FINAL EXAMINATION

(REVISED SYLLABUS - 2008)

GROUP - III

Paper-13 : MANAGEMENT ACCOUNTING- STRATEGIC MANAGEMENT

Section I : Strategic Management

Q. 1. Differentiate between :

(a) Plan and policy

(b) Programmed and contingency strategy

(c) Effects of learning and experience curve

(d) Market and marketing research

Answer 1. (a)

Plan	Policy
A plan is directed towards achievement of specific objectives over a specified period of times.	A policy is a guide which delimits action but does not specify time. It is open ended, rather timeless. Thus, "a policy is not a plan, but guiding cannon of interest". Policies are planned expressions or understandings towards the range of behaviour, which guide or channel thinking and action in decision making and limit for discretionary action by individuals responsible for implementing overall plans.

Answer 1. (b)

Programmed Strategy	Contingency Strategy
(i) A programmed strategy is a strategy which is planned in such a detailed and integrated way that it is difficult to change it, once it has begun to be implemented.	A contingency strategy requires the planner to choose the preferred strategy, given the best estimates of conditions and other strategic choices. But it is flexible enough to allow for shifts in the thrust of the plan, when conditions warrant it.
(ii) In effect, programmed strategies emanate from first-generation planning.	Second generation planning leads to contingency strategy formation.
(iii) Programmed planning is suitable for stable environment with people who prefer well-defined roles.	The contingency strategy is suitable for unstable environment with people who prefer variety and stimulation.

Answer 1. (c)

Effects of Learning Curve	Effects of experience curve
(i) Learning effects typically refer in a narrow way to labour costs alone, as they reflect short term cost reductions achieved through learning by doing.	On the other hand, experience effects refer to the reduction in total costs achieved over the total life of a product. Both are measured by total accumulated output to date. But, learning and experience curves differ with respect to the range of costs covered, the range of output during which the reduction in costs supposedly takes place; and the causes of cost reduction.
(ii) Learning by doing is then seen to be something that only affects assembly operators.	Everyone involved in an organisation, from the chairperson to the apprentice - all of whom should improve the performance of their role through experience.

Answer 1. (d)

Marketing Research	Market Research
Information is essential if management is to set realistic objectives and strategies, and make effective decisions. Within the modern business, data from many sources is processed into information systems. Some of the necessary data can only be provided by specific research - marketing research, defined as "the systematic gathering, recording and analysing of data about problems relating to the marketing of goods and services".	Market research properly, is only one part of marketing research. Market research, is concerned with information about specific markets, their makeup, their behaviour and the change in them. Market research tends to be quantitative and much of it is concerned with measurement of parameters which may have been shown to be important by marketing research.

Q. 2. (a) 'The intensity of competition depends on several factors.' Identify these factors and discuss briefly on them.

(b) Can cost leadership strategy allow a firm to earn above-average returns despite strong competitive forces? Discuss .

(c) Explain : Cost leadership vs. cost reduction.

Answer 2. (a)

The intensity of competition depends on several factors. The possible factors are as follows :

(i) Large number of equally balanced competitors. When the competition is intense, firms may try to avoid competing on price.

(ii) The rate of growth in Industry. Where growth is slow or stagnant, rivalry may intensify and the firms may indulge in competing with each other for greater market share.

(iii) Ease of switching will encourage suppliers to compete.

(iv) Competitors may guess each others intentions. This may lead to uncertainty because of competitive strategy.

(v) Capacity and costs. Industries, characterized by economies of scale from substantial capacity increase, may face recurring periods of over capacity and price cutting.

(vi) High fixed costs and relatively low variable costs. This temps the firms to compete on price and sell at prices above marginal costs. As a result, there may be a failure to recover fixed costs.

(vii) High strategic stakes. A firm, putting in high capital funds and extensive efforts to achieve targets and making success(a strategic action), is likely to be more proactive and competitive to attain further high targets.

(viii) Exit barriers- are the circumstances which make it difficult for an existing supplier to leave the country.

Answer 2. (b)

Cost leadership strategy will allow a firm to earn above average returns despite strong competitive forces. A glaring example is that of Tata's Nano Venture. The following factors facilitates a firm under 'Cost leadership strategy' to earn above average returns despite strong competitive forces :

(i) **Rivalry :** Having the low cost position serves as a valuable defense against rivals . Because of the cost leader's advantageous position, especially in logistics, rivals cannot reduce their costs lower than the cost leaders and so they cannot claim above average returns.

(ii) **Buyers :** The cost leadership strategy also protects against the power of customers. Powerful customers can drive prices lower but they are not likely to be driven below that of the next –most –efficient industry competitor. Prices below this would cause the next –most –efficient competitor to leave the market, leaving the cost leader in a stronger position relative to the buyer.

(iii) **Suppliers :** The cost leadership strategy also allows a firm to better absorb any cost increases forced on it by powerful suppliers because the cost leader has greater margins than its competitors. In fact, a cost leader may be able to force its suppliers to keep prices low for them.

(iv) **Entrants :** The cost leadership strategy also discourages new entrants because the new entrant must be willing to accept no better than average returns until they gain the experience and core competencies required to approach the efficiency of the cost leader.

(v) **Substitutes :** For substitutes to be used , they must not only perform a similar function but also be cheaper than the cost leader's product. When faced with substitutes products, the cost leader can reduce its price.

Answer 2. (c)

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.

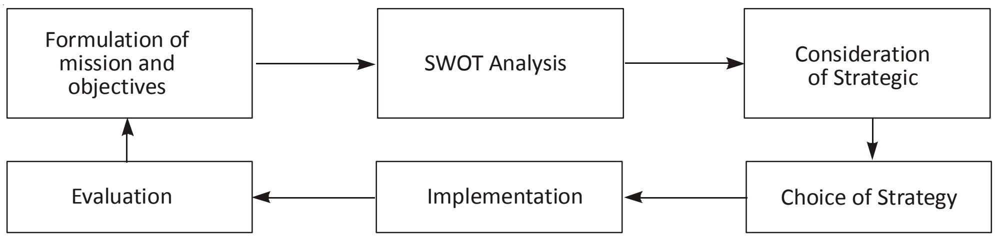
No cost is at a level that it cannot be cut and reduced. Cost cutting and reduction is an important exercise which should be periodically undertaken in every enterprise. The areas of cost reduction can be classified as: raw material and inventory costs; manufacturing costs; labour costs; finance costs; 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.

Q. 3. The strategic management process encompasses three phases-strategy formulation, implementation, and evaluation and control. —Discuss.

Answer 3.

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.

Q. 4. (a) List the Environmental factors that can affect an organisation's Strategy.

(b) How would you analyse Competitive Environment?

Answer 4. (a)

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

The demographic change —

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

The economic environment —

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

The Political/Legal environment —

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

The technological environment —

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

- Investment in new technologies
- Growth in new technologies.

The industry environment —

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

Answer 4. (b)

With growing industrialisation, expanding size of business operation and rapid advancement of technology, degree of competition within the industry and across the industry has increased tremendously. There is neck-to-neck competition among the business organisations who are investing massive funds on research and development to innovate new methods of production or new uses of existing products or adopting new marketing devices in their market share. Under these circumstances managers must be fully aware of the competitive environment and formulate strategy to cope with the competition. The competitive environment should be analysed from the viewpoint of all such factors which affect the ferocity of competitive behaviour. These factors are market share of the participants in the industry, growth, rate of the industry, general level of profits, cost of entry into and exit from an industry, degree of differentiation, economies of scale and nature of product.

Analysis of market share of different firms at a point of time and over a period of time provides an insight into the competitive strength of the organisation. Such analysis should be undertaken to discern the factors responsible for differential market share of firms. These factors could be product differentiation, pricing, high corporate competence, wide distribution network, customer service, dispensation of discount facilities, etc. The management must keep these factors in view while formulating strategy. Furthermore, analysis of the competitive environment presents a picture of dominance of the industry by a few firms. An industry dominated by one firm having a significant market share tends to be less fiercely competitive than the one having no firm with dominant market share.

In studying the competitive environment it should also be the prime concern of the management to find out if there is a minimum critical mass for the product. Critical mass is the market share which a firm must obtain so as to become fully competitive on price and cost.

Growth rate of the industry decisively affects the competitive behaviour. Where growth rate of the industry is relatively high and demand of industrial products tends to expand, competitive behaviour will be less aggressive because each firm can increase its sales without necessarily increasing its market share. But in an industry with falling growth rate, competition will tend to be intense. In such a situation the management should diversify the product line. High level of profits in one industry is likely to provide a measure of tolerance for competitors. A change to lower profits may trigger off more aggressive behaviour.

Cost of entry and exit is another vital factor which needs comprehensive appraisal. If market shares in the industry are widely diffused and small investment is needed to enter the business and if the government does not foreclose entry to the industry, there will be great mobility of firms in and out. In such a case, a firm in the industry lacks security of its position because any entrepreneur with a small capital and small operation can enter the market. Such a tendency poses a serious threat of entry particularly to large established organisations which lack the flexibility and quick response possessed by small firms. Small organisations will, however, consider such an environment as an opportunity to them. Where investment is large, highly specialised and fixed costs are a relatively high proportion of total costs; competition will not be aggressive because the scope of new entrants will be very limited.

High degree of product differentiation creates a barrier to entry of new firms since they might have to spend a great deal on advertising and sales promotion in order to overcome the loyalty of consumers to the existing brand. But the competition is likely to be fiercest when all firms are offering products of commodity status.

Competitive behaviour is likely to be more aggressive when there exist marked economies of scale in the industry. This may happen when cost levels depend on large volumes. The competitive behaviour will tend to be more fierce in a growth market with elastic demand and product subject to mass production. However, new firms will have to be very large so as to avoid cost disadvantages. Nature of the product is another factor to be considered while studying the competitive environment-A durable product is likely to be less vulnerable to random price cutting than one which can not be preserved easily and cheaply.

The management must also try to study the possibility of availability of substitutes of the product in the market because the industry's prospects depend on it. With the emergence of a new substitute, a number of new firms with different cost structures may come into existence in the competitive arena. A substitute will often increase the buying power of the buyer and decrease the power of the seller.

Q. 5. (a) Draft a conceptual model for creating a 'strategic plan' for a company.

(b) What is 'situation audit' in strategic planning?

Answer 5. (a)

'Strategic Plan' has to be drawn as per the tailor-made requirements for each company. To create a Strategic Plan for a company, the following steps could be adopted :

Where are we?

- Corporate philosophy, trust, mission.
- Financial position.
- Competitive situation.
- Markets served.
- Product reliability acceptability etc.

Where do we want to go?

- Preliminary redefinition of aims.
- Strategic alternatives to achieve revised aims.
- Evaluation of alternatives in the light of SWOT.
- Current momentum.

