industries are never precisely the same, the competitive process works similarly enough to use a common analytical framework in gauging the nature and intensity of competitive forces.

Porter's five forces model is useful in understanding the competition. It is a powerful tool for systematically diagnosing the main competitive pressures in a market and assessing how strong and important each one is. Not only is it the widely used technique of competition analysis, but it is also relatively easy to understand and apply.

2.7.1 COMPETITIVE LANDSCAPE

Competitive landscape is a business analysis which identifies competitors, either direct or indirect. Competitive landscape is about identifying and understanding the competitors and at the same time, it permits the comprehension of their vision, mission, core values, niche market, strengths and weaknesses. Understanding of competitive landscape requires an application of "competitive intelligence".

An in-depth investigation and analysis of a firm's competition allows it to assess the competitor's strengths and weaknesses in the marketplace and helps it to choose and implement effective strategies that will improve its competitive advantage. Thus, understanding the competitive landscape is important to build upon a competitive advantage.

Steps to understand the Competitive Landscape

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

This answers the question:

- Who are the competitors and how big are they?

- 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.

This answers the question:

- What are their product and services?

- iii. **Determine the strengths of the competitors:** What are the strengths of the competitors? What do they do well? Do they offer great products? Why are consumers liking their product/service? Do they utilize marketing in a way that comparatively reaches out to more consumers? Why do customers give them their business?

This answers the questions:

- What are their financial positions?
- What gives them cost and price advantage?
- What are they likely to do next?
- How strong is their distribution network?
- What are their human resource strengths?

- iv. **Determine the weaknesses of the competitors:** Identify the areas where the competitor is lacking or is weak. Weaknesses (and strengths) can be

identified by going through consumer reports and reviews appearing in various media. Financial strength and weakness can always be learnt from annual reports.

This answers the question.

➤ Where are they lacking?

- 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.

This answers the questions:

- What will the business do with this information?
➤ What improvements does the firm need to make?
➤ How can the firm exploit the weaknesses of competitors?

2.7.2 Key factors for competitive success

An industry's Key Success Factors (KSFs) are those things that most affect industry members' ability to prosper in the marketplace - the particular strategy elements, product attributes, resources, competencies, competitive capabilities, and business outcomes that spell the difference between profit and loss and, ultimately, between competitive success or failure. KSFs by their very nature are so important that all firms in the industry must pay close attention to them.

Key success factors are the prerequisites for industry success or, to put it another way, KSFs are the factors that shape whether a company will be financially and competitively successful.

The answers to three questions help identify an industry's key success factors:

- ◆ On what basis do customers choose between the competing brands of sellers? What product attributes are crucial to sales?
- ◆ What resources and competitive capabilities does a seller need to have to be competitively successful, better human capital, quality of product or quantity of product, cost of service, etc.?

- ◆ What does it take for sellers to achieve a sustainable competitive advantage, something that can be sustained for long term?

For example, in apparel manufacturing, the KSFs are appealing designs and colour combinations (to create buyer interest) and low-cost manufacturing efficiency (to permit attractive retail pricing and ample profit margins).

Determining the industry's key success factors, given prevailing and anticipated industry and competitive conditions, is a top-priority analytical consideration. At the very least, managers need to understand the industry situation well enough to know what is more important to competitive success and what is less important. They need to know what kind of resources are competitively valuable. Misdiagnosing the industry factors critical to long-term competitive success greatly raises the risk of a misdirected strategy. In contrast, an organisation with perceptive understanding of industry KSFs can gain sustainable competitive advantage by training its strategy on industry KSFs and devoting its energies to being distinctively better than rivals on one or more of these factors. Indeed, business organisations that stand out on a particular KSF enjoy a stronger market position for their, efforts-being distinctively better than rivals on one or more key success factors presents a golden opportunity for gaining competitive advantage. Hence, using the industry's KSFs as cornerstones for the company's strategy and trying to gain sustainable competitive advantage by excelling at one particular KSF is a fruitful competitive strategy approach.

Key success factors vary from industry to industry and even from time to time within the same industry as driving forces and competitive conditions change. Only rarely does an industry have more than three or four key success factors at any one time. And even among these three or four, one or two usually outrank the others in importance. Managers, therefore, have to resist the temptation to include factors that have only minor importance on their list of key success factors. The purpose of identifying KSFs is to make judgments about what things are more important to competitive success and what things are less important. To compile a list of every factor that matters even a little bit defeats the purpose of concentrating management attention on the factors truly critical to long-term competitive success.

SUMMARY

In this chapter, we learnt about the concept of strategic analysis, which is an important tool to appreciate and assess environment of business as it largely defines how an organisation conducts its operations. We have also discussed in detail the environmental influences on business functioning and competition. Employees, customer demands and expectations, supply and demand, management, clients, suppliers, owners, government actions, technological innovation, social trends, market trends, economic changes, and so on are all part of the business environment.

Modern businesses face competitive challenges covering condition in a market in which businesses or sellers struggle for the attention of buyers in order to attain a certain commercial goal. We explored competition and competitive landscape, which is a business analysis to identify competitors, either direct or indirect. The chapter also covered PESTLE analysis, product life cycle, experience curve, competitive analysis and value chain analysis,

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *KSFs stand for:*
 - (a) *Key strategic factors*
 - (b) *Key supervisory factors*
 - (c) *Key success factors*
 - (d) *Key sufficient factors*
2. *Competitive landscape requires the application of-*
 - (a) *Competitive advantage*
 - (b) *Competitive strategy*
 - (c) *Competitive acumen*
 - (d) *Competitive intelligence*

3. *The term PESTLE analysis is used to describe a framework for analyzing:*
 - (a) *Macro Environment*
 - (b) *Micro Environment*
 - (c) *Both Macro and Micro Environment*
 - (d) *None of above*
4. *'Attractiveness of firms' while conducting industry analysis should be seen in-*
 - (a) *Relative terms*
 - (b) *Absolute terms*
 - (c) *Comparative terms*
 - (d) *All of the above*
5. *What is not one of Michael Porter's five competitive forces?*
 - (a) *New entrants*
 - (b) *Rivalry among existing firms*
 - (c) *Bargaining power of unions*
 - (d) *Bargaining power of suppliers*
6. *Which of the following constitute Demographic Environment?*
 - (a) *Nature of economy i.e. capitalism, socialism, Mixed*
 - (b) *Size, composition, distribution of population, sex ratio*
 - (c) *Foreign trade policy of Government*
 - (d) *Economic policy i.e. fiscal and monetary policy of Government*
7. *All are elements of Macro environment except:*
 - (a) *Society*
 - (b) *Government*
 - (c) *Competitors*
 - (d) *Technology*

8. The emphasis on product design is very high, the intensity of competition is low, and the market growth rate is low in the _____ stage of the industry life cycle.
- (a) Maturity
 - (b) Introduction
 - (c) Growth
 - (d) Decline

Scenario Based Questions

1. ABC Corp, a multinational consumer electronics company, is planning to expand its operations into a new country. The company's senior management is evaluating the potential risks and opportunities of entering this new market. As part of their analysis, they decide to use the PESTLE framework to assess the external factors that could impact their decision. How can the PESTLE framework help ABC Corp assess the external factors affecting its decision to expand into a new country?

2. You are a strategic manager for a tech company launching a new smartphone model. The company wants to target tech-savvy consumers who value innovation and cutting-edge technology. Using the concept of customer behavior, develop a marketing strategy to promote the new smartphone.

3. GreenThrift Inc., a sustainable clothing retailer, is experiencing a surge in popularity due to the growing awareness of environmental issues among consumers. The company specializes in selling second-hand clothing and upcycled garments, offering an eco-friendly alternative to traditional fast fashion.

A major concern for GreenThrift Inc. is the emergence of new sustainable fashion brands in the market. These brands focus on using organic and recycled materials, as well as ethical manufacturing practices, which align with the values of environmentally conscious consumers.

4. Reshuffle Corp is a company that manufactures and sells office furniture. They offer a range of products, from desks and chairs to cabinets and shelves. Recently, the company has been facing increased competition from online retailers offering similar products at lower prices.

Analyzing the characteristics of products in the furniture industry, discuss how Reshuffle Corp can differentiate its products to maintain a competitive edge in the market.

5. *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.*
6. *A company has recently launched a new product in the market. Initially, it faced slow sales growth, limited markets, and high prices. However, over time, the demand for the product expanded rapidly, prices fell, and competition increased. Identify the stages of the product life cycle (PLC) that the company went through.*
7. *Rajiv Arya owns an electrical appliance company specializing in the manufacture of domestic vacuum cleaners. The market is competitive, with four other manufacturers offering similar products and achieving comparable sales volumes. Additionally, these rival firms hold several patents related to the vacuum cleaner technology. The supplier base for raw materials is extensive, with multiple suppliers available. Identify and explain the significant forces from Porter's Five Forces framework that are relevant to Rajiv Arya's company.*
8. *Suresh Singhania is the owner of an agri-based private company in Sangrur, Punjab. His unit is producing puree, ketchups and sauces. While its products have significant market share in the northern part of country, the sales are on decline in last couple of years. He seeks help of a management expert who advises him to first understand the competitive landscape.*

Explain the steps to be followed by Suresh Singhania to understand competitive landscape.

9. *Eco-carry bags Ltd., a recyclable plastic bags manufacturing, and trading company has seen a potential in the ever-growing awareness around hazards of plastics and the positive outlook of the society towards recycling and reusing plastics.*

A major concern for Eco-carry bags Ltd. are paper bags and old cloth bags. Even though they are costlier than recyclable plastic bags, irrespective, they are being welcomed positively by the consumers.

Identify and explain that competition from paper bags and old cloth bags fall under which category of Porter's Five Forces Model for Competitive Analysis?

10. Baby Turtle is a children's clothing brand that has been created a new age demand for washable diapers. The major benefit for the brand has been that not many companies have shown interest in the product, thinking it is not viable, however, customers, majorly working mothers are loving their product. The core material needed for production is also used in many other water proofing products in various industries. Baby Turtle sources this material from a renowned supplier at comparatively low prices. Which of the five forces of competitive pressure would Baby Turtle experience due to above setup and what are major factors that create such pressure for a product? Do you think Baby Turtle has an advantage in some way to fight off this pressure?

Descriptive Questions

1. Explain the concept of Experience Curve and highlight its relevance in strategic management.
2. Write a short note on Product Life Cycle (PLC) and its significance in portfolio diagnosis.
3. Explain Porter's five forces model as to how businesses can deal with the competition.

ANSWERS/SOLUTION

Answers to Multiple Choice Questions

1	(c)	2	(d)	3	(a)	4	(a)	5	(c)	6	(b)
7	(c)	8	(b)								

Answers to Scenario Based Questions

1. The PESTLE framework can help ABC Corp assess the external factors affecting its decision to expand into a new country by considering the following aspects:
 - ◆ **Political Factors:** These include the stability of the government, government policies on foreign investment, trade agreements, and regulatory frameworks. By analyzing these factors, ABC Corp can assess the political risks associated with entering the new market.
 - ◆ **Economic Factors:** Economic factors such as GDP growth rate, inflation rate, exchange rates, and economic stability can impact ABC Corp's decision. By analyzing these factors, the company can understand the economic environment of the new market and its potential impact on business operations.
 - ◆ **Social Factors:** Social factors such as cultural norms, demographics, and lifestyle trends can influence consumer behavior and demand for ABC Corp's products. Understanding these factors can help the company tailor its marketing strategies to the new market.
 - ◆ **Technological Factors:** Technological factors such as infrastructure, technological advancements, and the level of technology adoption in the new market can impact ABC Corp's operations. By assessing these factors, the company can determine the technological requirements for entering the new market.
 - ◆ **Legal Factors:** Legal factors such as laws and regulations related to foreign investment, intellectual property rights, and labor laws can impact ABC Corp's decision. By analyzing these factors, the company can ensure compliance with legal requirements in the new market.
 - ◆ **Environmental Factors:** Environmental factors such as climate change, environmental regulations, and sustainability practices can impact ABC Corp's operations and reputation. By considering these factors, the company can assess the environmental risks and opportunities in the new market.

Overall, the PESTLE framework can provide ABC Corp with a comprehensive analysis of the external factors that could impact its decision to expand into a new country, helping the company make informed and strategic decisions.

2. To target tech-savvy consumers for the new smartphone model, the tech company can develop a marketing strategy based on customer behavior. Consumer behaviour may be influenced by a number of things. These elements can be categorised into the following conceptual domains:

- ◆ **External Influences:** Utilize online platforms and tech forums to generate buzz around the new smartphone. Partner with tech influencers and bloggers to review the product and create awareness among tech-savvy consumers.
- ◆ **Internal Influences:** Appeal to the desire for innovation and advanced features among tech-savvy consumers. Highlight the unique selling points of the new smartphone, such as its cutting-edge technology, performance, and design.
- ◆ **Decision Making:** Recognize that tech-savvy consumers are early adopters who value functionality and performance. Provide detailed specifications and comparisons with other smartphones to help them make an informed decision.
- ◆ **Post-decision Processes:** Offer excellent customer service and support to address any technical issues or concerns. Encourage customers to provide feedback and reviews to build credibility and trust among tech-savvy consumers.

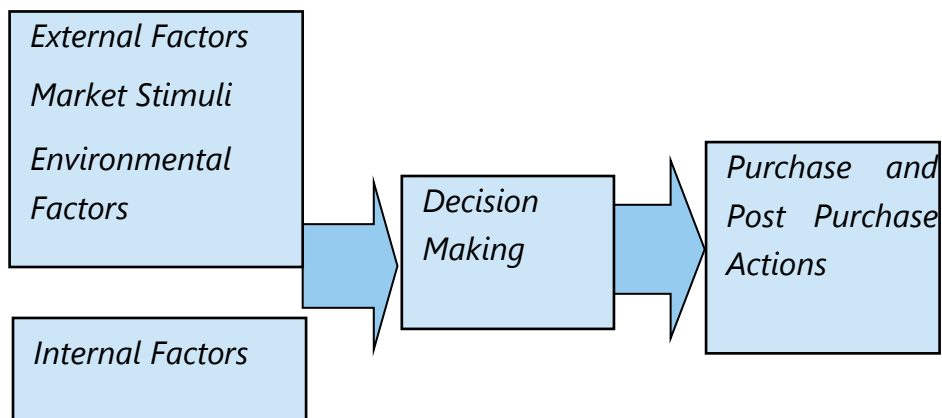


Figure: Process of consumer behaviour

By understanding the behavior of tech-savvy consumers and aligning the marketing strategy with their preferences, the tech company can effectively promote the new smartphone and attract this demographic.

3. Competition from new sustainable fashion brands falls under the "Threat of New Entrants" category of Porter's Five Forces Model for Competitive Analysis. These new entrants pose a threat to existing sustainable clothing retailers like *GreenThrift Inc.* by increasing competition and potentially eroding market share. The emergence of these brands, focusing on using organic and recycled materials along with ethical manufacturing practices, aligns with the values of environmentally conscious consumers, making them strong competitors in the sustainable fashion market.
4. To maintain a competitive edge in the face of increased competition, *Reshuffle Corp* can differentiate its products in several ways:
 - **Tangible and Intangible Aspects:** *Reshuffle Corp* can focus on the tangible aspects of its products, such as using high-quality materials and innovative designs to create furniture that is both functional and aesthetically pleasing. Additionally, they can emphasize the intangible aspects of their products, such as excellent customer service and a strong brand reputation for reliability and durability.
 - **Pricing Strategies:** While market prices are often dictated by competition, *Reshuffle Corp* can work on cost optimization to maintain profitability. They can also consider offering value-added services, such as free installation or extended warranties, to justify a higher price point.
 - **Product Features:** By continually optimizing their product features based on customer feedback and market trends, *Reshuffle Corp* can ensure that their products deliver maximum satisfaction to their target customers. This may include features that enhance functionality, design, quality, and overall user experience.
 - **Product Centric Approach:** *Reshuffle Corp* should keep their products at the center of their strategic activities, ensuring that all business

processes, from production to sales and marketing, are aligned to meet customer needs and expectations.

- **Product Life Cycle Management:** *Reshuffle Corp* should be aware of the life cycle of their products and plan for reinvention or replacement accordingly. They can introduce new product lines or upgrade existing ones to keep up with changing customer preferences and market trends.

5. 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.

6. 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.

7. The competitive rivalry will be a significant force in case of company of Rajiv Arya as all the rivals are similar in sizes and are manufacturing similar products. It is difficult for any single manufacturer to dominate the market. Large number of patents will make it difficult for new entrants to break into the market. Further, as there are a large number of small suppliers the power that suppliers can exert will also be low.

There is no information relating to substitutes and bargaining power of customers in the information given in scenario. However, a domestic vacuum cleaner will directly compete with other options such as house maids. Availability of house maids at low cost can significantly disturb the sales of products.

Further, as the products are similar customers can easily shift from one company to another. This will only enhance competitive rivalry.

8. Steps to understand the competitive landscape:
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 - (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.

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9. Eco-carry bags Ltd. faces competition from paper bags and old cloth bags and falls under *Threat of Substitutes* force categories in Porter's Five Forces Model for Competitive Analysis. Paper and cloth bags are substitutes of recyclable plastic bags as they perform the same function as plastic bags. Substitute products are a latent source of competition in an industry. In many cases, they become a major constituent of competition. Substitute products offering a price advantage and/or performance improvement to the consumer can drastically alter the competitive character of an industry.
10. Baby Turtle would experience, Bargaining Power of Suppliers, as a competitive pressure for their washable diaper product. This is because the core material for production is sourced from a single supplier, who is renowned and in a position to create pressure in terms of prices.

Further, other factors that lead to such pressure are:

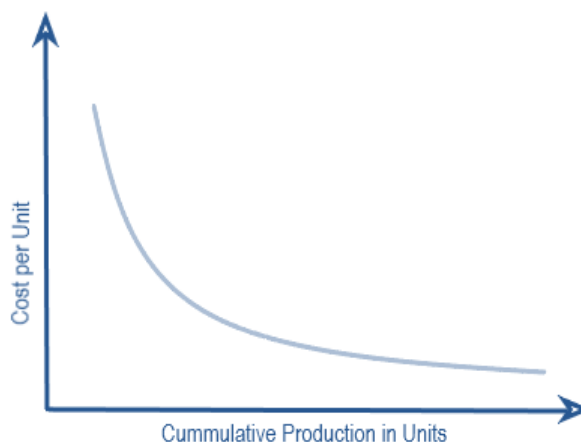
1. Their products are crucial to the buyer and substitutes to the material required for production are not available.
2. Suppliers can manipulate switching cost as the brand is in inception stage and making margins are important.

An advantage that Baby Turtle has is even though the material required has no substitutes, but it used to make many other products and thus there are

many other suppliers who can provide that material. It might affect operations in short term but will help to fight off the pressure created by existing supplier.

Answers to Descriptive Questions

1. Experience curve is similar to learning curve which explains the efficiency 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 represented diagrammatically as shown in the next page.



The implication is that larger firms in an industry would tend to have lower unit costs as compared to those of smaller organizations, 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.

The concept of experience curve is relevant for a number of areas in strategic management. For instance, 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.

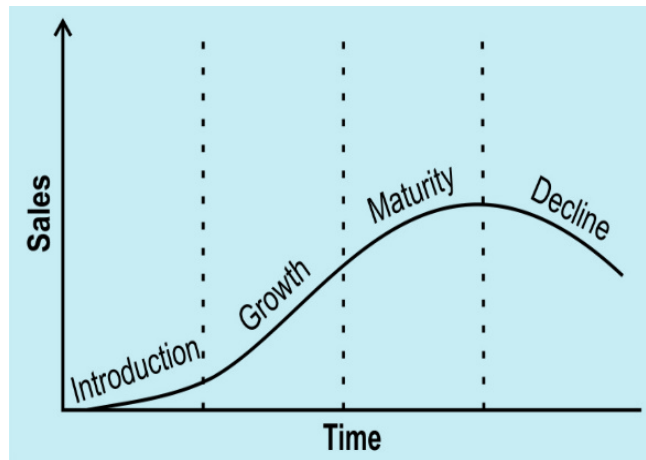
2. Product Life Cycle is an important concept in strategic choice and S-shaped curve which exhibits the relationship of sales with respect of time for a product that passes through the four successive stages.

The first stage of PLC is the introduction stage in which competition is almost negligible, prices are relatively high and markets are limited. The growth in sales is also at a lower rate.

The second stage of PLC is the growth stage, in which the demand expands rapidly, prices fall, competition increases and market expands.

The third stage of PLC is the maturity stage, where in the competition gets tough and market gets stabilized. Profit comes down because of stiff competition.

The fourth stage is the declining stage of PLC, in which the sales and profits fall down sharply due to some new product replaces the existing product.



Product Life Cycle

PLC can be used to diagnose a portfolio of products (or businesses) in order to establish the stage at which each of them exists. Particular attention is to be paid on the businesses that are in the declining stage. Depending on the diagnosis, appropriate strategic choice can be made. For instance, expansion may be a feasible alternative for businesses in the introductory and growth stages. Mature businesses may be used as sources of cash for investment in other businesses which need resources. A combination of strategies like selective harvesting, retrenchment, etc. may be adopted for declining businesses. In this way, a balanced portfolio of businesses may be built up by exercising a strategic choice based on the PLC concept.

3. To gain a deep understanding of a company's industry and competitive environment, managers do not need to gather all the information they can find and waste a lot of time digesting it. Rather, the task is much more focused. A powerful and widely used tool for systematically diagnosing the significant competitive pressures in a market and assessing the strength and importance of each is the Porter's five-forces model of competition. This model holds that the state of competition in an industry is a composite of competitive pressures operating in five areas of the overall market:
- Competitive pressures associated with the market manoeuvring and jockeying for buyer patronage that goes on among rival sellers in the industry.
 - Competitive pressures associated with the threat of new entrants into the market.
 - Competitive pressures coming from the attempts of companies in other industries to win buyers over to their own substitute products.
 - Competitive pressures stemming from supplier bargaining power and supplier-seller collaboration.
 - Competitive pressures stemming from buyer bargaining power and seller-buyer Collaboration.

3 CHAPTER

STRATEGIC ANALYSIS: INTERNAL ENVIRONMENT

The function of education is to teach one to think intensively and to think critically. Intelligence plus character - that is the goal of true education.

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68 Marks Arsalan Ali	67 Marks Abhay Nahar	67 Marks Harsh
66 Marks Ankita Rani	66 Marks Anshu Kumar	65 Marks Pulkrit Luthra
65 Marks Seerat Sharma	65 Marks Ayush Sharma	65 Marks Shubham

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78 Marks ANUSHKA SHARMA	77 Marks SAIKAT GHOSH	76 Marks NUZAIF AKTHAR	75 Marks KOMAL SANWAL	74 Marks ASHUTOSH KUMAR	73 Marks ARYAN MERATWAL
75 Marks SHALINI SONI	74 Marks NANDA CHATURVEDI	73 Marks DEEPANSHI JAIN	73 Marks KAUSHAL ARORA	73 Marks SONALI VIJ	72 Marks MAYURI PRAMOD
73 Marks PREETHAM BHAT	72 Marks ANKIT JAIN	72 Marks SANCHIT	72 Marks SONU AGRAWAL	71 Marks ANURAG AGGRAWAL	70 Marks CHIRAG JAIN
72 Marks TANYA BANSAL	70 Marks PARAS BANSAL	70 Marks RAJVI DILIP	70 Marks NITESH LAHU	70 Marks RAJSHREE	70 Marks YASH JAIN

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STRATEGIC ANALYSIS: INTERNAL ENVIRONMENT



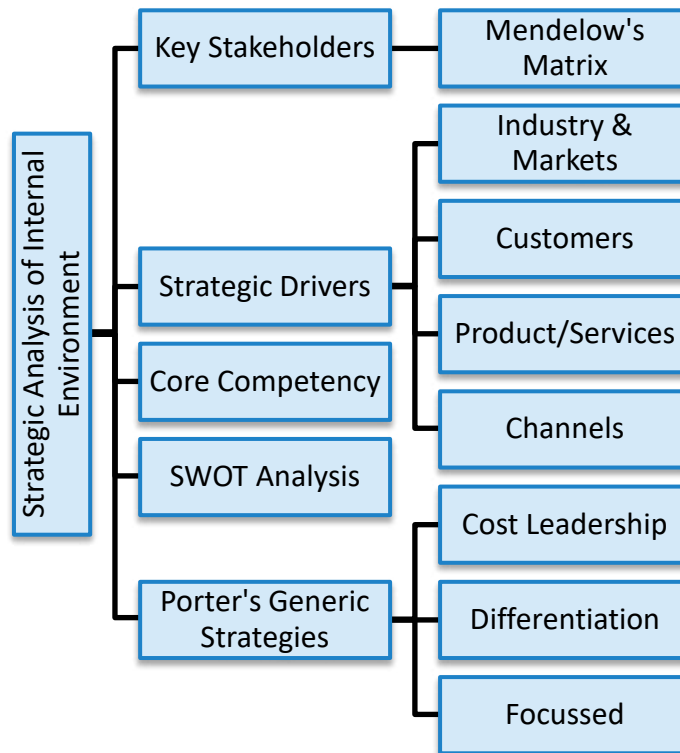
Video for Interpretation of the List: <https://youtu.be/dVq9NF7s8I4>

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ◆ Understand the importance of the internal environment in strategic analysis.
- ◆ Explain the stakeholder view of the firm.
- ◆ Identify and explain the strategic drivers.
- ◆ Examine the role of firm-level resources and competencies in shaping the strategic advantage of the firm.
- ◆ Integrate analyses of internal and external environments into SWOT and formulation of business level strategies.

CHAPTER OVERVIEW



3.1 INTRODUCTION

Strategic Analysis is equally important when it comes to internal environment assessment.

Internal environment refers to the sum total of people – individuals and groups, stakeholders, processes- input-throughput-output, physical infrastructure- space, equipment and physical conditions of work, administrative apparatus- lines of authority & power, responsibility, accountability and organizational culture- intangible aspects of working- relationships, philosophy, values, ethics- that shape an organization's identity.

In other words, the internal environment is specific to each organisation. It is based on its structure and business model and includes all stakeholders like top management, investors, employees, board of directors, investors, etc.

Internal environment also involves understanding of the ethics, principles, work environment, employee friendliness, confidence of investors and other philosophical and cultural aspects of business, which aim for the success of the organisation.

Thus, it is even more important to understand the internal environment from a strategic analysis perspective.

3.2 UNDERSTANDING KEY STAKEHOLDERS

Who are Stakeholders and how do we identify them?

A firm may be viewed as a coalition of stakeholders- all those individuals and entities that have a stake in its success and can impact it as well. They may be the employees, shareholders, investors, suppliers, customers, regulators and so on. This view of the firm is in contrast to the earlier view of the firm that was considered to be an extension of the owners and shareholders alone.

Thus, it may be reiterated that the stakeholders can be defined as any person/group of individuals, internal or external, that has an interest in, or impact on the business or corporate strategy of the organisation. They have the power to influence the strategy or performance of that organisation.

Generally, stakeholders include management, employees, shareholders, customers and vendors. Additionally, other individuals and groups, such as governments, labour unions and local groups, which are often considered as stakeholders depending on their impact on the particular organisation. Each stakeholder or stakeholder group will be affected by the business strategy that the organisation chooses and implements.

It is important to first identify the key stakeholders. Each stakeholder exerts a different level of influence and can have differing levels of interest in the organisation. **For example**, an organisation involved in healthcare innovation needs to have a long-term perspective about its return on investment (ROI) as there may be a long time between investment into research timelines and a commercial

outcome. While, shareholders, whose main concern is quick profits, may be more hesitant to support the organisation spending funds on something that they may not see the return in the near future.

Since the expectations of key stakeholders can influence the organisation's strategy, a clash of objectives may have unfavourable consequences for the organisation.

Example of Key Stakeholders and their requirements for an OTT Platform

Stakeholders	Requirements
Shareholders	◆ Innovation and continuous creative content ◆ Total shareholder return (RoI) ◆ Corporate social responsibility ◆ Top rankings of the organisation ◆ Highest market share
CEO and Board of Directors	◆ Prestige ◆ Market share ◆ Revenue and profit growth ◆ Market rankings
Major Vendors (Production Houses)	◆ Growth ◆ Stability of ordering ◆ Stable margins
Consumers (Viewers)	◆ New content - Innovation ◆ Better deals - Pricing Benefits ◆ Value for money ◆ Continuous supply
Employees	◆ Wages and benefits ◆ Stability of employment ◆ Pride of working for a reputed organisation

3.2.1 Mendelow's Matrix

The Mendelow Stakeholder matrix (also known as the Stakeholder Analysis matrix and the Power-Interest matrix) is a simple framework to help manage key stakeholders.

Managing a project is extremely complicated as it involves managing the competing interests of various stakeholders. Who needs to know what and when, who needs to give their feedback and who has the final approval can be confusing. However, managing stakeholders is critical to the success of a project. This is where a stakeholder analysis matrix i.e. Mendelow's Matrix can help.

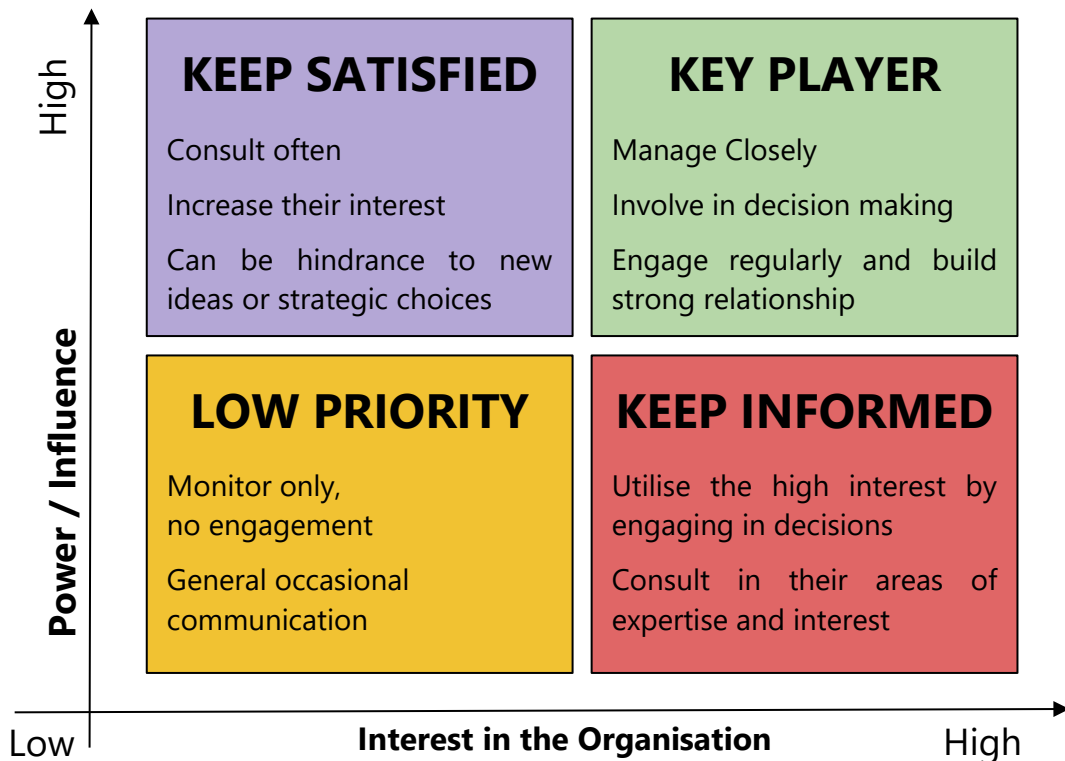
Mendelow suggests that one should analyse stakeholder groups based on Power (the ability to influence organisation strategy or resources) and Interest (how interested they are in the organisation succeeding). A thing to remember is that all stakeholders may seem to have lots of power and organisation may hope they would have lots of interest too. But in reality, some stakeholders will hold more Power than others, and some stakeholders will have more Interest than others. **For example**, a big shareholder is likely to have high power and high interest in the organisation, whereas a big competitor would have high power to impact strategy, but potentially less Interest in success of rival organisation.

Developing a Grid of Stakeholders

Mendelow's Matrix is based on Power and Interest. It suggests identifying which stakeholders are incredibly important. Metrics to define the importance being High Power and High Interest which management would need to manage closely, while investing a lot of time and resources.

For example, the CEO is likely to have more Power to influence the work and also high interest in it being successful. Keeping them informed almost daily should be a priority.

However, those stakeholders with low power and low interest like research institutes seeking an organisation data should be monitored rarely and minimum effort expended on them in terms of time and money.



In the above figure, we see categorisation of stakeholders into four groups by Mendelow's;

- ♦ **KEEP SATISFIED Stakeholders: High power, less interested people** - Organisation should put in enough work with these people to keep them satisfied with their intended information on a regular basis. **For example,** banks, government, customers, etc.
- ♦ **KEY PLAYERS Stakeholders: High power, highly interested people** - Organisation's aim should be to fully engage this group of stakeholders, making the greatest efforts to satisfy them, take their advice, build actions and keep them informed with all information on a regular basis. **For example,** Shareholders, CEO, Board of Directors, etc.

- ♦ **LOW PRIORITY Stakeholders: Low power, less interested people** - Organisation should only monitor them with no actions to satisfy their expectations. Strategically, minimal efforts should be spent on this group of stakeholders while keeping an eye to check if their levels of interest or power change. **For example**, business magazines, media houses, etc.
- ♦ **KEEP INFORMED Stakeholders: Low power, highly interested people** - Organisation should adequately inform this group of people and communicate with them to ensure that no major issues arise. These audiences can also help with real time feedback and areas of improvement for an organisation. **For example**, employees, vendors, suppliers, legal experts, etc.

An important thing that strategists should be aware of is the importance of remembering that the environment is highly dynamic and certain things might happen that can cause stakeholders to suddenly move between quadrants.

For example, an organisation might inadvertently contravene a regulation, say GST compliance which would cause the regulatory body i.e. the Indirect Taxes Department to move from High Power, Low Interest to High Power, High Interest. This would then require a different way of managing and communicating with this stakeholder. Equally, the media houses would also move from Low Power, Low interest, to Low Power, High Interest. So, it's always worth re-analysing Mendelow's grid for one's organisation in the event of a change in the environment.

Activity	
Identify and group the below stakeholders in the 4 groups as suggested by Mendelow for an Ecommerce startup. Ms. Suhasini (CEO), Mango Partners and TRIK Group (Investors), MSME Ministry, Customers from NorthEast India, Sellers from Rajasthan, Jandhan Bank (Lender), and Kumar S and Sharma T (Sr. Managers in the Co.)	
	Keep Satisfied
	Key Players
	Low Priority
	Keep Informed

3.3 STRATEGIC DRIVERS

An important aspect of internal analysis is assessing the current performance of the business. And in assessing current performance, the strategic drivers consider what differentiates an organisation from its competitors.

It involves analysis of the key markets in which the organisation operates, as well as its key customers, the products and services it provides, the channels in which the products or services are delivered, and the organisation's competitive advantage. Some of these components are interlinked, such as markets and products/services, and channels and key customers in each channel.

There can be varied ways to assess the current performance of a business and it is highly subjective based on the managements metrics and ways of doing business. It can either be profit driven, purpose driven or any other metrics that the management seems to fit in. But in general, the key strategic drivers of an organisation include:

- ◆ industry and markets
- ◆ customers
- ◆ products/services
- ◆ channels

3.3.1 Industry and Markets

In terms of the internal environment, it is very important for an organisation to understand its relative position in the industry and in the market in which it operates. There are many ways to do this but require analysis and understanding of the environment.

Similar companies are grouped together into industries. Basically, industry grouping is based on the primary product that a company makes or sells. **For example,** Maruti, Mahindra, Tata Motors, TVS, Bajaj Auto, are all selling automotives as their primary product and thus categorised into Automotive Industry. Similarly, Zara, H&M, Marks & Spencer, Pantaloons, Westside, Uniqlo, are all selling apparels and accessories for the youth, and thus categorised under apparels industry.

A market is defined as the sum total of all the buyers and sellers in the area or region under consideration. The value, cost and price of items traded are as per forces of supply and demand in a market. The market may be a physical entity or may be virtual like e-commerce websites and applications. It may further be local or global, depending on which all countries the business sells its products in.

Is market the same for all businesses?

Market refers to all the buyers and sellers of a particular product/service and so it would be incorrect to say that market is the same for all businesses. Each business has its own set of customers i.e. market and more so, each product within a business has its own market. **For example**, for a FMCG brand selling Shampoos, Dairy Products, Flours, Washing Powder, etc. - each product line will have a separate market to cater to and therefore build strategies specific to the market of concern.

3.3.1.1 Analysing Industry and Markets

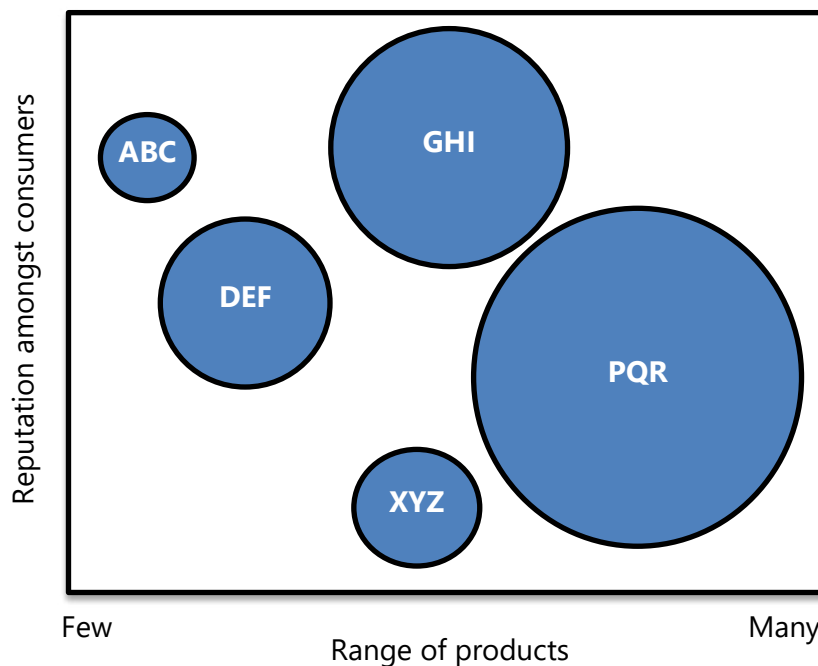
Industry and market analysis is extremely important to identify one's position as compared to the competitors, who can be of equal size and value, or bigger in size and value or even smaller and newer. A tool used for this is called - **Strategic Group Mapping**.

