Paper- 13 : MANAGEMENT ACCOUNTING – STRATEGIC MANAGEMENT

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

The figures in the margin on the right side indicate full marks.

Section -I (60 Marks)
(Strategic Management)
Answer Question No.1 and any other two more from the rest in this section.
(Please answer all part of the question at one place.)

Question 1.

(a) In each of the cases/ statements given below, one of four alternatives is most appropriate. Indicate the correct answer: [1×10]

(i) The BGG growth matrix is based on two dimensions:
(A) Market size and Competitive intensity;
(B) Profit margins and Market size;
(C) Relative market share and Market/Industry growth rate;
(D) Market size and Profit margins.

(ii) The maturity stage of the PLC is most often associated with:
(A) rapid growth;
(B) uncertainty in market;
(C) improvements in manufacturing processes;
(D) re-alignment of competitive structure.

(iii) BSNLs plan behind introduction of "Internet Plan 99", ISDN Virtual Private Network etc would be an example of:
(A) Utilisation of newer technologies;
(B) Portfolio generation;
(C) Diversification of business;
(D) Product development.

(iv) Green-mail tactics is where a firm:
(A) Purchases its own stocks at a premium to avert a take-over bid;
(B) Forestalls the possible take-over bid through legal mode;
(C) Arranges to sell one of its highly profitable S.B.U.s in order to dissuade the predator;
(D) None of the above.

(v) Delphi Technique is used in:
(A) Budgeting
(B) Projecting Business
(C) Market Research Technique
(D) Technological Forecasting

(vi) Brand names such as Coca-Cola, Sony, McDonald's and Nike are a source of competitive advantage as:
(A) They are owned by global firms;

(B) They are well managed brands;
(C) They are more than 50 years old;
(D) They are highly innovative firms.

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

(viii) Technology adaptation is:
(A) the complete assimilation of technical know-how acquired from a collaborator;
(B) the acquisition of technical know-how from the source external to the firm;
(C) the acquisition of design from a collaborator and carrying onto necessary modifications thereto;
(D) the improvement of the level or quality.

(ix) Business process re-engineering is:
(A) Eliminating loss-making process;
(B) Redesigning operational processes;
(C) Redesigning the product and services;
(D) Recurring the process engineers.

(x) Pepsi's "Nothing Official About it" would be an example of:
(A) Mission;
(B) Vision;
(C) Strategic intent;
(D) Policy.

Answer:

(i) (C) Relative market share and Market/Industry growth rate
(ii) (C) improvements in manufacturing processes
(iii) (D) Product development
(iv) (A) Purchases its own stocks at a premium to avert a take-over bid
(v) (D) Technological Forecasting
(vi) (B) They are well managed brands
(vii) (D) For those companies who are strong in the market but not leaders and might capture market share from the leader
(viii) (C) the acquisition of design from a collaborator and carrying onto necessary modifications thereto
(ix) (B) Redesigning operational processes
(x) (C) Strategic intent

(b) State whether the following statements are 'True' or 'False' with justification for your answer: **[1x5]**

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

(ii) "Strategic planning" focuses on forecasting the future by using economic and technical tools.

(iii) Penetration Pricing is the use of price to drive a competitor out of business.

(iv) "Simulation model" helps to narrate and predict the characteristics of a given system under different conditions.

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

Answer:

(i) False: "Question Marks" are the products in a high-growth market but where they have a low-market share. "Star" has a high-market share.

(ii) False: "Long range planning" focuses on forecasting the future by using economic and technical tools.

(iii) False: In penetration pricing, a low initial price is set to reach the mass market immediately.

(iv) True: It is used to describe any model which somehow represents a 'real' system.

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

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

(i) Turbulence

(ii) Conglomerate diversification

(iii) Merger

(iv) Franchising

(v) Market Segmentation

Answer:

(i) Turbulence can be defined as a disruption in the relationship with the environment in which the organisation operates. It is perhaps easy to regard the environment as given with slow and easily measurable rates of change.

(ii) Conglomerate diversification consists of making entirely new products for new classes of customers. These new products have no relationship to the company's current technology, products or markets.

(iii) Combination of two or more firms is known as merger. A combination of two or more business units in which one acquires the assets and liabilities of the other in exchange for cash or shares and/or debentures, is generally known as "merger" through acquisition of absorption

(iv) Franchising is a method of doing business wherein a "franchisor" authorizes a "franchisee" it's proven method of doing business for a given set of return.

(v) Market Segmentation is the division of a market into fairly homogeneous subsets, where each subset can be chosen, reached and served by its own tailored marketing mix.