Can we get there?

- Organisational requirements.
- Current momentum.
- Personnel needs.
- Facilities requirements.
- Financial requirements.

Which strategies will achieve aims?

- Iteration among aims and strategies in light of managerial values and situation audit.
- Conclusion concerning aims.
- Conclusion concerning strategies to achieve aims.

What decisions must be taken to get there?

- Short term budgets
- Short term organization ,personnel, decisions/actions etc.

Monitoring performance

Recycling the process annually.

Answer 5. (b)

'Situation audit' in relation to strategic planning is to break down the business into component parts and evaluate them –

- in relation to each other;
- in relation to whole thing and;
- in relation to environmental factors that affect them.

Thus this concept tries to break the business into its component parts and functions, and then evaluates those parts and functions in relation to the environment that affects them.

The basic purpose of 'situation audit' are :

(i) To identify and analyze the key trends and forces that have a potential impact on strategy formulation.

(ii) To emphasize on the systematic assessment of environment impacts.

(iii) To analyse divergent views about relevant environmental changes.

(iv) All such information collected provide a base for the strategic planning process- from evaluating missions to strategy formulations or implementation.

(v) A critical assessment of key market forces and its impact.

A situation audit covers basically the following issues :

- Estimation of insiders' and outsiders' interest in relation to competitors, consumers, business community and managerial staff.
- Data base of past achievement level and the current conditions.
- Key market forces.

With these data, strategists will be in a position to define the basic mission of the organization, purpose, strategies and various policies.

Contents of situation audit are :

- Expectations of outside constituents
- Expectations of inside constituents
- Data base
- SWOT Analysis-Environment.

(i) Expectations of outside constituents :

The constituents viz., the 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 help a company 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. These will not only influence objectives but also will influence all sorts of decisions made in the planning process.

(iii) Data base :

Basic data base for the past performance shall be useful as a base for assessing the present scenario and possible developments in the near future. Data pertaining to forecasts of markets , sales, competition etc. are of prime concern to the company. Further the estimates of future technological developments , the changing social expectations, anticipated political and regulatory forces likely to affect the company and are of particular concern to the company.

(iv) SWOT Analysis- Environment :

This is the most critical phase of 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 SWOT in relation to the perceived opportunities and threats affects the strategy formulation and its implementation.

Q. 6. (a) The true nature of marketing today is not serving the customer; it is outwitting & outfitting one's competitors. Briefly explain the four ways this war can be fought.

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

Answer 6. (a)

It is true that the marketing War can be fought today by following the principles of Defensive Warfare, offensive Warfare, Flanking Warfare and Guerrilla Warfare. A brief Notes on each of the aforesaid ways is given below :

The Defensive Warfare : This is essential recommended for market leaders. It aims at protecting against regulatory provisions, industrial licensing restrictions etc. A leader has to spend more time in safeguarding its interests against Government, Social and Public Environment rather than the immediate next competitor. Thus for Companies like TELCO, Hindustan Lever, Bajaj Auto etc. the major worry may be the interference with the Government. At the same time, a leader cannot afford to overlook the moves of the competitors. A leader should also be able to attack itself. The three principles of defensive warfare are :

- Only the market leader should consider playing defence,
- The best defensive strategy is the courage to attack yourself, and
- Strong competitive moves should always be blocked.

The Offensive Warfare : Offensive warfare is almost like a mirror image of the defensive warfare. Organisations occupying number two position in the industry are suggested to follow the Offensive Strategy by identifying a weakness in leader's strength and attacking at the point. Thus, very high prices of steel tubes of Tata Steel gave an opportunity to other pipe manufacturers like Zenith Tubes, Gujarat Steel Tubes and the like to capture sizable market at lower prices.

The principles of offensive warfare are :

- The main consideration is the strength of the leader's position,
- Find the weakness in the leader's strength and attack at the point,
- Launch the attack on as narrow front as possible.

The Flanking Warfare : Flanking is the most innovative form of marketing warfare. Over the years, most of the biggest marketing successes have been flanking moves. It is recommended to firms with limited resources. These firms can not afford to fight the large firms holding number one or two position on the same battle ground. The entry of 'promise toothpaste with clove oil clout' is an example of flanking warfare. Flanking can be achieved in any manner such as flanking with low price, flanking with small size, flanking with large size, flanking with distribution, flanking with product form etc.

One can see a parallel between a market-cutting a niche and flanking. Basically they mean the same thing, i.e. creating a distinctive position for itself and avoiding any head collision with the leaders.

The principles of flanking warfare are :

- A good flanking move must be made in an uncontested area,
- Tactical surprise ought to be an important element of the plan,
- The pursuit is just as critical as the attack itself.

The Guerrilla Warfare : The last form is the guerrilla warfare. Most of the players in a marketing war would be fighting in the market place like the guerrillas. Smaller companies can be highly successful as long they do not try to emulate the giants in their field. Like flanking form, there can be many guerrillas; like Geographic guerrillas, Demographic guerrillas, Industry guerrillas, product guerrillas and High End guerrillas. In each state, one will find both local make suitcase and other luggage items along with the well known national brands.

Local brands of rubber and plastic chappals are the example of low price end guerrillas.

"Chirag Din" shirts, "Metro Shoes" (Both Mumbai based) are some examples of high price end form of guerrilla warfare.

The principles of guerrilla warfare are :

(i) find segment of the market small enough to defend;

(ii) no matter how successful you become, never act like the leader;

(iii) be prepared to buy out at a moment's notice.

Answer 6. (b)

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

The product/market targets may be quantified —

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

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

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

- Market share or market segment share (both in the existing markets and the markets it would likely to enter into);
- Market positioning - positioning is concerned with such matters as product quality, image and reliability, price, outlets, types of customers.

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

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

The gap could be analysed in terms of -

- What products the organisation will be missing from the product range?

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

Strategies to close the gap would include —

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

Q. 7. (a) Explain the GE Multifactor Portfolio Matrix with suitable examples.

(b) Explain strategic implications of BCG matrix model.

Answer 7. (a)

The GE Multifactor Portfolio Matrix, also known as Business Attractiveness Screen, developed in the 1970s by the General Electric of USA, is a three by three matrix which rates each SBU against two critical variables, viz., industry attractiveness and business strength. The vertical axis in the following figure indicates industry attractiveness and the horizontal axis shows the business strength in the industry. Each dimension is a composite measure of several component factors. One superiority of the GE matrix over the BCG matrix , thus, is that while the BCG matrix bases industry attractiveness on a single variable (industry growth rate), in the GE matrix industry attractiveness is measured by a number of factors like size of market, market growth rate, industry profitability, competitive intensity, technological requirement etc. Similarly, the business strength is rated considering a number of factors such as market share, market share growth rate, profitability, distribution efficiency, brand image etc.

Kotler observes that those factors (market attractiveness and business strength) "make excellent marketing sense for rating a business. Companies will be successful to the extent that they go into attractive markets and possess the required business strengths to succeed in those markets. If one or the other is missing, the business will be producing outstanding results. Neither a strong company operating in an unattractive market nor a weak company operating in an attractive market will do very well".

Each of the dimensions (industry attractiveness and business strength) is classified into three categories of high (strong), medium, and low (weak), thus creating nine cells. This is another refinement of the four-cell BCG matrix.

Every factor on each of the dimensions is assigned a weight. The choice of the factors and the weights assigned to the factors may vary from business unit to business unit. For example, the relative importance of technology, brand image, distribution efficiency, after-sales service, pricing etc. may vary from industry to industry.

The choice of factors determining the industry attractiveness and business strength and the determination of weights are very critical in this analysis. Therefore, they often involve a lot of research.

Table 1 gives a hypothetical illustration of rating of industry attractiveness and business strength. Each factor is assigned a weight. Each factor is also rated on a 10 point scale. Rating of 1 to 4 considered as low: 4 to 7 medium and 7 to 10 high.

In the hypothetical case illustrated in Tables 1 and 2, the total score for market attractiveness is 6.75 and for business strength is 7.55 out of the maximum possible score of 10 for each. In other words, the industry attractiveness is medium and the business strength is high.

All the businesses of a company are shown in the following figure. The size of the circles represents the size of the relevant markets (not the size of the company's business as in the BCG matrix). The company's market share in each of the business is represented by the shaded area.

The position of the business in the matrix would suggest the appropriate strategy for the business. There are three possible strategies. Along the lower left to upper right diagonal (cell G,E and C) representing SBUs which are medium in overall attractiveness, selective investment may be appropriate, (i.e., investment based on their potential, and within each selected business, selecting skill areas, products and functions in which marginal investments are likely to yield the highest returns.)

The three cells below the diagonal (H,I,F) represent SBUs that are low in overall attractiveness. The appropriate strategy for them would be harvesting or divesting. The three cells .at the upper left (A.B.D) indicates SBUs that are high in overall attractiveness. There are businesses in which company should invest further and grow.

Table 1: Industry Attractiveness

Factors	Weights	Rationing (1-10)	Value
Availability of inputs	0.20	7	1.40
Overall market size	0.15	8	1.20
Annual growth rate of market	0.15	6	0.90
Profitability	0.15	7	1.05
Competitive intensity	0.15	6	0.90
Technological requirements	0.15	7	0.70
Capacity utilisation	0.10	6	0.60
Total	**1.00**		**6.75**

Table 2: Business Strength

Factors	Weights	Rationing (1-10)	Value
Market Share	0.15	5	0.75
Market share growth rate	0.20	7	1.40
Brand image	0.05	8	0.40
After sales service	0.05	7	0.35
Pricing	0.10	7	0.70
Distribution capacity	0.10	9	0.90
Capacity utilisation	0.10	9	0.90
Product quality	0.10	8	0.80
Technology	0.15	9	1.35
Total	**1.00**		**7.55**

