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."

Question.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) all joint ventures involve equity participation

(ii) 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

(iii) 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. Us in order to dissuade the predator
(d) None of the above.

(iv) Switching Costs refer to the:
(a) cost of changing a firm's strategic group
(b) cost of installing new electric switches in a factory when technology changes.
(c) onetime costs incurred by the customers when they buy from a different supplier
(d) all of the above

(v) Which of the following is NOT an entry barrier to an Industry?
(a) Expected competitor retaliation
(b) Economies of scale
(c) Customer product loyalty
(d) Bargaining power of suppliers

(b) State whether the following statements, based on the quoted terms, are 'True' or 'False' with justifications for your Answer. If any given statement is 'False', you are required to give the correct terms duly quoted. No credit will be given for Answers without justifications.
[1x5=5]

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

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

(iii) Synergy signifies a condition where the whole is greater than the sum of its parts.

(iv) 'Niche' means concentrating around a product and market.

(v) "Balanced Strategy" is about translating the vision, communicating and linking, business planning, target setting, etc.

(c) Define the following terms in not more than two sentences: [1x5=5]

(i) Long Range Planning
(ii) Marketing Strategy
(iii) Portfolio Planning
(iv) Activity Based Management
(v) Channels of Distribution

Answer:

(a)

(i) (b) - all joint ventures are strategic alliances.

(ii) (d) - Product development

(iii) (a) – Purchases its own stocks at a premium to avert a take- over bid

(iv) (c) - onetime costs incurred by the customers when they buy from a different supplier

(v) (d) - Bargaining power of suppliers

(b)

(i) False

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

(ii) False

The appropriate term is 'long range planning' instead of the words 'Strategic Planning'. In long range planning, we make more use of economic and technical tools. Thus the corrected statement is – 'Long range planning' focuses on forecasting the future by using economic and technical tools.

(iii) True

Synergy signifies a condition where the whole is greater than the sum of its parts.

(iv) True

'Niche' means concentrating around a product and market.

(v) False

"Balanced Score Card" is about translating the vision, communicating and linking, business planning, target setting, etc.

(c)

(i) **Long Range Planning:** It becomes the basis for the strategies to be pursued to drive an organization towards its mission. It is a long-term view of what an organization is planning to become in future, indicating the basic thrust of the firm, including its products, business and markets. It focuses on forecasting the future by using economic and technical tools.

(ii) **Marketing Strategy:** It is basically the formula for achieving marketing success in business. It is the plan for getting the best return from resources, the selection of the kind of business to engage in and the scheme for obtaining a favourable position in the business field.

(iii) **Portfolio Planning:** Portfolio Planning attempts to describe methods of analyzing a product-market portfolio with the aim of identifying the current strengths and weakness of an organization's products in the markets and the state of growth or decline in each of these markets and also to identify what strategy is needed to maintain a strong position in each of these products.

(iv) **Activity Based Management:** Activity Based Management is a discipline that focuses on the efficient and effective management of activities as the route to continuously improving the value received by customer and the profit received by providing this value.

(v) **Channels of Distribution:** Channels of Distribution are the institutional linkage between the producers and consumers, commonly referred to as middlemen.

Section-I

Question.2

(a) Explain how 'Gap Analysis' might be applied to a product/market situation. [5]

Answer.

If 'Gap Analysis' is applied to 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 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.

(iii) 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 products are developed.
- The market mix for the existing products remains the same

(iv) 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?

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

(b) Difference between Cost leadership and Cost reduction. [5]

Answer:

Cost leadership vs. Cost reduction:

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 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. 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 Raymond's is worsted suiting, then one will know what it means to be a market leader through cost leadership. The task is formidable.

(c) Why New Products Fail? [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.

Question.3

(a) Write short note on the following: [3×5=15]

(i) Role of brands in the construction of barriers to entry

(ii) Objectives of Sales Promotion activities

(iii) Reverse Engineering

Answer:

(i) Role of brands in the construction of barriers to entry

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

(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.

(iii) 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 Rverese 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.

Question.4

(a) What are the types of simulation models? What are the advantages and disadvantages of simulation models? [2+5]

Answer:

There are several types of simulation as given below:

- Probabilistic Simulation, where one or more independent variables is conceptualized as a probability distribution of values.
- Discrete simulation, where it becomes important to know when an event exactly occurs.
- Visual Simulation is a graphical representation of computerized results. Software for this method is one of the recent developments in computer-human interaction and problem solving.

