

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

Solutions

Note: Please note these solutions are for guidance purpose only.

ANSWERS TO CASE STUDY: 1

1.1 Credit due diligence for recommending subscription of the debentures

- 1) **Assessment of project sponsor:** Sponsor is a leading pharmaceutical company in India having track record of near five decades which provides sufficient comfort with respect to experience and expertise of the sponsor.
- 2) **Integrity and reputation of the borrowers:** Arjun Limited is promoted by one of the reputed families of India.
- 3) **Track record in the relevant sector:** Arjun Limited is acquiring a pharmaceutical company. Arjun Limited itself has an operational track record of nearly fifty years in the pharmaceutical industry.
- 4) **Sector Perspective:** Historically, pharmaceutical sector has been perceived as stable and low risk business sector
- 5) **Commercial and economic viability:** The borrowed amount is being used to fund the acquisition of Karna Limited. Karna Limited is already an operational entity having commercial and economic viable products in the market. Hence, the acquisition is commercially viable.
- 6) **Debt servicing capabilities:** Debt servicing capabilities includes capability to timely service the interest payment and timely repayment of the scheduled term debt/debenture.
 - a. As per the projections shared in the case study, Arjun Limited's Earnings before Interest Depreciation and Tax (EBIDT) is sufficient to cover its interest payment liability in all the years where interest payment is due.
 - b. Further, as per the projections shared, Arjun Limited is expected to meet its scheduled debenture redemption liability reflected by projected balance sheet as of March 31, 2023, March 31, 2024 and March 31, 2025.
- 7) **External Credit Rating:** MICRA Limited assigned credit rating of 'AA' to the non-convertible debentures issue of Arjun Limited which indicates high safety.
- 8) **Nature of security and its enforceability:** The debentures are secured by way of charge on intangible assets of the company which are not recorded on the books of the company. The realizable value of the intangible assets is assessed at ₹1,000 crore against the debenture issue of ₹6000 crore. Hence value of security is inadequate.
- 9) **Put/call options:** Issuer and the debenture holder has the Call/Put options on the debentures.

(1 Marks for each correct point = Max. 7 Marks)

- 1.2** The debentures issued by Arjun Limited pay interest rate of 8% p.a. If interest rate offered by debentures having similar credit risk profile is now at 11% p.a. The investor of debentures of Arjun Limited will exercise put option. The issuer faces two risks in this scenario.

1. Liquidity risk (Refinancing Risk): If the investor exercises the put option on the debentures, Arjun limited have to redeem all of the outstanding debentures on which put option is exercised. In this case Arjun Limited's cash-flow might be insufficient to meet the immediate redemption requirement, despite the company being solvent. **(1 Mark)**
2. Interest Rate risk: Arjun Limited is paying interest at a rate of 8% p.a. However, if the investor exercise the put option, Arjun Limited has to borrow to refinance the debentures which may carry higher interest rate. **(1 Mark)**

1.3 Calculation of the Debt Service Coverage Ratio

Particulars	FY 23	FY 24	FY 25
Opening Cash Balance	2,040	1,080	490
Add: PAT	1,040	1,410	1,750
Add: Depreciation	100	100	100
Add: Interest	480	320	160
Less Amount Spent on Capital Expenditure	100	100	100
Less Incremental Working Capital	-	-	-
Total Cash Available for Debt Servicing (A)	3,560	2,810	2,400
Interest Payment liability	480	320	160
Debenture redemption liability	2,000	2,000	2,000
Add: Decline in the working capital requirement	-	-	-
Total Debt Servicing Liability (B)	2,480	2,320	2,160
Debt Service Coverage Ratio (A/B)	1.44	1.21	1.11

1½ x 3 = 4½ Marks

Risk of default is maximum in the year FY 25 where debt service coverage ratio is minimum among all the years. **1½**

- 1.4 (C) **2**
- 1.5 (B) **2**
- 1.6 (A) **2**
- 1.7 (D) **2**
- 1.8 (B) **2**

ANSWERS TO CASE STUDY: 2

2.1 XYZ limited if current facing with below risks apart from pandemic risk:

- (1) **Financial Risk:** As the company operation shut for 3 months, XYZ Ltd. with facing financial risk in terms of negative profit & cash flow.
- (2) **Credit Risk:** It is a probability of loss due to inability or unwillingness of customer to pay its dues. Due to XYZ Ltd. customer not paying its outstanding amount, it is also facing credit risk.
- (3) **Liquidity Risk:** The potential inability to honour its commitments when it falls due. As XYZ payment for loan instalment gets due in September, 20, it faces liquidity risk.
- (4) **Market Risk:** It arises due to adverse changes in market variables in terms of commodity prices, exchange rate, interest rate etc.

