Paper – 13: Management Accounting –Strategic Management

Time Allowed: 3 Hours **Full Marks: 100**

Answer Question No.1 and Question No.6, which are Compulsory and any three Questions from Section I and another two Question from Section-II.

Working Notes should form part of the answer
"Wherever necessary, suitable assumptions should be made and indicated in answer by the candidates."

Question.1

(a) Choose the most appropriate one from the stated options and write it down: [1x5=5]

(i) What are the enduring statements of purpose that distinguish one business from other similar firms?
(a) Policies
(b) Mission statements
(c) Objectives
(d) Rules

(ii) Brand names such as Coca-Cola, Sony, McDonald's and Nike are a source of competitive advantage as :
(a) They are owned by global firms
(b) They are more than 50 years old
(c) They are well managed brands
(d) They are highly innovative firms

(iii) Mckinsey's T-s framework consists of:
(a) Structure, strategy, software, skills, styles, staff and supervision.
(b) Structure, strategy, systems, skills, styles, syndication and shared values,
(c) Structure, strategy, systems, skills, steering power, styles and shared values.
(d) None of the above

(iv) Successful differentiation strategy allows the company to
(a) Gain buyer loyalty to its brands
(b) Charge too high a price premium.
(c) Depend only on intrinsic product attributes
(d) Have product quality that exceeds buyers' needs

(v) Intensity of competition is ……………. in low return industries
(a) Low
(b) Highest
(c) Non-existent
(d) Not important

(a) State whether the following statement are 'True' or 'False' with justification for your answer. [1x5=5]

(i) Performance measures for monitoring strategies cannot be mainly financial.

(ii) 'Long Range planning' focuses on forecasting the future by using economic and technical tools.

(iii) The acquisition of Hutch by 'Vodafone' is an example of Horizontal integration.

(iv) 'Repositioning' does not involves moving the product or brand into a different market segment.

(v) 'Dogs' are the products in a high-growth market but where they have a low market share.

(b) Define the following terms in not more than two sentences: [1x5=5]

(i) Stake-holder

(ii) Conglomerate diversification

(iii) Harvest

(iv) Values

(v) Merger

Answer:

(a)

(i) (b) Mission Statement

(ii) (c) They are well managed brands

(iii) (d) None of the above

(iv) (a) Gain buyer loyalty to its brands

(v) (b) Highest

(b)

(i) True

Performance measures for monitoring strategies cannot be mainly financial, there are other aspects also.

(ii) True

'Long range planning' focuses on forecasting the future by using economic and technical tools.

(iii) True

The acquisition of Hutch by 'Vodafone' is an example of Horizontal integration

(iv) False

'Repositioning' is a strategic marketing approach and involves moving the product into different market segment.

(v) False

As per BCX Matrix, "dogs" are units with low market share in a mature, slow-growing industry.

(c)

(i) Stake-holder – an individual or organization whose behaviour can directly affect the firm's future but is not directly under the control of the firm.

(ii) Conglomerate diversification – consists of making entirely new products for new classes of customers. These new products have no relationship to the company's current technology, products or markets.

(iii) Harvest: is the strategic option in which the market share is allowed to fall to earn better short term profits. Harvest means a strategy aiming for a lower market share which will give the company its best short-run return with a longer term of eventually pulling out of market. This strategic option is appropriate when the product has a poor market share in a declining market or when the product has a poor start of a growing market. This strategy can be used to gather in funds which can be divested into other fruitful investment.

(iv) Values – Beliefs, business principles and practices that are incorporated into the way the company operates and the behaviour of the company personnel.

(v) Merger: Combination of two or more firms is known as merger. A combination of two or more business units in which one acquires the assets and liabilities of the other in exchange for cash or shares and/or debentures, is generally known as 'merger 'through acquisition of absorption

Section I

Question.2

(a) What are the different policies taken by the Government of India to improve the productivity and competitiveness of the Indian economy? [10]

Answer:

Proactive policy measures taken by the Government of India to improve the productivity and competitiveness of the Indian economy enunciated in the various sectors of the economy – real, fiscal, external, monetary and financial.