A strategic group consists of those rival firms which have similar competitive approaches and positions in the market. Companies in the same strategic group can resemble one another in any of the several ways: they may have comparable product-line breadth, sell in the same price/quality range, emphasize the same distribution channels, use essentially the same product attributes to appeal to similar types of buyers, depend on identical technological approaches, or offer buyers similar services and technical assistance. An industry contains only one strategic group when all sellers pursue essentially identical strategies and have comparable market positions. At the other extreme, there are as many strategic groups as there are competitors when each rival pursues a distinctively different competitive approach and occupies a substantially different competitive position in the marketplace.

The procedure for constructing a strategic group map and deciding which firms belong in which strategic group is straightforward:

- ◆ Identify the competitive characteristics that differentiate firms in the industry typical variables are price/quality range (high, medium, low); geographic coverage (local, regional, national, global); degree of vertical integration (none, partial, full); product-line breadth (wide, narrow); use of distribution channels (one, some, all); and degree of service offered (no-frills, limited, full)
- ◆ Plot the firms on a two-variable map using pairs of these differentiating characteristics.
- ◆ Assign firms that fall in about the same strategy space to the same strategic group.
- ◆ Draw circles around each strategic group making the circles proportional to the size of the group's respective share of total industry sales revenues.

Strategic Group Mapping



Explanation of Diagram (Strategic Group Mapping)

ABC, DEF, GHI, XYZ AND PQR are companies operating in the same industry. Let us assume these all are companies selling Laptops.

Now on the Y-Axis (vertical) is the reputation of the company and on the X-Axis (horizontal) is the range of their products.

The Reputation is depicted through the size of the bubble of the company along with how high it is on the Y-Axis. While on the X-Axis, we can see how huge their product range is, whether they have few models or they have many models on offer for the customers.

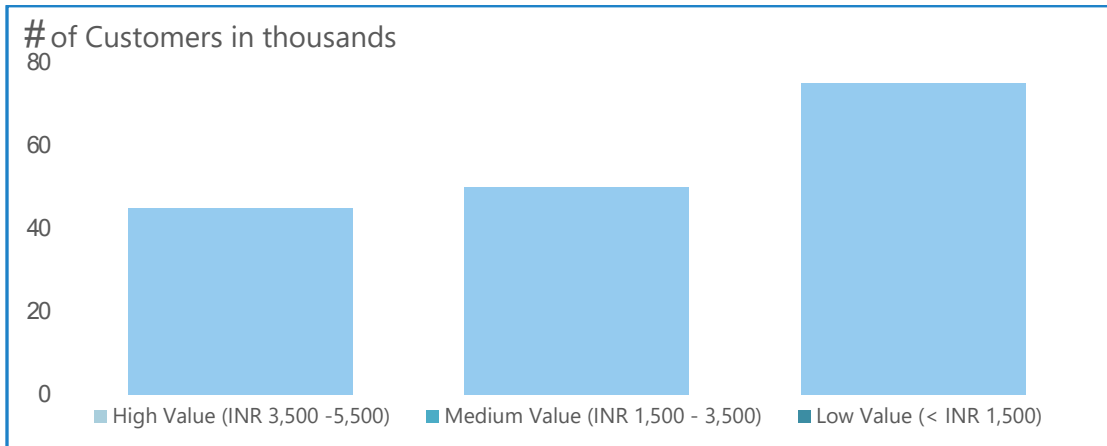
A simple glance of the mapping chart shows us that even though ABC has few models, but it has great reputation in the market. Similarly, GHI has a good range of products and is the most reputed company in laptops. Another view is that XYZ and GHI have the same number of models as both are on the same place on X-Axis, but GHI has much greater reputation than XYZ, as it has a bigger bubble and is higher on the Y-Axis.

Strategists can analyze the market by making any number of scenarios like above to understand the competition. Thus, this analysis helps a business understand its competition in terms of two or more factors (like reputation and range of products in this case) in a single graphical representation.

3.3.2 Customers

Understanding the different types of customers to whom the organisation's products/services are sold or provided, is not only important but also the first step in deciding the product/service. Different customers may have different needs and require different sales models or distribution channels.

Consider the example of a headphones brand - the customers can be grouped under high value buyers, medium value buyers and low value buyers based on the amount they are willing to spend on a product, thus helping the business understand their key customers and focus areas of improvement.



As customers are often responsible for the generation of profits obtained by an organisation, it is important to be able to collect and display data in order to show customer trends and profitability. Issues with customers can be identified, and target areas for growth can be pursued based on the findings.

Another interesting concept is the difference between Customer and Consumer - while a customer is the one who buys a product/service, the consumer is the one who finally uses/consumes the bought product or service. **For example** - A parent buying stationery products for their kids might be the customers, but consumers of stationery are the kids who would actually use it. Thus, understanding both is important for the marketers.

From a pricing perspective - the customer is of more importance and from value creation and design/usability, consumer needs to be kept at the center of decision making.

Customer versus Consumer

A simple bifurcation yet extremely important for strategy build up. Consumers are the ones who finally use a product/service, while customers are the buyers of that product. A customer can be a consumer and vice versa. But for strategy teams especially marketing teams it is important to understand the customer and consumer separately. **For example**, baby diapers are bought by parents (customers) who are willing to pay higher price for higher quality, while the real consumers are the babies, who are more concerned about the comfort and easiness of the diaper. If babies do not accept the product i.e. if consumers aren't satisfied, it is difficult to retain the buyer i.e. customers as well.

3.3.3 Product/Services

Products and services are closely linked and interrelated with the markets that the organisation wants to serve. In this component of the strategic drivers' analysis, business identifies the key products/ services that the organisation offers and how those products/services are performing. It attempts to answer the general question: What business are we in and what should be done to win over competition in each product/service we serve.

Product stands for the combination of "goods-and-services" that the company offers to the target market. Strategies are needed for managing existing product over time, adding new ones and dropping failed products. Strategic decisions must also be made regarding branding, packaging and other product features such as warranties. The products can also be classified on the basis of industrial or consumer products, essentials or luxury products, durables or perishables.

There are products that have a wide range of quality and workmanship and these also change over time since products and markets are infinitely dynamic. An organization has to capture such dynamics through a set of policies and strategies. Some products have consistent customer demand over long period of time while others have short life spans.

Products can also be differentiated on the basis of size, shape, colour, packaging, brand names, after-sales service and so on. Organizations seek to hammer into customers' minds that their products are different from others. It does not matter whether the differentiation is real or imaginary. Quite often the differentiation is psychological rather than physical. It is enough if customers are persuaded to believe that the marketer's product is different from others. **For example,** Shampoos with different branding namely Head & Shoulders, Olay, Old Spice, Pantene are all produced by the same company P&G.

Organizations formalize product differentiation through designating 'brand names' to their respective products. These are generally reinforced with legal sanctions and protection. Brands enable customers to identify the product and the organization behind it. The products and even firms' image is built around brands through advertising and other promotional strategies. Customers tend to develop strong brand loyalty for a particular product over a period of time.

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

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

Products and services need heavy investment in reaching out to customers. Over the years, a number of marketing strategies have been evolved, which are given to handle marketing strategically and fight the competition in the market.

- ◆ **Social Marketing:** It refers to the design, implementation, and control of programs seeking to increase the acceptability of a social ideas, cause, or practice among a target group to bring in social change. For instance, the publicity campaign for prohibition of smoking in Delhi explained the place where one can and can't smoke and also indicates that smoking is injurious to health.
- ◆ **Augmented Marketing:** This type of marketing includes additional customer services and benefits that a product can offer besides the core and actual product that is being offered. It can be in the form of the introduction of hi-tech services like movies on demand, online computer repair services, secretarial services, etc. Such innovative offerings provide a set of benefits that promise to elevate customer service to unprecedented levels.
- ◆ **Direct Marketing:** Marketing through various advertising media that interact directly with consumers, generally calling for the consumer to make a direct response. Direct marketing includes catalogue selling, e-mail, telecomputing, electronic marketing, shopping, and TV shopping.
- ◆ **Relationship Marketing:** The process of creating, maintaining, and enhancing strong, value-laden relationships with customers and other stakeholders. **For example,** *Airlines offer special lounges at major airports for frequent flyers. Thus, providing special benefits to select customers to strengthen bonds. It can go a long way in building relationships.*
- ◆ **Services Marketing:** It is applying the concepts, tools, and techniques of marketing to services. Services is any activity or benefit that one party can offer to another that is essentially intangible. This marketing requires

different marketing strategies since it has peculiar characteristics of its own such as inseparability, variability etc.

- ◆ **Person Marketing:** People can also be marketed. Person marketing consists of activities undertaken to create, maintain or change attitudes and behaviour towards particular person. **For example**, *politicians, sports stars, film stars, etc. i.e., market themselves to get votes, or to promote their careers.*
- ◆ **Organization Marketing:** It consists of activities undertaken to create, maintain, or change attitudes and behaviour of target audiences towards an organization. Both profit and non-profit organizations practice organization marketing.
- ◆ **Place Marketing:** Place marketing involves activities undertaken to create, maintain, or change attitudes and behaviour towards particular places say, marketing of business sites, tourism marketing.
- ◆ **Enlightened Marketing:** It is a marketing philosophy holding that a company's marketing should support the best long-run performance of the marketing system that is beyond the prevailing mindset; its five principles include customer-oriented marketing, innovative marketing, value marketing, sense-of-mission marketing, and societal marketing.
- ◆ **Differential Marketing:** It is a market-coverage strategy in which a firm decides to target several market segments and designs separate offers for each. **For example**, *Hindustan Unilever Limited has Lifebuoy, Lux and Rexona in the popular segment and Dove and Pears in premium segment.*
- ◆ **Synchro-marketing:** When the demand for a product is irregular due to season, some parts of the day, or on hour basis, causing idle capacity or overworked capacities, synchro-marketing can be used to find ways to alter the pattern of demand through flexible pricing, promotion, and other incentives. **For example**, *products such as movie tickets can be sold at lower prices over weekdays to generate demand.*
- ◆ **Concentrated Marketing:** It is a market-coverage strategy in which a firm goes after a large share of one or few sub-markets. It can also take the form of Niche marketing.

- ◆ **Demarketing:** It includes marketing strategies to reduce demand temporarily or permanently. The aim is not to destroy demand, but only to reduce or shift it. This happens when there is overfull demand. **For example,** *buses are overloaded in the morning and evening, roads are busy most of the time, zoological parks are over-crowded on Saturdays, Sundays and holidays. Here demarketing can be applied to regulate demand.*

3.3.4 Channels

Channels are the distribution system by which an organisation distributes its product or provides its service. To understand the concept of channels let us see some **examples** of how the following companies distribute their products and services:

- ◆ Lakme - sells its products via retail stores, intermediary stores (like Nykaa, Westside, Reliance Trends), as well as online mode like amazon, flipkart, nykaa online and its own website.
- ◆ Boat Headphones - only online via e-commerce platforms like flipkart and amazon
- ◆ Coca Cola - retail shops across the nation, in each district, each town as well as online mode via dunzo, blinkit, etc.

All the above are the channels via which companies sell their products and services to the customers. The wider and stronger the channel the better position a business has to fight and win over competition. Also, having robust channels of business distribution helps keep new players away from entering the industry, thus acting as barriers to entry.

There are typically three channels that should be considered: sales channel, product channel and service channel.

- ◆ **The sales channel** - These are the intermediaries involved in selling the product through each channel and ultimately to the end user. The key question is: Who needs to sell to whom for your product to be sold to your end user? **For example,** many fashion designers use agencies to sell their products to retail organisations, so that consumers can access them.

- ♦ **The product channel** - The product channel focuses on the series of intermediaries who physically handle the product on its path from its producer to the end user. This is true of Australia Post, who delivers and distributes many online purchases between the seller and purchaser when using eBay and other online stores.
- ♦ **The service channel** - The service channel refers to the entities that provide necessary services to support the product, as it moves through the sales channel and after purchase by the end user. The service channel is an important consideration for products that are complex in terms of installation or customer assistance. **For example**, a Bosch dishwasher may be sold in a Bosch showroom, and then once sold it is installed by a Bosch contracted plumber.

Channel analysis is important when the business strategy is to scale up and expand beyond the current geographies and markets. When a business plans to grow to newer markets, they need to develop or leverage existing channels to get to new customers. Thus, analysis of channels that suit one's products and customers is of utmost importance.

For example - if a healthcare brand wants to reach out to elderly customers - they need to be more focused on offline mode of business where agents reach out physically to the elderly as most of their potential customers (i.e. the old aged) are not active on smartphones.

Another example being - if a new drink brand wants to acquire customers - they need to place their products via every channel possible to get more attraction from customers like placing their drinks in stores, and shops alike, offering competitive campaigns to create awareness via online modes (social media) and so and so forth.

Thus, channels, the partners in growth, play a crucial role in internal strategic alignment.

Ever been to a hill station or a desert or a far-off location on vacation, and still had access to bottled water and cold drinks?

This is possible because of strong channels of distribution. Some of the most renowned brands who have created competitive advantage in channels are Coca Cola, HUL, Patanjali, Asian Paints, Ola, to name a few.



3.4 ROLE OF RESOURCES AND CAPABILITIES: BUILDING CORE COMPETENCY

An organization may be viewed as an entity endowed with resources and capabilities. These resources and capabilities may be so synergized as to impart distinct competencies that the organization may leverage to its advantage. C.K. Prahalad and Gary Hamel have advocated a concept of core competency, which is a widely used concept in management theories. They defined core competency as the collective learning in the organization, especially coordinating diverse production skills and integrating multiple streams of technologies. An organization's combination of technological and managerial know-how, wisdom and experience are a complex set of capabilities and resources that can lead to a competitive advantage compared to a competitor.

Competency is defined as a combination of skills and techniques rather than individual skill or separate technique. For core competencies, it is characteristic to have a combination of skills and techniques, which makes the whole organization utilize these several separate individual capabilities. Therefore, core competencies cannot be built on one capability or single technological know-how, instead, it has to be the integration of many resources. The optimal way to define core competence is to consider it as sum of 5- 15 areas of developed expertise.

According to C.K. Prahalad and Gary Hamel, major core competencies are identified in three areas -

- ◆ competitor differentiation,
- ◆ customer value, and
- ◆ application to other markets

Competitor differentiation is one of the main three conditions. The company can consider having a core competence if the competence is unique and it is **difficult for competitors to imitate**. This can provide a company with an edge compared to competitors. It allows the company to provide better products or services to market with no fear that competitors can copy it. The company has to keep on improving these skills in order to sustain its competitive position. Competence does not necessarily have to exist within one company in order to define as core competence. Although all companies operating in the same market would have the

equal skills and resources, if one company can perform this significantly better; the company has obtained a core competence. **For example**, it is quite difficult to imitate patented innovation, like Tesla has been winning over competition in electric vehicles.

The second condition to be met is **customer value**. When purchasing a product or service it has to deliver a fundamental benefit for the end customer in order to be a core competence. It will include all the skills needed to provide fundamental benefits. The service or the product has to have a real impact on the customer as the reason to choose to purchase them. If a customer has chosen the company without this impact, then competence is not a core competence, and it will not affect the company's market position. The essence is that the consumer should value the differentiation offered. Without it, the core competency does not make sense.

The last condition refers to the **application of competencies** to other markets. Core competence must be applicable to the whole organization; it cannot be only one particular skill or specified area of expertise. Therefore, although some special capability would be essential or crucial for the success of business activity, it will not be considered as core competence if it is not fundamental from the whole organization's point of view. Thus, a core competence is a unique set of skills and expertise, which will be used throughout the organisation to open up potential markets to be exploited.

If the three above-mentioned conditions are met, then the company can regard its competence as core competency.

Core competencies are often visible in the form of organizational functions. **For example**, Marketing and Sales is a core competence of Hindustan Unilever Limited (HUL) This means that HUL has used its resources to form marketing related capabilities that in turn allow it to market its products in ways that are superior those of competitors. Because of this core competence, HUL is capable of launching new brands in the market successfully.

A core competency for a firm is whatever it does best: **For example**: Wal-Mart focuses on lowering its operating costs. The cost advantage that Wal-Mart has created for itself has allowed the retailer to price goods lower than most competitors. The core competency in this case is derived from the company's ability

to generate large sales volume, allowing the company to remain profitable with a low profit margin.

Core competencies are the knowledge, skills, and facilities necessary to design and produce core products. Core competencies are created by superior integration of technological, physical and human resources. They represent distinctive skills as well as intangible, invisible, intellectual assets and cultural capabilities. Cultural capabilities refer to the ability to manage change, the ability to learn and teamwork. Organizations should be viewed as a bundle of a few core competencies, each supported by several individual skills. Core Competence-based diversification reduces risk and investment and increases the opportunities for transferring learning and best practice across business units.

Core technological competencies are also corporate assets; and as assets, they facilitate corporate access to a variety of markets and businesses. For competitive advantage, a core technological competence should be difficult for the competitors to imitate.

3.4.1 Criteria for building a Core Competencies (CC)?

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. **For example,** *Intel has enjoyed a first-mover advantage more than once because of its rare fast R&D cycle time capability that brought SRAM and DRAM integrated circuit technology and brought microprocessors to market well ahead of the competitor.* The product could be imitated in due course of time, but it was much more difficult to imitate the R&D cycle time capability.
- 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.



For example, For years, firms tried to imitate Tata's low-cost strategy, but most have been unable to duplicate Tata's success. They did not realize that Tata has a unique culture and attracts some of the top talent in the industry. The culture and excellent human capital worked together in implementing Tata's strategy and are the basis for its competitive advantage.



The strategic value of capabilities increases as they become more difficult to substitute.

For example, Competitors are deeply aware about Apple's operating system's (iOS) successful model. However, to date, no competitor has been able to imitate Apple's capabilities. These are also protected through copyrights.



To sum up, we can say that only when a capability is valuable, rare, costly to imitate, and non-substitutable, it is a core competence and a source of competitive advantage. Over a time, core competencies must be supported. Core competencies are a source of competitive advantage only when they allow the firm to create value by exploiting opportunities in its external environment.

Zero Customer Complaints!

Airtel has its marketing campaign that talks about - Zero Customer Complaints. This is about creating a core competency of great customer service.



3.5 COMBINING EXTERNAL AND INTERNAL ANALYSIS (SWOT ANALYSIS)

SWOT analysis is the analysis of a business's strengths, weaknesses, opportunities and threats. The primary objective of a SWOT analysis is to help organizations develop a full awareness of all the factors (external as well as internal), involved in making a business decision.

SWOT analysis shall be implemented before all company actions, whether it is exploring new initiatives, revamping internal policies, considering opportunities to grow or alter a plan midway. One shall also use SWOT analysis to discover recommendations and strategies, with a focus on leveraging strengths and opportunities to overcome weaknesses and threats.

Since its creation, SWOT has been the most widely used tool for business owners to grow their companies. Sometimes it's wise to perform SWOT analysis just to check on the current landscape of your business to improve business operations as needed. The analysis can show areas where an organization is performing well, as well as areas that need improvement.



SWOT Analysis

SWOT Analysis Example

Let us understand with an example of a law firm - what could its SWOT analysis help understand about its business.

STRENGTH	WEAKNESS
Multiple Partners with varied expertise Long Term contractual service agreements 70 years of brand value Services spread across 20 states of India 400+ employee strength to deliver work	Run by old methods No automation of work and documentation Not very employee friendly culture
OPPORTUNITY	THREAT
Automation driven advancement. Startups can be supported with experienced partners. Investment in technology can multiply returns.	Online players entering market. AI based solutions and applications. Price point of online being very competitive Speed of work becoming faster by the day.

The benefit of this analysis is that it identifies the complex issues for an organisation and puts them into a simple framework. While on the other hand, one of the major criticisms of this tool is that it does not generally provide for evaluation of strengths, weaknesses, opportunities and threats in the competitive context.

Therefore, an organisation while using this tool, SWOT analysis, should consider relative competitors, and external factors affecting the organisation. Although a simple tool, it is a useful starting point for analysis.

SWOT Analysis for Internal or External Environment?
SWOT stands for Strengths, Weaknesses, Opportunities and Threats. Internal analysis is more focused on understanding the existing structure and competencies of the business, thus highlighting the Strengths and Weaknesses, while External Analysis is about identifying and preparing for uncontrollable which can either be Opportunities or threats.
Therefore, SWOT Analysis is a tool which is used for both Internal and External Analysis.



3.6 COMPETITIVE ADVANTAGE: USING MICHAEL PORTER'S GENERIC STRATEGIES

Why do some companies succeed while others fail?

Why did Hindustan Motors do so well for several decades?

How did Apple return from near obsolescence in the late 1990s and become the world leader and a dominant technology company of today?

In the Indian airline industry, how has Indigo Airlines managed to keep increasing its revenues and profits through both good times and bad, while rivals struggled?

For most, if not all, companies, achieving superior performance relative to rivals is the ultimate challenge. If a company's strategies result in superior performance, it is said to have a competitive advantage.

Strategic management involves development of competencies that managers can use to achieve better performance and a competitive advantage for their organization. Competitive advantage allows a firm to gain an edge over rivals when competing. 'It is a set of unique features of a company and its products that are perceived by the target market as significant and superior to the competition.'

In other words, an organization is said to have competitive advantage if its profitability is higher than the average profitability for all companies in its industry.

***"If you don't have a competitive advantage, don't compete"* - Jack Welch**

The competitive advantage is the achieved advantage over rivals when a company's profitability is greater than the average profitability of firms in its industry. It is achieved when the firm successfully formulates and implements the value creation strategy and other firms are unable to duplicate it or find it too costly to imitate. Further, it can be said that a firm is successful in achieving competitive advantage only after other firm's efforts to duplicate or imitate it fails.

3.6.1 Sustainability of Competitive Advantage

The sustainability of competitive advantage and a firm's ability to earn profits from its competitive advantage depends upon four major characteristics of resources and capabilities:

- i. **Durability:** The period over which a competitive advantage is sustained depends in part on the rate at which a firm's resources and capabilities

deteriorate. In industries where the rate of product innovation is fast, product patents are quite likely to become obsolete. Similarly, capabilities which are the result of the management expertise of the CEO are also vulnerable to his or her retirement or departure. On the other hand, many consumer brand names have a highly durable appeal.

- ii. **Transferability:** Even if the resources and capabilities on which a competitive advantage is based are durable, it is likely to be eroded by competition from rivals. The ability of rivals to attack position of competitive advantage relies on their gaining access to the necessary resources and capabilities. The easier it is to transfer resources and capabilities between companies, the less sustainable will be the competitive advantage which is based on them.
- iii. **Imitability:** If resources and capabilities cannot be purchased by a would-be imitator, then they must be built from scratch. How easily and quickly can the competitors build the resources and capabilities on which a firm's competitive advantage is based? This is the true test of imitability. **For example,** In financial services, innovations lack legal protection and are easily copied. Here again the complexity of many organizational capabilities can provide a degree of competitive defense. Where capabilities require networks of organizational routines, whose effectiveness depends on the corporate culture, imitation is difficult.
- iv. **Appropriability:** Appropriability refers to the ability of the firm's owners to appropriate the returns on its resource base. Even where resources and capabilities are capable of offering sustainable advantage, there is an issue as to who receives the returns on these resources. This means, that rewards are directed to from where the funds were invested, rather than creating an advantage with no actual reward to people to invested capital.

3.6.2 Michael Porter's Generic Strategies

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. These strategies have been termed generic, because they can be pursued by any type or size of business firm and even by not-for-profit organisations.

- ◆ Cost leadership emphasizes on producing standardized products at a very low per-unit cost for consumers who are price-sensitive.

- ◆ Differentiation is a strategy aimed at producing products and services considered unique industry-wide and directed at consumers who are relatively price-insensitive.
- ◆ Focus means producing products and services that fulfil the needs of small groups of consumers with very specific taste.

Porter's strategies imply different organizational arrangements, control procedures, and incentive systems. Larger firms with greater access to resources typically compete on a cost leadership and/or differentiation basis, whereas smaller firms often compete on a focus basis.

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

Figure: Michael Porter's Generic Strategies

Porter stresses the need for strategists to perform cost-benefit analysis to evaluate "sharing opportunities" among the firm's existing and potential business units. Sharing activities and resources enhances competitive advantage by lowering costs or raising differentiation. In addition to prompting sharing, Porter stresses the need for firms to "transfer" skills and expertise among autonomous business units effectively in order to gain competitive advantage. Depending upon factors such as type of industry, size of firm and nature of competition, various strategies could yield advantages in cost leadership differentiation, and focus.

3.6.2.1 Cost Leadership Strategy

It is a low-cost competitive strategy that aims at broad mass market. It requires vigorous pursuit of cost reduction in the areas of procurement, production, storage and distribution of product or service and also economies in overhead costs. Because of its lower costs, the cost leader is able to charge a lower price for its

products than most of its competitors and still earn satisfactory profits. **For example,** McDonald's fast-food restaurants have successfully followed low-cost leadership strategy. Decathlon Group's mega sports stores have been following low-cost leadership strategy to gain international recognition and also beat competition.

A primary reason for pursuing forward, backward, and horizontal integration strategies is to gain cost leadership benefits. Generally, cost leadership must be pursued in conjunction with differentiation. A number of cost elements affect the relative attractiveness of generic strategies, including economies or diseconomies of scale achieved, learning and experience curve effects, the percentage of capacity utilization achieved, and linkages with suppliers and distributors. Other cost elements to consider while choosing among alternative generic strategies include the potential for sharing costs and knowledge within the organization, R&D costs associated with new product development or modification of existing products, labour costs, tax rates, energy costs, and shipping costs. This internal strategy of sharing resources to build a competitive advantage is called synergy benefit.

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

- ◆ when the market is composed of many price-sensitive buyers and
- ◆ when there are few ways to achieve product differentiation.

Further, when buyers do not care much about differences from brand to brand, or when there are a large number of buyers with significant bargaining power. The basic idea is to underprice competitors and thereby gain market share driving some of the competitors out of the market.

A successful cost leadership strategy usually permeates the entire firm, as evidenced by high efficiency, low overheads, limited perks, intolerance of waste, intensive screening of budget requests, wide span of controls, rewards linked to cost containment, and broad employee participation in cost control efforts.

Some risks of pursuing cost leadership are;

- ◆ that competitors may imitate the strategy, therefore driving overall industry profits down;

- ◆ that technological breakthroughs in the industry may make the strategy ineffective; or that buyer interests may swing to other differentiating features besides price.

Achieving Cost Leadership Strategy

To achieve cost leadership, following actions could be taken:

1. Prompt forecasting of demand of a product or service.
2. Optimum utilization of the resources to achieve cost advantages.
3. Achieving economies of scale; thus, lower per unit cost of product/service.
4. Standardisation of products for mass production to yield lower cost per unit. (Example of McDonald's)
5. Invest in cost saving technologies and using advance technology for smart efficient working.
6. Resistance to differentiation till it becomes essential.

Advantages of Cost Leadership Strategy

A cost leadership strategy may help to remain profitable even with rivalry, new entrants, suppliers' power, substitute products, and buyers' power.

1. Rivalry – Competitors are likely to avoid a price war, since the low-cost firm will continue to earn profits even after competitors compete away their profits.
2. Buyers – Powerful buyers/customers would not be able to exploit the cost leader firm and will continue to buy its product.
3. Suppliers – Cost leaders are able to absorb greater price increases from suppliers before they need to raise prices for customers.
4. Entrants – Low-cost leaders create barriers to market entry through their continuous focus on efficiency and cost reduction.
5. Substitutes – Low-cost leaders are more likely to lower the costs to induce existing customers to stay with their products, invest in developing substitutes, and even purchase patents.

Disadvantages of Cost Leadership Strategy

1. Cost advantage may not last long as competitors may imitate cost reduction techniques.
2. Cost leadership can succeed only if the firm can achieve higher sales volume.
3. Cost leaders tend to keep their costs low by minimizing cost of advertising, market research, and research and development, but this approach can prove to be expensive in the long run.
4. Technological advancement areas a great threat to cost leaders.

3.6.2.2 Differentiation Strategy

This strategy is aimed at 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, dealer network or customer service. Because of differentiation, the business can charge a premium for its product. **For example**, Domino's Pizza has been offering home delivery within 30 minutes or the order is free, is a unique selling point that differentiates it from its rivals.

Differentiation does not guarantee competitive advantage, especially if standard products sufficiently meet customer needs or if rapid imitation by competitors is possible. Durable products protected by barriers to quick imitation by competitors' areas better. Successful differentiation can mean greater product flexibility, greater compatibility, lower costs, improved service, less maintenance, greater convenience, or more features. Product development is an example of a strategy that offers the advantages of differentiation.

Differentiation strategy should be pursued only after a careful study of buyers' needs and preferences to determine the feasibility of incorporating one or more differentiating features into a unique product that features the customers' desired attributes.

A successful differentiation strategy allows a firm to charge a higher price for its product and to gain customer loyalty, because consumers may become strongly attached to the differentiated features. Special features that differentiate one's product can include superior service, spare parts availability, engineering design, product performance, useful life, gas mileage, or ease of use.

A risk associated with pursuing a differentiation strategy is that the unique product may not be valued high enough by customers to justify the higher price. When this happens, a cost leadership strategy will easily defeat a differentiation strategy. Another risk of pursuing a differentiation strategy is that competitors may develop ways to copy the differentiating features quickly. Firms must find durable sources of uniqueness that cannot be imitated quickly or cheaply by rival firms.

For example, Amazon Prime offers deliver within two hours. This is quite difficult to imitate by its rivals, and thus this differentiating factor helps it to lead the market.

Basis of Differentiation

There are several bases of differentiation, major being: Product, Pricing and Organization.

- ◆ **Product:** Innovative products that meet customer needs can be an area where a company has an advantage over competitors. However, the pursuit of a new product offering can be costly – research and development, as well as production and marketing costs can all add to the cost of production and distribution. The payoff, however, can be great as customer's flock to be among the first to have the new product. **For example,** Apple iPhone, has invested huge amounts of money in R&D, and the customers' value that. They want to be among the first ones to try the new offerings from the company.
- ◆ **Pricing:** It fluctuates based on its supply and demand and may also be influenced by the customer's ideal value for a product. Companies that differentiate based on product price can either determine to offer the lowest price or can attempt to establish superiority through higher prices. **For example,** Apple iPhone dominates the smart phone segment by charging higher prices for its products.
- ◆ **Organisation:** Organisational differentiation is yet another form of differentiation. Maximizing the power of a brand or using the specific advantages that an organization possesses can be instrumental to a company's success. Location advantage, name recognition and customer loyalty can all provide additional ways for a company differentiate itself from the competition. **For example,** Apple has been building customer loyalty since years and has a fanbase of consumers that are called "Apple Fanboys/Fangirls".

Achieving Differentiation Strategy

To achieve differentiation, following strategies could be adopted by an organisation:

1. Offer utility to the customers and match products with their tastes and preferences.
2. Elevate/Improve performance of the product.
3. Offer the high-quality product/service for buyer satisfaction.
4. Rapid product innovation to keep up with dynamic environment.
5. Taking steps for enhancing brand image and brand value.
6. Fixing product prices based on the unique features of product and buying capacity of the customer.

Advantages of Differentiation Strategy

A differentiation strategy may help an organisation to remain profitable even with rivalry, new entrants, suppliers' power, substitute products, and buyers' power.

1. Rivalry - Brand loyalty acts as a safeguard against competitors. It means that customers will be less sensitive to price increases, as long as the firm can satisfy the needs of its customers.
2. Buyers – They do not negotiate for price as they get special features and they have fewer options in the market.
3. Suppliers – Because differentiators charge a premium price, they can afford to absorb higher costs of supplies as the customers are willing to pay extra too.
4. Entrants – Innovative features are an expensive offer. So, new entrants generally avoid these features because it is tough for them to provide the same product with special features at a comparable price.
5. Substitutes – Substitute products can't replace differentiated products which have high brand value and enjoy customer loyalty.

Disadvantages of Differentiation Strategy

1. In the long term, uniqueness is difficult to sustain.
2. Charging too high a price for differentiated features may cause the customer to switch-off to another alternative. As we see a shift of iPhone users to other android flagship smart phones.
3. Differentiation fails to work if its basis is something that is not valued by the customers. Home delivery of packed snacks in 30 minutes would not even be a differentiator as the consumer wouldn't value such an offer.

3.6.2.3 Focus Strategies

A successful focus strategy depends on an industry segment that is of sufficient size, has good growth potential, and is not crucial to the success of other major competitors. Strategies such as market penetration (new product for existing customers) and market development (new product for new customers) offer substantial focusing advantages. Midsize and large firms can effectively pursue focus-based strategies only in conjunction with differentiation or cost leadership-based strategies. All firms in essence follow a differentiated strategy. Because only one firm can differentiate itself with the lowest cost, the remaining firms in the industry must find other ways to differentiate their products.

Focus strategies are most effective when consumers have distinctive preferences or requirements, and when the rival firms are not attempting to specialize in the same target segment. Risks of pursuing a focus strategy include the possibility of numerous competitors recognizing the successful focus strategy and imitating it, or that consumer preferences may drift towards the product attributes desired by the market as a whole. An organization using a focus strategy may concentrate on a particular group of customers, geographic markets, or on particular product-line segments in order to serve a well-defined but narrow market better than competitors who serve a broader market. **For example,** Ferrari sports cars.

Focused cost leadership: A focused cost leadership strategy requires competing based on price to target a narrow market. A firm that follows this strategy does not necessarily charge the lowest prices in the industry. Instead, it charges low prices relative to other firms that compete within the target market. Firms that compete based on price and target a narrow market follow a focused cost leadership strategy.

Focused differentiation: A focused differentiation strategy requires offering unique features that fulfil the demands of a narrow market. Similar to focused low-cost strategy, narrow markets are defined in different ways in different settings. Some firms using a focused differentiation strategy concentrate their efforts on a particular sales channel, such as selling over the internet only. Others target particular demographic groups. Firms that compete based on uniqueness and target a narrow market are following a focused differentiations strategy. **For example,** Rolls-Royce sells limited number of high-end, custom-built cars.

Achieving Focused Strategy

To achieve focused cost leadership/differentiation, following strategies could be adopted by an organization:

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

Advantages of Focused Strategy

1. Premium prices can be charged by the organisations for their focused product/services.
2. Due to the tremendous expertise in the goods and services that the organisations following focus strategy offer, rivals and new entrants may find it difficult to compete.

Disadvantages of Focused Strategy

1. The firms lacking in distinctive competencies may not be able to pursue focus strategy.
2. Due to the limited demand of product/services, costs are high, which can cause problems.
3. In the long run, the niche could disappear or be taken over by larger competitors by acquiring the same distinctive competencies.

3.6.2.4 Best-Cost Provider Strategy ✓

The new model of best cost provider strategy is a further development of above three generic strategies. It is directed towards giving customers more value for the money by emphasizing on both, low cost and upscale differences. The objective is to keep costs and prices lower than those of other sellers of "comparable products".

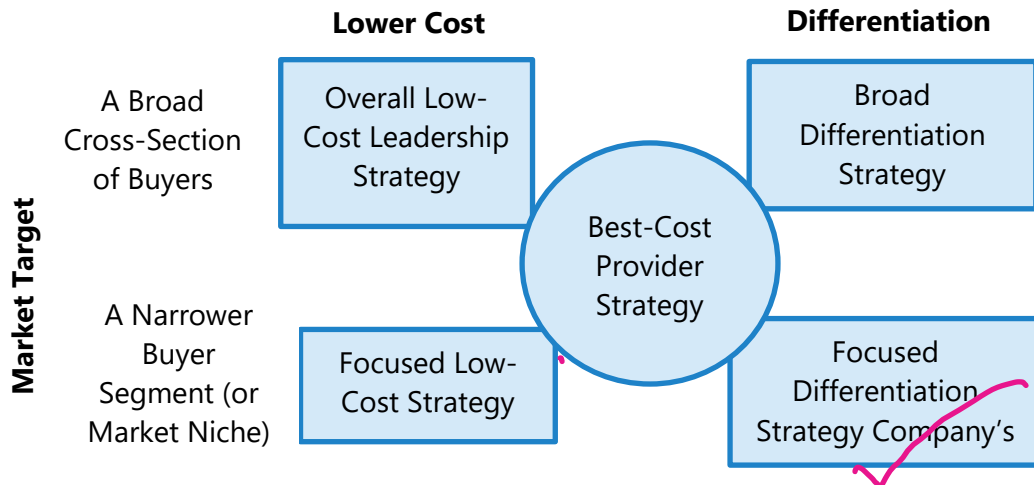


Figure: The Five Generic Competitive Strategies

Best-cost provider strategy involves providing customers more value for the money by emphasizing on lower cost and better-quality differences. It can be done through:

- (a) offering products at lower price than what is being offered by rivals for products with comparable quality and features

Or

- (b) charging similar price as by the rivals for products with much higher quality and better features.

For example, android flagship phones from OnePlus, Xiaomi, Oppo, Vivo, etc, are all rooting for giving better quality at lowest prices to the customers. They are following the best-cost provider strategy to penetrate market.

Activity for Michael Porter's Generic Strategies

Use the blank space against each business idea to identify which generic strategy is being used;

Business Idea	Michael Porter's Generic Strategy
Building the best in class headphones with noise cancellation and premium quality ear cushions	
Providing maximum value features in a phone which is within the spendable limits of the middle class of India	
Being in a position to dominate the glass manufacturing units across the country and thus using economies of scale to beat competition	
Targeting the below poverty line individuals and providing them nutritious meals	

SUMMARY

The understanding of internal environment becomes more important in current times, as dynamics change, and consumers take lead. For a business, strategising continuously becomes more so important for which it needs tools and access to decision-oriented analysis. Once analysed, the plans need to take the form of actions and thereby drive results.

