

MOCK TEST PAPER 1
FINAL (NEW) COURSE: GROUP – I
PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT (NEW COURSE)
SUGGESTED ANSWERS/HINTS

1. (a) **Net payoff for the holder of the call option**

	(Rs.)				
Share price on exercise day	200	210	220	230	240
Option exercise	No	No	No	Yes	Yes
Outflow (Strike price)	Nil	Nil	Nil	220	220
Out flow (premium)	6	6	6	6	6
Total Outflow	6	6	6	226	226
Less inflow (Sales proceeds)	-	-	-	230	240
Net payoff	-6	-6	-6	4	14

Net payoff for the holder of the put option

	(Rs.)				
Share price on exercise day	200	210	220	230	240
Option exercise	Yes	Yes	No	No	No
Inflow (strike price)	220	220	Nil	Nil	Nil
Less outflow (purchase price)	200	210	-	-	-
Less outflow (premium)	5	5	5	5	5
Net Payoff	15	5	-5	-5	-5

The call option can be exercised gainfully for any price above Rs. 226 (Rs. 220 + Rs. 6) and put option for any price below Rs. 215 (Rs. 220 - Rs. 5).

(b) (i) Expected dividend for next 3 years.

$$\text{Year 1 (D}_1\text{)} \quad \text{Rs. } 14.00 (1.09) = \text{Rs. } 15.26$$

$$\text{Year 2 (D}_2\text{)} \quad \text{Rs. } 14.00 (1.09)^2 = \text{Rs. } 16.63$$

$$\text{Year 3 (D}_3\text{)} \quad \text{Rs. } 14.00 (1.09)^3 = \text{Rs. } 18.13$$

$$\text{Required rate of return} = 13\% (\text{Ke})$$

$$\text{Market price of share after 3 years} = (\text{P}_3) = \text{Rs. } 360$$

The present value of share

$$P_0 = \frac{D_1}{(1+ke)} + \frac{D_2}{(1+ke)^2} + \frac{D_3}{(1+ke)^3} + \frac{P_3}{(1+ke)^3}$$

$$P_0 = \frac{15.26}{(1+0.13)} + \frac{16.63}{(1+0.13)^2} + \frac{18.13}{(1+0.13)^3} + \frac{360}{(1+0.13)^3}$$

$$P_0 = 15.26(0.885) + 16.63(0.783) + 18.13(0.693) + 360(0.693)$$

$$P_0 = 13.50 + 13.02 + 12.56 + 249.48$$

$$P_0 = \text{Rs. } 288.56$$

- (ii) If growth rate 9% is achieved for indefinite period, then maximum price of share should Mr. A willing be to pay is

$$P_0 = \frac{D_1}{(k_e - g)} = \frac{\text{₹ } 15.26}{0.13 - 0.09} = \frac{\text{₹ } 15.26}{0.04} = \text{Rs. } 381.50$$

- (iii) Assuming that conditions mentioned above remain same, the price expected after 3 years will be:

$$P_3 = \frac{D_4}{k_e - g} = \frac{D_3(1.09)}{0.13 - 0.09} = \frac{18.13 \times 1.09}{0.04} = \frac{19.76}{0.04} = \text{Rs. } 494$$

(c) Differences between a start-up and entrepreneurship

Startups are different from entrepreneurship. The major differences between them have been discussed in the following paragraphs:

- (i) Start up is a part of entrepreneurship. Entrepreneurship is a broader concept and it includes a startup firm.
- (ii) The main aim of startup is to build a concern, conceptualize the idea which it has developed into a reality and build a product or service. On the other hand, the major objective of an already established entrepreneurship concern is to attain opportunities with regard to the resources they currently control.
- (iii) A startup generally does not have a major financial motive whereas an established entrepreneurship concern mainly operates on financial motive.

