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.
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.)

Section -I (60 Marks)
(Strategic Management)

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

i. Strategic analysis is concerned with stating, the position of the organisation in terms of:
- A. Mission, choice of market segments, product selection, financial targets, external appraisal.
- B. Mission, goals, corporate appraisal, position audit and gap analysis.
- C. Mission goals, identification of key competitors, SWOT and environmental appraisal.
- D. Mission, targeted ROI, manpower planning, position audit.

ii. The role of leadership can be best evaluated by looking at
- A. Mission
- B. Strategy
- C. Communication
- D. All of the above

iii. Pepsi's 'Nothing Official About it' would be an example of
- A. Mission
- B. Vision
- C. Strategic intent
- D. Policy

iv. Mckinsey's 7-S framework consists of:
- A. Structure, strategy, software, skills, styles, staff and supervision.
- B. Structure, strategy, systems, skills, styles, syndication and shared values.
- C. Structure, strategy, systems, skills, steering power, styles and shared values.
- D. None of the above.

v. For an Entrepreneur
- A. Vision is before the mission
- B. Mission is before the vision
- C. Both are developed simultaneously
- D. Profitability is most crucial

vi. Identifying and evaluating key social, economic, technological and competitive trends/ events comprise of:
- **A. Developing a mission statement**
- **B. An implementing strategy**
- **C. Performing an external audit**
- **D. Identifying market trends**

vii. Successful differentiation strategy allows the company to:
- **A. Gain buyer loyalty to its brands**
- **B. Charge too high a price premium**
- **C. Depend only on intrinsic product attributes**
- **D. Have product quality that exceeds buyers' needs**

viii. McCarthy's marketing mix refers to
- **A. Price, push, pull and product**
- **B. Price, promotion, place and product**
- **C. Price, profit, promotion and product**
- **D. Price, promotion, profit and product portfolio**

ix. Judy Strauss and Raymond Frost's e-marketing model defines e-business as
- **A. EB = EC + SCM + ERP**
- **B. EB =EC + BI + CRM + SCM + ERP**
- **C. EB =EC+BI+CRM**
- **D. EB = CRM + SCM + ERP**

x. The BCG growth matrix is based on the two dimensions:
- **A. Market Size and Market Share**
- **B. Market Size and Profit Margins**
- **C. Market Size and Competitive Intensity**
- **D. None of the above**

Answer:

i. B - Mission, goals, corporate appraisal, position audit and gap analysis
ii. D - All of the above
iii. C - Strategic intent
iv. D - None of the above.
v. A - Vision is before the mission
vi. C - Performing an external audit
vii. A - Gain buyer loyalty to its brands
viii. B - Price, promotion, place and product
ix. B - EB = EC + BI + CRM + SCM + ERP
x. D - None of the above

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

(i) Product line gap
(ii) Barriers to entry
(iii) Non-price competition
(iv) Societal Marketing
(v) Going-rate pricing method

Answer:

(i) A 'Product line gap' arises from a difference between what a firm offers in terms of product items and what the industry provide in terms of product line.

(ii) 'Barriers to entry' is the expression indicates the factors like economies of scale, product differentiation and capital requirements, which make it difficult for a new entrant to enter and to gain a foothold in an industry.

(iii) 'Non-price competition' is a marketing strategy in which one firm tries to distinguish its product/service from competing product/service on the basis of attributes like design, workmanship, quality of service, extensive distribution, customer focus, or any other sustainable competitive advantages than price.

(iv) 'The Societal Marketing' concept is an enlightened marketing concept that holds that a company should make good marketing decisions by considering customers' wants/needs/fashions/tastes etc. the company's requirements, and also the society's long-term interest.

(v) 'Going-rate pricing' method refers to a pricing policy whereby the prices are fixed in consideration of the prices of the competitors and the firm's cost. This is like 'follow the leader' i.e., price leadership. Under this method, price is fixed near about the prices of the leaders. This pricing policy does not have any scientific basis like considerations of cost and marketing factors.