Question 2.

(a) State the various criteria used in selecting a forecasting method. [4]

Answer:

Various criteria used in selecting a forecasting method: Managers are often confronted with the problem of preparing forecasts for which sourcing of data becomes a difficult problem and the

decisions regarding selection of the method of forecast with the available data. Following are some of the factors that would influence the criteria for selecting a forecasting method:

- Quantum of data-maximum/minimum no. of observations, peaks and troughs, weightage, seasonal data etc.
- Pattern of data-stationary, trend, seasonality, complexity, cyclic etc.
- Time horizon-short, medium and long.
- Preparation time-short, medium and long.
- Type of skills required- no sophistication, moderate sophistication or high sophistication.

(b) What is Corporate Mission? State the benefits of Mission Statement. [2+5]

Answer:

Corporate Mission: The term, "mission" implies the fundamental and enduring objectives of an organization that set it apart from other organizations of similar nature. The mission is general enduring statement of instruction of an organization. It indicates the nature and scope of business operations in terms of product, market and technology. Corporate mission establishes the principal concentration of company effort in terms of customers. It provides a systematic yet somewhat visionary overview of a company's position in the competitive world. A mission provides the basis of awareness of a sense of purpose, the competitive environment, the degree to which the firm's mission fits its capabilities and the opportunities which the environment offers.

Benefits of Mission Statement: The benefits of Mission Statements are: Mission Statements

- describe what the company is about;
- provide a guideline philosophy: give direction in case of doubts;
- display the area in which the company is operating;
- define the broad social purpose and scope of the organisation;
- clearly chart out the future direction for the organisation and establishes a basis for organisational decision making;
- enable employees to clearly understand the values and principles that will guide them in the present and future activities;
- provides a realistic assessment of what is attainable in the future by the organisation, considering its culture, history and shared values;
- encourage commitment and energies all employees towards fulfilling the mission;
- guide and inspire the organisation for many years to come;
- stimulate debate as to how the mission can be implemented;

(c) Distinguish between Corporate Planning and Long-Range Planning. [2+2]

Answer:

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

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

(d) "Technology forecasting is a crucial input in strategy formulation." Which is the best method to forecast the technological changes? State. [3]

Answer:
In the case of forecasting the technological changes, reliable data needed for one of the quantitative technique is not available. As such, the estimation is generic and is a subjective judgment, to be drawn through a process of statistical group response. Thus, for any long term technological forecasting at macro level, the Delphi technique is the best suitable method of obtaining expert opinion from a large group of people in a systematic way. This technique has three attributes: anonymity, feedback and group response. The final result is a statistical group response. This technique being a modification of the panel or committee approach eliminates some of the disadvantages of classical committee.

(e) What do you mean by, "Marketing Mix"? [2]

Answer:
Marketing mix is the pack of four sets of variables namely, product variables, price variables, promotion variables and place variable. It is the blend of all the marketing efforts covering the four elements of product-price-promotion and place. Ideally, the ingredients of a good marketing mix flow logically from all the relevant dimensions of a target market.

Question 3.
(a) Discuss how "Gap Analysis" might be applied to a product/market situation. [7]

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

The product/market targets may be quantified —

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

(ii) There should also be targets for markets/market segments that the organisation would like to be in and targets for —
- Market share or market segment share (both in the existing markets and the markets it would likely to enter into);
- Market positioning - positioning is concerned with such matters as product quality, image and reliability, price, outlets, types of customers.

A projection of the organisation's products and the market shares and market positioning for each of its products would be made on the assumption that:—
- No new products are developed.

- The market mix for the existing products remains the same.

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

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

(b) There are several reasons as to why new products fail. Mention few of those. [5]

Answer:
Following are the reasons for the failure of new products:

- In-adequate market analysis and market appraisal,
- In-sufficient and in effective marketing support,
- Bad-timing of introducing a new product,
- Failure to recognize rapidly changing market environments,
- Absence of formal product planning and development procedure,
- Failure of the product to fill the customer's needs,
- Technical and production problems,
- Higher costs than estimated costs,
- Product problems and its defects,
- Failure to estimate the strength of the competitors,
- Too many new products entering the market.

(c) Describe the role of brands in the construction of barriers to entry. [5]

Answer:
A barrier of entry makes it difficult for a new entrant to gain a foothold in a market. Barriers to entry include economies of scale, product differentiation, capital requirements, switching costs, access to distribution, and other cost advantages. Brands function as entry barrier in the following ways:

- Product differentiation - Porter discusses two criteria. Brand image is built up through advertising and other special features and reflects both use and signaling criteria.

