# FINAL EXAMINATION

## GROUP III

## (SYLLABUS 2008)

## SUGGESTED ANSWERS TO QUESTIONS

## DECEMBER 2014

## Paper- 13 : MANAGEMENT ACCOUNTING – STRATEGIC MANAGEMENT

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

**The figures in the margin on the right side indicate full marks.**
**(Please answer all part of the question at one place.)**

**Section - I (60 Marks)**
**(Strategic Management)**

**Answer Question No. 1 and any two more from the rest in this section.**

1. (a) In each of the cases/statements given below, one out of the four alternatives is most appropriate. Indicate the correct answer: (Answer any ten) 1x10=10

(i) The following is not a characteristic of Corporate Strategy:
(A) Formulated by lower level management
(B) Long term
(C) Integrated
(D) Action oriented

(ii) The following is not a Primary Measure in a balanced score card.
(A) Customer Perspective
(B) Competitor Perspective
(C) Internal Perspective
(D) Learning and Growth Perspective

(iii) The following is not a limitation of environmental analysis:
(A) It does not foretell the future
(B) It does not eliminate uncertainty
(C) It guarantees organizational effectiveness
(D) Its potential is often not realized

(iv) Strategic decision making towards achievement of mission is a primary responsibility of
(A) Board of Directors
(B) Corporate Managers
(C) Business Managers
(D) Both (A) and (B)

(v) The following has the maximum risk among the strategies presented in Ansoff's Matrix:
(A) Diversification

(B) Market Penetration
(C) Market Development
(D) Product Development

(vi) Offensive Strategy is a strategy
(A) For small companies that consider offensive attacks in the market.
(B) For those companies that search for new inventory opportunities to create competitive advantage.
(C) For the market leader who should attack the competitor by introducing new products that makes existing ones obsolete.
(D) For those companies who are strong in the market but not leaders and might capture the market share from the leader.

(vii) Airtel's decision to go into the DTH business is an example of
(A) Expansion
(B) Concentric Diversification
(C) Related Diversification
(D) Unrelated Diversification

(viii) A separate division for a major product or a product line or a market in a multi product or a multi business organization is called
(A) Strategic Business Unit
(B) Sister Business Unit
(C) Same Business Unit
(D) Specific Business Unit

(ix) A tooth-paste maker's "brush your teeth twice a day" campaign is an example of the following corporate level strategic objective:
(A) Improve return on assets
(B) Increase overall profit
(C) Increase sales by improving market penetration in the existing markets
(D) Increase manufacturing productivity

(x) Target price is
(A) Investment driven
(B) Product driven
(C) Market driven
(D) Cost driven

(xi) The following does not provide an optimal solution:
(A) Heuristic Model
(B) EOQ Model
(C) Critical Path Analysis
(D) Linear Programming Model

(b) State whether the following statements based on the quoted terms are 'TRUE' or 'FALSE' with justifications for your answer. For false statements, you are required to state the correct terms. No credit will be given for an answer without a justification: 1x5=5

(i) A 'flexible budget' is a budget prepared for a rolling period which is reviewed monthly and updated accordingly.
(ii) 'Question marks' are products in a high-growth market where they have a high market share.
(iii) 'Information Technology, Human Resource Management' are known as critical functions within organizations.

**(iv) 'Market Forecast' by a company involves the selection of its market and setting as an objective a target share of each market.**
**(v) "Spider-Web strategy" is the acquisition of many small firms by a large firm.**

**(c) Define the following terms (in not more than two sentences):** **1x5=5**
**(i) Sources of Synergy**
**(ii) Diversification**
**(iii) Manufacturing Resource Planning**
**(iv) Cash Cows**
**(v) Mission Statement**

**Answer:**

1. (a) (i) (A) Formulated by lower level management
(ii) (B) Competitor Perspective
(iii) (C) It guarantees organizational effectiveness
(iv) (D) Both (A) and (B)
(v) (A) Diversification
(vi) (D) for those companies who are strong in the market but not leaders and might capture the market share from the leader.
(vii) (D) Unrelated Diversification
(viii) (A) Strategic Business Unit
(ix) (C) Increase sales by improving market penetration in the existing markets.
(x) (C) Market driven
(xi) (A) Heuristic Model

(b) (i) False: A flexible budget is updation of a budget in accordance with the activity level, taking into account the variable and fixed nature of costs according to different levels of activity.
(ii) False: Question Marks are products in markets with high growth and low market share in the BCG matrix.
(iii) False: The critical functions are Finance, Product and marketing.
(iv) False: "Market Positioning" or Product Positioning" or Target Marketing" is to be used instead of "Market Forecast".
(v) False: A small firm establishes a series of joint ventures so that it can survive and not swallowed by its large competitors.

(c) (i) Sources of Synergy-Competencies, knowledge, and customer-based intangibles (e.g., brand recognition, reputation) might be developed and shared across the firm's businesses, Operational resources, facilities, or functions (e.g., plants, R&D, sales force) might the firm's businesses share to increase their efficiency.
(ii) Diversification is a form of corporate strategy for a company. It seeks to increase profitability through greater sales volume obtained from new products and new markets.
(iii) Manufacturing Resource Planning is a closed-loop manufacturing system that integrates all facets of a manufacturing business, including production, sales, inventories, schedules, and cash flows.
(iv) Cash cows needs very little capital expenditure and generate high levels of cash income. Normally stars will become cash cows, with a high share of a low-growth market.
(v) It is a statement of intentions what a company wants to create and through which lines of business.