- (5) **Operational Risk:** It is the risk of loss resulting from the failure of the people working in the organisation, internal process, systems, or external factors which are detrimental to the interest of the organisation.
- (6) **Strategic Risk:** It is risk related to Poor business decisions, improper implementation of decision, lack of response to industry, economic and technological changes which has impact on current & prospective earning of the organisation.
- (7) **Interest Rate Risk:** Risk associated with changes in market interest rate which effect organisation net interest earnings.
- (8) **Staffing Risk:** Risk associated with talented employees leaving the organisation which effects the operations of the company.
- (9) **Technological Risk:** Risk associated with outdated or old technology/products which effect organisation market share, reputation, customers etc.

(1 Marks for each correct point = Max. 8 Marks)

- 2.2 Enterprise risk management (ERM) is a leading best practice approach to effectively manage and optimize business events that have the potential to impact business objectives or risks, enabling a company to determine how much uncertainty and risk are acceptable to an organization.

Specifically, ERM can help XYZ Ltd.:

- (1) Identification of strategic risk opportunities: Had XYZ Ltd. identified other related Strategic Opportunities such as road transportation then same can facilitate achieving organizational goals.
- (2) Introduction of common language: A common language within the XYZ Ltd. needs to be inculcated in the organization so that the people recognize problems and adopt a problem solving approach by developing risk treatment actions.
- (3) Providing senior management with the most up-to-date information: Had up-dated information relating pandemic been provided to management at initial stage then XYZ Ltd. may have taken decision accordingly.
- (4) ERM initiative and adherence to capital market: Since the company is a listed company there is a need to establish a linkage between the ERM initiative and adherence to capital market reporting disclosures and other corporate laws and regulations.
- (5) Alignment of Annual Performance: There is requirement of alignment of Annual Performance with the goals with risk identification and management.
- (6) Reporting of Business-risk opportunities and challenges: There should be a system of Encouraging and rewarding upstream reporting of business-risk opportunities and challenges.
- (7) Alignment of other risk monitoring initiatives: There should be a system of aligning other risk monitoring initiatives such as self-appraisals, internal auditing activities, control assessments, continuous control monitoring, to organizational objectives.
- (8) Imagining key Risk Scenarios: There should be a system of imaging key Risk Scenarios that could potentially result in a stress on the financial position of the company. VaR and Stress Testing are some of such techniques.
- (9) Financial Risk Monitoring: It is a part of the ERM initiative can balance the financial stability equation of XYZ Ltd.

(1 Marks for each correct point = Max. 4 Marks)

- 2.3 According to Paul Hopkins, risk is generally divided in 3 categories:

- (a) **Hazard (or Pure) Risks:** This are risk which are associated with uncertainties which may cause loss to the organisation. It may occur loss or no loss occurs but there is no possibility of gain. This arises from perils such as fire, flood etc. or from human action such as theft, accident etc. They are also called as operational or insurable risk.

There are 3 types of pure risk:

- ❖ Personal risk- which may arise due to early death, sudden accident and disability or unemployment etc.
 - ❖ Property risk- it arises due to reduction in value of asset due to physical damage, theft, fire etc.
 - ❖ Liability Risk- It is the risk of legal liability for damages accruing to customers, vendors, suppliers etc. Such risk is also associated with compensation payable to employees for injuries and other harm inflicted in the workplace.
- (b) **Control (or Uncertainty) Risks:** These are associated with unknown and unexpected events. They are also called as uncertainty risk as they are very difficult to quantify. In these circumstances, it is known that event will occur, but precise consequences of those events are difficult to predict and control. Therefore, the approach is based on minimising the potential consequences of these events.
- (c) **Opportunity (or Speculative) Risks:** In such kind of risk, there are 3 outcomes- loss, no loss or gain. Such risk is deliberately taken with the hope of gain. Such risks are not insurable.

2 Marks

XYZ limited is mainly suffering from Control risk of pandemic which is caused due to external factors and to some extent XYZ Ltd. is not in position to determine when the impact of pandemic will finish, and organisation will return to its normalcy.

1 Mark

- | | |
|---------|----------|
| 2.4 (B) | <u>2</u> |
| 2.5 (D) | <u>2</u> |
| 2.6 (D) | <u>2</u> |
| 2.7 (C) | <u>2</u> |
| 2.8 (D) | <u>2</u> |

ANSWERS TO CASE STUDY: 3

Multiple Choice Questions

- | | |
|---------|----------|
| 3.1 (D) | <u>2</u> |
| 3.2 (A) | <u>2</u> |
| 3.3 (B) | <u>2</u> |
| 3.4 (A) | <u>2</u> |
| 3.5 (A) | <u>2</u> |
- 3.6 The analysis of country risk is important because it affects the profitability of MNCs. Country risk is also an important concern for FDI, FPI who invest their money in MNCs.

