

MOCK TEST PAPER
FINAL COURSE: GROUP – II
PAPER – 6A: RISK MANAGEMENT

CASE STUDY: 1

1.1 Analysis of Potential Risk Associated with the Project

Every Project involving production of niche products is susceptible to various risks both at the Project stage as well during operations. The risk gets enhanced when the Project is 100% Export Oriented. Whatever may be the background or reputation of the Promoter Group, risks cannot be eliminated and need to be factored in both during project stage as well during operations.

Having said this, potential risk associated with the project of TW Ceramics Limited can be analysed as follows-

Since two aspects relating to the project are involved both needs to be analysed.

Fast changing business scenario, complexities involved, competition, Protectionist tendencies of countries as well as volatility in commodity prices increase the risk in executing a project. Thus TW Ceramics Limited were exposed to the following potential risks while executing the project-

- ◆ **Financial Risk-** These risks are associated with the managing the execution of project through regular analysis including setting up of mile stones, chart of activities, brainstorming by personnel involved in project execution etc. This must include close monitoring of cost of various items involved in the project through periodic reports giving up dates on expenses incurred under each head v/s budgeted expenditure coupled with strict control over expenditure. It is evident that TW Ceramics did not have a system in place to monitor the financial aspect of the project which resulted in cost overrun to the extent of 30%
- ◆ **Reputational Risk-** TW ceramics has been promoted by a leading group who have established global reputation for their products and services- Hence selection of the right collaborator to execute the project and manage it essential. The risk assumes significance where collaboration involves financial stake as well. The fact that collaborator failed on different fronts, enhances the risk of reputation of the group getting damaged.
- ◆ **Business Risk-** The group has ventured into the business for the first time. This places the group in a vulnerable position as far as execution, running and marketing of the product is concerned. Proper execution, commissioning and operations of the project depend in close coordination at all levels is essential. This is a risk of high consequence exposing the group to damage in terms of finance as well failure of the project as evidenced in the case of TW Ceramics Limited who were slapped with claim for damages of US \$ 1 million. This also covers the aspect of proper due diligence while choosing the collaborator in every aspect like reputation and standing, technical capability, marketing strength etc. Unless a thorough due diligence covering all aspects and risks is carried out, the project faces the risk of getting grounded.
- ◆ **Human Resource Risk-** Identification of the right man power to execute the project is important. Persons with prior knowledge and experience in executing a project need to be recruited. Added to this, unless persons with knowledge of ceramic industry and regulatory exposure in executing the project involving Export Processing Zone requirements are in the team, risk associated is manifold. The absence of such personnel resulted in cost overrun, delay in commissioning, quality aspects as well as marketing glitches. Had this aspect been taken care of, TW Ceramics would not have suffered risks associated with the project at every stage.

(8 Marks)

1.2 Suggest a Risk Management Framework-

Risk management framework to be successful, involves-

- ◆ Identification and sources of Risk.
- ◆ Quantification of Risks.
- ◆ Impact of business risk.
- ◆ Role of Risk Manager and Risk Committee.

(i) **Identification and Sources of Risk-** Risk identification is the initial process in the area of risk management. Risk identification is the action or process of identifying some potential internal or external event, or threat or vulnerability or a fact that could cause damage to the entity or prevent it from achieving its objectives. It includes documenting the potential risks in the form of a risk questionnaire or risk register and communicating the risks to executive management. Risk identification is effective when the when the risk management team understands the business, industry or sector in which the business operates. Imaginative thinking and ability to foresee events is critical to effective risk management,

- (a) Include entity and functional levels.
- (b) Analyze internal and external factors.
- (c) Estimate significance of risks identified.
- (d) Determine how to respond to risks.
- (e) The various risks that need to be assessed are-
 - Strategic
 - Operational
 - Financial
 - Knowledge Management
 - Compliance Management

(ii) **Quantification of Risks-**

- (a) What is the possibility that the risks will occur?
- (b) What it will cost the business if it does happen?
- (c) Each risk needs to be assessed in numerical terms.
- (d) Swot analysis based on which decisions can be taken relating to various aspects of business to mitigate the impact of risks.

