Paper 13: Management Accounting – Strategic Management

Section- I

(i) Choose the most appropriate one from the stated options and write it down:

(i) Most Indian firms did not have a mission statement till recently because
- (a) It was not a statutory requirement
- (b) Companies were not professionally managed
- (c) Growth options were controlled by Government policy
- (d) There was lack of specialists

(ii) 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.

(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 environmental factors that affect an organisation's strategy are
- (a) Exchange rate movements, political and legal developments, capital base and nature of the tax system
- (b) Technological factors, economic factors, social conditions, political & legal developments
- (c) Public vs. private sector ownership, industrial climate, technological base, skilled manpower
- (d) Demographic composition, financial constitution, political environment, infrastructural facilities

(v) Which would best describe the SBU format?
- (a) The General Insurance Corporation of India
- (b) Hindustan Lever limited
- (c) ITC
- (d) Steel Authority of India Limited

Answer:

(i) (c) - Growth options were controlled by Government policy

(ii) (d) - For those companies who are strong in the market but not leaders and might capture a market share from the leader.

(iii) (c) - the acquisition of design from a collaborator and carrying onto necessary modifications thereto

(iv) (b) technological factors, economic factors, and social conditions, political and legal developments

(v) (a) The General Insurance Corporation of India

(b) State whether the following statements are 'true' or 'False' with justification for your answer.

(i) "Meta-Technology" is the science and study of sociological and technological developments, values and trends -with a view to planning for the future.

(ii) 'Market forecast' by a company involves the selection of its market and setting as an objective a target share of each market segment.

(iii) 'Divestment' means selling off a part of a firm's operations, or putting out of certain product-market operations.

(iv) 'Debt recovery' is an arrangement to have debts collected by a factor company, which advances a proportion of the money it is due to collect.

(v) 'Acquisition' is nothing but the joining of two separate firms to form a single firm.

Answer:

(i) False. Meta-technology is a technology whose field of action is the determination of reality. It proceeds by unbelief—by decrease in credulity relative to the prevailing culture. The term was propounded by Henry (a) Flynt, Jr.(1979),

(ii) False. The appropriate term is 'Market Positioning' or 'Product Positioning' or 'Target Marketing' instead of the words 'Market Forecast'. Market selection and target share of it are aimed in 'Market Positioning' and not in 'Market Forecast'. Thus the corrected statement is - 'Market Positioning' by a company involves the selection of its market and setting as an objective a target share of each market segment.

(iii) True. 'Divestment' means selling off a part of a firm's operations, or putting out of certain product-market operations.

(iv) False. The appropriate term is 'Factoring' instead of the word 'Debt recovery'. 'Debt recovery' is a recovery of debts from borrowers. Thus the corrected statement is- 'Factoring' is an arrangement to have debts collected by a factor company, which advances a proportion of the money it is due to collect.

(v) False. The correct statement is: 'Merger' is nothing but the joining of two separate firms to form a single firm.

(c) Define the following terms (in not more than one/two sentences):

(i) Cash Cows

(ii) Human Resource Strategy

(iii) Fiscal Policy

(iv) Market Skimming

(v) Acquisition

Answer:

(i) **Cash cows**: Cash cows needs very little capital expenditure and generate high levels of cash income. Normally stars will become cash cows, with a high share of a low-growth market.

(ii) **Human Resource Strategy:** The primary objective of this strategy is to improve productivity by reducing the unit cost of output/employee, optimising costs in the areas of man-machine relationship, structuring wage levels, outsourcing, introducing automation, etc.

(iii) **Fiscal policy:** A policy that involves taxation and other sources of income, government spending and borrowing whenever spending exceeds income.

(iv) **Market Skimming:** A policy to gain high unit profit very early when a product is first launched It is at the opposite end of the spectrum to penetration prices in the range of prices that are possible,

(v) **Acquisition:** is the purchase of the controlling interest of another company.

Question.2
(a) What is a 'Model' in business decisions and strategies?

Answer
Model:
The word 'model' is often used in conjunction with quantitative techniques for business decision making and for strategic choices. Almost all quantitative techniques can be classified as models.
Generally all business decision situations, although decision-contents greatly vary, have certain common factors like – (i) alternative choices, (ii) possibility of various outcomes against a particular choice, (iii) occurrence of probabilities against an alternative, and (iv) inequality of the probabilities for each outcome. In such a situation, decision maker or the strategist has to determine the value or the utility with each unique action-outcome combination – before he makes the final decision or strategy – mostly in terms of pay-offs and costs.
A quantitative technique incorporates all these elements of business decision situations into a 'model' that is intended to maximize pay-offs and minimize costs.

(b) Give various classifications of 'models'.

Answer
Classification of 'Models'
There are several basic kinds of models.
(i) **Analog model:** An 'analog' model is a physical representation of the real world. A mockup of an airplane is an analog model. An architect may place a mockup of a building to examine the characteristics of alternative designs. Such models are always reduced in size.

(ii) Iconic model: An 'iconic' model is one which does not act like the real thing but only looks like it. For example, a road map or an organization chart. A road map abstract the facts like distance, direction, kinds of highways, bridges and tunnels, etc. needed by a driver. Similarly, in an organization chart, the boxes represent specific offices or formal roles and the lines represent channels of communications and reporting relationships.

(iii) Verbal model: It involves a verbal description of a real situation. Language, written or spoken is employed to abstract the relevant factors or characteristics. A newspaper description of a football game is a verbal model.

(iv) Mathematical model: This model employs mathematical manipulation of symbols to abstract and represent the behaviour of a real-world system. The use of electronic computers has led to the rapid and wide adoption of mathematical models in managerial decisions. A complex series of mathematical formulae representing the growth of Indian economy can be classified as a model.

(c) Why should a manager consider using 'models' in business decisions and strategies?

Answer:

The specific reasons are –

(i) A model in a decision situation provides a frame of reference to consider the decision-cum- strategy problem. A number of diverse considerations can be brought together in an organized fashion.

(ii) A model can suggest gaps in the manager's information about the decision, even though the gaps are not immediately apparent. It can, consequently, suggest useful lines of inquiry.

(iii) A model brings out into the open the process of abstraction and decision-cum-strategy making. The process of abstraction is deliberate.

(iv) A model, be it iconic, verbal or mathematical, can be easily manipulated. For example, a mathematical model of an entire economy is capable of testing the effects of a variety of monetary and fiscal policies on economic outcomes without waiting for the actual economy to behave.

(v) A model is always cost-effective and considered as the safest means to test alternative designs.

(vi) Building a model allows the decision maker to simplify reality to the extent that he can grasp its salient characteristics, make his understanding of the situation rather more concrete, and focus his attention on the most important elements of the situation.

(vii) A model serves as a kind of filter, eliminating extraneous of confusing data, while highlighting meaningful pattern.

(viii) The primary value of a model lies in its simplicity relative to the real world.

Question.3 Write short notes on the following:

(i) Benefits of Strategic management
(ii) Crisis Turnarounds
(iii) Types of Buying Behaviour
(iv) Premium and Penetration Pricing
(v) Strategic Total Cost Management

Answer

(i) Strategic management is defined as a set of decisions and actions resulting in formulation and implementation of strategies designed to achieve the objectives of an organisation.

The following are some of the benefits that would accrue to any company if it practices sound strategic management.

(a) Financial benefits: Improved financial performance in terms of both profit and growth
(b) Enhanced capability of problem Prevention:
(c) Improved quality of strategic decisions through group interaction,
(d) Greater Employee Motivation.
(e) Reduction of gaps and overlaps in activities
(f) Minimum resistance to change,
(g) Positive impact on the long-term prosperity of the firm
(h) Leads to better analysis and diagnosis of the current and likely future environment, identifying opportunities and threats.

(ii) Crisis turnaround refers to the management measures which reverse the negative trends in the performance indicators of the company. In other words, turnaround management refers to the management measures which turn a sick company back to a healthy one or those measures which reverse the deteriorating trends of the performance indicators such as falling market share, sales (in, constant rupees), profitability and worsening debt-equity ratio. The exact nature of crisis turnaround and the relative importance of different factors may vary from company to company. The important factors commonly employed in turnaround management are:

(a) management factor,
(b) human resources factor,
(c) production facilities,
(d) financial management,
(e) product-mix modifications and
(f) marketing strategy.

According to one leading organisation scientist, the elements of a successful turnaround strategy are:

(a) change in top management,
(b) initial credibility-building actions,
(c) neutralising external pressures,
(d) initial control,
(e) identifying quick pay-off activities,
(f) quick cost reductions,
(g) revenue generation,
(h) asset liquidation for generating cash,
(i) mobilisation of the organisation and
(j) better internal co-ordination.

(iii) Consumer decision making varies with type of buying decision. Complex and expensive purchases are likely to involve more buyer deliberation and more participants. 4 types of consumer buying behaviour based on the degree of buyer involvement and the degree of difference among brands can be distinguished. They are:

Complex buying behaviour - Consumer go through complex buying behavior when they are highly involved in a purchase and highly aware of significant differences among brands. Consumers are highly involved when the product is expensive, bought infrequently, risky and highly self-expressive. Typically the consumer does not know much about the product category and has much to learn.

Dissonance - Reducing buying behavior: Sometimes the consumer is highly involved in purchase but sees little difference in the brands. The high involvement is again based on

the fact that the purchase is expensive, infrequent, and risky. In this case, the buyer will shop around to learn what is available but will buy fairly quickly because brand differences are not pronounced.
Habitual buying behavior - Many products are bought under conditions of low consumer involvement and the absence of significance brand differences. They go to the store and reach for the brand. If they keep reaching for the same brand, it is out of habit, not strong brand loyalty. Consumer behavior does not pass through the normal belief/ attitude / behavior sequence.
Variety - Seeking buying behavior: Some buying situations are characterised by low consumer involvement but significant brand differences. Here consumers are often observed to do a lot of brand switching.