**2. (a) Explain Porter's three competitive strategies to defend competitive forces.** **6**
**(b) Distinguish between 'Strategy' and 'Policy'.** **4**

**(c) What is branding? What are the decisions that need to be taken with regard to brand selection and its use? Explain each decision. 2+8=10**

**Answer:**

2. (a) A competitive nation, Porter assumes does not exist. The only meaningful measure of national competitiveness is the productivity and effectiveness of industries. (1) No nation can have competitive industry in every product. (2) International competition helps to upgrade national productivity, (3) Rising exports, combined with high living standards in a country result when the exporting industries are ones with high levels of productivity.

In order to create a defendable position against the five competitive forces, Porter suggests the following three competitive strategies.

(1) **Positioning:** This means making such positioning of the firm that its capability provides the best defence against the existing array of competitive forces.
(2) **Influencing the Balance:** The strategy here is to improve the firm's relative position through strategic moves that influence the balance of forces.
(3) **Exploiting Change:** The approach is to adopt appropriate strategy for the changing environment ahead of the rivals.

(b) **Strategy:** Strategy refers to the determination of the purpose or mission and the basic long term objectives of an organisation and the adoption of courses of action and allocation of resources necessary to achieve these aims. Therefore, objectives are a part of the strategic formulation.

**Policy:** Policies are general statements or understandings that guide managers thinking in decision making. They ensure that decisions fall within certain boundaries. They usually do not require action but are intended to guide managers in their commitment to the decision they ultimately make. The essence of policy is discretion. Strategy, on the other hand, concerns the direction in which human and material resources will be applied in order to increase the chance of achieving selected objectives.

Certain major policies and objectives may be essentially the same. A policy of developing only through retailers may be an essential element of a company's strategy for new product development or marketing. One company may have a policy of growth through the acquisition of other companies, while another may have a policy of growing only by expanding present markets and products. While these are policies, they are also essential elements of major strategies. Perhaps one way to draw a meaningful distinction is to say that policies will guide a manager's thinking in decision making if a decision is to be made while a strategy implies the commitment of resources in a given direction.

(c) **Branding:** Branding removes anonymity and gives identification to a company and its goods and services. Branding is actually a very general term covering brand names, designs, trademarks, symbols, a distinctive letterhead; an identifiable shop front or van etc., which may be used to distinguish one organisation's goods and services from another's. According to Kotler, a brand is a name, term, sign, symbol or design or combination of them, intended to identify the goods or services of one seller or group of sellers and to differentiate them from those of competitors. Branding and a firm's reputation are heavily linked.

As appropriate branding is one of the most important activities in the area of marketing of products, especially consumer products, several decisions need to be taken with regard to brand selection and its use. These are:

**(1) Should the product be branded at all?**

The decision to brand or not to brand a product can be taken only after considering the nature of the product, the type of outlets envisaged for the product, the perceived advantage of branding and the estimated costs of developing the brand. Historically, it is found that brand development is closely correlated with the increase in the disposable income, the sophistication of the distribution system and the increasing size of the national market. The same trend is visible in India now. Several firms have started marketing branded products in such product categories as wheat,' flour and refined salt. The reason for such a trend is that a class of consumers are willing to pay more for uniform and better quality product represented by the brand.

**(2) Who should sponsor the brand?**

The question of sponsorship of a brand refers to the decision as to whether it should be a manufacturer's brand, also known as a national brand or a private brand, also known as a middlemen's brand. This is a major decision in most developed countries, where large chain/departmental stores dominate' the retail distribution system. This is however, largely a hypothetical question in India where retail distribution system is highly fragmented. Only super markets have started marketing a few products that are specially packed arid sold under their names. However, some retailers' brand names in product categories such as car accessories have already been established.

**(3) What quality should be built into the brand?**

A very crucial decision is with regard to the quality and other attributes to be built into the product. The matrix of such attributes will decide the product positioning. A marketer has the option to position his product at any segment of the market: top, bottom or the intermediate. Taking an example, "Ariel" is positioned as a premium quality and high priced product. At the other end of the scale, "Wheel" is positioned as low priced.

**(4) Should each product be individually branded or a family brand should be adopted for all the products?**

The marketer also has to decide at the' outset whether he would like to adopt a family brand under which all the products of the company would be sold or he would like to brand each product separately. Kissan follows the former policy. The same brand name is used for jam, squashes, juices and sauces. 'Hindustan Lever' follows the latter policy. Some firms follow a slightly modified strategy. This involves using brands individually but also giving prominence to the company name or logo in all promotional campaigns as well as in product packaging. For example, Tata group Companies follow this strategy. In many cases a brand extension strategy is adopted for securing additionally mileage from a particularly successful product. For example, 'Lifebuoy Gold' and 'Lifebuoy Plus' are extensions of 'Lifebuoy'.

