Paper – 13: MANAGEMENT ACCOUNTING – STRATEGIC MANAGEMENT

Question 1.

(a) State whether the following statements are 'True' or 'False' with justification for your answer:

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

(ii) 'Loss leader' is the leader, who is unable to conceptualize and analyse strategic problems.

(iii) In strategic outsourcing, companies have been separating into certain non-core activities within the business.

(iv) 'Merger' is the purchase of controlling interest of another company.

(v) 'Repositioning' involves moving the product or brand into a different market segment.

Answer:

(i) False: As per BCX Matrix, "dogs" are units with low market share in a mature, low-growing market.

(ii) False: In marketing, a loss leader is a type of pricing strategy where an item is sold below cost in an effort to stimulate other profitable sales. It is a kind of sales promotion.

(iii) True: strategic outsourcing has been in relation to non-core activity are a high technology activity which is not the core competence of the company.

(iv) False: Merger is the combination of two or more corporations in which one of the corporations survives and the other corporation ceases to exist. A merger occurs when two companies combine to form a single company.

(v) True: 'Repositioning' is a strategic marketing approach and involves moving the product into different market segment.

(b) For each of the questions given below, one out of four answers is correct. Indicate the correct answer.

(i) 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 make existing ones obsolete;

D. For those companies who are strong in the market but not leaders and might capture market share from the leader.

(ii) Successful differentiation strategy allows the company to:

A. Gain buyer loyalty to its brands;

B. Charge too high a price premium;

C. Depend only on intrinsic product attributes;

D. Have product quality that exceeds buyers' needs.

(iii) Technology adaptation is :

A. the complete assimilation of technical know-how acquired from a collaborator;

B. the acquisition of technical know-how from the source external to the firm;

C. the acquisition of design from a collaborator and carrying onto necessary modifications thereto;

D. the improvement of the level or quality.

(iv) The acquisition of Hutch by 'Vodafone' is an example of:
A. Horizontal integration;
B. Forward integration;
C. Vertical integration;
D. Concentric diversification.

(v) The BCG growth matrix is based on the two dimensions:
A. Market Size and Market Share;
B. Market Size and Profit Margins;
C. Market Size and Competitive Intensity;
D. None of the above.

Answer:

(i) D. For those companies who are strong in the market but not leaders and might capture market share from the leader.
(ii) A. Gain buyer loyalty to its brands.
(iii) C. the acquisition of design from a collaborator and carrying onto necessary modifications thereto.
(iv) A. Horizontal integration.
(v) D. None of the above.

Question 2.
(a) Describe the term 'Strategic Positioning'?

Answer:
The logic of the strategic positioning is that competitive strategy which is about being different. It means deliberately choosing a different set of activities to deliver a unique mix of value. In other words, 'the essence of strategy is in the activities - choosing to perform activities differently or to perform different activities than rivals'.

Types of positioning - According to Porter, strategic options emerge from three distinct sources, which are not mutually exclusive and often overlap. These are as follows:

(i) Variety based positioning - the focus, essentially, is on product or service varieties and not on customer segments.
(ii) Need based positioning - the focus is on all or most of the needs of a particular group of customers. This strategy comes closer to the strategy of targeting a particular segment of customers. This strategy is appropriate when there are groups of customers with differing needs and when a tailored set of activities can serve these need based.
(iii) Access based positioning - it is applicable when the needs of different sets of customers are similar but the best ways of accessibility are different due to factors like geography or customer scale.

(b) Discuss in brief the elements of a meaningful mission statement of a corporate organization.

Answer:
The major elements of an effective corporate mission statement are:

(i) Clearly articulated: The mission statement should be succinct and easy to understand so that the values, purposes and goals of the organization are clear to everybody in the organization and will serve as a guide to them.
(ii) Relevant: A mission statement should be appropriate to the organization in terms of its history, culture and shared values.
(iii) Current: A mission statement may become obsolete after some time. As such it should be reviewed and updated on a regular basis taking into consideration the changes in environmental and organizational factors.
(iv) Written in a positive tone: A mission statement should be capable of inspiring and encouraging commitment towards fulfilling the mission.
(v) Unique: An organization's mission statement should established the individually, if not uniqueness, of the company.
(vi) Enduring: A mission statement should continually guide and inspire and be challenged in the pursuit of the mission of the organization, never achieving the ultimate goal.
(vii) Acceptable to the target audience: Ideally, the mission statement should define the customers, product/services, markets, technology, philosophy and self-concept.

Question 3.
(a) List the Environmental factors that can affect an organisation's Strategy.

Answer:
The following list of environmental factors that can affect an organisation's strategy:

(i) The demographic change -

- A general change in educational level
- A distinct shift in the value system
- Increase in productivity, augmented by automation
- A general erosion of values and ethics
- Decreasing family sizes
- Loss of stability of family units
- Decreasing power of religion
- Increasing geographic mobility
- Increasing domestic mobility
- Increasing role and power of women in society
- Change in worker's attitude to work.

(ii) The economic environment -

- Inflation
- Energy shortage
- Energy resource
- Growth rate in productivity
- Individual savings rate
- Growing international interdependence
- Clear environment
- Quality education
- Old age security
- National economic factors.

(iii) The Political/Legal environment -

- Economic goals of the government
- Fiscal policies
- Monetary policies
- Foreign exchange/balance of payment
- Privatisation policies
- Education policies
- Corporate and industrial laws.

(iv) The technological environment -

- R & D facilities for new technologies
- Tax and interest incentives
- Investment in new technologies
- Growth in new technologies.

(v) The industry environment -

- Market size/age
- Number of competitors
- Rules of game
- Industry trends/driving forces
- Industry attractiveness.

(b) State the reasons why are mergers not always successful.

Answer:
The possible reasons for failure of mergers may be one or more of the following lapses on the part of management:

(i) Failure of management to establish merger objective which fit into the overall corporate strategy. Indeed, the objectives of merger should stem from corporate strategy since merger or acquisition is one of the means of achieving corporate goals.

(ii) Management's failure to consider the relative merits of internal and external means of achieving corporate goals. Considering the low rate of success, mergers should be recognized as more risky than internal growth strategy.

(iii) Lack of serious consideration of the financial stake. Not infrequently pricing of acquisitions is characterized by an attitude of recklessness, and on occasions there is considerable overpricing and high premiums paid by acquiring firms. Sometimes over-pricing is due to unrealistic assumptions made about the future earnings. This again reflects inadequate scrutiny of the merger plan.

(iv) Insufficient familiarity of the management of acquiring firms with the business of the acquired firms. Failure of mergers is often due to the facile assumption that management expertise can be carried over from one type of activities to another. Actually, human problems and complex structuring of organizational relations are sometimes beyond the capability of the management of acquiring firms. This again may be due to the lack of any serious analysis of the merger proposal.

(v) Lack of preparedness with post-merger planning, organization and control. Undoubtedly, the post-merger phase of management action is as important for success as the pre-merger consideration. In many cases there was more eagerness for acquisition than for rationalization.

Question 4.

(a) Write down the different strategies of Joint Venture.

Answer:

There are three Joint Venture strategies, namely:

- Spider web strategy: In this strategy, a small firm establishes a series of joint ventures, so that it can survive and not absorbed by its large competitors.

