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INDEX

Sr. No.	Title	Author	Subject	Page No.
1	Current Issues In Indian Capital Market	Bhavin S. Shah	Accountancy	1-3
2	Accounting Standard (AS) 30 Accounting for Financial Instruments	Kalola Rimaben A, Chauhan Lalit R.	Accountancy	4-6
3	A Study on Lithology and Petrography of the Tipam Sandstones Exposed along the Tipong Pani River Section of Upper Assam Basin	Dr. Pradip Borgohain	Applied Geology	7-11
4	Study of Fluvial Geomorphic Features of the Lower Subansiri Basin, North-East India using Remote Sensing and GIS.	Dr. Uttam Goswami	Applied Geology	12-14
5	Sheared volcanics in the north of Pugging, East Siang District, Arunachal Pradesh	T. K. Goswami, P. Bhattacharyya, D. Bezbaruah	Applied Geology	15-18
6	Heavy Metal Biosorption Using A Biopolymer Chitin	D. Saravanan, P. N. Sudha	Chemistry	19-23
7	Impact of peripheral cues on rural consumer buying decision for FMCG products with special reference to Palitana (Gujarat)	Dr K.S. Vataliya, Bhavik .P. Parmar	Commerce	24-26
8	A Growth of Rural Postal Life Insurance in India [A Study with special Reference to Dharmapuri District]	Dr. A. Vinayagamoorthy K. Senthilkumar	Commerce	27-28
9	Promotional Strategies for International Markets with respect to Agricultural Products	Dr. B. B. Bhosale	Commerce	29-30
29	Business Risk And Financial Risk - Indian Corporate Sector	Dr. M. Dhanabhakyam, P. Balasubramanian	Commerce	31-33
10	"Customer Relationship Management"- In Banking Industry	G.V. Kori, Sri. Basavaraj Huggi	Commerce	34-36
11	Role of Investment Banks and Institutions in Economic Development	Jitendra Dhirajlal Karia, Dr. (Prof.) Vijay Kumar Soni	Commerce	37-38
12	Nature Of Information Shared And Communication Methods Used In Small Manufacturing Firms	Vipul Chalotra	Commerce	39-41
13	China's WTO Accession: An Empirical Assessment of Merchandise Trade with India	Anjali Tandon	Economics	42-45
14	Regional Disparities - Social Sector Expenditure in Rural-Urban India	Dr. Shankar B. Ambhore, Dr. Ashok S. Pawar	Economics	46-47
15	(Presenting Thought About Industry, Trade And Co-operation Of Rajarshri Shahu Maharaj)	Dr. Ashok Shankarrao Pawar, Dr.Sunita J. Rathod	Economics	48-49
16	An Assessment On Poverty Alliviation Programmes In Rural India-A Case Study	Dr. Parvathamma G. L.	Economics	50-55
17	Liveability in Guwahati: A Factor Analytic Approach	Dr. Daisy Das, Dr. Ratul Mahanta	Economics	56-58
18	Backward Class Disparities in higher Education in India	Dr. Shankar B. Ambhore, Dr. Pawar Ashok S.	Economics	59-60
19	Revenue and Expenditure Pattern of Municipal Corporations of Punjab	Naresh Kumar	Economics	61-66