- Existing firms in an industry may have built up a good brand image and strong customer loyalty over a long period of time, through advertising, product quality, etc.

- A firm might develop a variety of brands to crowd out the competition. Some firms own many brands to make it harder for competitors to get noticed by consumers, as there are so many alternatives. This creates a barrier of entry, because new entrants would have to spend heavily to overcome the existing brand loyalties and to build up a brand image of their own.

- With some brands, there are also quite high switching costs, which is why many people are unwilling to change bank account because of the inconvenience of so doing.

- Economies of scale are also relevant. A certain amount of volume may be necessary to justify the promotion of the brand. Existing producers may already have built up.

(d) What is SWOT Analysis? State in brief the purpose of it. [2+1]

Answer:
The acronym SWOT stands for Strengths, Weaknesses, Opportunities, and Threats. SWOT analysis attempts to assess the internal strengths and weaknesses of an organisation and the opportunities and threats that its external environment presents. SWOT seeks to isolate the major issues facing an organisation through careful analysis of each of these four elements. Managers can then formulate strategies to address key issues.

The purpose of the analysis is to express, qualitatively or quantitatively, which areas of the business have strengths to exploit, and which areas have weaknesses which must be improved. Although every area of the business should be investigated, only the areas of significant strength or weakness should warrant further attention.

Question 4.

(a) Your research shows that over 53% of all purchases are made on impulse. You advise your packaging design team that the package must communicate many of the sales tasks. List the sales tasks that packaging must now incorporate. [3]

Answer:
Packaging may be defined as the general group of activities in the planning of a product. These activities concentrate on formulating a design of the package and producing an appropriate and attractive container or wrapper for a product. The tasks of packaging are:

(i) Attract attention;
(ii) Describe the product's features;
(iii) Create consumer confidence, and
(iv) Make a favourable overall impression.

(b) Mention the specific tools with which the Management Accountant should associate himself in the implementation of Strategic Total Cost Management (TCM) in an organization. [5]

Answer:
As an important member of the strategic management team in an organization, the Management Accountant plays a very significant role in the introduction of Total Cost Management strategy which can embrace many different areas in business and as such there are specific tools to be employed for the implementation as follows:

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

(ii) Production Cost Management: Aims at reduction of total cost of design, material management, production by Kaizen method of optimizing each cost component;

(iii) Marketing Cost Management: Identifies products, brands, segments and markets that augur greater growth with least incremental marketing costs;

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

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

(c) State the differences between Cost leadership and Cost reduction. [4]

Answer:

Cost leadership: 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.

Cost reduction: 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 vigorously, 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.

(d) Write a short note on the following: [4+4]

(i) Reverse Engineering

(ii) Objectives of Sales Promotion activities

Answer:

(i) Reverse Engineering: Reverse Engineering is the dissection of an already existing finished product and preparation of manufacturing designs with a view to improve the product. It is essentially a four stages development process:

- Development of awareness: The competitor comes to know of the new product in market with customer acceptance.
- Initiation of Reverse Engineering: The firm obtains the new product, breaks open the formula and analyses/ understand process.
- Development of know-how and attempts to design new prototypes with improvements.
- Commercialization: as a competitive product or a substituted (through replacement) Reverse Engineering has a big role to play as a functional strategy.

(ii) Objectives of Sales Promotion activities: Non-media advertising and below the line advertising are alternative terms which mean sales promotion activities. Some of the commonly attempted sales promotion objectives include:

- Increase sales
- Make the sales of slow moving products faster
- Identifying and attract new customers
- Launch a new product quickly
- Educate customers regarding product developments
- Reduce the perception of risk associate with the purchase
- Motivate dealers to stock and sell more
- Attract dealers to participate in display and sales contests
- Obtain better and more shelf space and displays
- Bring more customers to dealer stores
- Make good move faster through dealers
- Improve manufacturer-dealer relationship
- Motivate sales force to achieve more than targets
- Counter competitor's marketing efforts
- Provide punch to the advertising efforts
- Build goodwill.

SECTION-II (40 Marks)
(Risk Management)

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

Question 5.

(a) In each of the cases/statements given below, one of four alternatives is correct. Indicate the correct answer: **[1x5]**

(i) ECOR in risk management means:
(A) Expected Cost of Ruin;
(B) Expected Cost of Opportunity Loss;
(C) Economic Cost of Ruin;
(D) Economic Cost of Opportunity Loss.