- Go together Split Strategy: In this strategy, the firms agree to form a joint venture for a specific length if time. When that project is completed, they once again split.

- Successive Integration Strategy: In this strategy, a firm begins an alliance, which is weak and then develops several joint ventures which can then lead to a merger. In fact, Joint Venture could be a laboratory setting prior to a merger.

(b) "In the maturity stage of Product Life Cycle (PLC) the market becomes saturated, price competition intensifies and the rate of sales growth slows down." Suggest five strategic choices in such a stage of PLC.

Answer:

In order to face the situations characterised by the maturity stage of PLC, alternative marketing and distribution strategies listed below are suggested:

(i) Brand - stressing advertising:
More attractive design and functional packaging;
More after - sale services;
Heavier point of sale effort, and
Increase in sales promotion expenditure to hold customer loyalty.

(ii) Trading down through:
Introduction of low price models of an established product;
Price - cutting of an entire product line and keeping prices close to private levels, and
Entering a `fighting brand' on the market at lower price to avoid killing of an established premium brand.

(iii) Trading up (strategy opposite to item ii) through:
Improvement of quality / appearances;
Use of prestige packaging;
Price increase to cream market levels (in order to increase market penetration earns more margins on possibly lower sales/keep greater differentiation over competitive products).

(iv) Proliferation, exclusive or radical, by:
More designs;
More exclusive and innovative features;
Creating radical/distinct package designs, and
More options.

(v) Increase of product availability and point – of - sale services through more distribution outlets/dealers/services centres, etc.

Question 5.
(a) There are various steps to strategic planning. Mention those steps.

Answer:
The various steps to strategic planning are–

1. **Customer Need:** Find out the future needs of the customer. What are the requirements? How the organisation meets and exceeds expectations?
2. **Customer Positioning:** Determine where your organisation is in relation to customer. Do you want to retain, reduce or expand the customer network?
3. **Predict the Future:** Demographics, economic forecasts, technical assessments need to be carefully analysed to predict the future conditions that affect your product.
4. **Gap analysis:** Find out the gaps between the current state & future state of your organisation.
5. **Closing the gap:** Develop the plan to close the gap by establishing goals & responsibilities.
6. **Alignment:** Align the plan with mission, vision and core values & concept of your organisation.
7. **Implementation:** Allocate the resources to collect data, designing changes and overcoming resistance to change. The planning group or committee should meet at least once a year to assess and take any corrective action needed.
8. **Strategic planning or strategy formulation:** It is the key steps of strategic management. The planned or formulated strategy is implemented to achieve desired objectives.

(b) Discuss various pricing methods based on competition.

Answer:
(i) Skimming pricing method: This refers to a pricing policy which sets relatively high prices at the outset and successively offers lower prices as the market expands at later stages. The idea behind this pricing policy is that the introduction of a new product with a high price is an efficient way to segment the markets with different price elasticity of demand. The initial high price can serve to skim the cream off those segments which are less sensitive to price. Subsequent price reductions reach customers with higher elasticity and enlarge the size of the market.

(ii) Penetration pricing method: This method refers to a pricing policy of setting a relatively low initial price with an intention to help the product penetrate into the markets to hold a position. This method is just opposite to the skimming pricing method. This pricing strategy is adopted when there seems to be no distinctive classes of customers with different price elasticity, and when advantages of mass production drastically reduce costs, and when the product's distinctiveness i.e. protection from the competitors is likely to be short-lived.

(iii) Seasonal discount pricing method: This is a type of pricing strategy to promote sales by offering special discounts during certain seasons. This policy is found to be followed by the manufacturers of air conditioners, refrigerators, electric fans, etc.

(iv) Going-rate pricing method: This method refers to a pricing policy whereby the prices are fixed in consideration of the prices of competitors and the firm's costs. This is like 'follow the leader' i.e. price leadership. It is quite popular because it is easy to avoid competition and make reasonable profits. Under this method, prices are fixed near about the prices of the leaders. This pricing policy does not have any scientific basis like considerations of cost and marketing factors.

(v) Discriminatory pricing method: This method of pricing refers to a policy of following different prices for different customers based on their ability to pay or place of customers. It involves 'selling a product or service at two or more prices and the difference in price is not based on difference in costs', according to Philip Kotler.

(vi) Oligopolistic pricing: An oligopolistic competition, by definition, refers to 'a market in which there are a few sellers who are highly sensitive to each other's pricing and marketing strategies'. In other words, each seller in the market has a significant effect on the market price and each seller considers the likely effect of price changes on the competitors. The life cycle of a product and corresponding market stage play a great role in this pricing policy.

(vii) Monopolistic pricing: A monopolistic competition, by definition, refers to "a market in which many buyers and sellers trade over a range of prices rather than a single market price" (Philip Kotler). This state of competition offers a greater degree of flexibility in the pricing strategy as such market is characterized by : (a) large number of competitors, and (b) price change by any one competitor tends to have little effect on other competitors.

Question 6.

(a) "Marketing channels can be characterised according to the number of channel levels." — Discuss the statement.

Answer:

Every producer seeks to link together the set of marketing intermediaries which fulfill the firm's objectives. This set of marketing intermediaries is called the marketing channel.

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 the numbers of intermediary levels to designate the length of a channel.

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.

(b) "The benchmarking is a versatile tool. The distinct types of benchmarks have been over a period of time." —Discuss the different types of benchmarking in this respect.

Answer:
The Benchmarking is of following as —

1. **Competitive Benchmarking:** It involves the comparison of competitors products, process and business results with own. Benchmarking partners are drawn from the same sector. However to protect confidentiality it is common for the companies to undertake this type of benchmarking through trade associations or third parties.

2. **Strategic Benchmarking:** it is similar to the process benchmarking in nature but differed in its scope and depth. It involves a systematic process by which a company seeks to improve their overall performance by examining the long-term strategies. It involves comparing high-level aspects such as developing new products and services core competencies etc.

3. **Global Benchmarking:** It is a benchmarking through which distinction in international culture, business processes and trade practices across companies are bridged and their ramification for business process improvement are understood and utilised. Globalisation and advances in information technology leads to use this type of benchmarking.

4. **Process Benchmarking:** It involves the comparison of an organisation critical business processes and operations against best practice organisation that performs similar work or delivers similar services.

5. **Functional benchmarking:** This type of benchmarking is used when organisations look to benchmark with partners drawn from different business sectors or areas of activity to find ways of improving similar functions or work processes. This sort of benchmarking can lead to innovation and dramatic improvements.

6. **Internal Benchmarking:** Internal benchmarking involves seeking partners from within the same organisation. For example, form business units located in different areas. The main advantages of internal benchmarking are that access to sensitive data and information are easier; standardised data is often readily available; and usually less time and resources are needed. There may be fewer barriers to implementation as practices may be relatively easy to transfer across the same organisation.

7. **External Benchmarking:** External benchmarking involves seeking help of outside organisations that are known to be best in class. External benchmarking provides opportunities of learning from those who are at the leading edge. This type of benchmarking may take up more time and resource to ensure the comparability of data and information, the credibility of the findings and the development of sound recommendations.

Question 7.