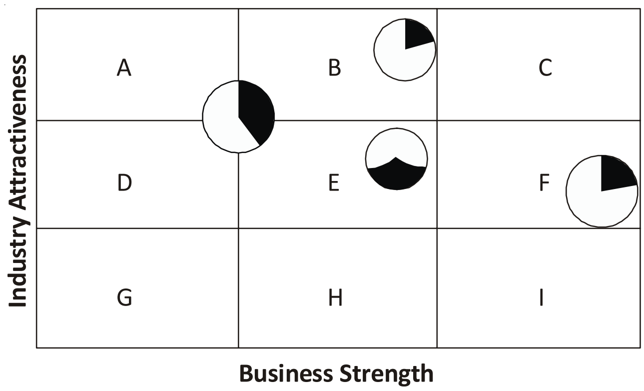


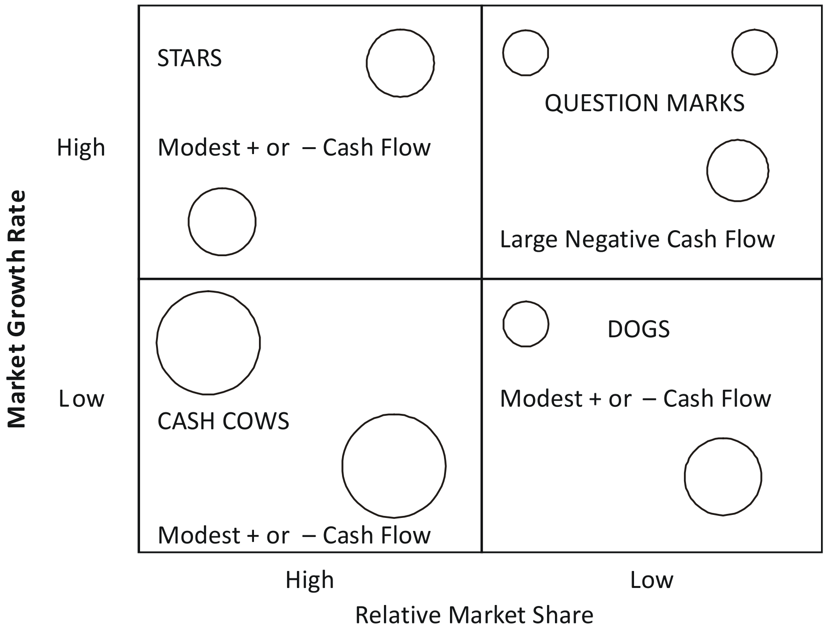
Fig. Nine-cell GE Matrix

Answer 7. (b)

Strategic implications of BCG matrix model :

In general, for large companies, there is always a problem of allocating resources amongst its business units in some logical/rational ways. To overcome such problems, Boston Consulting Group(BCG) has developed a model, which has been termed as the "BCG Matrix".

A simple pictorial depiction of the BCG matrix is as below :



BCG Matrix

The model uses the Market Growth(vertical axis) as the indicator of the industry's attractiveness and a typical marketer's market share(horizontal axis) as its competitive position. This sort of analysis enables a company to assess its competitive position. This sort of analysis enables a company to assess its competitive standing and enables to decide future resources allocation for its product portfolio.

Boston Classification	Strategic Implications
Question Marks	- High Market growth rate but low market share - Must decide whether to try for a star-hold or divest.
Stars	- Since the stars are growing rapidly and have the advantage of already having achieved a high share of the market, they provide the firms best profit and growth opportunities. - The firm should hold and build even though additional investment may be required.
Dogs	- Low market share and low market growth rate. - Dogs hold little promise for the future and may not even pay their own way, they are prime candidates for divesture
Cash cows	- Because of their high share positions in a low growth area. Cash cows are ideal for providing the funds needed to pay dividends and debts, recover overheads and supply the funds for investment in other growth areas.

The above model is a very handy tool for the management in resource allocation decisions.

Q. 8. Conceptually, strategy of a firm consists of two inseparable parts: business strategy and corporate strategy.

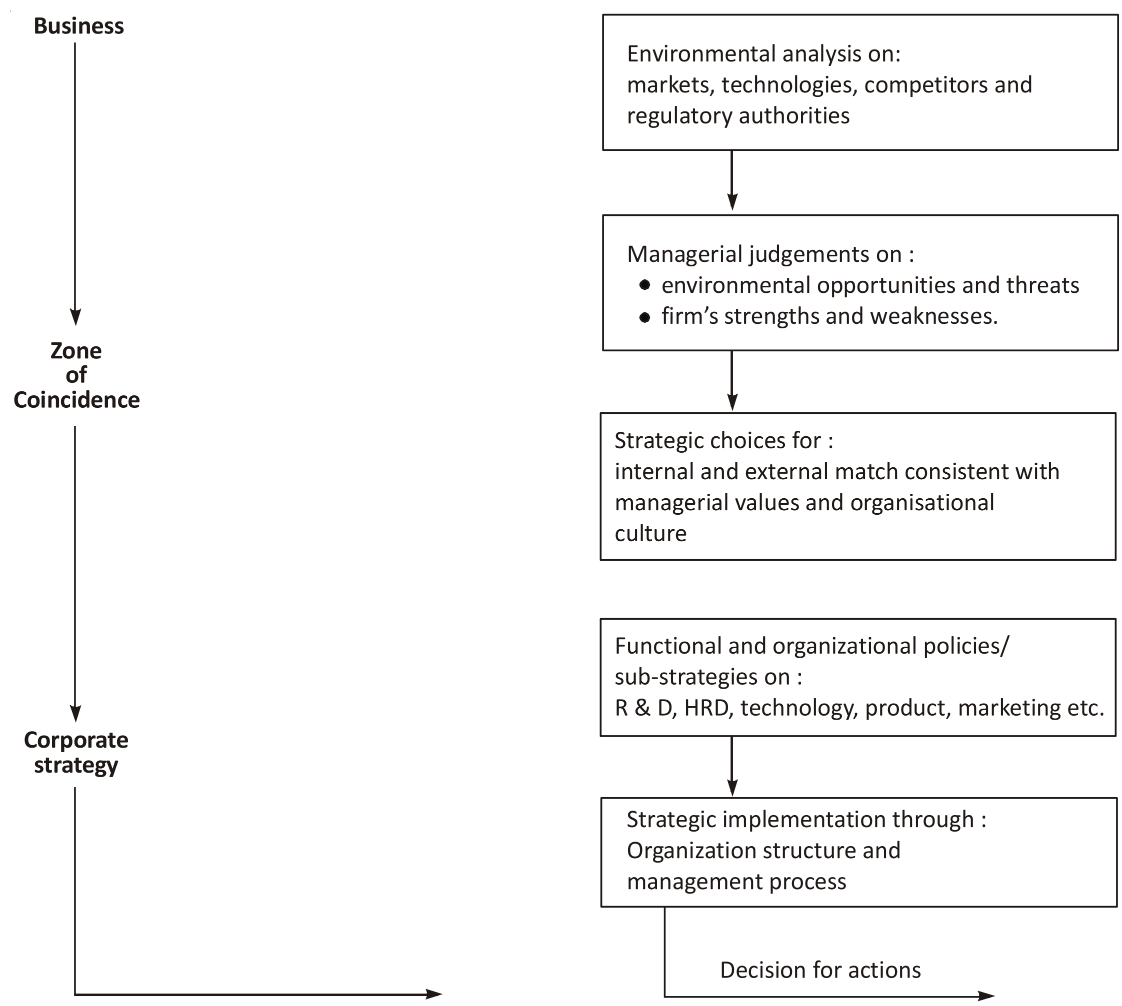
(a) Distinguish between business strategy and corporate strategy.

(b) Identify the key elements considered to develop and formulate such master strategy.

Answer 8. (a)

Business strategy vs. corporate strategy :

Typically, both business strategy and corporate strategy coincide at a zone or stage in a strategic decision making framework presented below :



Business strategy : Once a firm has decided to operate in a particular business, it must then determine how to compete in that business. Decisions of this sort are known as business strategies. A firm's decision to choose product/service or expand the line etc. is called formulation of the business strategy since it enables the firm to compete more effectively in the chosen business.

Corporate strategy : On the other hand, corporate strategy defines the nature and range of businesses a firm intends to operate. A company's decision to expand its business portfolio move from cigarettes to biscuit and then confectionery or health drinks are examples of its corporate strategy decisions.

At the basic level, corporate strategy deals with the Question, "What businesses should we be?" whereas a business strategy addresses the Question, "How should we compete in that business?"

Answer 8. (b)

The following key elements need to be deliberated upon to formulate the master strategy of a firm :

(i) Markets to serve and an analysis of their nature.

(ii) Assess the current demand consumption rate, substitutes, identification of various types of consumers or market segment etc.

(iii) Supply related issues with due consideration of existing capacity, nature of technology and its impact; likelihood of adopting new technology.

(iv) Nature of industry who are the key players, assessment of competition, role of trade associations and governmental regulations.

(v) Crucial factors for future success such as leadership in R & D, cost leadership, product/service differentiation, customer service, product quality etc.

(vi) Position in market that is, measurement of marketing strengths, comparative assessment of market share, product quality, price etc.

(vii) Service abilities that are, rendering services fitted to consumer needs.

(viii) Financial management.

(ix) Adding to capabilities that are the fuller use of existing resources.

(x) Vertical integration that is, ability to access a resource, both forward and backward.

(xi) Strategy of sequence that is, what activities to be performed first and how fast. Thus, product specification must precede cost estimation etc.

(xii) Resource limitations, be they human, physical or financial.

(xiii) The right time to act and to make a change.

Q. 9. (a) "Advertising is used to build brand loyalty and sales promotion is used to break brand loyalty". Discuss.

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

Answer 9. (a)

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.

Answer 9. (b)

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

This policy fails to recognize that -

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

Q. 10. (a) Given below is an extract from the literary supplement of a leading newspaper :

An imprint of one's own

"Earlier, Publishing houses, focusing on writing by women and books on women-oriented subject, might have been inconceivable. But now such Publishing houses, mostly with a distinct feminist slant to what they publish, have become a reality worldwide.

Virago, Women's Press, Kali for Women, Stree, Labyrinth, Attic Press, Minnesota Women's Press, Street Women Press etc., have not only given women a voice long due to them, but have also earned themselves a respectable position in the Publishing Industry.

In fact, Seagull Bookstore is possibly the only bookstore in the city of Kolkata that has a separate shelf for books on "gender". Seagull Bookstore has translated a lot a Mahasweta Devi's works into English, which have reached many people all over the world."

Does this convey any strategy-related message?

If so, write in brief a note on the same.

(b) M/s. XYZ Ltd., is business organized as three divisions and Head Office. The divisions are based on market groupings, which are Retail, Wholesale and Government. The divisions do not trade with each other. The main method of control of the divisions has been the requirement to earn a return on investment (ROI) of 15% per annum. The definition of return and capital employed is provided by Head Office, as is the criterion rate of 15%.

The recent experience of M/s. XYZ Ltd., is that the group, as a whole, has been able to earn 15% ROI but there have been wide variations between the results obtained by different divisions. This infringes upon another group policy that forbids cross-subsidization i.e., each and every division must earn the criterion ROI.

M/s. XYZ Ltd., is now considering divestment strategies and this could include the closure of one or more of-its divisions.

The Head Office is aware that the Boston Product Market Portfolio Matrix (BPMPM) is widely used within the divisions in the formulation and review of marketing strategies. As it is so widely known within the group and is generally regarded by the divisions as being useful, the Head Office is considering employing this approach to assist in the divestment decision.