**(5) Should two or more brands be developed in the same product category?**

A firm may decide to have several brands of the same product, which to some extent are competing inter se. The basic reason is that, at least in the consumer products, various benefits, appeals and even marginal differences between brands can win a large following. Example: 'Hindustan Lever' markets several soaps under different brands for different segments.

**(6) Should the established brand be given a new meaning (repositioning)?**

Over the life cycle of a product, several market parameters might undergo a change. All and each of such changes call for a relook as to whether the original positioning of the product is still optimal or not. Stagnating Or declining sales also point to a need for reassessment of the original product positioning. For example, 'Lifebuoy Soap' has been repositioned several times in the recent past.

**3. (a) How are dimensions as composite measures calculated in the Directional Policy Matrix? How is this matrix an improvement over the BCG matrix? 3+3=6**

**(b) Explain the use of Activity Based Cost Management to excel in business. 4**

**(c) Write short notes on any two: 5+5=10**

**(i) Reasons for conglomerate diversification with examples when it is appropriate**

**(ii) Kaizen Costing**

**(iii) The Channel levels of Marketing**

**Answer:**

3. (a) In the Directional Policy Matrix each dimension is a composite measure of several component factors. Industry attractiveness is a function of a number of factors. The procedure involves assigning each of the factors a weight depending on its perceived Importance, followed by assessing how each business compared on each factor using a 1 to 10 rating scale, and then computing a weighted composite rating. The choice of the factors and the weights assigned to the factors vary from business unit to business unit. The same approach is used to measure Business Strength where aspects relevant to competitive position are considered. Each of the dimensions is classified into three categories: high (strong); medium; low (weak); thus, creating nine cells.

This model is an improvement over the BCG matrix in the sense that while BCG matrix bases industry attractiveness on a single variable (industry growth rate), in this model Industry attractiveness is measured by a number of factors. Similarly, while the BCG matrix bases business growth entirely on relative market share, in this model, the business strength is rated by considering a number of factors. Also, the Nine cell model is a refinement of the four-cell BCG matrix (only high and low), which is too simplistic and in which the link between market share and profitability is not necessarily strong. Low share business can be profitable and vice versa.

(b) Activity Based Cost Management (ABCM) signifies a system which uses the data provided by Activity Based Costing (ABC) for various analysis to achieve continuous improvement. The use of ABC tool for managing costs at activity level is known as ABCM.

ABCM allows managers to examine non-value-added activities and make rational decisions to eliminate them. ABCM manages activities rather than resources. It supports business excellence by providing information to facilitate long-term strategic decisions about such phenomenon as product mix, process, line of business, product design, capital Investments, pricing, etc,

ABCM models business processes to determine cost, profitability and drivers. It allows product designers to understand the impact of different designs on cost and flexibility and then to modify their designs accordingly.

Further, ABCM focuses on management of activities as the route to improving the value received by the customers and the profit achieved by producing the value and new insights on performance management.

(c) (i) Unrelated diversification is known as Conglomerate Diversification in which there will be addition of dissimilar products or services to the existing line of business. The reasons underlying the use of Conglomerate diversification may be:

(1) to achieve a growth rate higher than what can be realised through expansion,
(2) to make better use of financial resources with retained profits exceeding immediate investment needs,
(3) to avail of potential opportunities of profitable investments,
(4) to achieve distinct competitive advantage and broader stability,
(5) to spread the risk or gain increased stability,
(6) to improve the price-earnings ratio and bring about a higher market price of shares.

An unrelated business which offers attractive investment opportunities as exemplified by organisations like Godrej, Reliance Industries, Hindusthan Machine Tools, etc. Conglomerate Diversification could be a good strategy where

(1) Basic industry is experiencing declining annual sales and profits.
(2) An organisation has capital and management talent required to compete in a new industry.
(3) There is some synergy between existing and proposed new areas of business (ITC in apparel/agri-business).
(4) Acquire an unrelated business which offers attractive investment opportunity (Kingfisher Airlines).
(5) Existing business is continuous threat of saturated demand (Generic chemicals, cigarette and phones, etc. business).
(6) When an organisation is subjected to environmental safety or pollution control or anti-trust law.

(ii) **Kaizen Costing**

A philosophy that sees improvement in productivity as a gradual and methodical process.

A method of costing that involves making continual, incremental improvements to the production process during the manufacturing phase of the product/service lifecycle, typically involving setting targets for cost reduction. Some of the key objectives of the Kaizen philosophy include the elimination of waste, quality control, just-in-time delivery, standardized work and the use of efficient equipment.

Kaizen is a Japanese term meaning "change for the better". The concept of Kaizen encompasses a wide range of ideas; it involves making the work environment more efficient and effective by creating a team atmosphere, improving everyday procedures, ensuring employee satisfaction and making a job more fulfilling, less tiring and safer.

An example of the Kaizen philosophy in action is the Toyota production system, in which suggestions for improvement are encouraged and rewarded, and the production line is stopped when a malfunction occurs.