(c) State whether the following statements are 'True' or 'False' with justification for your answer: [1x5=5]

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

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

(iii) 'Merger' is the purchase of controlling interest of another company.

(iv) 'Repositioning' involves moving the product or brand into a different market segment.

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

Answer:

(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) True.

(iii) False, Merger is the combination of two or more corporations in which one of the corporations survives and the other corporation cease to exist. A merger occurs when two companies combine to form a single company.

(iv) True.

(v) 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.

2. (a) How a firm can use foreign collaboration as a strategy of growth? [7]

Answer :

Collaboration with foreign companies has been found to have special appeal as a growth strategy particularly in developing countries. Depending on the purpose in view, such collaborations may be classified as: technical, financial and/or managerial.

There are many advantages which a firm in the host country can derive from the collaboration deal:

- Upgradation of existing technology or introduction of advanced technology, acquiring technical know-how, and facilitating transfer of technology;
- Developing indigenous production of components and spare parts;
- Fostering cultural changes with respect to work ethos, attitude towards discipline, etc.;
- Improving competitive abilities for domestic and export marketing;
- Enlarging the scale of operations and reducing costs;
- Deriving the benefits of import substitution and increased foreign exchange earnings;
- Developing the brand image of products more quickly;
- Securing foreign equity investment as a part or risk capital and enhancing the potential ability to raise necessary funds from the domestic capital market.

Some benefits may accrue to the foreign collaborators also:

- Earning by way of royalty and fees for technological collaboration, supply of drawings and documents, technical and managerial know-how;
- Return on financial outlay;
- Market expansion in countries restricting hard currency imports;
- Tax benefits derived in low-tax host countries, royalties, technical fees, and service charges are taxed at a lower rate than profits.

(b) Identify the most important pitfalls that ought to be avoided in starting and doing strategic planning. [7]

Answer:

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

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

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

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

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

(v) Failure to modify the planning system.

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

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

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

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

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

(c) Discuss the difference between "company demand" and "company's sales forecast"? [2+2=4]

Answer:

Company demand is the company's estimated share of market demand at the alternative levels of the marketing efforts in a given time period. It subjects to all the determinants of the market demand plus the determinants of the company's market share.
The company sales forecast is the expected level of company sales based on a chosen marketing chain and an assumed marketing environment. Sales forecast refers to the estimates of future sales of Company's products.

(d) In which sector of products market-skimming pricing practice is used? [2]

Answer:

Market-skimming pricing is a strategy whereby prices start high and slowly drop over time. This is a prevalent practice in consumer electronics products.

3. (a) If the first commandment in marketing is 'know the customer', second is 'know the product'. Explain. [8]

Answer:

Product definition : A 'product' is a thing which is bought and sold in the market. Prof. Stanton defines the term 'product' as "a complex of tangible attributes, including packing, colour, price, manufacturer's and retailers' prestige, and manufacturers' and retailers' services which the buyer may expect as offering satisfaction of wants or needs." So, a company's product can be described in two ways:

(i) by its physical characteristics and

(ii) by its functions or uses.

From the aspect of physical characteristics, a product offered to the market includes physical objects, services, amenities and satisfaction. From the user's point of view, a product is the right to own or use a bundle of need satisfactions.

Of the four elements of marketing mix (i.e. product, price, promotion and place), the product is the main element without which other elements have no role to play. The method of describing a product has an important implication for the whole marketing philosophy of the manufacturing company.

Product – why important in marketing:

The knowledge of product is important in marketing in the sense that there can be no marketing functions without the existence of a product.

A product assumes its importance in consideration of following facts:

(i) The key element in a successful marketing policy and strategy is finding and meeting the needs of the consumers. A product through its tangible attributes like quality, services and amenities can meet the consumers' needs and wants.

(ii) For the performance of marketing functions like selling, purchasing, distribution, etc., the existence of a product is a must.

(iii) The success of a company of its marketing efforts, in most cases, depends on the product policy.

(iv) The policies relating to pricing, distribution, sales promotion, and customer satisfaction are all dependent on the product policy.

(v) The study of market size, sales volume, profits and profitability, and their growth or decline which serve as effective guide to the marketing management – are all done always in consideration of the product.