Advantages of Simulation Models:

Decision support systems have been increasingly using Simulation Models for the following reasons:

- Simulation theory is relatively easy to comprehend.
- Simulation can offer solution to "what-if" type question.
- Decision support system analysis work closely with managers who seek solution.
- Simulation Models allow inclusion of real life complexities and no simplifications are necessary.

Disadvantages of Simulation Models:

- An optimal or the best solution is not always guaranteed.
- Building simulation model is a slow and costly process.
- Solutions and inferences from a specific Simulation Model cannot be transferred for other problems.

(b) Write short note on Public-Private Partnership (PPP). [4]

Answer:

The concept of Public-Private Partnership (PPP) has been a comparatively new one in our national economic development scenario. It has been observed that the growth of infrastructure has lagged behind and may assume serious proportions impeding our economic growth. To overcome this, Government of India has been actively pursuing PPP to bridge the gap in the infrastructure.

Under the overall guidance of the committee of infrastructure, headed by the Prime Minister, the PPP programme formulation and implementation are being closely monitored by the relevant ministry/departments. An appraisal mechanism has been given a mandate

and guidelines for drawing up time-frame for according approvals to proposals in a speedy manner.

PPP projects normally involve long term contracts between the Government and the private parties detailing the rights and obligations of both the contracting parties. Government has decided to develop standardized frame-work, based on due diligence and agreements will follow international practices. They will also create a framework with a right matrix of risk allocation, obligations and returns.

Planning Commission has also issued Model Concession Agreement (MCA) for ports, state highways and operation maintenance agreements for highways. To promote PPP programme, all state governments and central ministries are setting up PPP cell with a senior level officer as a nodal officer. Technical assistance has been obtained from Asian Development Bank (ADB) including hiring of consultants and training of personnel.

(c) Write the role of Product development as a part of an overall marketing strategy. **[4]**

Answer:

Product development involves an organisation seeking to create new products to replace existing ones. The new products may be completely new or revised versions of existing ones.

Within a marketing strategy, a company's competitive posture is determined by its overall product-market mix and product development strategy is a part of this. Many firms attempt to have a combination of current and new products for survival and growth.

The strategies of market penetration, market development and diversification are also coordinated with the strategy of product development. For an overall marketing strategy, a company will attempt a mixture of these strategies.

As a part of an overall marketing strategy, product development performs the following roles:

- Replacement of products, which are in the maturity of PLC.
- Risk reduction through production of a range of products.
- Brand extension
- New markets' entry, etc.

Question.5

(a) State the factors to be considered while pricing a new product. **[7]**

Answer:

There are three elements in the pricing decision for a new product.

- getting the product accepted
- maintaining a market share in the face of competition
- making a profit from the product.

When a firm launches a new product on to the market, it must decide on a pricing policy which lies between the two extremes of market penetration and market skimming.

Market penetration pricing is a policy of 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 interests of long-term profits. The circumstances which favour a penetration policy are as follows:—

- The firm wishes to discourage rivals from entering the market
- The firm wishes to shorten the initial period of the product's life cycle, in order to enter the growth and maturity stages as quickly as possible.
- A firm might therefore deliberately build excess production capacity and set its prices very low; as demands 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.
- In this way, early year losses will enable the firm to dominate the market and have the

lowest costs.

Market skimming: The aim of market skimming is to gain high unit profits very early on in the product's life.

(i) The firm charges high prices when a product is first launched.

(ii) The firm spends heavily on advertising to win customers.

(iii) As the product moves into the later stages of its life cycle progressively lower prices will be charged. The profitable cream is thus skimmed off in progressive stages until sales can only be sustained at lower prices.

(iv) Conditions which are suitable for such a policy are as follows:

- Where the product is new and different, so that customers are prepared to pay high prices so as to be 'one up' on other people who do not own one.
- Where demand elasticity is unknown. It is better to start by charging high prices and the reducing them if the demand for product turns out to be price elastic.
- High initial prices might not be profit-maximising in the long run, but they generate high initial cash flow. A firm with liquidity problems may prefer market-skimming
- Skimming may also enable the form to identify different market segments for the product, each prepared to pay progressively lower prices. If product differentiation can be introduced, it may be possible to continue to sell at higher prices to some market segments.

(v) The firm may lower its prices in order to attract more price-elastic segments of the market; however, these price reductions will be gradual. Introductory offers may be used to attract an initial customer interest. Introductory offers are temporary price reductions, after which the price is raised to its normal commercial rate.