(iii) **The Channel levels of Marketing**

Marketing channels can be characterised according to the number of channel levels. Each institution and persons who work to bring the product and its title to the point of consumption constitutes a channel level. Since both the producer and the ultimate consumer perform some work in bringing the product and its title to point of consumption, they are included in every channel.

There are numbers of intermediary levels to designate the length of a channel. The channel levels are as follows:

**(1) Zero-Level Channel: -** It is also called a direct marketing channel. It consists of a manufacturer selling directly to a consumer.
**(2) One Level Channel: -** It contains one selling intermediary. In consumer markets this intermediary is typically a retailer. In industrial markets, it is often a sales agent or a broker.
**(3) Two-Level Channel: -** It contains two intermediaries. In consumer markets they are typically a wholesaler and a retailer. In industrial markets they may be a sales agent and wholesaler.
**(4) Three-Level Channel: -** A three-level channel contains three intermediaries. An example is found in the meat packing industry, where a jobber usually intervenes between the wholesalers and the retailers. The jobber buys from

wholesalers and sells to the smaller retailers, who generally are not serviced by the large wholesaler.

**(5)** **Higher-Level marketing channels: -** They are also found, but with less frequency. From the producer's point of view the problem of control increases the number of levels, even though the manufacturer typically deals only with the adjacent level.

**4. (a) How can a management accountant contribute to the 'Financing Strategy' of an enterprise? 10**

**(b) As a newly appointed consultant for strategic management, you are required to make a presentation on the approaches to be adopted by the management. What are the steps that you would adopt for an effective case analysis? 6**

**(c) How would you resolve the conflicts relating to the goals of an organization? 4**

**Answer:**

4. (a) An Important task of the central management is to see that the capital necessary to execute the corporate strategy is provided at a reasonable cost and with minimum risk. In financing strategy, a finance manager has to decide about the optimal financing mix or make up of capitalisation in order to maximise earning per share and so also market value of shares. This involves detailed examination of some of the following vital factors:

(i) What sources of long-term funds should be tapped and in what proportion?
(ii) To what extent should long-term debt be resorted?
(iii) Should the firm take recourse to lease financing?
(iv) Should the firm employ trade credit as a means of financing and if yes, to what extent?

1. **Capital Structure Strategy**: Capital structure strategy provides framework for the makeup of a firm's long-term financing of debt, preferred stocks and equity stock. The central thrust of this strategy is on minimisation of cost of capital and maximisation of value of stocks. In formulating capital structure strategy for the firm, some fundamental financial principles, namely, cost, risk, control, flexibility and timing should be kept in view. According to the cost principle, ideal pattern of capital structure is one that tends to minimise cost of financing and maximise earning per share. From this angle, the debt should occupy a prominent place in the capital structure of a firm because it is the cheapest source of financing. The risk principle suggests that such a pattern of capital structure should be devised so that the firm does not run the risk of bringing on a receivership with all its difficulties and losses. Since a bond is a commitment for a long period, it involves risk. If income of the firm declines to such a low level that debt cannot be serviced, the bondholders in that case may foreclose and consequently, equity stockholders may lose part of all their assets. As against this, equity stock does not entail any fixed charges nor is the issuer under any legal obligation to pay dividends. The firm does not incur risk of insolvency. Thus, the risk principle places relatively greater reliance on common stock for financing capital needs of the firm.

   Finance manager should also consider the control principle. He has to choose a pattern that does not disturb the controlling position of residual owners. The use of preferred stock and also bonds offer a means of raising capital without jeopardizing control. Management desiring to retain control must raise funds through bonds, since equity stock carries voting rights, issue of new equity shares will dilute control of existing shareholders. The control principle, therefore, suggests that issue of equity shares should be avoided.

According to flexibility principle, an enterprise should strive toward achievements of such combination of securities which the management finds it easier to manoeuvre sources of funds in response to major changes in need of funds. Not only several alternatives are open for assembling required funds but the bargaining position of the firm is also strengthened while dealing with supplier of funds. For example, if a company is top heavy with debt and has mortgaged all its fixed assets to secure presently outstanding debt, it may subsequently find it difficult to obtain any loan further even though the market condition in respect of availability of debt is favourable because lenders feel shy about lending money to such a highly risky company. Accordingly, the company might be compelled to raise equity share capital at a time when there is scarcity of such capital in the market. Thus, for the sake of maneuverability the company should not assume more debt. Further, the management should, as far as possible, avoid getting cheaper loan on terms and conditions that limit the company's ability to procure additional resources.

Thus, we find that principles determining the choice of different sources of capital funds are antagonistic to each other. For instance, cost principle supports induction of additional doses of debt in the firm which may not be favoured from the risk of bankruptcy. Similarly, the control factor strongly supports the issue of bonds but the maneuverability factor discounts this step and favours the issue of common stock. Thus, to formulate appropriate strategy of capital structure of the company, finance manager has to bring about a satisfactory compromise among these conflicting principles. This compromise is to be reached by assigning weights to these principles in terms of economic and industrial characteristics as also in terms of specific characteristics of the company.