20	Livelihood Security of Traditional Fishermen of Kerala: Analysing and Identifying the Roles of Self Help Groups	(Dr.) D. Rajasenan, Rajeev B.	Economics	67-70
21	Levels and Types of Questions Raised by EFL Teachers In Southern Al-Mazar Directorate of Education	Dr. Jihad Al-Turki	Education	71-74
22	Issues And Recommendations Of National Knowledge Commission In Higher Education System	Vidhi Bhalla	Education	75-77
23	Multiple Sequence Alignment of Different Species	Perna, Pankaj Bhambri, Dr. O.P. Gupta	Engineering	78-82
24	Analyzing the Phylogenetic Trees with Tree- building Methods	Jasmine, Pankaj Bhambri, Dr. O.P. Gupta	Engineering	83-85
25	Low Power High Speed with Improved Noise Margin for Domino CMOS Inverter.	Pushpa Raikwal, Dr.Vaibhav Neema, Dr.Sumant Katiyal	Engineering	86-88
26	Analysis of Drag for an Aircraft Wing Model with and without Winglet	Mitul Patel, Sharvil Shah, Dharmendra Dubey	Engineering	89-91
27	Cognitive Radio	Chauhan Jayesh R.	Engineering	92-95
28	Problems In Teaching English As A Compulsory Subject	Prof. Madhvi R. Acharya	English	96-97
30	Financial Banking Is The Science Of Managing Money: Indian Financial System	Dr. Shailesh N. Ransariya, Dr. Shailesh N. Ransariya	Finance	98-100
31	Carbon Trading a Step towards Green Environment	Ashok R. Bantwa	Finance	101-102
32	Effect of Supplementation of A Multinutrient Chocolate Bar on Nutritional Status and Athletic Performance	P. Muhtulakshmi, Dr. M. Sylvia Subapriya	Home Science	103-104
33	Imperatives of Inclusive Growth for Sustainable Development of Indian Economy Post Globalization	Dr Mahalaxmi Krishnan	Indian Economy	105-107
34	RIGHT TO INFORMATION ACT AND THE ROLE OF PRESS, MEDIA & NGO'S	Dr. Krushna Chandra Dalai	Law	108-109
35	``Thesis: A Powerful Source Of Information``	Arvind M Bhadrashetty	Library Science	110-111
36	Present Day English and Inflections	Dr Syed Mohammed Haseebuddin Quadri	Literature	112-113
37	Jigsaw II: An Effective Strategy To Develop Reading Comprehension Of High School Students	Dr. P. Nagaraj, Sindhu Thamba	Literature	114-115
38	CAPITAL STRUCTURE ANALYSIS (An Empirical Study of Paper Mills in India)	Ashok Mundhra	Management	116-118
39	Emerging Trends In Indian Rural Market	Dr. N. Ramanjaneyalu	Management	119-121
40	Credit Card Usage in Coimbatore	G. Murali Manokari, Dr. R. Ganapathi	Management	122-126
41	Micro Credit – Two Sides of the Same Coin	R. Durga Rani, J. Gnanadevan, Dr. R. Ganapathi	Management	127-130
42	Work Place Stress and Yoga Therapy	K. Revathi, Dr. R. Ganapathi	Management	131-132
43	Customer's Satisfaction Towards Modernized Petrol Stations With Reference to Coimbatore City	Dr. R. Ganapathi	Management	133-137

44	Evaluation Tactics: A tool to evaluate success of corporate training programme	Dr. Shobha Dedhia	Management	138-140
45	A Preliminary Study On Issues And Challenges Faced In Measurement Of Social Media Return On Investment	Khushbu Pandya	Management	141-142
46	Profitability Analysis (A Case Study of Selected Public and Private Sector Companies)	Manish Manglik	Management	143-144
47	Performance Management System	S.Jayakrishna, N.Sainath, M.V.Subbareddy, N.Raji Reddy	Management	145-147
48	A Study On Organizational Culture In Bharath Heavy Eletrical Limited, Ranipet	S.Sridhar, D.Yuvaraj, V. Kandasamy	Management	148-150
49	Cost Effective Transportation	Sarada Prasanna Patra Dr. Manjusmita Dash	Management	151-154
50	A Study On Efficiency Of Outbound Training With Reference to Titan Industries, Hosur	V. Kandasamy, D. Yuvaraj, S. Ragothaman	Management	155-157
51	Performance Improvement Enhance The Efficiency	Vidya L. Hulkund	Management	158-159
52	Packaging- The Salient Seller	Vidya L. Hulkund	Management	160-161
53	An Empirical Study Of Student Satisfaction With Reference To Gujarat Technological University (Gtu)	Dr. Vijay K. Patel	Management	162-163
54	Maximizing Customer Profitability in Retailing Industry (Durable Goods) - Role of Analytical CRM -A Case Analysis	Dr.A.R.Krishnan, R.Selvamani	Management	164-165
55	Financial Inclusion - Role Of Banking Industry	Dr. K. Marutha Muthu, Ms.T. A.Tamilselvi	Management	166-167
56	The Growth of Self Help Groups in India: A Study	S.Ravi, Dr. P. Vikkraman	Management	168-170
57	Role of E-Banking	K. K. Devi	Marketing	171-172
58	Reasons after the war of going Green –Green Marketing	Kavita A. Trivedi	Marketing	173-175
59	Strongly Minimal Generalized Boundary	K. Chandrasekhara Rao, P . Padma	Mathematics	176-177
60	ACCESSORY RENAL ARTERY: A CASE REPORT	Archana U Shekokar, Vandana A Tendolkardolkar	Medical Science	178-179
61	Fibrinous Pericarditis: A Case Report	Vandana A Tendolkar, Archana U Shekokar	Medical Science	180-181
62	Social life, Addictions and Subjective Wellbeing of the Transsexuals	Seemanthini.T.S, Manjula. M. Y	Psychology	182-184
63	Using E-Content In Science Class: The Effect Of Treatment, Gender, And Their Interaction On Science Achievement	Suman Rani	Psychology	185-188
64	Bullying - Societal Curse- A Serious Issue	Latha Janaki. R, Dr.Kalyani Kenneth	Social Science	189-191
65	Factor Influencing Foetal Wastage	Dr. Dipti Bhavsar, Dr. C. D. Bhavsar	Environment	192-195
66	Approach Of Universilization Educational And Women Empowerment Of Rajarshri Shahu Maharaj	Dr. Ashok Shankarrao Pawar, Dr. Sunita J. Rathod	Economics	196-199