(a) Mr. Abraham has recently joined as the Production Manager of Super Food Products Ltd., an Indian subsidiary of a multinational food manufacturer and having an annual turnover of ₹ 500 crores. His first major assignment in the company was to give a new marketing thrust to the several leading known brands of the company whose market share was continuously eroding in the face of growing competition.

To start with, he decided to concentrate on two major brands, Power-pack Instant Milk Powder for family and Tomato Ketchup with an annual turnover of ₹ 80 crores and ₹ 100 crores respectively. These accounted for a market share of 47% and 28% respectively for the financial year 2013-14 as compared to 68% and 45% for the financial year 2010-11. In spite these slide in the market shares; these brands could retain higher consumer preference and loyalty vis-a-vis other competitive brands.

With a view to having a better appreciation of promotional themes, Mr. Abraham convened a meeting with the advertising agency, Progressive Advertising Ltd. The meeting generated several new ideas on how to push brands up in the consumer recall and preference.

In the light of the above, answer the following questions:

(i) List out the possible reasons why the company has suffered a fall in its market share?

(ii) If you were the Product Manager, what would be your marketing strategy for arresting the trend of slackening sales in the light of the meeting with the advertising agency?

Answer:

(i) Possible reasons for fall in the market share are:

- Increased domestic and foreign competition
- Shifts in consumer tastes
- Increasing price cutting and better dealer margins by rivals
- Complacency on the part of the top management, taking leadership position in the market for granted
- Technological advances through better R&D by competitors

(ii) As a product manager, I would focus on the following marketing strategy:

- Find new users - convince people who do not consume milk powder and tomato ketchup to start using the same under market penetration strategy
- New users - discover and promote new uses for the products
- Continuous innovation through better R&D
- Increase distribution effectiveness
- Maintain price level or reduce the same through cost cutting

(b) State the important features which human resource management strategy may bring to bear on the organisation.

Answer:
The features are as follows:

(i) **Orientation of the members.** HRM strategy has to ensure that individuals employed in the organisation have necessary orientation so that the mission and objectives of the organisation are internalized by the members and they have a sense of identification with the values and culture of the organisation.

(ii) **Facilitation of organisational changes as and when called for.** The practices and procedures are required to be in conformity with the changing internal and external conditions. This is a vital role of HR strategy management.

(iii) **Coping with diversity of workforce.** Modern organisations with highly complex nature of jobs and processes generally have a highly diversified workforce differentiated in terms of age, sex, religion, professional and technical skills and educational background. To maintain a balanced workforce with harmonious relations and providing equitable incentives and rewards are aspects of HRM functions which can sustain an effective workforce. This is a responsibility of HR strategy managers.

(iv) **Maintaining competent and committed workforce in a competitive environment.** The intensity of market competition for enterprises has been growing fast with globalisation and liberalization of economic policies. There are competitive strategies of low cost production and differentiation of products which may enable companies to secure a competitive edge. HRM has the responsibility of managing workforce so as to make it competent in ability as well as committed to organisational success.

(v) **Development of core competency.** An enterprise succeeds in achieving its strategic objectives mainly on the basis of capabilities in the technical, marketing or human skills in areas of crucial importance. These are known as core competencies of the organisation which are unique internal strengths not possessed by competitors. HRM is required to undertake building up of core competency by the organisation as to secure dynamic leadership in the product market.

(vi) **Empowered workforce as an active resource.** HR strategy is best managed when the members of an organisation are individually in control of their work and are able to realise their potentials with empowerment to take relevant decisions on their own. This is likely to secure enduring performance based achievements.

(vii) **Appropriate work culture and ethical norms.** No organisation can get the best contribution from its members unless individuals develop a liking for challenging jobs and follow the ethical norms of the organisation functionally. This may require redesigning of jobs and work processes as well as developing trust and confidence among individuals and work groups, as also emphasizing intrinsic motivation for improving performance. HRM encompasses creation of an appropriate work culture on the above lines.

Question 8.
(a) State the components of Corporate Strategy.

Answer:
Five Corporate Strategy Components and Issues are:
(i) Scope, mission and intent;
(ii) Objectives;
(iii) Development Strategy;
(iv) Resource allocation; and
(v) Sources of synergy along with their associated issues.

(b) What challenges in long term commitment the companies faces while entering into rural emerging markets in designing a marketing channel strategy that meets the needs of rural customers?

Answer:
Challenges in designing a marketing channel strategy that meet to needs of the customers in the rural emerging market:

(i) Decisions in distribution in network design (i.e. channels of distribution coverage);
(ii) Creating an effective distribution network on the ground (i.e. network logistics).
(iii) Affordability;
(iv) Lack of brand and reputation trust;
(v) Lack of education and awareness in topics like hygiene, health, modern agriculture practices, proper uses of products and services, etc.
(vi) After - sales service to customers and its quality.

Question 9.
(a) Discuss how 'Gap Analysis' might be applied to a product/market situation.

Answer:
If 'gap analysis' is applied to a product/market situation, the organisation will consider its targets for different types of products it wants to manufacture and different types of markets/ market segments where it wants sell its products.

The product/market targets may be quantified —

(i) The organisation should have targets (quantitative) for its products it wants to sell, classified into —

- Those in the introductory stage of their life, those in the growth stage, those in the
  maturity stage and those in the decline stage (PLC classification);
- Cash cows, stars, dogs and question marks (BCG classification);
- What sort of products the organisation wants to sell, e.g. does it want a more
  diversified range of products?

(ii) There should also be targets for markets/market segments that the organisation would like to be in and targets for —

- Market share or market segment share (both in the existing markets and the

markets
it would likely to enter into);
- Market positioning - positioning is concerned with such matters as product quality,
image and reliability, price, outlets, types of customers.

A projection of the organisation's products and the market shares and market positioning for each of its products would be made on the assumption that:—

- No new products are developed.
- The market mix for the existing products remains the same.

The gap could be analysed in terms of -

- What products the organisation will be missing from the product range?
- What markets/market segments it is failing to enter into?
- How far out of position in the market will the product be?

Strategies to close the gap would include -

- new product development strategies or new market development strategies;
- a strategy of product and market diversification through a takeover policy;
- a marketing mix strategy to gain the required position in target markets.

(b) How does 'Market Research' help a Management Accountant to gain strategic cost advantage for a firm?

Answer:
Market Research helps the Management Accountant to gain strategic cost advantage for a firm in the following ways:

i) By helping understand current customer tastes and preferences in order to ensure that they continue to buy company's products or services.
ii) Help to understand the tastes and preferences of competition customers in order to try and sell company's products and services to them.
iii) Helping launch the new products and services effectively by understanding the potential of the market.
iv) Help to find profitable ventures' location to draw more customers. The office or store location is often a very important factor, particularly for ventures selling directly to the public.
v) Help to gather customer experience with additional information as to how quality can be perceived and measured.
vi) Helps in collecting technological advancement which the competitor firm follow to reduce cost effectively.

Question 10.
(a) Write a short note on 'Activity Based Management (ABM)'.

Answer:

Activity Based Management (ABM) uses the information in various analyses designed to yield continuous improvement. ABM manages activity rather than resources. It determines what drives the activities of the organization and how these activities can be improved to increase the profitability. ABM utilizes the cost information gathered to activity based cost. ABM is a discipline that focuses on the management of activities as the route to improve the value received by the customers and the profit achieved by providing this value. The various analyses under ABM are:

(i) Cost Driver analysis - It identifies the factors that cause activities to be performed, in order to manage activity costing.