2. **Debt Strategy**: Determination of optimal level of debt is one of the most crucial but difficult decisions which a finance manager has to make. Because of tax deductibility of interest payments, use of financial leverage (i.e., use of fixed cost fund in long-term financing) increases the potential earnings of the owners. However, the firm is required to bear increasing costs — explicit and implicit — in borrowing funds owing to increased financial risk. Upto a certain limit tax benefits of leverage tend to be higher than the costs associated with debt financing. Beyond that limit cost of debt begins to outweigh the tax benefits. Debt limit should be fixed at this point because total value of the firm stops rising with leverage. Economists call this level as optimal level of debt. The finance manager has to find this level. Decision in this regard involves a tradeoff between opposite factors of risk and return.

   There are number of techniques that can help a finance manager to resolve this problem. None of these approaches can be considered satisfactory in so far as the determination of optimal level of debt is concerned. However, they equip the finance manager with adequate information for making a rational decision.

   EBIT-EPS analysis is one of the widely employed methods to determine the most appropriate level of debt. Through this analysis finance manager seeks to compare alternative methods of financing under various assumptions regarding EBIT and obtain indifference level of leverage. Indifferent point refers to the EBIT level at which EPS remains unchanged irrespective of debt-equity mix. Given the total amount of capitalisation and interest rate on bonds a firm reaches indifference point when it earns exactly the same amount of capital which it has promised to pay on debt.

   Another potent tool for comparing financing alternatives is to compute Coverage

Ratios.

They provide a measure of safety of interest payment or whatever specific commitment is being made. They prescribe the limit up to which debt can be resorted to without endangering the solvency of the firm. The coverage ratio is computed by dividing EBIT by interest charges.

By comparing the firm's debt-equity ratio with industry norms, suitable level of debt can be determined. If on comparison, the management finds that it has lower proportion of debt to total capitalisation in relation to industry average, it can raise further debt so long as its own ratio is equal to the average ratio.

**Refunding:** Another strategy aspect of long-term debt is refunding of debentures. Refunding is the device of substituting old bonds by new bond issue. Before deciding about refunding on outstanding bonds a finance manager must determine whether or not refunding is profitable. For this, he must match cost of refunding with receipt resulting from it. It is only when receipts exceed costs; he should proceed with refunding operation. Redemption is another device of avoiding the deleterious effects of debt or to eliminate debt with unduly restrictive convenants. Redemption is the actual paying off the debt represented by bond. This is possible only when bond issue contains all privilege giving the firm the option to buy back the bonds at a stated price before their maturity. The bond indenture provides the prices which a firm will pay to the bondholder for a bond called for redemption before their maturity. Generally, this redemption price is greater than the par value of bond. The actual price is set after taking into account par value of the bonds plus a reasonable premium.

The management may sometimes convert bonds into stocks in order to get rid of bonded indebtedness and the fixed obligations associated with it. The conversion is exercised generally at the opinion of the bond holders. However, the company may force conversion at a time when it is more profitable for bondholders to convert rather than surrender the bonds and receive cash. Before deciding about conversion, finance manager must examine the impact of the transaction on the market value of the stock as the decision criterion.

3. **Strategy on Lease Financing:** Leasing is an arrangement under which a company acquires that right to make use of an asset without holding the title to it. Since leasing represents an alternative to ownership, it can be regarded as a specialised means of gathering funds. In exchange for use of the asset, a company can issue a claim against its future cash flows, long-term debt, equity or lease obligations. Viewed in this sense, leasing is strictly a financing decision.

   The leasing decision involves choosing between leasing and owning for the purpose of securing the senders of fixed assets. This calls for comparison of financial costs of borrowing necessary funds to purchase assets. If cost of the leasing is found higher than cost of borrowing, it would be in the interest of the firm to buy the asset and borrow for it. The leasing strategy should be formulated after evaluating the two alternatives, i.e., leasing and borrowing. The evaluation process consists of seven steps, namely, calculation of savings for investment allowance, calculation of after-tax cost of owning, calculation of after-tax lease cost, calculation of present value of cost of owning and leasing, and comparison of present value of owning cost with present value of leasing.

   **Formulating Dividend Policy:** Dividend decision should be formulated in such a way as to optimise price of the firm's share in the market. The split between retention and dividend should be such as to attract potential investors and raise the market price to the highest attainable level. In formulating a policy regarding determination of amount of dividends to be paid out to the stockholders, careful consideration of a myriad of factors is necessary. The management should bear in mind environmental factors such as general condition of economy, state of capital market, state regulation and tax policy. If there is a depression in economy, the management may withhold dividend payments to retain larger income in order to preserve the firm's liquidity position in all times.

During periods of prosperity, the management may not always be liberal in dividend payment although earning power of the firm warrants it. This may be due to the management's inclination to exploit attractive investment opportunities which crop up during times of prosperity. Similarly, if the state of capital market is relatively comfortable and raising funds from different sources poses no problem, the management may be tempted to declare high dividends to maintain the confidence of existing stockholders and attract potential ones. But in the event of decline in the stock market when investors are indifferent towards buying securities, the management should adopt a strict dividend policy to tide over the current financial turmoil. Management should also keep in view rules and regulations.