(iv) Premium Pricing: New products when entering the market may resort to pricing at a premium. This Idea is to sell the product, which is a novelty item at a higher price, at the beginning, capture the niche market and later on lower the price and thereby make huge initial cash flows.
Following are the situations, when Premium Pricing is affected:
When the new product is a drastic improvement or is far superior to the existing options. In such situations and assuming consumers are less sensitive to price in the early stages, marketer can charge high price for its offering.
(a) When the product seems to have a high esteem value;
(b) When the potential customers are willing to pay high prices;
(c) When there is demand-elasticity for the demand of the product;
(d) When the BRAND of the product is identifiable and distinguishable.
(e) The Initial high price also serves to skim the cream of the market, as long as a section of the market, (i.e. early adopters) are keen to buy a superior quality product.
(f) This sort of premium pricing strategy is okay as long as the demand is likely to be far greater than firm's ability to meet the level of demand.
However, premium, pricing strategy is not always appropriate. It does have some drawbacks. It does not encourage rapid adoption or diffusion of the product. Moreover, as premium pricing usually results in high profit margins, it is likely to invite more new competition.
Penetration Pricing: It is a strategy where marketer deliberately keeps the offering at a somewhat lower price as a wedge to get into mass market early.
It is appropriate when:
(a) The main target is to capture major portion of the market share.
(b) Market is highly price sensitive and the demand is highly elastic.
(c) It is possible to manage with low prices and low margin as long as the sales volume is large, (e. g. Lifebuoy soap, Nirma detergent)
(d) Market is unwilling to pay a higher price to obtain the same product. This was the case in case of handsets of mobile phones in India. With drop in price, the market expanded at a rapid pace.
Example: Reliance has penetrated into the Telecom market with its low price and has obtained a big chunk of the market share.

(v) Strategic Total Cost Management is a new world-class approach to Cost Management. So long we had been classifying cost under 3 heads - as variable, semi-variable and fixed. When cost as a strategy is to be implemented, it presupposes that there is a time horizon, which is longer than a few accounting periods. In such a time-span, even the so-called fixed costs tend to vary e. g., rent, taxes, salaries, etc. So, the total cost management strategy has evolved a new classification namely, Bed rock Fixed Costs e.g., depreciation,

patent, amortisation, etc. , Managed Costs-like rent, taxes, salaries, maintenance, advertising, etc. , Truly Variable Costs- like materials, royalties, freight, overtime cost, etc.
The above classification helps in arriving at Break-even points, which are more credible and take into consideration the changes in the costs over a period. A single break even is not possible and not acceptable in the Total Cost Management.
Another very important feature of Total Cost Management is that almost all costs are manageable through cost strategy as even period costs tend to vary over time. For instance, rents, which are considered as fixed cost under normal parlance are treated as, managed costs in Total Cost Management Strategy. This is particularly so, because the quantum of rent variation can be managed through leasing, tax-planning etc.
Introduction of Strategic Total Cost Management can embrace many different areas in business and as such there are specific tools to be employed for the implementation as follows:
Enterprise wide cost system,
Production Cost System,
Marketing Cost Management,
Support Cost Management,
Transformation Cost Management
Strategic Total Cost Management emphasizes that enduring cost benefits will accrue to a company only when the organisation aligns its information systems to its strategic goals. ERP (Enterprise Resource Planning) concept stems from this tenet and introduces automation in areas where the human intervention may not be so efficient but more costly.

Question.4

(a) "In maturity stage of product life cycle the market becomes saturated, price competition intensifies, and the rate of sales growth slows down."
Suggest strategic choices in such situations.

Answer:

Marketing and distribution strategic choices for maturity stage of product life cycle:

The following is the list of alternative marketing and distribution strategies available before the marketing management to face the situations characterized by the maturing stage of the Product Life Cycle:

(i) Intensification of brand promotion by means of –
- **(a)** More intensive and brand-stressing advertising;
- **(b)** Heavier point-of-sale effort;
- **(c)** More attractive design and functional packaging;
- **(d)** Advertising messages and media for different market segments;
- **(e)** More after-sales service for the product; and
- **(f)** Increase in sales promotion expenditure rather than advertising to hold customer loyalty rather than seek out new buyers.

(ii) Trading down through –
- **(a)** Entering a 'fighting brand' on the market at a lower price to avoid jeopardizing an established premium brand;
- **(b)** Introduction of low-priced models of an established brand;
- **(c)** Lowering of prices of the entire product line and keeping prices close to private levels; and
- **(d)** Production for private levels.

(iii) Proliferation, exclusive or radical, by –

(a) Offering more variety in features and designs, etc.;
(b) Seeking more exclusive and innovative features;
(c) Creating more radical and distinct package designs; and
(d) Making more options available in accessories, and design, etc.

(iv) Trading up (strategy opposite to item ii) through -
(a) Improvement of quality, appearances, etc. to offer better product;
(b) Use of prestige packages, brand name, etc.; and
(c) Increase of prices to cream market labels (in order to increase penetration of markets willing to pay higher prices, earn more margin on possibly lower sales, and keep greater differentiation over competitive products).

(v) Increase of product availability and point-of-sale service through –
(a) More distribution centers closer to the point of use or sale;
(b) Longer channels to make the product more available at wholesale level;
(c) More outlets and different channels; and
(d) Improvement of services offered by dealers (where applicable) or establishment of own service centers.

(b) Distinguish between Corporate Planning and Long-Range Planning.

Answer:

Corporate Planning and Long-Range Planning: Corporate planning is concerned with determination of objectives treating the company as a whole and developing means to achieve the overall Company's objectives. It may encompass both short periods as well as long periods. It is an integrated system approaching plans of different components of the organisation. Corporate Planning is done at the corporate level.

Long Range Planning is a systematic and formalised process concerned with directing and controlling future options of an enterprise towards desired objectives for periods spreading generally over 5 or more years. It provides an opportunity to management to anticipate future problems and to have greater freedom of action to resolve them in an orderly manner.

Question.5

(a) The life cycle hypothesis is a powerful integrative tool for any industry. Discuss the various stages defined in three popular PLC models, namely:
(i) Porters Generic Strategies
(ii) Ansoff's Matrix
(iii) BCG Matrix

Answer

Stages	**Introduction**	**Growth**	**Maturity**	**Decline**
Porter	Differentiation	Differentiation	Cost	Cost focus
Ansoff	Market	Product	Penetration	Diversificatio
BCG	Question mark	Star	Cash cow	Dog

Porter:

- Cost leadership – become the lowest cost producer for the market as a whole.
- Differentiation – is the exploitation of a product or service, which is unique in the market as a whole.
- Focus (either cost or differentiation) – depends on segmentation and involves pursuing. Thus, instead of trying to serve the entire market with a single product, it is based on segmenting the market and targeting particular segments. With the segment only focus

on either cost or differentiation, depending on the requirement.

Ansoff:

- Market development – uses existing products in new markets.
- Product development – involves offering new products to existing market.
- Market penetration – involves trying to milk more from existing products and existing markets.
- Diversification – involves moving into new market with new products.

BCG:

- Question mark – is a product in a high growth market, but has a low market share. Because considerable expenditure would be needed to build up market share, question mark will usually be poor cash generator and show a negative cash flow.
- Stars – are products with a high share of a high growth market. In the short term, these require capital expenditure, possibly in excess of the cash they generate.
- Cash cows – are products with a high share of a low growth market. They need very little capital expenditure and generate high levels of cash incomes.
- Dogs – are products with a low growth market. They generate either modest positive or negative cash income.

(b) Write Short note on Strategic Business Unit.

Answer:

Strategic Business Unit:

First conceived by McKinsey, the concept of Strategic Business Units (SBU) has become an essential building block for the strategic planning process. A SBU is normally defined as a division of the organisation where the managers have control over their resources and direction over the deployment of resources within specified boundaries. SBUs have, an external market, for goods/services, distinct from those of other SBUs. In essence SBUs must have or be:

- A unique business mission
- An identifiable set of competitors
- A viable competitor
- Moreover the SBU strategic manager can make a strategic decision or implement relatively independent of other SBUs.
- Crucial operating decisions can be made within the SBUs.

Question.6

(a) Define 'marketing mix' and explain its main features.

Answer:

Marketing mix is a term used by Prof. Macarthy in mid 1960's. Some definitions on this term are given below:

(i) "Marketing mix refers to the amounts and kinds of marketing variables the firm is using at a particular time." (Philip Kotler)

(ii) "The marketing mix refers to the apportionment of the effort, the combination, the designing and integration of the elements of marketing into a programme or mix which on the basis of an appraisal of the market force will best achieve the objectives of an enterprise at a given time." (Prof. N.H. Bordon)

(iii) "Marketing mix is the combination of the four inputs which constitutes the core of a company's marketing system – the product, the price structure, the promotional activities, and the distribution system (place)." (Stanton)

Thus, the term marketing mix refers to a combination of marketing decisions which are aimed at stimulating sales and constitutes a firm's marketing system in a global sense. It denotes and consists of a well- designed plan that analyses the important forces having direct linkage with the firm's marketing operations and that outlines and implements policies relating to the firm's marketing programme through co-ordination of available resources such as sales promotion, advertising, personal sales, service, distribution, etc. The concept includes "Four P's" i.e. right product, right place, right promotion and right price.

Features of marketing mix - A product must be such as to satisfy the needs and wants of the consumer. The price of the product must be reasonable so as to enable the consumer to pay for the product. If it is exorbitant, most of the consumers reject it. Also the promotion such as advertising and personal selling must be right without exaggerating the advantages of the product. And place means transportation and channels of distribution.

These four P's are now widely discussed by the marketing executives because any one variable of them is of no use. Every element of the marketing mix must be planned with demographic profile in mind. The product design, price, advertising media, sales promotion tools and distribution channels will often be different depending upon whether the target market is young, and so on. Marketing plan must be based on the characteristics of the best planners, thus, look first at demographic characteristics since these are usually more available, reliable, and actionable than other types of characteristics. Changes in one or more demographic characteristics of the population often prompt a business firm or an entrepreneur to offer some new product or service aimed at the changing segment.

The marketing manager in the interest of his business firm has to arrange and co-ordinate the marketing in such a way that would advance harmonise development of each of the above P's.

(b) What is a Mission Statement?

Answer:

Mission Statement: A Mission Statement is a document, embodying some of the matters as outlined above. A Mission Statement provides a statement to insiders and outsiders on what the organisation stands for. It conveys the grand design of the firm and conveys what it wants to be. A Mission statement might be a short sentence, or a whole page. It is intentionally unquantified and vague and is sometimes seen as a statement of an organisation's values, rather than its distinctly commercial objectives. It should be a statement of the guiding priorities that govern a firm's behaviour. Mission statement should be simple to understand and as such jargons and buzzwords should be avoided. It should be appropriate to the organisation in terms of its culture, history and shared values. It should be consistent with the present situation. It should be written in a positive tone. Mission statement should be unique to the organisation. Further, it should be enduring and should guide and inspire the organisation for many years to come. Mission Statements are rarely changed as otherwise they have less force, and become mere slogans. However, there is no standardized content or format of Mission Statement.

Question.7. What is market share analysis? How is it determined?