In the case of TW Ceramics, technique of quantifying the risks needs to be put in place and analysed through Matrix. This should extend to both Project implementations where things went wrong and fix responsibility. This needs to be in place for operational areas as well.

(iii) **Impact of business risk-** There are risks associated with running any business that could have short term or long term consequences.

- (a) Strategy & Business Objectives.
- (b) Financial
- (c) Customer and Employee
- (d) Vendor/ Supplier
- (e) Compliance

(f) Reputation/ Brand Equity

Each risk needs to be assessed individually and addressed on regular basis.

- (iv) **Role of Risk Manager and Risk Committee-** The Companies Act, 2013 lays down great emphasis on identification of all risk factors and managing the same. This mandates appointment of a Risk Manager as well as Risk Management Committee. They are vested with the full responsibility of identifying risks, manage them and report deviations so that stake holders interests are protected. TW Ceramics would be well advised to constitute the committee as well as appoint a Chief Risk Officer to ensure proper identification and management of risks involved in view of the niche business that it has ventured into. **(7 Marks)**

1.3 (d)

1.4 (d)

1.5 (b)

1.6 (a)

1.7 (d)

(2 x 5 = 10 Marks)

CASE STUDY: 2

2.1. Various risks that the Resort is exposed to and consequences thereof.

Any business that operates in today's uncertain scenario is faced with multiple risks associated with running the business. Only difference is the risk factors vary from sector to sector. Having said this the risks that World resorts is exposed to can be described as follows-

- (a) **Financial risks-** Such risks are associated with the entire financial aspects like revenue management, receivables and payables, Financial assets and their management, working capital management, Third party service risk assessment and management including the entire spectrum of financial management. Unless these risks are identified and resources allocated prudently, things will turn for worse. From the facts given in the case study, it is evident that receivable management is weak thus reducing the flow of funds for smooth operations.
- (b) **Operational risk-** These risks are associated with day-to-day operations like non-availability of required materials on a certain day, breakdowns in equipment, failure of people, lack of proper internal process, external factors like economic uncertainty, Political upheaval resulting loss of business, sudden changes in tax rates, natural calamity etc.
- (c) **Human Resources risk-** This is one of the major risks facing any industry. This is more so in hospitality industry where availability of trained and skilled manpower is a challenge at all operating levels. There is constant shortage of trained manpower due to demand outstripping supply thereby forcing hotels to employ trainees or outsource them. These people lack knowledge of hotel industry including service standards required to be maintained lack of which leaves a customer dissatisfied and he never returns. The industry is service oriented and hence it is essential to have dedicated manpower.
- (d) **Strategic Risk-** This refers to the Strategy to be put in place in relation to dealing with eventualities, procurement of inputs at competitive rates at all times, innovative practices, competition, compliance, contract management, governance issues etc.
- (e) **Compliance Management-** This is one of the major risks facing any enterprise who are required to ensure compliance of various statutes as well as Governance failure of which can lead to serious damage including loss of reputation. **(5 Marks)**

2.2 Rate the risks and potential of these risks to cause damage to the business.

- ◆ Measurement and Rating of risks-

- Financial Risk- High and very likely- 4
- Operational risk- High and very likely- 4
- Human resources- likely- 3
- Strategic risk- Very likely- 4
- Compliance Management- Likely-3
- ◆ Consequences of Risk-
 - Financial – Major, Can cause serious disruption of business.
 - Operational- Major- Can cause disruption in operations and loss of business.
 - Human Resources- Medium- can cause disruption in service in the near term.
 - Compliance Management- High- Noncompliance can cause severe damage financially and loss of reputation.

(5 Marks)

2.3 Action Plan to treat the risks including monitoring mechanism-

It is clear that the resort suffers from various issues ranging from ineffective control mechanism, faulty implementation of contracts enabling the service provider to flout the agreement with no consequence, ineffective marketing set up, lack of internal control mechanism, absence of robust internal audit among others. This has severely eroded the business which is sliding despite the location and reputation the resort enjoys.

