FINAL EXAMINATION

GROUP III

(SYLLABUS 2008)

SUGGESTED ANSWERS TO QUESTIONS

JUNE 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.
Answer Question No. 1 and any other two more from the rest in this section.
(Please answer all part of the question at one place.)

Section -I (60 Marks)
(Strategic Management)

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

(i) For an actor in Bollywood, his outstanding performance would be a/an
(A) Asset
(B) Strategic asset
(C) Core competency
(D) Capability

(ii) As per Peter F. Drucker, father of management principles, mission to give answers to following except
(A) Present business
(B) Present customer
(C) Values to be delivered to customers to secure their delight
(D) Business our competitor want to develop
(E) Business we ought to take up

(iii) Which of the following market structures would be commonly identified with FMCG products?
(A) Monopoly
(B) Monopolistic competition
(C) Oligopoly
(D) Perfect competition

(iv) During Diwali seasons, the manager of Samsung at the Ranchi branch office may be in a dilemma to offer discount to the customer. There may not be any explicit policy to guide him. But to meet competition in local market situation where competitors offer discounts, top management, on the basis of an appeal made by the branch manager may allow him to offer discount. This is an example of
(A) Originated policies
(B) Appealed policies

(C) Externally imposed policies
(D) Implied policies

(v) By changing the value of different variables in the model, a number of different scenarios for the future will be produced. For example, wage increases can be altered to 10% from 5%; demand for a product can be reduced from 1,00,000 to 80,000 units the introduction of new processing equipment can be deferred by six months, on the revised assumption that there will be delays, and so on are a good example of
(A) Cost benefit analysis
(B) Risk analysis
(C) Parity analysis
(D) Sensitivity analysis

(vi) The introduction of 'Nano' by Tata Motors could be viewed as a good example of
(A) Price leadership
(B) Cost leadership
(C) Product leadership
(D) Technology leadership

(vii)A publisher of school books approach a publisher of college and/or university level books to establish a benchmarking relationship. This is an example of
(A) Intra-group benchmarking
(B) Inter-industry benchmarking
(C) Internal benchmarking
(D) Process benchmarking

(viii)A Strategic Business Unit (SBU) is defined as a division of an organisation
(A) that helps in the marketing operation
(B) that enables managers to have better control over the resources
(C) that helps in the choice of technology
(D) that helps in the allocation of scarce resources
(E) that helps in identifying talents and potentials of people

(ix) In the context of Strategic Management the term 'Portfolio Planning' implies
(A) the art and science of making decisions about investment mix and policy
(B) the choice of investments in debt vs equity for maximising returns
(C) developing a relationship between prices, cost and volume of business
(D) identification of current strengths and weakness of an organisation's products in the markets and the strategy needed to improve upon such a state

(x) Airtel basically a phone company decided to go into Direct to Home (DTH) television business, as there is no direct fit with the existing business. This is a good example of
(A) Related diversification
(B) Conglomerate diversification
(C) Distinctive capacity
(D) Financial analysis
(E) Sales value

(xi) The Flanking Warfare is
(A) one where the players in a marketing war would be fighting in the market place like the guerrillas
(B) the most innovative from marketing warfare
(C) finding a weakness in the leader's strength and attack at that point

(D) essentially recommended for market leaders

(b) State whether the following statements, based on the quoted terms, are 'TRUE' or 'FALSE' with justifications for your answer. If any statement is false, you are required to give the correct terms, duly quoted. No credit will be given for any answer without justification: 1x5

(i) 'CVP' model is a simple break-even model.
(ii) Market growth and market share are assumed to be reliable pointers for cash flow. High market share mean high profits, especially if a firm has high costs, or has bought market share by low pricing.
(iii) A stakeholder is a person or organisation that has an interest in an enterprise.
(iv) 'Leverage takeover' is achieved using a high proportion of debt.
(v) 'PIMS' analysis attempts to establish the profitability (i.e. return on capital) of various marketing strategies.