(i) Real sector policies

a. Agriculture and allied activities

Agricultural sector has remained a problem area and there has been a declaration in its growth. To arrest this trend and reverse the deceleration, number of policy inputs has been made. A National Rain Fed Area Authority (NRAA) has been created in November 2006 to support up-gradation and management of dry land and rain fed agriculture. The authority would coordinate all schemes relating to watershed development and other aspects of land use. The accelerated irrigation benefit programme is also being revamped to repair, renovate and restore water bodies in various states.

The National Agriculture Insurance Scheme (NAIS) and the National Rural Employment Guarantee Scheme (NREGS) are two important schemes which have been implemented. These have been extended to more number of villages, so that the under employment in agriculture sector is mitigated and business risk in agricultural farming due to natural calamities are also taken care of.

b. Manufacturing and infrastructure policies

If the increased activity in the manufacturing sector since 2003-2004 has to be sustained focus on upgrading the infrastructure facilities in the country is the need of the hour. Up gradation of human skills, work on golden quadrilateral, introduction of public private

partnership model, increase in the power production capacity, etc, have already been identified as the areas which need robust growth in the immediate future. Spiraling of crude oil prices has had a deleterious impact on production and logistics costs through higher fuel costs. Alternatives to fossil fuel are being looked into. Wind energy is being harnessed increasingly apart from utilizing the large coal reserves available in our country. The credible alternative of producing nuclear power is one of the salient government policy. In regard to the industrial policy, the micro, small and medium enterprises development act 2006 has modified the previous act to increase the threshold investment. A new national pharmaceutical policy has also been announced during the year 2006 to strengthen drug regulatory system and patent office. The public-private partnership model has enabled greater private sector participation in the creation and maintenance of infrastructure. Concepts of special economic zone are under introduction and there have been a lot of hiccups in this area. New modifications are on the anvil to take care of the displaced land owners as also protection of the fertile lands. The information technology amendment bill 2006 will put in place technology applications, security practices and procedures relating to such applications.

(ii) Fiscal policy

While preparing a policy to take care of the robust growth of the economy it has also been necessary to introduce fiscal corrections to reduce the fiscal deficit. Government of India subjected itself to a fiscal discipline for reducing deficits in the key areas viz, revenue, fiscal and primary. The tax base is being broadened to include more and more new services in the tax net. Personal taxation is being reduced so that the disposable incomes are bigger and savings grow. Introduction of value added tax (VAT) in various states has been a significant success and is expected to usher price stability as well as improved earnings to the various states through higher volumes.

(iii) External sector policies

Foreign trade policy of 2004-2009 was modified through an annual supplement in 2007 for deepening the incentives provided for focused products and markets. For simplifying and liberalizing the external payments regime and deepen the foreign exchange market the recommendations of the committee of Fuller Capital Account Convertibility have been considered by the Government of India and certain policy initiatives have been undertaken. They relate to increase in overseas investment limits for joint ventures/wholly owned subsidiaries abroad by Indian companies, higher portfolio investment limits for Indian companies/domestic mutual funds, higher ceilings for investments by foreign institutional investors in Government securities and enhanced repayment limits for external commercial borrowings.

(iv) Monetary policies

The necessity to balance the growth of economy with containing inflationary pressures has guided the monetary policy. The Reserve Bank of India (RBI) have taken its stance on the monetary policy to continue to reinforce the emphasis on price stability and well anchored inflation expectations and there by sustain the growth momentum contextually, financial stability may assume greater importance in the near future. RBI has been managing this area with the cash reserve ratio (CRR) on one-hand and Repo rates on the other. The interest rates are being modified whenever necessary on the basis of the monitoring exercise on rates of inflation.

(v) Financial sector policies

In view of the critical role played by the financial sector in supporting the robust growth of economy, RBI have tightened provisioning norms and risk weights to ensure asset quality, strengthened the accounting and disclosure norms for greater transparency and discipline. Final guidelines for the implementation of the new capital adequacy framework have been issued. Alongside its initiatives to strengthen the financial sector the RBI continue to take measures for protecting customers' rights and enhancing the quality of customer service.

