Webcast on
Strategy to Qualify & Excel in Final Course Paper-2
Strategic Financial Management

Strategic Financial Management or corporate finance is the bread and butter of most businesses. My take is that while accounting, auditing, tax and law may be construed by many as the core subjects in CA; it's financial management that ultimately is a driving and proactive business function. After all you need to raise money and manage money if you have to run business of any hue. And financial management as you know, deals with just that.

I will walk you through each topic, talk to you about its importance generally in terms of how it fits your long term plans, and single out what can be core areas for exams.

Let's begin with capital budgeting. Businesses invest heavily to generate future cash flows. You need to invest your money in the right asset. That's where capital budgeting decisions help. At the end of each year you also need to look at whether you should continue with an existing asset or replace it with a new one. It's here that abandonment and replacement decisions become useful in companies. Companies do not have all the money in the world but they have all kinds of assets to buy. It therefore becomes imperative to decide which asset to buy and which to leave out. It's here that capital rationing comes in handy.

From an exam and knowledge perspective get to know the long term fund principle. You must understand which cash flows are relevant and which are not. You must know which cash flows should be discounted at what rate. Remember, shareholders cash flow must be discounted at cost of equity and long-term fund cash flow at the WACC. Also in the changing global amalgam get to know about adjusted present value. It helps you get a low down on how the NPV is arrived at. This chapter has not found much favor with the examiners and has been asked for about 3.7% of marks.

Let's move on to risk analysis. Capital investments come with their own quota of risk. Risk is the other side of the investment coin. Reward is the one side. You must understand what is expected value, how probability are put to use, how standard deviation is computed, how to ascertain discount rates etc. Remember, higher the risk in a project higher is the discount rate. Also get to know what certainty equivalent factors are. CEF converts uncertain cash flow to certain cash flow. When so converted they need to be discounted at risk free rate. Then there is sensitivity. Pick up how to compute the sensitivity of a project to various input parameters. My sense is that you should also get to know how to use uneven cash flows. Remember sensitivity check is to be done to see what percentage change in input parameter will lead to a reversal of the investment decision. Hillier's model is an area that has received maximum attention by the examiners' God knows why. A fairly sensible model it talks about how risk can be different for the same set of cash flows if the nature of those cash flows is different. In real life, it may be hard to know whether cash flows are dependent or independent, although one could run correlation checks.

Joint Probability or combined probability must be studied. Simulation is the next level to sensitivity and is critical even from a practical angle. Between 2002 and 2008 Risk analysis received maximum attention from the examiners with a question on the topic popping up in every exam. Thereafter, the focus has been less intense so much so that only 3% marks have been set across the last 8 exams.

The third chapter is Dividends. Why has Microsoft despite its huge profits been shy of declaring dividends? And why do companies like Infosys and HUL declare dividends by the dozen? A complete understanding of this chapter will help you answer this. The chapter deals with various models, about 10 of them, though I am not sure whether these are actually tested out by CFOs before they declare dividends. The exams have focused on Walter's Model and Modigliani-Miller model. My own take is that you must understand what drives dividends; it's the segment that pieces together all the models. Once this was the most frequently asked chapter. Between 2002 and 2008 you had almost always a question on dividends. In the last 4 years, its intensity has come down and it caters to 6% of total marks.

Portfolio management is the chapter that won Harry Markowitz the Nobel Prize. He was the first man in the field of finance to bag that. There are 10 notions in that chapter and you need to grasp each with élan. The key to understanding the topic is to understand how diversification reduces risk. Look to the examples to appreciate this. Know how portfolio return is weighted average but portfolio is not weighted average risk. Learn about dominance, which has been a favorite question of the examiners. Learn about beta, about the capital asset pricing model, about how to identify under-valued and over-valued stocks. You should also read about the models beyond the CAP Model.

My view is that you should use stock data of the Sensex stocks to work out return, risk, portfolio return, portfolio risk, dominance, beta and under or over-valuation of those stocks and portfolio. This will give you an idea of marrying academic with practice. A very popular chapter in the exam it has had 11% marks in the last 8 exams.

Let's move over to Mutual Fund. Today this is the most important investment vehicle for investors. Actually you can start your mutual fund investment straight away as an Intern and see the benefits of long term investing! This topic will help you understand how the funds invest, why people invest there, what are the pluses and minuses, how to evaluate a fund scheme, how to select winning mutual funds etc.