Answer:

Market share analysis – Before a discussion is made about market share analysis, it is important to understand the meaning of the term 'market share'. Market share is the percentage of a business's sales relative to the combined sales of all competition in a given market. By achieving a large share of the market in which it competes, a business firm can gain important advantages over its smaller rivals. Market share analysis refers to a technique by which the relative merits of a company's product in comparison with the competitor's products are determined. It assists in knowing the present and long- term demand for the particular product of a company in relation to the total demand for the same product in the market. Such analysis requires an explicit evaluation of competition and of the company's market plans in terms of their effect of a firm's position in the industry. This analysis is a part of corporate planning vis-a-vis market planning exercise. The market share analysis is effective when trends are reasonably predictable and competition is centered on market share. In industries like fashion garments or toys for children, market shares are very unstable. Thus, any attempt to project market shares from historical data is likely to be misleading both in the short-run and in the long-run. It is only an approximate indicator of market position due to changing market conditions.

Determination of market share: In order to determine the market share, the total demand forecast is subjected to competitive analysis and a sales forecast for the company is prepared. The measurement of market share becomes meaningful if the 'Industry' can be precisely defined in terms of directly substitutable, non-differentiated products. In practice, market share measures can be only approximations of the market positions. In other words, we find that there are three determinants to ascertain market share – (i) total demand forecast, (ii) competitive analysis, and (iii) sales forecast.

(i) Demand forecast – There are various methods and techniques of quantitative forecasting of demands such as extrapolation, regression analysis, input-output analysis, and economic models.

Extrapolation implies projection of past trends. For example, a graph of past demand and sales for a product may be projected in the future and adjusted for any changes that are expected to occur. Time series analysis and exponential smoothing are used for the purpose of extrapolation.

Regression analysis is an independent forward projection technique that uses casual relationships between the elements of a situation. It predicts the dependent variable (say, demand in quantities of a product) on the basis of value of one or more independent variables (such as population changes, purchasing power, employment level, etc.).

Input-output analysis, which is appropriate for a short-term, demand forecast, can be used to study a company and a market. It shows the inter industry flow of products and services within the national economy on the assumption that output of one industry is the input of another industry and that there is no technology change over the forecasting horizon.

Econometric models, which are predictive and descriptive in nature, take the help of economics, mathematics, and statistics in order to express economic relationships. It is a system, whereby hypotheses are developed concerning the relationships among a set of variables and a certain economic phenomenon.

(ii) Competitive analysis – It involves (a) identification of competitors and their present market share; (b) comparison of the marketing strategies (product quality/ pricing/ discount/ packaging/ distribution/ promotion, etc.) of different competitors; and (c) forecast of changes in marketing strategies and their impact on the market share of each competitor.

(iii) Sales forecast – There may be long-term and short-term sales forecasting. The function of long-term forecast necessitates information about market conditions for a good length of period (5 or 10 years) upon which a rational plan of expansion, modernization, or diversification is based. In short-term forecasts, emphasis is on seasonal fluctuations in demand or on temporary changes in national income levels.

Question.8. Discuss and explain the concepts, scope, and dimensions of:

(a) Customer analysis
(b) Competitor analysis
(c) Industry analysis, and
(d) Economy analysis as parts of external analysis necessary in understanding the marketing strategy.

Answer

External analysis is concerned with identifying opportunities and threats and strategic questions that affect key factors of successful performance. Such analysis is necessary for strategy formulation and management in all fields of activity including marketing activity of an organization. This analysis is mainly concerned with the study of external environment in which a business firm operates.

The components of external environmental analysis can be summed up in the table below:

Components of external analysis	**Scope and dimensions**
Customer analysis	Segmentation, motivation and needs identification.
Competitor analysis	Identification of present and potential competitors, and understanding competition.
Industry analysis	Actual and potential industry size, industry structure, cost structure, distribution channels, industry trends, growth and product life cycle.
Economy analysis	Technology, government, demographics, culture and economics.

Each of the components are discussed below as to their scope and dimensions:

(a) Customer analysis: It is intended to identify the customer groups, their characteristics and buying motives and so on with a view to ascertaining the customer-oriented product-market scope. This analysis is done along the following dimensions -

(i) Segmentation – The differences in the responses among the various customer groups in a competitive environment are identified and a programme is made to deliver competitive offers to those identified segments.

(ii) Customer motivation – It involves the identification of factors that direct or motivate the customers to make buying decisions.

(iii) Needs identification – The identification of customer needs provides a basis for product development or for a policy to have an edge over competitors.

(b) Competitor analysis: It is intended to identify the competitors and understand the degree of competition.

(i) Competitors – existing and potential
- **a.** Intensity of competition, direct or indirect.
- **b.** Customer choice between own/ competitive products.
- **c.** Existing and/or substitute products.
- **d.** Mobility barriers
- **e.** Policies of potential competitors as to market expansion, product expansion, exports etc.

(ii) Competition
- **a.** Size, growth, profitability.
- **b.** Current and past strategies with respect to products and markets.
- **c.** Strengths and weaknesses of competitors.

(c) Industry analysis – It is conducted for the industry as a whole and for the important product-market structure within the industry along the following dimensions.

(i) Actual and potential industry size
- **a.** Size of current and potential market.
- **b.** Gap analysis with respect to usage, distribution, product line, product features, market penetration etc.

(ii) Industry structure
- **a.** Number of existing competitors.
- **b.** Product differentiation.
- **c.** Economies of scale.
- **d.** Substitute products.
- **e.** Capital investment.

(iii) Cost structure
- **a.** Plant capacity.
- **b.** Fixed assets investment.
- **c.** Working capital employed.
- **d.** R.O.I.

(iv) Distribution channels
- **a.** Branches and depots.
- **b.** Showrooms.
- **c.** Wholesales' and retailers' relative importance.

(v) Industry trends
- **a.** Average and norms typical of the industry
- **b.** History of innovation.
- **c.** Technological trends.
- **d.** Role of technology in success.
- **e.** New products.
- **f.** Profitability.

(vi) Growth and product life cycle
- **a.** Profits and profitability.
- **b.** New growth directions.
- **c.** Additions to the existing product line.
- **d.** Basic determinants of demand.
- **e.** Market share, concentration, segmentation, dominance.
- **f.** Relation to life cycle of the product and present stage.

g. Technology status.

(d) Economy analysis

(i) Technology

a. Maturity of old technologies

b. New technologies.

(ii) Government

a. Regulations

b. Tax policies.

c. Stability

d. Industrial policies.

(iii) Culture

a. Life cycle.

b. Fashions

c. Opinions

d. Education

e. Social up- liftment.

(iv) Demographics

a. Age

b. Income

c. Family

d. Geographic location

(v) Economics

a. National and international economic trends

b. Economic health of industries.

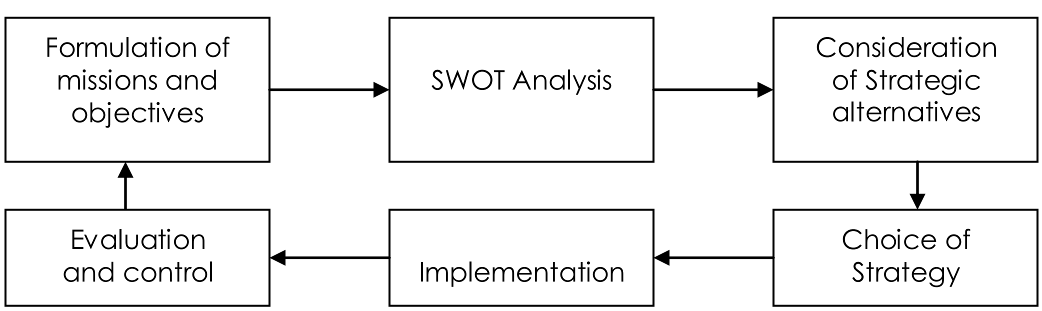
c. Interest rates.

d. Currency valuation.

Question.9. The strategic management process encompasses three phases-strategy formulation, implementation, and evaluation and control. —Discuss.

Answer:

The strategic management process encompasses three phases which together involve a number of systematic steps. These three phases are strategy formulation, implementation and evaluation and control.



Strategy formulation:

This phase involves four important steps, viz,

(i) determination of missions and objectives;

(ii) analysis of strengths and weaknesses of the firm and-the environmental opportunities and threats (SWOT Analysis);

(iii) generation of alternative strategies, and

(iv) choosing the most important strategy.

Strategic management can be defined as the art and science of formulating implementing and evaluating cross-functional decisions that enable an organisation to achieve its objectives. And, strategy is a means to achieve these objectives. It is, thus quite obvious that determining the mission' (which influences objectives) and objectives is the first step in strategy formulation.

The mission defines the broad social purpose and scope of the organisation whereas objectives more specifically define the direction to achieve the mission. Objectives help translate the organisational mission into results. While objectives may be generic in their expression, goals set specific targets to be achieved within a time frame.

In Strategic Management, the term strategic is used to mean 'pertaining to the relation between the firm and its environment'. This indicates the role of SWOT Analysis in Strategic Management. The strengths and weaknesses of the firm and opportunities and threats in the environment will indicate the portfolio strategy and other strategies it should pursue.

An organisation should address questions such as what are the changes (including possible future changes) in the environment which can be exploited utilising its strengths? What are the threats and does it have the strength to combat the threats? How can it mobilise its strength? What are its weaknesses? Can it overcome or minimise its weaknesses?

Given the mission and objectives and having analysed the strength and weaknesses of the firm and the environmental opportunities and threats, the strategists should proceed to generate possible alternative strategies. There may be different strategic options for accomplishing a particular objective. It is necessary to consider all possible alternatives to make the base for choice wide.

The purpose of considering different strategic options is to adopt the most appropriate strategy. This necessitates the evaluation of the strategic, alternatives with reference to certain criteria like suitability, feasibility and acceptability.

Implementation: Operationalising the strategy requires transcending the various components of the strategy to different levels; mobilising and allocation of resources; structuring authority, responsibilities, tasks and information flows; and establishing policies. Strategy implementation, often described as the action phase of the strategic management process, covers strategy activation and evaluation and control. Strategy is a blue print indicating the course of action to achieve the desired objectives. The objectives are achieved by proper activation of the strategy. The activation or implementation step in the strategic management encompasses the operational details to translate the strategy into effective practice - communicating and motivating; setting goals; formulating policies and functional strategies; organisational structuring; leadership implementation and resource allocation.

A good strategy by itself does not ensure success. The success depends, to a very large extent, on how it is implemented. Many strategies fail to generate the expected results because of the failure to properly implement the strategy. Strategy implementation is more operational in character, requires special skills in motivating and managing others, permeates all hierarchical levels and requires co-ordination among many.

The implementation process varies considerably between different types and sizes of organisations. The transition from strategy formulation to strategy implementation requires a shift in responsibility from strategists to divisional and functional managers. Implementation problems can arise because of this shift in responsibility specially if strategy- formulation decisions came as a surprise to the middle-level and lower-level managers.

Some writers break the strategy implementation phase into three components, viz.