(c) Define the following terms (in not more than two sentences): 1x5

(i) Make-or-buy decision
(ii) Scenario building
(iii) Corporate vision
(iv) Debt strategy
(v) Technical products

Answer:

1. (a) (i) (C) Core competency
(ii) (D) Business our competitor want to develop
(iii) (B) Monopolistic competition
(iv) (B) Appealed policies
(v) (D) Sensitivity analysis
(vi) (B) Cost leadership
(vii) (B) Inter-industry benchmarking
(viii) (B) That enables managers to have better control over the resources
(ix) (D) Identification of current strengths and weakness of an organisation's products in the markets and the strategy needed to improve upon such a state
(x) (B) Conglomerate Diversification
(xi) (B) The most innovative from a marketing warfare.

(b) (i) True: Break-even analysis is based on 'Cost-volume profit' analysis.
(ii) False: High market share does not necessarily mean high profits, especially if a firm has high costs, or has bought market share by low pricing.
(iii) True: A stakeholder is a person or organisation that has an interest in an enterprise.
(iv) True: 'Leverage takeover' or 'Leveraged buyout' is achieved when a company or single asset is purchased with a combination of equity and significant amounts of borrowed money, structured in such a way that the target's cash flows or assets are used as the collateral to secure and repay the money borrowed to purchase the target-company/asset.
(v) True: PIMS analysis attempts to establish the profitability (i.e., return on capital) of various marketing strategies. PIMS analysis is more relevant to industrial goods markets.

(c) (i) The decision about whether to produce parts and equipments in-house or to sub-

contract work to external suppliers" is referred to as the 'make-or-buy decision'. The direct comparison of in-house costs with supplier's prices is only one factor in the make-or-buy equation.

(ii) Scenario building is used in strategic planning. It can be described as the process of identifying alternative futures, i.e. constructing a number of distinct possible futures permitting deductions to be made about future developments of markets, products and technology.

(iii) Corporate vision represents a corporate dream which will have to achieve over a long time horizon. This is contained in a single sentence embracing the corporate ambition to excel in the defined area.

(iv) Determination of optimal level of debt because of tax deductibility of interest payments, use of financial leverage, increases the potential earnings is one of the most crucial decisions which a finance manager has to make.

(v) Technical product – such as conveyor system and electronic data processing equipment – call for much technical selling, expert installation, and servicing. Wholesalers often are not interested in or able provide all these required services.

2. (a) Why 'environmental scanning' is necessary in corporate planning? How it helps the management?

(b) Write three consumer dimensions for identifying Strategic Business Unit (SBU).

(c) Write five reasons for stagnation in traditional approach to organisational structure

(d) How company's strategic intent can help the company? (4+4)+3+5+4

Answer:

2. (a) Environmental scanning is an important step out of five major steps of corporate planning. Environmental scanning is referred as the basic monitoring system. The business environment is scanned to secure up-to-date information on opportunities and threats revealed by the changing environmental forces, such as customer needs, competition, economic, social-cultural, political climate, ecology, technology and others.
There are two types of environmental scanning :
(i) Internal environmental scanning, and
(ii) External environmental scanning.
Both offer us the SWOT. Marketing information and research enable us to scan external environment. The sales audit and cost analysis enable us to study internal environment.

Environment appraisal enables the management to predict future development to make the invisible more visible and, thus, lessen the uncertainty about the future in the face of spectacular, powerful and rapid environmental changes. Those who foresee the critical changes that affect the firm will have a far better chance of being successful than those who will not be able to do so.

Thus, the management has to search the environment to determine which factors pose threat to the firm's present product-market strategy and accomplishment of

objectives and which environment forces present opportunities for greater accomplishment of objectives by adjusting the firm's current strategy. No organisation can afford to ignore changes in technology, competitive environment, government policy or changes in social values. If it does not react to the demands of the environment by changing its strategy, it is counting decline or extinction.