(b) Write a short note on Horizontal Integration. [5]

Answer:

Horizontal Integration

Horizontal Integration is the effort to achieve a competitive edge with increased size and scope. Acquisitions and mergers are the means through which such an increase in the size and scope are attempted. An acquisition takes place when a company uses its resources to purchase another similar company and the acquired company continues to remain as a separate entity. In a merger two companies agree to combine their operations and create a new entity. E.g. — Cement Companies acquiring manufacturing facilities.

Horizontal Integration has acquired more significance in a global market with a view to achieving competitive advantage by growing in size as the organic mode of substantial expansion and green field projects take long gestation time, acquisitions and mergers are becoming more important to take advantage of a growing market expeditiously. The main benefits of horizontal integration are:

(i) Reduction in mining cost
(ii) Possibility of offering a range of products through differentiation
(iii) Managing existing rivalry through market operations; and
(iv) Augmenting bargaining capacity over buyers and suppliers

However there are certain limitations to horizontal integration, they are:

(i) The problems associated with mergers and acquisitions
(ii) Conflicts that can arise due to statutory requirements while the process of acquisition are mergers is pursued

Question.3

(a) Unrelated Diversification can sometimes work well. When is unrelated diversification a good strategy? Illustrate. [6]

Answer:

Unrelated diversification is also known as conglomerate diversification. Under this type of diversification, there will be addition of dissimilar products or services to the existing line of business. It involves diversification into business fields, which are not significantly related or similar to the primary business mission. Further under unrelated diversification, a firm may acquire another firm, which has surplus cash even though there may be nothing common with existing business.

Unrelated diversification is a good strategy where,

(i) Basic industry is experiencing declining annual sales and profits.
(ii) An organization has capital and managerial talent required to compete in a new industry.
(iii) There is some synergy between existing and proposed new areas of business(ITC in apparel/Agri- business)
(iv) Acquire an related business which offers attractive investment opportunity(Kingfisher Airlines)
(v) Existing business is continuous threat of saturated demand.(Generic chemicals, Cigarette, Land phone etc. business)
(vi) When an organization is subjected to environmental safety or pollution control or antitrust law.

Some of the examples that demonstrate that unrelated diversification working well are listed below:

(i) GE is a classic example of an unrelated diversified company. Its unusual architecture allows its different businesses to effectively learn from one another.

(ii) Virgin group in U. K is another such company that covers trains, airlines, financial services, and cola amongst others. The company claims that most of its businesses are aimed at a common socio-demographic segment.

(iii) DCM Ltd has added engineering goods, fertilizers, chemicals, sugar rayon tyre cord etc to its existing business line of textiles.

(iv) Other classic examples are Tata and Reliance, which have developed management expertise and Government connections that enable them to thrive in the peculiar circumstances in India but have then refined their competences in some of their businesses to the point where they are genuinely world class.

(b) What are the different strategies of "Joint Venture". [3]

Answer:

There are three Joint Venture strategies, namely:

- Spider web strategy: In this strategy, a small firm establishes a series of joint ventures, so that it can survive and not absorbed by its large competitors.
- Go together Split Strategy: In this strategy, the firms agree to form a joint venture for a specific length if time. When that project is completed, they once again split.
- Successive Integration Strategy: In this strategy, a firm begins an alliance, which is weak and then develops several joint ventures which can then lead to a merger. In fact, Joint Venture could be a laboratory setting prior to a merger.

(c) Demand forecasting can be done using (i) Delphi technique, (ii) Time-series analysis and (iii) Regression analysis. Explain the strengths of these techniques and also indicate the situations where these techniques would be relevant. [2+2+2=6]

Answer:

(i) Delphi technique: The Delphi technique is a method of expert opinion from a large group of people in a systematic way. It is mainly required in any long term technological forecasting at macro level. This technique is a modification of the panel or committee approach, while it eliminates some of the disadvantages, of the classical committee. In the Delphi:

- Direct interaction is avoided by using a programmed sequential questionnaires of three or four rounds;
- The expert is not called to defend his publicly expressed opinion, and anonymity of individual forecasters is maintained.;
- Subordinates do not have to differ with senior executives face to face;
- The final result is a statistical group response;
- Results are based on interactions combined controlled feedback.

(ii) Time series: This is a short term sales forecasting tool, useful only as a micro tool at the level of company product. The basis of such analysts is that the future value is a recombination of its past performance, at least into near-term future, by decomposition into the components of trend, cycle, season and erratic events. So this is useful only as a micro tool.