(vi) It is the knowledge of the product, whether consumer category or industrial category, that has led to the concept of product and marketing guided organization structure.

The product is probably the bread and butter of a company's profit. It should receive close attention throughout its life cycle. The product or brand manager should pay day-to-day attention to the product's market behaviour during its introduction to maturity to growth life and bring forth new uses or applications to lengthen its life.

The producers must know the market and customers' needs, no doubt; but at the same time, they must know and understand the qualities of a product that can satisfy the customers.

(b) Discuss "Crisis Turnarounds". [6]

Answer:

Crisis turnaround refers to the management measures which reverse the negative trends in the performance indicators of the company. In other words, turnaround management

refers to the management measures which turn a sick company back to a healthy one or those measures which reverse the deteriorating trends of the performance indicators such as falling market share, sales (in, constant rupees), profitability and worsening debt-equity ratio.

The exact nature of crisis turnaround and the relative importance of different factors may vary from company to company. The important factors commonly employed in turnaround management are:

(i) management factor,
(ii) human resources factor,
(iii) production facilities,
(iv) financial management,
(v) product-mix modifications and
(vi) marketing strategy.

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

(i) change in top management,
(ii) initial credibility-building actions,
(iii) neutralising external pressures,
(iv) initial control,
(v) identifying quick pay-off activities,
(vi) quick cost reductions,
(vii) revenue generation,
(viii) asset liquidation for generating cash,
(ix) mobilisation of the organisation and
(x) better internal co-ordination.

(c) Explain the factors that should be considered when setting the advertising budget. [6]

Answer:

There are a number of factors which deserve consideration before a company fixes up/sets up its budget for advertisement of its product. These are as follows:

(i) The Scale of Production.
(ii) The Plant Capacity.
(iii) The availability of the Working Capital.
(iv) Competition in a market - Where there is an intense competitive and high advertisement spending, a brand will need to advertise more heavily.
(v) Product substitutes - Substitute brands in a commodity class like Soft drinks, Cigarettes etc will require a heavy advertising to establish a differential image.
(vi) Stage in the product life cycle - New products will typically require large budget to gain consumer awareness. Established products require lower budgets.
(vii) Advertising frequency - Based on the number of repetitions needed to put across the brands' message to consumers, the firm will decide on the Advertising frequency, which in turn, will affect Advertising Budget.
(viii) Market share and consumer base - High market share brands usually require less advertising expenditure as percentage of sales to maintain share. To build share by

increasing market size requires larger expenditures. On a cost –per-impression basis, it is less expensive to reach consumers of widely used brand than to reach consumers of low share brands.

(ix) Routine advertisement or campaign advertisement - The advertisement budget will depend on issues like- whether the advertisement is going to be a routine advertisement or whether it is going to be a campaign advertisement. Further the amount of expenditure will vary depending on the type of campaign.

Apart from the above, there are number of other factors, as listed below, which merit consideration while planning for Advertisement Budget like:

- How much money the Company can afford to spend?
- How much % of the total sales revenue shall be spent on advertisement?
- How much the competitors are spending?
- What will be the media to be used for Advertisement like newspaper, Magazines, T.V. , Radio, Hoardings on a high-way, short films?

4. (a) A leading steel manufacturing company in Western Maharashtra has one soaking pit at Blooming Mill to roll 4/5 metric tons of ingots. At present they are rolling 750 metric tons of ingots per month. The productivity was low and the fuel consumption was high in the soaking pit during the initial stages of production. Series of actions were taken to increase productivity and reduce the fuel consumption by introducing facilities to charge ingots in hot conditions (i.e. 750^0-800^0 Celsius). With these facilities in place the fuel cost is reduced and the production has increased by 50%. For reducing fuel costs, the technique of standard costing was followed and per week reporting of actual consumption as against the standard was introduced. This shows impressive results. In view of the growing demand for rolled products, the company has also decided to install additional equipments in the form of soaking pit with eight cells and all auxiliary equipments, which will cost the company ₹ 33 million. However, the cost reduction per month would be to the tune of ₹ 1.10 million and the payback period will be 3 years 9 months.