Priorities and challenges which start-ups in India are facing

The priority is on bringing more and more smaller firms into existence. So, the focus is on need based, instead of opportunity based entrepreneurship. Moreover, the trend is to encourage self-employment rather than large, scalable concerns. The main challenge with the startup firms is getting the right talent. And, paucity of skilled workforce can hinder the chances of a startup organization's growth and development. Further, startups had to comply with numerous regulations which escalates its cost. It leads to further delaying the chances of a breakeven or even earning some amount of profit.

2. (a) (A) To cover payable and receivable in forward Market

Amount payable after 3 months	\$7,00,000
Forward Rate	Rs. 48.45
Thus Payable Amount (Rs.) (A)	Rs. 3,39,15,000
Amount receivable after 2 months	\$ 4,50,000
Forward Rate	Rs. 48.90
Thus Receivable Amount (Rs.) (B)	Rs. 2,20,05,000
Interest @ 12% p.a. for 1 month (C)	Rs. 2,20,050
Net Amount Payable in (Rs.) (A) – (B) – (C)	Rs. 1,16,89,950

- (B) Assuming that since the forward contract for receivable was already booked it shall be cancelled if we lag the receivables. Accordingly any profit/ loss on cancellation of contract shall also be calculated and shall be adjusted as follows:

Amount Payable (\$)	\$ 7,00,000
Amount receivable after 3 months	<u>\$ 4,50,000</u>
Net Amount payable	<u>\$ 2,50,000</u>

Applicable Rate	Rs. 48.45
Amount payable in (Rs.) (A)	Rs. 1,21,12,500
Profit on cancellation of Forward cost (48.90 – 48.30) × 4,50,000 (B)	Rs. 2,70,000
Thus net amount payable in (Rs.) (A) + (B)	Rs. 1,18,42,500

Since net payable amount is least in case of first option, hence the company should cover payable and receivables in forward market.

(b) (i) The Betas of two stocks:

Aggressive stock	-	$40\% - 4\%/25\% - 7\% = 2$
Defensive stock	-	$18\% - 9\%/25\% - 7\% = 0.50$

Alternatively, it can also be solved by using the Characteristic Line Relationship as follows:

$$R_s = \alpha + \beta R_m$$

Where,

α = Alpha

β = Beta

R_m = Market Return

For Aggressive Stock

$$4\% = \alpha + \beta(7\%)$$

$$40\% = \alpha + \beta(25\%)$$

$$36\% = \beta(18\%)$$

$$\beta = 2$$

For Defensive Stock

$$9\% = \alpha + \beta(7\%)$$

$$18\% = \alpha + \beta(25\%)$$

$$9\% = \beta(18\%)$$

$$\beta = 0.50$$

(ii) Expected returns of the two stocks:-

Aggressive stock	-	$0.5 \times 4\% + 0.5 \times 40\% = 22\%$
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Defensive stock	-	$0.5 \times 9\% + 0.5 \times 18\% = 13.5\%$
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(iii) Expected return of market portfolio = $0.5 \times 7\% + 0.5 \times 25\% = 16\%$

\therefore Market risk prem. = $16\% - 7.5\% = 8.5\%$

\therefore SML is, required return = $7.5\% + \beta_i 8.5\%$

(iv) $R_s = \alpha + \beta R_m$

For Aggressive Stock

$$22\% = \alpha_A + 2(16\%)$$

$$\alpha_A = -10\%$$

For Defensive Stock

$$13.5\% = \alpha_D + 0.50(16\%)$$

$$\alpha_b = 5.5\%$$

- (c) Following are main problems faced in growth of Securitization of instruments especially in Indian context:

Stamp Duty

Stamp Duty is one of the obstacles in India. Under Transfer of Property Act, 1882, a mortgage debt stamp duty which even goes upto 12% in some states of India and this impeded the growth of securitization in India. It should be noted that since pass through certificate does not evidence any debt only able to receivable, they are exempted from stamp duty.

Moreover, in India, recognizing the special nature of securitized instruments in some states has reduced the stamp duty on them.