Having said this it is recommended to put in place a sound monitoring mechanism including in built controls and systems and ensure strict adherence to process with no tolerance for non-adherence.

Recommendation-

Financial- It is evident that lack of proper financial management has put severe strain on resources with disruption in supplies and services. A case in point is poor collection mechanism. Improper monitoring mechanism to collect fee related to loyalty program etc;

Suggested steps-

- ◆ Put in place a mechanism to have regular review meetings with marketing agency on collections. All current and old collections must be reviewed thoroughly including reasons for delay, non-collection and hold the agency responsible for the same. Sometimes, customers may withhold payment on unresolved issues related to billing or service. This must be attended to on priority so that money is not held up.
 - Revisit all the contracts entered into including clauses put in place to safeguard the interests of the resort. It is clear that the agreement related to Membership loyalty program has been drafted poorly leaving the resort exposed to risk of all types. The fact that the agency could get away without remitting the amount due to resort while allowing members to avail the benefit is a case in point. The entire agreement needs to be revisited and concerned agency must be terminated and action initiated to recover the dues. Any fresh agreement to be executed must contain clause which enables property to receive the money directly into designated account. Dues to the agency can be transferred on regular basis as mutually agreed.
 - Review all contractual obligations including outsourced activity like security services, car rental services, supply contracts for perishables etc; it is likely that the resort must be paying more due to delay in settling dues to suppliers. This needs to be addressed by

having a dialogue with the concerned suppliers and service providers on mutually agreed terms.

- Put in place Budgeting system covering all areas and have robust MIS to review the results every month with responsibility fixed for non-achievement of targets.
- ◆ Operational- This is more of a challenge impacting all areas and needs to be addressed properly.
 - Ensure that supplies to ensure smooth operations ranging from perishables to guest amenities are available all the time. For this co-ordination of operating department with providing department is a must. Planning needs to be done on regular basis which needs to be communicated to procurement team and sufficient lead time given to procure items.
 - Resort is suffering from loss of sales due to ineffective marketing strategy of outsourced agency. This needs to be addressed effectively with their commission withheld if need be. They must be given proper guidelines relating to rates below which they cannot go unless market conditions dictate quoting of lesser rates. Prior approval of Management is necessary in such cases.
 - Put in place review mechanism which allows regular review of all operational aspects including deviations. Emergency meeting to address serious issues can be held so that issue is resolved.
 - Have a system of Food & Beverage costing in place which is reviewed each month and compared with budget. To ensure proper Food & Beverage costing, it must be ensured that recipe costing and standards are in place.
 - Event wise Profit & Loss Account is a must including forecast Profit & Loss account where required. this will help in determining whether a particular event ended in loss or profit enabling pricing decision and correcting operational deficiency.
 - Standard Operating Procedure (SOP) department wise is a must and cannot be compromised. SOP's must be revisited regularly and corrected.
 - Put in place risk based Internal Audit system which brings out the risk involved to enable proactive action.
 - Sound internal control measures as well as Finance Policies must be in place.
- ◆ Human Resources- Human resources are the mainstay of hospitality industry. Availability of trained manpower at all levels is a challenge. Human Resource department needs to put in place robust HR practice to attract and retain right talent including compensation policy aimed at retaining talent. Union activities should be put down and cannot be allowed at any cost.
- ◆ Strategic Risk- Current business environment is fraught with uncertainty on all fronts. Only a management which can anticipate and strategize continuously can hope to survive. Possibility of having a Chief Strategic Officer must be looked into.
- ◆ Compliance Risk- Many a corporation come to grief due to noncompliance with various regulations resulting in severe loss of reputation and financial damage. Have a robust check list in place to ensure compliance of all regulations and review the same on monthly basis. Compliance calendar must be revisited to include fresh compliance requirement. Chief Compliance Officer must be vested with the responsibility to oversee the compliance.