State the five stages strategic management framework with reference to the above case.

[5]

Answer:

The steel manufacturing company in Western Maharashtra was facing the problem of low productivity and high consumption of fuel in the initial stages of production. This situation badly affected the cost effectiveness of the company. It wanted to improve productivity and reduce fuel cost by considering series of actions. The company then selected the facility to charge ingots in hot condition and by implement the facility the company is now able to reduce its fuel costs and simultaneously increase the production capacity by 50%.

Strategic management framework stages:

Stage - 1: Where are we in present condition?
Stage - 2: Where we want to go?
Stage - 3: Analysis of various alternatives.
Stage - 4: Draw a priority rank of the various alternatives and select the best one.
Stage - 5: Starting the implementation process along proper monitoring measures.

(b) What challenges in long term commitment the companies faces while entering into rural emerging markets in designing a marketing channel strategy that meets the needs of rural customers? [5]

Answer:

Challenges in designing a marketing channel strategy to meet the needs of the customers in the rural emerging market:

(i) Decisions in distribution in network design (i.e. channels of distribution coverage);
(ii) Creating an effective distribution network on the ground (i.e. network logistics).
(iii) Affordability;
(iv) Lack of brand and reputation trust;
(v) Lack of education and awareness in topics like hygiene, health, modern agriculture practices, proper uses of products and services, etc.
(vi) After-sales service to customers and its quality.

(c) What do you understand by the term 'Product Line'? Give an example. [2]

Answer:

Product line is group of products that are related either because they satisfy similar needs of different marketing segments or because they satisfy different but related needs of a given marketing segment. E.g.: Satisfy the need of same type that are used together - Toothpaste and Toothbrush, Blade and Razor, Pencil and Sharpener, etc.

(d) Why sometimes new products fail? Give five basic reasons. [6]

Answer:

The following are some of the reasons for the failure of the new products:

(i) Inadequate market analysis and market appraisal;
(iii) Insufficient and ineffective market support;
(iv) Bad timing of launching of new product in the market;
(v) Incapable for adjusting the rapidly changing marketing environment;
(vi) Failure to measure the SWOT analysis i.e., strengths, weaknesses in relation to the perceived opportunities and threats affects the strategy formulation and its effective implementation;
(vii) Higher cost of the product compares to the substitute products of the competitor;
(viii) To many new products entering in the market at the same time.

(e) What techniques you will follow to fill the 'New Product Planning Gap'. [2]

Answer:

The new product planning gap can be filled in two ways:

(i) Acquisition (three types like corporate, patent and license acquisition); and

(ii) New product development (includes original product, product improvements, product modifications, new brands that a firm develops through its own R&D efforts)

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.)

5. (a) In each of the cases/statements given below, one of four alternatives is correct. Indicate the correct answer: [1x5=5]

(i) The most commonly used technique for measurement of liquidity risk is

A. The gap analysis of maturing assets to the maturing liabilities
B. The financial analysis
C. The audit of maturing assets
D. The gap analysis of current assets to the maturing liabilities

(ii) Financial Risk do not include

A. Trade Cycles
B. Interest Rate Risk
C. Inflation Rate Risk
D. Exchange Risk

(iii) Future have four specific characteristics as against the forwards, which among them is not a character?

A. Liquidity
B. Standard volume
C. Third party warranty
D. Intermediate cash flows

(iv) Increase in rate of interest

A. Increase call-option value and decrease put-option value
B. Decrease call-option value and increase put-option value
C. Increase call-option value and increase put-option value
D. Decrease call-option value and decrease put-option value

(v) Unsystematic risk relates to

A. Market risk
B. Beta(β)
C. Inherent risk
D. Inflation risk

Answer:

(i) D - The gap analysis of current assets to the maturing liabilities
(ii) A - Trade Cycles
(iii) C - Third party warranty
(iv) A - Increase call-option value and decrease put-option value
(v) C - Inherent risk.