- (i) Understanding key stakeholders via Mendelow's Model - helps to identify the real areas of resource allocation
- (ii) An in-depth understanding of business strategic drivers like Industry & markets, Customers, Channels, Product & Services, enable the business to think out of the box, take inspiration from peers and drive innovation
- (iii) Core Competency with available resources and capabilities is what businesses should strive to build to beat competition and lead markets
- (iv) Once identified, strategists use the classic tool of SWOT Analysis to figure out what suits best to the business's nature and what is there to explore in the environment

- (v) Finally, a business strives to gain competitive advantage: which can broadly be achieved using Michael Porter's Generic Strategies of Cost Leadership, Differentiation and Focussed Differentiation, or the recent concept of Best Cost Provider in the market.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. The goal of SWOT analysis is to _____ the organization's opportunities and strengths while _____ its threats and _____ its weaknesses.
 - (a) avoid; neutralizing; correcting
 - (b) exploit; neutralizing; correcting
 - (c) avoid; capitalizing; neutralizing
 - (d) exploit; avoiding; ignoring
2. SWOT analysis is an evaluation of the organization's _____ strengths and weaknesses and its _____ opportunities and threats.
 - (a) external; internal
 - (b) internal; internal
 - (c) external; external
 - (d) internal; external
3. External opportunities and threats are usually:
 - (a) the minor cause of organizational demise or success
 - (b) least important for CEOs and the board of directors
 - (c) not as important as internal strengths and weaknesses
 - (d) largely uncontrollable activities outside the organization

4. *The sustainability of competitive advantage and a firm's ability to earn profits from its competitive advantage depends upon:*
 - (a) *Durability, reliability, transferability, approximately*
 - (b) *Appropriability, durability, transferability, imitability*
 - (c) *Transferability, imitability, reliability, approximately*
 - (d) *Imitability, durability, reliability, appropriability*
5. *Internal _____ are activities in an organization that are performed especially well.*
 - (a) *Opportunities*
 - (b) *Competencies*
 - (c) *Strengths*
 - (d) *Management*
6. *'Strategic group mapping' helps in-*
 - (a) *Identifying the strongest rival companies*
 - (b) *Identifying weakest rival companies*
 - (c) *Identifying weakest and strongest rival companies*
 - (d) *None of the above*
7. *In Michael Porter's generic strategy _____ emphasizes producing standardized products at a very low per unit-cost for consumers who are price sensitive.*
 - (a) *Cheap leadership*
 - (b) *Inferior product leadership*
 - (c) *Cost leadership*
 - (d) *Cost benefit*

8. *Differentiation Strategy can be achieved by following measures:*

1. *Match products with tastes and preferences of customers.*
2. *Elevate the performance of the product.*
3. *Rapid product innovation*

Which of the above is true:

- (a) *(1) and (2)*
- (b) *(1) and (3)*
- (c) *(2) and (3)*
- (d) *(1), (2) and (3)*

9. *What are the three different bases given by Michael Porter's Generic Strategies to gain competitive advantage?*

- (a) *differentiation, integration and compensation*
- (b) *integration, focus and differentiation*
- (c) *compensation, integration and focus*
- (d) *cost leadership, differentiation and focus*

10. *A firm successfully implementing a differentiation strategy would expect:*

- (a) *Customers to be sensitive to price increases.*
- (b) *To charge premium prices.*
- (c) *Customers to perceive the product as standard.*
- (d) *To automatically have high levels of power over suppliers.*

Scenario Based Questions

1. *A beverage company is launching a new line of energy drinks targeted at health-conscious consumers. The strategic manager wants to study the market position of rival companies in the energy drink segment. Which tool can be used for this analysis, and what is the procedure to implement it effectively?*

2. *EasyLife Corporation, a leading manufacturer of consumer electronics, is considering launching a new line of smart home devices. As a strategic manager,*

conduct a SWOT analysis for EasyLife Corporation to assess the feasibility and potential success of this new venture. Consider both internal and external factors that could impact the success of the new product line.

3. 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.

4. In spite of high commodity inflation, shortage of components and the threat of third wave of COVID-19 pandemic in India, manufacturers of packaged goods, home appliances and consumer electronics are expecting the business to grow by 12 to 25 percent in the coming months. After one-and-a-half years of disruption, manufacturers are now confident about managing their inventories better, keeping their supply channels well-stocked and preparing themselves to minimize the impact of any COVID related restrictions even as they gear up for the festive season, which usually accounts for 25 to 35 percent of their yearly sales.

The home appliances sector could be an example. After a dismal April-June quarter in the year 2021, producers of air conditioners, refrigerators and washing machines are expecting their business to grow by 15-20 percent in the months to come. All the companies operating in the sector have geared up to grab the opportunities available in the market.

A leading company in the home appliances domain, XXP India, is planning to launch various innovative product designs and offer loyalty programmes to lure consumers.

With reference to Michael Porter's generic strategies, identify which strategy XXP India has planned for? Explain how this strategy will be advantageous to the company to remain profitable?

5. Rohit Sodhi runs a charitable organisation for promotion of sports in the country. His organisation conducts regular free training camps for youths interested in playing cricket, football, hockey, badminton and so on. Many of his trainees have reached national level contests. Rohit noticed that with success of IPL (Cricket) tournament there is an increasing trend to extend similar format in other sports as well. He wishes to know how the development is going to help sports and to which industries it will offer opportunities and threats.
6. Mr. Banerjee is head of marketing department of a manufacturing company. His company is in direct competition with thirteen companies at national level. He wishes to study the market positions of rival companies by grouping them into like positions.

Name the tool that may be used by Mr. Banerjee? Explain the procedure that may be used to implement the technique.

7. Mohan has joined as the new CEO of XYZ Corporation and aims to make it a dominant technology company in the next five years. He aims to develop competencies for managers for achieving better performance and a competitive advantage for XYZ Corporation. Mohan is well aware of the importance of resources and capabilities in generating competitive advantage.

Discuss the four major characteristics of resources and capabilities required by XYZ Corporation to sustain the competitive advantage and its ability to earn profits from it.

8. Airlines industry in India is highly competitive with several players. Businesses face severe competition and aggressively market themselves with each other. Luxury Jet is a private Delhi based company with a fleet size of 9 small aircrafts with seating capacity ranging between 6 seats to 9 seats. These aircrafts are chartered by big business houses and high net worth individuals for their personalised use. With customised tourism packages their aircrafts are also often hired by foreigners. Identify and explain the Michael Porter's Generic Strategy followed by Luxury Jet.

9. *Gennex is a company that designs, manufactures and sells computer hardware and software. Gennex is well known for its innovative products that has helped the company to have advantage over its competitors. It also spends on research and development and concerned with innovative softwares. Often the unique features of their product, that are not available with their competitors helps them to gain competitive advantage. Gennex using the strategy is consistently gaining its position in the industry over its competitors.*

Identify and explain the Porter's generic strategy which Gennex has opted to gain the competitive advantage.

10. *Sohan and Ramesh are two friends who are partners in their business of making biscuits. Sohan believe in making profits through selling more volume of products. Hence, he believes in charging lesser price to the customers. Ramesh, however, of the opinion that higher price should be charged to create an image of exclusivity and for this, he proposes that the product to undergo some change.*

Analyse the nature of generic strategy used by Sohan and Ramesh.

11. *Infant care is a successful store chain that caters products for expectant mothers and new moms. They offer everything from nursing classes to strollers, toys, infant clothes, diapers and baby furniture. Due to a one-stop shop for infants, they are charging a premium for its products.*

Identify and explain how the strategy adopted by infant care.

12. *A century-old footwear company "Mota Shoes" had an image of being the footwear choice for formal occasions. In an attempt to reinvent its brand, it tied up with a foreign footwear giant "Buffrine" to manufacture and sell its HideseeK brand in the country. Putting its best foot forward, it launched extra soft, casual and relaxed footwear for young. Aiming at a brand and image makeover the "Mota Shoes" decided to price the Hide Seek products at premium.*

What kind of Michael Porter business level strategy is being used by "Mota Shoe company"? State its advantages.

13. *Rohit Patel is having a small chemist shop in the central part of Ahmedabad. What kind of competencies Rohit can build to gain competitive advantage over online medicine sellers?*

14. 'Value for Money' is a leading retail chain, on account of its ability to operate its business at low costs. The retail chain aims to further strengthen its top position in the retail industry. Marshal, the CEO of the retail chain is of the view that to achieve the goals they should focus on lowering the costs of procurement of products.

Highlight and explain the core competence of the 'Value for Money' retail chain.

Descriptive Questions

15. What is the purpose of SWOT analysis? Why is it necessary to do a SWOT analysis before selecting a particular strategy for a business organization?

ANSWERS/SOLUTION

Answers to Multiple Choice Questions

1	(b)	2	(d)	3	(d)	4	(b)	5	(c)	6	(c)
7	(c)	8	(d)	9	(d)	10	(b)				

Answers to Scenario Based Questions

- To study the market position of rival companies in the energy drink segment, the strategic manager can use **strategic group mapping**. This tool helps identify strategic groups, which consist of rival firms with similar competitive approaches and positions in the market. The procedure for implementing strategic group mapping effectively is as follows:
 - Identify the competitive characteristics** that differentiate firms in the industry typical variables that are price/quality range (high, medium, low); geographic coverage (local, regional, national, global); degree of vertical integration (none, partial, full); product-line breadth (wide, narrow); use of distribution channels (one, some, all); and degree of service offered (no-frills, limited, full).
 - Plot the firms on a two-variable map** using pairs of these differentiating characteristics.

3. **Assign firms that fall in about the same strategy space** to the same strategic group.
4. **Draw circles around each strategic group** making the circles proportional to the size of the group's respective share of total industry sales revenues.

By following these steps, the strategic manager can gain valuable insights into the competitive landscape of the energy drink segment and identify potential positioning strategies for the new line of energy drinks targeted at health-conscious consumers.

2. SWOT Analysis for *EasyLife Corporation's* New Smart Home Devices Venture:

Strengths • Strong brand reputation in consumer electronics. • Established distribution network. • Access to technological expertise for product development. • Financial resources to support product launch and marketing.	Weaknesses • Limited experience in the smart home devices market. • May require additional investments in research and development. • Potential challenges in integrating a new product line with existing offerings. • Lack of established customer base for smart home devices.
Opportunities • Growing market for smart home devices due to increasing consumer interest in home automation. • Possibility of partnering with existing smart home platform providers. • Potential to leverage brand loyalty from existing customers. • Ability to differentiate through innovative features and design.	Threats • Intense competition from established players in the smart home devices market. • Rapid technological advancements lead to short product life cycles. • Potential for cybersecurity threats in connected devices. • Economic factors impacting consumer spending on discretionary items.

The SWOT analysis highlights that while *EasyLife Corporation* has several strengths that can support the launch of a new smart home devices line, there are also significant weaknesses and threats to consider. To maximize the chances of success, *EasyLife Corporation* should focus on leveraging its brand reputation and distribution network while carefully addressing the weaknesses and threats identified. Additionally, staying informed about technological developments and consumer trends will be essential for maintaining competitiveness in the dynamic smart home devices market.

3. 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.
4. According to Michael Porter, strategies allow organizations to gain competitive advantage from three different bases: cost leadership, differentiation, and focus. Porter called these base generic strategies.

XXP India Ltd. has planned for Differentiation Strategy. The company is planning to launch various innovative product designs and offer loyalty programmes to lure customers.

Differentiation strategy should be pursued only after a careful study of buyers' needs and preferences to determine the feasibility of incorporating one or more differentiating features into a unique product that features the desired attributes. A successful differentiation strategy allows a firm to charge a higher price for its product and to gain customer loyalty, because consumers may become strongly attached to the differentiated features.

Advantages of Differentiation Strategy

A differentiation strategy may help an organisation to remain profitable even with rivalry, new entrants, suppliers' power, substitute products, and buyers' power.

1. **Rivalry** - Brand loyalty acts as a safeguard against competitors. It means that customers will be less sensitive to price increases, as long as the firm can satisfy the needs of its customers.
2. **Buyers** – They do not negotiate for price as they get special features, and they have fewer options in the market.
3. **Suppliers** – Because differentiators charge a premium price, they can afford to absorb higher costs of supplies as the customers are willing to pay extra too.
4. **Entrants** – Innovative features are an expensive offer. So, new entrants generally avoid these features because it is tough for them to provide the same product with special features at a comparable price.
5. **Substitutes** – Substitute products can't replace differentiated products which have high brand value and enjoy customer loyalty.

5. With the success of IPL, league matches are taking place in other sports as well. These are held in a grandeur manner between several teams. **For example**, *league matches in magnificent manner now take place in Football, Kabaddi and Hockey in India*. These events are profit and entertainment driven. These are going to help sports in India by generating interest in sports, making them more popular, increasing quality of competition and bringing money into sports.

A number of entities and processes are involved in these events from various industries offering opportunities and threats to them. An opportunity is a favourable condition in the organisation's environment which enables it to strengthen its position. On the other hand, a threat is an unfavourable condition in the organisation's environment which causes a risk for, or damage to, the organisation's position. An opportunity is also a threat in case internal weaknesses do not allow organization to take their advantage in a manner rival can. It will offer opportunity and threats to the following:

Opportunities

- ◆ Stadia.
- ◆ Manufacturers of sports goods.
- ◆ Media Industry – Sports channels / television, advertisers.
- ◆ Hotel Industry linking events with their offerings.

Threats

- ◆ Entertainment industry engaged in TV serials, cinema theatres, Entertainment theme parks as competitors will be fighting for the same viewers/target customers.
 - ◆ Event Management organisation engaged in non-sports events.
6. A tool to study the market positions of rival companies by grouping them into like positions is strategic group mapping. Grouping competitors is useful when there are many competitors such that it is not practical to examine each one in-depth. In the given scenario there are thirteen competitors. A strategic group consists of those rival firms which have similar competitive approaches and positions in the market.

The procedure for constructing a strategic group map and deciding which firms belong in which strategic group is as follows:

- ◆ Identify the competitive characteristics that differentiate firms in the industry typical variables that are price/quality range (high, medium, low); geographic coverage (local, regional, national, global); degree of vertical integration (none, partial, full); product-line breadth (wide, narrow); use of distribution channels (one, some, all); and degree of service offered (no-frills, limited, full).
 - ◆ Plot the firms on a two-variable map using pairs of these differentiating characteristics.
 - ◆ Assign firms that fall in about the same strategy space to the same strategic group.
 - ◆ Draw circles around each strategic group making the circles proportional to the size of the group's respective share of total industry sales revenues.
7. XYZ Corporation is aiming to transform into a dominant technology company under the leadership of Mohan, the new CEO. He aims to develop competencies for managers for achieving better performance and a competitive advantage for the corporation. Mohan is also well aware of the importance of resources and capabilities in generating and sustaining the competitive advantage. Therefore, he must focus on characteristics of resources and capabilities of the corporation.

The sustainability of competitive advantage and a firm's ability to earn profits from it depends, to a great extent, upon four major characteristics of resources and capabilities which are as follows:

- ◆ **Durability:** The period over which a competitive advantage is sustained depends in part on the rate at which a firm's resources and capabilities deteriorate. In industries where the rate of product innovation is fast, product patents are quite likely to become obsolete. Similarly, capabilities which are the result of the management expertise of the CEO are also vulnerable to his or her retirement or departure. On the other hand, many consumer brand names have a highly durable appeal.

- ♦ **Transferability:** Even if the resources and capabilities on which a competitive advantage is based are durable, it is likely to be eroded by competition from rivals. The ability of rivals to attack position of competitive advantage relies on their gaining access to the necessary resources and capabilities. The easier it is to transfer resources and capabilities between companies, the less sustainable will be the competitive advantage which is based on them.
 - ♦ **Imitability:** If resources and capabilities cannot be purchased by a would-be imitator, then they must be built from scratch. How easily and quickly can the competitors build the resources and capabilities on which a firm's competitive advantage is based? This is the true test of imitability. Where capabilities require networks of organizational routines, whose effectiveness depends on the corporate culture, imitation is difficult.
 - ♦ **Appropriability:** Appropriability refers to the ability of the firm's owners to appropriate the returns on its resource base. Even where resources and capabilities are capable of offering sustainable advantage, there is an issue as to who receives the returns on these resources.
8. The Airlines industry faces stiff competition. However, Luxury Jet has attempted to create a niche market by adopting focused differentiation strategy. A focused differentiation strategy requires offering unique features that fulfil the demands of a narrow market.

Luxury Jet compete in the market based on uniqueness and target a narrow market which provides business houses, high net worth individuals to maintain strict schedules. The option of charter flights provided several advantages including, flexibility, privacy, luxury and many a times cost saving. Apart from conveniences, the facility will provide time flexibility. Travelling by private jet is the most comfortable, safe and secure way of flying your company's senior business personnel.

Chartered services in airlines can have both business and private use. Personalized tourism packages can be provided to those who can afford it.

9. 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.

Gennex has opted differentiation strategy. Its products are designed and produced to give the customer value and quality. They are unique and serve specific customer needs that are not met by other companies in the industry. Highly differentiated and unique hardware and software enables Gennex to charge premium prices for its products hence making higher profits and maintain its competitive position in the market.

Differentiation strategy is aimed at 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, dealer network or customer service.

10. Considering the generic strategies of Porter there are three different bases: cost leadership, differentiation and focus. Sohan and Ramesh are contemplating pricing for their product.

Sohan is trying to have a low price and high volume is thereby trying for cost leadership. Cost leadership emphasizes producing standardised products at a very low per unit cost for consumers who are price sensitive.

Ramesh desires to create perceived value for the product and charge higher prices. He is trying to adopt differentiation. Differentiation is aimed at producing products and services considered unique industry wide and directed at consumers who are relatively price insensitive.

11. Infant care is opting for differentiation strategy. A one-stop shop is a benefit for this type of customers, seeking convenience in a time. Infant care is catering the products only related to an infant that is perceived by the customers as unique. Because of differentiation, the Infant care is charging a premium for its product.
12. Mota shoes is trying to use differentiation. This strategy is aimed at 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, dealer network or customer service. Because of differentiation, the business can charge a premium for its product.

A differentiation strategy has definite advantages as it may help to remain profitable even with rivalry, new entrants, suppliers' power, substitute products, and buyers' power.

- i. **Rivalry:** Brand loyalty acts as a safeguard against competitors. It means that customers will be less sensitive to price increases, as long as the firm can satisfy the needs of its customers.
 - ii. **Buyers:** They do not negotiate for price as they get special features and also, they have fewer options in the market.
 - iii. **Suppliers:** Because differentiators charge a premium price, they can afford to absorb higher costs of supplies and customers are willing to pay extra too.
 - iv. **New entrants:** Innovative features are expensive to copy. So, new entrants generally avoid these features because it is tough for them to provide the same product with special features at a comparable price.
 - v. **Substitutes:** Substitute products can't replace differentiated products which have high brand value and enjoy customer loyalty.
- 13.** Capabilities that are valuable, rare, costly to imitate, and non-substitutable are core competencies. A small chemist shop has a local presence and functions within a limited geographical area. Still, it can build its own competencies to gain competitive advantage. Rohit Patel can build competencies in the areas of:
- (i) Developing personal and cordial relations with the customers.
 - (ii) Providing home delivery with no additional cost.
 - (iii) Developing a system of speedy delivery that can be difficult to match by online sellers. Being in central part of city, he can create a network to supply at wider locations in the city.

- (iv) Having extended working hours for convenience of buyers.
- (v) Providing easy credit or a system of monthly payments to the patients consuming regular medicines.

14. A core competence is a unique strength of an organization which may not be shared by others. Core competencies are those capabilities that are critical to a business achieving competitive advantage. In order to qualify as a core competence, the competency should differentiate the business from any other similar businesses. A core competency for a firm is whatever it does is highly beneficial to the organisation.

'Value for Money' is the leader on account of its ability to keep costs low. The cost advantage that 'Value for Money' has created for itself has allowed the retailer to price goods lower than competitors. The core competency in this case is derived from the company's ability to generate large sales volume, allowing the company to remain profitable with low profit margin.

Answers to Descriptive Questions

15. An important component of strategic thinking requires the generation of a series of strategic alternatives, or choices of future strategies to pursue, given the company's internal strengths and weaknesses and its external opportunities and threats. The comparison of strengths, weaknesses, opportunities, and threats is normally referred to as SWOT analysis.

- ◆ **Strength:** Strength is an inherent capability of the organization which it can use to gain strategic advantage over its competitors.
- ◆ **Weakness:** A weakness is an inherent limitation or constraint of the organization which creates strategic disadvantage to it.
- ◆ **Opportunity:** An opportunity is a favourable condition in the organisation's environment which enables it to strengthen its position.
- ◆ **Threat:** A threat is an unfavourable condition in the organisation's environment which causes a risk for, or damage to, the organisation's position.

SWOT analysis helps managers to craft a business model (or models) that will allow a company to gain a competitive advantage in its industry (or industries). Competitive advantage leads to increased profitability, and this maximizes a company's chances of surviving in the fast-changing, competitive environment. Key reasons for SWOT analysis are:

- ◆ It provides a logical framework.
- ◆ It presents a comparative account.
- ◆ It guides the strategist in strategy identification.

4 CHAPTER

STRATEGIC CHOICES

The function of education is to teach one to think intensively and to think critically. Intelligence plus character - that is the goal of true education.

Important Questions January 2025



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FM-SM



75 Marks Sanskar Jain	75 Marks Shushobit Verma	75 Marks Mayank Gupta
74 Marks Vasudev	72 Marks Preeti Aggarwal	69 Marks Sandeep Shaw
69 Marks Shashank	69 Marks Riya Bansal	68 Marks Akansha
68 Marks Arsalan Ali	67 Marks Abhay Nahar	67 Marks Harsh
66 Marks Ankita Rani	66 Marks Anshu Kumar	65 Marks Pulkrit Luthra
65 Marks Seerat Sharma	65 Marks Ayush Sharma	65 Marks Shubham

3000+ Exemptions
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MEENAKSHI AIR 20	ROHIT AIR 22	SHUBHAM AIR 23	ANUSHKA AIR 36	CHERRY AIR 37	SANJEEV AIR 47

SATYAM KUMAR 87 MARKS	SUSHANT ARORA 83 MARKS
BHARAT GAUTAM 80 MARKS	PRADEEP ROHILLA 79 MARKS
ANUSHKA SHARMA 78 MARKS	KSHITIZ TAYAL 78 MARKS
SAIKAT GHOSH 77 MARKS	NILESH JAISWAL 76 MARKS
NUZAIF AKTHAR 76 MARKS	KOMAL SANWAL 75 MARKS
SHALINI SONI 75 MARKS	ASHUTOSH KUMAR 74 MARKS
NANDA CHATURVEDI 74 MARKS	ARYAN MERATWAL 73 MARKS
DEEPANSHI JAIN 73 MARKS	KAUSHAL ARORA 73 MARKS
PREETHAM BHAT 73 MARKS	SONALI VIJ 73 MARKS
ANKIT JAIN 72 MARKS	MAYURI PRAMOD 72 MARKS
SANCHIT 72 MARKS	SONU AGRAWAL 72 MARKS
TANYA BANSAL 72 MARKS	ANURAG AGGRAWAL 71 MARKS
CHIRAG JAIN 70 MARKS	NITESH LAHU 70 MARKS
PARAS BANSAL 70 MARKS	RAJSHREE 70 MARKS
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STRATEGIC CHOICES

Om Swastika

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ◆ Describe and discriminate between strategic choices such as strategic intensification, strategic diversification and strategic exits.
- ◆ Formulate strategic options.
- ◆ Explain the reasons for- relative costs & risks and benefits of the adoption of various types of corporate strategies.
- ◆ Describe the circumstances necessitating pursuit of combination strategies and strategic alliances.

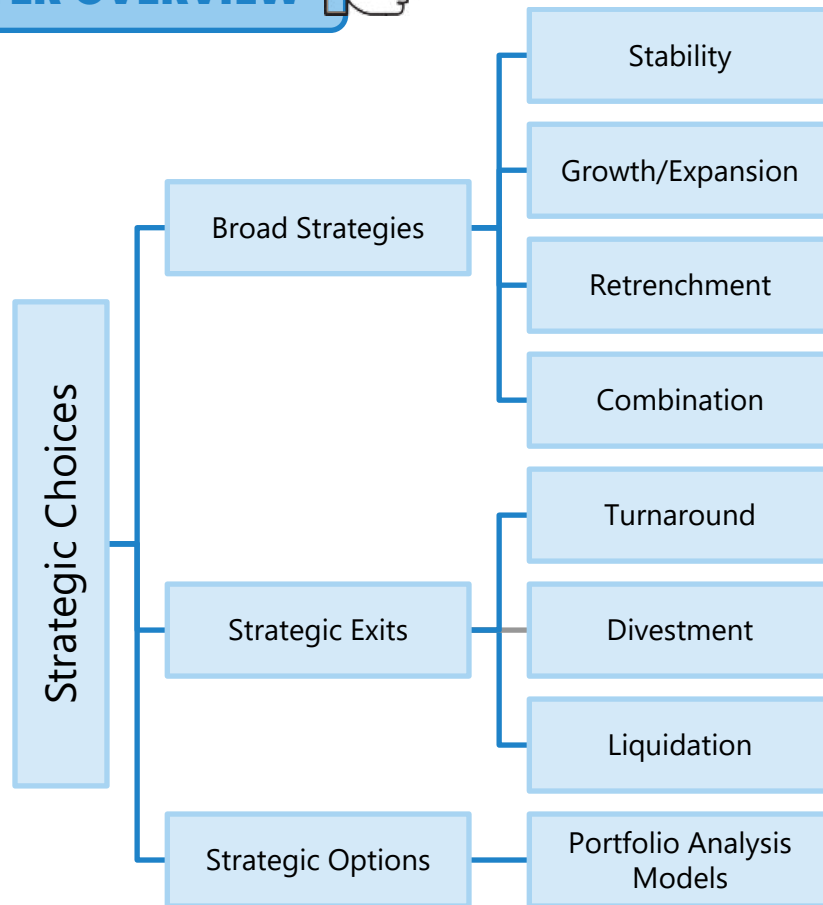
Know about combination strategies and strategic alliances.

Chance favours the prepared mind.

Louis Pasteur

Strategy is a deliberate search for a plan of action that will develop a business competitive advantage and compound it.

Bruce D. Henderson

CHAPTER OVERVIEW **4.1 INTRODUCTION**

Strategies are formulated at different levels of an organization. Strategy formulation involves well thought of decision making and cover actions dealing with the objective of the firm, shareholders and allocation of resources and coordination of strategies of various business units for optimal performance. Top management of the organization makes strategic decisions, which pan down for delegation at middle management level and finally the functional level managers execute the same with their teams.



4.2 STRATEGIC CHOICES

Businesses follow different types of strategies to enter the market, to stay relevant and grow in the market. A large number of strategies with different nomenclatures have been employed by different businesses and also suggested by different authors on strategy. For instance, William F Glueck and Lawrence R Jauch discussed four generic strategies including stability, growth, retrenchment and combination. These strategies have also been called Grand Strategies/Directional Strategies by many other authors. Michael E. Porter suggested competitive strategies including Cost Leadership, Differentiation, Focus Cost Leadership and Focus Differentiation which could be used by the corporates for their different business units. Besides these, we come across functional strategies in the literature on Strategic Management and Business Policy. Functional Strategies are meant for strategic management of distinct functions such as Marketing, Financial, Human Resource, Logistics, Production etc.

We can classify the different types of strategies on the basis of levels of the organisation, stages of business life cycle and competition as given in the Table –1.

Table: 1- Different types of strategies on the basis of their classification

Basis of Classification	Types
Level of the organisation	Corporate Level Business Level Functional Level
Stages of Business Life Cycle	Entry/Introduction Stage - Market Penetration Strategy Growth Stage - Growth/Expansion Strategy Maturity Stage - Stability Strategy Decline Stage - Retrenchment/ Turnaround Strategy
Competition oriented	Competitive Strategies - Cost Leadership, Differentiation, Focus Collaboration Strategies - Joint Venture, Merger & Acquisition, Strategic Alliance

Above are the various types of strategies available for an organisation to adopt. The organisation adopts either of these depending upon their needs and requirements. For instance, a start-up or a new enterprise might follow either a competitive strategy i.e., entering the market where a number of rivals are already operating, or a collaborative strategy, i.e., enter into a joint venture with an established company. However, majority of startups are launched on a small scale and their main strategy is to penetrate the market and to reach the breakeven stage at the earliest and later pursue growth strategy. While a going concern can continue with the competitive strategy or resort to collaborative strategy to ensure business growth.

Business conglomerates having multiple product folios formulate strategies at different levels, viz., corporate, business unit and functional. Corporate level strategies are meant to provide 'direction' to the company. Business level strategies are formulated for each product/process division known as strategic business unit. While for implementation of the corporate and business strategies, functional strategies are formulated in business areas like production/operations, marketing, finance, human resources etc. In fact, big corporates follow an elaborate system of strategy formulation, implementation and control at different levels in the company to survive and grow in the turbulent business environment. In this chapter, we shall discuss the corporate level strategies.

The corporate strategies a firm can adopt may be classified into four broad categories:

1. Stability strategy
2. Expansion strategy
3. Retrenchment strategy
4. Combination strategy

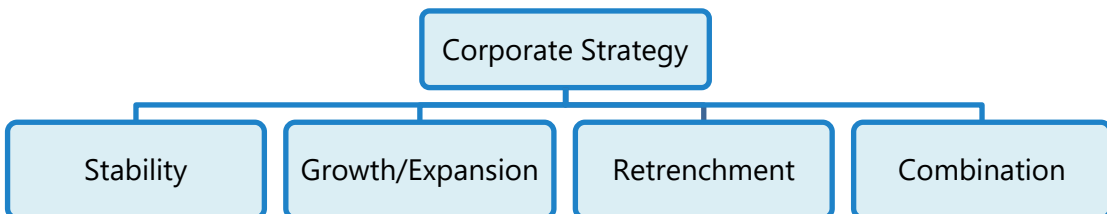


Figure:-Types of Corporate Strategies

Before proceeding further, let us discuss the basic features of all the types of corporate strategies to get the bird's eye view. The basic features of the corporate strategies are as follows:

Table:2- Basic Features of Corporate Strategies

Strategy	Basic Feature
Stability	The firm stays with its current businesses and product markets; maintains the existing level of effort; and is satisfied with incremental growth.
Expansion	Here, the firm seeks significant growth-maybe within the current businesses; maybe by entering new business that are related to existing businesses; or by entering new businesses that are unrelated to existing businesses.
Retrenchment	The firm retrenches some of the activities in some business (es), or drops the business as such through sell-out or liquidation.
Combination	The firm combines the above strategic alternatives in some permutation/combination so as to suit the specific requirements of the firm.

4.2.1. Stability Strategy

One of the important goals of a business enterprise is stability strategy is to stabilise- it may be opted to safeguard its existing interests and strengths, to pursue well established and tested objectives, to continue in the chosen business path, to maintain operational efficiency on a sustained basis, to consolidate the commanding position already reached, and to optimise returns on the resources committed in the business.

A stability strategy is pursued by a firm when:

- ◆ It continues to serve in the same or similar markets and deals in same or similar products and services.
- ◆ This strategy is typical for those firms whose product have reached the maturity stage of product life cycle or those who have a sufficient market share but need to retain that. They have to remain updated and have to pace

with the dynamic and volatile business world to preserve their market share. Hence, stability strategy should not be confused with 'do nothing' strategy. Small organizations may also follow stability strategy to consolidate their market position and prepare for the launch of growth strategies. For deeper understanding of these strategies, let us delve into their characteristics:

4.2.1.1. Characteristics of Stability Strategy

- ◆ A firm opting for stability strategy stays with the same business, same product-market posture and functions, maintaining same level of effort as at present.
- ◆ The endeavour is to enhance functional efficiencies in an incremental way, through better deployment and utilization of resources. The assessment of the firm is that the desired income and profits would be forthcoming through such incremental improvements in functional efficiencies.
- ◆ Stability strategy does not involve a redefinition of the business of the corporation.
- ◆ It is a safe strategy that maintains status quo.
- ◆ It does not warrant much of fresh investments.
- ◆ The risk involved in this strategy is less.
- ◆ While opting for this strategy, the organization can concentrate on its resources and existing businesses/products and markets, thus leading to building of core competencies.
- ◆ The firms with modest growth objective choose this strategy.

4.2.1.2 Major Reasons for Stability Strategy

- ◆ A product has reached the maturity stage of the product life cycle.
- ◆ The staff feels comfortable with the status quo as it involves less changes and less risks.
- ◆ It is opted when the environment in which an organisation is operating is relatively stable.
- ◆ Where it is not advisable to expand as it may be perceived as threatening.
- ◆ After rapid expansion, a firm might want to stabilize and consolidate itself.

Why don't Startups aim for stability?

A startup is an entrepreneurial venture in the early stages of ideation and development, generally created for solving real-life problems through technology. For it, the most important factors are speed and agility, because of it being in a nascent stage of operations. Stability on the other hand is more meaningful strategy when the size of operations is expanded to full capacity and business is at a mature stage. Thereby, we rarely see startups aiming for stability.

4.2.2. Growth/Expansion Strategy

Growth/Expansion strategy is implemented by redefining the business by enlarging the scope of business and substantially increasing investment in the business. It is a strategy that can be equated with dynamism, vigour, promise and success. It is often characterised by significant reformulation of goals and directions, major initiatives and moves involving investments, exploration and onslaught into new products, new technology and new markets, innovative decisions and action programmes and so on. This strategy may take the enterprise along relatively unknown and risky paths, full of promises and pitfalls.

4.2.2.1 Characteristics of Growth/Expansion Strategy

- ◆ Expansion strategy involves a redefinition of the business of the corporation.
- ◆ Expansion strategy is the opposite of stability strategy. While in stability strategy, rewards are limited, in expansion strategy they are very high. In the matter of risks, too, the two are the opposites of each other.
- ◆ Expansion strategy leads to business growth. A firm with a mammoth growth ambition can meet its objective only through the expansion strategy.
- ◆ The process of renewal of the firm through fresh investments and new businesses/products/markets is facilitated only by expansion strategy.
- ◆ Expansion strategy is a highly versatile strategy; it offers several permutations and combinations for growth. A firm opting for the expansion strategy can generate many alternatives within the strategy by altering its propositions regarding products, markets and functions and pick the one that suits it most.

- ◆ Expansion strategy holds within its fold two major strategy routes: Intensification Diversification. Both of them are growth strategies; the difference lies in the way in which the firm actually pursues the growth.

4.2.2.2 Major Reasons for Growth/Expansion Strategy

- ◆ It may become imperative when environment demands increase in pace of activity.
- ◆ Strategists may feel more satisfied with the prospects of growth from expansion; chief executives may take pride in presiding over organizations perceived to be growth-oriented.
- ◆ Expansion may lead to greater control over the market vis-a-vis competitors.
- ◆ Advantages from the experience curve and scale of operations may accrue.
- ◆ Expansion also includes intensifying, diversifying, acquiring and merging businesses. Therefore, growth strategies can take the following forms:

4.2.2.3 Types of Growth/ Expansion Strategy

The growth strategies can be classified into two main types:

- A. Internal growth strategies
- B. External growth strategies

A. Internal growth strategies

Internal growth strategies can be further divided into:

- I Expansion through Intensification
- II Expansion through Diversification

I Expansion or growth through Intensification

Expansion or growth through intensification means that the organisation tries to grow internally by intensifying its operations either by market penetration or market development or by product development. It tries to cash on its internal capabilities and internal resources. The firm can intensify by adopting any of the following strategies:

- (i) **Market Penetration:** Highly common expansion strategy is market penetration/concentration on the current business. The firm directs its

resources to the profitable growth of its existing product in the existing market.

- (ii) **Market Development:** It consists of marketing present products, to customers in related market areas by adding different channels of distribution or by changing the content of advertising or the promotional media.
- (iii) **Product Development:** Product development involves substantial modification of existing products or creation of new but related items that can be marketed to current customers through establish channels.

Igor. H. Ansoff gave a framework as shown in figure below which describes the intensification options available to a firm.

Table:3- Product-Market Expansion Grid

Market Penetration ◆ Increase market share. ◆ Increase product usage. ◆ Increase the frequency used. ◆ Increase the quantity used. ◆ Find new application for current users.	Product Development ◆ Add product features, product refinement. ◆ Develop a new-generation product. ◆ Develop new product for the same market.
Market Development ◆ Expand geographically Target new segments.	Diversification involving new products and new markets ◆ Related / Unrelated.

II Expansion or Growth through Diversification

When a firm tries to grow and expand by diversifying into various products or fields, it is called growth by diversification. This is also an internal growth strategy. Innovative and creative firms always look for opportunities and challenges to grow, to venture into new areas of activity and to break new frontiers with the zeal of entrepreneurship using their internal resources. They feel that diversification offers greater prospects of growth and profitability than intensification.

Diversification is defined as an entry into new products or product lines, new services or new markets, involving substantially different skills, technology and knowledge. When an established firm introduces a new product, which has little or

no affinity with its present product line and which is meant for a new class of customers different from the firm's existing customer groups, the process is known as conglomerate diversification. Both the technology of the product and the market are different from the firm's present experience.

For some firms, diversification is a means of utilising their existing facilities and capabilities in a more effective and efficient manner. They may have excess capacity or capability in manufacturing facilities, investible funds, marketing channels, competitive standing, market prestige, managerial and other manpower, research and development, raw material sources and so forth. Another reason for diversification lies in its synergistic advantage. It may be possible to improve the sales and profits of existing products by adding suitably related or new products, because of linkages in technology and/or in markets.

Based on the nature and extent of their relationship to existing businesses, diversification can be classified into two broad categories:

- (i) Concentric diversification: diversification into related business to benefit from synergistic gains
- (ii) Conglomerate diversification: diversification into unrelated business to explore more opportunities beyond existing areas of expertise
- (iii) Expansion through Innovation

Diversification endeavours can be related or unrelated to existing businesses of the firm.