(5 Marks)

2.4 (d)

2.5. (c)

2.6 (d)

2.7 (c)

2.8 (d)

(2 x 5 = 10 Marks)

CASE STUDY: 3

3.1 (c)

3.2 (d)

3.3 (b)

3.4 (d)

3.5 (a)

(2 x 5 = 10 Marks)

3.6 There are many areas of risk that a company may face relating to governance risks. The absence of an effective corporate governance framework and properly documented governance policies can create serious risks. There has to be equitable treatment of shareholders, and the role of stakeholders have to be defined, communicated and monitored, to prevent risks in these areas.

There are disclosure and transparency norms and if they are not articulated, considerable risks arise. The various responsibilities of the Board cannot be left undefined, nor undocumented or not reviewed. If the Board has not defined risk capacity, appetite and risk response strategies, and initiated a proper enterprise risk management policy and approach to risks, there can arise risks for governance.

The Board cannot be ignorant of the risks facing the company. Risk managers should be independent and be not implementing strategy. The Risk management function and the CRO should report directly report to the Board. Board should ensure that risk management and oversight practices should not face challenges and all stakeholder concerns should be met. Boards need to look at the long term; many risks will arise if the focus is on the short term. They need to disclose the process of risk management and the results of risk assessments. They should ensure that whistle-blower matters are attended, and shield the company against negative media reports, shareholder activism, unauthorised related party transactions, disputes among promoter/owners and other shareholders.

An independent assessment of risk governance framework has to be initiated so that there is an improving risk management capability for the company. The risk management framework (RMF) should define a policy statement on matters such as determining when to review the RMF and the frequency for undertaking the review, and deciding who is responsible for the review. This may be done by the Audit Committee or a team of Directors or with external facilitation and selecting the scope and review. The results have to be sent to the various layers of the company and risk management tightened and enhanced.

(4 Marks)

3.7 Fraud risk is an inherent risk which arises from the opportunities to make an unlawful gain by an internal employee or an external person or entity by exploiting the gaps in the processes of the organisation. Fraud risk in financial reporting also has assumed importance. The COSO framework has been enhanced to ensure highest degree of accuracy and completeness in financial statements. Operational control failures such as those that allow an employee to deliberately tamper with the data can lead to fraud risk owing to poorly designed reporting of data.

Fraud risk can be reduced by ensuring that there are controls in place, such as proper verification by the same or another person. There has to be reconciliation of facts and figures. Equally important is the segregation of duties which will not allow a person of one department to carry out the entire

transaction on his own. There is also the need for physical controls such as safekeeping of money, documents, legal agreements in safe vaults etc. Use of two keys may be required when dealing with high amounts of cash or high value documents. There has to be supervisory controls, exception triggers and proper authorization and approval. There has to be proper preventive controls, detective controls, manual controls and automated controls.

The Board has to see that the Internal Audit Function has carried out their management function in ensuring that internal controls and other defenses are in place so that the chances of fraud and financial crimes are minimized and there is a tightening based on reviews.

(3 Marks)

- 3.8** The first step is to identify credit risks and hence there is need to study borrower's profile to understand the borrower's financial stability, regularity in payments, possibility of default risk, the source of income etc.

Credit risk has to be migrated through means such as funded and non-funded risk mitigation. Funded credit is when the bank has recourse to cash or assets of the buyers. Funded credit mitigation methods include On Balance Sheet Netting of mutual claims/reciprocal cash balances between the bank and counterparty. Another method is collateral method whereby assets or security is retained or deposited with the bank against grant of any loan advances, debit or credit lines. These can be in the form of cash, gold, Corporate Debt Securities etc.

Unfunded credit risk mitigation process involves an unsecured obligation of third party, where this entity is more credit worthy than the primary borrower.

BASEL II has provided updated norms for the financial market, which has three main pillars. The first is more focussed on credit risk. It provides three different ways of managing credit risks:

1. Standardised approach based on credit rating and risk weight,
2. Internal rating-based approach with a basic foundational and higher-level advanced approach,
3. Credit risk mitigation steps through CDS and counter party risk approaches as also through securitisation.