Input-output relationship between a firm and environment also necessitates environmental scanning. A firm, in order to function, must produce various inputs as human, capital, managerial, and technical from the environment. These inputs are then converted into goods and services and made available to those living in the environment. Thus, firm's operations regarding acquisition of quantum and kinds of input and distribution of output are subject to environmental influences.

The management must also scan the environment of home as well as host countries so as to find out what are the diverse claims and expectations of different sections of the society which the firm has to fulfill in order to be socially acceptable. These claims need to be accorded due weightage while formulating overall as well as subsidiary level objectives, policies and strategies.

(b) Three consumer dimensions for identifying Strategic Business Unit (SBU) are:
   (i) Customer needs to be met.
   (ii) Group of customers to be served.
   (iii) Product or service to fulfill those needs.

(c) The main reasons for stagnation of organisational structure are:
   (i) Competition
   (ii) Total economic recession
   (iii) International economic slowdown situation
   (iv) Globalisation and its adverse impact
   (v) Free imports and hence affecting the growth of the home industries

(d) A company's strategic intent can help the company in many ways like:
   (i) In becoming the dominant company in the industry.
   (ii) Unseating the existing industry leader.
   (iii) Delivering the best customer service in the industry (or the world)
   (iv) Turning new technology into products which capable of changing the way people work and live.

3. (a) The SWOT analysis is simple and useful tool of environmental analysis. Highlight its application for an Indian bulk drug company.

(b) What are the limitations of SWOT analysis in the context of a growth oriented company?

(c) Show how PLC is related to marketing strategy and marketing planning.

(d) What do you understand by the term 'benchmarking'? Distinguish between 'intra-group benchmarking' and 'inter-industry benchmarking'. 8+2+4+(2+4)

Answer:

3. (a) A critical assessment of the strength and weakness, opportunities and threats in

relation to the internal and environmental factors affecting an entity is needed. It is also known as SWOT analysis.

A typical SWOT analysis of an Indian bulk drug company is given below:

Strengths:
- Excellent reputation for quality of products.
- Best production yields and raw material consumption ratios.
- Trained manpower.
- Fully balanced and integrated production facilities.
- Adequate working capital arrangements
- Marketing tie-up with reputed formulation units.

Weakness:
- No patented technology or production process.
- Very little in-house R&D.
- No marketing skill within the organisation.
- Location in a backward area.
- Dependence on imported raw materials.

Opportunities:
- Growth in Medicare.
- Expanding export market.
- Scope for backward integration.
- Scope for obtaining approval for patent from USA.

Threats:
- Very few entry barriers.
- Too much cut-throat competition.
- Severe fluctuation in foreign exchange rates.
- Formulation subject to price control.

(b) Limitations of SWOT analysis:

- SWOT analysis enables a manager to present a picture before it chooses any strategy. Such assessment clarifies the perspective of the company at a given point of time.

- SWOT analysis offers a static picture of the company in relation to some specific environmental condition. It lacks the analytical rigor. It is also language sensitive. However, any growth oriented company needs to have direction plan or a set of exact strategies. This cannot be formulated on the basis of SWOT analysis.

(c) The interesting thing about Product Life Cycle (PLC) is that it occupies an important place in the long run planning and strategies for marketing. When the product reaches growth stage, economies of scale are realised and the costs go down.

At maturity stage the products need constant improvement of functions style, design, packaging, etc. If the competitors adopt intensification of advertising, the management concerned must also follow the same policy.

Philip Kotler observes that PLC must be considered in relation to marketing strategy and so all the four stages of PLC must be different from one stage to another. Depending upon the stages of PLC, strategies of promotion/product modification /product improvement/advertising, etc. must have to be carefully formulated and

adopted.

PLC, marketing strategy and marketing planning are interrelated and go hand in hand. The external environment variables such as competition, technology changes, consumer perception and behaviour, population changes, international environment, etc. are needed to be considered for marketing planning as well as marketing strategy and understanding of their impacts on PLC. These can be done by proper market research and market surveys. Thus, we find a correlation between PLC and planning for marketing operations and marketing strategy in long-run.