(i) operationalising the strategy (communicating strategy, setting annual objectives, developing divisional strategies and policies, and resource allocation);

(ii) institutionalising the strategy (organisational structuring and leadership implementation)

(iii) evaluation and control of the strategy.

Evaluation and Control:

It is the last phase of the strategic management process. The objective is to examine whether the strategy as implemented is meeting its objectives and, if not, to take corrective actions. Continuous monitoring of the environment and implementation of the strategy is essential. In the diagram, the loop connecting the evaluation and control to the starting point of the strategic management process indicates the strategic management is a continuous process, the evaluation providing the feedback for modifications.

The traditional approach to control is to compare the actual performance with the standards established and to take corrective measures if there are deviations. This reactive measure is not sufficient to control a strategy that takes a long period for implementation and to produce results. The uncertain future environment makes continuous evaluation of the planning premise and strategy implementation necessary.

Competition for the future is different from competition for the present. It is necessary to exercise strategic control which is concerned with tracking the strategy as it is being implemented, detecting problems or changes in underlying premises, and making necessary adjustments. In contrast to past-action control, strategic control is concerned with controlling and guiding efforts on behalf of the strategy as action is taking place and while the end result is still several years into the future.

There are two broad types of control -strategic control and operational control. Strategic control augmented by operational control makes strategic implementation more effective. While strategic controls attempt to steer the company over extended time period (usually five years or more), operational controls provide post-action evaluation and control over short time periods (usually from one month to one year).

The basic types of strategic control-are - premise control, implementation control, strategic surveillance and special alert control. The basic types of operational control are - budgeting, scheduling, and focusing on key factors. .

Question.10. What are the advantages and disadvantages of a formal system of Strategic Planning?

Answer:

The advantages of a formal system of strategic planning might be as follows -

- As companies increase in size, the risks also increase. (Risks would be defined as the potential losses from the inefficient and ineffective use of resources). Strategic planning helps in managing these risks.
- Strategic planning can give a sense of purpose to the personnel in the company, leading to an improved quality of management, and it can encourage creativity and initiative by tapping the ideas of the management team.
- Companies can not remain static - they have to cope with changes in the environment. A strategic plan helps to chart the future possible areas where the company may be involved and draw attention to the need to keep on changing and adopting, not just to stand still and survive.
- Strategic plans are not merely stating on paper the departmental objective which has always existed. They help to make them more effective and workable.
- A well prepared plan drawn up after analysis of internal and external factors - risks and

uncertainties- is in the long term best interests of the company because better quality decisions will be made (on the whole) and management control can be better exercised.
- Long-term, medium-term and short-term objectives, plans and controls can be made consistent with one another.

Of course, a business can grow and prosper without a formal strategic plan or a strategic planning process. Strategic planning might appear to be the very antithesis of entrepreneurship. However, Drucker has argued that an entrepreneur who builds a long lasting business has a theory of business which informs his business decisions. In large organisations that theory of the business has to become public knowledge, as decisions can not be taken by only the person. As Drucker says, "business enterprise — requires that entrepreneurship be systemised, spelled out as a discipline and organised as work".

The disadvantages of a formal system of strategic planning might be as follows:
- Many of the strategic planning models fail to account for how strategies are made. The whole planning exercise - was programmed in great detail: the delineation of steps, the application of checklists and techniques, the scheduling of this whole thing. The missing detail was the strategy formation itself. In practice, there is little evidence to show that planning activities can be linked effectively to strategy formation.
- Empirical studies have not demonstrated that planning necessarily contributes to improved performance. Data about planning process is however, hard to gather. Anecdotal evidence does not point to its success.
- Strategic planning often occurs in an annual cycle. But a firm cannot allow it to wait every year for the month of February to address its problems.
- Formal planning discourages strategic thinking. Once a plan is locked in place, people are unwilling to question it.
- Planning can result in an obsession with control, which result in a reluctance to consider truly creative ideas, and a fear of risk. Planning gives an illusion of control even though the forecast assumptions on which it is based are wrong.
- Initial problems in planning often result in a negative image of planning. Good plans can be poorly implemented, resulting in failure. A good strategy can fail during implementation due to inadequate operating plans and policies.
- Organisational resource positions may be an obstacle to effective planning.
- Effective planning can be time consuming and expensive.

Question.11. List down at least three situations, where strategic planning is not suitable /relevant. Illustrate.

Answer:

The first limitation shows up in the way planning is usually restricted to hard business concerns like building facilities, setting up marketing programmes and balancing the portfolio of business units. These are critical matters, but there is a conspicuous lack of attention to the different new soft issues that have become so critical; the revolution information technology, labour productivity, product quality, customers' attitudes, government regulations and a vast range of other social concerns. The crux of the matter is that these problems arc so unusual and confusing that few people know how they should be handled and they are often avoided because they involve sensitive socio-political controversies that can be personally disturbing.

The second problem involves difficulties in the working relations between executives, operating managers and employees. Most companies advocate decentralised planning, but the reality is that the chain-of-command usually imposes decisions on lower units, thereby interfering with the autonomy that people need to do their jobs in an innovative way. A hierarchical, authoritarian organisation is prone to create planning system that is merely an appendage to its bureaucracy, transforming what should be a creative. entrepreneurial process into another useless chore. Procedures like annual planning cycle have not been terribly effective. Strategy becomes a routine exercise. The process ends up having the perverse effect of desensitising people to strategic issues.

The third limitation is that the planning process is isolated from the external groups that critically affect the company; labour leaders, consumer advocates, government officials and the like. Large firms have staffs responsible for consumer affairs, public policy and other such boundary spanning functions, but these units try to focus on conducting studies -' rather than working with stakeholders. Most companies are entangled in a hectic web of difficult external relationships, yet contracts with such groups are usually limited 10 accusatory exchanges with take place through the media and the courts. The participation of outsiders in strategic decisions is anathema to most managers and it poses a realistic problem of consuming time and risking painful confrontations. The most severe obstacles, however, is a common belief that stockholder collaboration is a moral luxury rather than a practical means of injecting a healthy dose of reality into the planning process.

(b) Distinguish between Cost leadership and cost reduction.

Answer:

Cost is the greatest and the most enduring competitive advantage for the long-term success of any product or service. Cost leadership, i.e. enjoying the lowest costs often translates into market leadership, allowing a company to dictate terms in the market place. There are five major variables which influence cost leadership. They are: output level, factor prices, factor productivity, technology and size of the unit. Obviously, the cost tends to be the lowest for a firm with; the highest output levels; the lowest factor prices; the highest factor productivity; the right and relevant technology; and an economically optimum size. No cost is at a level that it cannot be cut and reduced. Cost cutting and reduction is an important exercise which should be periodically undertaken in every enterprise. The areas of cost reduction can be classified as: raw material and inventory costs; manufacturing costs; labour costs; finance costs; marketing costs; R&D costs; general administrative costs. However, these areas are a brief outline only. Many more operational areas of cost reduction can be identified. Cost reduction is not a one-shot exercise. One should keep at it continually and vigourously, practically, all the time. Otherwise, costs have a natural tendency to rise. On their own, they will never come down. One must continually push them down. Believe that cost can always be cut. They must be cut.

Once one acquire cost leadership, one's survival in the market place is better assured. Try competing with Bajaj Auto in scooters, with Raymonds is worsted suiting, then one will know what it means to be a market leader through cost leadership. The task is formidable.

Question.12. Acquisition and Internal new venturing are tools that companies use to enter any new business. What factors influence the choice between the two? Why do many acquisitions and internal new ventures fail to create value?

Answer:

For many organizations, internal new venturing or internal development has always been the primary method for development of strategy and there are some compelling reasons why this should be so. Very often, particularly with products that are highly technical in design or method of manufacture, companies will choose to develop new products themselves since the process of development is seen as the best way of acquiring the necessary skills and knowledge to exploit the product and compete successfully in the market place. A parallel argument would apply to the development of new markets by direct involvement. Although the final cost of developing new activities internally may be greater than that of acquiring other companies the spread of cost may be more favourable and realistic. This obviously a strong argument in favour of internal development for small companies that simply do not have the resources available, in the short term, to develop in any other way. A related issue is that of minimizing disruption to other activities. The slower pace of change that internal development brings usually fabourable in this.

Perhaps the most compelling reason for development by acquisition is the speed with which it allows the company to enter new product/ market areas. In some cases the product and/ or market are changing so rapidly that it is the only way of successfully entering the market since the process of internal development is by compassion too slow. Another common reason for acquisition is the lack of knowledge or resources to develop certain strategies internally. The competitive situation may influence a company to choose acquisition. In markets that are static and where market shares of companies are reasonably steady, it is often a difficult proposition for a totally new company to enter the market since its presence would upset the equilibrium. Sometimes also there are reasons of cost efficiency that would make acquisition more favourable.

The first disadvantage or factor disfavoring internal development to create value is that of knowledge necessary for developing certain strategies. Processing this knowledge, as also developing an appropriate strategy, may require resources beyond the scope of the company. Perhaps the worst thing a strategic manager can do is to attempt to develop a strategy that is bound to be hamstrung by an inadequacy of resources. The second major disadvantage is the time likely to be required. Environmental conditions may change significantly between the time s strategic decision is taken and its implementation. The overriding problem with acquisition to create value lies in the ability to integrate the new company into the activities of the old, and this is where the major difficulty often lies. Instead of such integration, innumerable behavioural roadblocks may arise because of cultural incompatibility. Often the experience may become traumatic, with many capable managers and experts of the acquired company leaving, thus causing tremendous drainage of human resource. Those remaining may also be uncooperative, distrustful, and any attempt at placating them may be a source of resentment amongst the manpower in the acquiring company.

Steps to be taken to make successful acquisition are –

- Detailed assessment of the rationale for making a particular acquisition
- Compatibility of the two corporate cultures
- Assessment of synergies between the two businesses
- Anticipation of the potential integration problems
- Evaluation of the acquired firm's
    - Financial position
    - Product-market attractiveness
    - Competitive standing
    - Management capabilities

Question.13. The sequence of strategies suggested by Ansoff is industry specific. Develop this sequence for two diverse industries like Insurance and Colour TVs keeping in mind the Indian market.

Answer:

The Ansoff's Matrix identifies four different kinds of Product market strategy that an Industry should adopt. These are Market Penetration, Market development, Product development and Diversification.