(i) Evaluate the use by M/s. XYZ Ltd., of the ROI and its policy that forbids cross-subsidization.

(ii) Describe the extent to which the BPMPM could be applied by M/s. XYZ Ltd., in its divestment decision. Evaluate the appropriateness of the use of BPMPM for this purpose.

Answer 10. (a)

The strategy adopted by publishing houses of having books written by women and having books on women oriented subjects clearly indicates a Niche strategy.

By having books from women writers, publishers have successfully created a distinct position vis-a-vis the other general publishers, thus overcoming competition. Such a strategy would not only help in creating a new market space by attracting a new segment of customers - women, it would earn them a respect of being a firm that thinks beyond profit and takes care of women by 'giving them a voice long due to them'.

Answer 10. (b)

Return of Investment (ROI) and Cross Subsidization :

ROI is widely used as a means as a measure to evaluate performance. So M/s XYZ has rightly adopted it as a tool to monitor the performance of the company as a whole as well as its divisions.

However, ROI can also be misinterpreted to one's own interest. The mis-interpretation can be in either of the following forms :

- The returns can be presented with distortions. As profit is usually calculated after depreciation of fixed assets, depreciation rates can be easily influenced.
- The figures w.r.t. capital employed for investment can also be engineered.
- It is important to note that ROI excludes risk
- ROI ignores business cycle. In the case of the divisions of M/s XYZ, it is possible that the business cycle of the three divisions could be of different lengths.

Issue with Cross Subsidy :

The issue of Cross Subsidy is a rather complex concept. No data are available regarding allocation of investment funds. If the Head Office allocates them and the division cannot take their own investment decisions, there is cross-subsidization as it were one-division's hard-earned cash is used to buy another division's assets.

Appropriateness of the use of BCG Market Portfolio Matrix for Divestment Decision :

BCG as a strategy aims at linking the overall growth' of the market for a product and the growth in the market share of a product with the product's cash-generative activities. BCG Matrix classifies company's products in terms of potential cash generation and cash expenditure requirements into cash cows, dogs, stars and question marks.

Stars are products with a high share of a growth market. In the short term, these require capital expenditure, in excess of the cash they generate, in order to maintain their positions but promise high return in future.

In due course, however, stars become cash cows, which are characterized by a high market share but low sales growth. Cash cows need very little capital expenditure and generate high level of cash income.

Question marks are products with a high growth market but with a low market share.

Dogs are products with a low share of market growth market. They may be ex-cash cows that have now fallen on hard times. Dogs should be allowed to die.

BCG Matrix may not be suitable for applications to businesses with divisions as in the case of XYZ Ltd. The problem is that we do not know enough about the firm's product range to suggest how the matrix could be applied. It will not be appropriate if the divisions are slotted in any of the four quadrants of the BCG Matrix. Moreover, BCG Matrix should not be used in isolation as at times dogs may have a low growth market but can earn sufficient profits.

Q. 11. (a) How would you define channels of distribution? What factors would govern your choice of distribution in the competitive structure of an industry?

(b) Suggest a framework to evaluate the effectiveness of advertisement.

Answer 11. (a)

The term channels of distribution refer to the marketing institutions through which goods or services are transferred from the original producers to the ultimate customers. Channels of distribution include the following :

(i) Retailers, who may be classified by—
- type of goods sold
- type of service
- size
- location

Although the retailer may sell the goods acquired, the retailer is also a customer, as the retailer hopes to make a profit from distributors.

(ii) Wholesalers, many of them specialising in particular products. Most wholesalers deal in consumer goods, but some specialise in industrial goods.

(iii) Distributors and dealers. Organisations which contracts to buy a manufacturer's goods. and sell them to customers.

(iv) Agents. Agents differ from distributors in the following way :
- Distributors buy the manufacturer's goods and resell them at a profit.
- Agents do not purchase the manufacturer's goods, but earn a commission on whatever sales they make.

(v) Franchisees.

(vi) Multiple stores, which buy goods for retailing direct from the producers, many of them even under their own label.

(vii) Direct selling, also an aspect of promotion.

The reasons for direct distribution, perhaps with a dedicated sales force, might be as follows :

- The need to demonstrate a technical product.
- Wholesalers and retailers will try to sell all the products they handle, and will not favour one manufacturer's products. Even dealers are sometimes lethargic in trying to sell their products.
- An inability to persuade intermediaries to accept products
- High intermediary profit margins affecting the final sale prices to customers.
- A small market with only a few target customers may make direct selling cheap.
- As a means of maintaining good relations with end customers and obtaining feed back. The reasons against direct distribution and in favour of using intermediaries are as follows :
- A lack of financial resources.
- Financial resources may be available but can be employed more profitably elsewhere.
- A lack of a sufficiently wide assortment of products to sell.
- A wide geographical market area makes the costs of direct selling very high.

It is important to consider who has the greatest power in a distribution channel and is therefore able to exert greatest influence over the activities of other members of the channel. Monitoring the balance of power is a vital component in marketing information system. The shift in the balance of power has two consequences:

- Large multiples are able to dictate product specifications, and drive much harder bargains on matters of price and delivery.
- The large multiple's won-labels brands are increasingly the major competition against branded goods.

The significance of this is that retailers are themselves customers. In other words, this is a key feature of the organisation's competitive environment. The bargaining power of customers, as one of the competitive forces, has therefore increased, as well as the threat of substitutes, because :

- Retailers are customers;
- Retailers can offer their own substitute products to the end consumers.

Answer 11. (b)

There cannot be just one criterion for measuring the Effectiveness of Advertising since advertising has various objectives, calling for different techniques for testing the fulfillment for each. So, because of a large number of complex and interdependent variables, the results obtained by applying a specific technique to test the fulfillment or otherwise of a specific objective, may not be reliable under all situations.

More often than not, sales are considered to be the most obvious test for measuring advertising effectiveness. But such measurement may be vitiated by various factors and cannot be considered an infallible guide to measure advertisement effectiveness. Such factors are :

(i) Advertisement is only a part of the total marketing effort, the result of which is reflected through sales.

(ii) Similarly it will be difficult to segregate the effect of advertising on sales due to changing economic conditions.

(iii) The time-lag between advertisement and buyers response to it is almost impossible to determine.

(iv) Measurement of indirect effect of advertising is almost impossible.

(v) The result of one particular company's advertising campaign might be nullified or enhanced, depending on the extent and skill of the competitor's marketing efforts.

However, some broad ideas can be formed and approximate results can be arrived at by such a test. A summary of several methods developed and published for "Measuring advertising Results" are as follows :

(i) **Measuring awareness :** This is the simplest and most superficial. This is intended to assess knowledge without reference to source. There are four ways of doing this viz. YES/NO Questions; Open-ended questions; checklist questions and rating-scales.

(ii) **Measuring recalls :** There are two basic ways: viz., unaided recall and aided recall.

(iii) **Measuring attitude :** The various methods used are direct questions, rating scale, check-lists, semantic differential test and partially structured interviews.

(iv) **Psychological Measurement :** To explore the pre-conscious and unconscious levels of mind.

(v) **Sort-and-Count Measurement :** To request prospective buyers to ask for information, samples, etc.

(vi) **Measuring usage :** By consumer interviews, etc.

The methods given above cannot be used to develop an acceptable basis of financial measurement of advertising effectiveness. There is no such simple procedure to measure whether the money sport on advertisement as well as on sales promotion has gone down the drain or has given back some return to the company. Attempts are being made by various companies and advertising experts to develop some acceptable method or approach. These methods or approaches are usually not published but adopted for the own use of the companies concerned.

Q. 12. Comment on the following statement :

(a) "Delphi can never be useful as a sales forecasting tool though it may be a reasonably good tool for demand estimating".

(b) "Complementary mergers may result in each firm filling in the missing pieces of their firm with pieces from other firm".

Answer 12. (a)

The Delphi Technique is a method of obtaining expert opinion from a large group of people in a systematic way. This has three attributes: anonymity, feed back and group response. The final result is a statistical group response. Thus, being a subjective judgment in nature, Delphi Technique fails to treat the future as deterministic. Accordingly, Delphi can never be useful as a sales forecasting tool, because of the fact that, sales forecast is specific to a company and we are talking about brand specific products. However, it may be a reasonably good tool for demand estimation, as such estimation is generic and at the level of industry.

Answer 12. (b)

A merger of a firm with strong R & D unit would help to improve new product development while with a firm with a strong distribution network, may benefit better distribution. For example, Dr. Reddy's went for acquisitions of R&D units to strengthen their exploration for new molecules to shorten the product development time horizon. Coca Cola when entered into India, took over the distribution systems of Parle and this saved them both efforts and time to develop distribution network.

Q. 13. (a) Examine the degree to which the three concepts: positioning, product differentiation and market segmentation relate with each other.

(b) What is an 'Operating Turnaround Strategy'?

Answer 13. (a)

Product positioning starts by segmenting the market based on different benefits that each customer group seeks from the product. This can be used to identify opportunities and specify the current and desired positioning of the product or service.

Product differentiation is the act of distinguishing a product from that of its competitors on one or more basic performance or image features-like design, quality, etc.,

Market segmentation is 'the act of dividing a market into distinct groups of buyers who might require separate products and/or marketing mixes.'

The relationship among these three concepts can possibly be expressed as under-

- The goal of product positioning is to develop a differential product (product differentiation) that creates a unique mind share, particularly in the target market segment.
- When designing the product, quality assurance is incorporated into the features that most affect the desired competitive positioning (market segment) of the product.
- Setting the price for the positioned product, by estimating how much extra quality the product will possess over and above the competition and how much the target markets' consumers are prepared to pay for this extra quality-over and above the competitor's actual selling price.

To sum up, product positioning is the art of "designing the company's product and marketing mix to fit a given place in the consumers' mind."

Answer 13. (b)

The Operating Turnaround Strategy emphasizes on improving internal efficiency. The environmental conditions leading to turnaround strategies usually include recessions or depressions in the economy as a whole or in industries, the firm does business in.

The major approaches include:

(1) Reducing costs — e.g. lay off, voluntary retrenchments, trimming of travelling expenses of the executives, using less costly stationery etc.

(2) Increasing revenues — e.g. better investment of cash and current assets, tighter inventory, better collection of debtors, effective advertising etc.

(3) Reducing assets — e.g. selling out equipments no longer needed or those needed to implement expansion that now appears unrealistic.

(4) Reorganising product and/or markets to achieve greater a efficiency — it may be called for if many or most of the following conditions are present:

- the unit's product is in a stable or declining market;
- the unit does not provide sales stability or prestige for the firm;
- the unit's market share is small and it would be too costly to increase that share;
- the unit does not contribute a large percentage to total sales;
- the corporation has better uses for its funds;
- the decline in sales will be more rapid than the reduction in corporate support;
- the price or availability of raw materials presents problem.