(ii) Activity analysis - It involves identification of an organization and the activity centres or activity cost pools. This analysis also identifies the Value Added and Non - Value Added activities.

(iii) Performance analysis - It aims to identify the best ways to appropriate measure the performance of factors that are important to organizations in order to stimulate continuous improvement, consistent with each unit's goals and objectives.

(b) How a firm's vision and mission help to achieve organisation's goal?

Answer:

The firm's vision is a picture of what it wants to be and what it wants to ultimately achieve. The firm's mission is based on its vision. It specifies the businesses in which the firm intends to compete and the customers to intend to serve. The value of having a vision and mission is that they inform stakeholders what the firm is, what it seeks to accomplish, and who it seeks to serve? A successful vision is inspirational.

The mission is more concrete and guides employees' behaviour as they achieve the firm's vision. Research shows that an effectively formed vision and mission positively impacts firm performance in terms of growth in sales, profits, employment, and net worth.

Question 11.

(a) "Break-even analysis is a simple method for investigating the potential value of a proposed investment." — State its usefulness in the analysis of strategic management decisions.

Answer:

Break-even analysis is useful in the analysis of three important types of strategic management decisions:

1. In new product decisions, break-even analysis can help determine how much of a new product a firm must sell to achieve profitability.

2. Break-even analysis can be used as a broad framework for studying the effects of a general expansion in the level of a firm's operations.

3. When the firm is considering modernisation and automation projects where it invests in more equipment in order to reduce variable costs, particularly the cost of labour, break-even analysis can help managers analyse the consequences of the action.

(b) Write about the various activities of an organisation into a value chain analysed by Porter.

Answer:
The various activities of Value Chain:

Primary activities are those directly related with production, sales, marketing, delivery and services. The five primary activities are:

(i) Inbound logistics are those activities involved with receiving, handling and storing inputs to the production system. It thus includes warehousing, transport, stock control and so forth.
(ii) Operations are those activities which convert inputs into final product.
(iii) Outbound logistics are those activities relating to storing the product and its distribution to customers.
(iv) Marketing and sales are those activities that relate to informing customers about the product, persuading them to buy it and enabling them to do so. This includes advertising, promotion and so forth.
(v) After sales service. For many companies there are activities such as installing products, repairing them, providing spare parts and so forth.

Support activities are those which provide purchased inputs, human resources, technology and infrastructural functions to support the primary activities. Support activities include the following.

(i) Procurement: It reports to those activities which acquire the resource inputs to the primary activities.
(ii) Technology development: These activities are related to both product design and to improving processes and/or resource utilisation.
(iii) Human resource management: It is the activities of recruiting, training, developing and rewarding people.
(iv) Firm infrastructure: The systems of planning, finance, quality control are activities which Porter believes are crucially important to an organisation's strategic capability in all primary activities.

Furthermore, in addition to the categories described above Porter identifies three other ways of categorizing activities.

(i) Direct activities are concerned with adding value to inputs,
(ii) Indirect activities enable direct activities to be performed.
(iii) Quality Assurance. This type of activity monitors the quality of other activities and includes: Inspection, Review, and Audit.

Question 12.
(a) The SWOT analysis is simple and useful tool of environmental analysis. Highlight its application for an Indian bulk drug company.

Answer:
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) Write down the tools of Total Cost Management.

Answer:
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 optimizing 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.

Question 13.
(a) Dabur, The pharmaceutical company wants to grow its business. Draw Ansoff's Product Market Growth Matrix to advise them of the available options.

Answer:

The Ansoff's product market growth matrix (proposed by Igor Ansoff) is a useful tool that helps businesses decide their product and market growth strategy. With the use of this matrix a business can get a fair idea about how its growth depends upon its new or existing products in both new and existing markets.

The Ansoff's product market growth matrix is as follows:

	Existing Products	New Products
Existing Markets	Market Penetration	Product Development
New Markets	Market Development	Diversification

Based on the Matrix, Dabur may segregate its different products. Being in pharmaceuticals development of new products is result of extensive research and involves huge costs. There are also social dimensions that may influence the decision of the company. It can adopt penetration, product development, market development, market development or diversification simultaneously for its different products.

Market penetration refers to a growth strategy where the business focuses on selling existing products into existing markets. It is achieved by making more sales to present customers without changing products in any major way. Market development refers to a growth strategy where the business seeks to sell its existing products into new markets. It is a strategy for company growth by identifying and developing new markets for current company products. Product development is refers to a growth strategy where business aims to introduce new products into existing markets. It is a strategy for company growth by offering modified or new products to current markets. Diversification refers to a growth strategy where a business markets new products in new markets. It is a strategy by starting up or acquiring businesses outside the company's current products and markets.

As market conditions change overtime, a company may shift product-market growth strategies. For example, when its present market is fully saturated a company may have no choice other than to pursue new market.

(b) Distinguish between 'intra-group benchmarking' and 'inter-industry benchmarking'.

Answer:
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.

Question 14.

(a) Mention the areas in which Activity Based Information is used for Decision-making.

Answer:
The areas in which Activity based Information is used for decision making are as under:

- Pricing
- Market segmentation and distribution channels
- Make-or-buy decisions and outsourcing
- Transfer pricing
- Plant closed down decisions
- Evaluation of offshore production
- Capital Investment decisions
- Product line profitability

(b) Point out the roles of Cost Accountant in a Target Costing Environment.

Answer:
The roles of Cost Accountant in a Target Costing Environment are as follows:

1. The Cost Accountant should be able to provide for the other members of the design team a running series of cost estimates based on initial design sketches and activity-based costing reviews.
2. The Cost Accountant helps the project team in capital budgeting decisions.
3. The Cost Accountant works with the design team to help it understand cost-benefit-tradeoffs of using different design or cost options in the new product.
4. The Cost Accountant continues to compare a product's actual cost to the target cost even after the design is completed.

Question 15.

(a) Mention the areas in which the application of learning curve can help a manufacturing organisation.

Answer:
The areas in which the application of learning curve can help a manufacturing organisation:

1. Improvement of Productivity: as the experience is gained the performance of workers improves, time taken per unit reduces and thus his productivity goes up.

2. Cost Predictions: Learning curve provides better cost predictions to enable price quotations to be preferred for potential orders.

3. Work scheduling: learning curve enables us to predict the inputs required more effectively and helps in the preparation of accurate delivery schedules.

4. Standards setting: If budgets and standards are set without considering learning curve, it is meaningless because variances will arise.

(b) State the usefulness of Pareto Analysis.

Answer:
Pareto analysis is useful to the following cases:

- Prioritize problems, goals and objectives.
- Identify root causes
- Select and define key quality improvement programs.
- Select key customer relations and service programs.
- Select key employee relations improvement programs.
- Select and define key performance improvement programs.
- Maximize research and product development time.
- Verify operating procedures and manufacturing processes
- Sales/distribution of Products or services.
- Allocate physical, financial and human resources.

Question 16.

(a) Explain why a direct relationship between the cost of production and selling price may be inappropriate as a pricing strategy.