(iii) Regression: In this analysis also the past observations are described as a function of time and identified pattern is then used to forecast ahead. This method is often used for long-term forecasting. Being cause and effect models, it can only be used at the level of the industry. However, it is too easy and therefore encourages thoughtlessness; particularly in the long-term. A curve depending only on time cannot provide a suitable description of the distant future.

Question.4

(a) "A Dog (in respect of BCG matrix) need not be divested always. Someone can acquire a Dog." State. [3]

Answer:

Considerable criticism has been made for some time of the BCG's belief that "Dogs are essentially worthless" and they should be liquidated or divested, if possible. In some industries however, Dogs provide a platform for development of future stars, act as loss leaders or otherwise help to complete a product range. Dogs can also be acquired for strategic reasons-could be for tax planning, could be to kill competition etc.

(b) What are the different factors about which firms can become complacent at each stage of the life-cycle and the dangers that this can pose. [6]

Answer:

At the introductory stage, complacency can arise about the industry's prospects. There could be speculation that growth and riches are just around the corner. Firms in the Industry sometimes may over-estimate the benefits it brings vis-à-vis established substitutes. They might under-estimate the technological hurdles to be overcome in order to make their product acceptable.

All of these can lead to poor decisions about investment in enhancing product features or extending the range of offerings and underinvestment in marketing and in building relational capital. A firm may be confident about the novelty of the offering and may not create enough awareness and pull amongst the target customers.

At the growth stage, firms may become complacent about their capacity to sustain growth and to fulfill stakeholder expectations. They may become acclimated to high levels of annual growth and assume that these can be maintained for ever. This may lead to overly optimistic investments in new capacity towards the end of the growth phase.

Firms may also be complacent about their ability to locate, attract and train staff with appropriate qualifications and motivation assuming that this will continue to be as easy as it is today. This may lead to capacity constraints and to the erosion of margins as firms compete to attract people from a limited pool of talent.

At the maturity stage, complacency can set in about the likely hood of technological change, leading firms to over-invest. They may also be complacent about the degree to which the customers are tied into their offerings. Leading firms may become complacent about their leadership position and underestimate competitors' capacity to instigate disruptive, perhaps even hyper-competitive change. Finally, firms may become blind to the possibility of eventual industry decline and make poor investment decisions.

At the decline stage, firms may become complacent about the eventual eclipse of the industry and the pace at which it occurs.

(c) Differentiate between:

(i) Products & Brands

(ii) Above-the-line & Below-the-line Advertising. [3+3]

Answer:

(i) Products & Brands: A product can be defined as something which is offered to a market in order to satisfy customer needs in some way: it is a package of benefits. A brand, on the other hand, is rather different: it is a name, term or symbol or design or combination of them which is intended to signify the goods and services of one seller or group of sellers and to differentiate them from those of competitors. For examples, denim jeans, the product, underpin a number of brands, e.g. Wrangler, Lee, and New Port. These brand names do not only apply to jeans and can be found also on shirts.

Sometimes, it has been argued that products have life cycles whereas brands do not. But, this statement is a false dichotomy. This model applies to some products but not to all. On the other hand, some products do not have a life cycle, although some stages of

the life cycle model still apply. With brands, the situation is equally ambivalent. Some brands appear immortal, despite the changes in the products they support. On the other hand, some brands do die, if they are not properly supported.

(ii) Above-the-line & Below-the-line Advertising: Above-the-line advertising is in its normal or popular sense — e.g. T.V. or radio commercials, poster ads, newspaper and magazine advertisement. Below-the-line advertising is the sales promotion activities — i.e. 'non-media' advertising. Though, to a large extent, advertising and sales promotion are complementary and sales promotion is used often as a means of reinforcement for bringing a media campaign closer to the customer, a distinction is often sought to be made between them. Advertising is effective product positioning. It is, therefore, commonly associated with mass media. The general role of sales promotion is persuasive communication. Basically, the task of sales promotion comprises stimulating customer buying and distribution effectiveness. Accordingly, sales promotion is short-term more specific and focused and talked about including immediate purchase.