A number of internal factors such as company's investment opportunities and stockholders' preferences, stability of earnings, growth rate, access to capital market, liquidity position of a company and its fund requirements, repayment of debt, restrictions in debt agreements and control should also be kept in mind while deciding dividend rate. Thus, a company with an array of profitable investment opportunities in hand and stockholders having strong preference for long-term gains have no alternative but to retain larger portion of earnings to finance investment projects. However, management will be in dilemma if the company has a number of potential investment proposals but stockholders have a strong preference for a dividend income. In such a situation, it is necessary to balance the net preference of stockholders against differential cost of retained earnings and net stock financing before deciding about the dividend rate.

Size of dividend is affected by stability of earnings. A company with stable level of earnings will pay stable dividend. The principle of conservation need not be followed by such a company. In contrast, a company with fluctuating earnings must retain a larger share of income during boom periods in order to ensure that the dividend policy is not affected by the business cycle.

A company's growth fate is influenced by the dividend decision. Hence, the growth factor should receive a due attention from the management while taking dividend decision. A rapidly growing concern will need a regular supply of long-term funds to seize upon favourable opportunities and for that purpose it may find it expedient to finance a greater part of its expansion. Therefore, strategy of such company will be to keep dividend at a minimum level.

(b) The approach for an effective presentation of Case Analysis on strategic management deserves careful preparation which should involve the following steps:

(a) **Allow adequate time in preparing a case:** Many of the cases involve complex issues that are often not apparent without careful reading and purposeful reflection on the information in the cases.

(b) **Reference to each case to be made at least twice:** Due to involvement of complex decision making processes, the respective cases should be read at least twice, once for an overview of the organisation's unique circumstances and on next reading for allowing the reader to concentrate on the most critical issues and to appreciate the most important information to be considered for the purpose.

(c) **Key strategic issues in each case to be highlighted**: Efforts to be made to emphasise on the key strategic issues involved in each case for which such cases might be required to be studied over and over again.

(d) **To give proper attention to exhibits:** The exhibits in such cases need to be considered an integral part of the presentation. In many cases, analysis of financial data, evaluation of organisational charts and understanding the firm's products arid/or services are presented in the form of exhibits.

(e) **Adoption of appropriate time frame:** The presentation should relate to appropriate time frame which is relevant for the organisation to act upon.

(f) **Discussion of alternatives:** The proper strategic management sequence should be followed by (1) identifying .alternatives, (2) evaluating each alternative, and (3) recommending the alternative that is considered to be the best.

(g) **Specific recommendations:** Specific recommendations are to be developed logically and to make sure that such recommendations are well defended with cogent reasons.

(h) **Mode of implementation:** The analysis should also include suggestions as to how the recommendations are to be implemented including some of the specific actions needed to achieve the desired objectives.

(c) **Resolving conflicting objectives:**

Existence of a corporate body in an environment bounded by social, political, economic and technological developments is bound to have competing objectives arising out of the following:

Balancing between profit maximization and social responsibilities
Incongruence between goals of different stake holders
Mismatch of Internal Goals.

These problems are usually resolved by adopting the following techniques:

**Ranking**: Managements can rank the various priorities and try to achieve a balance through setting particular levels of achievement, e.g., a target level for ROCE, as against a target for pollution control expenditure to meet their social responsibilities to the society.

**Weightage:** The above ranking can be made more meaningful by according different weights to the priorities, and the weighted score can be compared.

**Composite Measures**: Effective tools like balancing score card can be used to gauge the impact of performance both physically and financially. Formulation of goals should also take into account following responsibilities arising out of: ethical, discretionary, legal and economic areas. The ethical approach dictates what the company should do while the discretionary approach leaves enough elbow room. The legal responsibility lays down what the company has to do. While the economic obligations determine "the must do objectives".

**Section - II (40 Marks)**

**(Risk Management)**

**Question No. 5 is compulsory.**
**Answer any two questions from the remaining three questions.**
**(Please answer all parts to a question at one place.)**

**5. (a) Choose the most appropriate alternative from the four alternatives given. (Answer any five) 1x5=5**

**(i) The following is not a risk assessment technique:**
(A) Questionnaires and Checklists
(B) Flowcharts
(C) SWOT and PESTLE analyses
(D) Risk Appetite

**(ii) The following is not a legal principle of insurance:**
(A) Insurable Interest
(B) Subrogation
(C) Probability
(D) Indemnity

**(iii) Risk is defined as**
(A) A variation from the actual.
(B) A possible event.
(C) Uncertainty concerning loss.
(D) A certain loss.