Answer:
The relationship between the cost of production and selling price is technically termed as cost plus pricing policy. Such a policy is inappropriate for the following reasons:

This policy fails to recognize the following matters —
- Sales demand is determined by sales price
- Profit-maximizing price is not directly related to the cost of the product
- Product cost computation is a subjective exercise as arbitrary cost apportionments decisions are in practice.
- A firm having spare capacity might be interested to accept marginal business but this policy leads to high prices for losing potential customers.
- This policy could lead to an upward spiral of price increases if it is regularly.
- In the early stage of Product Life Cycle, unit cost of a product is high. This may not sufficient demand for achieving the desired market share.

(b) "Corporate planning is the means of achieving the business objectives." State the characteristics of Corporate Planning.

Answer:
The characteristics of Corporate Planning:

1. It is a long-term planning exercise in the organisation covering all activities such as - marketing, production, human resource, commercial, financing, projects planning and technological developments.

2. It takes into consideration, national and international level competitiveness in cost and quality so as to emerge as a global player.

3. It takes into account the latest developments in business and economic scenario.

4. It is prepared for a long period say five years and above.

5. It is prepared for the organisation as a whole based on the corporate vision and corporate mission together with growth strategy.

Question 17.

(a) "Collaboration with foreign companies has been found to have special appeal as a growth strategy particularly in developing countries." — How a firm can use foreign collaboration as a strategy of growth?

Answer:

Depending on the purpose in view, collaborations may be classified as: technical, financial and/or managerial. There are many advantages which a firm in the host country can derive from the collaboration deal:

1. Upgradation of existing technology or introduction of advanced technology, acquiring technical know-how, and facilitating transfer of technology;
2. Developing indigenous production of components and spare parts;
3. Fostering cultural changes with respect to work ethos, attitude towards discipline, etc.;
4. Improving competitive abilities for domestic and export marketing;
5. Enlarging the scale of operations and reducing costs;
6. Deriving the benefits of import substitution and increased foreign exchange earnings;
7. Developing the brand image of products more quickly;
8. Securing foreign equity investment as a part or risk capital and enhancing the potential ability to raise necessary funds from the domestic capital market.

Benefits which may accrue to the foreign collaborators are:

1. Earning by way of royalty and fees for technological collaboration, supply of drawings and documents, technical and managerial know-how;
2. Return on financial outlay;
3. Market expansion in countries restricting hard currency imports;
4. Tax benefits derived in low-tax host countries, royalties, technical fees, and service charges are taxed at a lower rate than profits.

(b) It is said that there is no one way to do strategic planning. Identify different acceptable approaches of doing it.

Answer:

Fundamentally, there are four different approaches to do formal strategic planning. These are:

I. Top-down approach: In a centralized company, such planning is done at the top of the corporation and the departments and outlaying activities are advised straightway what to do.

   In a decentralized company, the CEO or the President may give the divisions guidelines and ask for plans. The plans after review at the head office are sent back to the divisions for modifications or with a note of acceptance.

II. Bottom-up approach: The top management gives the divisions no guidelines but asks them to submit plans. Such plans may contain information on:
   (i) major opportunities and threats;
   (ii) major objectives;
   (iii) strategies to achieve the objectives;
   (iv) specific data on sales/ profits/ market share sought;
   (v) capital requirements, etc.

   These plans are then reviewed at top management levels and the same process, as in the top-down approach, is then followed.

III. Mixture of the top-down and bottom-up approaches: This is practiced in most large decentralized companies. In this approach, the guidelines given by the top management to the divisions are broad enough to permit the divisions a good amount of flexibility in developing their own plans. Sometimes, the top management may decide basic objectives by dialogue with divisional managers in respect of sales and return on investments especially when divisional performance is measured upon those criteria.

IV. Team approach: The chief executive, in a small centralized company, often use his line managers to develop formal plans. The same approach is used even by the president of a large company. In many other companies, the president meets and interacts with his group of executives on a regular basis to deal with all the problems facing by the company so that the group can develop written strategic plans.

Question 18.
(a) State the relationship between Product Life Cycle (PLC) and marketing planning.

Answer:
Relationship between PLC and marketing planning:

1. Introductory stage begins with new products. In this stage, there is delay in consumer acceptance because the product is new and the expansion of facilities takes time. In the case of expensive products, the number of buyers is small. In other words, the sales are low and the profits are low. Thus, money is needed to develop the market through promotion as the customers are unknown.

2. Growth stage opens more opportunities for the new products because by now the consumers will have heard about the product and became interested in it. They will buy it. The market share increases and the profits also grow up. The economies of scales are introduces, costs go down, and the market segmentation is possible to be adopted.

3. At maturity stage, sales continue to increase but at a lesser rate than before and the price competition increases. This stage is characterized by over-capacity, product improvement, new uses of products, and more market segmentation.

4. At declining stage, the market demand slackens because of market saturation. The weak products are dropped if they do not meet profit target.

The interesting thing about PLC is that it occupies an important place in long-term planning for marketing. When the product reaches growth stage, economies of scale are realized 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 have strategy. Especially pricing strategy 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 and for understanding of their impacts on PLC. These can be done by proper marketing research and market surveys. Thus, we find a correlation between PLC and planning for marketing operations and actions.

(b) Write down the basic goals of Environmental analysis.

Answer:
Environmental analysis has three basic goals, such as:

(i) The analysis should provide an understanding of current and potential changes taking place in the environment. It is important that one must be aware of the existing environment and at the same time have a long-term perspective too.

(ii) Environmental analysis should provide inputs for strategic decision-making. Mere collection of data is not enough. The information collected must be used in strategic decision-making.

(iii) Environmental analysis should facilitate and foster strategic thinking in organization, typically, a rich source of ideas and understanding of the context within which a firm operates. It should challenge the current wisdom bringing fresh viewpoints into the organization.

Question 19.
(a) Describe the types of risks a firm may face while developing a new product /market?

Answer:
Developing a new product/market exposes a firm to a combination of four kinds of risks. These risks are particularly acute where diversification is concerned because of the simultaneous novelty of both product and market.

i) Market risk: The firm has entered in a new market where established firms already operate. The risks involved are:
   1. Not correctly understanding the culture of the market or the needs of the consumer;
   2. High distribution costs due to lack of economies of scale;

3. Failure to be seen as credible by the buyers in the market due to the lack of track record or brand;
4. Exposure to retaliation by established firms with more entrenched position.

ii) Product risk: the firm is involving itself in a new production process, which is already being conducted by the rival firms. The risks this poses are:
1. Higher production costs due to lack of experience;
2. Initial quality problems or below quality products causing irreparable harm to the reputation in the market;
3. Lack of established production infrastructure and supply-chain relations, which will make costs higher and may limit product innovation and quality.

iii) Operational and Managerial Risk: this boils down to the danger that management will not be able to run the new business properly. This carries with it with the second danger that management will also be distracted from running the original business effectively too.

iv) Financial risk: this relates to the share price of the business. Shareholders are generally suspicious of 'radical' (and particular diversification) for the following reasons:
1. The product and market risks lead to volatile returns;
2. The firm may need to write off substantial new net assets if the venture fails;
3. The investment needed will reduce dividend and/or necessitate new borrowing;
4. A diverse and unique portfolio makes it harder to compare the firm with others in the same industry when trying to evaluate its risks and returns. The effect will be for the share price to decline to reflect the uncertainties created by the strategy.