Q. 14. (a) Discuss Porter's five forces model. How does it help managers to identify the opportunities and threats confronting a company?

(b) How would you define the terms ETOP and SAP?

Answer 14. (a)

Porter categorizes five competitive factors in the environment of the firm as follows :

(A) The threats of new entrants to the industry.

A prospective industry often faces threat of new entrants which can alter the competitive environment. There may, however, be a number of barriers to entry. Potential competition tends to be high if the industry is profitable or critical, entry barriers are low and expected retaliation from the existing firms is not serious.

Following are some of the important common entry barriers.

(i) **Government Policy :** In many cases government policy and regulation are important entry barriers. For example, prior to the economic liberalisation in India, government-dictated entry barriers were rampant, like reservation of industries/products for public sector and small sector, industrial licensing, regulations under MRTP Act, import restrictions, restrictions on foreign capital and technology etc.

(ii) **Economies of Scale :** Economies of scale can deter every firm in two ways: it keeps out our small players and discourages even potentially large players because of the risk of large stakes.

(iii) **Cost Disadvantages Independent of Scale :** Entry barrier may also arise from the cost advantages, besides that of economies of scale, enjoyed by the established firms which cannot be replicated by new firms, such a proprietary product technology, learning or experience curve, favourable access to raw materials, favourable location, government subsidies etc.

(iv) **Product Differentiation :** Product differentiation characterised by brand image, customer loyalty, product attributes etc. may form an entry barrier forcing new entrants to spend heavily to overcome this barrier.

(v) **Monopoly Elements :** Proprietary product/technology, monopolisation / effective control over raw material supplies, distribution channels etc. are entry barriers which are insurmountable or difficult to overcome.

(vi) **Capital Requirements :** High capital intensive nature of the industry is an entry barrier to small firms. Further, the risk of huge investment could be a discouraging factor even for other firms.

(B) The threats of substitute products or services.

An important force of competition is the power of substitutes. Substitutes limit the potential returns in an industry by placing a ceiling on the price firms in the industry can profitability charge. The more attractive the price performance alternative offered by substitutes, the firmer the lid on industry profits.

Firms in many industries face competition from those marketing close or distant substitutes. Porter points out that substitute products that deserve the most attention are those that (1) are subject to trends improving their price - performance trade off with the industry's product, or (2) are produced by industries earning high profits.

(C) The bargaining power of customer.

For several industries, buyers are potential competitors - they may integrate backward. Besides, they have different degrees of bargaining power. "Buyers compete with the industry by forcing down prices, bargaining for higher quality or more services, and playing competitors against each other - all at the expense of industry profitability".

Important determinants of the buyer power, explained by Porter, are the following :

1. The volume of purchase relative to the total scale of the seller.
2. The importance of the product to the buyer in terms of the total cost.
3. The extent of standardisation or differentiation of the product.
4. Switching costs.
5. Profitability of the buyer (low profitability tends to pressure costs down).
6. Potential for backward integration by buyer.
7. Importance of the industry's product with respect to the quality of the buyer's production or services.
8. Extent of buyers' information.

(D) The bargaining power of suppliers.

The important determinants of supplier power are the following :

(i) Extent of concentration and domination in the supplier industry.
(ii) Importance of the product to the buyer.
(iii) Importance of the buyer to the supplier.
(iv) Extent of substitutability of the product.
(v) Switching costs.
(vi) Extent of differentiation or standardisation of the product.
(vii) Potential for forward integration by suppliers.

(E) The rivalry amongst current competitors in the industry.

Rivalry among existing competitors is often the most conspicuous of the competitions. Firms in an industry are "mutually dependent" — competitive moves of a firm usually affects others and may be retaliated. Common competitive actions include price changes, promotional measures, customer service, warranties, product improvements, new product introductions, channel promotion etc.

There are a number of factors which influence the intensity of rivalry. These include:

(i) Number of firms and their relative market share, strengths etc.

(ii) **State of growth of industry :**

In stagnant, declining and, to some extent, slow growth industries a firm is able to increase its sales only by increasing its market share, i.e., at the expense of others.

(iii) **Fixed or storage costs :**

When the fixed or storage costs are very high, firms are provoked to take measures to increase sales for improving capacity utilisation or reducing storage costs.

(iv) **Indivisibility of capacity augmentation :**

Where there are economies of scale, capacity increases would be in large blocks necessitating, in many cases, efforts to increase sales to achieve capacity utilisation norms.

(v) **Product standardisation and switching costs :**

When the products of different firms are standardised, price, distribution, after-sales service, credit etc. become important strategic variables of competition. Absence of switching costs makes firms more vulnerable.

(vi) **Strategic stake :**

Rivalry in an industry becomes more volatile if a number of firms have high stakes in achieving success there. For example, a firm which regards a particular as its core business will give great importance to success in that industry.

(vii) **Exit barrier :**

High exist barriers (for example, compensation for labour, emotional attachment to the industry etc.) tend to keep firms competing in an industry even though the industry is not very attractive.

(viii) **Diverse competitors :**

Rivalry becomes more complex and unpredictable when competitors are very diverse in their strategies, origins, personalities, relationships to their parents etc.

(ix) **Switching Costs :**

In some cases a barrier to entry is created by switching costs (i.e., one-time costs facing the buyer of switching from one supplier's product to another's) such as cost of retraining the employees, cost of new ancillary equipment etc.

(x) **Expected Retaliation :**

The potential entrants' expectations about the reactions of the existing competitors may also sometimes deter entry.

It is in the context of the five dimensions of competitive environment that strategic decisions have to be made. The objective of such decisions is to obtain a proper strategic fit between the environment and the organization. Such a strategic fit obviously require a proper understanding of the objectives; the ever changing environment , and the organization .Perhaps it would be useful to consider this in greater detail. So, by using the above model a manager can assess the broad trends of profit potential and the future of the business. One can sense the customers level of satisfaction, possibility of new entrants, forward integration by suppliers, switch over to substitutes and even foresee incoming competition from domestic as well as international companies.

Answer 14. (b)

Environmental diagnosis seeks a statement of problems and opportunities, the environment is offering. Preparation of Environmental Threat and Opportunity Profile (ETOP) is one of the systematic techniques for such purpose. The environmental sectors in the analysis are listed in summary fashion. In a more extensive diagnosis, the sub-factors would be examined first and the summary ETOP would be prepared.

The Strategic Advantage Profile (SAP) is a tool for making a systematic evaluation of the enterprise's strategic advantage factors which are significant for the company and its environment.

Executives develop a SAP and match it with the ETOP to create conditions for adjusting. or changing strategies or policies.

Q. 15. (a) Explain with example the terms Mission, the Vision, and the Strategic Intent Statements. Why and when is there likely to be conflict between them?

(b) Explain in what circumstances you would recommend an organization to adopt 'freewheeling opportunism'?

Answer 15. (a)

There are two senses in which mission affects an organisation's direction and performance. The strategy school views mission primarily as a strategic tool, an intellectual discipline which defines the business's commercial rationale and target market. It is perceived as the first step in strategic management; it exists to answer two fundamental Questions: what is our business and what should it be? On the other hand, it is sometimes argued that a mission is the cultural glue that enables an organisation to function as a collective unity. In this case, it is a statement of values rather than description of ultimate commercial objectives. It is possible, however, to reach a more expanded definition of mission to include four elements: purpose; strategies; policies & standards of behaviour; and values. For there to be a strong sense of mission, the four elements must be mutually reinforcing.

A vision, which is our preference for how it should be identified, provides an organisation with a forward looking, idealised image of itself and its uniqueness. Vision can appear to be soft and non managerial. Because of this, having a dream or vision for an organisation sometimes can bring discomfort both to the visionary or visionaries and those vision impacts. Nevertheless, regardless of what it is called - a purpose, a goal, a personal agenda, a legacy, or a vision or dream - the positive consequences of having one is clear. It provides members of the organisation with a view of the future that can be shared, a clear sense of direction, a mobilisation of energy, and a sense of being engages in something important.

Strategic intent has a shorter perspective with an emotional content. Sometimes strategic intent of an organisation forms the major slogan of an organisation. Since such slogans are mission based, if and when environment compulsions make a company change its set mission, its slogan should similarly be changed. Accordingly, mission is a statement of fact; vision is the aspiration; and strategic intent is a vision with an emotional context, ego; will help one to achieve desired mission state faster.

Conflicts between them are likely to arise: internally - of leadership and externally for product life cycle.

Answer 15. (b)

Freewheeling opportunism is appropriate under following circumstances :

- Turbulent environment-where change is impossible to predict and the organization is in some respect vulnerable to change.
- Size of the firm(small firms need to establish a market niche).
- Type of industry- Freewheeling opportunism might also be a feature of certain industries eg. Fashion or music industries.
- For exploiting synergies.

Q. 16. "Companies that fail to develop new products are putting themselves at risk. At the same time, new product developments are risky."

(a) List the reasons for failure of new products.

(b) List and briefly explain the factors that hinder the progress of new product development.

Answer 16. (a)

The reasons for failure of new products are-

(i) Product is perhaps not well designed.

(ii) Improper or inadequate advertisement for the product.

(iii) Initial high price of the product for most of the customers.

(iv) Inadequate distribution channel used for the product.

(v) The idea is good but there is an over estimation of market size of the product.

(vi) Development costs are higher than expected.

(vii) The product is incorrectly positioned in the market.

(viii) Competing firms fight back harder than expected.

(ix) Inspite of an unfavourable market research findings, yet the idea of a new product had been pushed through by the top management of the firm.

(x) Extra differentiation features than necessary.

Answer 16. (b)

Several factors tend to hinder new product development. Some of them are as follows :

(i) **Lack of innovative ideas** to develop new product. There is very little scope to improve some of basic products such as steel, detergents etc.

(ii) **Fragmented markets :** Initially a company has to aim its new products at smaller market segment. This can mean lower sales and lower profit for the product.

(iii) **Social /Government restrictions :** New products have to satisfy consumer safety and environmental norms.

(iv) **R&D Costs :** A company typically has to generate/compare/evaluate many ideas to find one worthy of development and this leads to high costs.

(v) **Production/Marketing costs :** The basic factors, similar to R&D efforts, often lead to high costs on them.

(vi) **Shortage of funds :** Some companies with good ideas cannot raise funds that are necessary for its R&D activities, pilot production activities, test marketing, etc.

(vii) **Development time :** Time span for new product's development and its marketing should be brief.Most companies do not know how to shorten this time by advance planning in the areas of techniques, processes and strategic partnership etc.

(viii) **Shorter product life cycle** if rival firms are quick to imitate, when a new product is successful. There are plenty of crafty imitators.