Question.5

(a) Discuss the ways by which companies can achieve a cost advantage by reconfiguring their value chains. [7]

Answer:

Dramatic cost advantages can emerge from finding innovative ways to restructure processes and tasks, cut out frills, and provide the basics more economically. The primary ways companies can achieve a cost advantage by reconfiguring their value chains include:

- Stripping away the extras and offering only a basic, non-frills product or service, thereby cutting out activities and cost associated with multiple features and potions.
- Re-engineering core business processes to cut out needless work step, and low-value added activities.
- Shifting to a simpler, less capital-intensive or more streamlined technological process.
- Using direct-to-end-user sales and marketing approaches that cut out large costs and margins of wholesalers and retailers
- Relocating facilities closer to suppliers, customers or both to curtail inbound & outbound logistical costs.
- Achieving a more economical degree of forward or backward vertical integration, relative to competitors.
- Dropping the something for everyone approach and focusing on a limited product/ service to meet a special, but important, need of the target buyer, thereby eliminating activities and costs associated with numerous product versions.

(b) Difference between 'Marketing' and Societal Marketing' concepts. Why is the 'Societal Marketing' concept so important? [4+4=8]

Answer:

The marketing concept is a business philosophy that believes that the customer's satisfaction is the reason for the business's existence. The marketing concept holds that achieving organizational goals depends on the needs and aspirations of the target consumers and delivering the desired satisfactions more effectively and efficiently than competitors do.

The marketing concept starts with a well-defined target market, focuses attention on understanding those customers' needs, coordinates all the marketing efforts by creating long-term customer relationships based on customer value and satisfaction. Under such marketing concept, companies produce what consumers want, thereby satisfying consumers and making profits.

The societal marketing concept holds that a company should make good marketing decisions by considering consumers' wants, the company's requirements, and society's long-

term interests. It is closely linked with the principles of Corporate Social Responsibility and of Sustainable Development.

The concept has an emphasis on social responsibility and suggests that for a company to focus on exchange relationship with customers might not be in order to sustain long-term success. Rather, marketing strategy should deliver value to customers in a way that maintains or improves both the consumer's and the society's well-being.

The societal marketing concept holds that the organization should determine the needs and interests of target markets. It should then deliver the desired satisfactions more effectively and efficiently than competitors in a way that improves the consumer's and the society's well-being.

Importance of societal marketing concept:

The societal marketing concept is a new marketing philosophy. It is important because it not only encompasses all activities that ensures delivery of what the customers want, but also ensures that the rights of the society are not infringed while delivering to customers who form a particular segment of society.

Most companies recognize that socially responsible activities improve their image among customers, stockholders, the financial community, and other relevant publics. Ethical and socially responsible practices are simply good business, resulting not only in favourable image, but ultimately in increased sales.

The societal marketing concept Questions whether the pure marketing concept is adequate in an age of environmental problems, resource shortages, worldwide economic problems and neglected social services. It asks if the firm that senses, serves and satisfies individual wants is always doing what's best for consumers and society in the long run.

According to the societal marketing concept, the pure Marketing concept overlooks possible conflicts between short-run consumer wants and long-run consumer welfare.

Section II

Question.6

(a) Choose the most appropriate one from the stated options and write down: [1x5=5]

(i) The most commonly used techniques for measurement of liquidity risk is………
(a) The gap analysis of maturing assets to the maturing liabilities
(b) The financial analysis
(c) The audit of maturing assets
(d) The gap analysis of current assets to the maturing liabilities

(ii) SCO means
(a) Successful competitor outcome
(b) Successful customer outcomes
(c) Successful commercial organization
(d) None of the above

(iii) MTO stands for
(a) Mark to order
(b) Move to order
(c) Move to open area
(d) None of the above

(iv) Life Insurance do not include
(a) Whole life
(b) Pension

(c) Motor vehicle
(d) Endowment

(v) MTS stand for
(a) Make to sell
(b) Make to stock
(c) Move to sell
(d) Move to store

(b) State whether the following statements are 'True' or 'False'. [1x5=5]

(i) Capital Assets Pricing Model attempts to measure the risk of capital assets of a company.

(ii) The concept of certainty equivalent coefficient does not represent the computation of a certain amount equivalent to a probable income or loss.