(d) The Benchmarking is a powerful tool for continuous improvement in performance. It involves comparing firm's products, services or activities against other best performing organisations, either internal or external to the firm. The objective is to find out how the product, services or activity can be improved and ensure that the improvements are implemented.

In Intra-group benchmarking the groups of companies in the same industry agree that similar units within the cooperating companies will pool data on their process. The processes are benchmarked against each other at or operational level.

In Inter-industry benchmarking a non-competing business with similar process is identified and asked to participate in a benchmarking exercise. For example, a publisher of schoolbook may approach a publisher of college/university level books to establish a benchmarking relationship. Although two publishers are not in direct competition but there are obviously many similarities in their business with respect to sources of supply, distribution channels, etc.

4. (a) As CMA you need to anticipate future trends and new developments that may change the existing market and industry structure. In this reference explain the distinction between market and industry.

(b) Hindusthan Unilever Limited (HUL), the Indian subsidiary of Unilever, was the country's largest FMCG Company. HUL had extended many of its popular brands with varying degree of success. After a phase of stagnant growth for over a decade, HUL decided to re-position 'Lifebuoy' from health bar soap to up-market family bath soap. It also extended its product range to give new life to 'Lifebuoy".
As CMA working in HUL you have to take five specific decisions with regerd to brand selection and its use in Indian context.

(c) Write 5-tools of Total Cost Management.

(d) Write short note on 'The Ansoff Matrix'. 5+5+5+5

Answer:

4. (a) The initial analysis of industry structure provides a snap of the competitive environment. The Distinction between market and industry:

(i) The market comprises customers or potential customers, having needs, and which are satisfied by a product or services.
(ii) The industry comprises those firms which use a particular competence, technology, product or service to satisfy customer needs.
(iii) An individual company might be found in any of the following situation:

- One industry, one market
- Two or more industries, one market
- One industry, two or more markets
- Two or more industries, two or more markets

Of course, the boundaries between individual industries and between individual markets are not hard and fast. Porter makes a distinction between two groups of factors, like:
A. Environmental factors that characterise the nature of competition in one industry compared with another. Example: in the chemical industry compared to clothing retail industry - and make one industry as a whole potentially more profitable than another.
B. Factors that characterise the nature of competition within-a particular industry, these relate to the competitive strategies that individual firms might select.

(b) Branding removes anonymity and gives identification to a company and its goods and services. 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 uses. These are:

(i) 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, type of outlets envisaged for the product, the perceived advantage of branding and the estimated costs of developing the brand.

(ii) 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 national brand or a private brand, also known as middlemen's brand. This is a major decision in most developed countries, where a large chain/departmental store dominate the retail distribution system. However, some retailers' brand names in product categories such as car accessories have already been established.

(iii) 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 market has the option to position his product at any segment of the market: top, bottom or the intermediate.

(iv) 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. For example, "Kissan" follows the former policy. The same brand name is used for jam, squashes, juices, and sauces. HUL 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 Groups Company follows this strategy.

(v) Should two or more brands be developed in the same product category?
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: HUL markets several soaps under different brands for different segments.

(vi) 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 need for reassessment of the original product positioning. For example, "'Lifebuoy Soap" has been repositioned several times in the recent past.

(c) Introduction of Total Cost Management strategy can embrace many different areas in business and as such there are specific tools to be employed for the implementation as follows:

(i) Enterprise wise cost system: Depicts beginning to end costs starting from designing, sourcing. manufacturing and delivering a product or set of products to the customer.

(ii) Production cost management: Aims at reduction of total cost of design, material management, and production by Kaizen method of optimising each cost component.

(iii) Marketing cost management: Identifies products, brands, segments and markets that predict greater growth least incremental marketing costs.