Business Risk And Financial Risk - Indian Corporate Sector

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ABSTRACT

In today's competitive business scenario, the task of framing appropriate strategy is important to stabilize a firm's earnings (business risk) and add value to firm's owners (financial risk). Business risk is defined as representing the risks to the company's operating results. Financial risk is the risk inherent in the company's choice of financing structure. The concept of financial risk can be combined with the business risk profile, in order to develop logical alternative financial strategies for different type of business. Combining together a high business risk strategy gives a very high total risk profile. This paper attempts to analyze the business and financial risk of Indian corporate sector (3 different industries - 15 selected companies from BSE 100) during post liberalization period specifically from fiscal year 1999 to 2009. This paper uses co-variation and Ratio analysis as a primary method to determine the business and financial risk. The paper evaluates the interdependence of business risk and financial risk and analyzes the theoretical concept - "higher the risk higher the return". Further, the paper checks for uniformity amongst capital productivity risk, cost structure and liquidity risk. Finally, the study tries to answer the following questions - How the capital structure affects the earning capacity of selected industries? Which portfolio of capital structure provides lowest business risk?

Keywords : Business Risk, Competitive Business, Corporate Sector, Financial Risk

INTRODUCTION

The risk management procedure being currently followed tend to be reactive than proactive. Risk management is essential for a firm to stabilize its earnings and to add value to its owner's wealth. Firms adjust business risk and financial leverage to obtain the desirable amount of total systematic risk. In today's competitive business scenario, it is tough task to design the appropriate strategies for managing risk. All the firms have to face the risk in different form. Therefore it is essential for every firm to achieve its objectives through managing risk within their risk appetites.

The total risk can be broadly divided into - business risk and financial risk. Business risk was defined as representing the risks to the company's operating results. Financial risk is the risk inherent in the company's choice of financing structure. Business risk is caused by several factors which are categorized as (i) industry-specific factor (ii) company-specific factor (iii) general factor. General factors are those factors which affects the entire sector. They are fluctuation in foreign exchange, competition, inflation, government import and export regulation etc. Company- specific factors are focused on human resource which is under the control of management. Industry- specific factors are related to which the company belongs, special status enjoyed by the industry.

REVIEW OF LITERATURE

Bodla .B.S and RichaVerma (2008)¹ discuss that the operational risk is the risk of loss resulting from inadequate or failed internal process, people and systems or from external events. He suggested that irrespective of sector and size of bank, the risk management and the operational risk management framework of banks in India are on the right and they are based on the RBI's guidelines issued in this regard. He also highlighted that credit risk is the most important risk faced by the schedule commercial bank in India.

Cesare Conti and ArnaldoMauri (2008)² described in his ti-

tle "Corporate financial Risk Management: Governance and Disclosure Post IFRS7" the main aspects of the regulatory context of CFRM and gave guidelines in the new context of CFRM, accounting data and internal reporting should be approached and integrated in a new way, to promote the language of value creation.

Strauch, Brain.A (2008)³ in "Profitability and business risk of fall versus spring calving in Wyoming" examined the profitability and business risk (Profit variability) associated with three spring calving and two fall calving enterprises are analyzed using linear programming (GAMS) and @ RISK stimulation. Twenty years of livestock price data, published budgets, and interview data are used in the analysis. For all enterprises, the fall cow-short yearling model is the most profitable enterprise and renders the least business risk. The spring cow-short yearling enterprise is the least profitable and renders the most business risk of all enterprise.