From an exam perspective the focus has been on computing NAV, growth in NAV, plus of-course the Sharpe, Treynor and Jensen Index that evaluate fund performance.

My own view is that Derivatives is the jewel in this paper. In volatile markets derivatives offer a good opportunity to hedge. These instruments have developed deeply in Indian market and throw up investment (okay speculation) as also arbitrage opportunities. CAs who want to make a mark can work in derivative areas for high rewards. Even as you learn the subject there are opportunities for practical testing of the knowledge gained in the classroom. A case in point is arbitrage trading. Recently when HUL had an open offer at 601, and was trading in the cash market around that price, the instrument was available in the futures market at 571. That was a huge opportunity to make an arbitrage killing.

The examiners have been very partial to this chapter with questions amounting to 15% appearing from here. Post 2008, almost all the session have had questions on derivatives cutting across the entire chapter beginning with basics and ending with valuation of options. If you pick up the chapter through the tables and charts that offer ease of computing you will go a long way in doing well in this chapter

The next blockbuster chapter is International Finance. At a time when the Rupee is facing a tsunami in the forex market it will be good for you to know what causes these. Again this is a very practical chapter especially as you would one day deal with imports and exports. Should we or should we not take forward contracts, what do we do when an import or an export doesn't materialize, what are the other risk management tools like netting, leading-lagging, currency invoicing etc. You also must familiarize yourself with international capital budgeting and understand how and why the discount rates are different when you evaluate based on home currency and when you evaluate based on foreign currency.

Leasing is another key chapter. Pre 2008, every exam, every May and every Nov we had a question on leasing. The trend has changed now with about 4% marking in the last 4 years. You could test your knowledge practically by checking whether your client should buy a car or take it on lease. An important area that seemed to have foxed most students and let them around to work round about answers is in understanding the appropriate discount rate. While models about which tell us what rate to adopt in which circumstance, the most popular model in industry is the present value model. Here you compare the present value of lease payments with the present value of borrow and buy. So long as the discount rate is the after tax cost of capital, we can ignore principal repayments and interest payment since compounding at one rate and discounting at the same rate will lead to the original value. This is the most frequently asked question in the exam.

Bond is an important element of the capital market. They provide steady returns. However, in volatile markets they fluctuate massively in line with interest rate changes. You need to know what is duration, what Is YTM, what are the tricks to be kept in mind when refunding a bond etc. Surprisingly this is one of the most frequently asked chapters in the exam and we have had close to 8% of marks in the last 8 exams.

Mergers and Acquisitions represent the hot area in the corporate world. These are taking place across time and space. Get to know what drives merger, what are the defenses against merger, why mergers fail. Also get to learn how to compute the value of synergy gain. My view is that this is the critical part when you begin to work in industry. The exam questions have normally focused on swap ratios and distribution of gains. Questions on this have appeared with monotonous regularity and they have been of the same kind.

Valuation of shares: In the corporate world there cannot be anything more important than this. While it is primarily read in Financial Reporting, in SFM you get to read the discounted cash flow model. The questions that have appeared in the exams fall in the gray area between dividend chapter and valuation chapter. You need to know whether you are valuing for the firm or for equity shareholders. Accordingly the nature of cash flow and the discount rate will differ. Also familiarize yourself with the CAPM formula as that will have a bearing on valuation. About 11% of marks have come from this area

General: A miniscule of questions have come from no-man's land in terms of the topics listed here.

I do not want to talk to you about how you should go about taking the exams. You would have already heard CA. T.N. Manoharan, our Past President, speak of it with elan. I would only like to tell you that you must enjoy your journey of preparation, that you should take the exams with a very positive mind frame and then success would be yours. Remember, once you finish your CA, the world would be your oyster.

Chapter	Total Marks since Nov' 08	Percentage of Marks
Capital Budgeting	43	3.7%
Risk Analysis	28	2.4%
Corporate Dividend Policy	67	5.8%
Portfolio Management	128	11.0%
Mutual Funds	93	8.0%
Derivatives	172	14.8%
International Finance	158	13.6%
Financial Services	66	5.7%
Leasing	46	4.0%
Bond Valuation	91	7.8%
Mergers & Acquisition	126	10.8%
Valuation of Shares	130	11.2%
General	16	1.4%