Paper – 13: Management Accounting –Strategic Management

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

Answer Question No.1 and Question No.6, which are Compulsory and any three Questions from Section I and another two Question from Section-II.

Working Notes should form part of the answer
"Wherever necessary, suitable assumptions should be made and indicated in answer by the candidates."

Section I

1. (a) Choose the most appropriate one from the stated options and write it down: [1x5=5]
   (i) The difference between strategic alliances and joint ventures can best be explained by
      (a) All strategic alliances are joint ventures
      (b) All joint ventures are strategic alliances
      (c) All strategic alliances are temporary phenomena
      (d) There is no connection between SA and JVs.
   (ii) Pepsi's 'Nothing Official About it' would be an example of
      (a) Mission
      (b) Vision
      (c) Strategic intent
      (d) Policy
   (iii) The difference between Horizontal integration and Vertical integration can be best explained in terms of:
      (a) economics
      (b) vision
      (c) choices
      (d) perspective
      (e) profitability
   (iv) The maturity stage of the PLC is most often associated with:
      (a) rapid growth
      (b) uncertainty in market
      (c) improvements in manufacturing processes
      (d) high exit barriers
      (e) re-alignment of competitive structure.
   (v) 'Niche' is similar to the
      (a) Growth strategy
      (b) Milking strategy
      (c) Flanking strategy
      (d) Survival strategy

   (b) Define the following terms in not more than two/three sentences: [1x5=5]
   (i) Turbulence
   (ii) Market Espionage
   (iii) Brand Positioning
   (iv) Product Differentiation
   (v) Marketing Data base

   (c) State whether the following statement are 'True' or 'False' : [1x5=5]

(i) Penetration Pricing is the use of price to drive a competitor out of business.
(ii) 'Repositioning' involves moving the product or brand into a different market segment.
(iii) 'Acquisition' is nothing but the joining of two separate firms to form a single firm.
(iv) 'Divestment' means selling off a part of a firm's operations, or putting out of certain product-market operations.
(v) 'Forward Integration' means in-house production of critical inputs for the main business.

Answer:

1. (a) (i) (b) All joint ventures are strategic alliances.
(ii) (c) Strategic intent.
(iii) (a) economics.
(iv) (c) improvements in manufacturing processes.
(v) (c) Flanking strategy

(b) (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) As a technique for environmental analysis and also as a part of market intelligence activity, it aims to secure information about competitors' plans and actions by secret means. It attempts to eliminate competitors, prevents new entrants, takes timely counter-action etc. Although it varies by industry, marketing espionage appears to be increasing.

(iii) It is an activity which seeks to determine and achieve a position in the perception of the buyers relative to that of the competitors. In order to effectively place a brand has to communicate carefully- choose the message which has best chance to get into prospect's mind - which prospect can understand, which behold his attention, gives him a reason to read. It should also provoke a thought process in his mind and should create a distinct image, a position for the brand in his mind; the message can create an unfavorable position or a favorable position.

(iv) It is a generic strategy to outperform other firms in an industry.
The marketer tries to choose specific dimensions of the product or certain aspects of the consumers' important buying criterion etc. It is a strategy to establish a kind of difference from other offerings in the minds of the consumers. It could be in the form of branding / positioning in select market segment.

(v) Marketing database provides relevant information to any company about the total marketing environment in which the company is operating. This includes customers, competitors and the marketing mix strategies and enables managers to take appropriate decisions.

(c) (i) False;
(The correct statement is: Predatory Pricing is the use of price to drive a competitor out of business.)
(ii) True;
('Repositioning' is a strategic marketing approach and involves moving the product into different market segment.)
(iii) False;

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

(iv) True;
(The term 'divestment' denotes getting rid of something.)

(v) False;
('Backward Integration' means In-house production of critical inputs for the main business.)

2. (a) What do you know about recycling of strategy? [9]
(b) Discuss how 'Gap Analysis' might be applied to a product/market situation. [6]

Answer:

2. (a) Where the basic position of a company is changed and/or the fundamental premises on which the present strategy is founded are challenged, it becomes imperative to recycle the strategy. Recycling refers to reformulation or remaking of strategy. Recycling may take place when the company's strategic position has undergone significant changes. Thus, for instance, the management's thrust of stability or survival of the organisation due to a sudden and impending decline in sales and earnings or due to emerging financial crises, forces the organisation to take drastic actions and reformulate corporate strategy to solve the immediate and future problems.