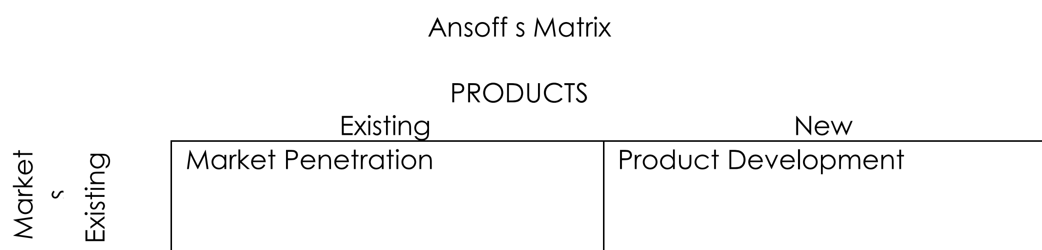
(iv) Support cost management: Aims at improving productivity and efficiency of all line functions while reducing the resources needed to provide such improvements.

(v) Transformation cost management: Identifies and drives the efforts of change management towards avenues where they will have the maximum impact on costs.

(d) A successful market must develop its products and markets, if it avoids eventual extinction. This calls for strategic decisions about product market development and manufacturing.

Ansoff drew up a growth vector matrix, describing a combination of a firm's activities in current and new markets, with existing and new products, he was mainly interested in growth, but firms in declining industries may wish to scale down their operations in existing markets products areas. This is outlined in Figure as below:

Ansoff s Matrix



Markets	PRODUCTS: Existing	PRODUCTS: New
Existing	Market Penetration	Product Development

New	Market Development	Market Diversification ➢ Related ➢ Unrelated

Market Penetration Strategy: Firms increase its sales in its present line business. This can be accomplished by:
(i) Price reduction;
(ii) Increase in promotion and distribution support;
(iii) Acquisition of a rival in the same market;
(iv) Modest product refinements.

Product Development Strategy: This involves extending the product range available to the firm's existing markets. These products may be obtained by:
(i) Investment in research and development of additional products;
(ii) Acquisition of rights to produce someone else's product;
(iii) Buying in the product and "branding" it;
(iv) Joint development with ownership of another product who need access to the firm's distribution channels or brands.

Market Development Strategy:
(i) Different customer segments;
(ii) Industrial buyers for a good that was previously sold only to the households;
(iii) New areas or regions of the country
(iv) Foreign markets.

This strategy is more likely to be successful where:-
(i) The firm has a unique product technology it can leverage in the new market;
(ii) It benefits from economies of scale if it increases output;
(iii) The new market is not too different from the one it has experience of;
(iv) The buyers in the market are intrinsically profitable.

Diversification Strategies:
(i) Related Diversification - Here there is relationship and, therefore, potential synergy, between the firms in existing business and the new product/market space.
(a) Concentric diversification, and (b) Vertical integration.

(ii) Unrelated Diversification: This is otherwise termed conglomerate growth because the resulting corporation is a conglomerate, i.e. a collection of businesses without any relationship to one another.

Section - II (40 Marks)

(Risk Management)

Answer Question No. 5 and any other two more from the rest in this section.
(Please answer all part of the question at one place.)

5. (a) In each of the cases/statements given below, one of four alternatives is most appropriate. Indicate the correct answer: (Answer any five) 1x5

(i) Uncertainty of damage to property by fire or flood or the prospect of premature death caused by accident or illness would be example of

(A) Speculative risk
(B) Static risk
(C) Pure risk
(D) Liability risk

(ii) Social insurance does not involve
(A) Rural Insurance Policy
(B) Professional Indemnity Policy
(C) Child Welfare Policy
(D) Women Marriage Welfare Policy

(iii) The fraction of total risk which is unique to a company or industry due to inherent factors like managerial capabilities, consumer responsiveness, labour unrest etc. are known as
(A) Systematic risk
(B) Unsystematic risk
(C) Market risk
(D) Exchange risk

(iv) Risk is defined as
(A) a variation from the actual
(B) a variation from the expected,
(C) a possible event
(D) a possible uncertainty