Taxation

Taxation is another area of concern in India. In the absence of any specific provision relating to securitized instruments in Income Tax Act experts' opinion differ a lot. Some are of opinion that in SPV as a trustee is liable to be taxed in a representative capacity then other are of view that instead of SPV, investors will be taxed on their share of income. Clarity is also required on the issues of capital gain implications on passing payments to the investors.

Accounting

Accounting and reporting of securitized assets in the books of originator is another area of concern. Although securitization is slated to an off-balance sheet instrument but in true sense receivables are removed from originator's balance sheet. Problem arises especially when assets are transferred without recourse.

Lack of standardization

Every originator follows own format for documentation and administration have lack of standardization is another obstacle in growth of securitization.

Inadequate Debt Market

Lack of existence of a well-developed debt market in India is another obstacle that hinders the growth of secondary market of securitized or asset backed securities.

Ineffective Foreclosure laws

For last many years there are efforts are going on for effective foreclosure but still foreclosure laws are not supportive to lending institutions and this makes securitized instruments especially mortgaged backed securities less attractive as lenders face difficulty in transfer of property in event of default by the borrower.

3. (a) (i) Swap Ratio

Gross NPA	5:40	5/40 x 30%	0.0375
CAR	5:16	5/16 x 28%	0.0875
Market Price	12:96	12/96 x 32%	0.0400
Book Value Per Share	12:120	12/120x 10%	0.0100
			0.1750

Thus for every share of Weak Bank, 0.1750 share of Strong Bank shall be issued.

Calculation of Book Value Per Share

Particulars	Weak Bank (W)	Strong Bank (S)
Share Capital (Rs. Lakhs)	150	500

Reserves & Surplus (Rs. Lakhs)	80	5,500
	230	6,000
Less: Preliminary Expenses (Rs. Lakhs)	50	--
Net Worth or Book Value (Rs. Lakhs)	180	6,000
No. of Outstanding Shares (Lakhs)	15	50
Book Value Per Share (Rs.)	12	120

(ii) No. of equity shares to be issued:

$$\frac{150}{10} \times 0.1750 = 2.625 \text{ lakh shares}$$

(iii) **Balance Sheet after Merger**

Calculation of Capital Reserve

Book Value of Shares	Rs. 180.00 lac
Less: Value of Shares issued	Rs. 26.25 lac
Capital Reserve	Rs. 153.75 lac

Balance Sheet

	Rs. lac		Rs. lac
Paid up Share Capital	526.25	Cash in Hand & RBI	2900.00
Reserves & Surplus	5500.00	Balance with other banks	2000.00
Capital Reserve	153.75	Investment	20100.00
Deposits	48000.00	Advances	30500.00
Other Liabilities	3390.00	Other Assets	2070.00
	57570.00		57570.00

(iv) **Calculation of CAR & Gross NPA % of Bank 'S' after merger**

$$\text{CAR / CRWAR} = \frac{\text{Total Capital}}{\text{Risky Weighted Assets}}$$

	Weak Bank	Strong Bank	Merged
	5%	16%	
Total Capital	Rs. 180 lac	Rs. 6000 lac	Rs. 6180 lac
Risky Weighted Assets	Rs. 3600 lac	Rs. 37500 lac	Rs. 41100 lac

$$\text{CAR} = \frac{6180}{41100} \times 100 = 15.04\%$$

$$\text{GNPA Ratio} = \frac{\text{Gross NPA}}{\text{Gross Advances}} \times 100$$

	Weak Bank	Strong Bank	Merged
GNPA (Given)	0.40	0.05	
	$0.40 = \frac{\text{GNPA}_R}{\text{₹ } 3500 \text{ lac}}$	$0.05 = \frac{\text{GNPA}_S}{\text{₹ } 27000 \text{ lac}}$	
Gross NPA	Rs. 1400 lac	Rs. 1350 lac	Rs. 2750 lac

- (b) (i) For 3 months, $r_{CAD} = 2.25\%$ and $r_{DEM} = 1.75\%$. Since the exchange rate is in CAD/ DEM term the appropriate equation for Interest Rate Parity is as follows:

$$\frac{F}{S} = \frac{(1 + r_{CAD})}{(1 + r_{DEM})}$$

$$\frac{0.780}{0.775} = \frac{(1 + 0.0225)}{(1 + 0.0175)}$$

$$1.00645 \neq 1.00491$$

Since both sides are not equal, Interest Rate Parity does not hold.