At times, phenomenal and unexpected changes in environmental conditions occur in and outside the country. For instance, the energy crisis of the 70s and subsequent changes in customers' preferences forced many automobile companies to reformulate their strategies. In addition to external events, changes in the internal position of the company such as change in the top management of the company or acquisition of other forms may also being about phenomenal changes in the current strategy.

The general process of recycling of strategy is the same as that entailed in strategy making. However, recycling is less formal and is quickly formulated and executed because it is carried out in urgency and only those elements which are affected by the new strategy need the attention of the management.

Reformulation of strategy is managed by all those engaged in formulation and execution of corporate strategy. Management adopts a sensing-adjusting response mechanism for the reformulation of strategy.

One of the major problems involved in reformulating strategy is the success syndrome. Generally, the management of a successful organisation is not interested in change and often acts in too slovenly a manner to be effective. Another problem that may arise in the course of reformulation of strategy relates to changes in overall corporate policy. It has been found in real life that policy changes may not be appreciated by all senior managers and may result in resentment and resignation of some sensitive managers. This, in turn, is likely to jeopardise the exiting organisational structure with further complicates the situation.

Implementation of a reformulated strategy poses still greater problem because it requires a transitional period during which existing concepts and methods are discarded, new ones are tried and accepted, and the newly structured organisation put into operation.

(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 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.

3. (a) "An organisation can choose from a wide variety of grand strategies such as Stability Strategies, Growth Strategies, Retrenchment Strategies and Combination Strategies". Explain these strategies and highlight the conditions under which each one is the most appropriate. [8]

(b) What do you understand by "Corporate Reconstructing"? Specify and discuss about Corporate Level Restructuring Strategies. [5]

(c) Define Divestiture Strategy. [2]

Answer:

3. (a) Four grand strategies: stability, growth, retrenchment and combination are opinions for the pace or level of efforts in the current business definition or for changing the business definition.

Stability: A stability strategy is a strategy that a firm pursues when -
- It continues to serve the public in the same product or services, market and function sector as defined in its business definition or in very similar sectors.

- Its main strategic decisions focus on incremental improvement of functional performance.
- Stability strategies are implemented by 'steady as it goes' approaches to decisions. Few major functional changes are made in the product or service line, markets or functions. In an effective stability strategy, a company will concentrate its resources where it presently has or can rapidly develop a meaningful competitive advantage in the narrowest possible product - market- function scope consistent with its resources and market requirement.

Growth: A growth strategy is a strategy that a firm pursues when -
- It serves the public in additional product or service sector or adds markets or functions to its definition.
- It focuses its strategic decisions on major increases on major increases in the pace of activity within its present business definition.

A firm implements this strategy by redefining the business- either adding to the scope of activity or substantially increasing the efforts of the current business. Growth is usually thought of as 'the way' to improve performance. An increase in assets or sizes is thought by many to yield growth in profit or ROI. Several studies support this proposition. But the opinions and research of others suggest that short-run inefficiencies often result.

Retrenchment: A retrenchment strategy is pursued by a firm when -
- It sees the desirability of or necessity for reducing its product or service lines, markets of functions.
- It focuses its strategic decisions on functional improvement through the reduction of activities in units with negative cash flows.
- A firm can redefine its business by divesting itself of a major product line or an SBU. It could abandon some market territories. A firm could also reduce its functions. Of course, the ultimate redefinition is total liquidation.

Combination: A combination strategy is a strategy that a firm pursues when -
- Its main strategic decision focuses on the conscious use of several grand strategies at the same time (simultaneously) in several SBUs of the company.
- It plans to use several grand strategies at different future times (sequentially).

With combination strategy, the decision makers consciously apply several grand strategies to different parts of the firm or to different future periods. The logical possibilities for a simultaneous approach are stability in some areas, growth in others; stability in some areas, retrenchment in others; retrenchment in some areas, expansion in others; and all three grand strategies in different areas of the company.

(b) 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 organizational 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.

(c) **Divestiture:** A divestiture strategy involves the sale of a business or a major business component. When retrenchment fails to accomplish the desired turnaround, strategic managers often decide to sell the business. However, because the intent is to find a buyer willing to pay a premium above the value of fixed assets for a going concern, the term marketing for sale is more appropriate. Prospective buyers must be convinced that because of their skills and resources, or the synergy with their existing businesses, they will be able to profit from the acquisition.