Market penetration involves trying to milk more from the existing products and existing markets. If the market as a whole is growing, this might appear a fairly low risk strategy to adopt. Where the market is stagnant, market penetration might involve market share at the expense of other players in the field.
Market development uses existing products in new markets. This strategy might be attractive if the unit has to achieve high sales volumes to utilize capacity efficiently.
Product development involves offering new products to the existing markets.
Diversification involves moving into new market with new product.
Ansoff model is a framework for discussing alternative directions. It is a model for identifying for product-market opportunities. There is no criterion for any choice amongst the strategies suggested by Ansoff. There is nothing to stop a company carrying out all the four strategies simultaneously, provided it has the resources. For example, a firm can pursue simultaneously a penetrating strategy in its existing markets as well as diversifying into new ones.

Insurance Sector :

Insurance sector is a on-going growing industry. Hitherto 'Life Insurance Corporation of India' (LIC) had been monopolizing this sector. But under the changed scenario, following liberalization & Globalization, a number of new players have come in and are posing a real threat to the Industry's Leader viz., LIC.
Further the market size of this Industry is very huge. There is lot of scope to develop many new products.
The market is at a developing stage, with the Industry spreading out mostly across the urban and middle class income group.
The sequence of strategies as suggested by Ansoff for the Insurance Sector should be –

- Product development
- Market development
- Penetration and finally
- Diversification.

Product development

Product development involves offering new products to the existing markets.
The scope for product development in this sector is tremendous and this should be accorded the top most priority. A lot of new ideas are fact filtering into our country from different countries abroad. LIC should offer attractive new policies to its existing millions of clientale and thereby retain its number uno status.

Market development

Market development is taking place because of the huge market size and the unawareness of people across the country, especially in rural areas about the product.

Market penetration

We are already noticing the huge market penetration that is taking place in the Insurance Sector. Market players are lashing the premium and are making attractive offers – specially to the rural folk by undertaking big publicity campaigns.

Diversification

Insurance biggies like ICICI Prudential, Bajaj Alianz, who are the two top private sector players have already diversified into new areas like Mutual Fund etc.
To sum up, Ansoff's model has a lot of relevance for the Insurance Sector. All the strategies, as suggested by Ansoff, are being put into play, as per the sequence suggested above.

Colour TV Industry

Colour TV came into the market for the first time during The Asian Games, 1984. Before that only Black and White TVs were only available. In the language of Strategic Management, we can say that the product 'Black and White TVs' were in the Maturity

Phase of Product Life Cycle, whereas the Colour TVs had just been only in the 'introduction' Phase.

The sequence of strategies as suggested by Ansoff for the Colour TV Industry should be –

- Market development
- Penetration
- Product development and
- Diversification.

Market development

The Market development for the Colour TV Industry has been growing exponentially in view of a no. of new TV channels that are entering the Indian market specializing in different areas like Sports Channel, Entertainment channel, kids' entertainment, music, knowledge based channel etc. With the introduction of some populist measures taken by some state Government in the south by distributing YVs for the poor and the under-privileged communities the market has suddenly got heated up. Due to the stiff competition, the price have also tumbled down for a colour TV. The market for Black and White TV has almost come to a 'Zero level. Every one are now going crazy for a colour TV!

Market penetration

Market penetration is going on at a feverish pitch, due to the emerging new technology like LCD, Plasma, LED etc.

Product development

Product development has assumed a special significance for the Colour TV industry. There is a huge stress on quality. The final result as a consequence is a squeeze on profit margin, due to market penetration.

Diversification

Diversification to other areas related to shopping goods are taking place. Many players are moving into new products like Home Theatres, Refrigerators etc.

To sum up, Ansoff's model has a lot of relevance for the Colour TV industry. All the strategies, as suggested by Ansoff, are being put into play, as per the sequence suggested above.

Question.14.

(a) State the key internal factors in various functional areas, which have potential strengths and weaknesses of Marketing.

Answer:

Key Internal Factors:

Potential strengths and weaknesses Marketing:

- Firm's products/services- breadth of product line.
- Concentration of sales in a few products or to a few customers.
- Ability to gather needed information about markets.
- Market share or submarket shares.
- Product/service mix and expansion potential life cycle of key products, profit/sales balance in product/service.
- Channels of distribution number, coverage, and control.
- Effective sales organisation, knowledge of customer needs.
- Product/service image, reputation, and quality.
- Imaginative, efficient, and effective sales promotion and advertising.
- Pricing strategy and pricing flexibility.
- Procedures for digesting market feedback and developing new products, services, or markets. After-sale service and follow-up.
- Good will/brand loyalty.

Finance and Accounting:

- Ability to raise short-term capital.
- Ability to raise long-term capital, debt/equity,
- Corporate-level resources (multi business firm).
- Cost of capital relative to industry and competitors.
- Tax considerations.
- Relations with owners, investors, and stockholders.
- Leverage position capacity to utilise alternative financial strategies, such as lease or sale and leaseback.
- Cost of entry and barriers to entry.
- Price earning ratio.
- Working capital, flexibility of capital structure.
- Effective cost control, ability to reduce cost.
- Financial size.
- Efficient and effective accounting system for cost, budget, and profit planning.

Production/Operations/Technical

- Raw materials cost and availability, supplier relationships.
- Inventory control system, inventory turnover,
- Location of facilities, layout and utilisation of facilities.
- Economies of scale.
- Technical efficiency of facilities and utilisation of capacity.
- Effective use of subcontracting.
- Degree of vertical integration, value added and profit margin.
- Efficiency and cost/benefit of equipment.
- Effective operation control procedures, design, scheduling, purchasing, quality control, and efficiency.
- Costs and technological competencies relative to industry and competitors.
- Research and development/technology/innovation.
- Patents, trademarks, and similar legal protection.

Personnel:

- Management personnel.
- Employees' skill and morale.
- Labour relations costs compared to industry and competition.
- Efficient and effective personnel policies.
- Effective use of incentives to motivate performance.
- Ability to level peaks and valleys of employment.
- Employee turnover and absenteeism.
- Specialised skills.
- Experience.

Organisation of General Management:

- Organisational structure.
- Firm's image and prestige.
- Firm's record for achieving objectives.
- Organisation of communication system.
- Overall organisational control system (effectiveness and utilisation).
- Organisational climate, culture.
- Use of systematic procedures and techniques in decision making.
- Top management skill, capabilities, and interest. Strategic planning system.

Intraorganisational synergy (multibusiness firms).

(b) "Advertising is used to build brand loyalty and sales promotion is used to break brand loyalty".

Answer:

Sellers generally use inventive-type promotions to attract new tiers, to reward loyal customers and to increase the repurchase rates of occasional users. New tiers are of three types - users of another brand in the same category, users in other categories and frequent brand switchers. Sales promotion often attracts the brand switchers, as they are primarily looking for low price, good value or premiums. Accordingly, sales promotion cause brand - quality - image dilution and decreasing brand loyalty. Advertising on the other hand, appears to be capable of increasing the "prime franchise" of a brand.

Question.15

(a) Explain the way a cost leadership strategy can help a firm in handling the five competitive forces.

Answer:

Cost leadership strategy in handling five competitive forces:

Being the low-cost provider in an industry, a firm can provide some attractive defences against the five competitive forces:

- In meeting the challenges of rival competitors, the low cost firm is in the bet position to compete offensively on the basis of price, to defend against price war conditions, to use the appeal of lower price to grab sales (and market share) from rivals, and to earn above-average profits (based on bigger profit margins or greater sales volume). Low cost is a powerful defence in markets where price competition thrives.
- In defending against the power of buyers, low costs provide a company with partial profit margin proaction since powerful customers are rarely able to bargain price down past the survival level of the next most cost-efficient seller.
- In countering the bargaining leverage of suppliers, the low-cost producer is more insulated than competitors from powerful suppliers if the primary source of its cost advantage in greater internal efficiency.
- As regards potential entrants, the low-cost leader can use price-cutting to make it harder for a new rival to win customers; the pricing power of the low-cost provider acts as a barrier for new entrants.
- In competing against substitutes, a low-cost leader is better positioned to use low prices as a defence against companies trying to gain market inroads with a substitute product or service.

(b) Identify the most important pitfalls that ought to be avoided in starting and doing strategic planning.

Answer:

The issues in a corporate strategic planning involve judgments, values, passions and perceived consequences. So, irrationality cannot be avoided. Major pitfalls that should be avoided in starting and doing the strategic planning may be listed as follows :

(i) Failure to develop throughout the company an understanding of what strategic planning really is, how it is to be done, and the degree of commitment of top management in doing it well.

(ii) Failure to accept and balance interrelationships among intuition, judgment, managerial values and the formality of the planning system.

(iii) Failure to tailor and design the strategic planning system to the unique characteristics of the company and its management.

(iv) Failure to encourage managers to do effective strategic planning by basing performance appraisal and rewards solely on short-range performance measures.

(v) Failure to modify the planning system as conditions within the company change.

(vi) Failure to understand the analytical tools used in different parts of the planning process.

(vii) Failure to balance and link appropriately the major elements of the strategic planning and implementation process.

(viii) Failure to secure in the company a climate for strategic planning that is necessary for its success.

(ix) Failure to understand the importance of strategy implementation and how to make that process efficient and effective.

(x) Failure to mesh properly the process of management and strategic planning.

Question.16

(a) What is 'Situation Audit' in strategic planning?

Answer:

Strategic planning is the process of making current risk-taking decision with the best possible knowledge of the future consequences and situations. It thus requires sensing of expectations and needs, creating awareness throughout the organization, crystallizing the development focus and making people committed to achievement of specific goals. 'Situation audit' refers to the analysis and appraisal of these basic planning premises and covers the entire process of determining the following pertinent issues –

(i) Expectations of major outside interests in relation to : society, community, stakeholders, customers, suppliers and creditors;

(ii) Expectations of major inside interests in relation to : top managers, senior and middle-level managers, supervisors, staff and workmen;

(iii) Data base with respect to past performance, current situation and forecasts; and

(iv) Evaluation of environment (i.e. opportunities and threats) and of company (i.e. strengths and weaknesses).

(b) Discuss its fundamental purposes with a brief description of the contents.

Answer:

Fundamental purposes of Situation Audit.

(a) A major objective of the situation audit is to identify and analyse the key trends, forces and phenomena that may have a potential impact on the formulation of strategies. This helps a company to identify specific elements in the environment that will be addressed.

(b) The situation audit serves to emphasise the importance of systematic assessment of environmental impacts.

(c) The situation audit is a forum for sharing and debating divergent views about relevant environmental changes. The more open the debate about them, the more likely the planning system will be effective.

(d) Systematic attempts to appraise the environment, through situation audit, help individuals to sharpen vague amorphous attitudes about forces operating in the environment.

(e) Finally, all of the information collected in the situation audit provide a base for completing the strategic planning process in all of its phases, from revaluating missions to formulating strategies and implementing them.

Contents of Situation Audit

(i) Expectations of outside constituents: The constituents viz. outside people and groups are interested to understand what a large corporation wants to do. Systematic examination of the attitudes, demands, and expectations of these groups and their considerations in appropriate forms helps a corporation in the strategy formulation.