- (ii) Since IRP does not hold there is an arbitrage opportunity.

$$\text{Interest Differential} = 2.25\% - 1.75\% = 0.50\%$$

$$\text{Premium} = \frac{0.780 - 0.775}{0.775} \times 100 = 0.645\%$$

Since the interest rate differential is smaller than the premium, it will be profitable to place money in Deutschmarks the currency whose 3-months interest is lower.

The following operations are carried out:

- (i) Borrow CAD 1 Million at 9 per cent for 3- months;
(ii) Change this sum into DEM at the spot rate
 $= (1,000,000/0.775) = 1,290,323$
(iii) Place DM 1,290,323 in the money market for 3 months to obtain a sum of DM
- | | |
|-----------------------------------|------------------|
| Principal: | 1,290,323 |
| Add: Interest @ 7% for 3 months = | <u>22,581</u> |
| Total | <u>1,312,904</u> |
- (iv) Sell DEM at 3-months forward to obtain CAD $= (1,312,904 \times 0.780) = \text{CAD } 1,024,065$
(v) Refund the debt taken in CAD with the interest due on it, i.e.,

	CAD
Principal	1,000,000
Add: Interest @9% for 3 months	<u>22,500</u>
Total	<u>1,022,500</u>
Net arbitrage gain = CAD 1,024,065 – CAD 1,022,500 = CAD 1,565	

- (c) Some of the techniques used for economic analysis are:

- (i) **Anticipatory Surveys:** They help investors to form an opinion about the future state of the economy. It incorporates expert opinion on construction activities, expenditure on plant and machinery, levels of inventory – all having a definite bearing on economic activities. Also future spending habits of consumers are taken into account.
- (ii) **Barometer/Indicator Approach:** Various indicators are used to find out how the economy shall perform in the future. The indicators have been classified as under:
- (1) *Leading Indicators:* They lead the economic activity in terms of their outcome. They relate to the time series data of the variables that reach high/low points in advance of economic activity.

- (2) *Roughly Coincidental Indicators*: They reach their peaks and troughs at approximately the same in the economy.
- (3) *Lagging Indicators*: They are time series data of variables that lag behind in their consequences vis-a-vis the economy. They reach their turning points after the economy has reached its own already.

All these approaches suggest direction of change in the aggregate economic activity but nothing about its magnitude.

(iii) **Economic Model Building Approach**: In this approach, a precise and clear relationship between dependent and independent variables is determined. GNP model building or sectoral analysis is used in practice through the use of national accounting framework.

4. (a) Return for the year (all changes on a per year basis)

Particulars	Rs./Unit
Change in price (Rs. 13.00 – Rs. 12.25)	0.75
Dividend received	1.25
Capital gain distribution	<u>1.00</u>
Total Return	<u>3.00</u>

$$\text{Return on investment} = \frac{3.00}{12.25} \times 100 = 24.49\%$$

Alternatively, it can also be computed as follows:

$$\frac{(\text{NAV}_1 - \text{NAV}_0) + D_1 + \text{CG}_1}{\text{NAV}_0} \times 100$$

$$= \frac{(13 - 12.25) + 1.25 + 1.00}{12.25} \times 100$$

$$= 24.49\%$$

If all dividends and capital gain are reinvested into additional units at Rs. 12.50 per unit the position would be.