(b) When should the insured have an insurable interest in the subject matter of insurance in case of (i) Life Insurance, (ii) Fire Insurance, and (iii) Marine Insurance?

Answer:

The insured should have insurable interest in the subject matter of insurance at the following items:

(i) In life insurance: at the time of taking policy.
(ii) In the fire insurance: at the time taking policy as well as at the time of loss, and
(iii) In marine insurance: an assured need to have an insurable interest at the time of affecting the marine insurance.

Question 20.

(a) Describe risk? Discuss different types of risk.

Answer:

Risk expressed mathematically is the dispersion of a probability distribution: how much do individual outcomes deviate from the expected outcome. A simple measure of dispersion is a range of possible outcomes, which is simply the difference between upper most and the lowest outcomes. This is mathematically measured as standard deviation. Physically, risk can be identified as an event which has different probabilities of happening, but the time of the event is not known as also the impact of such risk can vary. While uncertainty cannot be quantified a risk can be quantified though mathematical models, probability models, correlation, etc. and also measured through quantitative models and technological tools.

Types of Risk:

The risk can include both upside and downside. Potential risk management often refers to reducing downside potential and enhances the returns on topside.

Risks are of many types as follows:

1. Physical Risk like natural calamities: fire, tsunami, floods, earthquake, etc.
2. Business Risk which is inherent to a business due to its nature and susceptibility to environment, e.g., change of fashion, business cycles, conflicts like war, insurgency, cross border terrorism, technological obsolescence, etc.
3. Financial Risk arising out of the nature of financial transactions and conduct of business and investment.

(b) Explain the term 'Profit Loading'.

Answer:

The purpose of every business activity is to earn profits and insurance business is no exception to this. Just like all other for - profit entitles, insurance companies also need to earn sufficient amount of profit in order to cover up business expenses and cost of capital to keep the stake - holders especially investors happy. Profit loading is simply an amount added (by the insurance company or insurer) to an insurance premium to cover business expenses and contingencies including cost of capital. Just like other normal businesses insurance companies must cover its 'trading cost' which are claims and must earn ABOVE its business costs (which is both claims and other business expenses) in order to prosper. That additional amount earned which is above the cost of claims and other business expenses are called 'profit loading'. And the gross total is termed as simply premium or target premium.

The following is the mathematical equation for more understanding about how these figures are connected:

Premium = Claims + Business Expenses + Profit Loading

Where;

Premium is the amount that will be demanded from the insure;

Claims is the total amount of losses insured; and

Expenses are different business expenses including the cost of capital of the insurer.

Question 21.

(a) Why 'Risk - Adjusted Return on Capital' (RAROC) is mainly used by banks and insurance companies?

Answer:

RAROC is a risk - adjusted framework for profitability measurement and profitability management. It is a tool for measuring risk - adjusted financial performance. And it provides a uniform view of profitability across business (Strategic Business Unit / Divisions). This approach attempts to allocate risk costs to the many different activities of the firm, such as products, projects, loans and so on. In effect, RAROC assesses much capital would be required by the organisation's various activities to keep the probability of bankruptcy below a specified probability level. RAROC is defined as the ratio of risk - adjusted return to economic capital. As a

result of RAROC, managers at bank and insurance company are forced to consider risk levels in evaluating the profitability of their decisions.

(b) How is 'Project - Risk Management' done in practice?

Answer:
In reality, the risk assessment is done through considering the various components of the financial estimates and developing certain judgemental approaches:

(i) Estimation of revenues - revenues projected for a project need to be justified on the basis of real data available and then the projections are made conservatively. This avoids optimistic projections of income.

(ii) Cost estimates - it always includes a margin safety to take care of impact of inflation over the time horizon for which the projections are being made. The margin of safety is computed on the basis of trend analysis of inflation over the recent past and the lead indicators that are available from fundamental analysis.

(iii) Acceptable return on investment - this is the prime measure and as such it should be arrived at on the basis of certain consensus. It will depend on the payback period to be assumed, the industry experience and the company's norm for return on any new project on the basis of the current experience.

(iv) Overall certain index - the critical risks of the project are identified and the certainty index of each of these risks is quantified. Then the overall certainty index is developed as an average of the critical indices already computed. For instance, raw materials availability, power availability, intensity of competition is a few of the risks, which are quantified in terms of certainty indices.

(v) Judgment perceptions - three different estimates of return on the investment are developed - (pessimistic, most likely and optimistic) on the basis of the stage at which the particular industry is in its life cycle. On the basis of the three estimates and comparing them with the earlier methods available on certainty equivalent coefficient, a judgemental decision can be taken.

Question 22.
(a) State the process of 'risk mapping' for Pharmaceuticals industries involved with developing a new product?

Answer:
In Pharmaceutical industry, it takes a number of years to develop and test a new drug before it can be introduced into the market, and for much of this time, there will be a real possibility that the new drugs may never become a commercial success. This poses a great amount of risk for this industry in new product development process. With the evaluation of enterprise risk management, risk mapping or profiling method of risk identification and assessment have great use in such kind of new product development risk. In this method, identifying all the risk facing pharmaceutical company using cataloging and making sense of structure than in a manner firm may face them. This involves arraying these risks in a matrix with one dimension being a frequency of event and other being the severity. Each risk then marked to indicate whether it is covered by insurance or not by configuring the likelihood and severity of each of the risk in this

matrix as well as the extent, to which the insurance protection is already available, it becomes possible for the firm to identify the risk that are most likely to seriously affect the firm's ability to achieve its goals.

(b) What do you understand by the term 'Subrogation'? Give two examples to enumerate the term.

Answer:
The term 'Subrogation' means the transfer of all the rights and remedies available to the insured in respect of the subject matter to the insurer after indemnity has been effected. It is also referred to as getting into shoes of the others. It implies substitution of the insurer in place of the insured in respect of the latter's rights and remedies.

For example:
- (i) when loss is caused by the 'wrongful act of a third party, the insurer can proceed against the third party after paying the insured his loss. This principle holds good only in the case of fire and marine insurance.
- (ii) Subrogation also arises in motor insurance as, for example, where an inward motor vehicle is damaged owing to the negligence of a third party against whom the insurers will, therefore, claim in an endeavour to recover the cost of repairs paid by them under their policy.

Question 23.
(a) Write down the strategies which are adopted to manage the risk by the Corporates.

Answer:
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 risk management, the following strategies are generally adopted:
- (i) Risk Avoidance - it is strategy by which the organisation does not engage in the activity of 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 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.

(b) Explain the concept of 'Risk Pooling' and 'Diversification of Risk' in the field of risk management.

Answer:
Risk Pooling: The concept of pooling risk is the process of identification of separate risks and put them all together in a single basket, so that the monitoring, combining, integrating and diversifying risk can be implemented easily.

Monitoring become easier when the specific agency put in charge knows that all the risks have been identified and being monitored accordingly to the system drawn up to quantify the total risk through pooling and with a control figure. Process is as follows:

Step I – plan the way to monitor
Step II – monitoring executed
Step III – controlling and checking whether there is any variation from monitoring exercise, and
Step IV – act to corrective measures for deviation. This correction act can be combining or integrating or diversifying risks.