(ii) Expectations of inside constituents : The values, attitudes and interests of individuals and groups within a corporation constitute significant premises for planning. The value systems of top management particularly are basic and fundamental premises in any comprehensive corporate planning system. These value systems not only influence objectives but also influence all sorts of decisions made in the planning process.

(iii) Data base :

(a) Past performance: The data about it are useful as a base for assessing the present situation and possible developments in the future. Data about the past covers the basic information as sales, profits, return on investment, productivity, marketing systems, and so on. Current situation – the data about it could include the company's financial position, market share, competition, customers and markets, evaluation of managerial and employee skills, various measures of efficiency (e.g. sales per employee, plant utilization, investment per employee), constituent demands, government regulations, general environmental setting, and so on.

(b) Forecasts: The data about this would certainly include forecasts of markets, sales, competition and selected economic trends of prime concern to the company. These are traditional projections. But the estimates of future technological developments, changing social expectations, anticipated political and regulatory forces likely to affect the company and other trends of particular concern to the firm (e.g. population, international political turbulence, etc.) are vitally necessary in the situation audit.

(iv) SWOT analysis: Environment — This is a critical phase of the situation audit. In this phase, a company seeks to identify the principal opportunities that appear to exist in the environment of the future as well as the threats that may adversely affect the company. The assessment of company strengths and weaknesses in relation to the perceived opportunities and threats affects the strategy formulation and its implementation.

Question.17

(a) 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 elasticities 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 elasticities and enlarge the size of the market.

A higher price at the initial stage of market penetration can achieve a larger sales volume and a higher sales revenue. This higher sales revenue ensures profit maximization and provides a good base for sound financing necessary for the production expansion and promotional activities during the later stages of the market development.

(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 elasticities, 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. This strategy aims at capturing the market at the very outset and in case of a competitive product, aims at capturing the major share of the market, and discourages the competitors to enter.

(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. Small firms usually determined this pricing strategy on the considerations that the big firms have determined the prices carefully and scientifically, and that the general consumers are price conscious.

(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. During the later stage of market growth or early stage of market maturity of a product of perishable distinctiveness, an oligopolistic pricing situation develops.

(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. While pursuing a price reduction strategy under monopolistic competition, the marketing management of a company must consider the possibility that too drastic a reduction may set off a price war throughout the whole industry.

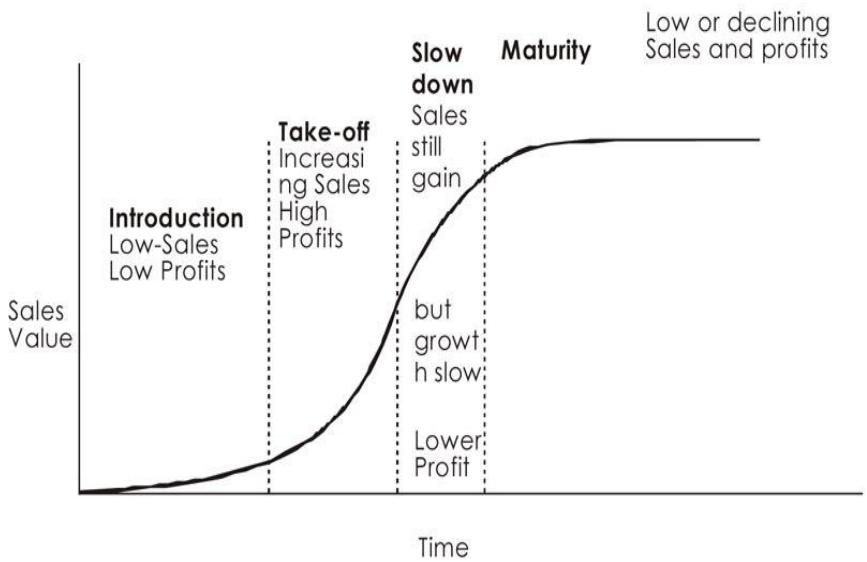
Question.18

(a) Elucidate the concept of Product-life Cycle. Show how it is related to marketing planning.

Answer:

Product Life Cycle - One concept which is of value in many forecasting situations is that of the product life cycle (PLC). The concept and idea of PLC has been formed to be

useful in marketing also. This suggests that all products pass through a series of growth curves (the first part of which is S-shaped), until they reach a point when they either level out or begin to decline.



The curve begins with a period of low sales and low profit as the new product is introduced to the market. This is followed by a period of take-off associated with rapidly increasing sales and relatively high profits, the period during which the product is gaining acceptance and has little competition. At this stage, any competitive product tends to increase the total market. At the same time, unit costs are lower because the benefits of increasing sale of product are achieved.

By the third stage the rate of growth slows down considerably as more competitors enter the market and as, in any case, it becomes more difficult to increase sales penetration. The additional expenditure to increase sales and to meet competitive activity reduces the profit per unit (although it may increase in total).

The product moves to maturity, where it reaches a situation of low or declining sales growth, and a fall- off in profitability. Yet another and final stage may result, where the product declines rapidly to obscurity.

Relation between PLC and marketing planning :

(a) 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.

(b) 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.

(c) 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.

(d) 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) Porter, in his value chain model proposed some activities of an organization. What are those activities and their relationships between them?

Answer:

The value of an organization depends upon the activities of the organization. The activities of an organization can broadly classified under two heads, namely – Primary Activities and Secondary Activities.

Primary Activities : Primary activities comprises of the primary or the basic activities of a firm. These activities adds value to the firm i.e. It represents all those activities which are involved in converting an input into a finished product and subsequent sales and after sales service. All such primary activities affect the value of an organization. Some of these Primary activities are as listed below :

(i) In bound logistics: This activity involves the reaching of the raw materials to the place of production from the stores. It includes activities like receiving, handling and storing inputs to the production system.

(ii) Operations : Involves all those activities connected with converting the resource inputs into final outputs like Product Planning and Development. Product process development, Product line and Product mix decisions, Lay out planning etc.

(iii) Outbound logistics : This activity represents the distribution of finished products, storage, warehousing, transportation, channel of distribution, branding, packaging, containerization, inventory management etc. There are varied scopes in this activity to reduce cost, attaining delivery schedule, meeting demand at the right time and at the right place.

(iv) Marketing and sales : Informing customers about the product, persuading them to buy it, and enabling them to do so. Marketing activities encompasses different kinds of routes like advertising, sales promotion, personal selling etc. The best method should be adopted to create value to the potential customers.

(v) Various after sales services activities like, installing, repairing products, providing spares etc.

Support activities: The above mentioned primary activities are supported by the following activities called the support activities, which are as enumerated below :

(i) Procurement: The 'Supply chain management' is becoming more and more popular these days.
Sourcing or procurement should be from the best available sources, keeping in mind that the value is passed to the consumers right from there.

(ii) Technology: Keeping in pace with the up to date technology is another main activity. This will result in offering better products at low cost to the customers. Further adoption of latest technology will go a long way in product design and improving process and / or resources utilization.

(iii) Human resources development and management : Includes activities like-recruiting, training and rewarding people. Machine, Money and Material cannot function without the active support and involvement of 'Men'. Human resources is an integral support function. Identifying the strengths and weaknesses of the individuals and motivating them will result in a very efficient functioning of the firm.

(iv) Firm infrastructure: Concerns the systems of planning, finance etc. which are crucially important in all primary activities. Further the infrastructure of the firm should ensure that the production activities are carried out smoothly and the workers are at their best performance while working.

Both the primary and support activities are interlinked to each other.
Linkages between the activities connect the interdependent elements of the value chain together. One element affects the cost or effectiveness of another. The element of 'Margin' (the excess of amount that a customer pays over costs of resource inputs and value activities) provides the final linkage. technology, procurement, HR, infrastructure effects the quality of the product. On the other hand, the product quality, price etc., affect the infrastructure / image of the firm.
These are so interlinked that one's doing will have a great impact on the other. All these in combination comprise the value chain model.

Section II

Question.19

(a) Choose the most appropriate one from the stated options and write it down:

(i) Risk Management Strategies are
(a) Avoid risk, Reduce risk, Retain risk, Combine risk
(b) Transfer risk, Share risk and Hedge risk
(c) Both (a) and (b)
(d) None of the above

(ii) Risk Management techniques do not include
(a) Risk avoidance
(b) Risk premium
(c) Risk retention
(d) Risk transfer

(iii) Project risk does not include
(a) Institutional risk
(b) Turbulence
(c) Completion risk
(d) Uncertainty

(iv) General insurance do not include
(a) Fire Policy
(b) Burglary Policy
(c) Contractor's all risk Policy
(d) Life Policy

(v) Life Insurance do not include
(a) Whole life
(b) Pension
(c) Motor vehicle
(d) Endowment

Answer:

(i) Both (a) and (b)

(ii) (b) risk premium

(iii) (d) Uncertainty

(iv) Life Policy

(v) (c) Motor vehicle

(b) State weather the following statements are 'True' or 'False':

(i) Portfolio Management reduces Systematic Risk.

(ii) Product liability policy is one of the products of "Industrial Insurance".

(iii) VAR means Value at Risk.

(iv) Interest Rate Risk refers to the uncertainty of market volumes in the future and the quantum of future income caused by the variations in the interest rates.

(v) Financial Risk includes trade cycle.

Answer:

(i) True

(ii) False

(iii) True

(iv) True

(v) False

Question.20

(a) What is risk?

Answer:

Uncertainty and risk are two terms which are anathema to every manager. Certainty and uncertainty are the two extremities on a continuous platform and risk is identified somewhere between the two extremes. Uncertainty is a totally indefinable happening and is also unexpected. An uncertain situation is faced when the variables are many and their interaction can be innumerable. For example different people behave and react differently to the same situation and uncertainty arises.

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.

(b) Write short note on Utility Theory.

Answer:

Utility Theory:

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

Risks can be classified into various types:

(a) Financial and non-financial risks
(b) Dynamic risks
(c) Speculative risks

Risk cannot be avoided through insurance but may be considered as a means to transfer the risk. It is also a mechanism to compensate the financial and economic loss due to risk. Safety measures and damage control management can be adopted to mitigate or eliminate the magnitude of risk. The fundamental principle of insurance is to share the losses and to substitute uncertainty with certainty. Expected utility theory emphasizes that the demand for insurance is a demand for certainty. The conventional specification of the theory perceives that the buyers of insurance prefer certain losses to actuarially equivalent uncertain losses. But certain other surveys indicate that individuals actually prefer uncertain losses to actuarially equivalent certain losses. This can be explained by saying that "the purpose of any insurance policy is to convert an uncertain, but potentially large loss into a certain small loss. Such a conversion benefits the consumer, if greater losses cause progressively larger declines in utility (i.e., if there is diminishing marginal utility of wealth)" – Newhouse, 1978, page.19. For example, insurance against fire peril where the bigger part of the loss will be insured that is uncertain for a specific premium today.
Another approach evaluates a conventional expected utility theory explaining the demand for insurance by an individuals demand for an uncertain *payoff* of income in a pre specified state. This can be explained through the demand for health insurance. According to this theory, becoming ill fundamentally changes preferences. Thus an insured customer is able to transfer income into the ill state where the marginal utility of income is greater.