$$\text{Total amount reinvested} = \text{Rs. } 2.25 \times 300 = \text{Rs. } 675$$

$$\text{Additional units added} = \frac{\text{₹ } 675}{12.50} = 54 \text{ units}$$

$$\text{Value of 354 units as on 31-12-2010} = \text{Rs. } 4,602$$

$$\text{Price paid for 300 units on 31-12-2009} (300 \times \text{Rs. } 12.25) = \text{Rs. } 3,675$$

$$\text{Return} = \frac{\text{₹ } 4,602 - \text{₹ } 3,675}{\text{₹ } 3,675} = \frac{\text{₹ } 927}{\text{₹ } 3,675} = 25.22\%$$

(b) First of all we shall calculate premium payable to bank as follows:

$$P = \frac{rp}{\left[(1+i) - \frac{1}{i \times (1+i)^t} \right]} \times A \text{ or } \frac{rp}{\text{PVAF}(3.5\%, 4)} \times A$$

Where

P = Premium

A = Principal Amount

rp = Rate of Premium

i = Fixed Rate of Interest

t = Time

$$= \frac{0.01}{\left[(1/0.035) - \frac{1}{0.035 \times 1.035^4} \right]} \times \text{£}15,000,000 \text{ or } \frac{0.01}{(0.966 + 0.933 + 0.901 + 0.871)} \times \text{£}15,000,000$$

$$= \frac{0.01}{\left[(28.5714) - \frac{1}{0.04016} \right]} \times \text{£}15,000,000 \text{ or } \frac{\text{£}150,000}{3.671} = \text{£} 40,861$$

Please note above solution has been worked out on the basis of four decimal points at each stage.

Now we see the net payment received from bank

Reset Period	Additional interest due to rise in interest rate	Amount received from bank	Premium paid to bank	Net Amt. received from bank
1	£ 75,000	£ 75,000	£ 40,861	£34,139
2	£ 112,500	£ 112,500	£ 40,861	£71,639
3	£ 150,000	£ 150,000	£ 40,861	£109,139
TOTAL	£ 337,500	£ 337,500	£122,583	£ 214,917

Thus, from above it can be seen that interest rate risk amount of £ 337,500 reduced by £ 214,917 by using of Cap option.

(c) The key decisions falling within the scope of financial strategy include the following:

- Financing decisions:** These decisions deal with the mode of financing or mix of equity capital and debt capital.
- Investment decisions:** These decisions involve the profitable utilization of firm's funds especially in long-term projects (capital projects). Since the future benefits associated with such projects are not known with certainty, investment decisions necessarily involve risk. The projects are therefore evaluated in relation to their expected return and risk.
- Dividend decisions:** These decisions determine the division of earnings between payments to shareholders and reinvestment in the company.
- Portfolio decisions:** These decisions involve evaluation of investments based on their contribution to the aggregate performance of the entire corporation rather than on the isolated characteristics of the investments themselves.

5. (a) (i) Working for calculation of WACC

	Orange	Grape	Apple
Total debt	80,000	50,000	20,000
Post tax Cost of debt	10.4%	8.45%	9.75%
Equity Fund	20,000	50,000	80,000

WACC

Orange: $(10.4 \times 0.8) + (26 \times 0.2) = 13.52\%$

Grape: $(8.45 \times 0.5) + (22 \times 0.5) = 15.225\%$

Apple: $(9.75 \times 0.2) + (20 \times 0.8) = 17.95\%$

(ii) EVA of companies can be computed as follows:

	Orange	Grape	Apple
Net Income (Rs.)	8,970	12,350	14,950
Pre Tax Income (Rs.) (A)	13,800	19,000	23,000
Debt Amount (Rs.)	80,000	50,000	20,000
Interest (Rs.) (B)	12,800	6,500	3,000
EBIT (Rs.) (A) + (B)	26,600	25,500	26,000
Tax 35% (Rs.)	9,310	8,925	9,100
EAT	17,290	16,575	16,900
Less: WACC X Invested Capital	13,520	15,220	17,950
EVA (Rs.)	3,770	1,355	-1,050

(iii) Orange would be considered as the best investment since the EVA of the company is highest and its weighted average cost of capital is the lowest.