Amit K Malik and Debasish Sur (2009)⁴, in his title "Business and Financial Risks in Indian Corporate Sector: An Empirical Analysis in the Post-Liberalization Era" suggested that no industries proved itself as an aggressive risk-taker , as no one was placed in the high risk-high return category during the study period. Although a 'high-low' combination of business risks and financial risks in theoretically desirable, there is no strong evidence of positive and negative relationship between business and financial risks associated with the selected companies was noticed during the study period.

M.Eleftheriadis, K.A. Agorasto and P.G. Efthymoglou (2009)⁵ in their research work entitled "An investigation of the relationship between Business and Financial risk using Accounting Data" have critically investigated the effect of business risk to the determination of financial leverage and of the level of total systematic risk. The empirical tests were carried on a sample of 319 firms from the food and beverage manufacturing sector. The study revealed that there is an inverse relationship

between the variables of operating beta and mean debt ratio which measures business risk and financial leverage respectively. Consequently, the empirical findings supporting the hypothesis is operative for the cluster of food and beverage manufacturing companies.

OBJECTIVES OF THE STUDY

The objectives of the study are:

- ✓ To determine the extent of benefit obtained from business risk and financial risk.
- ✓ Measuring the business risk, financial risk and total risk with effective statistical tools.
- ✓ To determine the risk-return status of the selected companies in Indian industries.
- ✓ To determine the major components of business risk namely Cost Structure Risk (CSR), Capital Productivity Risk (CPR) and Liquidity Risk (LR).
- ✓ To evaluate the interdependence of business risk and financial risk.
- ✓ Analyze whether the results correlate with theoretical assumption.

GEOGRAPHICAL AREA OF THE STUDY AND METHODOLOGY

BSE 100 includes 18 major groups of industries. Of these 3 groups of industries are selected for study. Under each group five companies are selected for analysis. The selected 3 industries and 15 companies were listed in appendix 1. The secondary data used in the study for the period 1999-2000 to 2008-2009 was taken from capital line of capital market. The statistical tools used are ratio analysis, standard deviation, mean, co-variance, simple correlation, rank correlation.

ANALYSIS REPORT

Table 1: Total risk of each of the selected industries has been measured by the coefficient of variation (CV) of its return on equity and the business risk has been measured by the CV of its operating profit to capital employed (OPCE). The difference between total risk and business risk is taken as financial risk. The financial risk and business risk was high in Refineries followed by Steel and then Automobiles.

Table 1: Ranks of business and financial risk of the selected Indian Corporate industries

Industry	Business Risk	Rank	Financial Risk	Rank	Total Risk	Rank
Automobiles	0.37	3	0.42	3	0.79	3
Refineries	0.69	1	1.45	1	2.32	1
Steel	0.58	2	0.74	2	1.28	2

Source: Computed from Capitaline corporate data base

Three major components of company - specific business risk namely cost structure risk (CSR), capital productivity risk (CPR), and liquidity risk (LR) of each of the selected companies have been measured by the CV of cost to sales ratio and CV of capital turnover ratio and that of working capital ratio.

Table 2 depicts that average cost structure risk and average capital productivity risk is low in Automobiles. Average cost structure risk is high in Steel industry compare to Refineries. Average productivity risk is high Refineries than Steel industry. The negative value of average liquidity risk exhibits that liquidity is more dangerous in Automobiles followed by Steel and Refineries.

Table 2: Ranks of various components of Business risk of the selected Indian industries

Industry	Average Cost Structure Risk	Rank	Average Productivity Risk	Rank	Average Liquidity Risk	Rank
Automobiles	0.08	3	0.26	3	-1.21	2
Refineries	0.10	2	0.67	1	1.66	1
Steel	0.41	1	0.60	2	-2.05	3

Source: Computed from Capitaline corporate database.

Risk-Return Status - Indian Industries

Risk-Return status of the selected companies in Indian Industries was assessed on the basis of operating profit to capital employed with business risk and Return on equity risk of the selected companies.

Table 3 a: Risk-Return status based on business risk and operating profitability of the selected companies in Indian Industries

OPEC Business Risk	High (≥ 30%)	Moderate (15% -30%)	Low (≤ 15%)
High (≥ 0.40)	-----	Refineries, Steel	-----
Moderate (>0.25<0.40)	Automobiles	-----	-----
Low (≤0.25)	-----	-----	-----

Source: Computed from Capitaline corporate data base

Table 3a exhibits Automobiles was a moderate risk with high return industry. Refineries and steel industry was a high risk with moderate return.