4. (a) Explain the variants of Retrenchment Strategy? [9]
(b) What is Turnaround Management? [6]

Answer:

4. (a) There are three major variants of retrenchment strategy.
They are: Turn-around strategy, Survival strategy, and Liquidation strategy

(i) **Turn-around strategy:**
When an enterprise has been suffering business losses for a long period of time because of continued decline in sales, it takes recourse to turn-around strategy to arrest and reverse the declining performance of the business. A turn around strategy with its basic philosophy of hold the present business and cut the costs is an extreme step which stops just short of selling the liberation or degenerating into insolvency. Such a course of action should be resorted to only when the business is worth saving. It is, therefore, necessary to determine the firm's future earning power and compare the same with the estimated liquidation value. If the firm's future earning power is higher than the liquidation value, it will be worthwhile to continue the operation of the firm.
A turn around strategy calls for strong managerial action to restore profit and rebuild morale. Before developing the turn - around strategy, decision has to be taken as to who should direct the turn-around operation. In other words, should the existing top management be continued or should a new one be brought in from outside. Such a decision has to be taken by the BODs. Once this decision is taken, the BODs and the Chairman jointly formulate objectives of the operation.

(ii) Survival strategy: When a firm's business has reached the stage of extinction, it focuses all its energy on the search of a survival strategy. Six danger signs of a company in need of help are losing money (negative profit), shortage of cash, losing market share, deteriorating physical facilities, departing of personnel and low morale among those remaining. Most kinds of the business trouble that can threaten a firm seriously will externally be manifested in a cash flow problem. Survival drives have psychological, sociological and systematic roots. These reflect individual drives for personal security, tribal interdependence, and allegiance of social groups and dynamic inertia of complex organisations to continue functioning as they are. There are three approaches to survival strategy. They are: Management Restructuring Divestment and Restructuring Business.

(iii) Liquidation Strategy: This is usually the strategy of last resort. Liquidation of the present business enterprise is the ultimate retrenchment. Liquidation strategy is the decision to sell off or close down a firm. Such a decision is taken under the following circumstances.

When the business condition of a firm is perilous and there is no hope of recovering from the present crisis.

At times, the managers may feel the business is at its peak but the future is uncertain and the firm is unable to see any direction in which it can enter and operate.

A firm may be suffering from a business crisis and it may not have adequate resources to get out of the present crisis.

When a firm has been facing very badly in the past few years and has consequently suffered considerable losses and some other firm offers to buy it for tax consideration or any other reason.

Sometimes, a firm may be offered a price higher than its real worth and the management may be tempted to sell off the business, particularly when it is found that there are suitable alternative investments or business where the sale proceeds could be gainfully employed.

(b) **Turnaround Management:** Turn-around management refers to the management measures which reverse the negative trends in the performance indicators of the company. In other words, turn around management refers to the management measures which turn a sick company back to a healthy one or those measures which reverse the deteriorating trends of the performance indicators such as falling market share, sales (in constant rupees), and worsening debt-equity ratio.

Turn-around Management Factors: Management Factor: Managerial inefficiency is the root cause of the problems in a number of cases. Therefore, improvement of the management becomes a prerequisite. The new CEO should streamline things and in many cases will have to change the organisational culture.

(i) Human Resource Factor: In many of the companies which are in very bad shape, the human resource is redundant, demoralised and surplus. The surplus manpower should be got rid of morale should be restored and the quality of the manpower should be improved through training and recruitment of competent people for the key positions, if needed.

(ii) Production Facilities: Modernisation and other improvements of plant, equipments etc., are also often an important part of the turnaround management.

(iii) Finance Management: Arranging additional finance, financial discipline, financial restructuring (described under Business Reorganisation).

(iv) **Product Mix Modification:** A number of turnaround management cases involve modification of the product mix. Unprofitable products may have to be dropped and new products may have to be introduced.

(v) **Marketing Strategy:** An appropriate marketing strategy could help improve such cases.

(vi) **Miscellaneous:** Liquidation of assets, which are not in use.

5. (a) Distinguish the following statements:

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

(ii) "Regression may be appropriate at the aggregate level of an industry but it may not be so at the level of a company". [3+3=6]

(b) How are decisions taken with regard to brand selection and its use in the Indian context? [9]

Answer:

5. (a) (i) 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, feedback 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.

(ii) Regression is a trend extrapolation technique and basically encompass that the future value is only an extension of the past performances, at least into near-term future. The past observations are described as a function of time and the identified pattern is then used to forecast ahead. Therefore, it encourages thoughtlessness; particularly in the long-term as to why should a curve depending only on time provide a suitable description of the distant future. Accordingly, though it may be taken as appropriate at the aggregate level of an industry to some extent, it may not be so at the level of a company, wherein much more specific data is demanding, to search through other techniques.