- (i) **Concentric Diversification:** Concentric diversification takes place when the products are related. In this diversification, the new business that it diversifies into is linked to the existing businesses through process, technology or marketing. The new product is a spin-off from the existing facilities and products/processes. This means that in concentric diversification too, there are benefits of synergy with the current operations. The new product is only connected in a loop-like manner at one or more points in the firm's existing process/technology/product chain. **For example,** a company producing clothes ventures into the manufacturing of shoes.

Concentric diversification is generally understood in two directions, vertical and horizontal integration;

- (a) **Vertically Integrated Diversification:** In vertically integrated diversification, firms opt to engage in businesses that are related to the existing business of the firm. The firm remains vertically within the same process sequence moves forward or backward in the chain and enters specific product/process steps with the intention of making them into new businesses for the firm. The characteristic feature of vertically integrated diversification is that the firm remains in the vertically linked product-process chain. A firm can either opt for forward or backward integration or horizontal integration.

Forward and Backward Integration: Forward and backward integration forms part of vertically integrated diversification. In vertically integrated diversification, firms opt to engage in businesses that are vertically related to the existing business of the firm. The firm remains vertically within the same process. While diversifying, firms opt to engage in businesses that are linked forward or backward in the chain.

Backward integration is concerned with creation of effective supply by entering business of input providers. Strategy employed to expand profits and gain greater control over production/supply of a product whereby a company will purchase or build a business that will increase its own supply capability or lessen its cost of production. **For example,** A large supermarket chain considers to purchase a number of farms that would provide it a significant amount of fresh produce.

On the other hand, forward integration is moving forward in the value chain and entering business lines that use existing products. Forward integration will also take place where organizations enter into businesses of distribution channels. **For example,** A coffee bean manufacture may choose to merge with a coffee cafe.

- (b) **Horizontal Integrated Diversification:** A firm gets horizontally diversified by integrating through acquisition of one or more similar businesses operating at the same stage of the production-marketing

chain. They can also integrate with the firms producing complementary products or by-products or by taking over competitors' products. The following figure explains the horizontal diversification, wherein, textile mill 1 acquires textile mill 2 and 3 as well.

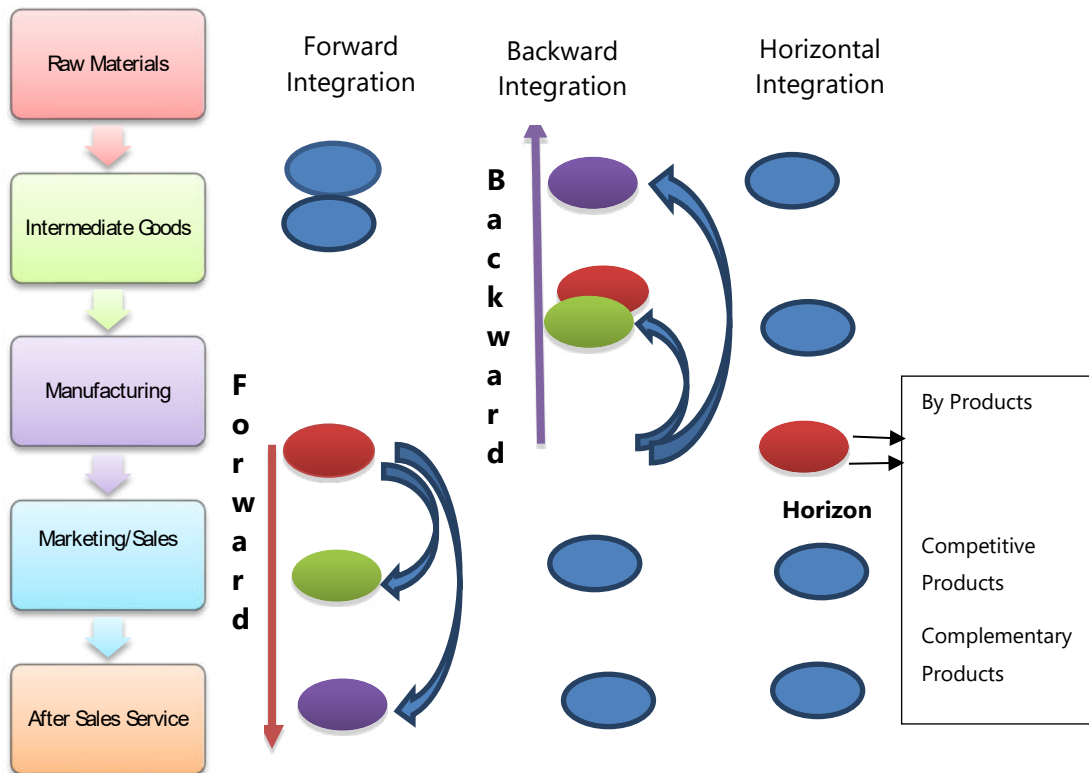


Figure: Diversification

- (ii) **Conglomerate Diversification:** In conglomerate diversification, no linkages related to product, market or technology exist; the new businesses/products are disjointed from the existing businesses/products in every way; it is a totally unrelated diversification. In process/technology/function, there is no connection between the new products and the existing ones. Conglomerate diversification has no common thread at all with the firm's present position. **For example,** A cement manufacturer diversifies into the manufacture of steel and rubber products.


Table 4: Related vs. Unrelated Diversification


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

Is it really worth expanding so much to diversify a business into unrelated products?

Despite of its complexity, conglomerate diversification (diversification into unrelated business) financially makes a lot of sense. It creates access a new pool of customers, thereby expanding its customer base. It allows access to markets and cross-selling new products, leading to increased revenues. Further, it eases the management of losses in a business; profits in one business can be used to keep the loss making business afloat within the same organisation.

(iii) Innovation: Innovation drives upgradation of existing product lines or processes, leading to increased market share, revenues, profitability and most important, customer satisfaction. Some may argue that innovation leads to unnecessary expenses that do not give as much returns, but on the contrary, for a business to grow long term, innovation offers the following;

- **Helps to solve complex problems:** A business strives to find opportunities in existing problems of the society, and it does so though planned innovation in areas of expertise. This guided innovation help

solve complex problems by developing customer centric sustainable solutions. **For example**, the pressing problem of environmental damage is being tackled head on by shifting to renewable sources of energy like solar, wind, sea waves, etc. It might be costly in introductory stages but in the long run it will only have economical and environmental sustainability.

- **Increases Productivity:** Innovation leads to simplification and in most cases automation of existing tasks. Productivity is defined as a measure of final output from a task or a process, and companies are willing to spend millions on increasing their productivity. Innovation, by automating repetitive tasks, and simplifying the long chain of processes, adds to productivity of teams and thereby the organisation as a whole. **For example**, MS Excel, every finance professional uses this software to simplify and automate their manual tasks. Such digital innovation which leads to improved productivity, creates opportunities to further develop processes and products within and outside the organisation. Thus, innovation creates a ripple effect that has a far and wide impact across industries.
- **Gives Competitive Advantage:** Being ahead of competition is a need, and businesses spend majority of their strategic time building solutions to achieve this advantage. An interesting concept about innovation is - the faster a business innovates, the farther it goes from its competitor's reach. Innovative products need less marketing as they aim to provide added satisfaction to consumers, thus, creating a competitive advantage. Innovation not only helps retain the existing customers but helps acquire new ones with ease.

B. External Growth Strategies

When the organization instead of growing internally thinks of diversifying by making alliances with external organisations, it is called external growth diversification. It can be classified in two ways:

I Expansion through Mergers and Acquisitions

Acquisition or merger with an existing concern is an instant means of achieving the expansion. It is an attractive and tempting proposition in the sense that it

circumvents the time, risks and skills involved in screening internal growth opportunities, seizing them and building up the necessary resource base required to materialise growth. Organizations consider merger and acquisition proposals in a systematic manner, so that the marriage will be mutually beneficial, a happy and lasting affair.

Apart from the urge to grow, acquisitions and mergers are resorted to for purposes of achieving a measure of synergy between the parent and the acquired enterprises. Synergy may result from such bases as physical facilities, technical and managerial skills, distribution channels, general administration, research and development and so on. Only positive synergistic effects are relevant in this connection which denotes that the positive effects of the merged resources are greater than the effects of the individual resources before merger or acquisition.

Merger and acquisition in simple words are defined as a process of combining two or more organizations together. There is a thin line of difference between the two terms but the impact of combination is completely different in both the cases. Some organizations prefer to grow through mergers. Merger is a process when two or more companies come together to expand their business operations. In such a case the deal gets finalized on friendly terms and both the organizations share profits in the newly created entity. In a merger two organizations combine to increase their strength and financial gains along with breaking of the trade barriers.

When one organization takes over the other organization and controls all its business operations, it is known as acquisition. In acquisition, one financially strong organization overpowers the weaker one. Acquisitions often happen during recession in economy or during declining profit margins. In this process, the stronger one overpowers the weaker one. The combined operations then run under the name of the powerful entity. A deal in case of an acquisition is often done in an unfriendly manner, it is more or less a forced association where the powerful organization acquires the operations of the company that is in a weaker position and is forced to sell its entity.



Types of Mergers

The following are the types of mergers and are quite similar to the types of diversification.

(a) Horizontal Merger

Horizontal merger is a combination of firms engaged in the same industry. It is a merger with a direct competitor. The principal objective behind this type of merger is to achieve economies of scale in the production process by shedding duplication of installations and functions, widening the line of products, decrease in working capital and fixed assets investment, getting rid of competition and so on. **For example**, formation of Brook Bond Lipton India Ltd. through the merger of Lipton India and Brook Bond.

(b) Vertical Merger

It is a merger of two organizations that are operating in the same industry but at different stages of production or distribution system. This often leads to increased synergies with the merging firms. If an organization takes over its supplier/producers of raw material, then it leads to backward integration. On the other hand, forward integration happens when an organization decides to take over its buyer organizations or distribution channels. Vertical merger results in many operating and financial economies. Vertical mergers help to create an advantageous position by restricting the supply of inputs to other players, or by providing the inputs at a higher cost. **For example**, backward integration and forward integration.

(c) Co-generic Merger

In Co-generic merger two or more merging organizations are associated in some way or the other related to the production processes, business markets, or basic required technologies. Such merger includes the extension of the product line or acquiring components that are required in the daily operations. It offers great opportunities to businesses to diversify around a common set of resources and strategic requirements. **For example**, an organization in the white goods category such as refrigerators can diversify by merging with another organization having business in kitchen appliances.

(d) Conglomerate Merger

Conglomerate mergers are the combination of organizations that are unrelated to each other. There are no linkages with respect to customer groups, customer functions and technologies being used. There are no important common factors between the organizations in production, marketing, research and development and technology. In practice, however, there is some degree of overlap in one or more of these factors.

II. Expansion through Strategic Alliance

A strategic alliance is a relationship between two or more businesses that enables each to achieve certain strategic objectives which neither would be able to achieve on its own. The strategic partners maintain their status as independent and separate entities, share the benefits and control over the partnership, and continue to make contributions to the alliance until it is terminated. Strategic alliances are often formed in the global marketplace between businesses that are based in different regions of the world.

Advantages of Strategic Alliance

Strategic alliance usually is only formed if they provide an advantage to all the parties in the alliance. These advantages can be broadly categorised as follows:

- 1. Organizational:** Strategic alliance helps to learn necessary skills and obtain certain capabilities from strategic partners. Strategic partners may also help to enhance productive capacity, provide a distribution system, or extend supply chain. Strategic partners may provide a good or service that complements thereby creating a synergy. Having a strategic partner who is well-known and respected also helps add legitimacy and creditability to a new venture.
- 2. Economic:** There can be reduction in costs and risks by distributing them across the members of the alliance. Greater economies of scale can be obtained in an alliance, as production volume can increase, causing the cost per unit to decline. Finally, partners can take advantage of co-specialization, creating additional value, such as when a leading computer manufacturer bundles its desktop with a leading monitor manufacturer's monitor.

3. **Strategic:** Rivals can join together to cooperate instead of competing with each other. Vertical integration can be created where partners are part of supply chain. Strategic alliances may also be useful to create a competitive advantage by the pooling of resources and skills. This may also help with future business opportunities and the development of new products and technologies. Strategic alliances may also be used to get access to new technologies or to pursue joint research and development.
4. **Political:** Sometimes strategic alliances are formed with a local foreign business to gain entry into a foreign market either because of local prejudices or legal barriers to entry. Forming strategic alliances with politically influential partners may also help improve your own influence and position.

Disadvantages of Strategic Alliance

Strategic alliances do come with some disadvantages and risks. The major disadvantage is **sharing**. Strategic alliances require sharing of resources and profits, and also sharing knowledge and skills that otherwise organisations may not like to share. Sharing knowledge and skills can be problematic if they involve trade secrets. Agreements can be executed to protect trade secrets, but they are only as good as the willingness of parties to abide by the agreements or the courts willingness to enforce them. Strategic alliances may also create potential competition when an ally becomes an opponent in future when it decides to separate out



4.3 STRATEGIC EXITS

Strategic Exits are followed when an organization substantially reduces the scope of its activity. This is done through an attempt to find out the problem areas and diagnose the causes of the problems. Next, steps are taken to solve the problems. These steps result in different kinds of retrenchment strategies. If the organization chooses to focus on ways and means to reverse the process of decline, it adopts a turnaround strategy. If it cuts off the loss-making units, divisions, or SBUs, curtails its product line, or reduces the functions performed, it adopts a divestment (or divestiture) strategy. If none of these actions work, then it may choose to abandon

the activities totally, resulting in a liquidation strategy. We deal with each of these strategies below.

I. Turnaround Strategy

Retrenchment may be done either internally or externally. For internal retrenchment to take place, emphasis is laid on improving internal efficiency, known as turnaround strategy.

There are certain conditions or indicators which point out that a turnaround is needed if the company has to survive. These danger signals are:

- ◆ Persistent negative cash flow from business(es)
- ◆ Uncompetitive products or services
- ◆ Declining market share
- ◆ Deterioration in physical facilities
- ◆ Over-staffing, high turnover of employees, and low morale
- ◆ Mismanagement

Action Plan for Turnaround

For turnaround strategies to be successful, it is imperative to focus on the short and long-term financing needs as well as on strategic issues. A workable action plan for turnaround would involve the following stages:

- ◆ **Stage One – Assessment of current problems:** The first step is to assess the current problems and get to the root causes and the extent of damage the problem has caused. Once the problems are identified, the resources should be focused toward those areas essential to efficiently work on correcting and repairing any immediate issues.
- ◆ **Stage Two –Analyze the situation and develop a strategic plan:** Before you make any major changes; determine the chances of the business's survival. Identify appropriate strategies and develop a preliminary action plan. For this one should look for the viable core businesses, adequate bridge financing and available organizational resources. Analyze the strengths and weaknesses in the areas of competitive position. Once major problems and

opportunities are identified, develop a strategic plan with specific goals and detailed functional actions.

- ◆ **Stage Three –Implementing an emergency action plan:** If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive. The plan typically includes human resource, financial, marketing and operations actions to restructure debts, improve working capital, reduce costs, improve budgeting practices, prune product lines and accelerate high potential products. A positive operating cash flow must be established as quickly as possible and enough funds to implement the turnaround strategies must be raised.
- ◆ **Stage Four –Restructuring the business:** The financial state of the organization's core business is particularly important. If the core business is irreparably damaged, then the outlook for the entire organization may be bleak. Prepare cash forecasts, analyze assets and debts, review profits and analyze other key financial functions to position the organization for rapid improvement.

During the turnaround, the "product mix" may be changed, requiring the organization to do some repositioning. Core products neglected over time may require immediate attention to remain competitive. Some facilities might be closed; the organization may even withdraw from certain markets to make organization leaner or target its products toward a different niche.

Morale building is another important ingredient in the organization's competitive effectiveness. Reward and compensation systems that encourage dedication and creativity amongst employees to think about profits and return on investments.

- ◆ **Stage Five –Returning to normal:** In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added. Emphasis is placed on a number of strategic efforts such as carefully adding new products and improving customer service, creating alliances with other organizations, increasing the market share, etc.

The important elements of turnaround strategy are as follows:

- Changes in the top management
- Initial credibility-building actions
- Neutralising external pressures
- Identifying quick payoff activities
- Quick cost reductions
- Revenue generation
- Asset liquidation for generating cash
- Better internal coordination

II. Divestment Strategy

Divestment strategy involves the sale or liquidation of a portion of business, or a major division, profit centre or SBU. Divestment is usually a part of rehabilitation or restructuring plan and is adopted when a turnaround has been attempted but has proved to be unsuccessful. The option of a turnaround may even be ignored if it is obvious that divestment is the only answer.

A divestment strategy may be adopted due to various reasons:

- ◆ A business that had been acquired proves to be a mismatch and cannot be integrated within the company.
- ◆ Persistent negative cash flows from a particular business create financial problems for the whole company, creating the need for divestment of that business.
- ◆ Severity of competition and the inability of a firm to cope with it may cause it to divest.
- ◆ It is not possible for the business to do Technological upgradation that is required for the business to survive, a preferable option would be to divest.
- ◆ A better alternative may be available for investment, causing a firm to divest a part of its unprofitable business.

Characteristics of Divestment Strategy

- ◆ This strategy involves divestment of some of the activities in a given business of the firm or sell-out of some of the businesses as such.
- ◆ Divestment is to be viewed as an integral part of corporate strategy without any stigma attached.

Major Reasons for Retrenchment/Turnaround Strategy

- ◆ The management no longer wishes to remain in business either partly or wholly due to continuous losses and unviability.
- ◆ The management feels that business could be made viable by divesting some of the activities or liquidation of unprofitable activities.
- ◆ A business that had been acquired proves to be a mismatch and cannot be integrated within the company.
- ◆ Persistent negative cash flows from a particular business create financial problems for the whole company, creating the need for divestment of that business.
- ◆ Severity of competition and the inability of a firm to cope with it may cause it to divest.
- ◆ Technological upgradation is required if the business is to survive but where it is not possible for the firm to invest in it, a preferable option would be to divest.
- ◆ A better alternative may be available for investment, causing a firm to divest a part of its unprofitable businesses.

Is Turnaround strategy only relevant to loss making businesses?

Interestingly, turnaround strategy is relevant when a company is experiencing a period of poor performance. Poor performance does not always mean losses, it may also mean lower than expected growth, no future clarity, or even lesser than target profits.

4.4 STRATEGIC OPTIONS

Strategic options need to be carved out from existing products and innovations that are happening in the industry. There are a set of models that help strategists in taking strategic decisions with regard to individual products or businesses in a firm's portfolio. Primarily used for competitive analysis and corporate strategic planning in multi-product and multi business firms. They may also be used in less-diversified firms, if these consist of a main business and other minor complementary interests. The main advantage in adopting a portfolio approach in a multi-product, multi-business firm is that resources could be channelised at the corporate level to those businesses that possess the greatest potential.

For instance, a diversified company may decide to divert resources from its cash-rich businesses to more prospective ones that hold promise of a faster growth so that the company achieves its corporate level objectives efficiently.

In order to design the business portfolio, the management must analyse its current business portfolio and decide which business should receive more, less, or no investment. Depending upon analyses management may develop growth strategies for adding new products or businesses to the firm's portfolio.

4.4.1 Ansoff's Product Market Growth Matrix

The Ansoff's product market growth matrix (proposed by Igor Ansoff) is a useful tool that helps businesses decide their product and market growth strategy. With the use of this matrix a business can get a fair idea about how its growth depends upon it markets in new or existing products in both new and existing markets. Companies should always be looking to the future. One useful device for identifying growth opportunities for the future is the product/market expansion grid. The product/market growth matrix is a portfolio-planning tool for identifying growth opportunities for the company.

	Existing Products	New Products
Existing Markets	Market Penetration	Product Development
New Markets	Market Development	Diversification

Figure: Ansoff's Product Market Growth Matrix

Market Penetration: Market penetration refers to a growth strategy where the business focuses on selling existing products into existing markets. It is achieved by making more sales to present customers without changing products in any major way. Penetration might require greater spending on advertising or personal selling. Overcoming competition in a mature market requires an aggressive promotional campaign, supported by a pricing strategy designed to make the market unattractive for competitors. Penetration is also done by effort on increasing usage by existing customers. **For example, Gucci, a luxury clothing brand, selling its luxury clothing in European markets with new designs, is market penetration.**

Market Development: Market development refers to a growth strategy where the business seeks to sell its existing products into new markets. It is a strategy for company growth by identifying and developing new markets for current company products. This strategy may be achieved through new geographical markets, new product dimensions or packaging, new distribution channels or different pricing policies to attract different customers or create new market segments. **For example, Gucci, a luxury clothing brand, selling its luxury clothing in Chinese markets, is market development.**

Product Development: Product development refers to a growth strategy where business aims to introduce new products into existing markets. It is a strategy for company growth by offering modified or new products to current markets. This strategy may require the development of new competencies and requires the

business to develop modified products which can appeal to existing markets. **For example,** *Gucci, a luxury clothing brand, selling casual clothing in European markets, is product development.*

Diversification: Diversification refers to a growth strategy where a business markets new products in new markets. It is a strategy by starting up or acquiring businesses outside the company's current products and markets. This strategy is risky because it does not rely on either the company's successful product or its position in established markets. Typically, the business is moving into markets in which it has little or no experience. **For example,** *Gucci, a luxury clothing brand, selling casual clothing in Chinese markets, is diversification.*

As market conditions change overtime, a company may shift product-market growth strategies. **For example,** *when its present market is fully saturated a company may have no choice other than to pursue new market.*

4.4.2 ADL Matrix

The ADL matrix (derived its name from Arthur D. Little) is a portfolio analysis technique that is based on product life cycle. The approach forms a two-dimensional matrix based on stage of industry maturity and the firms competitive position, environmental assessment and business strength assessment. Stage of industry maturity is an environmental measure that represents a position in industry's life cycle. Competitive position is a measure of business strengths that helps in categorization of products or SBU's into one of five competitive positions:

- ◆ dominant,
- ◆ strong,
- ◆ favourable,
- ◆ tenable and
- ◆ weak

It is four by five matrix as follows:

Stage of industry maturity - Arthur D. Little (ADL) Matrix				
Competitive position	Embryonic	Growth	Mature	Ageing
Dominant	- Fast grow - Build barriers - Act offensively	- Fast grow - Attend cost leadership - Renew - Defend position - Act offensively	- Defend position - Attend cost leadership - Renew - Fast grow - Act offensively	- Defend position - Renew - Focus - Consider withdrawal
Strong	- Differentiate - Fast grow	- Differentiate - Lower cost - Attack small firms	- Lower cost - Focus - Differentiate - Grow with industry	- Find niche - Hold niche - Harvest
Favorable	- Differentiate - Focus - Fast grow	- Focus - Differentiate - Defend	- Focus - Differentiate - Harvest - Find niche - Hold niche - Turnaround - Grow with industry - Hit smaller firms	- Harvest - Turnaround
Tenable	- Grow with industry - Focus	- Hold niche - Turnaround - Focus - Grow with industry - Withdraw	- Turnaround - Hold niche - Retrench	- Divest - Retrench
Weak	- Find niche - Catch-up - Grow with industry	- Turnaround - Retrench - Niche or withdraw	- Withdraw - Divest	- Withdraw

Figure: Arthur D. Little Strategic Condition Matrix

The competitive position of a firm is based on an assessment of the following criteria:

Dominant: This is a comparatively rare position and in many cases is attributable either to a monopoly or a strong and protected technological leadership.

Strong: By virtue of this position, the firm has a considerable degree of freedom over its choice of strategies and is often able to act without its market position being unduly threatened by its competitors.

Favourable: This position, which generally comes about when the industry is fragmented and no one competitor stands out clearly, results in the market leaders a reasonable degree of freedom.

Tenable: Although the firms within this category are able to perform satisfactorily and can justify staying in the industry, they are generally vulnerable in the face of increased competition from stronger and more proactive companies in the market.

Weak: The performance of firms in this category is generally unsatisfactory although the opportunities for improvement do exist.

4.4.3 Boston Consulting Group (BCG) Growth-Share Matrix

The BCG growth-share matrix is the simplest way to portray a corporation's portfolio of investments. Growth share matrix also known for its cow and dog metaphors is popularly used for resource allocation in a diversified company. Using the BCG approach, a company classifies its different businesses on a two-dimensional growth-share matrix. In the matrix:

- ◆ The vertical axis represents market growth rate and provides a measure of market attractiveness.
- ◆ The horizontal axis represents relative market share and serves as a measure of company strength in the market.

Using the matrix, organisations can identify four different types of products or SBU as follows:

		Relative Market Share	
		High	low
Market Growth Rate	High	Stars 	Question Marks 
	Low	Cash Cows 	Dogs 

Figure: BCG Growth-Share Matrix

- ◆ **Stars** are products or SBUs that are growing rapidly. They also need heavy investment to maintain their position and finance their rapid growth potential. They represent best opportunities for expansion.
- ◆ **Cash Cows** are low-growth, high market share businesses or products. They generate cash and have low costs. They are established, successful, and need less investment to maintain their market share. In long run when the growth rate slows down, stars become cash cows.
- ◆ **Question Marks**, sometimes called problem children or wildcats, are low market share business in high-growth markets. They require a lot of cash to hold their share. They need heavy investments with low potential to generate cash. Question marks if left unattended are capable of becoming cash traps. Since growth rate is high, increasing it should be relatively easier. It is for business organisations to turn them stars and then to cash cows when the growth rate reduces.

- ◆ **Dogs** are low-growth, low-share businesses and products. They may generate enough cash to maintain themselves, but do not have much future. Sometimes they may need cash to survive. Dogs should be minimised by means of divestment or liquidation.

4.4.3.1 BCG Matrix: Post Identification Strategies

After a firm, has classified its products or SBUs, it must determine what role each will play in the future. The four strategies that can be pursued are:

1. **Build:** Here the objective is to increase market share, even by forgoing short-term earnings in favour of building a strong future with large market share.
2. **Hold:** Here the objective is to preserve market share.
3. **Harvest:** Here the objective is to increase short-term cash flow regardless of long-term effect.
4. **Divest:** Here the objective is to sell or liquidate the business because resources can be better used elsewhere.

Is BCG Matrix really helpful?

The growth-share matrix has done much to help strategic planning; however, there are some problems and limitations with the technique. BCG matrix can be difficult, time-consuming, and costly to implement. Management may find it difficult to define SBUs and measure market share and growth. It also focuses on classifying current businesses but provide little advice for future planning. They can lead the company to placing too much emphasis on market-share growth or growth through entry into attractive new markets. This can cause unwise expansion into hot, new, risky ventures or divesting established units too quickly.

Identify if the following is a Star or a Cash Cow?

SO Pharma Ltd. developed a new age medicine which cures cough in 3 hours with an investment of INR 80 crores in R&D. They named it "COUFIX". Coufix needs a lot of marketing spend to create awareness amongst the public and also needs funds to get licenses from the regulators. Interestingly, Coufix has gained 60% market share within 6 months of launch and been profitable since day 1. Is Coufix, a cash cow or a star for SO Pharma Ltd.?

It is a Star.

Stars are products or SBUs that are growing rapidly. They also need heavy investment to maintain their position and finance their rapid growth potential. They represent best opportunities for expansion.

Just one parameter of market share cannot define the status of an SBU, it should be categorised basis the inherent characteristics, and hence Coufix has more representation as a Star.

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

This model has been used by General Electric Company (developed by GE with the assistance of the consulting firm McKinsey and Company). This model is also known as Business Planning Matrix, GE Nine-Cell Matrix and GE Model. The strategic planning approach in this model has been inspired from traffic control lights. The lights that are used at crossings to manage traffic are: green for go, amber or yellow for caution, and red for stop. This model uses two factors while taking strategic decisions: Business Strength and Market Attractiveness.

Understanding the GE Matrix

The **vertical** axis indicates market **attractiveness**, and the **horizontal** axis shows the **business strength in the industry**. The market attractiveness is measured by a number of factors like:

- ◆ Size of the market.
- ◆ Market growth rate.
- ◆ Industry profitability.
- ◆ Competitive intensity.
- ◆ Availability of Technology.
- ◆ Pricing trends.
- ◆ Overall risk of returns in the industry.
- ◆ Opportunity for differentiation of products and services.
- ◆ Demand variability.

- ◆ Segmentation.
- ◆ Distribution structure (e.g. direct marketing, retail, wholesale) etc.

Business strength is measured by considering the typical drivers like:

- ◆ Market share.
- ◆ Market share growth rate.
- ◆ Profit margin.
- ◆ Distribution efficiency.
- ◆ Brand image.
- ◆ Ability to compete on price and quality.
- ◆ Customer loyalty.
- ◆ Production capacity.
- ◆ Technological capability.
- ◆ Relative cost position.
- ◆ Management calibre, etc.

		Business strength		
		Strong	Average	Weak
Market attractiveness	High	Invest/Expand	Invest/Expand	Select/Earn
	Medium	Invest/Expand	Select/Earn	Harvest/Divest
	Low	Select/Earn	Harvest/Divest	Harvest/Divest

If a product falls in the green section, the business is at advantageous position. To reap the benefits, the strategic decision can be to expand, to invest and grow. If a product is in the amber or yellow zone, it needs caution and managerial discretion is called for making the strategic choices. If a product is in the red zone, it will eventually lead to losses that would make things difficult for organisations. In such cases, the appropriate strategy should be retrenchment, divestment or liquidation.

This model is similar to the BCG growth-share matrix. However, there are differences. Firstly, market attractiveness replaces market growth as the dimension of industry attractiveness and includes a broader range of factors other than just the market growth rate. Secondly, competitive strength replaces market share as the dimension by which the competitive position of each SBU is assessed.

SUMMARY

Businesses are born out of ideas to solve existing problems with an aim to survive forces of competition and charter a path of constant growth. For a business, having multiple strategic choices for any and every situation is imperative and strategy teams should regularly analyse the possibilities of slowing down, growing faster, or liquidating the business as it demands. For each of these broad decisions, there are multiple strategic choices with advantages and disadvantages of each.

Deciding the stage in its life cycle of, identifying its current position with its Vision and Mission, and developing a future path is crucial, and strategic choices of growth, stability and expansion shall be explored with an eye for all stakeholders.

In order to develop the strategic options, the company must conduct Portfolio analysis through BCG matrix, Ansoff's product market growth matrix, ADL matrix and the General Electric matrix.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. Which strategy is implemented after the failure of turnaround strategy?
 - (a) Expansion strategy
 - (b) Diversification strategy
 - (c) Divestment strategy
 - (d) Growth strategy
2. Retrenchment strategy in the organization can be explained as
 - (a) Reducing trenches (gaps) created between individuals.
 - (b) Divesting a major product line or market.
 - (c) Removal of employees from job through the process of reorganization.
 - (d) Removal of employees from job in one business to relocate them in other business.
3. An organisation diversifies in backward sequence in the product chain and enters specific product/process to be used in existing products. It is:
 - (a) Forward diversification.
 - (b) Vertical diversification.
 - (c) Horizontal diversification.
 - (d) Reactive diversification.
4. Corporate strategy includes:
 - (i) expansion and growth, diversification, takeovers and mergers
 - (ii) Vertical and horizontal integration, new investment and divestment areas
 - (iii) determination of the business lines

From the combinations given below select a correct alternative:

 - (a) (i), and (ii)
 - (b) (i) and (iii)
 - (c) (ii) and (iii)
 - (d) (i) (ii) and (iii)

5. *Vertical integration may be beneficial when*
 - (a) *Lower transaction costs and improved coordination are vital and achievable through vertical integration.*
 - (b) *Flexibility is reduced, providing a more stationary position in the competitive environment.*
 - (c) *Various segregated specializations will be combined.*
 - (d) *The minimum efficient scales of two corporations are different.*
6. *Stability strategy is a _____ strategy.*
 - (a) *SBU level*
 - (b) *Corporate level*
 - (c) *Business level*
 - (d) *Functional level*
7. *Conglomerate diversification is another name for which of the following?*
 - (a) *Related diversification*
 - (b) *Unrelated diversification*
 - (c) *Portfolio diversification*
 - (d) *Acquisition diversification*
8. *Diversification primarily helps to:*
 - (a) *Reduce competition*
 - (b) *Reduce risk*
 - (c) *Reduce taxes*
 - (d) *Reduce costs*
9. *If suppliers are unreliable or too costly, which of these strategies may be appropriate?*
 - (a) *Horizontal integration*
 - (b) *Backward integration*
 - (c) *Market penetration*
 - (d) *Forward integration*



Scenario Based Questions

1. *The CEO of a textile mill believes that his company, currently operating at a loss, can be turned around. Develop an action plan outlining steps the CEO can take to achieve this turnaround.*
2. *StarTech Solutions, an aerospace technology firm, operates in a highly competitive industry. Despite the fierce competition in the aerospace sector, StarTech has carved out a niche for itself by focusing on serving unique, high-end clients. Unlike its competitors, StarTech has chosen not to diversify its target market and instead specializes in providing cutting-edge solutions to this niche market.*

Identify and explain the strategy adopted by StarTech Solutions. Discuss the advantages and disadvantages of this strategy.

- 
3. *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?*
 4. *Pizza Galleria was India's first pizza delivery chain enjoying monopoly for several years. However, after the entry of Modino and Uncle Jack it is struggling to compete. Both Modino and Uncle Jack have opened several eateries and priced the product aggressively. In the last four years the chain has suffered significant losses. The chain wishes to know whether they should go for a turnaround strategy. List out components of action plan for turnaround strategy.*
 5. *Gautam and Siddhartha, two brothers, are the owners of a cloth manufacturing unit located in Faridabad. They are doing well and have substantial surplus funds available within the business. They have different approaches regarding corporate strategies to be followed to be more competitive and profitable in future.*

Gautam is interested in acquiring another industrial unit located in Faridabad manufacturing stationery items such as permanent markers, notebooks, pencils

and pencil sharpeners, envelopes and other office supplies. On the other hand, Siddhartha desires to start another unit to produce readymade garments.

Discuss the nature of strategic choices being suggested by the two brothers with reference to the payoffs and the risks involved.

6. XYZ Company is facing continuous losses. There is decline in sales and product market share. The products of the company became uncompetitive and there is persistent negative cash flow. The physical facilities are deteriorating, and employees have low morale. At the board meeting, the board members decided that they should continue the organization and adopt such measures such that the company functions properly. The board has decided to hire young executive Shayamli for improving the functions of the organization. What corporate strategy should Shayamli adopt for this company and what steps need to be taken to implement the strategic choice adopted by Shayamli?
7. Organo is a large supermarket chain. It is considering the purchase of a number of farms that provides Organo with a significant amount of its fresh produce. Organo feels that by purchasing the farms, it will have greater control over its supply chain. Identify and explain the type of diversification opted by Organo?
8. With the global economic recession Soft Cloth Ltd. incurred significant losses in all its previous five financial years. Currently, they are into manufacturing of cloth made of cotton, silk, polyester, rayon, lycra and blends. Competition is also intense on account of cheap imports. The company is facing cash crunch and has not been able to pay the salaries to its employees in the current month.
Suggest a grand strategy that can be opted by Soft Cloth Ltd.
9. X Pvt. Ltd. had recently ventured into the business of co-working spaces when the global pandemic struck. This has resulted in the business line becoming unprofitable and unviable, and a failure of the existing strategy. However, the other businesses of X Pvt. Ltd. are relatively less affected by the pandemic as compared to the recent co-working spaces. Suggest a strategy for X Pvt. Ltd. with reasons to justify your answer.
10. Atrix Ltd. is a company engaged in the designing, manufacturing, and marketing of mechanical instruments like speed meters, oil pressure gauges, and so on. Their products are fitted into two and four wheelers. During the last couple of years, the company has been observing a fall in the market share.

This is on account of shift to the new range of electronic instruments. The customers are switching away mechanical instruments that have been the backbone of Atrix Ltd.

As a CEO of Atrix Ltd., what can be the strategic options available with you.

Descriptive Questions

1. Describe the construction of BCG matrix and discuss its utility in strategic management.
2. An industry comprises of only two firms-Soorya Ltd. and Chandra Ltd. From the following information relating to Soorya Ltd., prepare BCG Matrix:

Product	Revenues (in ₹)	Percent Revenues	Profits (in ₹)	Percent Profits	Percentage Market Share	Percentage Industry Growth rate
A	6 crore	48	120 lakh	48	80	+ 15
B	4 crore	32	50 lakh	20	40	+ 10
C	2 crore	16	75lakh	30	60	-20
D	50 lakh	4	5 lakh	2	5	-10
Total	12.5 crore	100	250 lakh	100		

3. Aurobindo, the pharmaceutical company wants to grow its business. Draw Ansoff's Product Market Growth Matrix to advise them of the available options.

4. In the context of Ansoff's Product-Market Growth Matrix, identify with reasons, the type of growth strategies followed in the following cases:

- (i) A leading producer of tooth paste, advises its customers to brush teeth twice a day to keep breath fresh.
- (ii) A business giant in hotel industry decides to enter into dairy business.
- (iii) One of India's premier utility vehicles manufacturing company ventures to foray into foreign markets.
- (iv) A renowned auto manufacturing company launches ungeared scooters in the market.

ANSWERS/SOLUTION

Multiple Choice Questions

1	(c)	2	(b)	3	(b)	4	(d)	5	(a)	6	(b)
7	(b)	8	(b)	9	(b)						

Answers to Scenario Based Questions

- A workable action plan for turnaround of the textile mill would involve:

 - Stage One – Assessment of current problems:** In the first step, assess the current problems and get to the root causes and the extent of damage.
 - Stage Two – Analyze the situation and develop a strategic plan:** Identify major problems and opportunities, develop a strategic plan with specific goals and detailed functional actions after analyzing strengths and weaknesses in the areas of competitive position.
 - Stage Three – Implementing an emergency action plan:** If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive.
 - Stage Four – Restructuring the business:** If the core business is irreparably damaged, then the outlook for the entire organization may be bleak. Efforts to be made to position the organization for rapid improvement.
 - Stage Five – Returning to normal:** In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added.
- The strategy adopted by *StarTech Solutions* is Focused differentiation. This strategy involves targeting a specific segment of the market with unique products or services that are perceived as valuable by customers in that

segment. By specializing in serving unique, high-end clients, *StarTech* is able to differentiate itself from competitors and create a competitive advantage.