There are other methods to enable proper credit rating:

1. *Risk based pricing*: Where the risk of default is higher, the interest rate will be increased.
2. *Credit insurance*: The lender can transfer the risk to an insurer such as in housing loans to ensure that the mortgage is secured.
3. *Tightening*: Lender can tighten the norms for lending.
4. *Diversification*: By lending to a greater number and kinds of small borrowers to diversify the lending pool.
5. *Covenants*: Covenants may be entered into with the borrowers for review, full payment in case of improvement in debt coverage ratio, audit of business operation etc.

There can also be qualitative techniques of credit risk management duly implemented by three levels of approach as under:

- a. Transaction risk management
- b. Portfolio risk management
- c. Policies and processes that keep improving the risk management of all lending activities.

Financial institutions also attempt to mitigate lending risks by performing credit analysis on individuals and businesses by a review of the borrower's five C's which are capacity, capital, character, collateral and conditions.

(8 Marks)

CASE STUDY: 4

4.1 (d)

4.2 (a)

4.3 (b)

4.4 (d)

4.5 (a)

(2 x 5 = 10 Marks)

4.6 The types of risk can be faced by the firm are as follows:

- (i) Market Risk: The firm is facing Market Risk due to adverse change in raw material cost and scarcity of water. There is lull in the demand for big housing projects as most of the middle-class households are moving towards low cost housing. Hence the firm could not sell/ book the two apartments.
- (ii) Operational Risk: Risk of loss resulting from failure of people employed in the organization as workers are not adequately trained and accidents are occurring at the site. In addition to this workers and supervisors are not following safety instructions. The inefficiency of the workers resulted in wastage of material and caused delay. The substitute for natural sand might result in poor finishing and less mortar bonding. Water scarcity forced the firm to pay extra money for the construction.
- (iii) Compliance Risk: As payment of Income Tax not made out on time. Hence it might face action from the Income Tax Department.
- (iv) Strategic Risk: Since the current and prospective impact on earning is adverse.
- (v) Financial Risk: The risks in connection with the cash flows and the pressure given by the bank in its notice for the repayment of the loan.
- (vi) Credit Risk: The inability of the firm to repay the outstanding dues to the bank.
- (vii) Liquidity Risk: The act of paying for the purchase of bricks and cement from out of the funds earmarked for the payment of Income Tax shows the firm is facing the same.
- (viii) Reputation Risk: As the project is getting delayed, the firm is subject to reputation risk.
- (ix) Legal Risk: The persons who have booked the apartments may sue the firm or ask for compensation for the delay in completion.
- (x) Safety Risk: The workers are not following the safety standards.
- (xi) Environment Risk: The increased dust and pollution cause environmental risks

(6 Marks)

4.7 Sample Risk Register on dust and pollution risk faced by the firm

Risk	Dust and Pollution Risk.
Causes	Usage of electric drills, hammers, cement & sand mixing etc.,
Consequences	Workers health affected, complaints from neighbours, regulatory authorities imposing fines etc.
Ownership	Owned by the site supervisors.
Inherent risk score	Seven out ten. This is calculated before implementing controls towards containing the dust and pollution
Controls	Provide safety masks, helmets, boots, hand gloves to workers. Sprinkle water periodically so that the minute waste does not fly.
Residual risk score	Four out of ten. After implementing the controls, residual risk stands at

	this level.
Process	Processes to control the dust are implemented
Action for further mitigation	To explore and study measures adopted by the other industry players. To educate and train the workers.
Action owner	Site Manager.
Due Date	Within three months.

(5 Marks)

4.8 The Risk Management Payoff Model of Epstein and Rejc, 2005, demonstrates how improved risk measurement and management provides benefits throughout the organization. Benefits extend to:

1. Enhanced working environment
Safety measures are to be addressed by giving training which in turn would increase the performance of the workers.
2. Improved allocation of resources to the risks that really matter
Key risk areas identified and resources are allocated.
3. Sustained or improved corporate reputation
By completing the project on time would increase the credibility of the firm.
4. Other gains, all of which lead to prevention of loss, better performance and profitability, and increased shareholder value.