(b) Branding removes anonymity and gives identification to a company and its goods and services. Branding is actually a very general term covering brand names, designs, trademarks, symbols, a distinctive letterhead; an identifiable shop front or van etc., which may be used to distinguish one organisation's goods and services from another's. According to Kotler, a brand is a name, term, sign, symbol or design or combination of them, intended to identify the goods or services of one seller or group of sellers and to differentiate them from those of competitors. Branding and a firm's reputation are heavily linked.

As appropriate branding is one of the most important activities in the area of marketing of products, especially consumer products, several decisions need to be taken with regard to brand selection and its use. These are:

(1) Should the product be branded at all?

The decision to brand or not to brand a product can be taken only after considering the nature of the product, the type of outlets envisaged for the product, the perceived -advantage of branding and the estimated costs of developing the brand. Historically, it is found that brand development is closely correlated with the increase in the disposable income, the sophistication of the distribution system and the increasing size of the national market. The same trend is visible in India now. Several firms have started marketing branded products in such product categories as wheat,' flour and refined salt. The reason for such a trend is that a class of consumers are willing to pay more for uniform and better quality product represented by the brand.

(2) Who should sponsor the brand?

The question of sponsorship of a brand refers to the decision as to whether it should be a manufacturer's brand, also known as a national brand or a private -brand, also known as a middlemen's brand. This is a major decision in most developed countries, where large chain/departmental stores dominate the retail distribution system. This is however, largely a hypothetical question in India where retail distribution system is highly fragmented. Only super markets have started marketing a few products that are specially packed and sold under their names. However, some retailers' brand names in product categories such as car accessories have already been established.

(3) What quality should be built into the brand?

A very crucial decision is with regard to the quality and other attributes to be built into the product. The matrix of such attributes will decide the product positioning. A marketer has the option to position his product at any segment of the market: top, bottom or the intermediate. Taking an example, "Ariel" is positioned as a premium quality and high priced product. At the other end of the scale, "Wheel" is positioned as low priced.

(4) Should each product be individually branded or a family brand should be adopted for all the products?

The marketer also has to decide at the outset whether he would like to adopt a family brand under which all the products of the company would be sold or he would like to brand each product separately. Kissan follows the former policy. The same brand name is used for jam, squashes, juices and sauces. 'Hindustan Lever' follows the latter policy. Some firms follow a slightly modified strategy. This involves using brands individually but also giving prominence to the company name or logo in all promotional campaigns as well as in product packaging. For example, Tata group Companies follow this strategy. In many cases a brand extension strategy is adopted for securing additionally mileage from a particularly successful product. For example, 'Lifebuoy Gold' and 'Lifebuoy Plus' are extensions of 'Lifebuoy'.

(5) Should two or more brands be developed in the same product category?

A firm may decide to have several brands of the same product, which to some extent are competing inter se. The basic reason is that, at least in the consumer products, various benefits, appeals and even marginal differences between brands can win a large following. Example: 'Hindustan Lever' markets several soaps under different brands for different segments.

(6) Should the established brand be given a new meaning (repositioning)?

Over the life cycle of a product, several market parameters might undergo a change. All and each of such changes call for a relook as to whether the original positioning of the product is still optimal or not. Stagnating or declining sales also point to a need for reassessment of the original product positioning. For example, 'Lifebuoy Soap' has been repositioned several times in the recent past.

Section II

6. (a) Choose the most appropriate one from the stated options and write down: [1x5=5]

(i) MTA stands for
- **(a) Mark to area**
- **(b) Move to assembly**
- **(c) Make to assembly**
- **(d) Monitor in area**
- **(e) Move to accelerate**

(ii) Post-loss objectives in risk management are
- **(a) Survival of the organisation, Continuance of the organisation's operations**
- **(b) Initiate and improve the income /earnings**
- **(c) Obligation to society**
- **(d) Both (a) and (b)**
- **(e) All the above**

(iii) ________________ is the uncertainty of the purchasing power of the monies to be received, in the future.
- **(a) Purchasing power risk**
- **(b) Market risk**
- **(c) Physical risk**
- **(d) Interest rate risk**
- **(e) Exchange risk**

(iv) EPD in risk management means
- **(a) Economic policy holder deficit**
- **(b) Expected probability of holder deficit**
- **(c) Expected policy holder deficit**
- **(d) Expected policy holder default**
- **(e) None of the above**

(v) Performance related risk measures do not include
- **(a) Operating earnings**
- **(b) EBITDA**
- **(c) WACC**
- **(d) EVA**
- **(e) Shortfall risk**

(b) State whether the following statements are 'True' or 'False'. [1x5=5]

(i) The concept of Pooling risk is the process of identification of separate risks and put them all together in a single basket, so that the monitoring, combining, integrating or diversifying risk can be implemented.