Advantages of Focused Differentiation:

- **Strong Customer Loyalty:** By catering to a specific niche market, *StarTech* can build strong relationships with its customers, leading to higher customer loyalty and retention.
- **Higher Profit Margins:** Serving a niche market allows *StarTech* to command higher prices for its specialized products or services, leading to higher profit margins.
- **Reduced Competition:** By focusing on a niche market that other firms are not targeting, *StarTech* faces less competition, allowing it to establish itself as a leader in that segment.
- **Better Resource Allocation:** Focusing on a specific market segment allows *StarTech* to allocate its resources more efficiently, concentrating on areas that will provide the greatest return on investment.

Disadvantages of Focused Differentiation:

- **Limited Market Size:** The niche market that *StarTech* is targeting may be limited in size, restricting the company's potential for growth.
- **Risk of Market Changes:** Changes in the market or customer preferences could impact on the demand for *StarTech's* specialized products or services, leading to potential revenue loss.
- **Higher Costs:** Serving a niche market may require specialized resources and expertise, leading to higher costs of operation.
- **Imitation by Competitors:** If *StarTech's* success in the niche market attracts competitors, they may attempt to imitate its strategy, eroding its competitive advantage.

Overall, the focused differentiation strategy adopted by *StarTech Solutions* has allowed it to differentiate itself in a competitive industry and build a strong position in the market. However, the company must be aware of the potential challenges and risks associated with this strategy and continue to innovate and adapt to maintain its competitive edge.

3. 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."

4. Pizza Chain may choose to have turnaround strategy if there are:

- ◆ Persistent negative cash flow from business.
- ◆ Uncompetitive products or services.
- ◆ Declining market share.
- ◆ Deterioration in physical facilities.
- ◆ Over-staffing, high turnover of employees, and low morale.
- ◆ Mismanagement.

For turnaround strategies to be successful, it is imperative to focus on the short and long-term financing needs as well as on strategic issues. The chain may attempt to leverage the potential Indian market by engaging a new logistics partner. It may bring innovation in food items, as well as quality and improvements in the overall dine-in and delivery experience. During the turnaround, the "product mix" may be changed, requiring the organization to do some repositioning.

A workable action plan for turnaround would involve:

Stage One – Assessment of current problems: The first step is to assess the current problems and get to the root causes and the extent of damage the problem has caused.

Stage Two – Analyze the situation and develop a strategic plan: Before making any major changes; determine the chances of the business's survival. Identify appropriate strategies and develop a preliminary action plan.

Stage Three – Implementing an emergency action plan: If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive. A positive operating cash flow must be established as quickly as possible and enough funds to implement the turnaround strategies must be raised.

Stage Four – Restructuring the business: The financial state of the organization's core business is particularly important. If the core business is irreparably damaged, then the outlook for the entire organization may be bleak. Efforts to be made to position the organization for rapid improvement.

Stage Five – Returning to normal: In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added. Emphasis is placed on a number of strategic efforts such as carefully adding new products and improving customer service, creating alliances with other organizations, increasing the market share, etc.

5. Gautam wishes to diversify in a business that is not related to their existing line of product and can be termed as conglomerate diversification. He is interested in acquiring another industrial unit located in Faridabad manufacturing stationery items such as permanent markers, notebooks, pencils and pencil sharpeners, envelopes and other office supplies, which is not related to their existing product. In conglomerate diversification, the new businesses/ products are disjointed from the existing businesses/products in every way; it is an unrelated diversification. In process/ technology/ function, there is no connection between the new products and the existing ones. Conglomerate diversification has no common thread at all with the firm's present position.

On the other hand, Siddhartha seeks to move forward in the chain of existing product by adopting vertically integrated diversification/ forward integration. The cloth being manufactured by the existing processes can be used as raw material of garments manufacturing business. In such diversification, firms opt to engage in businesses that are related to the existing business of the firm. The firm remains vertically within the same process and moves forward or backward in the chain. It enters specific product/process steps with the intention of making them into new businesses for the firm. The characteristic feature of vertically integrated diversification is that here, the firm does not jump outside the vertically linked product-process chain.

Both types of diversifications have their own risks. In conglomerate diversification, there are no linkages with customer group, customer marketing functions and technology used, which is a risk. In the case of vertical integrated diversification, there is a risk of lack of continued focus on the original business.

6. XYZ Company is facing continuous losses, decline in sales and product market share, persistent negative cash flow, uncompetitive products, declining market share, deterioration in physical facilities, low morale of employees. In such a scenario, Shayamli may choose **turnaround strategy** as this strategy attempts to reverse the process of decline and bring improvement in organizational health. This is also important as Board has decided to continue the company and adopt measures for its proper functioning.

For success, Shayamli needs to focus on the short and long-term financing needs as well as on strategic issues. During the turnaround, the “product mix” may be changed, requiring the organization to do some repositioning. A workable action plan for turnaround would involve:

Stage One – Assessment of current problems: In the first step, assess the current problems and get to the root causes and the extent of damage.

Stage Two – Analyze the situation and develop a strategic plan: Identify major problems and opportunities, develop a strategic plan with specific goals and detailed functional actions.

Stage Three – Implementing an emergency action plan: If the organization is in a critical stage, an appropriate action plan must be developed to stop the bleeding and enable the organization to survive.

Stage Four – Restructuring the business: If the core business is irreparably damaged, then the outlook for the entire organization may be bleak. Efforts to be made to position the organization for rapid improvement.

Stage Five – Returning to normal: In the final stage of turnaround strategy process, the organization should begin to show signs of profitability, return on investments and enhancing economic value-added.

7. *Organo* is a large supermarket chain. By opting backward integration and purchase a number of farms, it will have greater control over its supply chain. Backward integration is a step towards, creation of effective supply by entering business of input providers. Strategy employed to expand profits and gain greater control over production of a product whereby a company will purchase or build a business that will increase its own supply capability or lessen its cost of production.
8. Soft Cloth Ltd. is facing internal as well as external challenges. The external environment is in economic recession and the organization is facing cash crunch. The company needs to work on retrenchment / turnaround strategy. The strategy is suitable in case of issues such as:
 - ◆ Persistent negative cash flow.
 - ◆ Uncompetitive products or services
 - ◆ Declining market share
 - ◆ Deterioration in physical facilities
 - ◆ Overstaffing, high turnover of employees, and low morale
 - ◆ Mismanagement

The company may consider to substantially reduce the scope of its activity. This is done through an attempt to find out the problem areas and diagnose the causes of the problems. Next, steps are taken to solve the problems.

These steps result in different kinds of retrenchment strategies. If the organization chooses to focus on ways and means to reverse the process of

decline, it adopts a turnaround strategy. If it cuts off the loss-making units, divisions, or SBUs, curtails its product line, or reduces the functions performed, it adopts a divestment strategy. If none of these actions work, then it may choose to abandon the activities totally, resulting in a liquidation strategy.

9. It is advisable that divestment strategy should be adopted by X Pvt. Ltd.

In the given situation where the business of co-working spaces became unprofitable and unviable due to Global pandemic, the best option for the company is to divest the loss-making business.

Retrenchment may be done either internally or externally. Turnaround strategy is adopted in case of internal retrenchment where emphasis is laid on improving internal efficiency of the organization, while divestment strategy is adopted when a business turns unprofitable and unviable due to some external factors. In view of the above, the company should go for divestment strategy.

Further, divestment helps address issues like:

1. Persistent cash flows from loss making segment could affect other profit-making segments, which is the case in the given scenario.
 2. Inability to cope from the losses, which again is uncertain due to pandemic.
 3. Better investment opportunity, which could be the case if X Pvt. Ltd. can invest the money it generates from divestment.
10. Atrix is having a product portfolio that is evidently in the decline stage. The product is being replaced with the technologically superior product. Strategically the company should minimize their dependence on the existing products and identify other avenues for the survival and growth. As a CEO of Atrix Ltd., following can be the strategic options available with the CEO:
- ◆ Invest in new product development and switchover to the new technology. Atrix Ltd. also need time to invest in emerging new technology.
 - ◆ They can acquire or takeover a competitor provided they have or are able to generate enough financial resources.

- ◆ They may also consider unrelated growth and identify other areas for expansion. This will enable Atrix Ltd. to spread their risks.
- ◆ In longer run, they should divest the existing products. However, they may continue with the existing products in a limited manner for such time there is demand for the product.

Answers to Descriptive Questions

1. Companies that are large enough to be organized into strategic business units face the challenge of allocating resources among those units. In the early 1970's the Boston Consulting Group developed a model for managing portfolio of different business units or major product lines. The BCG growth-share matrix facilitates portfolio analysis of a company having invested in diverse businesses with varying scope of profits and growth.

The BCG matrix can be used to determine what priorities should be given in the product portfolio of a business unit. Using the BCG approach, a company classifies its different businesses on a two-dimensional growth share matrix. Two dimensions are market share and market growth rate. In the matrix:

- ◆ The vertical axis represents market growth rate and provides a measure of market attractiveness.
- ◆ The horizontal axis represents relative market share and serves as a measure of company's strength in the market.

Thus, the BCG matrix depicts quadrants as shown in the following table:

		Relative Market Share	
		High	Low
Market Growth Rate	High	Stars	Question Marks
	Low	Cash Cows	Dogs

BCG Matrix

Different types of business represented by either products or SBUs can be classified for portfolio analyses through BCG matrix. They have been depicted by meaningful metaphors, namely:

- (a) **Stars** are products or SBUs that are growing rapidly. They also need heavy investment to maintain their position and finance their rapid growth potential. They represent best opportunities for expansion.
- (b) **Cash Cows** are low-growth, high market share businesses or products. They generate cash and have low costs. They are established, successful, and need less investment to maintain their market share. In long run when the growth rate slows down, stars become cash cows.
- (c) **Question Marks**, sometimes called problem children or wildcats, are low market share business in high-growth markets. They require a lot of cash to hold their share. They need heavy investments with low potential to generate cash. Question marks if left unattended are capable of becoming cash traps. Since growth rate is high, increasing it should be relatively easier. It is for business organisations to turn them stars and then to cash cows when the growth rate reduces.
- (d) **Dogs** are low-growth, low-share businesses and products. They may generate enough cash to maintain themselves, but do not have much future. Sometimes they may need cash to survive. Dogs should be minimised by means of divestment or liquidation.

The BCG matrix is useful for classification of products, SBUs, or businesses, and for selecting appropriate strategies for each type as follows.

- (a) Build with the aim for long-term growth and strong future.
- (b) Hold or preserve the existing market share.
- (c) Harvest or maximize short-term cash flows.
- (d) Divest, sell or liquidate and ensure better utilization of resources elsewhere.

Thus, BCG matrix is a powerful tool for strategic planning analysis and choice.

2. Using the BCG approach, a company classifies its different businesses on a two dimensional growth-share matrix. In the matrix, the vertical axis represents market growth rate and provides a measure of market attractiveness. The horizontal axis represents relative market share and serves as a measure of company strength in the market. With the given data on market share and industry growth rate of Soorya Ltd, its four products are placed in the BCG matrix as follows:

		Retain Market Share	
		High	Low
Market Growth Rate	High	<i>Product A</i> <i>[80% Market Share + 15% Growth Rate]</i> Stars	<i>Product B</i> <i>[40% Market Share + 10% Growth Rate]</i> Question Marks
	Low	<i>Product C</i> <i>[60% Market Share - 20% Growth Rate]</i> Cash Cows	<i>Product D</i> <i>[05% Market Share - 10% Growth Rate]</i> Dogs

Product A is in best position as it has a high relative market share and a high industry growth rate. On the other hand, product B has a low relative market share, yet competes in a high growth industry. Product C has a high relative market share but competes in an industry with negative growth rate. The company should take advantage of its present position that may be difficult to sustain in long run. Product D is in the worst position as it has a low relative market share and competes in an industry with negative growth rate.

3. The Ansoff's product market growth matrix (proposed by Igor Ansoff) is a useful tool that helps businesses decide their product and market growth strategy. With the use of this matrix, a business can get a fair idea about how its growth depends upon its markets in new or existing products in both new and existing markets.

The Ansoff's product market growth matrix is as follows:

	Existing Products	New Products
Existing Markets	Market Penetration	Product Development
New Markets	Market Development	Diversification

Ansoff's Product Market Growth Matrix

Based on the matrix, Aurobindo may segregate its different products. Being in pharmaceuticals, development of new products is result of extensive research and involves huge costs. There are also social dimensions that may influence the decision of the company. It can adopt penetration, product development, market development or diversification simultaneously for its different products.

Market penetration refers to a growth strategy where the business focuses on selling existing products into existing markets. It is achieved by making more sales to present customers without changing products in any major way.

Market development refers to a growth strategy where the business seeks to sell its existing products into new markets. It is a strategy for company growth by identifying and developing new markets for the existing products of the company.

Product development refers to a growth strategy where business aims to introduce new products into existing markets. It is a strategy for company growth by offering modified or new products to current markets.

Diversification refers to a growth strategy where a business markets new products in new markets. It is a strategy by starting up or acquiring businesses outside the company's current products and markets.

As market conditions change overtime, a company may shift product-market growth strategies. **For example**, when its present market is fully saturated a company may have no choice other than to pursue new market.

4. The Ansoff's product market growth matrix (proposed by Igor Ansoff) is a useful tool that helps businesses decide their product and market growth strategy. This matrix further helps to analyse different strategic directions. According to Ansoff there are four strategies that organisation might follow.
- (i) **Market Penetration:** A leading producer of toothpaste, advises its customers to brush teeth twice a day to keep breath fresh. It refers to a growth strategy where the business focuses on selling existing products into existing markets.
 - (ii) **Diversification:** A business giant in hotel industry decides to enter into dairy business. It refers to a growth strategy where a business markets new products in new markets.
 - (iii) **Market Development:** One of India's premier utility vehicles manufacturing company ventures to foray into foreign markets. It refers to a growth strategy where the business seeks to sell its existing products into new markets.
 - (iv) **Product Development:** A renowned auto manufacturing company launches ungeared scooters in the market. It refers to a growth strategy where business aims to introduce new products into existing markets.

5 CHAPTER

STRATEGY IMPLEMENTATION AND CONTROL

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CHAPTER

5

STRATEGY IMPLEMENTATION AND EVALUATION

19.15



Don Swinudi

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ◆ Describe the process of Strategy Management: From Formulation to Implementation
- ◆ Evaluate the salience of strategy implementation.
- ◆ Explain Strategic Change through Digital Transformation
- ◆ Differentiate between Organisation Structure (hard) and Culture (soft)
- ◆ Signify the meaning and importance of Strategic Leadership
- ◆ Discuss the role of Strategic Control
- ◆ Identify and Classify Strategic Performance Measures

"Effective leadership is not about making speeches or being liked; leadership is defined by results not attributes".

- **Peter Drucker**

"A leader is one who knows the way, goes the way, and shows the way"

- **John Maxwell**

CHAPTER OVERVIEW

 **5.1 INTRODUCTION**

Strategy implementation and evaluation are critical phases of the process of strategic management in an organization. Implementation involves putting the plans and initiatives developed as part of the strategy into action, while evaluation refers to the process of measuring and assessing the effectiveness of these actions. In this chapter, we will explore various implementation and evaluation methods that organizations can use to assess the success of their strategy implementation and identify areas for improvement. This chapter will provide a comprehensive overview of the implementation and evaluation process and equip readers with the knowledge and skills needed to effectively execute and assess their organization's strategies. To begin with an overview of the process of strategic management is provided in the next section.

5.2 STRATEGIC MANAGEMENT PROCESS

The process of developing an organisation's strategy is quite methodical. The organisation first develops a clear vision, mission, values and goals. They then must then discuss and analyse a number of themes to determine which options are most promising. All these aspects come together in a strategic plan that details the organisation's vision, mission, values, goals, strategic themes, a high-level implementation plan and key performance measures. The key performance measures are included in the strategic plan and are used to link the themes back to the organisation's goals and to measure the success of the strategy after it is implemented.

The strategic management process is dynamic and continuous. A change in any one of the major components in the model can necessitate a change in any or all of the other components. For instance, a shift in the economy could represent a major opportunity and require a change in long-term objectives and strategies; a failure to accomplish annual objectives could require a change in policy; or a major competitor's change in strategy could require a change in the firm's mission.

Therefore, strategy formulation, implementation, and evaluation activities should be performed on a continual basis, not just at the end of the year or semi-annually. The strategic management process never really ends.

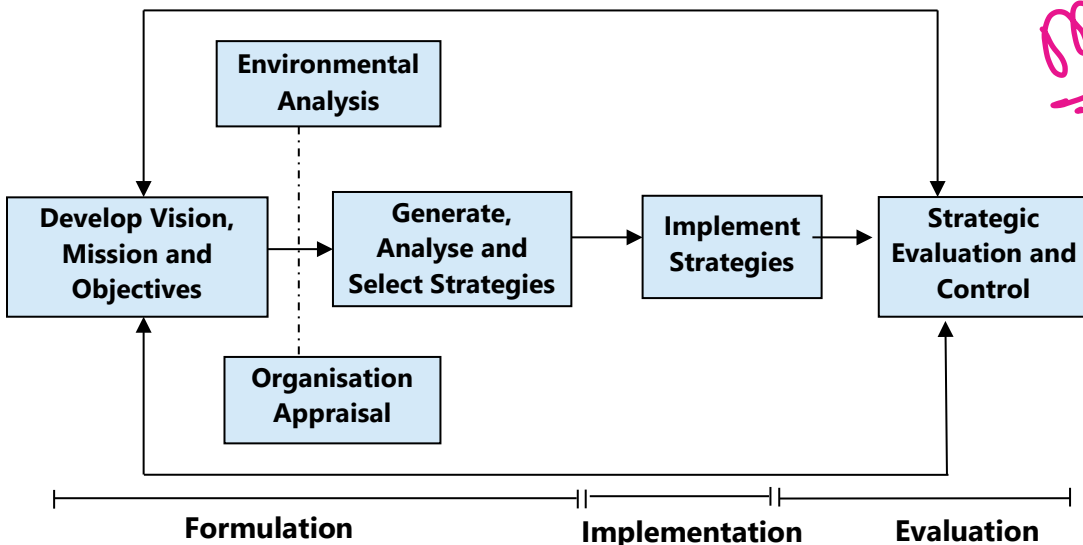


Figure: Strategic Management Model (Fred R David)

The strategic management process can best be studied and applied using a model. Every model represents some kind of process. The model illustrated in the Figure: Strategic Management Model (Fred R David) is a widely accepted, comprehensive. This model like any other model of management does not guarantee sure-shot success, but it does represent a clear and practical approach for formulating, implementing, and evaluating strategies. Relationships among major components of the strategic management process are shown in the model.

In practice, strategists do not go through the process in lockstep fashion. Generally, there is give-and-take among hierarchical levels of an organisation. The process essentially is iterative and involves a lot of back-and-forth considerations across different stages in the strategic management process. Many organisations conduct formal meetings semi-annually to discuss and update the firm's vision/mission, opportunities/threats, strengths/weaknesses, strategies, objectives, policies, and performance. Creativity from participants is encouraged in meeting. Good communication and feedback are needed throughout the strategic management process.

5.2.1 Stages in Strategic Management

Crafting and executing strategy are the heart and soul of managing a business enterprise. But exactly what is involved in developing a strategy and executing it proficiently? And who besides top management has strategy – formulation – executing responsibility?

Strategic management involves the following stages:

1. Developing a strategic vision and formulation of statement of mission, goals and objectives.
2. Environmental and organisational analysis.
3. Formulation of strategy.
4. Implementation of strategy.
5. Strategic evaluation and control

Stage 1: Strategic Vision, Mission and Objectives

First a company must determine what directional path the company should take and what changes in the company's product – market – customer – technology – focus would improve its current market position and its future prospect. Deciding to commit the company to one path versus other pushes managers to draw some carefully reasoned conclusions about how to try to modify the company's business makeup and the market position it should carve out. Top management's views and conclusions about the company's direction and the product-customer-market-technology focus constitute a strategic vision for the company. A strategic vision delineates management's aspirations for the organisation and highlights a particular direction, or strategic path for it to follow in preparing for the future and molds its identity. A clearly articulated strategic vision communicates management's aspirations to stakeholders and helps steer the energies of company personnel in a common direction.

Mission and Strategic Intent: Managers need to be clear about what they see as the role of their organisation, and this is often expressed in terms of a statement of mission. This is important because both external stakeholders and other managers in the organisation need to be clear about what the organisation is seeking to achieve and, in broad terms, how it expects to do so. At this level, strategy is not concerned with the details of SBU competitive strategy or the directions and methods the businesses might take to achieve competitive advantage. Rather, the concern here is overall strategic direction.

Corporate goals and objectives flow from the mission and growth ambition of the corporation. Basically, they represent the quantum of growth the firm seeks to achieve in the given time frame. They also endow the firm with characteristics that ensure the projected growth. Through the objective setting process, the firm is tackling the environment and deciding the focus it should have in the environment. The objective provides the basis for major decisions of the firm and also help the organisational performance to be realized at each level. The managerial purpose of setting objectives is to convert the strategic vision into specific performance targets – basically the results and outcomes the management wants to achieve - and then use these objectives as yardsticks for tracking the company's progress and performance.

Ideally, managers ought to use the objective-setting exercise as a tool for truly stretching an organisation to reach its full potential. Challenging company personnel to go all out and deliver big gains in performance pushes an enterprise to be more inventive, to exhibit some urgency in improving both its financial performance and its business position, and to be more intentional and focused in its actions.

Objectives are needed at all organisational levels. Objective setting should not stop with top management's establishing of companywide performance targets. Company objectives need to be broken down into performance targets for each separate business, product line, functional department, and individual work unit. Company performance can't reach full potential unless each area of the organisation does its part and contributes directly to the desired companywide outcomes and results. This means setting performance targets for each organisation unit that support-rather than conflict with or negate-the achievement of companywide strategic and financial objectives.

Stage 2: Environmental and Organisational Analysis

This stage is the diagnostic phase of strategic analysis. It entails two types of analysis:

1. Environmental scanning
2. Organisational analysis

The external environment of a firm consists of economic, social, technological, market and other forces which affect its functioning. The firm's external environment is dynamic and uncertain. So, the management must systematically be analysed various elements of environment to determine opportunities and threats for the firm in future.

Organisational analysis involved a review of financial resources, technological resources, productive capacity, marketing and distribution effectiveness, research and development, human resource skills and so on. This would reveal organisational strengths and weaknesses which could be matched with the threats and opportunities in the external environment. This would provide us a framework for SWOT analysis (Strength, Weakness, Opportunity and Threat) which could be in

the form of a table highlighting various strengths and weaknesses of the firm and opportunities and threats which the environment we create for the firm.

Stage 3: Formulating Strategy

The first step in strategy formulation is developing strategic alternatives in the light of organisation strengths and weaknesses, and opportunities and threats in the environment. The second step is the deep analysis of various strategic alternatives for the purpose of choosing the most appropriate alternative which will serve as the strategy of the firm.

A company may be confronted with several alternatives such as:

- i. Should the company continue in the same business carrying on the same volume of activities?
- ii. If it should continue in the same business, should it grow by expanding the existing units or by establishing new units or by acquiring other units in the industry?
- iii. If it should diversify, should it diversify into related areas or unrelated areas?
- iv. Should it get out of an existing business fully or partially?

The above strategic alternatives may be designated as stability strategy, growth/expansion strategy and retrenchment strategy. A company may also follow a combination of these alternatives called combination strategy.

Stage 4: Implementation of Strategy

Implementation and execution are an operations-oriented activity aimed at shaping the performance of core business activities in a strategy-supportive manner. It is the most demanding and time-consuming part of the strategy-management process. To convert strategic plans into actions and results, a manager must be able to direct organisational change, motivate people, build and strengthen company competencies and competitive capabilities, create a strategy-supportive work climate, and meet or beat performance targets.

In most situations, strategy-execution process includes the following principal aspects:

- ◆ Developing budgets that steer ample resources into those activities critical to strategic success.

- ◆ Staffing the organisation with the needed skills and expertise, consciously building and strengthening strategy-supportive competencies and competitive capabilities and organising the work effort.
- ◆ Ensuring that policies and operating procedures facilitate rather than impede effective execution.
- ◆ Using the best-known practices to perform core business activities and pushing for continuous improvement.
- ◆ Installing information and operating systems that enable company personnel to better carry out their strategic roles day in and day out.
- ◆ Motivating people to pursue the target objectives energetically.
- ◆ Creating a company culture and work climate conducive to successful strategy implementation and execution.
- ◆ Exerting the internal leadership needed to drive implementation forward and keep improving strategy execution. When the organisation encounters stumbling blocks or weaknesses, management has to see that they are addressed and rectified quickly.

Good strategy execution involves creating strong “fits” between strategy and organisational capabilities, between strategy and the reward structure, between strategy and internal operating systems, and between strategy and the organisation’s work climate and culture.

Stage 5: Strategic Evaluation and Control

The final stage of strategic management process – evaluating the company’s progress, assessing the impact of new external developments, and making corrective adjustments – is the trigger point for deciding whether to continue or change the company’s vision, objectives, strategy, and/or strategy-execution methods. So long as the company’s direction and strategy seem well matched to industry and competitive conditions and performance targets are being met, company executives may decide to stay the course. Simply fine-tuning the strategic plan and continuing with ongoing efforts to improve strategy execution are sufficient.

But whenever a company encounters disruptive changes in its external environment, questions need to be raised about the appropriateness of its direction and strategy. If a company experiences a downturn in its market position or shortfalls in performance, then company managers are obligated to ferret out whether the causes relate to poor strategy, poor execution, or both and then to take timely corrective action. A company's direction, objectives, and strategy have to be revisited anytime external or internal conditions warrant. It is to be expected that a company will modify its strategic vision, direction, objectives, and strategy over time.

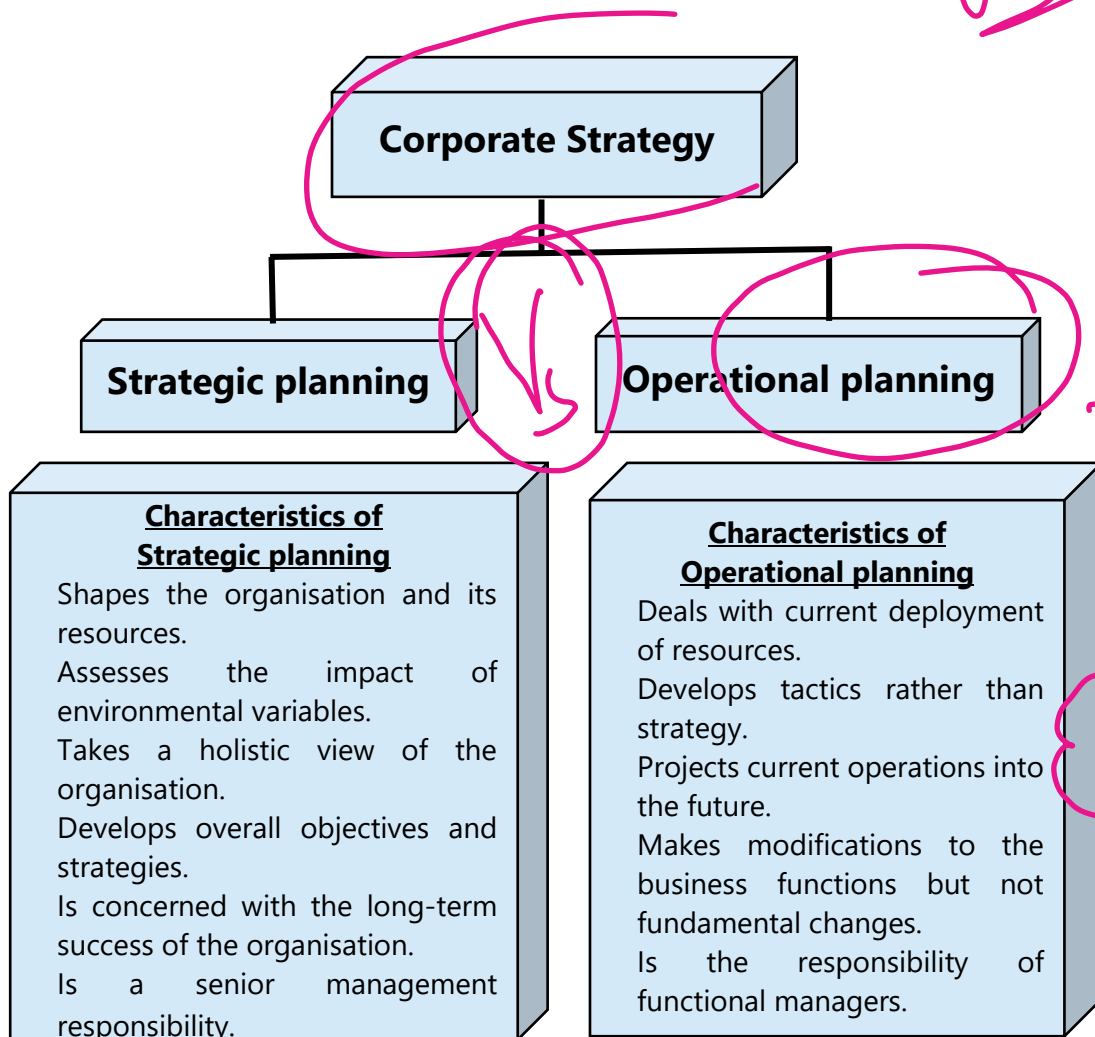
Proficient strategy execution is always the product of much organisational learning. It is achieved unevenly – coming quickly in some areas and proving nettlesome and problematic in others. Periodically assessing what aspects of strategy execution are working well and what needs improving is normal and desirable. Successful strategy execution entails vigilantly searching for ways or continuously improve and then making corrective adjustments whenever and wherever it is useful to do so.

5.2.2 Strategy Formulation

Corporate Strategy

Planning entails choosing what has to be done in the future (today, next week, next month, next year, over the next couple of years, etc.) and creating action plans. An essential element of effective management is adequate planning. Choosing a path of action to achieve defined goals is a part of planning.

The game plan that really directs the company towards success is called “corporate strategy”. Planning may be operational or strategic. Senior management develops strategic plans for the entire organisation after evaluating the organization's strengths and weaknesses in light of potential possibilities and dangers in the outside world. They involve gathering and allocating resources in order to achieve organisational goals. But operational plans on the other hand are made at the middle and lower-level management. They provide specifics on how the resources are to be used effectively to achieve the goals.



Strategic Planning: The game plan that really directs the company towards success is called "corporate strategy". The success of the company depends on how well this game plan works. Because of this, the core of the process of strategic planning is the formation of corporate strategy. The formation of corporate strategy is the result of a process known as strategic planning.

- ♦ Strategic planning is the process of determining the objectives of the firm, resources required to attain these objectives and formulation of policies to govern the acquisition, use and disposition of resources.

- ◆ Strategic planning involves a fact of interactive and overlapping decisions leading to the development of an effective strategy for the firm.
- ◆ Strategic planning determines where an organisation is going over the next year or more and the ways for going there.
- ◆ The process is organisation-wide or focused on a major function such as a division or other major function.

Strategic uncertainty and how to deal with it?

Strategic uncertainty refers to the unpredictability and unpredictability of future events and circumstances that can impact an organization's strategy and goals. It can be driven by factors such as changes in the market, technology, competition, regulation, and other external factors. Dealing with strategic uncertainty can be challenging and organizations need to have the flexibility, resilience, and agility to quickly respond to changes in the environment and minimize its impact. To be manageable, they need to be grouped into logical clusters or themes. It is then useful to assess the importance of each cluster in order to set priorities with respect to Information gathering and analysis.

- ◆ **Flexibility:** Organizations can build flexibility into their strategies to quickly adapt to changes in the environment.
- ◆ **Diversification:** Diversifying the organization's product portfolio, markets, and customer base can reduce the impact of strategic uncertainty.
- ◆ **Monitoring and Scenario Planning:** Organizations can regularly monitor key indicators of change and conduct scenario planning to understand how different future scenarios might impact their strategies.
- ◆ **Building Resilience:** Organizations can invest in building internal resilience, such as strengthening their operational processes, increasing their financial flexibility, and improving their risk management capabilities.
- ◆ **Collaboration and Partnerships:** Collaborating with other organizations, suppliers, customers, and partners can help organizations pool resources, share risk, and gain access to new markets and technologies.

Impact of uncertainty: Each element of strategic uncertainty involves potential trends or events that could have an impact on present, proposed, and even potential businesses., a trend toward natural foods may present opportunities for

juices for a firm producing aerated drinks on the basis of a strategic uncertainty. The impact of a strategic uncertainty will depend on the importance of the impacted SBU to a firm. Some SBUs are more important than others. The importance of established SBUs may be indicated by their associated sales, profits, or costs. However, such measures might need to be supplemented for potential growth as present sales, profits, or costs may not reflect the true value.

5.2.3 Strategy Implementation

Strategy implementation concerns the managerial exercise of putting a freshly chosen strategy into action. It deals with the managerial exercise of supervising the ongoing pursuit of strategy, making it work, improving the competence with which it is executed and showing measurable progress in achieving the targeted results. Strategic implementation is concerned with translating a strategic decision into action, which presupposes that the decision itself (i.e., the strategic choice) was made with some thought being given to feasibility and acceptability. The allocation of resources to new courses of action will need to be undertaken, and there may be a need for adapting the organization's structure to handle new activities as well as training personnel and devising appropriate systems.

Relationship with strategy formulation

Many managers fail to distinguish between strategy formulation and strategy implementation. Yet, it is crucial to realize the difference between the two because they both require very different skills. Also, a company will be successful only when the strategy formulation is sound and implementation is excellent. There is no such thing as successful strategic design. This sounds obvious, but in practice the distinction is not always made. Often people, blame the strategy model for the failure of a company while the main flaw might lie in failed implementation. Thus, organizational success is a function of good strategy and proper implementation. The matrix in the figure below represents various combinations of strategy formulation and implementation:

Strategy Formulation	Sound	A	B
	Flawed	C	D
		Weak	Excellent

Figure: Strategy formulation and implementation matrix

The above-mentioned figure depicts the distinction between sound/flawed strategy formulation and excellent/ weak strategy implementation.

Square A is the situation where a company apparently has formulated a very competitive strategy but is showing difficulties in implementing it successfully. This can be due to various factors, such as the lack of experience (e.g. for startups), the lack of resources, missing leadership and so on. In such a situation the company will aim at moving from square A to square B, given they realize their implementation difficulties. Square B is the ideal situation where a company has succeeded in designing a sound and competitive strategy and has been successful in implementing it.

Square D is the situation where the strategy formulation is flawed, but the company is showing excellent implementation skills. When a company finds itself in square D the first thing, they have to do is to redesign their strategy before readjusting their implementation/execution skills.

Square C is denotes for companies that haven't succeeded in coming up with a sound strategy formulation and in addition are bad at implementing their flawed strategic model. Their path to success also goes through business model redesign and implementation/execution readjustment.

Taken together all the elements of business strategy, it is to be seen as a chosen set of actions by means of which a market position relative to the competing enterprises is sought and maintained. This gives us the notion of competitive position.

It needs to be emphasized that 'strategy' is not synonymous with 'long-term plan' but rather consists of an enterprise's attempts to reach some preferred future state by adapting its competitive position as circumstances change. While a series of strategic moves may be planned, competitors' actions will mean that the actual moves will have to be modified to take account of those actions.

In contrast to this view of strategy there is another approach to management practice, which has been followed in many organizations. In organizations that lack strategic direction there has been a tendency to look inwards in times of stress, and for management to devote their attention to cost cutting and to shedding unprofitable divisions. In other words, the focus has been on efficiency (i.e., the relationship between inputs and outputs, usually with a short time horizon) rather than on effectiveness (which is concerned with the attainment of organisational goals - including that of desired competitive position). While efficiency is essentially introspective, effectiveness highlights the links between the organization and its environment. The responsibility for efficiency lies with operational managers, with top management having the primary responsibility for the strategic orientation of the organization.

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

Figure: Principal combinations of efficiency and effectiveness

An organization that finds itself in cell 1 is well placed and thrives, since it is achieving what it aspires to achieve with an efficient output/input ratio. In contrast, an organization in cell 2 or 4 is doomed, unless it can establish some strategic direction. The particular point to note is that cell 2 is a worse place to be than is cell 3 since, in the latter, the strategic direction is present to ensure effectiveness

even if rather too much input is being used to generate outputs. To be effective is to survive whereas to be efficient is not in itself either necessary or sufficient for survival.

In crude terms, to be effective is to do the right thing, while to be efficient is to do the thing right. An emphasis on efficiency rather than on effectiveness is clearly wrong. But who determines effectiveness? Any organization can be portrayed as a coalition of diverse interest groups each of which participates in the coalition in order to secure some advantage. This advantage (or inducement) may be in the form of dividends to shareholders, wages to employees, continued business to suppliers of goods and services, satisfaction on the part of consumers, legal compliance from the viewpoint of government, responsible behaviour towards society and the environment from the perspective of pressure groups, and so on.

Even the most technically perfect strategic plan will serve little purpose if it is not implemented effectively. Many organizations tend to spend an inordinate amount of time, money, and effort on developing the strategic plan, treating the means and circumstances under which it will be implemented as afterthoughts. Change comes through implementation and evaluation, not through the plan. A technically imperfect plan that is implemented well will achieve more than the perfect plan that never gets off the paper on which it is typed.

Successful strategy formulation does not guarantee successful strategy implementation. It is always more difficult to do something (strategy implementation) than to say you are going to do it (strategy formulation).