Question.21.What is Risk Management? Discuss the strategies involved in risk management.

Answer:

Risk management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events. Risks can come from uncertainty in financial markets, project failures, legal liabilities, credit risk, accidents, natural causes and disasters as well as deliberate attacks from an adversary.

In ideal risk management, a prioritization process is followed whereby the risks with the greatest loss and the greatest probability of occurring are handled first, and risks with lower probability of occurrence and lower loss are handled in descending order. In practice the process can be very difficult, and balancing between risks with a high probability of occurrence but lower loss versus a risk with high loss but lower probability of occurrence can often be mishandled.
The International Organistaion for Standardisation identifies the following principles of risk management :

- Risk management should create value.
- Risk management should be an integral part of organizational processes.
- Risk management should be part of decision making.
- Risk management should explicitly address uncertainty.
- Risk management should be systematic and structured.
- Risk management should be based on the best available information.
- Risk management should be tailored.
- Risk management should take into account human factors.
- Risk management should be transparent and inclusive.
- Risk management should be dynamic, iterative and responsive to change.
- Risk management should be capable of continual improvement and enhancement.

Strategy for risk management

Risk management strategies are seven fold and they are: Avoid Risk, Reduce Risk, Retain Risk, Combine Risks, Transfer Risk, Share Risk and Hedge Risk.

Avoid Risk :
Avoid risk is the prevention method and proven method. This method results in complete elimination of exposure to loss due to a specific risk. It may involve avoidance of an activity which is risky. This can be approached in two ways

(i) Do not assume risk: This means that no risky projects are undertaken. E.g., the Government has clearly mandated that no hazardous chemical industry can be put up near a populated area. This is a proactive avoidance.

(ii) Discontinuance of an activity to avoid risk: While a proactive avoidance follows a sound decision knowing fully the perils of the risk, abandoning a project to avoid risk midway is a decision taken while handling the project. E.g., A PVC plant was being put up on the basis of alcohol as a raw material to be converted to an intermediate product known as ethylene-di-chloride. Unpredictability of alcohol supplies suddenly became risk due to a distillery which was supposed to come up in this area did not materialize. So the root of using alcohol was abandoned half way through the PVC product and ethylene-di-chloride was imported to be processed to PVC.

Reducing Risk :
Reduction of risk is attempted to decrease the quantum of losses arising out of a risky happening e.g., earthquake, storm, floods, etc. Risk reduction can be achieved through Loss Prevention and Loss Control.

Loss Prevention: Prevention of loss is the most insignificant of dealing with the risk, prevention systems like fire sprinkler systems, burglar alarms, etc., are typical prevention measures to reduce the risk of fire burglary. Other measures are the understanding of the risk or the comprehension of the risk arising out of an activity is environment and relationship between the activity and the environment. This will help in the following way:

Modify the risk involved in the activity itself through improved design or technology;

Tailor the surroundings where the risky activity is to take place by isolation or notification or proper layout;

Identify the linkage between the activity and the environment and institute suitable safe guards through training of people, safety devices and providing knowledge and institute mock exercises, etc.

Loss Control: Is accomplished through measures which will douse the fire in the case of fire accident, e.g. using fire hydrants, fire extinguishers. Loss control is also accomplished by on line process control which operates in the event of a risky happening, e.g., Gas leaks fires.

Retain Risk :
Risk retention is adopted when it cannot be avoided, reduced or transferred. It can be a voluntary or involuntary action. When it is voluntary it is retained through implied agreements, involuntary retention ensures when the organization is unaware of the risk and faces it when it come up.

Combine Risks :

When the business faces two or three risks the over all risk is reduced by a combination. This strategy is prevalent mainly in the area of financial risk. Different financial instruments being negative risk return of co relation like Bonds and Shares are taken in a single port folio to reduce the risk. A physical risk of non- availability of a particular material is often solved by having more than one supplier.

Transfer Risk :

Normally in projects assignments or multifaceted exercises, execution is fought with risks. Different agencies work together and these agencies take care to transfer risk in their areas to another agency which is better equipped to take care of a risk for a consideration. Here the concept of core competence curves in and whenever a particular agency, individual or a firm finds that it is dealing in a area where it does not have the core competence to deal with it seeks the help of another agency which has the specific core competence to transfer its own risk. The risk may be in the form of loss of reputation or sub quality performance and this risk is taken care of through transfer.

Sharing Risk :

Insurance is a method of sharing risk for a consideration, viz., premium insurance loss, undertakes to share the risk with the companies and share their own risk through re-insurance with other companies. Some times big conglomerates share risk among their own group of companies in proportion to their risk bearing strengths by creating a corpus instead of paying premium to insurance companies.

Hedging Risk :

Exposures of funds to fluctuations in foreign exchange rates, interest rates, prices, etc. bring about financial risks resulting in losses or gains. The downside risk is often taken care of by hedging. Hedging is done by an agency taking over the risk for a consideration for a period and select band of fluctuation.

Risk optimization :

Risk optimization means utilizing information on risk to compute precisely what types and combinations of risk to take. It also develops the precise trade off between risk and reward and the corresponding appropriate product pricing to reflect the risk taken.

Question.22. Write short notes on:

(a) DCF analysis
(b) Monte Carlo simulation analysis
(c) Risk adjusted performance measurement

Answer:

(a) DCF analysis

This financial tool computes the present value of future cash flows over multiple periods using a discount factor. The formula for net present value of alternative decisions can be computed as below:

$$NPV = \sum_{t=0}^{n} \frac{E(NCF_t)}{(1+r)^t}$$

Where

$E(NCF_t)$ = Expected net cash flow in year *t*

r = opportunity cost of capital (reflects the risk of the cash flows)

For example, consider a compound wall's Upfront cost = ₹1,50,000

Compound will reduce theft loss by ₹ 55,000 each year for 3 years Security expenses will be reduced by ₹15,000 each year for 3 years Discount rate = 10%
NPV = (1, 50, 00 – [1x 70,000 + 0.909 x 70,000 + 0.826 x 70,000]) = +12936

Thus NPV is positive.

(b) Monte Carlo simulation analysis
Monte Carlo simulation is a process of deriving a simulated distribution of an output variable (like cash flow or firm value) by randomly combining values of input variables in repeated drawings. It involves the following steps :

- Model the firm's value or cash flow as a function of macro-economic variables (exchange rate, interest rate, inflation rate and so on).

- Specify the probability distribution of each of the macroeconomic variables.

- Select a value, at random, from the probability distributions of each of the macro economic variables.

- Determine the firm's value or cash flow corresponding to the randomly generated values of exogenous variables.

- Repeat steps (3) and (4) a number of times to get a large number of values of the firm or cash flow so that the simulated distribution of firm's value or cash flow can be defined.

(c) Risk adjusted performance measurement
The best practice recommendation on risk management was enunciated in the G30 report on derivatives. The recommendations have been considered very sound and are very much in use currently. They include: Involve senior management

(i) Establish independent risk managers for market and credit risk

(ii) Market to Market on a daily basis with consistent valuation measures

(iii) Measure and limit market and credit risk rating using value at risk (VaR) techniques to estimate probable loss over a period of time

(iv) Strengthen operational controls, systems and training
(v) Make investment and funding forecasts

(vi) Identify revenue sources and next conduct stress testing

The above recommendations ensure that adequate information could be available for the management to manage risk and avoid nasty surprises. RAPM framework brings together and measures the trade off between risks and rewards.

Question.23. What is Insurance? What are the requirements & characteristics of an insurance contract?

Answer:
Insurance can be defined as transferring or lifting of risk from one individual to a group

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

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

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

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

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

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

Unilateral Contract: Insurer is the only party to the contract who makes promises that can be legally enforced.
Generally, Non life insurance contracts are usually annual contracts and have to be renewed each year. Each time the policy is renewed a new contract is issued by the Insurer.

Question.24. Write short notes on:
(a) Re-insurance
(b) Pricing

(c) I R D A

Answer:

(a) Re-insurance:

All insurance companies have a risk appetite i.e. a limit on the amounts that they can settle for any given claim that is made by the Insured. Any claims made beyond this specified limit by the insured is settled by another company referred to as a Reinsurance company.

Thus, Reinsurance is insurance for insurance companies. Reinsurance is the transfer of part of the risk that a direct insurer assumes by way of an insurance contract on behalf of the insured, to a second insurance carrier, the Re-insurer who has no direct contractual relationship with the insured. Direct insurers need reinsurance to limit annual fluctuations in the losses they must bear on their accounts and to protect the assets of the company in the event of a catastrophe. Direct insurers take on hazards and risks from the policy holders. Re-insurers take on hazards and risks from the direct insurer.

Insurance companies typically enter into an agreement with the Re-insurer and sign a Reinsurance Treaty which states all the terms and conditions of the agreement. The Re-insurer agrees to accept a certain fixed share of risk upon terms as set in the agreement. The well known Reinsurance companies in the world are Swiss Re, Munich Re, and Zurich Re. For example, an Insurance company has a risk appetite of `1 million. but has issued a general insurance policy for an engineering project where the sum insured is `4 million. If a claim is made on this particular policy, the claim will be settled for `4 million. ` 1 million will be paid by the Insurance Company that issued the policy and the remaining 3 million will be paid by the Re- insurer.

(b) Pricing :

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

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

This is of particular importance to a management accountant as it is in the nature of pricing a product. The insurance premium can be broken up into four parts:

Cost of payment for losses

Cost of operation and maintenance of insurance pool

Reserve for contingencies

Return on Investment.

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

(c) IRDA :

This institution came into existence on the basis of Insurance Regulatory and Development Authority Act (IRDA), 1999. Providing Licenses for transacting insurance business and reviewing premium rates are the twin activities of IRDA. IRDA is consumer friendly and protects the interests of the consumer through adequate checks, premium rates, products, procedures and investments made by the insurance companies.

The Insurance Regulatory Authority of India (IRDA) regulated the general insurance covers for over a decade. Owing to the increase in the number of players in the Indian insurance market in the last few years and the fierce competition in the General Insurance segment, IRDA wanted to de tariff the market in January 2007 and Insurers were given greater freedom to price the three insurance covers that were still regulated by IRDA: fire, engineering and motor. Policies can now be priced on a standalone basis, and therefore match the risk.