(b) State whether the following statements, based on the quoted terms, are 'TRUE' or 'FALSE' with justifications for your answer. If any statement is false, you are required to give the correct terms, duly quoted:

[1x5=5]

(i) 'Purchasing Power Risk' is the uncertainty of the purchasing power of the monies to be received, in the future.
(ii) Future contracts have built-in safeguard against default risk, in the form of stock brokers or a clearing house guarantee.
(iii) MTS stands for "Make to assembly".
(iv) Risk cannot be avoided through insurance but may be considered as a means to transfer the risk.
(v) Physical hazard is a condition stemming from material characteristics of an object.

Answer:

(i) True
(ii) True
(iii) False; the correct answer is 'Move to assembly' and not to 'Make to assembly'.
(iv) True.
(v) True.

6. (a) Discuss the features of pure risk. [6]

Answer:

The risk that can be insured is generally referred to as pure risk.

The major types of pure risk that affect businesses include:

- Property Risk,
- Legal Liability Risk
- Other Risks:

Following are the common features of pure risk:

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

greater than the expected value can be very large and even threaten the firm's survival.

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

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

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

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

(b) How is 'Project-Risk Management' done in practice? [6]

Answer:

In reality, the risk assessment is done through considering the various components of the financial estimates and developing certain judgemental approaches:

(i) Estimation of revenues - revenues projected for a project need to be justified on the basis of real data available and then the projections are made conservatively. This avoids optimistic projections of income.

(iii) Cost estimates - it always includes a margin safety to take care of impact of inflation over the time horizon for which the projections are being made. The margin of safety is computed on the basis of trend analysis of inflation over the recent past and the lead indicators that are available from fundamental analysis.

(iii) Acceptable return on investment - this is the prime measure and as such it should be arrived at on the basis of certain consensus. It will depend on the payback period to be assumed, the industry experience and the company's norm for return on any new project on the basis of the current experience.

(iv) Overall certain index - the critical risks of the project are identified and the certainty index of each of these risks is quantified. Then the overall certainty index is developed as an average of the critical indices already computed. For instance,

raw materials availability, power availability, intensity of competition is a few of the risks, which are quantified in terms of certainty indices.

(v) Judgment perceptions -- three different estimates of return on the investment are developed - (pessimistic, most likely and optimistic) on the basis of the stage at which the particular industry is in its life cycle. On the basis of the three estimates and comparing them with the earlier methods available on certainty equivalent coefficient, a judgemental decision can be taken.

(c) State the Preloss objectives of Risk Management. [3]

Answer:

Risk management has important objectives. These objectives can be classified as Preloss objectives and Postloss objectives.
Important objectives before a loss occurs include economy, reduction of anxiety, and meeting legal obligations.

The, first objective means that the firm should prepare for potential losses in the most economical way. This preparation involves an analysis of the cost of safety programs, insurance premiums paid, and the costs associated with the different techniques for handling losses.

The second objective is the reduction of anxiety. Certain loss exposures can cause greater worry and fear for the risk manager and key executives.

The final objective is to meet any legal obligations. For example, government regulations may require a firm to install safety devices to protect workers from harm, to dispose of hazardous waste materials properly, and to label consumer products appropriately. The risk manager must see that these legal obligations are met.

7. (a) What is Insurance? Discuss the requirements & characteristics of an insurance contract? [2+3+4=9]

Answer:

Insurance can be defined as transferring or lifting of risk from one individual to a group and sharing of losses on an equitable basis by all members of the group. In legal terms insurance is a contract (policy) in which one party (insurer) agrees to compensate another party (insured) of its losses for a consideration (premium). Exposure to loss is the insured's possibility of loss.

Insurance is a means whereby a large number of people agree to share the loss which a few of them are likely to incur in the future. Insurance is also a means for handling risk. There is an uncertainty related to the risk. The business of Insurance is related to the protection of the economic value of any asset. So, every asset that has a value needs to be insured. Both tangible goods and intangibles can be insured.