(b) SEBI has introduced Corporate Governance in a comprehensive manner to protect shareholder's interests as well as provide teeth in monitoring a Company's performance through independent directors. Explain. [8]

Answer:

SEBI has introduced Corporate Governance in a comprehensive manner to protect shareholder's interests as well as provide teeth in monitoring a Company's performance through independent directors.

The following committees were recommended to be created for this purpose:

(i) Audit Committee

(ii) Shareholder's Grievance Committee

(iii) Remuneration Committee and

(iv) Share Transfer Committee.

(i) Audit Committee: This Committee has been empowered to discuss the performance of the Company both from the point of view of interest of shareholders and efficiency. This committee is also supposed to discuss in detail the quarterly performances taking care for proper disclosures and transparency. This committee is required to put up an annual report, which includes a report on Corporate Governance, Corpora Social Responsibilities and management's discussion on future plans.

(ii) Shareholder's Grievance Committee: The interest of the share holders re: dividend payments, change of addresses, any grievances of the shareholders against the company are discussed and are disposed off every quarter and status is indicated in quarterly report.

(iii) Remuneration Committee: Remuneration of whole time Directors and Managing Director are recommended, after application of mind as well as the relevant sections of the Companies Act, for approval in the General Meetings of the Shareholders.

(iv) Share Transfer Committee: With dematerialization, transfer of shares has become more transparent. This Committee also looks into the aspects of insider trading and any possibilities of malpractices.

Further, for good corporate governance, SEBI has suggested that- for a company with an Executive Chairman, at least half of the Board should be Independent Directors, or else at least one-third Board must be Independent Directors.

Section-II

Question.6

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

(i) Unsystematic Risk relates to
(a) Market Risk
(b) Beta
(c) Inherent Risk
(d) Interest Rate Risk

(ii) Variability in return on investment in the market is referred to as
(a) Market Risk
(b) Physical Risk
(c) Pooling Risk
(d) Business Risk

(iii) Commercial Insurance do not include
(a) Jewelers block policy
(b) Bankers Indemnity policy
(c) Endowment policy
(d) Marine cargo policy

(iv) Financial Risk do not include
(a) Trade Cycles
(b) Interest Rate Risk
(c) Inflation Rate Risk
(d) Exchange Risk

(v) Risk is defined as
(a) A Variation from the actual
(b) A Variation from the expected
(c) A possible event
(d) A possible uncertainty

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

(i) Measures relating to risk profiling are related to the level of operational efficiency of the company.

(ii) Capital Assets Pricing Model attempts to measure the risk of capital assets of a company.

(iii) Risk Management Techniques include among other things of the Risk Premium payable.

(iv) The concept of certainty equivalent coefficient represents the computation of a certain amount equivalent to a probable income or loss.

(v) **Product Liability Policy is one of the products of "Industrial Insurance".**

Answer:

(a)

(i) (c) Inherent Risk

(ii) (a) Market Risk

(iii) (c) Endowment policy

(iv) (a) Trade Cycles

(v) (a) A Variation from the actual

(b)

(i) False

(ii) False

(iii) False

(iv) True

(v) False

Question.7

(a) **"Mathematical Models as well as Statistical analysis have been helpful in risk assessment/evaluation". Recognize the models and measures and discuss them. [3+4]**

Answer:

While applying Statistical analysis, two concepts are applied for assessment of risk. They are:

(i) Measures of Central Tendency and
(ii) Measures of Variation.

(i) **Measures of Central Tendency:** Aims of this concept is to arrive at one single value that will denote the characteristics of the total data collected. Such a value is known as the Central Value or Average and can be expressed as Mean, Median and Mode according as the nature of risk being measured.

(ii) **Measures of Variation:** They are studied to gauge the dispersion or scatteredness from the Central Value or Average. The Statistical Analysis is based on the methods like Range, Mean Deviation, Standard Deviation, Variance and Coefficient of Variation.

Mathematical Models:

As risks are of different types, Probabilistic Models are used for obtaining the expected values e.g., Launching of a new product with uncertain demand, Launching of a product in a known area, where competition is keen with penetration prices, etc.

Frequency distribution of a random variable can be discrete or continuous.

When it is discrete, the probability function is known as probability Mass Function and its distribution is known as Discrete Probability Distribution.

When it is continuous, then its probability function is known as Probability Density Function and its Distribution is known as Continuous Probability Distribution.

Financial Model:

Convertion of a value can relate to different points of time in the future. Present value of future losses or earnings, in the form of Discounted Cash Flows, is one of such models.