By following better project management, the firm can reduce the wasteful expenditure and thereby achieving improved profitability.

(4 Marks)

CASE STUDY: 5

5.1 SWOT Analysis of Sunshine Ltd. is as follows:

Strength

- Specialization in the software development for their clients.
- Providing unique solutions to the clients.
- IT professional employed with the company.
- Sound Internal Control system
- A major portion of revenue comes from fixed price projects which allow it the flexibility to determine the resources it deploys and use software tools to deliver services.

Weakness

- Derives a major portion of its revenues from customers discretionary spending which is linked to their business outlook.
- Three-fourth of the revenue of is from traditional services.
- Dependence on the people.

Opportunity

- More focus on software led services which coincide with newer areas such as digital and cloud.

Threat

- Restrictive visa policy by USA may affect the work of sunshine Ltd. and threaten the prospect of global mobility of people as distributed software development requires free movement of people.
- Appreciation of the rupee against any major currency results in the revenue denominated in that currency to appear lesser in reported terms.
- Clients cutting their budgets on such services and shifting their focus on newer areas such as digital and cloud.

(5 Marks)

- 5.2** The first political risk is toughening of visa policies by present US Government. The new directive rescinds the previous guidance, which gave "deference" to previously approved visas as long as the key elements were unchanged and there was no evidence of a material error or fraud related to the prior determination. This may affect the free movement of IT people from India across USA thereby also affecting the work of Sunshine Ltd.

Secondly, the exit of Britain from European Union i.e. Brexit only added to the woes of the IT sector. Of the \$108-billion of the IT industry's estimated exports in 2015-16, 17 per cent was to the UK and about 11.4 per cent to other nations within the EU. For large Indian IT companies, over a fourth of their revenues come from Europe, in particular from the UK. This may affect the profitability position of Sunshine because of the currency fluctuations.

(3 Marks)

- 5.3** The types of exposures risks to be encountered by Sunshine Ltd. are discussed as below:

Transaction Exposure - It measures the effect of an exchange rate change on outstanding obligations that existed before exchange rates changed but were settled after the exchange rate changes. Thus, it deals with cash flows that result from existing contractual obligations. For example, in the case of Sunshine Ltd. if services are exported to USA for \$10,00,000 due in one month and if the dollar depreciates relative to the rupee, a cash loss occurs. Conversely, if the dollar appreciates relative to the rupee, a cash gain occurs.

Further, domestic ratings agency ICRA has highlighted that the appreciation in the rupee is aggravating the troubles of the Indian IT sector, which is already hit by a change in the market landscape and compressing revenue growth.

Economic Exposure – It refers to the extent to which the economic value of a company can decline due to changes in exchange rate. ICRA has said that despite an 8.1 per cent growth in USD revenue, IT players have registered a growth of only three per cent in the second quarter of the current fiscal, due to the rupee appreciation of four per cent during the quarter.

It also pointed out that IT Services players profitability also remains sensitive to rupee depreciation vis-a-vis major currencies such as USD, GBP and Euro and the same too will have an impact.

(3 Marks)

- 5.4** The Internal Financial Control System of the Sunshine Ltd. is more or less efficient. The reasons are given as below:

- ◆ Recording and providing reliable financial and operation information.
- ◆ Safeguarding assets.
- ◆ Ensuring compliance with corporate policies.
- ◆ Well defined delegation of power.
- ◆ Efficient ERP system.

- ◆ Internal audit by one of the big audit firm.
- ◆ Periodic audit by specialized third party consultants.

And, finally Audit Committee found internal financial control adequate which shows that Sunshine Ltd. has a good Internal Financial Control System.

(4 Marks)

5.5 (a)

5.6 (a)

5.7 (a)

5.8 (d)

5.9 (c)

(2 x 5 = 10 Marks)