(iii) Product Liability Policy is not one of the products of "Industrial Insurance".

(iv) VAR means Value at Risk.

(v) Portfolio Management increases Systematic Risk.

Answer:
(a)
(i) (a) The gap analysis of maturing assets to the maturing liabilities

(ii) (b) Successful customer outcomes

(iii) (d) None of the above

(iv) (c) Motor vehicle

(v) (b) Make to stock

(b)
(i) False

(ii) False

(iii) True

(iv) True

(v) False

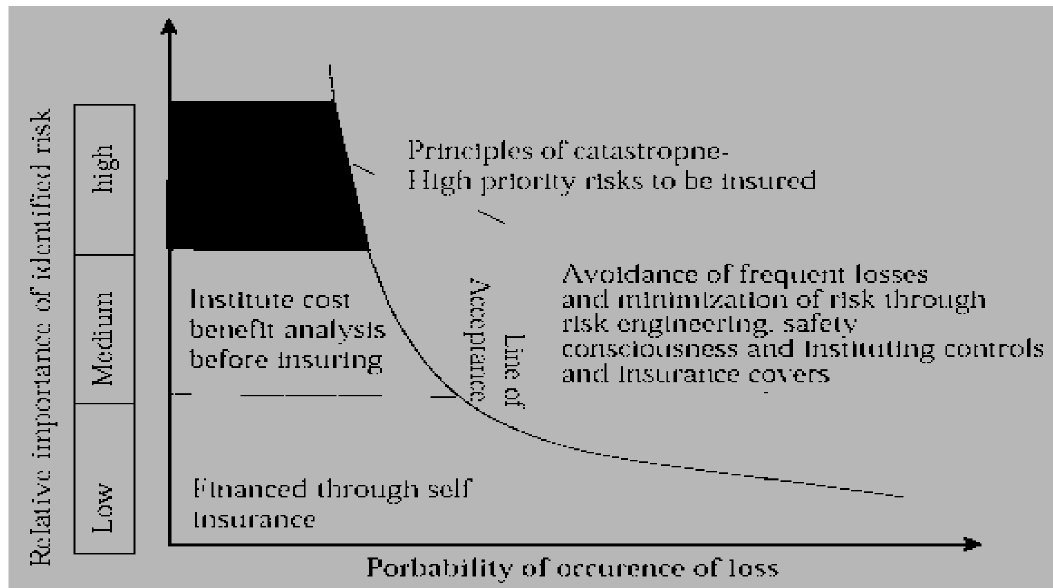
Question.7. Write short notes on: [5×3=15]
(a) Catastrophic Losses
(b) Utility Theory
(c) Impact of Macro Economic Factors and Risk

Answer:
(a) Catastrophic Losses

Catastrophic losses from natural disasters have two main characteristics:

(i) They are limited to geographic area where the impact has taken place.

(ii) Prediction of the event is very difficult. For example storms and floods or earthquakes etc. can create catastrophic losses as such an Insurer will have to take special precautions of calculating the premiums. Even then the loss may be so huge that the consumers normally resort to sharing the risks through reinsurance as also ensures dispersion of risks over a larger geographical area. To estimate the frequency and severity of the catastrophic losses probability analysis is resorted to:



(b) Utility Theory

The destruction caused by any unforeseen event is referred to as "Risk". In the insurance business, people exposed to the same risk form a group and share the loss together. Insurance companies collect the shares (Premiums) in advance from the group and create a fund. This fund is utilised to pay for the loss (Claims) that is incurred by any member of the group.

Risks can be classified into various types:

(i) Financial and non-financial risks

(ii) Dynamic risks

(iii) Speculative risks

Risk cannot be avoided through insurance but may be considered as a means to transfer the risk. It is also a mechanism to compensate the financial and economic loss due to risk. Safety measures and damage control management can be adopted to mitigate or eliminate the magnitude of risk. The fundamental principle of insurance is to share the losses and to substitute uncertainty with certainty. Expected utility theory emphasizes that the demand for insurance is a demand for certainty. The conventional specification of the theory perceives that the buyers of insurance prefer certain losses to actuarially equivalent uncertain losses. But certain other surveys indicate that individuals actually prefer uncertain losses to actuarially equivalent certain losses. This can be explained by saying that "the purpose of any insurance policy is to convert an uncertain, but potentially large loss into a certain small loss. Such a conversion benefits the consumer, if greater losses cause progressively larger declines in utility (i.e., if there is diminishing marginal utility of wealth)". For example, insurance against fire peril where the bigger part of the loss will be insured that is uncertain for a specific premium today.