Table 3 b: Risk-Return status based on total risk and owner's return

ROE Total Risk	High (≥30%)	Moderate (15%-30%)	Low (≤ 15%)
High (≥2.00)	Refineries	-----	-----
Moderate(>1.00<2.00)	Steel	-----	-----
Low (≤1.00)	Automobiles	-----	-----

Source: Computed from Capitaline corporate data base

In Table 3b, the Risk-Return profile of the selected industries was assessed on the basis of total risk and owner's profitability. Return on equity is considered for assessing owner's profitability. The above table shows us that Refineries falls under high risk high return. Steel was facing moderate risk with high return. An automobile was facing low risk with high return.

Table 4: Analysis of correlation between business and financial risk

Person's Simple Correlation	Spearman's Rank Correlation
0.87 (significant)	1 (not applicable)

Table 4 shows the extent of relationship between business and financial risk associated with the selected companies through correlation coefficient between business risk and financial risk taking into account of their magnitudes (i.e. by Pearson simple correlation coefficient), ranking of their magnitudes (i.e. by Spearman's rank correlation coefficient). In order to test whether the Pearson's simple correlation coefficient is statistically significant or not the t-test has been applied. Table 4 reveals that both correlation coefficients are perfectly positive and the Pearson's simple correlation was found to be statistically significant. So, study reveals that, during the period there is perfect correlation between business and financial risk which accepts the theoretical arguments.

Table 5: Results of Pearson's correlation coefficient

Business Risk & Operating Profit	Financial Risk & ROE	Total Risk & ROE	Total Risk & Operating Profit
-0.99	-0.027	-0.99	-0.90

Table 5 reveals that negative correlation arose between business risk and operating profit, financial risk and ROE, Total risk and ROE, Total risk and operating profit.

CONCLUSION

The ranks of business and financial risk of the selected Indian corporate industries are same. It reflects that both the risks are associated with each other. When a financial risk increases there is a corresponding increase in business risk, it indicates that if financial risk is controlled it will give a positive impact on business risk. A 'high-low' combination of business

risk and financial risk is theoretically desirable, but the study shows it is wrong.

The results of the study on the relationship between business risk and operating profit and that of financial risk and return on equity in the analysis of correlation, do not confirm to the theoretical argument that the higher the degree of risk, the greater the profitability.

How ever the study has some limitation. The study is based on the secondary data published by the company. Therefore the resultant accuracy is based on the accuracy of the published data. The cost structure risk result does not consider the forex management. Only the period of the study is ten years.

Appendix 1 List of Industries and companies under Study

Industries	Company	Industries	Company	Industries	Company
Automobiles	1.Ashok Leyland	Refineries	1.BPCL	Steel	1.JSW
	2.Hero Honda		2.Essar oil		2.SAIL
	3.M&M		3. HPCL		3.TATA
	4.Tata Motors		4. IOCL		4.Welspun Gujstah
	5.Maruti Suzuki		5.Reliance industries		5.Jindal

Appendix 2 Company wise risk-return data

Company	Business Risk (BR)	Financial Risk (FR)	Total Risk (TR)	Capital Productivity Risk(CPR)	Cost Structure Risk(CSR)	Liquidity Risk (LR)
Ashok Leyland	0.32	.36	0.68	0.36	0.08	0.86
Hero Honda	0.25	0.30	0.55	0.17	0.02	-1.08
M&M	0.36	0.10	0.46	0.27	0.16	-4.38
Tata motors	0.52	0.87	1.39	0.4	0.05	-3.37
Maruti Suzuki	0.42	0.46	0.88	0.08	0.07	1.91
Average	0.37	0.42	0.79	0.26	0.08	-1.21
BPCL	0.39	0.02	0.37	0.13	0.02	17.87
Essar oil	2.17	-7.82	-5.65	2.63	0.38	-4.2
HPCL	0.49	-0.1	0.39	0.20	0.04	-7.26
IOCL	0.23	0.10	0.33	0.09	0.02	1.03
Reliance Industries	0.15	0.53	0.68	0.30	0.05	0.86
Average	0.69	-1.45	-0.78	0.67	0.10	1.66
JSW	0.80	0.50	1.3	0.58	0.09	-2.65
SAIL	0.61	1.05	1.66	0.49	0.13	-3.70
Tata	0.45	0.42	0.87	0.42	0.48	2.98
Welspun Gujstah	0.68	0.76	1.44	0.61	1.29	0.6
Jindal	0.19	0.95	1.14	0.22	0.06	0.72
Average	0.55	0.74	1.29	0.60	0.41	-2.05

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