Diversification of risk: Diversifiable risk (also known as unsystematic risk) represents the portion of asset's risk that is associated with random causes that can be eliminated through diversification. It's attributable to firm specific events, such as strikes, lawsuit, regulatory actions and loss of a key account.

Unsystematic risk is due to factors specific to an industry or a company like labour unions, product categories, R&D, pricing & marketing strategy etc. While the non-diversifiable risk (also known as systematic risk) is the relevant portion of an asset's risk attributed to market factors that affect the firms such as war, inflation, international incidents, and political issues. It cannot be eliminated through diversification. These risks are unavoidable and the market does not compensate for taking exposure to such risks.

The systematic risk, which is the market risk is external to an organization and also termed as market risk. The characteristics of market risk are identified through statistical correlation "Beta" (β_i), which is a measure of market risk.

Question 24.
(a) What is meant by 'Incurred – But – Not - Reported Reserve (IBNR)'? Enumerate one suitable example.

Answer:
Many losses occur near the end of the accounting period but are not reported until the next period. The IBNR reserve is a reserve that must be established for claims that have already occurred but have not yet been reported. Loss reserves must be established for these losses that will be reported during the next accounting period. For example, on 31st March, a certain number of motor cycle accidents have already occurred but have not been reported to the insurer.

(b) What do you understand by 'Pure Risk'? What are the major types of 'Pure Risk' which affect the business? State in brief the different methods of managing 'Pure Risk'.

Answer:
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 the business include following:

- (i) Property Risk;
- (ii) Legal Liability Risk;
- (iii) Other Risks (includes risk of death, illness, disabilities to employees, risk of loss of services etc.

The methods of managing Pure Risk can be broadly classified as:

(i) Loss Control; Two general approaches:
1. reducing the level of risky activity and
2. Increasing precautions against loss for activities that are undertaken.

(ii) Risk Financing or Loss Financing; this method is used to obtain funds to pay for or offset losses that occur. Three approaches, like (a) retention, (b) insurance, and (c) other contractual risk transfers. These approaches are not mutually exclusive, that is, they often are used in combination.

(iii) Internal Risk Reduction; (i.e., business can reduce pure risk internally). There are two major forms of internal pure risk reduction; (a) diversification, and (b) investment in information.

Loss Control and Internal Risk Reduction are commonly involved in decisions to invest resources to reduce expected losses. They are conceptually equivalent to other investment decisions, such as firm's decision to buy a new plant or an individual's decisions. Risk Financing/Loss Financing decision refers to decisions about how to pay for losses if they do occur.

Question 25.

(a) Write a short note on 'Risk Assessment Techniques'.

Answer:

Risk Assessment is a fundamentally important part of the risk management process. In order to achieve a comprehensive risk management approach, an organization needs to undertake suitable and sufficient risk assessment techniques. It is also required in relation to routine operations.

Risk Assessment Techniques:

- (i) Structured Questionnaires and Checklists: to collect information to assets with the recognition of the significant risks.
- (ii) Workshops and Brainstorming: collection and sharing of ideas and discussion of the events that could impact the objectives, stakeholder expectations or key dependencies.
- (iii) Physical Inspections of premises and activities and Audits of compliance with established systems and procedures.
- (iv) Flow - charts and Dependency Analysis for identifying critical components that is key to success.
- (v) Hazard and Operability Studies (HAZOP) and Failure Models Effects Analysis (FMEA): These are the quantitative technical failure analysis techniques.
- (vi) SWOT and PESTLE Analysis: Strengths, Weaknesses, Opportunities and Threats analysis and Political, Economic, Social, Technological, Legal and Environmental analysis offered structured approaches to risk recognition.

(b) Define Net Single Premium (NSP). Write three basic assumptions of NSP.

Answer:
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.

Question 26.
(a) Discuss 'pricing' in relation to insurance products and the role of Management Accountant in this regard.

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

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

This is of particular importance to a management accountant as it is in the nature of pricing a product. The insurance premium can be divided into four parts:
(i) Cost of payments of losses;
(ii) Cost of operation and maintenance of insurance pool;
(iii) Reserve for contingencies;
(iv) ROI

In the life insurance, calculation of insurance premium is very complicated exercise as the variables involve are many, e.g., factors aggravating mortality rates like smoking, drinking, drugs and other habits, age of the insured, occupational hazard, etc. This computation is normally through actual computations involving mortality rates. Premium rate is often referred as rate per unit of exposure.

(b) Can you suggest an exchange rate risk management through asset-liability management for Indian IT firms becoming global?

Answer:

Indian IT firms are becoming global by expanding their businesses to USA and Europe, their financial performance are subject to exchange rate risk. To overcome this problem, they need to have exchange rate risk management through asset-liability management. As the exchange rate fluctuates the IT firm's assets and liability not match exactly and create stress. A simple solution to correct this risk is risk management and shareholders to match assets and liability in the same currency. The risk of foreign exchange borrowing of Indian IT firms can be passed on to the lender through dollar denominators loans. The uncovered loans are hedged at the time of contracting them through forward covers to the entire amount.

Question 27.
(a) State the requirements & characteristics of an insurance contract.

Answer:

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

(i) Agreement must be for a legal purpose, i.e., the contract of Insurance should not violate the principle of Insurable Interest and it is a contract of Uberrimae Faide (Utmost Good Faith).
(ii) Parties must have legal capacity to contract; Minors, Lunatics, Insolvents, Intoxicated persons, etc. do not have the legal capacity and cannot enter into an insurance contract.
(iii) There should be a valid offer and acceptance and
(iv) There must be exchange of consideration in response to an agreement which defines the quantum of possible loss to the insured. The premium amount is paid by the Insured by way of consideration on the basis of the policy risk insured. The Insurer's consideration will be a promise to indemnify the loss of the insured on the occurrence of the insured's risk.

Characteristics of insurance contract: Following are the unique characteristics which are distinct from other forms of contract:

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

(b) State the solvency related measures for risk management.

Answer:
Solvency-related measures (these measures concentrate on the adverse "trail" of the probability distribution – and are relevant for determining economic capital requirements)

- Probability of ruin – the percentile of the probability distribution corresponding to the point at which the capital is exhausted.

- Shortfall risk – the probability that a random variable falls below some specified threshold level. (Probability of ruin is a special case of shortfall risk in which the threshold level is the point at which capital is exhausted.)

- Value at risk (VAR) – the maximum loss an organization can suffer, under normal market conditions, over a given period of time at a given probability level. VaR is a common measure of risk in the banking sector, where it typically calculated daily and used to monitor trading activity.

- Expected policy holder deficit (EPD) or economic cost of ruin (ECOR) – an enhancement to the probability of ruin concept (and thus shortfall risk and VaR) in which the severity of ruin is also reflected. Technically, it is the expected value of the shortfall.

- Tail Value at Risk (Tail VaR) or Tail Conditional Expectation (TCE) – an ECOR-like measure in the sense that both the probability and the cost of "tail events" are considered.

- Tail events – unlikely but extreme events, usually from a skewed distribution. Rare outcomes, usually representing large monetary losses.]