5.2.4 Difference between Strategy Formulation and Implementation

Although inextricably linked, strategy implementation is fundamentally different from strategy formulation. Summarized are the key distinctions between strategy formulation and strategy implementation:

Strategy Formulation Vs. Strategy Implementation

Strategy Formulation	Strategy Implementation
Strategy Formulation includes planning and decision-making involved in developing organization's strategic goals and plans.	Strategy Implementation involves all those means related to executing the strategic plans.
In short, Strategy Formulation is placing the Forces before the action.	In short, Strategy Implementation is managing forces during the action.
An Entrepreneurial Activity based on strategic decision-making.	An Administrative Task based on strategic and operational decisions.
Emphasizes on effectiveness.	Emphasizes on efficiency.
Primarily an intellectual and rational process.	Primarily an operational process.
Requires co-ordination among few individuals at the top level.	Requires co-ordination among many individuals at the middle and lower levels.
Requires a great deal of initiative, logical skills, conceptual intuitive and analytical skills.	Requires specific motivational and leadership traits.
Strategic Formulation precedes Strategy Implementation.	Strategy Implementation follows Strategy Formulation.

Strategy formulation concepts and tools do not differ greatly for small, large, for-profit, or non-profit organizations. However, strategy implementation varies substantially among different types and sizes of organizations. Implementation of strategies requires such actions as altering sales territories, adding new departments, closing facilities, hiring new employees, changing an organization's pricing strategy, developing financial budgets, developing new employee benefits, establishing cost-control procedures, changing advertising strategies, building new facilities, training new employees, transferring managers among divisions, and building a better management information system. These types of activities

obviously differ greatly among manufacturing, service, and governmental organizations.

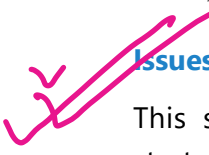
It is to be noted that the division of strategic management into different phases is only for the purpose of orderly study. In real life, the formulation and implementation processes are intertwined. Two types of linkages exist between these two phases of strategic management. The forward linkages deal with the impact of strategy formulation on strategy implementation while the backward linkages are concerned with the impact in the opposite direction.

5.2.5 Linkages and Issues in Strategy Implementation

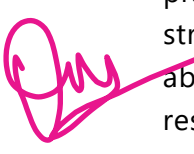
Linkages

Noteworthy is the fact that while strategy formulation is primarily an entrepreneurial activity, based on strategic decision-making, the implementation of strategy is mainly an administrative task based on strategic as well as operational decision-making.

- ◆ **Forward Linkages:** The different elements in strategy formulation starting with objective setting through environmental and organizational appraisal, strategic alternatives and choice to the strategic plan determine the course that an organization adopts for itself. With the formulation of new strategies, or reformulation of existing strategies, many changes have to be affected within the organization. For instance, the organizational structure has to undergo a change in the light of the requirements of the modified or new strategy. The style of leadership has to be adapted to the needs of the modified or new strategies. In this way, the formulation of strategies has forward linkages with their implementation.
- ◆ **Backward Linkages:** Just as implementation is determined by the formulation of strategies, the formulation process is also affected by factors related with implementation. While dealing with strategic choice, remember that past strategic actions also determine the choice of strategy. Organizations tend to adopt those strategies which can be implemented with the help of the present structure of resources combined with some additional efforts. Such incremental changes, over a period of time, take the organization from where it is to where it wishes to be.



Issues in Strategy Implementation



This section focuses on the various issues involved in the implementation of strategies. The different issues involved in strategy implementation cover practically everything that is included in the discipline of management studies. A strategist, therefore, has to bring a wide range of knowledge, skills, attitudes, and abilities. The implementation tasks put to test the strategists' abilities to allocate resources, design organisational structure, formulate functional policies, and to provide strategic leadership.

- ◆ The strategic plan devised by the organization proposes the manner in which the strategies could be put into action. Strategies, by themselves, do not lead to action. They are, in a sense, a statement of intent. Implementation tasks are meant to realise the intent. Strategies, therefore, have to be activated through implementation.
- ◆ Strategies should lead to formulation of different kinds of programmes. A programme is a broad term, which includes goals, policies, procedures, rules, and steps to be taken in putting a plan into action. Programmes are usually supported by funds allocated for plan implementation.
- ◆ Programmes lead to the formulation of projects. A project is a highly specific programme for which the time schedule and costs are predetermined. It requires allocation of funds based on capital budgeting by organizations. Thus, research and development programme may consist of several projects, each of which is intended to achieve a specific and limited objective, requires separate allocation of funds, and is to be completed within a set time schedule.

Implementation of strategies is not limited to formulation of plans, programmes, and projects. Projects would also require resources. After resources have been provided, it would be essential to see that a proper organizational structure is designed, systems are installed, functional policies are devised, and various behavioural inputs are provided so that plans may work.

Given below in sequential manner the issues in strategy implementation which are to be considered:

- ◆ Project implementation

- ◆ Procedural implementation
- ◆ Resource allocation
- ◆ Structural implementation
- ◆ Functional implementation
- ◆ Behavioural implementation

It should be noted that the sequence does not mean that each of the above activities are necessarily performed one after another. Many activities can be performed simultaneously, certain other activities may be repeated over time; and there are activities, which are performed only once. Thus, there can be overlapping and changes in the order in which these activities are performed.

In all but the smallest organizations, the transition from strategy formulation to strategy implementation requires a shift in responsibility from strategists to divisional and functional managers. Implementation problems can arise because of this shift in responsibility, especially if strategic decisions come as a surprise to middle and lower-level managers. Managers and employees are motivated more by perceived self-interests than by organizational interests, unless the two coincide. Therefore, it is essential that divisional and functional managers be involved as much as possible in the strategy-formulation process. Similarly, strategists should also be involved as much as possible in strategy-implementation activities.

Management issues central to strategy implementation include establishing annual objectives, devising policies, allocating resources, altering an existing organizational structure, restructuring and reengineering, revising reward and incentive plans, minimizing resistance to change, developing a strategy-supportive culture, adapting production/operations processes, developing an effective human resource system and, if necessary, downsizing. Management changes are necessarily more extensive when strategies to be implemented move a firm in a new direction.

Managers and employees throughout an organization should participate early and directly in strategy-implementation activities. Their role in strategy implementation should build upon prior involvement in strategy-formulation activities. Strategists' genuine personal commitment to implementation is a necessary and powerful motivational force for managers and employees. Too often, strategists are too busy

to actively support strategy-implementation efforts, and their lack of interest can be detrimental to organizational success. The rationale for objectives and strategies should be understood clearly throughout the organization. Major competitors' accomplishments, products, plans, actions, and performance should be apparent to all organizational members. Major external opportunities and threats should be clear, and managers and employees' questions should be answered satisfactorily. Top-down flow of communication is essential for developing bottom-up support.

Firms need to develop a competitor focus on all hierarchical levels by gathering and widely distributing competitive intelligence; every employee should be able to benchmark her or his efforts against best-in-class competitors so that the challenge becomes personal. This is a challenge for strategists of the firm. Firms should provide training for both managers and employees to ensure that they have and maintain the skills necessary to be world-class performers.

5.3 STRATEGIC CHANGE THROUGH DIGITAL TRANSFORMATION

Organizations are being pushed harder than ever to shift digitally in order to stay competitive. Digital transformation, however, may be a difficult and complicated process. To guarantee that projects for digital transformation are effective, change management is crucial. We will now examine change management's function in the digital transformation.

5.3.1 Strategic Change

The changes in the environmental forces often require businesses to make modifications in their existing strategies and bring out new strategies. Strategic change is a complex process that involves a corporate strategy focused on new markets, products, services and new ways of doing business.

Steps to initiate strategic change: For initiating strategic change, three steps can be identified as under:

- (i) **Recognize the need for change:** The first step is to diagnose which facets of the present corporate culture are strategy supportive and which are not. This basically means going for environmental scanning involving appraisal of both

internal and external capabilities may be through SWOT analysis and then determining where the lacuna lies and scope for change exists.

- (ii) **Create a shared vision to manage change:** Objectives of both individuals and organization should coincide. There should be no conflict between them. This is possible only if the management and the organization members follow a shared vision. Senior managers need to constantly and consistently communicate the vision to all the organizational members. They have to convince all those concerned that the change in business culture is not superficial or cosmetic. The actions taken have to be credible, highly visible and unmistakably indicative of management's seriousness to new strategic initiatives and associated changes.
- (iii) **Institutionalise the change:** This is basically an action stage which requires implementation of changed strategy. Creating and sustaining a different attitude towards change is essential to ensure that the firm does not slip back into old ways of thinking or doing things. Capacity for self-renewal should be a fundamental anchor of the new culture of the firm. Besides, change process must be regularly monitored and reviewed to analyse the after-effects of change. Any discrepancy or deviation should be brought to the notice of persons concerned so that the necessary corrective actions are taken. It takes time for the changed culture to prevail.

✓ **Kurt Lewin's Model of Change:** To make the change lasting, Kurt Lewin proposed three phases of the change process for moving the organization from the present to the future. These stages are unfreezing, changing and refreezing.

- (a) **Unfreezing the situation:** The process of unfreezing simply makes the individuals aware of the necessity for change and prepares them for such a change. Lewin proposes that the changes should not come as a surprise to the members of the organization. Sudden and unannounced change would be socially destructive and morale lowering. The management must pave the way for the change by first "unfreezing the situation", so that members would be willing and ready to accept the change.

Unfreezing is the process of breaking down the old attitudes and behaviours, customs and traditions so that they start with a clean slate. This can be

achieved by making announcements, holding meetings and promoting the new ideas throughout the organization.

(b) Changing to the new situation: Once the unfreezing process has been completed and the members of the organization recognise the need for change and have been fully prepared to accept such change, their behaviour patterns need to be redefined. H.C. Kellman has proposed three methods for reassigning new patterns of behaviour. These are compliance, identification and internalization.

- **Compliance:** It is achieved by strictly enforcing the reward and punishment strategy for good or bad behaviour. Fear of punishment, actual punishment or actual reward seems to change behaviour for the better.
- **Identification:** Identification occurs when members are psychologically impressed upon to identify themselves with some given role models whose behaviour they would like to adopt and try to become like them.
- **Internalization:** Internalization involves some internal changing of the individual's thought processes in order to adjust to the changes introduced. They have given freedom to learn and adopt new behaviour in order to succeed in the new set of circumstances.

(c) Refreezing: Refreezing occurs when the new behaviour becomes a normal way of life. The new behaviour must replace the former behaviour completely for successful and permanent change to take place. In order for the new behaviour to become permanent, it must be continuously reinforced so that this new acquired behaviour does not diminish or extinguish.

Change process is not a one-time application but a continuous process due to dynamism and ever changing environment. The process of unfreezing, changing and refreezing is a cyclical one and remains continuously in action.

5.3.2 How does digital transformation work?

The use of digital technologies to develop fresh, improved, or entirely new company procedures, goods, or services is known as "digital transformation." It's a fundamental adjustment that can be challenging to identify and even more challenging to implement.

Change management enters into the picture here. Organizations can plan, prepare for, and carry out changes to their operations, including digital transformations, with the aid of the discipline of change management. When implemented correctly, change management may assist firms in overcoming the obstacles posed by the digital transition and reaping the full rewards of their investment.

But how does change management appear when applied to digital transformation?

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

1. Defining the goals and objectives of the transformation
2. Assessing the current state of the organization and identifying gaps
3. Creating a roadmap for change that outlines the steps needed to reach the desired state
4. Implementing and managing the change at every level of the organization

To navigate a digital transformation successfully, each of these elements is necessary. But what matters most is how they collaborate to support organisations in achieving their goals.

How does change management work?

Change management is a process or set of tools and best practices used to manage changes in an organization. It assists in making changes in a safe and regulated manner, reducing the possibility of detrimental effects on the company. Any sort of organisation, including enterprises, organisations, governmental bodies, and even families, can utilise change management to manage changes.

Change management models and methods come in a wide variety, but they all have key things in common. These include creating a clear vision for the change, involving stakeholders in the process, coming up with a plan for putting the change into action, and keeping an eye on the results. Although change management is

frequently viewed as a difficult and complicated process, it is vital for ensuring that digital transformation projects are successful.

The role of change management in digital transformation

Digital transformation is a process of organizational change that enables an organization to use technology to create new value for customers, employees, and other stakeholders. A good change management strategy is necessary for a successful digital transformation.

Change management is the process of planning, implementing, and monitoring changes in an organization. It provides organizations in achieving their objectives while reducing risks and disruptions. For any organisation undergoing a digital transition, change management is crucial.

A properly implemented change management strategy can help an organization to:

- ◆ Specify the parameters and goals of the digital transformation
- ◆ Determine which procedures and tools need to be modified.
- ◆ Make a plan for implementing the improvements.
- ◆ Involve staff members and parties involved in the transformation process.
- ◆ Track progress and make required course corrections

A crucial component of any digital transition is change management. Why it gains more importance in the current times is because organizations can improve their chances of success by approaching change in a proactive and organized manner.

5.3.3 Change Management Strategies for Digital Transformation

One of the most important area of focus for guaranteeing a successful transformation is change management. Businesses nowadays increasingly find themselves responsible for managing more than simply their staff, clients, and products. Additionally, they are handling the introduction of new technology, the unexpected emergence of new market opportunities, and changes in customer preferences regarding the brands they choose, interact with, and hold to. In essence, modern firms must be able to manage change. They must modify their

management techniques in order to achieve this. **The five best practices for managing change in small and medium-sized businesses are:**

1. **Begin at the top:** A focused, invested, united leadership that is on the same page about the company's future is reflected in change that begins at the top. The culture that will motivate the rest of the organisation to accept change can only be generated and promoted in this way.
2. **Ensure that the change is both necessary and desired:** The fact that decision-makers are unaware of how to properly handle a digital transformation and the effects it will have on their firm is one of the main causes of this. If a corporation doesn't have a sound strategy in place, introducing too much too fast can frequently become a major issue down the road.
3. **Reduce disruption:** Employee perceptions of what is required or desirable change can differ by department, rank, or performance history. It's crucial to lessen how changes affect staff. The introduction of new tactics or technologies intended to improve management and corporate operations causes employee concern about change. It is possible to reduce workplace disruption by:
 - a. Getting the word out early and preparing for some interruption.
 - b. Giving staff members the knowledge and tools, they need to adjust to change.
 - c. Creating an environment that encourages transformation or change.
 - d. Empowering change agents to provide context and clarity for changes, such as project managers or team leaders.
 - e. Ensuring that IT department is informed of changes in technology or infrastructure and is prepared to support them.
4. **Encourage communication:** Create channels so that workers may contact you with queries or complaints. Encourage departmental collaboration to propagate ideas and innovations as new procedures take root. Communication promotes efficiency and has the power to influence culture, just like your vision. The people who will be affected the most by these

changes are reassured that they are not in danger through effective communication, which keeps everyone on the same page.

5. **Recognize that change is the norm, not the exception:** Change readiness may be defined as “the ability to continuously initiate and respond to change in ways that create advantage, minimize risk, and sustain performance.” In order to keep up with the customers, businesses must also adapt their operations. They must prepare for change in advance and expect them. It may run into difficulties because change is not a project but rather an ongoing process.

5.3.4 How to manage change during digital transformation?

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:

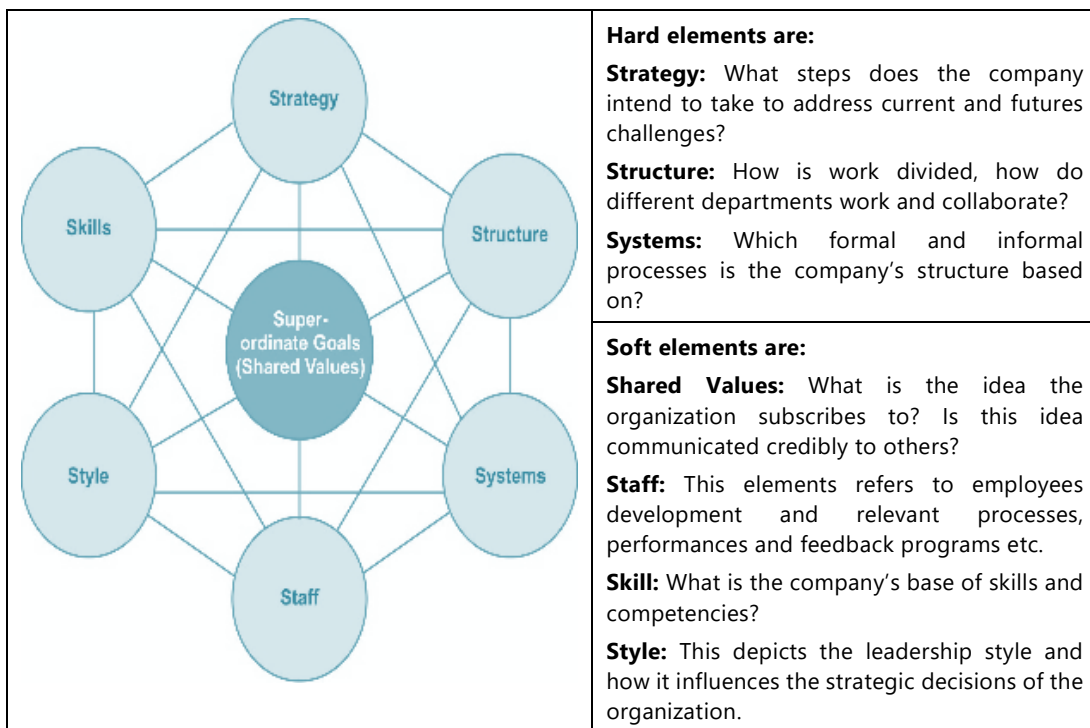
1. **Specify the digital transformation’s aims and objectives:** What is the intended outcome? What are the precise objectives that must be accomplished? It will be easier to make sure that everyone is on the same page and pursuing the same aims if everyone has a clear grasp of the goals.
2. **Always,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

5.4 ORGANISATIONAL FRAMEWORK

The McKinsey 7S Model refers to a tool that analyzes a company's "organizational design." The goal of the model is to depict how effectiveness can be achieved in an organization through the interactions of hard and soft elements. The McKinsey 7s Model focuses on how the "Soft Ss" and "Hard Ss" elements are interrelated, suggesting that modifying one aspect might have a ripple effect on the other elements in order to maintain an effective balance.



The Hard elements are directly controlled by the management. The following elements are the hard elements in an organization:

- ◆ **Strategy:** the direction of the organization, a blueprint to build on a core competency and achieve competitive advantage to drive margins and lead the industry.
- ◆ **Structure:** depending on the availability of resources and the degree of centralisation or decentralization that the management desires, it chooses from the available alternatives of organizational structures.
- ◆ **Systems:** the development of daily tasks, operations and teams to execute the goals and objectives in the most efficient and effective manner.

The Soft elements are difficult to define as they are more governed by the culture. But these soft elements are equally important in determining an organization's success as well as growth in the industry. The following are the soft elements in this model;

- ◆ **Shared Values:** The core values which get reflected within the organizational culture or influence the code of ethics of the management.
- ◆ **Style:** This depicts the leadership style and how it influences the strategic decisions of the organisation. It also revolves around people motivation and organizational delivery of goals.
- ◆ **Staff:** The talent pool of the organisation.
- ◆ **Skills:** The core competencies or the key skills of the employees play a vital role in defining the organizational success.

While the McKinsey 7S Model provides a structural approach to analyzing organizational effectiveness, it has certain limitations:

- ◆ It ignores the importance of the external environment and depicts only the most crucial elements within the organization.
- ◆ The model does not clearly explain the concept of organizational effectiveness or performance.
- ◆ The model is considered to be more static and less flexible for decision making.

- ◆ It is generally criticized for missing out the real gaps in conceptualization and execution of strategy.

5.4.1 Organization Structure

The ideal organizational structure is a place where ideas filter up as well as down, where the merit of ideas carries more weight than their source, and where participation and shared objectives are valued more than executive order.

– Edson Spencer

Changes in corporate strategy often require changes in the way an organization is structured for two major reasons. First, structure largely dictates how operational objectives and policies will be established to achieve the strategic objectives. **For example**, *objectives and policies established under a geographic organizational structure are couched in geographic terms.* Objectives and policies are stated largely in terms of products in an organization whose structure is based on product groups. The structural format for developing objectives and policies can significantly impact all other strategy-implementation activities.

The second major reason why changes in strategy often require changes in structure is that structure dictates how resources will be allocated to achieve strategic objectives. If an organization's structure is based on customer groups, then resources will be allocated in that manner. Similarly, if an organization's structure is set up along functional business lines, then resources are allocated by functional areas.

According to Chandler, changes in strategy lead to changes in organizational structure. Structure should be designed or redesigned to facilitate the strategic pursuit of a firm and, therefore, structure should follow strategy. Chandler found a particular structure sequence to be often repeated as organizations grow and change strategy over time. There is no one optimal organizational design or structure for a given strategy. What is appropriate for one organization may not be appropriate for a similar firm, although successful firms in a given industry do tend to organize themselves in a similar way. **For example**, *consumer goods companies tend to emulate the divisional structure-by-product form of organization. Small firms tend to be functionally structured (centralized). Medium-size firms tend to be divisionally structured (decentralized). Large firms tend to use an SBU (strategic*

business unit) or matrix structure. As organizations grow, their structures generally change from simple to complex as a result of linking together of several basic strategies.

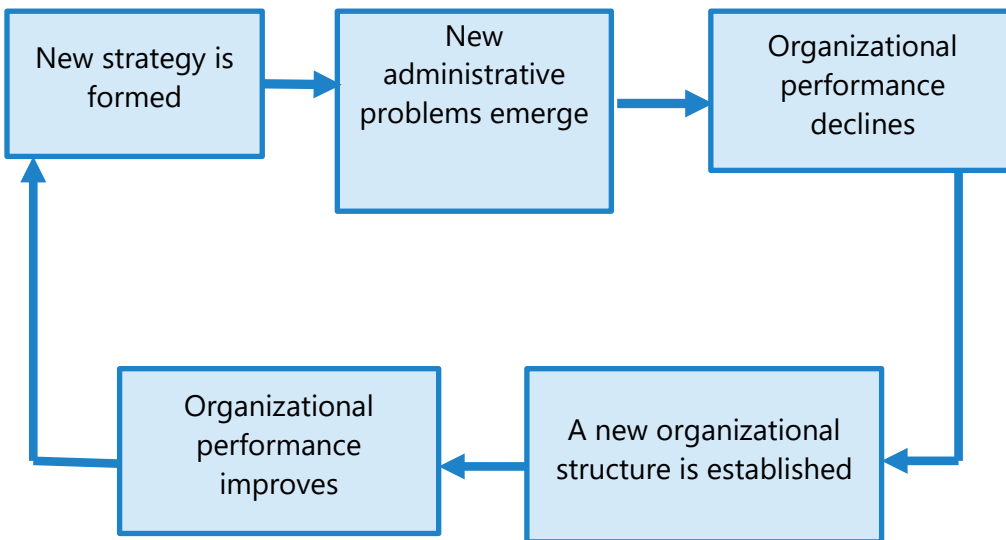


Figure: Chandler's Strategy-Structure Relationship

Every firm is influenced by numerous external and internal forces. But no firm can change its structure in response to each of these forces, because to do so would lead to chaos. However, when a firm changes its strategy, the existing organizational structure may become ineffective. Symptoms of an ineffective organizational structure include too many levels of management, too many meetings attended by too many people, too much attention being directed toward solving interdepartmental conflicts, too large a span of control, and too many unachieved objectives. Changes in organisational structure can facilitate strategy-implementation efforts, but changes in structure should not be expected to make a bad strategy good, to make bad managers good, or to make bad products sell.

Structure can also influence strategy. If a proposed strategy required massive structural changes, it would not be an attractive choice. In this way, structure can shape the choice of strategy. But a more important concern is determining what types of structural changes are needed to implement new strategies and how these changes can best be accomplished. We will examine this issue by focusing on the

following basic types of organizational structure: functional, divisional by geographic area, divisional by product, divisional by customer, divisional process, strategic business unit (SBU), and matrix.

In order to implement and manage strategies that have been formulated, all companies need some form of organizational structure. And, as companies formulate new strategies, increase in size, or change their level of diversification, new organizational structures may be required.

Types of Organization Structure

Organizational structure is the company's formal configuration of its intended roles, procedures, governance mechanisms, authority, and decision-making processes. Organizational structure, influenced by factors such as an organization's age and size, acts as a framework which reflects managers' determination of what a company does and how tasks are completed, given the chosen strategy. The most important issue is that the company's structure must be congruent with or fit with the company's strategy.

A Simple Structure

Simple organizational structure is most appropriate for companies that follow a single-business strategy and offer a line of products in a single geographic market. The simple structure also is appropriate for companies implementing focused cost leadership or focused differentiation strategies. A simple structure is an organizational form in which the owner-manager makes all major decisions directly and monitors all activities, while the company's staff merely serves as an executor.

Little specialization of tasks, few rules, little formalization, unsophisticated information systems and direct involvement of owner-manager in all phases of day-to-day operations characterise the simple structure. In the simple structure, communication is frequent and direct, and new products tend to be introduced to the market quickly, which can result in a competitive advantage. Because of these characteristics, few of the coordination problems that are common in larger organizations exist.

A simple organizational structure may result in competitive advantages for some small companies relative to their larger counterparts. These potential competitive advantages include a broad-based openness to innovation, greater structural flexibility, and an ability to respond more rapidly to environmental changes.

However, if they are successful, small companies grow larger. As a result of this growth, the company outgrows the simple structure. Generally, there are significant increases in the amount of competitively relevant information that requires processing. More extensive and complicated information-processing requirements place significant pressures on owner-managers (often due to a lack of organizational skills or experience or simply due to lack of time).

Thus, it is incumbent on the company's managers to recognise the inadequacies or inefficiencies of the simple structure and change it to one that is more consistent with company's strategy.

To coordinate more complex organizational functions, companies should abandon the simple structure in favour of the functional structure. The functional structure is used by larger companies and by companies with low levels of diversification.

B Functional Structure

A widely used structure in business organisations is functional type because of its simplicity and low cost. A functional structure groups tasks and activities by business function, such as production/operations, marketing, finance/accounting, research and development, and management information systems. Besides being simple and inexpensive, a functional structure also promotes specialization of labour, encourages efficiency, minimizes the need for an elaborate control system, and allows rapid decision making.

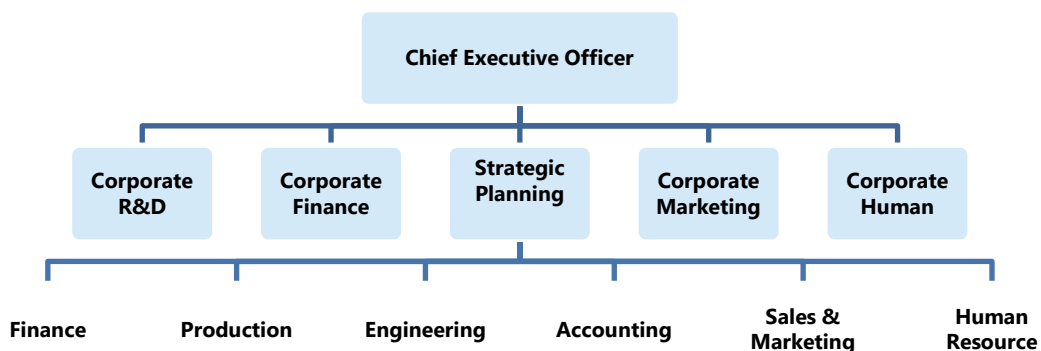


Figure: Functional Structure

The functional structure consists of a chief executive officer or a managing director and supported by corporate staff with functional line managers in dominant functions such as production, financial accounting, marketing, R&D, engineering,

and human resources. The functional structure enables the company to overcome the growth-related constraints of the simple structure, enabling or facilitating communication and coordination.

However, compared to the simple structure, there also are some potential problems. Differences in functional specialization and orientation may impede communications and coordination. Thus, the chief executive officer must integrate functional decision-making and coordinate actions of the overall business across functions. Functional specialists often may develop a myopic (or narrow) perspective, losing sight of the company's strategic vision and mission. When this happens, this problem can be overcome by implementing the multidivisional structure.

C Divisional Structure

As a firm, grows year after year it faces difficulty in managing different products and services in different markets. Some form of divisional structure generally becomes necessary to motivate employees, control operations, and compete successfully in diverse locations. The divisional structure can be organized in one of the four ways: **by geographic area, by product or service, by customer, or by process**. With a divisional structure, functional activities are performed both centrally and in each division separately.

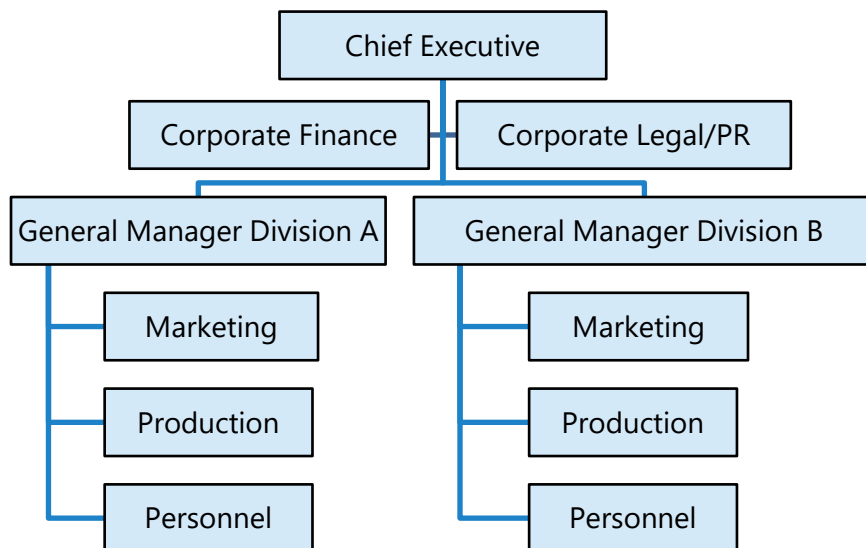


Figure: Divisional Structure

A divisional structure has some clear advantages. First and the foremost, accountability is clear. That is, divisional managers can be held responsible for sales and profit levels. Because a divisional structure is based on extensive delegation of authority, managers and employees can easily see the results of their good or bad performances. As a result, employee morale is generally higher in a divisional structure than it is in centralized structure. Other advantages of the divisional design are that it creates career development opportunities for managers, allows local control of local situations, leads to a competitive climate within an organization, and allows new businesses and products in be added easily.

The divisional design is not without some limitations. Perhaps the most important limitation is that a divisional structure is costly, for a number of reasons. First, each division requires functional specialists who must be paid. Second, there exists some duplication of staff services, facilities, and personnel; for instance, functional specialists are also needed centrally (at headquarters) to coordinate divisional activities. Third, managers must be well qualified because the divisional design forces delegation of authority better-qualified individuals requires higher salaries. A divisional structure can also be costly because it requires an elaborate, headquarters-driven control system. Finally, certain regions, products, or customers may sometimes receive special treatment, and It may be difficult to maintain consistent, companywide practices. Nonetheless, for most large organizations and many small firms, the advantages of a divisional structure more than offset the potential limitations.

A divisional structure by geographic area is appropriate for organizations whose strategies are formulated to fit the particular needs and characteristics of customers in different geographic areas. This type of structure can be most appropriate for organizations that have similar branch facilities located in widely dispersed areas. A divisional structure by geographic area allows local participation in decision making and improved coordination within a region.

The divisional structure by product (or services) is most effective for implementing strategies when specific products or services need special emphasis. Also, this type of structure is widely used when an organization offers only a few products or services, when an organization's products or services differ substantially. The divisional structure allows strict control over and attention to product lines, but it may also require a more skilled management force and reduced top management

control. **For example,** *General Motors, DuPont, and Procter & Gamble use a divisional structure by product to implement strategies.*

When a few major customers are of paramount importance and many different services are provided to these customers, then a divisional structure by customer can be the most effective way to implement strategies. This structure allows an organization to cater effectively to the requirements of clearly defined customer groups. **For example,** *book-publishing companies often organize their activities around customer groups such as colleges, secondary schools, and private commercial schools. Some airline companies have two major customer divisions: passengers and freight or cargo services. Bulks are often organised in divisions such as personal banking corporate banking, etc.*

A divisional structure by process is similar to a functional structure, because activities are organized according to the way work is actually performed. However, a key difference between these two designs is that functional departments are not accountable for profits or revenues, whereas divisional process departments are evaluated on these criteria.

D Multi Divisional Structure

Multidivisional (M-form) structure is composed of operating divisions where each division represents a separate business to which the top corporate officer delegates responsibility for day-to-day operations and business unit strategy to division managers. By such delegation, the corporate office is responsible for formulating and implementing overall corporate strategy and manages divisions through strategic and financial controls.

Multidivisional or M-form structure was developed in the 1920s, in response to coordination- and control-related problems in large firms. Functional departments often had difficulty dealing with distinct product lines and markets, especially in coordinating conflicting priorities among the products. Costs were not allocated to individual products, so it was not possible to assess an individual product's profit contribution. Loss of control meant that optimal allocation of firm resources between products was difficult (if not impossible). Top managers became over-involved in solving short-run problems (such as coordination, communications, conflict resolution) and neglected long-term strategic issues.

Multidivisional structure calls for:

- ◆ Creating separate divisions, each representing a distinct business
- ◆ Each division would house its functional hierarchy;
- ◆ Division managers would be given responsibility for managing day-to-day operations;
- ◆ A small corporate office that would determine the long-term strategic direction of the firm and exercise overall financial control over the semi-autonomous divisions.

This would enable the firm to more accurately monitor the performance of individual businesses, simplifying control problems, facilitate comparisons between divisions, improving the allocation of resources and stimulate managers of poorly performing divisions to seek ways to improve performance.

When the firm is less diversified, strategic controls are used to manage divisions. Strategic control refers to the operational understanding by corporate officers of the strategies being implemented within the firm's separate business units.

An increase in diversification strains corporate officers' abilities to understand the operations of all of its business units and divisions are then managed by financial controls, which enable corporate officers to manage the cash flow of the divisions through budgets and an emphasis on profits from distinct businesses.

However, because financial controls are focused on financial outcomes, they require that each division's performance be largely independent of the performance of other divisions. So, the Strategic Business Units come into picture.

E Strategic Business Unit (SBU) Structure

This concept is relevant to multi-product, multi-business enterprises. It is impractical for an enterprise with a multitude of businesses to provide separate strategic planning treatment to each one of its products/businesses; it has to necessarily group the products/businesses into a manageable number of strategically related business units and then take them up for strategic planning. The question is: what is the best way of grouping the products/businesses of such large enterprises?

An SBU is a grouping of related businesses, which is amenable to composite planning treatment. As per this concept, a multi-business enterprise groups its multitude of businesses into a few distinct business units in a scientific way. The purpose is to provide effective strategic planning treatment to each one of its products/businesses.

The three most important characteristics of a SBU are:

- ◆ It is a single business or a collection of related businesses which offer scope for independent planning and which might feasibly standalone from the rest of the organization.
- ◆ It has its own set of competitors.
- ◆ It has a manager who has responsibility for strategic planning and profit performance, and who has control of profit-influencing factors.

Historically, large, multi-business firms were handling business planning on a territorial basis since their structure was territorial. And in many cases, such a structure was the outcome of a manufacturing or distribution logistics. Often, the territorial structure did not suit the purpose of strategic planning.

When strategic planning was carried out treating territories as the units for planning, it gave rise to two kinds of difficulties: (i) since a number of territorial units handled the same product, the same product was getting varied strategic planning treatments; and (ii) since a given territorial planning unit carried different and unrelated products, products with dissimilar characteristics were getting identical strategic planning treatment.

The concept of strategic business units (SBU) breaks away from this practice. It recognises that just because a firm is structured into a number of territorial units, say six units, it is not necessarily in six different businesses. It may be engaged in only three distinct businesses. It is also possible that it is engaged in more than six businesses. The endeavour should be to group the businesses into an appropriate number of strategic business units before the firm takes up the strategy formulation task.

The SBU structure is composed of operating units where each unit represents a separate business to which the top corporate officer delegates responsibility for day-to-day operations and business unit strategy to its managers. By such

delegation, the corporate office is responsible for formulating and implementing overall corporate strategy and manages SBUs through strategic and financial controls. Hence, the SBU structure groups similar products into strategic business units and delegates authority and responsibility for each unit to a senior executive who reports directly to the chief executive officer. This change in structure can facilitate strategy implementation by improving coordination between similar divisions and channelling accountability to distinct business units.

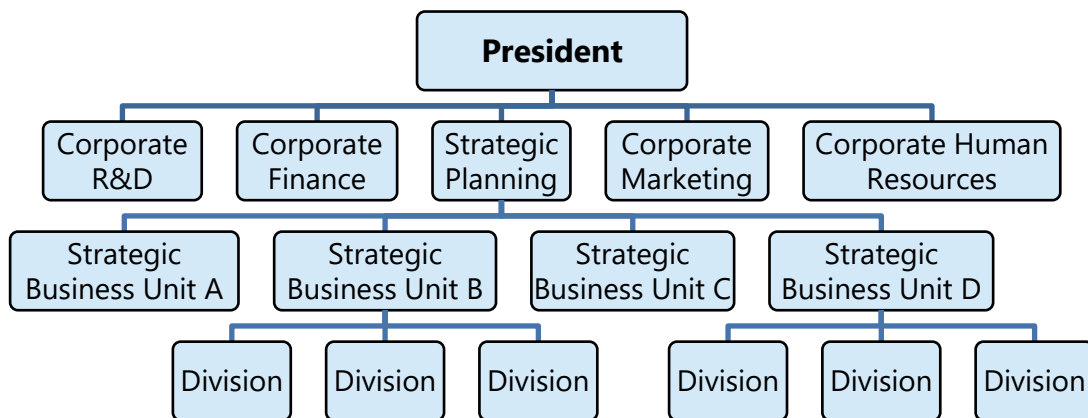


Figure: SBU Structure

A strategic business unit (SBU) structure consists of at least three levels, with a corporate headquarters at the top, SBU groups at the second level, and divisions grouped by relatedness within each SBU at the third level.

This enables the company to more accurately monitor the performance of individual businesses, simplifying control problems. It also facilitates comparisons between divisions, improving the allocation of resources and can be used to stimulate managers of poorly performing divisions to seek ways to improve performance.

This means that, within each SBU, divisions are related to each other, as also that SBU groups are unrelated to each other. Within each SBU, divisions producing similar products and/or using similar technologies can be organised to achieve synergy. Individual SBUs are treated as profit centres and controlled by corporate headquarters that can concentrate on strategic planning rather than operational

control so that individual divisions can react more quickly to environmental changes.