Another approach evaluates a conventional expected utility theory explaining the demand for insurance by an individual's demand for an uncertain payoff of income in a pre specified state. This can be explained through the demand for health insurance. According to this theory, becoming ill fundamentally changes preferences. Thus an insured customer is able to transfer income into the ill state where the marginal utility of income is greater.

(c) Impact of Macro Economic Factors and Risk

Relationship between risk and return can never be over emphasized, higher the risk the return needs to be higher and the computation of the risk premium has always been a million dollar question. However, risk perceptions of investors tend to be different with the onset of business cycles. In recession, investors tend to be conservative as their appetite for risk is reduced and they go after growth sectors which have lower risk. In a security market, low risk growth sector have always been the biggest gainers in terms of returns. This explains that onset of recession upset the risk return balance.

Macro Economic factors like change in interest rates, inflation, money supply and index of industrial production have a big impact on the investors risk perception. Analysis has shown that in a regime of high interest rates and high inflation low risk sectors perform better than high risk stocks. As the interest rates and inflation decline the high risk sectors tend to do better.

Question.8

(a) Why is Risk Reporting considered to be an important step in Risk Management? [7]

Answer:

Risk Reporting is an important step in Risk Management because:

- A transparent and effective risk reporting system is essential for a company, as it is obligatory on its part to disclose all material risks that it faces and its risk management practices. In recent years, the concept of risk reporting has assumed significant importance, after the collapse as well as other corporate failures. Existence of an adequate Risk Reporting System in an organization makes the managers more accountable for their actions. In the light of this, the importance of risk reporting system can be summarized as under:
- It can assist the Board to discharge its responsibilities, enabling the company to go for higher profits at lower risks.
- It helps in decision-making at all levels with objectivity.
- It can help investors to evaluate market situations with a view to building optimum portfolio of securities.
- Lenders can be supported in their lending operations and policy decisions.
- It can help a company in getting a better credit rating and access to cheaper source of finance.
- It develops transparency between managers and investors-leading to reduced agency cost, which in turn reduces the cost of capital and increases the basket of investment opportunities available to a firm.

It can create a niche for the company and can act as a trendsetter for others.

(b) Role of Insurance Industry in Service Sector. Explain. [4]

Answer:

In Service Sector the Insurance Industry ranks very high and is particularly relevant to growing economy like India. As the insurance Industry encourages and mops up Savings of the Society and also provides a safety net for personal and institutional risk this industry needs to be properly run and the structure properly regulated. In this regard, structure of the insurance industry is given below:

Insurance Market -> Policy holder or customer (insured) -> Various insurance products -> Agents broker etc. -> The insurer -> Re insurer -> I R D A

Insurance is classified into the following types: Non-Life (General) Insurance, and Life Insurance in most of the countries except in USA. IN USA the insurance industry is classified into property & Casualty, Life and Health. In India, General insurance includes Property & Casualty, Fire, Engineering Projects, Motor, Aviation and Marine Insurance.

General Insurance also includes legal liability to others like collision liability, employers' liability. etc. The Insured gets compensation only if the event occurs. The insured does not get any return if the event does not occur. Almost all insurance contracts are annual contracts other than the individual life insurance contracts which are long term contracts.

(c) State asset liability model and its utility for managing liquidity risk. [2+2]

Answer:

Asset liability management is a technique to compute matching of assets and liabilities by which a prudent management of an investment portfolio can be properly taken care of. Asset liability management is defined as "maximising the risk adjusted returns to shareholders over the long run". It is also defined as management of total balance sheet in terms of size and quality (composition of assets and liabilities).

Liquidity risk management through asset liability management

It is difficult to measure liquidity risk as it entails expecting likely inflow of deposits, loan dispersals, changes in competitive environment, etc. The most commonly used techniques for measurement of liquidity risks is the gap analysis. The assets and liabilities are arranged according to their maturity pattern in time brackets. The gap is the difference between the maturing assets to the maturing liabilities. A positive gap indicates that maturities of assets are higher than those of liabilities. A negative gap indicates that some rearrangement of funds will have to be done during that time bracket. It can be from sale of assets or issue of new liabilities or rolling over existing liabilities.