(v) Risk management strategies are
(A) Avoid risk, Reduce risk, and Retain risk
(B) Combine risks, Transfer risk, and Share risk
(C) Hedge risk
(D) All of the above

(vi) Project risk does not include
(A) Institutional risk
(B) Turbulence
(C) Completion risk
(D) Uncertainty

(b) State whether the following statements, based on the quoted terms, are 'TRUE' or 'FALSE' with justifications for your answer. If any statement is false, you are required to give the correct terms, duly quoted. No credit will be given for any answer without justification: **1x5**

(i) Risk transfer is another essential element of insurance. With the exception of self-insurance, a true insurance plan always involves risk transfer.
(ii) Personal and advertising injury liability is part of Public Liability (Industrial Insurance).
(iii) The policy reserve can be defined as the difference between the present value of future benefits and the present value of future net premium.
(iv) The IRDA regulates all kinds of insurance related activities in India.
(v) Risk management techniques do not include among other things the risk premium.

Answer:

5. (a) (i) (C) Pure risk
(ii) (B) Professional Indemnity Policy
(iii) (B) Unsystematic risk

(iv) (A) A variation from the actual
(v) (D) All of the above
(vi) (D) Uncertainty

(b) (i) True: In case of insurance, risk transfer means that a pure risk is transferred from the insured to the insurer, who is in a stronger financial position to pay the loss than the insured.
(ii) False: It is a part of Professional Indemnity Insurance.
(iii) True: The policy reserve can be defined as the difference between the present value of future benefits and the present value of future net premium.
(iv) True: The IRDA regulates all kinds of insurance related activities in India.
(v) False: Risk management in fact includes risk premium payable.

6. (a) Write the meaning of 'risk transfer' of insurance. Mention different forms of it.

(b) What is meant by 'Project Risk Management'? How such risks do arise?

(c) Define Net Single Premium (NSP). Write three basic assumptions of NSP. (5+5+5)

Answer:

6. (a) Risk transfer is an essential element of insurance. With the exception of self-insurance, a true insurance plan always involves risk transfer. Risk transfer means that a pure risk is transferred from the insured to the insurer, who typically is in a stronger financial position to pay the loss than the insured. The degree of risk is reduced through the transfer process, because the transferee may be in a better position to use the law of large numbers to predict losses. In other cases the degree of risk remains the same and is merely shifted from the transferor to the transferee for a price. From the view point of the individual, pure risks that are typically transferred to insurers include the risk of pre-mature death, poor health, disability, destruction and theft of property, and personal liability lawsuits.
The forms of risk transfer are as follows:
(i) Hold-Harmless Agreements;
(ii) Incorporation;
(iii) Diversification; and
(iv) Hedging.

(b) Projects are one time process-unique in nature. Each project will be different and has different gestation periods. By its own nature, a project is based on many assumptions to be realised at future and is subject to environmental changes and changes due to statutory policies. With a gestation period running into a few years, any change or revision in assumptions can transform itself into a big risk. Management of such risks is called "Project Risk Management", which can be difficult and would require special tools and models.
The project risk arises when a project fails to take off due to sudden and drastic changes in the base assumptions. A project exercise normally extends over a period of 5-10 years and the entire economics of the products is based on many assumptions. Where the assumptions had not been fully verified and tested, the projects came to grief. On the other hand risk may arise due to market changes, delay or difficulty in completion of the project, involvement of other institutions etc. All of these lead to turbulence when multiple issues arise initiating moves and counter moves and often ends in deadlock which may affect the flow of the project.
Especially in the case of an industry that pollutes the environment, the assumption that a company can get away with minimum treatment of the pollutant has proven to be disastrous.

(c) The Net Single Premium (NSP) can be defined as the present value of the future death benefit. It is that amount, which together with compound interest, will be sufficient to pay all death claims. In calculating the NSP, only mortality and investment income are considered. Insurance company expenses or the loading element are considered later, when the gross premium is calculated.