(ii) ECOR in risk management means 'Economic Cost of Ruin'.

(iii) Risk management techniques include among other things the risk premium payable.

(iv) Risk cannot be avoided through insurance but may be considered as a means to transfer the risk.

(v) Purchasing power risk is the uncertainty of the purchasing power of the monies to be received, in the future.

Answer:

6. (a) (i) (b) Move to assembly
(ii) (e) All the above
(iii) (a) Purchasing power risk
(iv) (c) Expected policy holder deficit

(v) (e) Shortfall risk

(b) (i) True
(ii) True
(iii) False
(iv) True
(v) True

7. (a) Explain management accountant's role in insurance risk management. [7]
(b) What are the strategies adopted for Corporate Risk Management? [5]
(c) How do you hedge and diversify project risk management and what are the strategies to be adopted? [3]

Answer:

7. (a) In the wake of economic uncertainties through which the business passes, a management accountant has to stay close to risk management process in an organisation and bring about a structured thinking within the business about risks. Irrespective of his role, as a management accountant in an insurance company or an insured company, a management accountant has to appreciate the computation of the premium rates for different insurance product, as also fully define the character of the losses to be covered.

Value imputation of risks to be covered by the insurer's company has two aspects:
(i) Quantifying the total risk to be covered for calculating a premium as a definite fraction of the risk value covered by the policy.
(ii) If the quantification of risk is so high and the corresponding premium is also likely to be high enough for an insured to back out, then develop a framework where the insurer's company can reinsure itself for the policy risk with another insurance company. This will help in reducing the premium for the insured.

A management accountant in an insured company has his task cut out in two directions. At the time of covering the risk, he has to work closely with the cross functional team to identify the direct values of the risks involved and indirect consequent values of the risks involved. For example, in the first instance, the replacement cost of a plant being insured is a direct cost and has to be quantified by proper methodology. The next step is to estimate the consequential loss of profits due to stoppage of plant due to breakdown of the plant being replaced.

During the period of economic uncertainties, the management accountant can fortify the management thinking process -through providing a robust, highly reliable, fast and responsive, transparent and reliable Information Management, which will continuously highlight the risks inherent in every management activity.

(b) In risk management, the following four strategies are generally adopted:
- **Risk Avoidance** is a strategy by which the organisation does not engage in the activity which involves any risk.
- **Risk Reduction** is another strategy where the organisation takes two steps. One is preventing the occurrence of risk and the second one is controlling the number of occurrences. One of the possible ways of reducing the risk is going for large number.
- **Risk Retention** is the most popular method of dealing with risk. Risk retention may be conscious or unconscious. Conscious risk retention takes place when the risk is

perceived and not transferred or reduced. When a risk is not recognised, it is unconsciously retained.

- **Risk Transfer** is another method of managing risk. Risk can be transferred to a person willing to take it. Hedging or insurance are best examples for risk transfer.
- **Risk Sharing** is process by which the potential risk is shared among many, so that the loss is not borne by a single person.

(c) Hedging and diversification of project risk management use the following tools: portfolios, insurance and hedging. Project risk could be reduced through building a diversified portfolio to balance risks and cash flows, hedging against currency fluctuations or commodity exposures, applying financial derivatives. Risk can be transferred by insuring risks as well as diversifying investments in different countries to reduce political risk.

8. (a) What is systematic risk and what is unsystematic risk? Discuss the further classification of systematic and unsystematic risk. [10]

(b) Write a brief note on significance of "Corporate Governance" in today's context in India. [5]

Answer:

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

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

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

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

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

Exchange Risk: With the 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.

(b) A role on the significance of Corporate Governance in India.

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 mis-governance 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 transparency. Further the management should ensure that there is a full and complete financial disclosure. 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.

9. Explain briefly the following: **[5x3=15]**

(i) Diversification of risk
(ii) Hedging risk
(iii) Transfer risk
(iv) Combine risk
(v) Sharing risk

Answer:

9. (i) This involves identifying that fraction, which is systematic and the remaining unsystematic. Systematic risk is that inherent and peculiar to the type of business or the organisation and can be reduced or diversified by acting within the organisation, which is through functional level strategy. The unsystematic risk, which is the market risk is external to an organisation and is also termed as market risk. The identification of characteristics of market risk through statistical correlation "Beta", which is a measure of market risk, lends itself for manipulation through portfolio management.

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

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

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

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