Question.9

(a) Discuss 'pricing' in relation to an insurance product. [7]

Answer:

The process of determining or fixing the rates of premium for a particular product is known as pricing. Traditionally, premiums have been calculated based on tariffs set by the Insurance Regulatory Authority. The rates are derived based on various factors like past loss ratio, location of the asset, type of asset, as well as exposure to the risks. Rate is the pricing factor upon which the premium is based. For example, car insurance policies are priced based on factors such as make and model of the car, purpose for which the car is used, etc.

Traditionally, for motor insurance, the parameters that are used to price a policy have been model of the car, age of the driver, location of the car and purpose for which the car is driven, etc. The industry will eventually move from price rating to risk rating. The pricing for each individual will be based on their track record. For example, for 'own damage' in a car insurance policy, the pricing parameters will be the model of the car, driver's age and engine capacity. This is of particular importance to a management accountant as it is in the nature of pricing a product.

The insurance premium can be broken up into four parts:

- Cost of payment for losses
- Cost of operation and maintenance of insurance pool
- Reserve for contingencies
- Return on Investment.

In the life insurance, calculation of insurance premium is very complicated exercise as the variables involve are many, e.g., factors aggravating mortality rates, like smoking, drinking, drugs and other habits, age of the insured, occupational hazard, etc. This computation is

normally through actuarial computations involving mortality rates. Premium rate is often referred as rate per unit of exposure.

(b) What is Insurance? What are the requirements & characteristics of an insurance contract? [2+2+4=8]

Answer:

Insurance can be defined as transferring or lifting of risk from one individual to a group and sharing of losses on an equitable basis by all members of the group. In legal terms insurance is a contract (policy) in which one party (insurer) agrees to compensate another party (insured) of its losses for a consideration (premium). Exposure to loss is the insured's possibility of loss. Insurance is a means whereby a large number of people agree to share the loss which a few of them are likely to incur in the future. Insurance is also a means for handling risk. There is an uncertainty related to the risk. The business of Insurance is related to the protection of the economic value of any asset. So, every asset that has a value needs to be insured. Both tangible goods and intangibles can be insured.

Requirements of an insurance contract:

Four requirements are laid down for a valid insurance contract as below:

Agreement must be for a legal purpose, i.e., the contract of Insurance should not violate the principle of Insurable Interest and it is a contract of Uberrimae Faide (Utmost Good Faith).

Parties must have legal capacity to contract; Minors, Lunatics, Insolvents, Intoxicated persons, etc. do not have the legal capacity and cannot enter into an insurance contract.

There should be a valid offer and acceptance and there must be exchange of consideration in response to an agreement which defines the quantum of possible loss to the insured. The premium amount is paid by the Insured by way of consideration on the basis of the policy risk insured. The Insurer's consideration will be a promise to indemnify the loss of the insured on the occurrence of the insured's risk.

Characteristics of insurance contract:

Following are the unique characteristics which are distinct from other forms of contract.

Aleatory contract (Dependent on chance): The values exchanged by the contracting parties in an insurance contract are unequal as they are dependent on chance or in other words in an insurance contract result depends entirely on risk. If the loss arises, compensation is paid by the Insurer on the occurrence of peril. If it doesn't occur insurer does not pay any compensation while the premium gets paid to the insurer. The question of paying compensation does not arise.

Conditional Contract: Insurance contracts lay down conditions like providing proof of insurable interest, immediate communication of loss, proof of loss, and payment of premium by the insured.

Contract of Adhesion: Legally obligatory on the part of the insurer to explain the terms of contract fully to all the parties. This is particularly important as under contract of adhesion, any ambiguity in the wording of the agreement will be interpreted against the insurer as he had laid down the terms.

Unilateral Contract: Insurer is the only party to the contract who makes promises that can be legally enforced.

Generally, Non life insurance contracts are usually annual contracts and have to be renewed each year. Each time the policy is renewed a new contract is issued by the Insurer.