(iv) Estimated Price of each company shares

	Orange	Grape	Apple
Net Income (Given) (Rs.)	8,970	12,350	14,950
Shares	6,100	8,300	10,000
EPS (Rs.)	1.4705	1.4880	1.4950
Stock Price (EPS x PE Ratio) (Rs.)	16.18	16.37	16.45

(v) **Market Capitalisation**

Estimated Stock Price (Rs.)	16.18	16.37	16.45
No. of shares	6,100	8,300	10,000
Estimated Market Cap (Rs.)	98,698	1,35,871	1,64,500

(b)

Shares	No. of shares (lakhs) (1)	Market Price of Per Share (2)	× (2) (Rs. lakhs)	% to total (w)	β (x)	wx
A Ltd.	3.00	500.00	1500.00	0.30	1.40	0.42
B Ltd.	4.00	750.00	3000.00	0.60	1.20	0.72
C Ltd.	2.00	250.00	500.00	0.10	1.60	0.16
			<u>5000.00</u>	1.00		<u>1.30</u>

(1) Portfolio beta 1.30

(2) Required Beta 0.91

Let the proportion of risk free securities for target beta $0.91 = p$

$$0.91 = 0 \times p + 1.30 (1 - p)$$

$$p = 0.30 \text{ i.e. } 30\%$$

Shares to be disposed off to reduce beta (5000 × 30%) Rs. 1,500 lakh and Risk Free securities to be acquired.

(3) Number of shares of each company to be disposed off

Shares	% to total (w)	Proportionate Amount (Rs. lakhs)	Market Price Per Share	No. of Shares (Lakh)
A Ltd.	0.30	450.00	500.00	0.90
B Ltd.	0.60	900.00	750.00	1.20
C Ltd.	0.10	150.00	250.00	0.60

(4) Number of Nifty Contract to be sold

$$\frac{(1.30-0.91) \times 5000 \text{ lakh}}{8,125 \times 200} = 120 \text{ contracts}$$

(5) 2% rises in Nifty is accompanied by 2% x 1.30 i.e. 2.6% rise for portfolio of shares

	Rs. Lakh
Current Value of Portfolio of Shares	5000
Value of Portfolio after rise	5130
Mark-to-Market Margin paid (8125 × 0.020 × Rs. 200 × 120)	39
Value of the portfolio after rise of Nifty	5091
% change in value of portfolio (5091 – 5000)/ 5000	1.82%
% rise in the value of Nifty	2%
Beta	0.91

(c) Despite being a country of many cultures and communities traditionally inclined to business and entrepreneurship, India still ranks low on comparative ratings across entrepreneurship, innovation and ease of doing business. The reasons are obvious. These include our old and outdated draconian rules and regulations which provides a hindrance to our business environment for a long time. Other reasons are red tapism, our time consuming procedures, and lack of general support for entrepreneurship. Off course, things are changing in recent times.

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

Angel investors provide more favorable terms compared to other lenders, since they usually invest in the entrepreneur starting the business rather than the viability of the business. Angel investors are focused on helping startups take their first steps, rather than the possible profit they may get from the business. Essentially, angel investors are the opposite of venture capitalists.

Angel investors are also called informal investors, angel funders, private investors, seed investors or business angels. These are affluent individuals who inject capital for startups in exchange for ownership equity or convertible debt. Some angel investors invest through crowdfunding platforms online or build angel investor networks to pool in capital.

Angel investors typically use their own money, unlike venture capitalists who take care of pooled money from many other investors and place them in a strategically managed fund.

Though angel investors usually represent individuals, the entity that actually provides the fund may be a limited liability company, a business, a trust or an investment fund, among many other kinds of vehicles.

Angel investors who seed startups that fail during their early stages lose their investments completely. This is why professional angel investors look for opportunities for a defined exit strategy, acquisitions or initial public offerings (IPOs).