(ii) Often analysts focus on characteristics of loss distribution such as:
(A) Expected loss;
(B) Standard deviation of loss;
(C) Maximum probable loss;
(D) All of the above.

(iii) Financial Risk arises out of:
(A) The nature of the financial transaction;
(B) Conduct of business and investment;
(C) Both (A) and (B);
(D) Increase of competition.

(iv) Motorola learning lessons from Domino's Pizza and Federal Express, to improve the speed of delivery for its cellular phones, comes under:
(A) Strategic Benchmarking;
(B) Functional Benchmarking;

(C) Process Benchmarking;
(D) Performance Benchmarking.

(v) Futures have four specific characteristics as against the forwards, which among them is not a character?
(A) Liquidity;
(B) Third party warranty;
(C) Standard volume;
(D) Intermediate cash flows.

Answer:

(i) (C) Economic Cost of Ruin
(ii) (D) All of the above
(iii) (C) Both (A) and (B)
(iv) (A) Strategic Benchmarking
(v) (B) Third party warranty

(b) State whether the following statements are 'True' or 'False' with justifications for your answer. [1x5]

(i) Causa proxima is defined as "the active efficient case that sets in motion a chain of events which brings about a result, without the intervention if any force started and working actively from a new and independent source."
(ii) The individual insurers or professional rate making organisation may determine insurance rates are called profit loaders.
(iii) Interest rate risk refers to the uncertainty market volumes in the future and the quantum of future income caused by the variations in the interest rates.
(iv) 'Future' a derivative, is used as a hedging mechanism against 'Risk'
(v) "Loss Control" is a method of risk financing for managing pure risk.

Answer:

(i) True: Causa proxima is defined as "the active efficient case that sets in motion a chain of events which brings about a result, without the intervention if any force started and working actively from a new and independent source." Proximate cause means the most closely and directly connected of the perils insured against with loss.
(ii) False: The individual insurers or professional rate making organisation may determine insurance rates are called Actuaries.
(iii) True: Interest rate risk is the risk (variability in value) borne by an interest-bearing asset, such as a loan or a bond, due to variability of interest rates. In general, as rates rise, the price of a fixed rate bond will fall, and vice versa.
(iv) True: 'Future' a derivative, is used as a hedging mechanism against 'Risk'.
(v) False: When particular risks cannot be avoided, actions may often be taken to reduce the losses associated with them. This method of dealing with risk is known as loss control.

Question 6.

(a) Why is Risk Reporting considered to be an important step in Risk Management? [6]

Answer:

Risk Reporting is an important step in Risk Management because:

- A transparent and effective risk reporting system is essential for a company, as it is obligatory on its part to disclose all material risks that it faces and its risk management practices. In recent years, the concept of risk reporting has assumed significant importance, after the collapse as well as other corporate failures. Existence of an adequate Risk Reporting System in an organization makes the managers more accountable for their actions. In the light of this, the importance of risk reporting system can be summarized as under:
- It can assist the Board to discharge its responsibilities, enabling the company to go for higher profits at lower risks.
- It helps in decision-making at all levels with objectivity.
- It can help investors to evaluate market situations with a view to building optimum portfolio of securities.
- Lenders can be supported in their lending operations and policy decisions.
- It can help a company in getting a better credit rating and access to cheaper source of finance.
- It develops transparency between managers and investors-leading to reduced agency cost, which in turn reduces the cost of capital and increases the basket of investment opportunities available to a firm.

It can create a niche for the company and can act as a trendsetter for others.

(b) Describe the broad categories of risks that can be identified for an organisation? [3]

Answer:

Broad categories of risks that can be identified for an organisation A number of factors influence the risk and depending upon the cause, the risks can be broadly classified into the following major types:

- Strategic Risks: examples are Government and economic factors, customers, competitors, new technologies etc.
- Operational Risks: examples are suppliers, process and internal risks, distribution, customers, competitors, environmental factors etc. ,
- Investment Risks- examples are interest rates, purchasing power, liquidity, default, convertibility, portfolio etc.

(c) State "Asset-Liability Model" and its utility for managing liquidity risk and exchange rate risk. [2+(2+2)]

Answer:

Asset-liability Management Model: Asset-liability Management Model involves matching of the assets and the 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 expected 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-get 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 is passed on to the lenders through dollar denominator loans. The uncovered loans are hedged at the time of contacting them through forward covers for the entire amount.

Question 7.