The second phase of de tariffing will allow the Insurers to structure their products as well where they may be allowed to offer some optional covers in addition to the compulsory covers. In other countries like U.S.A. where product structuring is allowed, factors like the colour of the car also can influence premiums.

De tariffing would allow Insurers to lower premiums. For policyholders, de tariffing is always beneficial. For the same amount of premium, customers can get a higher sum insured. The industry can also benefit from this, since lower premiums will lead to increased sales and thus product penetration.

Question.25. Write short notes on:

(a) CAPM

(b) APT

Answer:

(a) CAPM :

Harry Markowitz developed an approach that helps an investor to achieve his optimal portfolio position. Hence, portfolio theory, in essence, has a normative character as it prescribes what a rational investor should do.

William Sharpe and others asked the follow up question: If rational investors follow the Markowitizian prescription, what kind of relationship exists between risk and return? Essentially, the Capital Asset Pricing Model (CAPM) developed by them is an exercise in positive economics. It is concerned with two key questions:

- What is the relationship between risk and return for an efficient portfolio?
- What is the relationship between risk and return for an individual security?

The CAPM, in essence, predicts the relationship between the risk of an asset and its expected return. This relationship is very useful in two important ways. First, it produces a benchmark for evaluating various investments. For example, when we are analyzing a security we are interested in knowing whether the expected return from it is in line with its fair return as per the CAPM. Second, it helps us to make an informed guess about the return that can be expected from an asset that has not yet been traded in the market. For example, how should a firm price its initial public offering of stock?

Although the empirical evidence on the CAPM is mixed, it is widely used because of the valuable insight it offers and its accuracy is deemed satisfactory for most practical applications.

CAPM is based on the following assumptions:

- Investors are risk averse.
- Security returns are normally distributed,
- The utility function of investors is quadratic,
- Investors have homogeneous expectations – they have identical subjective estimates of the means, variances and co-variances among returns,
- The market is perfect: there are no taxes; there are no transactions costs; securities are completely divisible; the market is competitive,
- The quantity of risky securities in the market is given.

Looking at these assumptions, one may feel that the CAPM is unrealistic. However, the value of a model depends not on the realism of its assumptions, but on the validity of its conclusions. Extensive empirical analysis suggests that there is a lot of merit in the CAPM.

(b) APT
While the CAPM represents a seminal contribution to the field of finance, many empirical studies have pointed towards its deficiencies in explaining the relationship between risk and return.
A key challenge to the CAPM came from a set of studies that have suggested that it is possible to rely on certain firm or security characteristics and earn superior returns even after adjustments for risk as measured by beta. Examples: Banz found that small cap stocks outperformed large cap stocks on a risk- adjusted basis; Basu found that low P/E stocks outperformed high P/E stocks, after adjustment for risk; more recently, Fama and French documented that 'value stocks' (stocks with high book-to-market price ratios) generated larger returns than 'growth stocks' (stocks with low book-to-market ratios), on a risk- adjusted basis.
In an efficient market such return differentials should not exist. Does it mean that the markets are not particularly efficient for long periods of time? Or, does it mean that the markets are efficient but a single– factor model such as the CAPM does not capture risk adequately?
Since it is unlikely that markets are inefficient for extended periods of time, financial economists began looking for alternative risk-return models, beyond the CAPM. In the mid-1970s, Stephen Ross developed an alternative model called the Arbitrage Pricing Theory (APT) which is reasonably intuitive, requires only limited assumptions, and allows for multiple risk factors.

The APT does not require the following assumptions (which under gird the CAPM):the utility function of investors are quadratic; security returns are normally distributed; the market portfolio that contains all risky assets is mean-variance efficient.
The APT only assumes that the capital markets are perfectly competitive and that investors always prefer more wealth to less wealth with certainty.

Question.26. How is project management done in practice?

Answer:
In reality, the risk assessment is done through considering the various components of the financial estimates and developing certain judgmental approaches:
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.
Cost estimates: Always include a margin of safety to take care of impact of inflation over the time horizon for which the projections are being made. Here again 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.

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.

Overall certainty 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 material availability, power availability, intensity of competition is a few of the risks, which are quantified in terms of certainty indices. The cumulative average is the overall certainty index.

Judgmental 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 judgmental decision can be taken.

Question.27. What are the tools for managing enterprise risk. Discuss.

Answer:

Instrument	**Purpose**	**Remarks**
Guarantee	Guarantees can be financial guarantees or performance guarantees. Financial guarantees protects against the financial loss on failure to meet financial obligations Performance guarantees are protection against non- performance of contractual obligations.	Financial institutions provide guarantees as a risk coveragainst a collateral by the buyer for a consideration.
Letter of credit or documentary credit	Guarantee against non-payment of purchase consideration by the buyer	Financial institutions issue this instrument for a consideration. It can be revocable or irrevocable. Can also be revolving
Under-writing	Underwriting is a protection mechanism available in the capital market to cover the risk of non subscription to a public	Financial institutions offer this risk cover for a consideration after due evaluation of risk
Collateralized	Taken against short term and long term loans for working capital as well as fixed assets	Financial institutions offer this risk cover for a consideration after due evaluation of risk and cover themselves completely either through hypothecation or pledge or equitable markets

Asset Securitization	Companies offering financial services of hire purchasing, leasing, etc try to raise finance through this method	This is a special purpose vehicle (SPV) to manage default risk. Financial institutions as well as public subscribe to this method for a consideration in the form of interest and securitization is available from the assets that are being traded
Factoring	Companies resort to this instrument both as a risk cover and insure cash flow	Specific financial institutions called factoring companies offer this service for a commission with recourse or without the recourse

Question.28

(a) List the different statutes governing Employer- Employee liability in India.

Answer:

The following are some of the important statutes governing the Employer-Employee liability:

- Minimum Wages Act
- Payment of Wages Act
- Workmen's Compensation Act
- Provident Fund Act
- Shopes and Establishments Act
- Industrial Disputes Act
- Trade Union Act
- Factories Act

(b) State Catastrophic Losses.

Answer:

Catastrophic losses: Catastrophic losses from natural disasters have two main characteristics:

(i) Such losses are limited to geographic areas, where the impact has taken place.

(ii) Prediction of event is very difficult. Storms, floods or earth-quakes etc., can create catastropic losses. As such, insurers have to take precautions for premium calculations. Even then, the loss may be so massive that the consumer resorts to sharing risks through re-insurance as also ensure dispertion of risks over a large geographic area.

Question.29. To be effective, any Enterprise Risk Management (ERM) implementations should be integrated with strategy-setting". Do you agree? Give your views bringing out the basic elements of ERM and the reasons why ERM is implemented.

Answer:

"To be effective, any Enterprise Risk Management (ERM) implementation should be integrated with strategy-setting". To my mind, this statement is true.

In today's challenging business environment, opportunities and risks are constantly changing, giving rise to the need for identifying, assessing, managing and monitoring the organization's business opportunities and risks.

This, in turn, necessitates establishing the linkage between the opportunities and risks while managing the business. This requirement is addressed by ERM, which redefines the value proposition of risk management by elevating its focus from the 'tactical' to 'the strategic'.

ERM is about designing and implementing capabilities for managing the risks that matter. In the light of this, the statement is correct and therefore acceptable.

Basic Elements of ERM:

The following are the basic elements of ERM:

- A process , ongoing and flowing through an entity.
- Effected by people at every level of an organization.
- Applied in strategy setting.
- Applied across the enterprise, at every level and unit and includes taking an entry-level view of risk.
- Designed to identify potential events'affecting the entity and manage risk within its risk appetite.
- Able to provide reasonable assurance to an entity's management.
- Geared to the achievement of objectives in one or more separate but overlapping categories. It is 'a means to an end, not an end in itself.

Reasons why ERM is implemented:

ERM needs to be implemented for the following reasons:

- Reduce unacceptable performance variability.
- Align and integrate varying views of risk management.
- Build confidence of investment community and stakeholders.
- Enhance corporate governance.
- Successfully respond to changing business environment
- Align strategy and corporate culture.

Question.30. What is systematic risk and what is unsystematic risk? Discuss the further classification of systematic and unsystematic risk.

Answer:

The risk is understood as the sacrifice made by an individual by deferring the use of money to a future day by investing that money in a venture promising a higher return which has uncertainty. The forces that contribute to the variations in return can both be external or internal to a company in which an individual has invested. These forces can partly be controllable and the remaining uncontrollable. The uncontrollable portion, which is essentially external, is known as systematic risk and the controllable internal risk is known as unsystematic risk.

The external or systematic risk can be classified as three types of risk:

Market Risk: Variability in return on investments in the market is referred to as market risk. This is caused by investor reaction to the tangible as well as intangible events. Tangible events like economic, political, social events and intangible events arising out of a market psychology or the other factors like interest rates and inflation also form part of the forces behind market risk.

Interest Rate Risk: This risk refers to the uncertainty of market volumes in the future and the quantum of future income caused by the variations in the interest rates. These interest rates are normally controlled by the Reserve Bank of India in our country and the exigencies for changing the interest rates arise out of many economic factors which are monitored by the central bank i.e, R.B.I. Normally, when the interest rates increase the companies with higher quantum of borrowed money will have to pay out higher quantum of interest reducing their earnings and vice versa.

Purchasing Power Risk : Purchasing power risk is the uncertainty of the purchasing power of the monies to be received, in the future. In short purchasing power risks refers to the impact of inflation or deflation on an investment. Prudent investors normally include a premium for purchasing power risk in their estimate of expected return.

Exchange Risk: With the globalization of market cross border transactions are on the increase. Balance of payments comprising the net effect of exports and imports are subject to fluctuation in the various currencies. As recently, the strengthening of Rupee against the Dollar imports has made imports cheaper and exports costlier. The need to recognize this exchange risk is obvious as the international trade operations may be profitable or loss-making unless this risk is taken care of.

Unsystematic Risk: Unsystematic Risk is that fraction of total risk which is unique to a company or an Industry due to inherent internal factors like managerial capabilities, consumer responsiveness, labour unrest, etc. The operating environment of the business and the financing modalities involve this unsystematic risk. The first one is known as the Business Risk and the second is the Financial Risk

Business risks can be again divided into internal and external business risks. Internal business risk is mainly due to the variations in the operational efficiency of the company. The external business risks arise out of circumstances imposed on the company by external forces like business cycle, certain statutory restrictions or sops.

Financial risk is associated with the modalities adopted by a company to finance its activities. For instance the financial leverage like the Debt Equity Ratio or the type of borrowings and the variations thereof introduce financial risk. Lower the debt less is the financial risk.