The NSP is based on three basic assumptions:
(i) Premiums are paid at the beginning of the policy year;
(ii) Death claims are paid at the end of the policy year; and
(iii) The death rate is uniform throughout the year.

Certain assumptions must also be made concerning the probability of death at each attained age.

7. (a) What is meant by 'Utility Theory'? How risk can be classified in 'Utility Theory'?

(b) What is meant by "Loss Control" in risk measurement? State two general approaches to loss control.

(c) What is meant by the Time Value of an Option'?

(d) What is the meaning of valuation model based on the Discounted Cash Flow (DCF) technique? Can DCF technique be used to value the options? Give reasons with your answer. (2+2)+(2+2)+2+5

Answer:

7. (a) The destruction caused by any unforeseen event is referred to as "Risk". In the insurance business, people exposed to the same risk from a group and share the loss together. Insurance companies collect the shares (i.e., premiums) in advance from the group and create a fund. This fund is utilised to pay for the loss (i.e., claims) that is incurred by any member of the group. Risk can be classified into various types:
(a) Financial and non-financial risks;
(b) Dynamic risks;
(c) Speculative risks.

The fundamental principle of insurance is to share the losses and to substitute uncertainty with certainty. Expected utility theory emphasises that the demand for insurance is a demand for certainty.

(b) When particular risk cannot be avoided, actions may often be taken to reduce the losses associated with them. This method of dealing with risk is known as loss control. It is different than risk avoidance, because the firm or individual is still engaging in operations that give rise to particular risks. Rather than abandoning specific activities, loss control involves making conscious decisions regarding the manner in which those activities will be conducted. Common goals are either to reduce the probability of losses or to decrease the cost of losses that do occur.

Effective loss control sometimes requires technical knowledge of the exposure itself, as is the case with safety engineering in many manufacturing processes. In other instances, loss control measures may be quite simple and straightforward.

Two general approaches to loss control are as follows:
(i) Reducing the level of risky activity, and

(ii) Increasing precautions against loss for activities that are undertaken.

First, exposure to loss can be reduced by reducing the level of risky activities. For example by cutting back production of risky products or shifting attention to less risky product lines.

The second major approach to loss control is to increase the amount of precautions (i.e., level of care) for a given level of risky activity.

(c) The time value or time premium of an option is the amount by which the option price exceeds the intrinsic value. The option holder hopes that change in market price of the underlying asset will increase the value of the option (right) before the expiration date. For this expectation, the option buyer is ready to pay a premium above the intrinsic value. On the expiration date, the time value of option is zero and the premium is entirely represented by the intrinsic value. If there is at the money position, it means there is no intrinsic value and the entire premium is represented by the time value.
In equation it may be represented as follows:
Time Value of Option = Option Price - Intrinsic Value

(d) Valuation model based on the Discounted Cash Flow (DCF) technique can be used to value the Bonds and Shares.

The DCF requires:
(i) Estimation of future cash flows, and
(ii) A suitable discount rate representing the inherent risk of the security.
The valuation of a security is derived by discounting the future cash flows of the asset.

The DCF cannot be used to value the option.
There are some problems in applying the DCF for valuation of option. The problems arise because:
(i) It is very difficult to estimate the future cash flows of an option, and
(ii) The appropriate discount rate cannot be determined, because the risk of option cannot be determined.
The option is a derivative security and its risk depends upon the movement in the prices of the underlying security. An option is riskier than the underlying asset, but it is difficult to estimate exactly how much riskier. So the options cannot be valued by applying the DCF technique.

8. Answer any three from the following: 5x3=15

(a) Risk Protocols under Risk Management checklist.

(b) What do you understand by the term 'risk control' and 'degree of risk'?
(c) State two primary principles of insurance. What is meant by "All-risks" policy under insuring agreement? Give one example.

(d) Write five strategies in relation to the 'Corporate Risk Management'.