Q. 17. (a) "In the '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 a stage of the PLC."

(b) Discuss the buying process and its stages.

Answer 17. (a)

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

(i) Intensive promotion by means of—
- brand-stressing advertising;
- more attractive design and functional packaging;
- more after-sales service;
- heavier point of sale effort; and
- increase in sales promotion expenditure to hold customer loyalty.

(ii) Trading down through —
- introduction of low-priced models of an established product;
- price-cutting of the entire product line and keeping prices close to private levels; and
- entering a 'fighting brand' on the market at a lower price to avoid killing of an established premium brand.

(iii) Trading up (strategy opposite to item 2) through
- improvement of quality/appearances, etc.;
- use of prestige packages;
- price increase to cream market levels (in order to increase market penetration/ earn more margin on possibly lower sales/keep greater differentiation over competitive products)

(iv) Proliferation, exclusive or radical, by
- more designs/ varieties;
- more exclusive and innovative features;
- creating radical/ distinct package designs; and
- more options.

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

Answer 17. (b)

Buying is the formal process of purchasing goods and services. The buying process can vary from one organization to another but there are some key elements that are common throughout. The process has the following stages :

(i) **Problem recognition :** This is a stage where the consumer perceives a need and becomes motivated to solve a problem. Problem recognition results when there is a difference between one's desired state and one's actual state. Consumers are motivated to address this discrepancy and therefore they commence the buying process. Sources of problem recognition include :
- An item is out of stock
- Dissatisfaction with a current product or service
- Consumer needs and wants
- Related products/services
- Marketer induced
- New products

The relevant internal psychological process that is associated with problem recognition is motivation. A motive is a factor that compels action.

(ii) **Information search :** Once the consumer has recognized a problem, they search for information on products and services that can solve a consumer's problem. Consumers may undertake both an internal(memory) search and an external search.

Sources of information include :

- Personal sources
- Commercial sources
- Public sources
- Personal experience

The relevant internal psychological process that is associated with information search is perception. Perception is defined as 'the process by which an individual receives, selects, organises, and interprets information to create a meaningful picture of the world.'

(iii) **The selective perception stage :** Consumers choose particular promotional messages they are exposed to. Through selective attention consumers select which promotional messages they will pay attention to. Consumers interpret messages in line with their beliefs, attitudes, motives and experiences. Consumers tend to remember messages that are more meaningful or important to them.'

(iv) **Alternative evaluation :** Attitudes are 'learned predispositions' towards an object. Attitudes comprise both cognitive and affective elements— that is both what one thinks and how one feels about something.

At this stage the consumer compares the brands and products that are in their evoked set. Consumers evaluate alternatives in terms of the functional and psychological process that is associated with the alternative evaluation stage is attitude formation.

The multi-attitude model explains how consumers evaluate alternatives on a range of attributes. A number of possible strategies can be used to influence the process(attitude change strategies). Finally there are a number of ways that consumers apply to make their final choice decision. Thus any marketing organization is naturally keen to know how consumers evaluate alternatives on salient or important attributes and make their buying decision.

(v) **Purchase decision :** Once the alternatives have been evaluated, the typical consumer gets ready to make a purchase decision. Sometimes purchase intention stage is formed before actual purchase. Here, the marketer must facilitate the consumers to act on their purchase intention. The provision of credit or payment terms may encourage purchase, or a sales promotion such as the opportunity to receive a discount or offer an incentive to buy now. The relevant internal psychological process that is associated with purchase decision is integration.

(vi) **Post purchase evaluation :** Once the consumer has purchased and used any product, they are likely to evaluate their earlier purchase decision. They compare the product's performance with their expectations. If the product does not perform as expected they will experience some post purchase dissatisfaction. When consumers purchase any high involvement product, that is more expensive product for which they exert a greater purchasing effort in terms of time and search, they usually experience some level of discomfort after the purchase. That is, they experience some doubt or ambiguity about the right choice. This situation is technically referred as 'cognitive dissonsnce.'

The relevant internal psychological process that is associated with post purchase evaluation is learning.

Q. 18. Write short notes on :

(a) SBU(Strategic Business Unit)

(b) Conglomerate diversification

(c) Penetration pricing

(d) Corporate Reconstructing

Answer 18. (a)

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 with in the SBUs.

Answer 18. (b)

When a large firm acquires a business because it represents an investment opportunity for them and a source of earning profits, the strategy is known as conglomerate diversification. There is no concern to create product or market synergy with the existing business. Financial synergy is what is proposed to be achieved. It may seek to balance current business with cyclical sales and acquired business having counter cyclical sales to balance.

Answer 18. (c)

Market penetration pricing is a policy of charging low prices, when the product is first launched in order to gain sufficient penetration into the market. It is therefore, a policy of, sacrificing short term profits in the interest of long term profits.

The circumstances which favour a penetration policy are as follows :

(i) The firm wishes to discourage rivals from entering the market,

(ii) The firm wishes to shorten the initial period of the product's life cycle, in order to enter the growth and maturity stage as quickly as possible.

(ii) A firm might therefore, deliberately build excess production capacity and set its prices very low, as demand build up, the spare capacity will be used up gradually, and unit cost will fall; the firm might even reduce prices further as unit costs fall;

(iv) In this way early year losses will enable the firm to dominate the market and have the lowest costs.

Answer 18. (d)

Corporate restructuring refers to the process by means of which a firm makes an assessment and evaluation of itself at a point of time and refocuses itself to specific tasks of performance for improvements. It looks upon every activity as a green field project and question the firm's basic premise in order to engineer radical change rather than aim for just incremental gains. The concept is sometimes referred to as business process re-engineering as it involves consideration of at least: business portfolio revaluation; financial engineering; and organisational redesign.

Corporate level restructuring strategies can be thought of from two aspects: hardware and software.

Hardware restructuring involves redefining and/or modifying the structure of the organisation so as to make it more efficient in decision-making, responsiveness and intra-organisational communication etc. Some suggested strategies are :

- Identification of core competency and portfolio pruning
- Flattening of organisational layer
- Downsizing
- Creation of self directed teams
- Benchmarking.

Software restructuring involves cultural and process changes required to create collaborative environment for a firm's growth. Suggested steps are :

- Business strategy communication
- Co-ordination
- Trust
- Stretch
- Empowering people
- Industry foresight
- Training.

Section II : Risk Management

Q. 19. (a) How do you define Risk Management? What are its objectives?

(b) What are various types of risk?

Answer 19. (a)

"Risk Management can be defined as the logical development and execution of a plan to deal with potential losses". The risk will include both upsides as well as the downside ones.

Thus risk management is the identification, assessment, and prioritisation of risks followed by coordinated and economical application of resources to minimise, 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 prioritisation 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.

Objectives of Risk Management can be classified under two heads -viz.,

Pre-loss Objectives and Post-loss objectives :

Pre-loss Objectives :

- Understanding the environment.
- Fulfillment of external obligations-statutory requirements.
- Reduction in anxiety through preventive measures.
- Social obligations to make people aware of the risks.

Post-loss objectives :

- Survival of the organisation.
- Continuance of the organisation's operations.
- Initiate and improve upon the income/earnings.
- Obligations to the society.

Answer 19. (b)

Risks are of many types as follows :

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

Q. 20. (a) Briefly explain the objectives of "Portfolio Management".

(b) "Higher the return, higher will be the risk". In this context discuss the various risks associated with portfolio planning.

Answer 20. (a)

Portfolio management is concerned with efficient management of portfolio investment in financial assets, including shares and debentures of companies. The management may be by professionals or others or by individuals themselves. A portfolio of an individual or a corporate unit is the holding of securities and investment in financial assets. These holdings are the result of individual preferences and decisions regarding risk and return.

The investors would like to have the following objectives of portfolio management :

(a) Capital appreciation.

(b) Safety or security of an investment.

(c) Income by way of dividends and interest.

(d) Marketability.

(e) Liquidity.

(f) Tax Planning - Capital Gains Tax, Income tax and Wealth Tax.

(g) Risk avoidance or minimization of risk.

(h) Diversification, i.e. combining securities in a way which will reduce risk.

It is necessary that all investment proposals should be assessed in terms of income, capital appreciation, liquidity, safety, tax implication, maturity and marketability i.e., saleability (i.e., saleability of securities in the market). The investment strategy should be based on the above objectives after a thorough study of goals of the investor, market situation, credit policy and economic environment affecting the financial market.

The portfolio management is a complex task. Investment matrix is one of the many approaches which may be used in this connection. The various considerations involved in investment decisions are liquidity, safety and yield of the investment. Image of the organization is also to be taken into account. These considerations may be taken into account and an overall view obtained through a matrix approach by allotting marks for each consideration and totaling them.

Answer 20. (b)

There are four different types of risks in portfolio planning.

(i) **Interest rate risk :** It is due to changes in interest rates from time to time. Price of the securities move invertly with change in the rate of interest.

(ii) **Purchasing power risk :** As inflation affects purchasing power adversely. Inflation rates vary over time and the investors are caught unaware when the rate of inflation changes abruptly.

(iii) **Business risk :** It arises from sale and purchase of securities affected by business cycles and technological changes.

(iv) **Financial risk :** This arises due to changes in the capital structure of the company. It is expressed in terms of debt-equity ratio. Although a leveraged company's earnings are more, too much dependence on debt financing may endanger solvency and to some extent the liquidity.

Q. 21. (a) What is pure risk? Explain its features.

(b) Define cost of risk. What are its components?

Answer 21. (a)

The risk that can be insured is generally referred to as pure risk. The risk management function has traditionally focused on the management of pure risk. The major types of pure risk that affect businesses include:

(1) **Property Risk :** The risk of reduction in value of business assets due to physical damage, theft, and expropriation (i.e., seizure of assets by foreign governments).

(2) **Legal Liability Risk :** The risk of legal liability for damages for harm to customers, suppliers, shareholders, and other parties.

(3) **Other Risks :**

- The risk associated with paying benefits to injured workers under workers' compensation laws and the risk of legal liability for injuries or other harms to employees that are not governed by workers' compensation laws.
- The risk of death, illness, and disability to employees (and sometimes family members) for; which businesses have agreed to make payments under employee benefit plans, including obligations to employees under pension and other retirement savings plans.
- The risk of loss of services of one of key personnel on resignation/death.

The features of pure risk include the following :

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

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

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

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

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

Answer 21. (b)

'Cost of risk' is a measure of potential loss from a risky situation. Risk is costly. Regardless of the specific meaning of risk being used, greater risk usually implies greater costs.

Cost of risk = [Value without risk] – [Value with risk]

The cost of pure risk has five main components :

(i) **Cost of Losses :** The expected cost of losses includes the expected cost of both direct and indirect losses. Major types of direct losses include the cost of repairing or replacing damaged assets, the cost of paying workers' compensation claims to injured workers, and the cost of defending against and settling liability claims. Indirect losses include reductions in net profits that occur as a consequence of direct losses, such as the loss of normal profits and continuing and extra expense when production is curtailed or stopped due to direct damage to physical assets.