Requirements of an insurance contract:

Four requirements are laid down for a valid insurance contract as below:

Agreement must be for a legal purpose, i.e., the contract of Insurance should not violate

the principle of Insurable Interest and it is a contract of Uberrimae Faide (Utmost Good Faith)

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

There should be a **valid offer** and **acceptance** and

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

Characteristics of insurance contract:

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

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

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

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

Unilateral Contract: Insurer is the only party to the contract who makes promises that can be legally enforced.

Generally, Non life insurance contracts are usually annual contracts and have to be renewed each year. Each time the policy is renewed a new contract is issued by the Insurer.

(b) What is meant by the term 'Profit Loading'? [6]

Answer:

The purpose of every business activity is to earn profits and insurance business is no exception to this. Just like all other for - profit entitles, insurance companies also need to earn sufficient amount of profit in order to cover up business expenses and cost of capital to keep the stake-holders especially investors happy. Profit loading is simply an amount added (by the insurance company or insurer) to an insurance premium to cover business expenses and contingencies including cost of capital. Just like other normal businesses insurance companies must cover its 'trading cost' which are claims and must earn ABOVE its business costs (which is both claims and other business expenses) in order to prosper. That additional amount earned which is above the cost of claims and other

business expenses are called 'profit loading'. And the gross total is termed as simply premium or target premium.

The following is the mathematical equation for more understanding about how these figures are connected:

Premium = Claims + Business Expenses + Profit Loading Where;
Premium is the amount that will be demanded from the insure;
Claims is the total amount of losses insured; and
Expenses are different business expenses including the cost of capital of the insurer.

8. Answer any three from the following: [5×3=15]

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

Answer:

There are four different types of risks in portfolio planning.

(i) Interest rate risk : It is due to changes in interest rates from time to time. Price of the securities move invertly with change in the rate of interest.
(ii) Purchasing power risk : As inflation affects purchasing power adversely. Inflation rates vary over time and the investors are caught unaware when the rate of inflation changes abruptly.
(iii) Business risk : It arises from sale and purchase of securities affected by business cycles and technological changes.
(iv) Financial risk : This arises due to changes in the capital structure of the company. It is expressed in terms of debt-equity ratio. Although a leveraged company's earnings are more, too much dependence on debt financing may endanger solvency and to some extent the liquidity.

(b) Write a note in brief on 'Knock-for-Knock Agreement'.

Answer:

The 'knock-for-knock agreement' is an agreement entered into among the insurance writing motor insurance. The agreement provides that in the event of damage caused by collision or attempt to avoid between two vehicles, the insurer of each vehicle will bear his own loss within the limits of his policy; irrespective of legal liability and will not enforce his subrogation rights, if any, against the other insurer. This agreement covers all vehicles which are not playing for hire or reward.
While an insurer will be able to pursue a recovery from the party responsible for an accident or from its policy-holder, there will be a costly administrative procedure. The knock-for-knock agreement simplifies recovery claims among insurers and, over time, attributes costs fairly among insurers.
However, these agreements between insurers have been criticised as unfair on the party not responsible for an accident. If, for the sake of administrative ease, an insurer pays out to repair damage done to its policy-holder's own car instead of pursuing the party responsible for the accident for all relevant costs, an effective

claim is recorded against that policy-holder's insurance record. In this way, knock-for-knock agreements can result in policy-holders finding unexpectedly, when they come to renew their insurance, that there are higher premiums regardless of responsibility for an accident they were involved in.

(c) 'Risk Avoidance can be said to decrease one's chance of loss to zero', discuss.

Answer:

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

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

Answer:

If a firm has a group of exposure units large enough to reduce risk and thereby predict losses, the establishment of a fund to pay for those losses is a special form of planned, funded retention known as self-insurance. Some people object to this particular term, because the word insurance usually implies that a risk is transferred to another party. Obviously, self-insurance will not involve a transfer of risk in this sense. In spite of such objections, the term self-insurance continues to be used to describe some special situations in which risk retention has been consciously selected as an appropriate risk management technique.

There are two necessary elements of self-insurance: (i) existence of a group of exposure units that is sufficiently large to enable accurate loss prediction and (ii) prefunding of expected losses through a fund specifically designed for that purpose.