**(iv) Variability on return on investment in the market is referred to as**
(A) Physical risk
(B) Business risk
(C) Market risk
(D) Pooling risk

**(v) The following is not risk transfer:**
(A) Life insurance
(B) Self insurance
(C) Theft of property insurance
(D) Personal liability law suits

**(vi) The following does not come under general insurance:**
(A) Fire policy
(B) Burglary policy
(C) Life policy
(D) Contractor's all-risk policy

**(b) State whether the following statements are 'TRUE' or 'FALSE', justifying your answer. If a statement is false, give the correct term. (No marks will be given if there is no justification). 1x5=5**

**(i) Product Liability policy is one of the products of Industrial Insurance.**
**(ii) Dynamic risks, which can be either pure or speculative stem from an unchanging society that is in stable equilibrium.**
**(iii) Interest rate risk is the uncertainty of the purchasing power of the monies to be received in future.**
**(iv) The insured must have an insurable interest at the time of effecting a marine insurance policy.**
**(v) Knock-for-Knock agreement relates to a motor insurance policy relating to taxi services.**

**Answer:**

5. (a) (i) (D) Risk Appetite
   (ii) (C) Probability
   (iii) (C) Uncertainty concerning loss
   (iv) (C) Market risk
   (v) (B) Self insurance
   (vi) (C) Life policy

   (b) (i) False - Product Liability policy is a product of Indemnity Insurance.
   (ii) False - Static risks can be either pure or speculative, stem from an unchanging society that is in stable equilibrium.
   (iii) False - Purchasing power risk is the uncertainty of the purchasing power of monies to be received in future.
   (iv) False - an Insured need not have an insurable interest at the time of effecting marine insurance policy.
   (v) False - a knock-for-knock agreement is entered into among the insurers writing motor insurance covering all vehicles except that play for hire or reward.

**6. (a) Explain the concept of 'risk adjusted return on capital' (RAROC). 6**
**(b) What is pure risk? What are the major types of pure risk that affect business? Explain some common features of pure risk. 2+2+5=9**

**Answer:**

6. (a) The expanded expression of the term RAROC is 'Risk Adjusted Return On Capital', a target Return On Equity (ROE) measure in which the numerator is reduced depending on the risk associated with the instrument or project.

RAROC - expected net income divided by economic capital. Economic capital signifies market value of assets minus fair value of liabilities. Used in practice as a risk-adjusted capital measure; specially, the amount of capital required to meet an explicit solvency constraint (e.g., a certain probability of ruin)

RAROC is typically used to evaluate the relative performance of business segments that have different levels of solvency risk; the different levels of solvency risk are reflected in the denominator. Evaluating financial performance under RAROC calls for comparison to a benchmark return; when the benchmark return is risk-adjusted (e.g. for volatility in net income), the result is similar to RARORAC (meaning Risk Adjusted Return On Risk Adjusted Capital) though the term RAROC is still applied.

(b) The risk that can be insured is generally referred to as pure risk. The risk management function has traditionally focused on the management of pure risk.

The major types of pure risk that affect businesses include:

(1) **Property Risk:** The risk of reduction in value of business assets due to physical damage, theft, and expropriation (i.e., seizure of assets by foreign governments).
(2) **Legal Liability Risk:** The risk of legal liability for damages for harm to customers, suppliers, shareholders, and other parties.
(3) **Other Risks:**
- The risk associated with paying benefits to injured workers under workers' compensation laws and the risk of legal liability for injuries or other harms to employees that are not governed by workers' compensation laws.
- The risk of death, illness, and disability to employees (and sometimes family members) for; which businesses have agreed to make payments under

employee benefit plans, including obligations to employees under pension and other retirement savings plans.

- The risk of loss of services of one of key personnel on resignation/death.

Some common features of pure risk include the following:

(1) **Huge potential losses:** Losses from destruction of property, legal liability, and employee injuries or illness often have the potential to be very large relative to a business's resources. While business value can increase if losses from pure risk turn out to be lower than expected, the maximum possible gain in these cases is usually relatively small. In contrast, the potential reduction in business value from losses greater than the expected value can be very large and even threaten the firm's survival.

(2) **Pure risks are controllable**: The underlying causes of losses associated with pure risk, such as the destruction of a plant by the explosion of a steam boiler or product liability suits from consumers injured by a particular product, are often largely specific to a particular firm and depend on the firm's actions. As a result, the underlying causes of these losses are often subject to a significant degree of control by businesses; that is, firms can reduce the frequency and severity of losses through actions that alter the underlying causes (e.g., by taking steps to reduce the probability of fire or lawsuit).

(3) **Insurability:** Pure risks can be insured. Businesses commonly reduce uncertainty and finance losses associated with pure risk by purchasing contracts from insurance companies that specialize in evaluating and bearing pure risk. The prevalence of insurance in part reflects the firm-specific nature of losses caused by pure risk. The fact that events that cause larger losses to a given firm commonly have little effect on losses experienced by other firms facilitates risk reduction by diversification, which is accomplished with insurance contracts.

(4) **Lower probability:** The probability of occurrence of pure risk is low and less frequent In contrast the frequency and probability of occurrence of financial risk is high. For example, the fluctuations in the price of a commodity in the market place may be more frequent compared to the frequency of loss of stock of commodity itself.

(5) **Not associated with offsetting gains:** Losses from pure risk usually are not associated with offsetting gains for other parties. In contrast, losses to businesses that arise from other types or risk often are associated with gains to other parties. For example, an increase in input prices harms the purchaser of the inputs but benefits the seller. Likewise, a decline in the rupees value against foreign currencies can harm domestic importers but benefit domestic exporters and foreign importers of Indian goods.