(a) To be effective, any Enterprise Risk Management (ERM) implementations should be integrated with strategy-setting". Do you agree? Give your views. Bringing out the basic elements of ERM and the reasons why ERM is implemented. [3+(3+3)]

Answer:

—To be effective, any Enterprise Risk Management (ERM) implementation should be integrated with strategy-setting". To my mind, this statement is true. In today's challenging business environment, opportunities and risks are constantly changing, giving rise to the need for identifying, assessing, managing and monitoring the organization's business opportunities and risks. This, in turn, necessitates establishing the linkage between the opportunities and risks while managing the business. This requirement is addressed by ERM, which redefines the value proposition of risk management by elevating its focus from the 'tactical' to 'the strategic'. ERM is about designing and implementing capabilities for managing the risks that matter. In the light of this, the statement is correct and therefore acceptable.

Basic Elements of ERM: The following are the basic elements of ERM:

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

Reasons why ERM is implemented: ERM needs to be implemented for the following reasons:

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

(b) (i) State the rights and responsibilities of:

- **Insurer and**

- **Insured – in the sphere of Risk Insurance.**

(ii) Also mention two functions of insurers. **[(2+2)+2]**

Answer:

(i) The rights and responsibilities of the Insurer and insured in the sphere of Risk Insurance:

- **The rights and responsibilities of the Insurer in the sphere of Risk Insurance:** The Insurer has the right to collect the premium from the insured and also lay down conditions to the agreement. He has the responsibilities to pay compensation to the insured against a valid claim.

- **The rights and responsibilities of the Insured in the sphere of Risk Insurance:** The Insured has a right to collect compensation from the insurer against a valid claim. He has the responsibilities to pay the premium to the insurer, disclose all relevant data to the insurer in utmost good faith and should comply, with the terms and conditions laid down by the insurer.

(ii) Two main functions of insurers:

(A) **Receiving applications:** from intending individuals or institutions for insurance cover and the offer of cover to individuals after due evaluation and procedures.

(B) **Underwriting:** This ensures that the insurer will not incur losses that are different from the pattern on the basis of which premium rates are calculated. This process is done by judgmental or numerical method. Here, underwriting involves evaluating the applications and their information contents with reference to the key aspects.

Question 8.

Write short notes on the following: **[5×3]**

(a) Re-insurance

(b) Risk Retention

(c) Pure Risk

Answer:

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

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

Insurance companies typically enter into an agreement with the Re-insurer and sign a Reinsurance Treaty which states all the terms and conditions of the agreement. The Re-insurer agrees to accept a certain fixed share of risk upon terms as set in the agreement. For example, an Insurance company has a risk appetite of ₹ 1 million but has issued a general insurance policy for an engineering project where the sum insured is ₹ 4 million. If a claim is

made on this particular policy, the claim will be settled for ₹ 4 million. ₹ 1 million will be paid by the Insurance Company that issued the policy and the remaining ₹ 3 million will be paid by the Re- insurer.

(b) Risk Retention: A technique for managing risk, known as risk retention, involves the assumption of risk. That is, if a loss occurs, an individual or firm will pay for it out of whatever funds are available at the time. Retention can be planned or unplanned, and losses that occur can either be funded or unfunded in advance.
Planned retention involves a conscious and deliberate assumption of recognised risk. Sometimes planned retention occurs because it is the most convenient risk treatment technique or because there are simply no alternatives available short of ceasing operations. At other times, a risk manager has thoroughly analysed all of the alternative methods of treating an existing risk and has decided that retention is the most appropriate technique.

When a firm or individual does not recognise that a risk exists and unwittingly believes that no loss could occur, risk retention also is under way — albeit unplanned retention. Sometimes unplanned retention, occurs even when the existence of a risk is acknowledged. This result can ensue if the maximum possible loss associated with a recognised risk is significantly underestimated. For example, a manufacturer of kitchen appliances may recognise the potential for product liability suits. But the potential size of adverse liability judgments may be much greater than the manufacturer anticipates. Thus, even though the exposure is recognised, if the firm elects to purchase insurance based on its estimate of the maximum possible loss, it is engaging in unplanned retention of losses that exceed that estimate.

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

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

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

(3) Other Risks:

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

Some common features of pure risk include the following:

(1) Huge potential losses: Losses from destruction of property, legal liability, and employee injuries or illness often have the potential to be very large relative to a business's resources.

(2) Pure risks are controllable: The underlying causes of losses associated with pure risk 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.

(3) Insurability: Pure risks can be insured.

(4) Lower probability: The probability of occurrence of pure risk is low and less frequent.
(5) Not associated with offsetting gains: Losses from pure risk usually are not associated with offsetting gains for other parties.