(b) What are the rights and responsibilities of:
(i) Insurer and
(ii) Insured – in the sphere of Risk Insurance. [5]

Answer:

(i) 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.

(ii) 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.

(c) State the two functions of insurers. [3]

Answer:

Two main functions of insurers:

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

(ii) 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

(a) Write short notes on the following: [3×5=15]
(i) Impact of Macro Economic factors and Risk:
(ii) Computation of Insurance Premium for a particular product
(iii) Strategies adopted for Corporate Risk Management

Answer:

(i) Impact of Macro Economic factors and Risk:
Relationship between risk and return can never be emphasized; higher the risk, the return needs to be higher and computation of the risk premium has always been a million dollar question. However, risk perceptions of investor's tend to be different with the onset of business cycles. In recession, investors tend to be conservative as their appetite for risk is reduced and they go after growth sectors, which have lower risk. In a security market low risk growth sector have always been biggest gainers in terms of returns. This explains that onset of recession upsets the risk return balance.
Macro economic factors like change in interest rates, inflation, money supply and index of industrial production have a big impact on the investors like perception. Analysis has shown that in a regime of high interest rates and high inflation, low risk sectors perform better than high risk stocks. As the interest rates and inflation decline, the high risk sectors tend to do better.

(ii) Computation of Insurance Premium for a particular product:
The process of determining or fixing the rates of premium for a particular product is known as 'Pricing'. Traditionally, premiums have been calculated based on tariffs set by the IRDA i.e., the Insurance Regulatory and Development Authority. The rates are derived, based on various factors like past loss ratio, location of asset, type of asset, as

well as exposure to the risks. Rate is the pricing factor upon which the premium is based. For example car insurance policies are priced, based upon several factors like make and model of the car, the age of the driver, purpose for which the car is used, location where the vehicle is kept, etc.,

Premium is calculated using the formula

Premium= Annual Rate × Sum Insured

The annual rate is usually given per thousand Sum Insured.

Traditionally, for motor insurance, the parameters that are used to price a policy have been model of the car, age of the driver, location of the car, purpose for which the car is being driven, etc.

The industry will eventually move from price rating. The pricing for individuals will be based on their track record. For eg., for 'own damaged' in a car insurance policy, the pricing parameters will be the model of the car, driver's age, engine capacity, etc.

(iii) Strategies adopted for Corporate Risk Management:

In risk management, the following 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.

Question.9

(a) Define Business Risks. [3]

Answer:

Business Risk refers to variations in earnings due to demand variability, price variability, and variability for input prices etc., which are essentially external and are market driven. Business risk which is inherent to a business due to its nature and susceptibility to environment e. g., changes of fashion, business cycles, conflicts like war, insurgency, cross-border terrorism, technological obsolescence etc. ,

Business risks can be 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 the circumstances imposed on the company by external forces like business cycle, certain statutory restrictions or sops.

(b) How do you measure Physical Risk? [6]

Answer:

Physical risks (like natural calamities, fire, tsunami, earthquake etc.) can be measured by the application of technological tools. Earthquakes are measured in the Richter scale. Floods are measured through level monitoring and marking danger levels. Risk of fire is often monitored through measurement of Flash Point, Fire Point, Ignition temperatures and Propulsion temperatures. Spontaneous ignition temperatures are yet another measurement to identify fire risk, e. g., coal dumps, oil installations, explosive go downs, etc. ,

Physical Risk arising out of social, political, economic and legal environments are often identified through the performance of lead indicators. In social arena, lead indicators can be pestilence, expediencies, social upheavals etc. , Measurement of these social risks are done on the basis of the impact on the society, i.e. , increase in crimes, violence and accidents etc. ,

Political risk is often identified with the change in Government Policy approach like say-Capitalistic, Democratic or Totalitarian and can be measured by the impact of such Government policy on the economic activity e. g., Government's Industrial Policy or Labour Policy. Economic Risk may arise out of commercial transactions, foreign exchange currency variation, capital market fluctuations, trade cycles etc. , The lead indicators risks are like variations in GDF, IIP, Balance of Payments, Stock Market Indices, etc.

Legal Risk arises out of the implications of various statutes affecting business like say-Anti Trust Bills, Factory Act, Industrial Disputes Act, Foreign Exchange Management Act (FEMA) etc.

(c) What do you understand by systematic and unsystematic risks? How do you further classify systematic and unsystematic risks? [3+3=6]

Answer:

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

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

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

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

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

Exchange Risk: With the 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