**7. Write short notes on any three: 5+5+5=15**

**(a) Risk reporting as an important step in risk management**
**(b) Cross Currency Option in India**
**(c) Statistical concepts used in risk measurement**
**(d) Characteristics of an insurance contract distinct from other contracts**

**Answer:**

7. (a) **Risk Reporting as an important step in Risk Management**

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 of Enron as well as other corporate failures. Existence of an adequate Risk Reporting System in an organisation makes the managers more accountable for their actions. In the light of this, the importance of risk reporting system can be summarised 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) **Cross Currency Option in India**

(1) A person resident in India may enter into a cross currency option contract (not involving the rupee) with a bank in India to hedge foreign exchange exposure arising out of his trade: Provided that in respect of cost-effective risk reduction strategies like range forwards, ratio-range forwards or any other variable by whatever name called, there shall not be any net inflow of premium. These transactions may be freely booked and/or cancelled.

(2) Cross currency options should be written on a fully covered back-to-back basis. The cover transaction may be undertaken with a bank outside India, an off-shore banking unit situated in a Special Economic Zone or an internationally recognised option exchange or another bank in India.

(3) All guidelines applicable for cross currency forward contracts are applicable to cross -currency option contracts also.

(4) Banks desirous of writing options, should obtain a one-time approval, before undertaking the business, from RBI.

(c) **Statistical Concepts:**

(i) Theory of probability, probability of loss is used to predict future losses.

(ii) Mean – gives the expected value of a certain risk or loss.

(iii) Standard deviation ($\sigma$) – measures how close a group of individual measurements is to its mean.

(iv) Theoretical probability distribution.

(v) Law of large numbers – As the number of exposure units increases, degree of risk decreases. (e.g.; insurance)

(vi) Game theory – To maximize gain or minimize risk or regret.

(d) **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 as 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 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.

**8. (a) A company has a choice among three products A, B and C for which the following estimates are available:**

**Estimated profits based on demand forecast (₹ '000)**

| | **Market X** | **Market Y** | **Market Z** |
|---|---|---|---|
| **Product A** | **380** | **100** | **30** |
| **Product B** | **300** | **280** | **220** |
| **Product C** | **220** | **400** | **320** |

**(Probabilities are: X = 0.6, Y = 0.2, Z = 0.2)**

**Which project should be undertaken by the Company? 6**

**(b) What are the regulatory objectives of insurance rates? 3**

**(c) What are the pre-loss and post-loss objectives of risk management? 6**

**Answer:**

8. (a) In order to answer the question, it is desirable to take the help of a pay-off matrix which in turn demands the identification of the elements. e.g.; profits, events (demand), probabilities, actions (products A, B or C), outcomes represented by Expected Values (EVs).

| | | Profit (₹ '000) | Probability | Expected Value (₹'000) |
|---|---|---|---|---|
| Product A | X | 380 | 0.6 | 228 |
| | Y | 100 | 0.2 | 20 |
| | Z | 30 | 0.2 | 6 |
| | | | | 254 |
| Product B | X | 300 | 0.6 | 180 |
| | Y | 280 | 0.2 | 56 |
| | Z | 220 | 0.2 | 44 |
| | | | | 280 |
| Product C | X | 220 | 0.6 | 132 |
| | Y | 400 | 0.2 | 80 |
| | Z | 320 | 0.2 | 64 |
| | | | | 276 |

From the above matrix it is evident that Product B having the maximum EV of ₹ 2,80,000 should be selected.

(b) The goal of insurance regulation is to protect the public. The states have rating laws that require insurance rates to meet certain standards. In general, rates charged by insurers must be adequate, not excessive, and not unfairly discriminatory.

(c) **Objectives of risk management**

Risk management has important objectives. These objectives can be classified as follows:

- Preloss objectives
- Postloss objectives

**Preloss Objectives**:

Important objectives before a loss occurs include economy, reduction of anxiety, and meeting legal obligations. The, first objective means that the firm should prepare for potential losses in the most economical way. This preparation involves an analysis of the cost of safety programs, insurance premiums paid, and the costs associated with the different techniques for handling losses.

The second objective is the reduction of anxiety. Certain loss exposures can cause greater worry and fear for the risk manager and key executives. The final objective is to meet any legal obligations.

**Postloss Objectives**:
Risk management also has certain objectives after a loss occurs. These objectives include survival, continued operation, stability of earnings, continued growth, and social responsibility.

The most important postloss objective is survival of the firm. Survival means that after a loss occurs, the firm can resume at least partial operations within some reasonable time period. The second postloss objective is to continue operating. For some firms, the ability to operate after a loss is extremely important. The third postloss objective is stability of earnings. Earnings per share can be maintained if the firm continues to operate. However, a firm may incur substantial additional expenses to achieve this goal (such as operating at another location), and perfect stability of earnings may not be attained.

The fourth postloss objective is continued growth of the firm. A company can grow by developing new products and markets or by acquiring or merging with other companies. The risk manager must therefore consider the effect that a loss will have on the firm's ability to grow. Finally, the objective of social responsibility is to minimise the effects that a loss will have on other persons and on society. A severe loss can adversely affect employees, suppliers, creditors, and the community in general.