Question 28.
(a) What, in your opinion, are the ways one needs to equip himself to be a Strategic Cost Management Accountant?

Answer:
A Cost and Management Accountant has to equip himself in the following ways so as to become a Strategic Cost and Management Accountant:

(i) He needs exposure to multi-disciplines; Functional mileu has changed and watertight compartments do not exist anymore. Teamwork with peers in different areas is also a must.
(ii) He needs to be the change agent. He should help the firm to understand the environment and introduce necessary changes within the system to cope up with the fast changing world in the context of the third wave.
(iii) He should help in building strategic cost management. He should develop analytical skills for benchmarking exercises, SWOT analysis, activity orientation, Target costing, focus on both cost leadership and product differentiation.
(iv) Integrate customer satisfaction into total cost management using value-chain analysis. This aspect identifies the area of optimum value addition and the need to relate value to customer satisfaction in quantitative terms.
(v) Be a part of the management team; Step outside the ivory tower and mingle with the main stream to introduce total cost Management practice. This aspect

incorporates use of cost tables, shop floor exercises, interpretation of technical and efficiency improvements in terms of value.

(vi) Ability to undertake environmental scan and in carrying out SWOT analysis.

(vii) Be a part of cross-functional team to lay down strategic initiatives in a chronological order over the time horizon of the strategy.

(viii) Ability for developing targets, measuring and interpretation of deviation through proper tools like Balanced Scorecard, EVA, Strategy mapping, etc.

(ix) Sustain 'Kaizen'.

Thus the management accountant takes on the strategic change portfolio to a great extent because he is the thread, which runs through formulation, implementation and sustaining momentum for further modification and improvement.

(b) "Whether the buyer will exercise his right under the contract depends upon the spot price for the currency prevailing on the due date of the contract." — Classify the contract based on the prevailing spot price.

Answer:

Based on the prevailing spot price, the option contract may be considered as follows:

In-the-money Options:

An option is in-the-money when it would be advantageous for the holder of the option to exercise his right. Thus, a call option is in-the-money if on the maturity date the spot price for the currency being bought is higher than the strike price under the option contract. A put option, on the other hand, is in-the-market, if at maturity the spot price for the underlying currency is cheaper than the strike price under the contract. The difference between the option price and the spot price at maturity, which is in favour of the buyer is known as the intrinsic value of the option.

Out-of-the-money Options:

An option is out-of-the-money if it is not advantageous for the buyer to exercise his right. A call option is out-of-the-money if the spot price for the currency bought under option is lower than the strike price agreed under the contract. A put option is out-of-the-money on the maturity date where the spot price for the currency sold is higher than the strike price under the option contract. When the option is out-of-the-money, the buyer does not exercise his right and the seller stands to gain by the premium he received under the contract.

At-the-money Options:

An option contract is at-the-money when the strike price is equal to the spot rate for the currency concerned on the due date of the contract. It makes no difference to either of the parties whether the buyer exercises the option or not.

Question 29.

(a) State the factors on which the valuation of an option depends.

Answer:

The valuation of an option depends upon six factors relating to the underlying asset and the financial market. These factors are:

(i) **Current Value of the Underlying Asset**: As the options, being financial derivatives, derive their value from the underlying asset, the current value of the underlying asset is an important factor for valuation of options.

(ii) **Expected Volatility in the Value of the Underlying Asset:** Any expected change in the value of the underlying asset also affects the value of the option on that asset. In a call option (where the holder has a right to buy the asset), an increase in the value of the asset will increase the value of the call option. Similarly, if the value of the asset is expected to increase in case of put option, the value of the put option will decrease. So, the value of option depends upon the variation in the value of the asset. The higher the variations in the value of the underlying assets, the greater the value of the option.

(iii) **Strike Price of the Option:** The exercise of the option depends upon the difference between the strike price and the actual price of the underlying asset; therefore, the strike price is an important factor for valuation of options. In case of call option, the value of option will decline as the strike price increases, and in case of put option, the value of the option will increase as the strike price increases.

(iv) **Expiration Time of Option:** The longer the time to expiry, higher would be the value of the option. The simple reason being that longer expiry time will allow more time for the underlying asset to move. In terms of time value of money, the present value of the strike price will decrease as the expiry time of the option increases.

(v) **Rate of Interest:** The option holder has to pay the option premium upfront, i.e., in advance to buy the option. So, there is always an opportunity cost of this premium. This opportunity cost depends upon the time to expiry and prevailing interest rates. Increase in interest rate will increase the value of the call option but will reduce the value of the put option.

(vi) **Income from Underlying Asset:** During the life of the option, there may arise interest or dividend income on the underlying assets. The value of the asset will decrease, as the interest or dividend is paid. So, the value of the call option decreases and the value of the put option increases as more and more interest and dividends are paid on the underlying assets.

(b) List out the contents of Risk Management Policy.

Answer:

A risk management policy should include the following sections:

- Risk management and internal control objectives (governance)
- Statement of the attitude of the organisation to risk (risk strategy)
- Description of the risk aware culture or control environment
- Level and nature of risk that is acceptable (risk appetite)
- Risk management organisation and arrangements (risk architecture)
- Details of procedures for risk recognition and ranking (risk assessment)
- List of documentation for analysing and reporting risk (risk protocols)
- Risk mitigation requirements and control mechanisms (risk response)
- Allocation of risk management roles and responsibilities
- Risk management training topics and priorities.

Question 30.

(a) State whether the following statements, based on the quoted terms, are 'TRUE' or 'FALSE' with justifications for your answer:

(i) Net Single Premium (NSP) is the future value of the future death benefit.
(ii) Probable Maximum Loss (PML) is a risk measurement and evaluation technique.
(iii) Physical hazard is a condition stemming from material characteristics of an object.
(iv) Risk cannot be avoided through insurance but may be considered as an means to transfer the risk.
(v) 'Future' a derivative, is used as a hedging mechanism against 'Risk'.

Answer:

(i) False – The NSP can be defined as the present value of the future death benefit.
(ii) True - PML is a risk management and evaluation technique.
(iii) True - Physical hazard is a condition stemming from material characteristics of an object.
(iv) True - Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for payment.
(v) True - Futures are derivatives affording protection against exchange risk.

(b) In each of the cases/statements given below, one of four/five alternatives is correct. Indicate the correct answer:

(i) Unsystematic risk relates to:
(A) Market risk;
(B) Beta(β);
(C) Inherent risk;
(D) Inflation risk.

(ii) When risk is perceived and not transferred/ recognized /reduced is actually known as:
(A) Risk retention;
(B) Risk reduction;
(C) Risk transfer;
(D) Risk sharing.

(iii) 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.

(iv) Instruments that hedge against risk do not include:
(A) Guarantee;
(B) Underwriting;
(C) Factoring;
(D) Rights issues.

(v) Pre - loss objectives in risk management are:
(A) Understanding environment, fulfillment of external obligations — statutory requirements;
(B) Reduction in anxiety through preventive measures;
(C) Social obligations to make people aware of the risks;

(D) All the above.

Answer:

(i) (C) Inherent risk
(ii) (A) Risk retention
(iii) (D) All of the above
(iv) (D) Rights issues
(v) (D) All the above.