6. (a) (i) **Current Market Price of Bond**

Time	CF	PVIF 8% PV (CF)	PV (CF)
1	14	0.926	12.964
2	14	0.857	11.998
3	14	0.794	11.116
4	14	0.735	10.290
5	114	0.681	<u>77.634</u>
Σ PV (CF) i.e. $P_0 =$			<u>124.002</u>

Say

Rs. 124.00

(ii) Minimum Market Price of Equity Shares at which Bondholder should exercise conversion option:

$$\frac{124.00}{20.00} = \text{Rs. } 6.20$$

(iii) Duration of the Bond

Year	Cash flow	P.V. @ 8%		Proportion of bond value	Proportion of bond value x time (years)
1	14	0.926	12.964	0.105	0.105
2	14	0.857	11.998	0.097	0.194
3	14	0.794	11.116	0.089	0.267
4	14	0.735	10.290	0.083	0.332
5	114	0.681	<u>77.634</u>	<u>0.626</u>	<u>3.130</u>
			<u>124.002</u>	<u>1.000</u>	<u>4.028</u>

(b) The amount of EURO bought by selling US\$

$$\text{US\$ } 10,00,000 * \text{EURO } 1.4400 = \text{EURO } 14,40,000$$

$$\text{The amount of EURO sold for buying USD } 10,00,000 * 1.4450 = \underline{\text{EURO } 14,45,000}$$

$$\text{Net Loss in the Transaction} = \underline{\text{EURO } 5,000}$$

To acquire EURO 5,000 from the market @

(a) USD 1 = EURO 1.4400 &

(b) USD 1 = INR 31.4500

Cross Currency buying rate of EUR/INR is Rs. 31.4500 / 1.440 i.e. Rs. 21.8403

$$\text{Loss in the Transaction Rs. } 21.8403 * 5000 = \text{Rs. } 1,09,201.50$$

Alternatively, if delivery to be affected then computation of loss shall be as follows:

$$\text{EURO to be surrendered to acquire \$ } 10,00,000 = \text{EURO } 14,45,000$$

$$\text{EURO to be received after selling \$ } 10,00,000 = \underline{\text{EURO } 14,40,000}$$

$$\text{Loss} = \underline{\text{EURO } 5,000}$$

To acquire EURO 5,000 from market @

US \$ 1 = EURO 1.4400

US \$ 1 = INR 31.45

$$\text{Cross Currency} = \frac{31.45}{1.440} = \text{Rs. } 21.8403$$

$$\text{Loss in Transaction (21.8403 x EURO 5,000)} = \text{Rs. } 1,09,201.50$$

- (c) The various hints that may provide counter party risk are as follows:
- (a) Failure to obtain necessary resources to complete the project or transaction undertaken.
 - (b) Any regulatory restrictions from the Government.
 - (c) Hostile action of foreign government.
 - (d) Let down by third party.
 - (e) Have become insolvent.

The various techniques to manage this type of risk are as follows:

- (1) Carrying out Due Diligence before dealing with any third party.
- (2) Do not over commit to a single entity or group or connected entities.
- (3) Know your exposure limits.
- (4) Review the limits and procedure for credit approval regularly.
- (5) Rapid action in the event of any likelihood of defaults.
- (6) Use of performance guarantee, insurance or other instruments.

OR

Some of the parameters to identify the currency risk are as follows:

- (1) Government Action: The Government action of any country has visual impact in its currency. For example, the UK Govt. decision to divorce from European Union i.e. Brexit brought the pound to its lowest since 1980's.
- (2) Nominal Interest Rate: As per interest rate parity (IRP) the currency exchange rate depends on the nominal interest of that country.
- (3) Inflation Rate: Purchasing power parity theory impact the value of currency.
- (4) Natural Calamities: Any natural calamity can have negative impact.
- (5) War, Coup, Rebellion etc.: All these actions can have far reaching impact on currency's exchange rates.
- (6) Change of Government: The change of government and its attitude towards foreign investment also helps to identify the currency risk.