(ii) **Cost of loss control :** The cost of loss control reflects the cost of increased precautions and limits on risky activity designed to reduce the frequency and severity of accidents. For example, the cost of loss control for a pharmaceutical company would include the cost of testing the product for safety prior to its introduction and any lost profit from limiting distribution of the product in order to reduce exposure to lawsuits.

(iii) **Cost of loss financing :** The cost of loss financing includes the cost of self-insurance, the loading in insurance premiums, and the transaction costs in arranging, negotiating, other contractual risk, transfers. The cost of self-insurance includes the cost of maintaining reserve funds to pay losses. Note that when losses are insured, the cost of loss financing through insurance only reflects the loading in the policy's premium for the insurer's administrative expenses and required expected profit. The amount of premium required for the expected value of insured losses is included in the firm's expected cost of losses.

(iv) **Cost of internal risk reduction methods :**Insurance, hedging, other contractual risk transfers, and certain types of loss control can reduce the uncertainty associated with losses; that is, these risk management methods, can make the cost of losses more predictable. The uncertainty also can be reduced through investing in information to obtain better forecasts of losses. The cost of internal risk reduction includes the cost of obtaining and analysing data and other types of information to obtain more accurate cost forecasts. In some cases this may involve paying another firm for this information; for example, a pharmaceutical company may pay a risk management consultant to estimate the firm's expected liability costs.

(v) **Cost of residual uncertainty :** Uncertainty about the magnitude of losses seldom will be completely eliminated through loss control, insurance, hedging, other contractual risk transfers, and internal risk reduction. The cost of uncertainty that remains (that is "left over") once the firm has selected and implemented loss control, loss financing, and internal risk reduction is called the cost of residual uncertainty.

Q. 22. How do you define insurance? What are the requirements & characteristics of an insurance contract?

Answer 22.

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 :

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

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

(iii) There should be a valid offer and acceptance and

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

Characteristics of insurance contract :

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

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.

Q. 23. (a) Explain the term "Foreign Exchange Rate Risk".

(b) Write short note on Forward as hedge instrument.

Answer 23. (a)

This risk relates to the uncertainty attached to the exchange rates between two currencies. For example, the amount borrowed in foreign currency is to be repaid in the same currency or in some other acceptable currency.

Thus if the foreign currency becomes stronger than (say) Indian rupees, the Indian borrower has to repay the loan in terms of more rupees than the rupees he obtained by way of loan. The extra rupees he pays is not due to an increase in interest rate but because of unfavourable exchange rate. Conversely he will gain if the rupee is stronger. The fluctuation in the exchange rate causes uncertainty and this uncertainty gives rise to exchange rate risk.

Answer 23. (b)

International transactions both trade and financial give rise to currency exposures. A currency exposure if left unmanaged leaves a corporate open to profits or losses arising on account of fluctuations in currency ratio. One way in which corporate can protect itself from effects of fluctuations in currency rates is through buying or selling in forward markets.

A forward transaction is a transaction requiring delivery at future date of a specified amount of one currency for a specific amount of another currency. The exchange rate is determined at the time of entering into the contract but the payment and delivery takes place on maturity. Corporates use forwards to hedge themselves against fluctuations in currency price that would have a significant impact on their financial position. Banks use forward to offset the forward contracts entered into with non-bank customers.

Q. 24. (a) Write short note on Appraisal of projects under inflationary conditions.

(b) A company is considering two mutually exclusive projects A and B Project A costs Rs. 30,000 and Project B Rs. 36,000. You have been given below the net present value, probability distribution for each project :

Project A		Project B	
NPV Estimate Rs.	**Probability**	**NPV Estimate Rs.**	**Probability**
3,000	**0.1**	**3,000**	**0.2**
6,000	**0.4**	**6,000**	**0.3**
12,000	**0.4**	**12,000**	**0.3**
15,000	**0.1**	**15,000**	**0.2**

(i) Compute the risk attached to each project i.e., Standard Deviation of each probability distribution.

(ii) Which project do you consider more risky and why?

Answer 24. (a)

The timing of project appraisal is significant from the point of view of appraisers. A project under normal conditions is viewed from different angles, viz, technical feasibility, commercial and financial viability and economic and social considerations and managerial aspects. However, normal conditions seldom exist and a project is subjected to inflationary pressures from time to time because the project has to be implemented over a long time frame. During such a period, it will be difficult to predict when the trade cycle sets in and the up-turn economy is generated. Besides this, the size and magnitude of the project also varies from organization to organisation. In such a situation, inflation is bound to affect the project appraisal and implementation process.

In a developing country like ours, inflation has become a part of life and has been steadily increasing over a period of years. Therefore, it is always prudent to make adequate provision for a probable escalation in the project costs as a cushion to inflationary jerks.

It is well known that during a period of inflation, the project cost is bound to escalate on all heads viz. labours, raw material, cost of fixed assets, building materials, remunerations of technician and managerial personnel etc. Besides, such conditions erode the purchasing power of the consumers and are likely to affect the pattern of demand. Thus, not only the costs of production but also the projected statements of profitability, cash flows etc., will get seriously affected. Financial institutions may revise their lending rates of interest during such inflationary times. In these circumstances, project appraisal has to be done generally keeping in view the following guidelines which are adopted normally by governmental agencies, banks and financial institutions.

(i) It is always advisable to make provisions for cost escalation for all heads keeping in mind the rate of inflation, likely delay in completion of project etc.

(ii) The various sources of finance should be scrutinized carefully with response to possible revision in the rates of interest by lenders which will affect the cost of borrowing, the collateral securities offered, margins required etc.

(iii) Adjustments are to be made in the profitability and cash flow projections to take care of the inflationary pressure affecting future projections.

(iv) It is also advisable to critically examine the financial viability of the project at the revised rates and reasons the economic justification of the project. The appropriate measure for this is the economic rate of return for the project which will equate the present cost of capital expenditure to net cash flows over the project life. The rate of return should be acceptable which also accommodates the rate of inflation.

(v) In an inflationary situation, projects having early pay back periods should be preferred because projects with a longer pay back periods may tend to be risky.

Because inflation can have major effect on business, it is critically important and must be recognized. "The most effective way to deal with inflation is to build into each cash flow element, using the best available information about how each element will be affected, since one cannot estimate future rates of inflation, errors are bound to be made. Therefore, inflation adds to uncertainty, riskness and complexity to capital budgeting. Fortunately, computers and spread sheet models are available to help inflation analysis. Thus, in practice, the mechanics of inflation adjustments are not difficult.

Answer 24. (b)

Project A

NPV Estimate	Probability	NPV Estimate × Probability	Deviation from Expected NPV i.e. Rs. 9,000	Square of the deviation	Square of the deviation × Probability
Rs.		Rs.		Rs.	Rs.
3,000	0.1	300	6,000	3,60,00,000	36,00,000
6,000	0.4	2,400	3,000	90,00,000	36,00,000
12,000	0.4	4,800	-3,000	90,00,000	36,00,000
15,000	0.1	1,500	-6,000	3,60,00,000	36,00,000
Expected NPV		9,000			1,44,00,000

Project B

NPV Estimate	Probability	NPV Estimate × Probability	Deviation from Expected NPV i.e. Rs. 9,000	Square of the deviation	Square of the deviation × Probability
Rs.		Rs.		Rs.	Rs.
3,000	0.2	600	6,000	3,60,00,000	72,00,000
6,000	0.3	1,800	3,000	90,00,000	27,00,000
12,000	0.3	3,600	-3,000	90,00,000	27,00,000
15,000	0.2	3,000	-6,000	3,60,00,000	72,00,000
Expected NPV		9,000			1,98,00,000

(i) Standard Deviation = $\sqrt{\text{Square of the deviation} \times \text{probability}}$

In case of Project A : Standard Deviation = $\sqrt{\text{Rs. } 1{,}44{,}00{,}000}$

= Rs. 3,795

In case of Project B : Standard Deviation = $\sqrt{\text{Rs. } 1{,}98{,}00{,}000}$

= Rs. 4,450

(ii) Coefficient of variation = $\dfrac{\text{Standard deviation}}{\text{Expected net present value}}$

In case of Project A : Coefficient of variation = $\dfrac{3{,}795}{9{,}000} = 0.42$

In case of Project B : Coefficient of variation = $\frac{4,450}{9,000}$ = 0.49 or 0.50

Project B is riskier since it has a higher coefficient of variation.

Q. 25. (a) What is "Corporate Governance"? What are its salient features?

(b) Write a brief note on significance of this concept in today's context in India.

Answer 25. (a)

Corporate bodies function through the Board of Directors elected by the owners and the Board remains accountable to them for corporate performance. The corporate entity performs under the direction of the Board of Directors. Corporate governance is basically about how the Board of Directors carries out this function.

Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled. An important theme of corporate governance is the nature and extent of accountability of particular individuals in the organization, and mechanisms that try to reduce or eliminate the principal-agent problem.

Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. In contemporary business corporations, the main external stakeholder groups are shareholders, debt holders, trade creditors, suppliers, customers and communities affected by the corporation's activities. Internal stakeholders are the board of directors, executives, and other employees.

A related but separate thread of discussions focuses on the impact of a corporate governance system on economic efficiency, with a strong emphasis on shareholders' welfare; this aspect is particularly present in contemporary public debates and developments in regulatory policy.

There has been renewed interest in the corporate governance practices of modern corporations since 2001, particularly due to the high-profile collapses of a number of large corporations, most of which involved accounting fraud. Corporate scandals of various forms have maintained public and political interest in the regulation of corporate governance. In the U.S., these include Enron Corporation and MCI Inc. (formerly WorldCom). Their demise is associated with the U.S. federal government passing the Sarbanes-Oxley Act in 2002, intending to restore public confidence in corporate governance. Comparable failures in Australia (HIH, One.Tel) are associated with the eventual passage of the CLERP 9 reforms.

The salient features of corporate governance are as follows :

- **Rights and equitable treatment of shareholders**: Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by openly and effectively communicating information and by encouraging shareholders to participate in general meetings.
- **Interests of other stakeholders.** Organizations should recognize that they have legal, contractual, social, and market driven obligations to non-shareholder stakeholders, including employees, investors, creditors, suppliers, local communities, customers, and policy makers.
- **Role and responsibilities of the board**: The board needs sufficient relevant skills and understanding to review and challenge management performance. It also needs adequate size and appropriate levels of independence and commitment to fulfill its responsibilities and duties.
- **Integrity and ethical behavior**: Integrity should be a fundamental requirement in choosing corporate officers and board members. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making.