For example, Sony has been restructuring to match the SBU structure with its ten internal companies as organised into four strategic business units. Because it has been pushing the company to make better use of software products and content (e.g., Sony's music, films and games) in its televisions and audio gear to increase Sony's profitability. By its strategy, Sony is one of the few companies that have the opportunity to integrate software and content across a broad range of consumer electronics products.

The principle underlying the grouping is that all related products-related from the standpoint of "function"-should fall under one SBU. In other words, the SBU concept helps a multi-business corporation in scientifically grouping its businesses into a few distinct business units. Such a grouping would in its turn, help the corporation carry out its strategic management endeavour better. The concept provides the right direction to strategic planning by removing the vagueness and confusion often experienced in such multi-business enterprises in the matter of grouping of the businesses.

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.
- ◆ An SBU is a grouping of related businesses that can be taken up for strategic planning distinct from the rest of the businesses. Products/businesses within an SBU receive same strategic planning treatment and priorities.
- ◆ The task consists of analysing and segregating the assortment of businesses/portfolios and regrouping them into a few, well defined, distinct, scientifically demarcated business units. 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. If they could be assigned to any other SBU applying the criterion of functional relation, they are assigned; accordingly, otherwise they are made into separate SBUs.
- ◆ Grouping the businesses on SBU lines helps the firm in strategic planning by removing the vagueness and confusion generally seen in grouping businesses; it also facilitates the right setting for correct strategic planning and facilitates correct relative priorities and resources to the various businesses.
- ◆ Each SBU is a separate business from the strategic planning standpoint. In the basic factors, viz., mission, objectives, competition and strategy-one SBU will be distinct from another.
- ◆ Each SBU will have its own distinct set of competitors and its own distinct strategy.
- ◆ Each SBU will have a CEO. He will be responsible for strategic planning for the SBU and its profit performance; he will also have control over most of the factors affecting the profit of the SBU.

The questions posed at the corporate level are, first, whether the corporate body wishes to have a related set of SBUs or not; and if so, on what basis. This issue of relatedness in turn has direct implications on decisions about diversification relatedness might exist in different ways:

- ◆ SBUs might build on similar technologies, or all provide similar sorts of products or services.
- ◆ SBUs might be serving similar or different markets. Even if technology or products differ, it may be that the customers are similar. **For example, the technologies underpinning frozen food, washing powders and margarine production may be very different; but all are sold through retail operations, and Unilever operates in all these product fields.**
- ◆ Or it may be that other competences on which the competitive advantage of different SBUs are built have similarities. Unilever would argue that the marketing skills associated with the three product markets are similar **example.**

The identification of SBUs is a convenient starting point for planning. Once the company's strategic business units have been identified, the responsibilities for strategic planning can be more clearly assigned.

F Matrix Structure

Most organizations find that organising around either functions (in the functional structure) or around products and geography (in the divisional structure) provides an appropriate organizational structure. The matrix structure, in contrast, may be very appropriate when organizations conclude that neither functional nor divisional forms, even when combined with horizontal linking mechanisms like strategic business units, are right for the implementation of their strategies. In matrix structure, functional and product forms are combined simultaneously at the same level of the organization. Employees have two superiors, a product or project manager and a functional manager. The "home" department - that is, engineering, manufacturing, or marketing - is usually functional and is reasonably permanent. People from these functional units are often assigned temporarily to one or more product units or projects. The product units or projects are usually temporary and act like divisions in that they are differentiated on a product-market basis.

A matrix structure is the most complex of all designs because it depends upon both vertical and horizontal flows of authority and communication (hence the term matrix). In contrast, functional and divisional structures depend primarily on vertical flows of authority and communication. A matrix structure can result in higher overhead because it has more management positions. Other characteristics of a matrix structure that contribute to overall complexity include dual lines of budget authority (a violation of the unity command principle), dual sources of reward and punishment, shared authority, dual reporting channels, and a need for an extensive and effective communication system.

Despite its complexity, the matrix structure is widely used in many industries, including construction, healthcare, research and defence. Some advantages of a matrix structure are that project objectives are clear, there are many channels of communication workers can see the visible results of their work, and shutting down a project is accomplished relatively easily.

In order for a matrix structure to be effective, organizations need planning, training, clear mutual understanding of roles and responsibilities, excellent internal

communication, and mutual trust and confidence. The matrix structure is used more frequently by businesses because they are pursuing strategies add new products, customer groups, and technology to their range of activities. Out of these changes are coming product managers, functional managers, and geographic managers, all of whom have important strategic responsibilities. When several variables such as product, customer, technology, geography, functional area, have roughly equal strategic priorities, a matrix organization can be an effective structural form.

Matrix structure was developed to combine the stability of the functional structure with the flexibility of the product form. It is very useful when the external environment (especially its technological and market aspects) is very complex and changeable. It does, however, produce conflicts revolving around duties, authority, and resource allocation. To the extent that the goals to be achieved are vague and the technology used is poorly understood, a continuous battle for power between product and functional managers is likely.

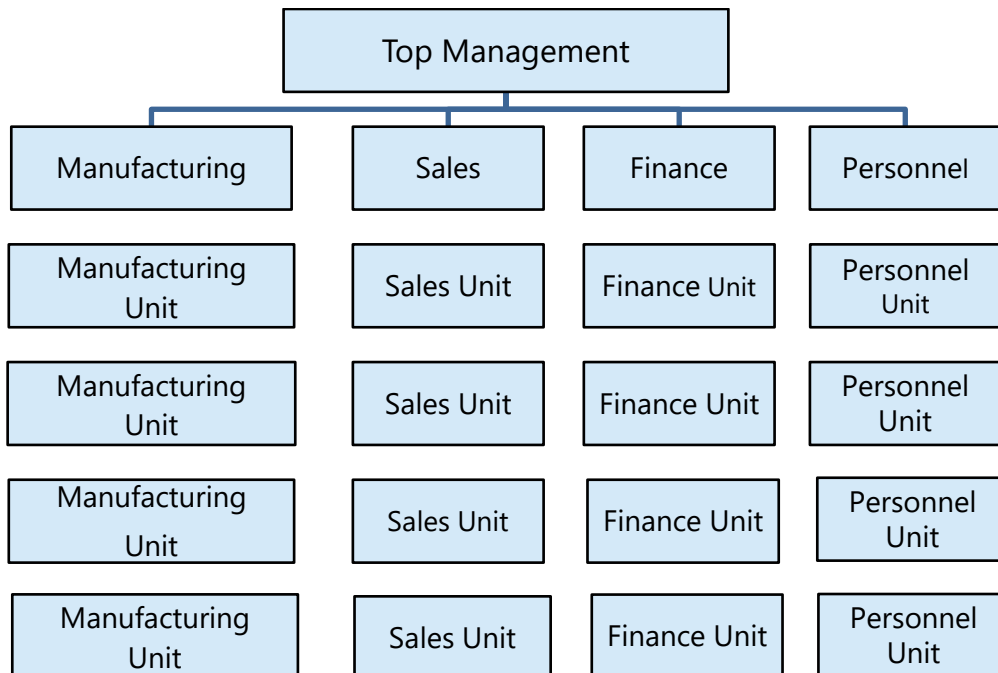


Figure: Matrix Structure

The matrix structure is often found in an organization or within an SBU when the following three conditions exists: 1) Ideas need to be cross-fertilised across projects

or products, 2) Resources are scarce and 3) Abilities to process information and to make decisions need to be improved.

Changing organizational design

Old Organizational Design	New Organizational Design
♦ One large corporation	♦ Mini-business units and cooperative relationships
♦ Vertical communication	♦ Horizontal communication
♦ Centralised top-down decision making	♦ Decentralised participative decision making
♦ Vertical integration	♦ Outsourcing & virtual organizations
♦ Work/quality teams	♦ Autonomous work teams
♦ Functional work teams	♦ Cross-functional work teams
♦ Minimal training	♦ Extensive training
♦ Specialised job design focused on individual	♦ Value-chain team-focused job design

For development of matrix structure Davis and Lawrence, have proposed three distinct phases:

1. **Cross-functional task forces:** Temporary cross-functional task forces are initially used when a new product line is being introduced. A project manager is in charge as the key horizontal link.
2. **Product/brand management:** If the cross-functional task forces become more permanent, the project manager becomes a product or brand manager and a second phase begins. In this arrangement, function is still the primary organizational structure, but product or brand managers act as the integrators of semi permanent products or brands.
3. **Mature matrix:** The third and final phase of matrix development involves a true dual-authority structure. Both the functional and product structures are permanent. All employees are connected to both a vertical functional superior and a horizontal product manager. Functional and product managers have

equal authority and must work well together to resolve disagreements over resources and priorities.

However, the matrix structure is not very popular because of difficulties in implementation and trouble in managing.

G Network Structure

A radical organizational design, the network structure is an example of what could be termed a “non-structure” by its virtual elimination of in-house business functions. Many activities are outsourced. A corporation organized in this manner is often called a virtual organization because it is composed of a series of project groups or collaborations linked by constantly changing non-hierarchical, cobweb-like networks. The network structure becomes most useful when the environment of a firm is unstable and is expected to remain so. Under such conditions, there is usually a strong need for innovation and quick response. Instead of having salaried employees, it may contract with people for a specific project or length of time. Long-term contracts with suppliers and distributors replace services that the company could provide for itself through vertical integration. Electronic markets and sophisticated information systems reduce the transaction costs of the marketplace, thus justifying a “buy” over a “make” decision. Rather than being located in a single building or area, an organization’s business functions are scattered at different geographical locations. The organization is, in effect, only a shell, with a small headquarters acting as a “broker”, electronically connected to some completely owned divisions, partially owned subsidiaries, and other independent organisation. In its ultimate form, the network organization is a series of independent firms or business units linked together by a common system that designs, produces, and markets a product or service.

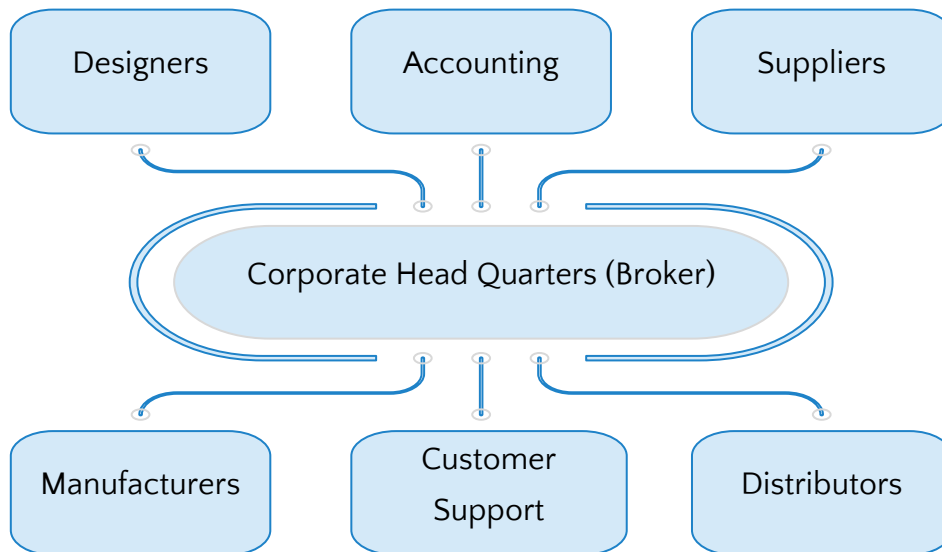


Figure: Network Structure

Companies like Airtel use the network structure in their operations function by subcontracting manufacturing to other companies in low-cost.

The network organization structure provides an organization with increased flexibility and adaptability to cope with rapid technological change and shifting patterns of international trade and competition. It allows a company to concentrate on its distinctive competencies, while gathering efficiencies from other firms who are concentrating their efforts in their areas of expertise. The network does, however, have disadvantages. The availability of numerous potential partners can be a source of trouble. Contracting out functions to separate suppliers/distributors may keep the firm from discovering any synergies by combining activities. If a particular firm over specialises on only a few functions, it runs the risk of choosing the wrong functions and thus becoming non-competitive.

The new structural arrangements that are evolving typically are in response to social and technological advances. While they may enable the effective management of dispersed organizations, there are some serious implications. The learning organization that is a part of new organizational forms requires that each worker become a self-motivated, continuous learner. Employees may lack the level of confidence necessary to participate actively in organization-sponsored learning experiences. The flatter organizational structures that accompany contemporary structures can seem intrusive as a result of their demand for more intense and

personal interactions with internal and external stakeholders. Combined, the conditions above may create stress for many employees.

H Hourglass Structure

In the recent year's information technology and communications have significantly altered the functioning of organizations. The role played by middle management is diminishing as the tasks performed by them are increasingly being replaced by the technological tools. Hourglass organization structure consists of three layers with constricted middle layer. The structure has a short and narrow middle-management level. Information technology links the top and bottom levels in the organization taking away many tasks that are performed by the middle level managers. A shrunken middle layer coordinates diverse lower-level activities. Contrary to traditional middle level managers who are often specialist, the managers in the hourglass structure are generalists and perform wide variety of tasks. They would be handling cross-functional issues emanating such as those from marketing, finance or production.

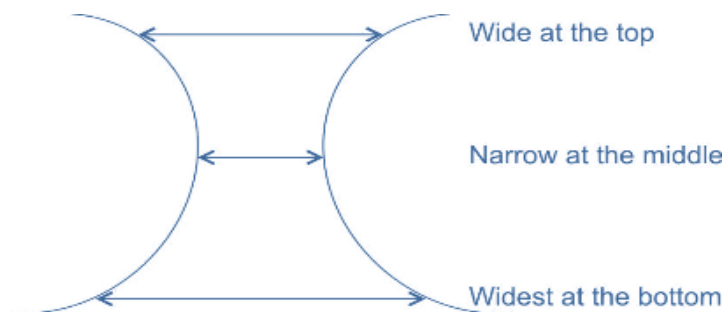


Figure: Hourglass Organisation Structure

Hourglass structure has obvious benefit of reduced costs. It also helps in enhancing responsiveness by simplifying decision making. Decision making authority is shifted close to the source of information so that it is faster. However, with the reduced size of middle management the promotion opportunities for the lower levels diminish significantly. Continuity at same level may bring monotony and lack of interest and it becomes difficult to keep the motivation levels high. Organisations try to overcome these problems by assigning challenging tasks, transferring laterally and having a system of proper rewards for performance.

5.4.2 Organization Culture

Every organisation has a unique organizational culture. It has its own philosophy and principles, its own history, values, and rituals, its own ways of approaching problems and making decisions, its own work climate. It has its own embedded patterns of how to do things. Its own ingrained beliefs and thought patterns, and practices that define its corporate culture.

Corporate culture refers to a company's values, beliefs, business principles, traditions, ways of operating, and internal work environment.

Where Does Corporate Culture Come From?

A company's culture is manifested in the values and business principles that management preaches and practices, in its ethical standards and official policies, in its stakeholder relationships (especially its dealings with employees, unions, stockholders, vendors, and the communities in which it operates), in the traditions the organization maintains, in its supervisory practices, in employees' attitudes and behaviour, in the legends people repeat about happenings in the organization, in the peer pressures that exist, in the organization's politics that permeate the work environment. All these sociological forces, some of which operate quite subtly, combine to define an organization's culture, beliefs and practices that become embedded in a company's culture can originate anywhere: from one influential individual, work group, department, or division, from the bottom of the organizational hierarchy or the top

Frequently, a significant part of a company's culture emerges from the stories that get told over and over again to illustrate to newcomers the importance of certain values and beliefs and ways of operating.

Culture: ally or obstacle to strategy execution?

An organization's culture is either an important contributor or an obstacle to successful strategy execution. The beliefs, vision, objectives, and business approaches and practices underpinning a company's strategy may or may not be compatible with its culture. When they are compatible, the culture becomes a valuable ally in strategy implementation and execution. When the culture is in conflict with some aspect of the company's direction, performance targets or

strategy, the culture becomes a stumbling block that impedes successful strategy implementation and execution.

Role of culture in strategy execution

Strong culture promotes good strategy execution when there's fit and impedes execution when there's negligible fit. A culture grounded in values, practices, and behavioural norms that match what is needed for good strategy execution helps energize people throughout the company to do their jobs in a strategy-supportive manner, adding significantly to the power and effectiveness of strategy execution.

For example, *a culture where frugality and thrift are values strongly shared by organizational members is very conducive to successful execution of a low-cost leadership strategy. A culture where creativity, embracing change, and challenging the status quo are pervasive themes is very conducive to successful execution of a product innovation and technological leadership strategy. A culture built around such business principles as listening to customers, encouraging employees to take pride in their work, and giving employees a high degree of decision-making authority is very conducive to successful execution of a strategy of delivering superior customer value.*

A work environment where the culture matches the conditions for good strategy execution provides a system of informal rules and peer pressure regarding how to conduct business internally and how to go about doing one's job. Strategy-supportive cultures shape the mood, temperament, and motivation the workforce, positively affecting organizational energy, work habits and operating practices, the degree to which organizational units cooperate, and how customers are treated.

A strong strategy-supportive culture nurtures and motivates people to do their jobs in ways conducive to effective strategy execution; it provides structure, standards, and a value system in which to operate; and it promotes strong employee identification with the company's vision, performance targets, and strategy. All this makes employees feel genuinely better about their jobs and work environment and the merits of what the company is trying to accomplish. Employees are stimulated to take on the challenge of realizing the company's vision, do their jobs competently and with enthusiasm, and collaborate with others as needed to bring the strategy to fruition.

Perils of Strategy-Culture Conflict: When a company's culture is out of sync with what is needed for strategic success, the culture has to be changed as rapidly as can be managed – this, of course, presumes that it is one or more aspects of the culture that are out of whack rather than the strategy. While correcting a strategy-culture conflict can occasionally mean revamping strategy to produce cultural fit, more usually it means revamping the mismatched cultural features to produce strategy fit. The more entrenched the mismatched aspects of the culture, the greater the difficulty of implementing new or different strategies until better strategy-culture alignment emerges. A sizable and prolonged strategy-culture conflict weakens and may even defeat managerial efforts to make the strategy work.

Creating a strong fit between strategy and culture: It is the strategy maker's responsibility to select a strategy compatible with the "sacred" or unchangeable parts of prevailing corporate culture. It is the strategy implementer's task, once strategy is chosen, to change whatever facets of the corporate culture hinder effective execution.

Changing a problem culture: Changing a company's culture to align it with strategy is among the toughest management tasks--easier to talk about than do. Changing a problem culture is very difficult because of the heavy anchor of deeply held values and habits-people cling emotionally to the old and familiar. It takes concerted management action over a period of time to replace an unhealthy culture with a healthy culture or to root out certain unwanted cultural obstacles and instill ones that are more strategy-supportive.

The first step is to diagnose which facets of the present culture are strategy supportive and which are not. Then, managers have to talk openly and forthrightly to all concerned about those aspects of the culture that have to be changed. The talk has to be followed swiftly by visible, aggressive actions to modify the culture-actions that everyone will understand are intended to establish a new culture more in tune with the strategy. The menu of culture-changing actions includes revising policies and procedures in ways that will help drive cultural change, altering incentive compensation (to reward the desired cultural behaviour), visibly praising and recognizing people who display the new cultural traits, recruiting and hiring new managers and employees who have the desired cultural values and can serve as role models for the desired cultural behaviour, replacing key executives who are

strongly associated with the old culture, and taking every opportunity to communicate to employees the basis for cultural change and its benefits to all concerned.

Implanting the needed culture-building values and behaviour depends on a sincere, sustained commitment by the chief executive coupled with extraordinary persistence in reinforcing the culture at every opportunity through both words and deed. Neither charisma nor personal magnetism is essential. However, personally talking to many departmental groups about the reasons for change is essential; organizational changes are seldom accomplished successfully from an office. Moreover, creating and sustaining a strategy-supportive culture is a job for the whole management team. Major cultural change requires many initiatives from many people. Senior managers, department heads, and middle managers have to reiterate values and translate the organization's philosophy into everyday practice. In addition, for the culture-building effort to be successful, strategy implementers must enlist the support of first line supervisors and employee opinion leaders, convincing them of the merits of practicing and enforcing cultural norms at the lowest levels in the organization. Until a big majority of employees join the new culture and share an emotional commitment to its basic values and behavioural norms, there's considerably more work to be done in both instilling the culture and tightening the culture strategy fit.

The task of making culture supportive of strategy is not a short-term exercise. It takes time for a new culture to emerge and prevail; it's unrealistic to expect an overnight transformation. The bigger the organization and the greater the cultural shift needed to produce a culture-strategy fit, the longer it takes. In large companies, changing the corporate culture in significant ways can take two to five years. In fact, it is usually tougher to reshape a deeply ingrained culture that is not strategy-supportive than it is to instill a strategy-supportive culture from scratch in a brand-new organization.

In conclusion, an excessive focus on the hard management, at best will result in a linear improvement in performance. On the other hand, performance can be improved exponentially by concentrating on the soft side of the management. The optimal management approach probably would be somewhere between these extremes. Accordingly, every organisation has to maintain a fine balance between a range of "hard" and "soft" management as even though a structure is appropriate

for the time it is established, by the time it is implemented, reality has already changed, especially in today's world.



5.5 STRATEGIC LEADERSHIP

A leader is best when people barely know he exists, when his work is done, his aim fulfilled, they will say: we did it ourselves.

—Lao Tzu

Strategic leadership sets the firm's direction by developing and communicating vision of future, formulate strategies in the light of internal and external environment, brings about changes required to implement strategies and inspire the staff to contribute to strategy execution. A manager as a strategic leader has to play many leadership roles to play: visionary, chief entrepreneur and strategist, chief administrator, culture builder, resource acquirer and allocator, capabilities builder, process integrator, crisis manager, spokesperson, negotiator, motivator, arbitrator, policy maker, policy enforcer, and head cheerleader. Sometimes it is useful to be authoritarian; sometimes it is better to be a perceptive listener and a compromising decision maker; sometimes a strongly participative, and sometimes being a coach and adviser is the proper role.

A strategic leader is a change agent to initiate strategic changes in the organisations and ensure that the changes are successfully implemented. For the most part, major change efforts have to be top-down and vision-driven. Leading change has to start with diagnosing the situation and then deciding which of several ways to handle it. Managers have five leadership roles to play in pushing for good strategy execution:

1. Staying on top of what is happening, closely monitoring progress, solving out issues, and learning what obstacles lie in the path of good execution.
2. Promoting a culture of *esprit de corps* that mobilizes and energizes organizational members to execute strategy in a competent fashion and perform at a high level.

3. Keeping the organization responsive to changing conditions, alert for new opportunities, bubbling with innovative ideas, and ahead of rivals in developing competitively valuable competencies and capabilities.
4. Exercising ethical leadership and insisting that the company conduct its affairs like a model corporate citizen.
5. Pushing corrective actions to improve strategy execution and overall strategic performance.

For example, N. R. Narayan Murthy, is known as a celebrated business leader because of the values he had institutionalised over his tenure as CEO of Infosys. One of the great legacies he left with Infosys is a strong management development program that builds management talent and strategic leader with ethical values.

Dhirubhai Ambani, pioneer of Reliance Group, was an icon in himself because of his ability to conceptualise and create sweeping strategies, to reach corporate goals, and proficiency in implementing his strategic vision. Dhirubhai Ambani had the ability to provide clear direction for the company and had strong interpersonal skills that inspired the employees to contribute their best for the accomplishment of strategic vision. These qualities made him an excellent strategic leader in the corporate world.

Leadership role in implementation: The strategic leaders must be able to use the strategic management process effectively by guiding the company in ways that result in the formation of strategic intent and strategic mission, facilitating the development and implementation of appropriate strategic plans and providing guidance to the employees for achieving strategic goals.



Figure: Strategy Design and Implementation: Interrelationship of Elements

Strategic leadership entails the ability to anticipate, envision, maintain flexibility, and empower others to create strategic change as necessitated by external environment. In other words, strategic leadership represents a complex form of leadership in companies. A manager with strategic leadership skills exhibits the ability to guide the company through the new competitive landscape by influencing the behaviour, thoughts, and feelings of co-workers, managing through others and successfully processing or making sense of complex, ambiguous information by successfully dealing with change and uncertainty.



Figure: Effective Strategic Leadership

In the today's competitive landscape, strategic leaders are challenged to adapt their frames of reference so that they can deal with rapid, complex changes. A managerial frame of reference is the set of assumptions, premises, and accepted wisdom that bounds a manager's understanding of the company, the industry in which it competes, and the core competencies that it exploits in the pursuit of strategic competitiveness (and above-average returns). In other words, a manager's frame of reference is the foundation on which a manager's mindset is built.

The importance of a manager's frame of reference can be seen if we perceive those competitive battles are not between companies or products but between mindsets or managerial frames. This implies that effective strategic leaders must be able to deal with the diverse and cognitively complex competitive situations that are characteristic of today's competitive landscape.

A Strategic leader has several responsibilities, including the following:

- ◆ Making strategic decisions.

- ◆ Formulating policies and action plans to implement strategic decision.
- ◆ Ensuring effective communication in the organisation.
- ◆ Managing human capital (perhaps the most critical of the strategic leader's skills).
- ◆ Managing change in the organisation.
- ◆ Creating and sustaining strong corporate culture.
- ◆ Sustaining high performance over time.

Thus, the strategic leadership skills of a company's managers represent resources that affect company performance. And these resources must be developed for the company's future benefit.

Strategic leadership sets the firm's direction by developing and communicating a vision of future and inspire organization members to move in that direction. Unlike strategic leadership, managerial leadership is generally concerned with the short-term, day-to-day activities.

Two basic approaches to leadership can be transformational leadership style and transactional leadership style.

- ◆ **Transformational leadership style** uses charisma and enthusiasm to inspire people to exert them for the good of the organization. Transformational leadership style may be appropriate in turbulent environments, in industries at the very start or end of their life-cycles, in poorly performing organizations when there is a need to inspire a company to embrace major changes. Transformational leaders offer excitement, vision, intellectual stimulation and personal satisfaction. They inspire involvement in a mission, giving followers a 'dream' or 'vision' of a higher calling so as to elicit more dramatic changes in organizational performance. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities and increasing their self-confidence, and also promote innovation throughout the organization.
- ◆ **Transactional leadership style** focuses more on designing systems and controlling the organization's activities and are more likely to be associated with improving the current situation. Transactional leaders try to build on the existing culture and enhance current practices. Transactional leadership style

uses the authority of its office to exchange rewards, such as pay and status. They prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement or non-achievement.

Transactional leadership style may be appropriate in static environment, in mature industries, and in organizations that are performing well. The style is better suited in persuading people to work efficiently and run operations smoothly.

5.6 STRATEGIC CONTROL

Controlling is one of the important functions of management and is often regarded as the core of the management process. It is a function intended to ensure and make possible the performance of planned activities and to achieve the pre-determined goals and results. Control is intended to regulate and check, i.e., to structure and condition the behaviour of events and people, to place restraints and curbs on undesirable tendencies, to make people conform to certain norms and standards, to measure progress to keep the system on track. It is also to ensure that what is planned is translated into results, to keep a watch on proper use of resources, on safeguarding of assets and so on.

The controlling function involves monitoring the activity and measuring results against pre-established standards, analysing and correcting deviations as necessary and maintaining/adapting the system. It is intended to enable the organisation to continuously learn from its experience and to improve its capability to cope with the demands of organisational growth and development.

The process of control has the following elements:

- (a) Objectives of the business system which could be operationalized into measurable and controllable standards.
- (b) A mechanism for monitoring and measuring the performance of the system.
- (c) A mechanism (i) for comparing the actual results with reference to the standards (ii) for detecting deviations from standards and (iii) for learning new insights on standards themselves.

- (d) A mechanism for feeding back corrective and adaptive information and instructions to the system, for effecting the desired changes to set right the system to keep it on course.

Primarily there are three types of organizational control, viz., operational control, management control and strategic control.

Operational Control: The thrust of operational control is on individual tasks or transactions as against total or more aggregative management functions. **For example,** *procuring specific items for inventory is a matter of operational control, in contrast to inventory management as a whole.* One of the tests that can be applied to identify operational control areas is that there should be a clear-cut and somewhat measurable relationship between inputs and outputs which could be predetermined or estimated with least uncertainty.

Many of the control systems in organisations are operational and mechanistic in nature. A set of standards, plans and instructions are formulated. The control activity consists of regulating the processes within certain 'tolerances', irrespective of the effects of external conditions on the formulated standards, plans and instructions. Some of the examples of operational controls can be stock control (maintaining stocks between set limits), production control (manufacturing to set programmes), quality control (keeping product quality between agreed limits), cost control (maintaining expenditure as per standards), budgetary control (keeping performance to budget).

Management Control: When compared with operational control, management control is more inclusive and more aggregative, in the sense of embracing the integrated activities of a complete department, division or even entire organisation, instead of mere narrowly circumscribed activities of sub-units.

The basic purpose of management control is the achievement of enterprise goals – short range and long range – in a most effective and efficient manner. The term management control is defined by Robert Anthony as 'the process by which managers assure the resources are obtained and used effectively and efficiently in the accomplishment of the organisation's objectives. Controls are necessary to influence the behaviour of events and ensure that they conform to plans.

✓ **Strategic Control:** According to Schendel and Hofer "Strategic control focuses on the dual questions of whether: (1) the strategy is being implemented as planned; and (2) the results produced by the strategy are those intended."

There is often a time gap between the stages of strategy formulation and its implementation. A strategy might be affected on account of changes in internal and external environments of organisation. There is a need for warning systems to track a strategy as it is being implemented. Strategic control is the process of evaluating strategy as it is formulated and implemented. It is directed towards identifying problems and changes in premises and making necessary adjustments.

✓ **Types of Strategic Control:** There are four types of strategic controls, which are as follows:

◆ **Premise control:** A strategy is formed on the basis of certain assumptions or premises about the complex and turbulent organizational environment. Over a period of time these premises may not remain valid. Premise control is a tool for systematic and continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built. It primarily involves monitoring two types of factors:

- (i) Environmental factors such as economic (inflation, liquidity, interest rates), technology, social and legal-regulatory.
- (ii) Industry factors such as competitors, suppliers, substitutes.

It is neither feasible nor desirable to control all types of premises in the same manner. Different premises may require different amount of control. Thus, managers are required to select those premises that are likely to change and would severely impact the functioning of the organization and its strategy.

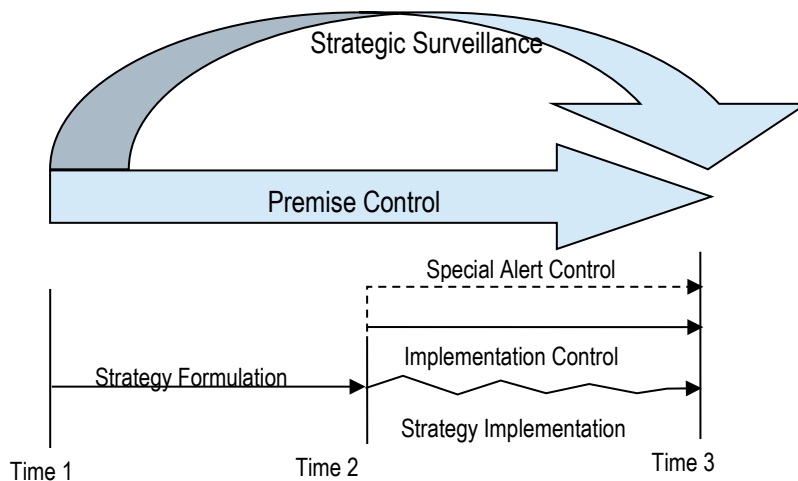
◆ **Strategic surveillance:** Contrary to the premise control, the strategic surveillance is unfocussed. It involves general monitoring of various sources of information to uncover unanticipated information having a bearing on the organizational strategy. It involves casual environmental browsing. Reading financial and other newspapers, business magazines, attending meetings, conferences, discussions and so on can help in strategic surveillance.

◆ Strategic surveillance may be loose form of strategic control but is capable of uncovering information relevant to the strategy.

- ◆ **Special alert control:** At times, unexpected events may force organizations to reconsider their strategy. Sudden changes in government, natural calamities, terrorist attacks, unexpected merger/acquisition by competitors, industrial disasters and other such events may trigger an immediate and intense review of strategy. To cope up with such eventualities, the organisations form crisis management teams to handle the situation.
- ◆ **Implementation control:** Managers implement strategy by converting major plans into concrete, sequential actions that form incremental steps. Implementation control is directed towards assessing the need for changes in the overall strategy in light of unfolding events and results associated with incremental steps and actions.

Strategic implementation control is not a replacement to operational control. Unlike operational control, it continuously monitors the basic direction of the strategy. The two basic forms of implementation control are:

- (i) **Monitoring strategic thrusts:** Monitoring strategic thrusts helps managers to determine whether the overall strategy is progressing as desired or whether there is need for readjustments.
- (ii) **Milestone Reviews:** All key activities necessary to implement strategy are segregated in terms of time, events or major resource allocation. It normally involves a complete reassessment of the strategy. It also assesses the need to continue or refocus the direction of an organization.



Source: John A Pearce II, Richard B Robinson, Jr. and Amita Mital "Strategic Management-Formulation, Implementation and Control".

These four strategic controls steer the organisation and its different sub-systems to the right track. They help the organisation to negotiate through the turbulent and complex environment.

5.7 STRATEGIC PERFORMANCE MEASURES

A company's performance depends heavily on execution of strategy. Companies that continuously outperform their competitors are those who execute well. Executives in a variety of businesses should explore about utilizing strategic performance measurement (SPM). SPM is a method that increases line executives' understanding of an organization's strategic goals and offers a continuous system for tracking progress towards these objectives using clear-cut performance measurements. SPM helps to eliminate silos by establishing a common language among all divisions of the organisation so they may communicate openly and productively.

Strategic performance measures are key indicators that organizations use to track the effectiveness of their strategies and make informed decisions about resource allocation. The measures provide a snapshot of the organization's performance, enabling leaders to assess whether their strategies are aligned with their goals and objectives and to make necessary adjustments to improve their performance.

Key performance measures and indicators must be created, selected, combined into reports and acted upon so that strategy implementation can have tangible outcomes. Firstly, there needs to be a clear cause and effect relationship between the indicators and strategic outcomes. Secondly, KPIs need to be carefully chosen because they will influence the behaviour of people within the organisation. However, managers should be aware of paralysis by over analysis.

Managing the political aspects of implementing a strategy

People involved in the planning process for the implementation of a strategy may be affected by two sets of forces. The "rational" forces of openness, communication, and self-analysis can exist on the one hand. On the other hand, there could be political forces concerned with preserving empires and fostering internal rivalry that urge knowledge retention, selective communication, and caution. When these two techniques conflict, the politically acceptable aspects may end up in the explicit

strategy while the sensitive elements may form an unspoken plan that contains the implicit strategy.

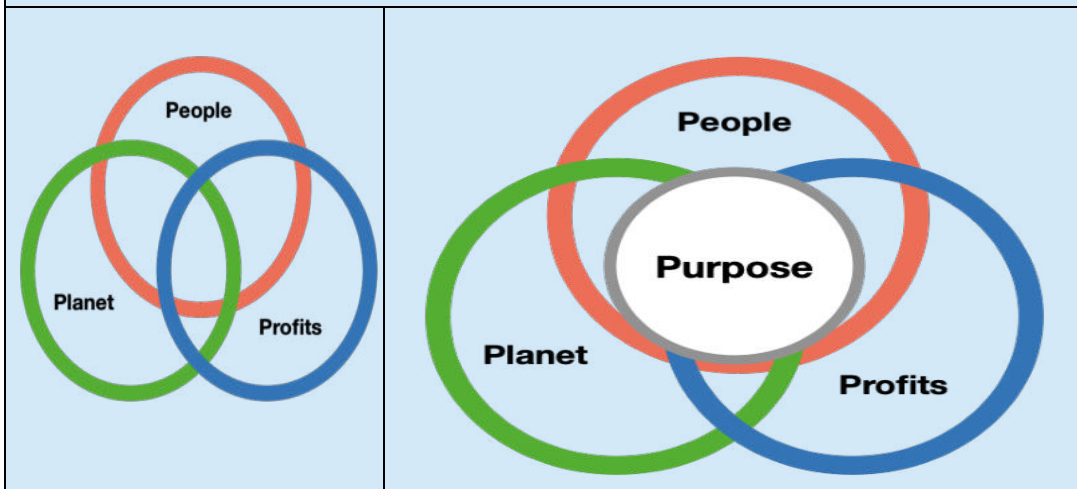
Types of Strategic Performance Measures

There are various types of strategic performance measures, including:

- ◆ **Financial Measures:** Financial measures, such as revenue growth, return on investment (ROI), and profit margins, provide an understanding of the organization's financial performance and its ability to generate profit.
- ◆ **Customer Satisfaction Measures:** Customer measures, such as customer satisfaction, customer retention, and customer loyalty, provide insight into the organization's ability to meet customer needs and provide high-quality products and services.
- ◆ **Market Measures:** Market measures, such as market share, customer acquisition, and customer referrals, provide information about the organization's competitiveness in the marketplace and its ability to attract and retain customers.
- ◆ **Employee Measures:** Employee measures, such as employee satisfaction, turnover rate, and employee engagement, provide insight into the organization's ability to attract and retain talented employees and create a positive work environment.
- ◆ **Innovation Measures:** Innovation measures, such as research and development (R&D) spending, patent applications, and new product launches, provide insight into the organization's ability to innovate and create new products and services that meet customer needs.
- ◆ **Environmental Measures:** Environmental measures, such as energy consumption, waste reduction, and carbon emissions, provide insight into the organization's impact on the environment and its efforts to operate in a sustainable manner.

Toward More Holistic Measures of Strategic Performance

Development of management thought and practice has persistently pushed the frontier of strategic performance beyond financial metrics. Thus, the Triple Bottom Line framework (TBL) emphasises People and Planetary Concerns besides profitability or Economic Prosperity alone. The Quadruple Bottomline adds the 4th P to add a spiritual dimension named 'Purpose.'