Answer:

8. (a) The following are the Risk Protocols under Risk Management checklist:
(i) Appropriate risk management framework identified and adopted, with modifications as appropriate;

(ii) Suitable and sufficient risk assessments completed and the results recorded in an appropriate manner;
(iii) Procedures to include risk as part of business decision-making established and implemented;
(iv) Details of required risk response recorded, together with arrangements to track risk improvement recommendations;
(v) Incident reporting procedure established to facilitate identification of risk trends. together with risk escalation procedure;
(vi) Business continuity plans and disaster recovery plans established and regularly tested;
(vii) Arrangements in place to audit the efficiency and effectiveness of the controls in place for significant risks, and
(ix) Arrangements in place for mandatory reporting on risk, including reports on at least the following:
- Risk apetite, tolerance and constraints;
- Risk architecture and risk escalation procedures;
- Risk aware culture currently in place;
- Risk assessment arrangements and protocols;
- Significant risk and key risk indicators;
- Critical controls and control weaknesses;
- Sources of assurance available to the Board.

(b) Risk Control: Risk control through elimination and reduction is one of the important steps in the process of risk management. Some risks can actually be eliminated - by deciding not to build a plant in an earthquake zone. Risks that cannot be eliminated can be reduced through loss prevention programmes. Fire exposure can be limited by installing smoke and sprinkler system and by making sure that "No Smoking'" rules are enforcesed in the areas containing flammable materials. Burglary and vandalism can be discouraged by employing guards and watchman and installing fencing, spotlights, and alarm systems. The risk of legal liability can be limited by instituting environmental protection programmes, reducing quantity of air, matter and solid waste pollutants and designing and manufacturing products that are safe for public consumption.

Ideally, loss control programmes should also include emergency catastrophe plans. Although this programme may seem to be expensive, they are actually far less costly than the losses that might occur if no preventive measures were taken. In the long-rum money spent on risk control is money worth spent.

Degree of risk: The amount of objective risk present in a situation, sometimes referred to as the degree of risk, is the relative variation of actual from expected losses. More precisely, the degree of risk is the range of variability around the expected losses, which are calculated using the chance of loss concept by means of the following formula:

$$\text{Objective Risk} = \frac{\text{Probable variation of Actual from Expected Losses}}{\text{Expected Losses}}$$

(c) Two primary principles of insurance are as follows:

(i) Principle of co-operation – the insurance is based on co-operative endeavour.
(ii) Principle of probability – the insurance is based on the theory of probability. The mortality table and accordingly the premium are calculated with the help of data available from the previous happenings and from an idea for the future likely events.

'All-Risks' policy: Under an 'All-Risks' policy in insuring agreement, all losses are covered except those losses specifically excluded. These policies are also called an open-perils policy and a special coverage policy. If the loss is not excluded, then it is covered.

Life insurance is an example of 'All-Risks' policy.

(d) 'Corporate Risk Management' is a process that identifies loss exposures faced by an organisation and selects the most appropriate techniques for treating such exposures.

As the term 'risk' is ambiguous and has different meanings, many risk managers use the term "loss exposure" to identify the potential losses.

In the corporate risk management, the following strategies are generally adopted:

(i) Risk Avoidance - it is a strategy by which the organisation does not engage in the activity which involves any risk.
(ii) Risk Reduction - it is another strategy where the organisation takes two steps. One is preventing the occurrence of risk and the second one is controlling the number of occurrences. One of the possible ways of reducing the risk is going for large number.
(iii) Risk Retention - it is the most popular method of dealing with risk. Risk retention may be conscious or unconscious. Conscious risk retention takes place when the risk is perceived and not transferred or reduced. When a risk is not recognised, it is unconsciously retained.
(iv) Risk Transfer - it is another method of managing risk. Risk can be transferred to a person willing to take it. Hedging and insurance are the best example of risk transfer.
(v) Risk Sharing - it is a process by which the potential risk is shared among many, so that the loss is not borne by a single person.