- **Disclosure and transparency**: Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide stakeholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

Answer 25. (b)

India's SEBI Committee on Corporate Governance defines corporate governance as the "acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal & corporate funds in the management of a company." It has been suggested that the Indian approach is drawn from the Gandhian principle of trusteeship and the Directive Principles of the Indian Constitution.

In India, Corporate governance has assumed significance and urgency due to the following reasons :

- changing profile of corporate ownerships
- preferential allotment of shares to promoters
- increasing inflow of foreign capital
- and dismantling of controls that hitherto provide protective cover to poorly managed corporates.

That corporate governance in India is lacking in many respects has been highlighted on several occasions in recent years and examples of Corporate misgovernance are many like :

- FERA violation by the ITC
- Desubsidiarisation by Escorts
- Fund diversion by Shaw Wallace
- Family feud in Modi Rubber

Effectiveness of the Board of Directors is a crucial factor of good Corporate Governance. For good corporate governance, a statement of Directors Responsibility (SDR) should be attached to the Annual A/cs for better transparancy. Further the management should ensure that there is full and complete financial disclosures. Further it is also the responsibility of the top Management to ensure that the Co's, has complied with all the legal and ethical standards in accordance with the provisions of law and the Co's own statement of values.

Further the good Corporate Governance, the top Management should ensure total transparency on issues like —

- Award of high value contracts
- Dividends
- Investment in Subsidiaries
- Merger/Acquisition etc.

Q. 26. Write short notes on :

(a) Probability of ruin.

(b) Risk adjusted performance measurement.

(c) Risk avoidance

Answer 26. (a)

Ruin Probability is essentially a study of risk of insolvency for a company with multiple business activity facing heavy claims from creditors. For this purpose, the company is permitted to transfer resources between business lines. But such transfers are restricted by transaction costs. Insolvency or ruin occurs when the negative positions in one or more business lines cannot be compensated by capital transfers. Such problems are normally solved on the basis of intermittent or continuous process. Mathematically, actuarial calculations are involved in such exercise. A clear expression of Laplace transformation of the finite type, for computing ruin probability is one such method. Another model developed by Clayton Levy Copulas takes into consideration the interdependence of components of risk.

Answer 26. (b)

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 :

(i) Involve senior management

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

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

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

(v) Strengthen operational controls, systems and training

(vi) Make investment and funding forecasts

(vii) 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.

Answer 26. (c)

Risk avoidance is a conscious decision not to expose oneself or one's firm to a particular risk of loss. In this way, risk avoidance can be said to decrease one's chance of loss to zero.

Risk avoidance is common, particularly among those with a strong aversion to risk. However, avoidance is not always feasible and may not be desirable even when it is possible. Risk managers must always weigh the relative costs and benefits associated with activities that give rise to risks. When a risk is avoided, the potential benefits, as well as costs, are given up. For example, the doctor who quits practicing medicine avoids future liability risks but, also forfeits the income and other forms of satisfaction that may be associated with a career in medicine. The firm that avoids manufacturing pharmaceuticals relinquishes potential profits as well as liability risks. And if a business is to operate at all, certain risks are nearly impossible to avoid. An example is the liability risk of owning or leasing premises from which the business is conducted.

Q. 27. (a) What type of risks a firm may face while developing a new product/market?

(b) What do you understand by 'self insurance'?

Answer 27. (a)

Developing a firm beyond its present product/market space exposes it to a combination of four sorts of risks. These risks are particularly acute where diversification is concerned because of the simultaneous novelty of both product and market.

(i) Market risk : The firm has entered a new market where established firms already operate. The risks here are :

- not correctly understanding the culture of the market or the needs of the customer;
- high distribution costs due to lack of economies of scale;

- failure to be seen as credible by the buyers in the market due to lack of track record or brand;
- exposure to retaliation by established firms with more entrenched positions

(b) Product risk : The firm is involving itself in a new production process which is already being conducted by rival firms: The risks this poses are :

- higher production costs due to lack of experience;
- initial quality problems or inferior products causing irreparable harm to reputation in the market;
- lack of established production infrastructure and supply-chain relations which will make costs higher and may limit product innovation and quality.

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

(d) F**inancial risk :** This relates to the share price of the business. Shareholders are generally suspicious of 'radical' departures (and particularly diversification) for the following reasons :

- the product and market risks lead to volatile returns;
- the firm may need to write off substantial new net assets if the venture fails;
- the investment needed will reduce dividend and/or necessitate new borrowing;
- a diverse and unique portfolio makes it harder to compare the firm with others in the same industry when trying to evaluate its risks and returns.

The effect will be for the share price to decline to reflect the uncertainties created by the strategy.

Answer 27. (b)

If a firm has a group of exposure units large enough to reduce risk and thereby predict losses, the establishment of a fund to pay for those losses is a special form of planned, funded retention known as self-insurance. Some people object to this particular term, because the word insurance usually implies that a risk is transferred to another party. Obviously, self-insurance will not involve a transfer of risk in this sense. In spite of such objections, the term self-insurance continues to be used to describe some special situations in which risk retention has been consciously selected as an appropriate risk management technique. There are two necessary elements of self-insurance: (1) existence of a group of exposure units that is sufficiently large to enable accurate loss prediction and (2) prefunding of expected losses through a fund specifically designed for that purpose.

Q. 28. (a) Describe asset liability model and its utility for managing liquidity risk and exchange rate risk.

(b) Define liability exposures.

Answer 28. (a)

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

Liquidity risk management through asset liability management :

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

Exchange rate risk management through asset liability management :

At a particular exchange rate assets and liabilities of a financial institution match exactly. As the exchange rate fluctuates this balance gets disturbed. A simple solution to correct this risk is to match assets and liabilities of the same currency. Many financial institutions do not have foreign exchange exposure as all their assets and liabilities are in rupee currency. The risk of foreign exchange borrowings of these institutions are passed on to the lenders through dollar denominator loans. The uncovered loans are hedged at the time of contracting them through forward covers for the entire amount.

Answer 28. (b)

Liability exposures can be defined as those losses, which are caused due to the failure to accomplish legally imposed obligations rather than enjoy the rights. The limit of liability of the Insurers under a policy is the sum insured. If there is a dispute in the settlement of a claim made by the insured, the matter can be taken to the court of law seeking a fair settlement.

The liability exposure may arise out of either statutory or common law. ***Statutory law*** is the body of written law created by legislatures. ***Common law***, on the other hand, is based on custom and court decisions. In evolving common law, the courts are guided by the doctrine of *stare decisis* (Latin for "to stand by the decisions"). Under the doctrine of ***stare decisis***, once a court decision is made in a case with a given set of facts, the courts tend to adhere to the principle thus established and apply it to future cases involving similar facts. This practice provides enough continuity of decision making that many disputes can be settled out of court by referring to previous decisions. Some people believe that in recent years, as new forms of liability have emerged, continuity has not been as prevalent as in the past.

Q. 29. (a) What do you understand by 'third party insurance'?

(b) What is systematic risk and what is unsystematic risk? Discuss the further classification of systematic and unsystematic risk.

Answer 29. (a)

In India, under the provisions of the Motor Vehicles Act, 1988, it is mandatory that every vehicle should have a valid Insurance to drive on the road. Any vehicle used for social, domestic and pleasure purpose and for the insurer's business motor purpose should be insured. Motor third-party insurance or third-party liability cover, which is sometimes also referred to as the 'act only' cover, is a statutory requirement under the Motor Vehicles Act. It is referred to as a 'third-party' cover since the beneficiary of the policy is someone other than the two parties involved in the contract i.e. the insured and the insurance company. The policy does not provide any benefit to the insured; however it covers the insured's legal liability for death/disability of third party loss or damage to third party property. Third party insurance policy is a policy under which the insurance company agrees to indemnify the insured person, if he is sued or held legally liable for injuries or damage done to a third party. The insured is one party, the insurance company is the second party, and the person you (the insured) injure who claims damages against you is the third party. Section 145(g) "third party" includes the Government.

Salient Features of Third Party Insurance

- Third party insurance is compulsory for all motor vehicles. Third party risks insurance is mandatory under the statute. This provision cannot be overridden by any clause in the insurance policy.
- Third party insurance does not cover injuries to the insured himself but to the rest of the world who is injured by the insured.

- Beneficiary of third party insurance is the injured third party, the insured or the policy holder is only nominally the beneficiary of the policy. In practice the money is always paid direct by the insurance company to the third party (or his solicitor) and does not even pass through the hands of the insured person.
- In third party policies the premiums do not vary with the value of what is being insured because what is insured is the 'legal liability' and it is not possible to know in advance what that liability will be.
- Third party insurance is almost entirely fault-based.(means you have to prove the fault of the insured first and also that injury occurred from the fault of the insured to claim damages from him).
- Third party insurance involves lawyers aid.
- The third party insurance is unpopular with insurance companies as compared to first party insurance, because they never know the maximum amounts they will have to pay under third party policies.

Answer 29. (b)

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 following 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 globalisation 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 recognise 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.

Q. 30. (a) List the contents of Enterprise risk management policy.

(b) Prepare a checklists for ERM protocols.

Answer 30. (a)

A risk management policy should include the following sections :

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

Many organisations issue an updated version of their risk management policy each year. This ensures that the overall risk management approach is in line with current best practice.

It also gives the organisation the opportunity to focus on the intended benefits for the coming year, identify the risk priorities and ensure that appropriate attention is paid to emerging risks. The policy should also describe the risk architecture of the organisation.

Mandate and commitment from the Board is critically important and it needs to be continuous and high-profile. Unless this mandate and commitment are forthcoming, the risk management initiative will be unsuccessful. Keeping the risk management policy up to date demonstrates that risk management is a dynamic activity fully supported by the Board.

In order to be successful, the ERM initiative needs to be comprehensive.

Answer 30. (b)

Enterprise Risk Management protocols may be as follows :

- Appropriate risk management framework identified and adopted, with modifications as appropriate.
- Suitable & sufficient risk assessments completed & the results recorded in an appropriate manner.
- Procedures to include risk as part of business decision-making established & implemented.
- Details of required risk responses recorded, together with arrangements to track risk improvement recommendations.

- Incident reporting procedures established to facilitate identification of risk trends, together with risk escalation procedures.
- Business continuity plans and disaster recovery plans established and regularly tested.
- Arrangements in place to audit the efficiency and effectiveness of the controls in place for significant risks.
- Arrangements in place for mandatory reporting on risk, including reports on at least the following :
  - Risk appetite, tolerance and constraints
  - Risk architecture and risk escalation procedures
  - Risk aware culture currently in place
  - Risk assessment arrangements and protocols
  - Significant risks and key risk indicators
  - Critical controls and control weaknesses