The Importance of Strategic Performance Measures

Strategic performance measures are essential for organizations for several reasons:

- ◆ **Goal Alignment:** Strategic performance measures help organizations align their strategies with their goals and objectives, ensuring that they are on track to achieve their desired outcomes.
- ◆ **Resource Allocation:** Strategic performance measures provide organizations with the information they need to make informed decisions about resource allocation, enabling them to prioritize their efforts and allocate resources to the areas that will have the greatest impact on their performance.
- ◆ **Continuous Improvement:** Strategic performance measures provide organizations with a framework for continuous improvement, enabling them to track their progress and make adjustments to improve their performance over time.

- ◆ **External Accountability:** Strategic performance measures help organizations demonstrate accountability to stakeholders, including shareholders, customers, and regulatory bodies, by providing a clear and transparent picture of their performance.

Choosing the Right Strategic Performance Measures

Organizations should choose strategic performance measures that are aligned with their goals and objectives and that provide relevant and actionable information. In selecting the right measures, organizations should consider the following factors:

1. **Relevance:** The measure should be relevant to the organization's goals and objectives, providing actionable and meaningful information. This ensures that the performance measures are directly aligned with what the organization aims to achieve, and that the information obtained can drive improvements and strategic decisions.
2. **Data Availability:** The measure should be based on data that is readily available and can be collected and analyzed in a timely manner. This is important to ensure that the organization can efficiently gather and utilize data without significant delays or obstacles.
3. **Data Quality:** The measure should be based on high-quality data that is accurate and reliable. Accurate and reliable data are crucial for making informed decisions and assessing the true performance of the organization.
4. **Data Timeliness:** The measure should be based on data that is current and up-to-date. Timely data allows organizations to make informed decisions quickly, enabling them to respond promptly to changes and emerging challenges.

These factors are important because they provide a framework for organizations to assess the success of their strategies, identify areas for improvement, and make informed decisions about resource allocation and strategic adjustments. Effective strategic performance measures should be relevant, meaningful, easy to understand, and regularly reviewed and updated to ensure their continued alignment with the organization's goals and objectives.

SUMMARY

The chapter on Strategy Implementation and Evaluation provides a comprehensive overview of the processes and factors involved in executing and assessing the effectiveness of organizational strategies. The following are the main learning objectives covered in the chapter:

- ◆ The process of Strategy Implementation: The chapter describes the process of strategy implementation, including the formulation vs. implementation matrix, the linkages and issues involved, and the role of clear communication, effective leadership, and proper resource allocation.
- ◆ Strategic Change through Digital Transformation: The chapter explores the impact of digital transformation on strategy implementation and the role of technology in driving strategic change.
- ◆ Organisation Structure (hard) vs Culture (soft): The chapter differentiates between hard factors, such as structure and systems, and soft factors, such as culture and leadership, in strategy implementation and explains their impact on organizational performance.
- ◆ Strategic Leadership: The chapter discusses the role of strategic leadership in the implementation process and the importance of leaders who are visionary, innovative, and able to motivate and engage their teams.
- ◆ Strategic Control: The chapter explains the role of strategic control in the implementation process and the importance of monitoring progress, adapting to changes in the environment, and making informed decisions based on data and analysis.
- ◆ Strategic Performance Measures: The chapter identifies key strategic performance measures, including customer satisfaction, market share, return on investment, employee satisfaction, innovation, and environmental sustainability, and explains their importance in tracking progress and making informed decisions about resource allocation.
- ◆ In conclusion, the chapter provides a comprehensive overview of the key elements of effective strategy implementation and evaluation and equips readers with the knowledge and skills needed to execute and assess their organization's strategies.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. _____ leadership style may be appropriate in turbulent environment.
 - (a) Transactional
 - (b) Transformational
 - (c) Autocratic
 - (d) None of these
2. An organizational structure with constricted middle level is:
 - (a) Divisional structure
 - (b) Network structure
 - (c) Hourglass structure
 - (d) Matrix structure
3. You are the head of operations of a company. When you focus on total or aggregate management functions in the sense of embracing the integrated activities of a complete department et al, you are practicing: -
 - (a) Strategic Control
 - (b) Management control
 - (c) Administrative Control
 - (d) Operations Control
4. Which of the following would be chosen by the core strategist to implement operational control: -
 - (a) Premise Control
 - (b) Special Alert Control
 - (c) Implementation Control
 - (d) Budgetary Control

5. *Compliance, Identification and Internalization are the three processes involved in:*
 - (a) *Refreezing*
 - (b) *Defreezing*
 - (c) *Changing behavior patterns*
 - (d) *Breaking down old attitudes*
6. *Which one is NOT a type of strategic control?*
 - (a) *Operational control*
 - (b) *Strategic surveillance*
 - (c) *Special alert control*
 - (d) *Premise control*

Scenario Based Questions

Qm *Swinder*

1. *Imagine you are a consultant advising a small manufacturing company embarking on a digital transformation journey. The company's leadership is concerned about managing the change effectively. Using the best practices for managing change in small and medium-sized businesses, outline a strategy to help the company navigate this transformation successfully.*
2. *A Mumbai-based conglomerate, PQR Ltd., has announced a major restructuring of its business operations. The company has decided to split its business into four separate units: Manufacturing, Retail, Services, and Technology. Each unit will operate as a separate business, with delegated responsibility for day-to-day operations and strategy to the respective unit managers. Identify the organization structure that PQR Ltd. has planned to implement. Discuss any four attributes and the benefits the firm may derive by using this organization structure.*
3. *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.

4. Ramesh, is owner of a popular brand of Breads. Yashpal, his son after completing Chartered Accountancy started assisting his father in running of business. The approaches followed by father and son in management were very different. While Ramesh preferred to use authority and having a formal system of defining goals and motivation with explicit rewards and punishments, Yashpal believed in involving employees and generating enthusiasm to inspire people to deliver in the organization.

Discuss the difference in leadership style of father and son.

5. Suresh Sinha has been recently appointed as the head of a strategic business unit of a large multiproduct company. Advise Mr Sinha about the leadership role to be played by him in execution of strategy.

6. KaAthens Ltd., a diversified business entity having business operations across the globe. The company leadership has just changed as Mr. D. Bandopadhyay handed over the pedals to his son Aditya Bandopadhyay, due to his poor health. Aditya is a highly educated with an engineering degree from IIT, Delhi. However, being very young he is not clear about his role and responsibilities,

In your view, what are the responsibilities of Aditya Bandopadhyay as CEO of the company.

7. Manoj started his telecom business in 2010. Over next five years, he gradually hired fifty people for various activities such as to keep his accounts, administration, sell his products in the market, create more customers, provide after sales service, coordinate with vendors.

Draw the organization structure Manoj should implement in his organization and name it.

8. Moonlight Private Limited deals in multi-products and multi-businesses. It has its own set of competitors. It seems impractical for the company to provide separate strategic planning treatment to each one of its product or businesses.

As a strategic manager, suggest the type of structure best suitable for Moonlight Private Limited and state its benefits.

9. Sanya Private Limited is an automobile company. For the past few years, it has been observed that the progress of the company has become stagnant. When scrutinized, it was found that the planning department was performing fairly well but the plans could not be implemented due to improper use of resources, undesirable tendencies of workers and non-conformance to norms and standards. You are hired as a Strategic Manager. Suggest the elements of process of control to overcome the problem.

Descriptive Questions

1. What is a strategic business unit? What are its advantages?
2. Draw 'Divisional Structure' with the help of a diagram. Also, give advantages and disadvantages of this structure in brief.
3. What is an 'hourglass structure'? How can this structure benefit an organization?
4. How can you differentiate between transformational and transactional leaders?
5. What is strategic change? Explain the change process proposed by Kurt Lewin that can be useful in implementing strategies?
6. What are the differences between operational control and management control?
7. What is strategic control? Briefly explain the different types of strategic control.
8. What is implementation control? Discuss its basic forms.

ANSWERS/SOLUTIONS

Multiple Choice Questions

1	(b)	2	(c)	3	(b)	4	(d)	5	(c)	6	(a)

Answers to Scenario Based Questions

1. To help the small manufacturing company navigate its digital transformation successfully, we would recommend the following strategy:

1. **Begin at the top:** The leadership team should be united and committed to the digital transformation. They should communicate a clear vision for the future of the company and lead by example.
2. **Ensure that the change is necessary and desired:** Before implementing any changes, the company should assess its current state and identify areas where digital transformation can add value. It's important to involve employees in this process to ensure their buy-in.
3. **Reduce disruption:** Employee perceptions of change can vary, so it's important to minimize disruption. This can be done by communicating early and often about the changes, providing training and support for employees, and empowering change agents within the organization.
4. **Encourage communication:** Create channels for employees to ask questions and provide feedback. Encourage collaboration between departments to share ideas and innovations. Effective communication can help alleviate fears and keep everyone aligned.
5. **Recognize that change is the norm:** Digital transformation is not a one-time project but an ongoing process. The company should be prepared to adapt to new technologies and market conditions continuously.

By following these best practices, the small manufacturing company can successfully navigate its digital transformation and position itself for future growth and success.

2. 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 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.
3. 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.

4. Ramesh is a follower of transactional leadership style that focuses on designing systems and controlling the organization's activities. Such a leader believes in using authority of its office to exchange rewards, such as pay and status. They prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement or non-achievement. Transactional leaders try to build on the existing culture and enhance current practices. The style is better suited in persuading people to work efficiently and run operations smoothly.

On the other hand, Yashpal is follower of transformational leadership style. The style uses charisma and enthusiasm to inspire people to exert them for the good of the organization. Transformational leaders offer excitement, vision, intellectual stimulation and personal satisfaction. They inspire involvement in a mission, giving followers a 'dream' or 'vision' of a higher calling so as to elicit more dramatic changes in organizational performance. Such a leadership motivates followers to do more than originally affected to do by stretching their abilities and increasing their self-confidence, and also promote innovation throughout the organization.

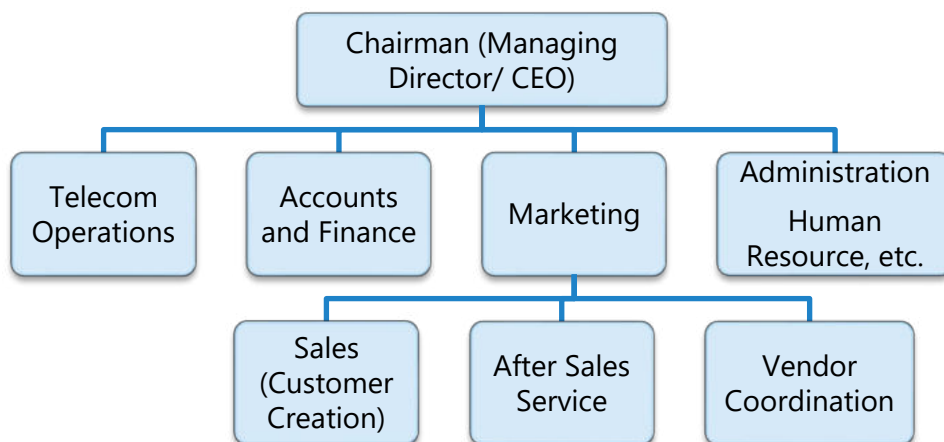
5. Leading change has to start with diagnosing the situation and then deciding which of several ways to handle it. Managers have five leadership roles to play in pushing for good strategy execution:

- (i) Staying on top of what is happening, closely monitoring progress, solving out issues, and learning what obstacles lie in the path of good execution.
 - (ii) Promoting a culture of esprit de corps that mobilizes and energizes organizational members to execute strategy in a competent fashion and perform at a high level.
 - (iii) Keeping the organization responsive to changing conditions, alert for new opportunities, bubbling with innovative ideas, and ahead of rivals in developing competitively valuable competencies and capabilities.
 - (iv) Exercising ethical leadership and insisting that the company conduct its affairs like a model corporate citizen.
 - (v) Pushing corrective actions to improve strategy execution and overall strategic performance.
6. Aditya Bandopadhyay, an effective strategic leader of KaAthens Ltd. must be able to deal with the diverse and cognitively complex competitive situations that are characteristic of today's competitive landscape.

A Strategic leader has several responsibilities, including the following:

- ◆ Making strategic decisions.
 - ◆ Formulating policies and action plans to implement strategic decision.
 - ◆ Ensuring effective communication in the organisation.
 - ◆ Managing human capital (perhaps the most critical of the strategic leader's skills).
 - ◆ Managing change in the organisation.
 - ◆ Creating and sustaining strong corporate culture.
 - ◆ Sustaining high performance over time.
7. Manoj has started a telecom business. Accounts, Administration, Marketing (customer creation, after sales service, vendor coordination) are the functional areas that are desired in the organisational structure. Further there is inherent need to have a department for the management of telecom services/ operations.

Thus, the functional structure in the telecom business of Manoj can be as follows:



8. It is advisable for Moonlight Private Limited to follow the strategic business unit (SBU) structure.

Moonlight Private Limited has a multi-product and multi-business structure where, each of these businesses has its own set of competitors. In the given case, Strategic Business Unit (SBU) structure would best suit the interests of the company.

SBU is a part of a large business organization that is treated separately for strategic management purposes. It is separate part of large business serving product markets with readily identifiable competitors. It is created by adding another level of management in a divisional structure after the divisions have been grouped under a divisional top management authority based on the common strategic interests.

Very large organizations, 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, just as is the case for Moonlight Private Limited. SBU structure becomes imperative in an organization with increase in number, size and diversity.

Benefits of SBUs:

1. Establishing coordination between divisions having common strategic interest.
2. Facilitate strategic management and control.
3. Determine accountability at the level of distinct business units.
4. Allow strategic planning to be done at the most relevant level within the total enterprise.
5. Make the task of strategic review by top executives more objective and more effective.
6. Help to allocate resources to areas with better opportunities.

Thus, an SBU structure with its set of advantages would be most suitable for the company with the given diverse businesses having separate identifiable competitors, but a common organizational goal.

9. Sanya Private Limited deteriorating performance due to poor implementation of plans that is improper use of resources, undesirable tendencies of the workers, and non-conformance to norms and standards, all point towards weak controls in the organization. Implementation of plans cannot assure results unless strong and sufficient controls are put in place. The management of the company should focus diligently on developing controls especially in the identified problem areas.

The process of control has the following elements:

- (a) Objectives of the business system which could be operationalized into measurable and controllable standards.
- (b) A mechanism for monitoring and measuring the performance of the system.
- (c) A mechanism (i) for comparing the actual results with reference to the standards (ii) for detecting deviations from standards and (iii) for learning new insights on standards themselves.

- (d) A mechanism for feeding back corrective and adaptive information and instructions to the system, for effecting the desired changes to set right the system to keep it on course.

Above elements of control would ensure a proper check on improper use of resources, undesirable tendencies of the workers, and non-conformance to norms and standards and ensure a result oriented implementation of plans.

Answers to Descriptive Questions

1. A strategic business unit (SBU) is any part of a business organization which is treated separately for strategic management purposes. The concept of SBU is helpful in creating an SBU organizational structure. It is discrete element of the business serving product markets with readily identifiable competitors and for which strategic planning can be concluded. It is created by adding another level of management in a divisional structure after the divisions have been grouped under a divisional top management authority based on the common strategic interests.

Advantages of SBU are:

- ◆ Establishing coordination between divisions having common strategic interests.
 - ◆ Facilitates strategic management and control on large and diverse organizations.
 - ◆ Fixes accountabilities at the level of distinct business units.
 - ◆ Allows strategic planning to be done at the most relevant level within the total enterprise.
 - ◆ Makes the task of strategic review by top executives more objective and more effective.
 - ◆ Helps allocate corporate resources to areas with greatest growth opportunities.
2. Divisional structure is that organizational structure which is based on extensive delegation of authority and built on division basis. The divisional structure can be organized in one of the four ways: by geographic area, by product or

service, by customer, or by process. With a divisional structure, functional activities are performed both centrally and in each division separately.

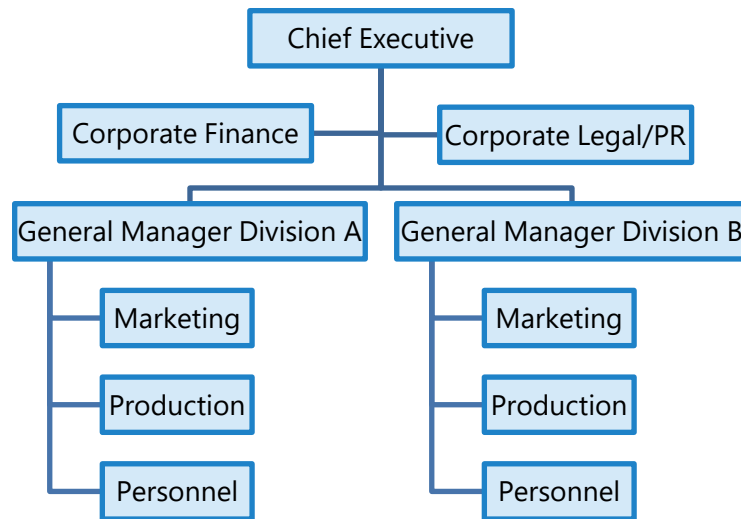


Figure: Divisional Structure

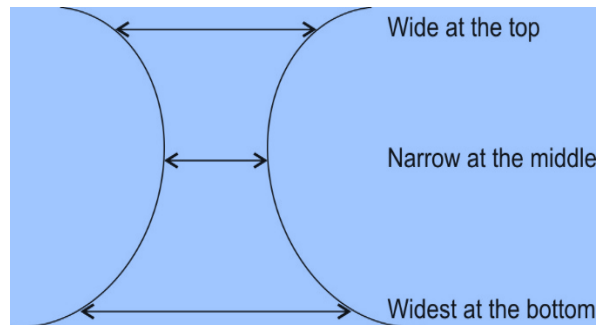
Advantages of Divisional Structure

- ♦ **Accountability is clear:** Divisional managers can be held responsible for sales and profit levels. Because a divisional structure is based on extensive delegation of authority, managers and employees can easily see the results of their good or bad performances and thus their morale is high.
- ♦ **Other advantages:** It creates career development opportunities for managers, allows local control of local situations, leads to a competitive climate within an organization, and allows new businesses and products to be added easily.

Disadvantages of Divisional Structure

- ♦ **Higher cost:** Owing to following reasons: (i). requires qualified functional specialist at different divisions and needed centrally (at headquarters); (ii). It requires an elaborate, headquarters –driven control system.

- ◆ **Conflicts between divisional managers:** Certain regions, products, or customers may sometimes receive special treatment, and it may be difficult to maintain consistent, company-wide practices.
3. In the recent years information technology and communications have significantly altered the functioning of organizations. The role played by middle management is diminishing as the tasks performed by them are increasingly being replaced by the technological tools. Hourglass organization structure consists of three layers in an organisation structure with constricted middle layer. The structure has a short and narrow middle management level. Information technology links the top and bottom levels in the organization taking away many tasks that are performed by the middle level managers. A shrunken middle layer coordinates diverse lower level activities.



Hourglass Organization Structure

Hourglass structure has obvious benefit of reduced costs. It also helps in enhancing responsiveness by simplifying decision making. Decision making authority is shifted close to the source of information so that it is faster. However, with the reduced size of middle management, the promotion opportunities for the lower levels diminish significantly.

4. **Difference between transformational and transactional leadership**
1. Transformational leadership style uses charisma and enthusiasm to inspire people to exert them for the good of organization. Transactional leadership style uses the authority of its office to exchange rewards such as pay, status symbols etc.
 2. Transformational leadership style may be appropriate in turbulent environment, in industries at the very start or end of their cycles, poorly

performing organisations, when there is a need to inspire a company to embrace major changes. Transactional leadership style can be appropriate in static environment, in growing or mature industries and in organisations that are performing well.

3. Transformational leaders inspire employees by offering excitement, vision, intellectual stimulation and personal satisfaction. Transactional leaders prefer a more formalized approach to motivation, setting clear goals with explicit rewards or penalties for achievement and non-achievement. Transactional leaders focus mainly to build on existing culture and enhance current practices.
5. The changes in the environmental forces often require businesses to make modifications in their existing strategies and bring out new strategies. Strategic change is a complex process and it involves a corporate strategy focused on new markets, products, services and new ways of doing business.

To make the change lasting, Kurt Lewin proposed three phases of the change process for moving the organization from the present to the future. These stages are unfreezing, changing and refreezing.

- (a) **Unfreezing the situation:** The process of unfreezing simply makes the individuals or organizations aware of the necessity for change and prepares them for such a change. Lewin proposes that the changes should not come as a surprise to the members of the organization. Sudden and unannounced change would be socially destructive and morale lowering. The management must pave the way for the change by first “unfreezing the situation”, so that members would be willing and ready to accept the change.

Unfreezing is the process of breaking down the old attitudes and behaviours, customs and traditions so that they start with a clean slate. This can be achieved by making announcements, holding meetings and promoting the ideas throughout the organization.

- (b) **Changing to New situation:** Once the unfreezing process has been completed and the members of the organization recognise the need for change and have been fully prepared to accept such change, their behaviour patterns need to be redefined. H.C. Kellman proposed three

methods for reassigning new patterns of behavior as compliance, identification and internalisation.

- (c) **Refreezing:** Refreezing occurs when the new behaviour becomes a normal way of life. The new behaviour must replace the former behaviour completely for successful and permanent change to take place. In order for the new behaviour to become permanent, it must be continuously reinforced so that this newly acquired behaviour does not diminish or extinguish.

Change process is not a one time application but a continuous process due to dynamism and ever changing environment. The process of unfreezing, changing and refreezing is a cyclical one and remains continuously in action.

6. Differences between Operational Control and Management Control are as under:

- (i) The thrust of operational control is on individual tasks or transactions as against total or more aggregative management functions. When compared with operational, management control is more inclusive and more aggregative, in the sense of embracing the integrated activities of a complete department, division or even entire organisation, instead of mere narrowly circumscribed activities of sub-units. **For example, procuring specific items for inventory is a matter of operational control, in contrast to inventory management as a whole.**
- (ii) Many of the control systems in organisations are operational and mechanistic in nature. A set of standards, plans and instructions are formulated. On the other hand, the basic purpose of management control is the achievement of enterprise goals – short range and long range – in an effective and efficient manner.

7. Strategic Control focuses on the dual questions of whether: (1) the strategy is being implemented as planned; and (2) the results produced by the strategy are those intended.

There are four types of strategic control:

- ◆ **Premise control:** A strategy is formed on the basis of certain assumptions or premises about the environment. Premise control is a tool for systematic and continuous monitoring of the environment to verify the validity and accuracy of the premises on which the strategy has been built.
 - ◆ **Strategic surveillance:** Strategic surveillance is unfocussed. It involves general monitoring of various sources of information to uncover unanticipated information having a bearing on the organizational strategy.
 - ◆ **Special alert control:** At times, unexpected events may force organizations to reconsider their strategy. Sudden changes in government, natural calamities, unexpected merger/acquisition by competitors, industrial disasters and other such events may trigger an immediate and intense review of strategy.
 - ◆ **Implementation control:** Managers implement strategy by converting major plans into concrete, sequential actions that form incremental steps. Implementation control is directed towards assessing the need for changes in the overall strategy in light of unfolding events and results.
8. Managers implement strategy by converting major plans into concrete, sequential actions that form incremental steps. Implementation control is directed towards assessing the need for changes in the overall strategy in light of unfolding events and results associated with incremental steps and actions.

Strategic implementation control is not a replacement to operational control. Strategic implementation control, unlike operational controls continuously monitors the basic direction of the strategy. The two basic forms of implementation control are:

- (i) **Monitoring strategic thrusts:** Monitoring strategic thrusts help managers to determine whether the overall strategy is progressing as desired or whether there is need for readjustments.
- (ii) **Milestone Reviews.** All key activities necessary to implement strategy are segregated in terms of time, events or major resource allocation. It normally involves a complete reassessment of the strategy. It also assesses the need to continue or refocus the direction of an organization.

CASE SCENARIOS



Case Scenario 1

In the fiercely competitive automotive industry, Zing, a promising newcomer, set out on a strategic journey with ambitions of making a substantial impact. Recognizing the significance of a robust distribution network early on, Zing forged partnerships with established dealerships, offering them attractive margins. This strategic move significantly enhanced Zing's reach, with a presence in 80% of the nation's dealerships by 2022, expanding its coverage significantly.

To differentiate themselves from competitors, Zing adopted two key strategies. Firstly, they prioritized product design, investing heavily in aesthetics and incorporating innovative features and environmentally friendly technologies. This focus on design led to their vehicles receiving excellent reviews and achieving an impressive 15% year-on-year growth in sales.

Secondly, Zing implemented switching costs to discourage customers from switching to other brands. Their vehicles featured branded software, making it both expensive and cumbersome for customers to transition to alternative brands. This strategic move effectively protected Zing's market share.

Zing's overarching goal was to position itself as a premium automotive brand, blending luxury with sustainability. However, their execution fell down as they challenged with maintaining consistent quality and service levels, resulting in mixed customer reviews.

Despite their best efforts, Zing's differentiation strategy fell short due to issues with inconsistent quality and service. Negative word-of-mouth and declining customer satisfaction scores tarnished their brand image, leading to stagnating sales. This failure to deliver on their brand promise proved to be a significant setback.

As Zing's reputation suffered from execution failures, securing additional funds for international expansion became challenging. Consequently, they made the difficult decision to postpone their global ambitions for the next five years, focusing instead on stabilizing their finances and rebuilding their brand image.

In summary, Zing's strategic journey illustrates the importance of not only crafting a compelling differentiation strategy but also executing it flawlessly. In the competitive automotive landscape, maintaining consistent quality and service is paramount to sustaining brand loyalty and achieving long-term success.

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

- (i) What key strategic approach did Zing use to expand its market presence in the automotive industry?
 - (a) Product innovation and design
 - (b) Cost leadership strategy
 - (c) Entering new international markets
 - (d) Vertical integration
- (ii) How did Zing protect its market share from potential competitors?
 - (a) Price-cutting strategy
 - (b) Branded software and switching costs
 - (c) Aggressive marketing campaigns
 - (d) International expansion
- (iii) Why did Zing's differentiation strategy fall short in the market?
 - (a) Intense price competition
 - (b) Poor marketing strategy
 - (c) Inconsistent quality and service
 - (d) Lack of international expansion
- (iv) Forging partnerships with established dealerships to enhance its distribution network falls under which level of strategy?
 - (a) Corporate level strategy
 - (b) Business level strategy

- (c) Functional level strategy
- (d) Competitive level strategy
- (v) How did Zing initially expand its market presence across the nation?
 - (a) Aggressive marketing campaigns
 - (b) Developing low-cost vehicles
 - (c) Partnering with established dealerships
 - (d) Launching a luxury brand

Answers

(i)	(a)	(ii)	(b)	(iii)	(c)	(iv)	(b)	(v)	(c)

Case Scenario 2

Café Delight, a thriving restaurant chain known for its unique blend of Australian and Indian culinary experiences, embarked on a remarkable journey from its humble beginnings as a small café in Australia to becoming a renowned player in the Indian restaurant industry. This case study digs into the strategic decisions and market dynamics that fueled Café Delight's growth, highlighting its transition from a single café in Powai, Mumbai, to a flourishing chain with a presence in five cities and over 25 stores. It explores how Café Delight effectively leveraged social media and adapted its pricing strategy to compete with global brands while maintaining a healthy profit margin.

In 2005, Café Delight was founded in Melbourne, Australia, by a passionate entrepreneur with a vision to bring the flavors of Australia and India together. The first café established in Powai, Mumbai, received accolades for its unique menu, blending Australian coffee culture with Indian culinary traditions. Over the course of five years, Café Delight expanded to three stores in Mumbai, driven by exceptional mouth publicity, customer loyalty, and consistent quality.

As the social media landscape evolved, Café Delight recognized the power of online platforms in reaching a wider audience. By effectively utilizing social media and online marketing, Café Delight expanded its presence to five cities across India and established over 25 stores. Customer engagement through social media platforms enabled the brand to create a strong and vibrant community, driving organic growth.

Café Delight's customer-centric approach involved continuously evolving its menu

to cater to the changing tastes and dietary preferences of its patrons. By understanding the evolving needs of its customers, Café Delight could offer personalized menu items, seasonal specials, and dietary alternatives. This approach created a sense of loyalty and engagement among customers, strengthening the brand's appeal. Not just customers but High-power, low-interest stakeholders, including regulatory authorities, were addressed with careful compliance and adherence to industry standards. Low-power, high-interest stakeholders, like potential customers and local communities, were engaged through targeted marketing campaigns and community involvement initiatives. This meticulous stakeholder analysis allowed Café Delight to build and maintain strong relationships with each group, effectively managing their influence and impact on the brand.

With its expanding presence and increasing popularity, Café Delight underwent a shift in its pricing strategy. It transitioned from a pocket-friendly pricing model to a skimming strategy, capitalizing on its unique blend of Australian and Indian flavors to position itself as a premium restaurant. Café Delight faced stiff competition from global brands entering the Indian market but maintained a profit margin of approximately 30% through menu engineering and targeted pricing.

In one of its kind, using strategic tools enabled Café Delight to identify and act on opportunities while mitigating threats, contributing to its long-term success in the highly competitive restaurant industry.

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

- (i) Café Delight effectively leveraged social media and adapted its pricing strategy as it stepped into which phase of business life cycle of operations?
 - (a) Introduction Stage
 - (b) Growth Stage
 - (c) Maturity Stage
 - (d) Decline Stage
- (ii) What stakeholder group did Café Delight engage through targeted marketing campaigns and community involvement initiatives?
 - (a) High-power, high-interest stakeholders
 - (b) Low-power, low-interest stakeholders
 - (c) Low-power, high-interest stakeholders

- (d) High-power, low-interest stakeholders
- (iii) What best describes Café Delight's initial expansion strategy when it expanded from one café to three in Mumbai?
 - (a) Aggressive price reduction
 - (b) Leveraging customer loyalty and word-of-mouth publicity
 - (c) Extensive online marketing
 - (d) Embracing global branding strategies
- (iv) At which level of strategic management does Café Delight's transition from a pocket-friendly pricing model to a skimming strategy fit?
 - (a) Corporate level
 - (b) Business level
 - (c) Functional level
 - (d) Operational level
- (v) What type of strategy did Café Delight use to differentiate itself from competitors in the Indian restaurant industry?
 - (a) Cost leadership strategy
 - (b) Focused differentiation strategy
 - (c) Cost focus strategy
 - (d) Hybrid strategy

Answers

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

Case Scenario 3

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

Answers

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

Case Scenario 4

Once upon a time in the land of sun, sand, and vibrant cultures, there existed a company named "MuseoGoa" - a company that managed museums in the beautiful state of Goa. MuseoGoa had a vision to celebrate the rich history and culture of Goa, but their journey was not without its fair share of challenges.

MuseoGoa had chosen a picturesque location in a quaint village to build their first museum. However, this initial enthusiasm was met with an uproar from the local communities. The villagers were concerned about the impact on their way of life and traditions. They worried that the influx of tourists might disrupt their peaceful existence.

To address this challenge, MuseoGoa applied Mendelow's matrix, identifying the local communities as key stakeholders. They decided to engage in open dialogues, understanding and respecting the villagers' concerns. MuseoGoa initiated community-building activities, such as involving locals in museum operations, supporting local artisans, and organizing cultural events that showcased the village's heritage. Slowly but steadily, the company transformed from being perceived as a threat to a valued partner within the community.

While MuseoGoa had successfully resolved their initial issues with the local community, they faced another challenge. Their location, although idyllic, was a bit off the beaten path. Tourists typically preferred the bustling beaches closer to the city, and this posed a real challenge. MuseoGoa decided to employ a pricing strategy. They priced their tickets affordably, significantly cheaper than the city's attractions. This strategy attracted budget-conscious tourists who were looking for unique experiences in Goa without burning a hole in their pockets. As word spread about the cultural gem tucked away in the village, visitors started flocking in, drawn not just by the museum's charm but also the economical ticket prices.

In the age of social media, MuseoGoa knew that word-of-mouth was no longer limited to whispers. They tapped into the power of social media to promote their unique museum experience. MuseoGoa ran interactive campaigns, encouraging visitors to share their experiences on various platforms. One particular Instagram post featuring a vibrant Goan mural in the museum went viral. This was the turning point. The picture-perfect aesthetics of the museum attracted influencers, bloggers, and travel enthusiasts, making MuseoGoa a social media sensation. Visitors came pouring in, not just from India but from across the globe, eager to capture their own moments at the "Instagrammable Museum of Goa."

With success came ambition. MuseoGoa decided to expand its footprint beyond Goa. To guide this expansion, they conducted a strategy audit and trend analysis. They identified emerging cultural and tourism trends and found potential markets in Pune and Trivandrum.

In Pune, MuseoGoa curated a special exhibition that celebrated the fusion of Goan and Maharashtrian cultures. They strategically partnered with local influencers and travel agencies to market the new experience. The expansion into Pune was met with resounding success.

For Trivandrum, MuseoGoa recognized the importance of local traditions and the distinct flavor of Kerala. They tailored their offerings to harmonize with the regional culture. MuseoGoa became the gateway for tourists to explore Kerala's rich heritage, with the museum acting as a bridge between Goa and Kerala's cultural tapestry.

MuseoGoa's journey from initial uproar to expansion was a testament to their commitment to community building, strategic pricing, social media savvy, and a keen eye for trends. The company continued to flourish, celebrating the diverse cultural tapestry of India and making history come alive in every location they touched.

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

- (i) Which strategic management concept did MuseoGoa use to address the initial concerns of the local community?
 - (a) SWOT analysis
 - (b) Mendelow's matrix
 - (c) Cost leadership strategy
 - (d) Porter's Five Forces model
- (ii) MuseoGoa's idyllic location in a quaint village posed a challenge as tourists preferred beaches closer to the city. To attract visitors, MuseoGoa priced their tickets affordably, cheaper than city attractions, drawing budget-conscious tourists looking for unique experiences. What business strategy did MuseoGoa employ to attract more tourists?
 - (a) Cost leadership strategy
 - (b) Differentiation strategy
 - (c) Focus strategy
 - (d) Diversification strategy
- (iii) How did MuseoGoa approach its expansion into new markets such as Pune and Trivandrum?
 - (a) Outsourcing strategy
 - (b) Franchising strategy
 - (c) Product diversification strategy
 - (d) Market development strategy
- (iv) Which element of the 7S McKinsey model is demonstrated by MuseoGoa's strategic use of social media and pricing strategies to attract visitors?
 - (a) Style
 - (b) Strategy
 - (c) Shared Values
 - (d) Skills

- (v) What played a crucial role in MuseoGoa's success in Pune and Trivandrum?
- (a) Strategic partnerships
 - (b) Aggressive advertising
 - (c) Product differentiation
 - (d) Vertical integration

Answers

(i)	(b)	(ii)	(a)	(iii)	(d)	(iv)	(b)	(v)	(a)

Case Scenario 5

Connect Innovations Pvt. Ltd., a Mumbai-based technology company, is entering the competitive landscape of the Indian smartphone market under its brand name "Poppy." The company is well aware of the influx of Chinese manufacturers dominating the smartphone industry. Given the recent global sentiment shift due to the COVID-19 pandemic, Connect Innovations plans to position Poppy as a patriotic choice, proudly promoting it as the "Desi" smartphone of India.

The company's strategic arm conducted a thorough industry analysis, revealing that Chinese brands had completely captured the budget phone segment. However, there was still an untapped opportunity in the lower segment of smartphones. To address this, Connect Innovations is introducing two models: Poppy A and Poppy B, priced at ₹ 4,499 and ₹ 5,499, respectively.

Recognizing the risk of imitation by competitors, Connect Innovations has assembled a team of marketing professionals to devise a strategy. Their proposed solution is to capitalize on the first-mover advantage by investing significant sums in advertising and promotions.

Additionally, to safeguard their business from potential disruption, Connect Innovations decided to expand their product line to include "desi" themed smartphone covers and accessories alongside Poppy smartphones. They made substantial investments in the manufacturing of these accessories. The company's investors set a target of achieving annual sales volumes of 15,000 handsets and 70,000 pieces of accessories.

While the accessory sales exceeded expectations, Poppy A and Poppy B did not receive the anticipated response. As a result, the leadership has decided to shift their focus, scaling back on smartphone production and concentrating primarily on the accessories business.

With this new direction, the "Desi" tag remains vital for success. Connect Innovations aims to establish strong barriers to entry for other domestic players. They plan to ramp up production significantly, driving down unit costs and enabling cost leadership through volume.

Based on the above case scenario, answer the multiple choice questions.

- (i) Connect Innovations Pvt. Ltd. entered a saturated market for smartphones, after a due market study of understanding the competitive landscape. Put the below steps in correct sequence of understanding the competitive landscape.
 - I. Understanding the competitors
 - II. Determining strengths and weaknesses of the competitors
 - III. Identify the competitors
 - IV. Put all information gathered together
 - (a) (I),(III),(II),(IV)
 - (b) (III),(I),(II),(IV)
 - (c) (II),(III),(IV),(I)
 - (d) (I),(III),(II),(IV)
- (ii) In which stage of strategic management are such annual objectives especially important?
 - (a) Formulation
 - (b) Control
 - (c) Evaluation
 - (d) Implementation
- (iii) The decision of Connect Innovations to shift to a new core business with a focus on more profitable ventures falls under which category of business strategy?
 - (a) Retrenchment strategy

- (b) Strategic alliance
 - (c) Diversification strategy
 - (d) Market development
- (iv) Considering the results from the market, which category of BCG's growth share matrix does the accessories business of Connect Innovations fall into?
- (a) Star
 - (b) Question mark
 - (c) Cash cow
 - (d) Dog
- (v) In phase two of shifting the business focus to peripheral accessories production, Connect Innovations has planned to implement which barrier to discourage potential competitors?
- (a) Capital requirement
 - (b) Product differentiation
 - (c) Access to distribution channels
 - (d) Economies of scale

Answer

(i)	(b)	(ii)	(d)	(iii)	(a)	(iv)	(c)	(v)	(d)