The following are the major types of country risk.

A. *Political risk*

Political risk mainly arises out of the changes in the political scenarios as well as the adverse decisions taken by the ruling government.

1. Nationalisation or expropriation risk -this type of risk occurs wherein the host country takes over the business of MNCs without or with inadequate compensation.
2. Exchange control risk- this form of risk prevents the MNCs to get converted their earning from local currency to foreign currency to repatriate the same to the home country. Due to this restrictions even investors in MNCs business suffer.

3. Taxes, rules and regulations risk -
 - a. Unanticipated increase in tax rates
 - b. Compulsion to hire local workforce
 - c. Strict environmental standards
4. Inefficient legal system
5. Repudiation of contracts

(2 Mark)

B. Financial and economic risk

The main risk covered in this category is sovereign risk i.e. default in repayment of borrowing by the government of the host country. The following economic variables can be used to identify such type of risk well in advance:-

- Ratio of country's import to its official reserve
- Ratio of import to its export
- Balance of payment surplus/deficit on current account
- Country's Debt service ratio
- Country's external debt to its GDP

(1 Mark)

Country risks faced by Facelift Ltd. in Japan

1. Exchange control risk- restrictions on conversion of Yen.
2. Inefficient legal system- lawsuits have been filed against Facelift Ltd., it faces risks uncertainty and high cost of operation due to inefficient legal system.

(2 Mark)

3.7 To

The Board of Directors

Selfie Ltd.

18 October 2020

Subject: - Grading/bucketing of identified risks

Introduction

This report covers the grading/bucketing of the risks identified by the client.

1. Safety standards leading to life threatening accidents.

Safety concerns or Life threatening accidents will create a negative public image, badwill, loss of employee trust. Consequently, Industrial Relations may worsen leading to declining revenues.

While the probability is low, the huge impact forces seeking appropriate mitigants. Hence the risk may be classified as **low probability high impact**. It is suggested to ensure the adequacy of safety systems. Expert safety advisor shall be consulted, wherever required.

2. Extensive capacity expansion and capex

Since the extensive capacity expansion plans will surely lead to large capex outflow - it may be classified as **high probability high impact risk** which needs immediate management attention.

3. **Exchange rate fluctuations:-** exchange rate fluctuation and volatile raw materials prices are serious business concern which affects the profitability. Impact is low because it affects all the businesses in the industry. Hence it may be classified as **low probability low impact**.

4. **Fierce competition from Googly Ltd**

Competition from other players in the industry may have a serious impact on the revenues and profits. Since the market is growing the probability of negative growth is low. Risk will be classified as **low probability high impact**.

Signed

Mr. Black

(1 Marks for each correct point = Max. 4 Marks)

1 Mark for Report Format

3.8 SWOT analysis is undertaken by an organization to identify its internal strengths and weaknesses, as well as its external opportunities and threats.

It is intended to specify the objectives of the business venture or project and identifying the internal and external factors that are favorable and unfavorable to achieve those objectives. **1 Mark**

SWOT Analysis of SELFIE Limited.

Strengths - Continuous dividend payout attracting investors - Extensive expansion plan to meet future demand	Weakness - Slow decision-making process - Skeptical Corporate governance policies
Opportunities - Expansion in other countries - Growing market demand due to population	Threats - Competition from Facelift Ltd. - Country risk from Japan

(1 Mark for each correct Box covering two points = Max. 4 Marks)

ANSWERS TO CASE STUDY: 4

Multiple Choice Questions

- 4.1 (A) 2
- 4.2 (D) 2
- 4.3 (B) 2
- 4.4 (D) 2
- 4.5 (B) 2
- 4.6 According to Section 134(5) of Companies Act 2013, Internal Financial Control refers to “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records and the timely preparation of reliable financial information”.

Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

1 Mark

Risks can arise or change due to the following circumstances-

- **Changes in Operating Environment-** Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks. There has been an increase in competition for Go Where with introduction of new business model of self driven cars in the industry. Also, the major existing market players are giving intense competition to the company. In order to survive, Go Where must come up with necessary modifications in its business model.
- **New Personnel-** New personnel may have a different focus on understanding of internal controls. With the change in payment policy, the company is expecting to hire new employees in place of those leaving the organisation, such new employees may have a different approach towards internal controls of the company. The company must clearly explain its SOP and related internal controls to all the new employees.
- **Rapid Growth-** Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- **New Technology-** Incorporating new technologies into production processes or information systems may change the risk associated with internal controls. The board of Go Where Ltd is proposing to develop a new software application. It must ensure that necessary internal controls related to information systems are adequate and there is no threat to the company information. Also the company should conduct Information Systems audit at regular intervals.
- **New accounting pronouncements-** Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements. Go Where Ltd, being a listed company is required to comply with various regulations. Any changes in Indian Accounting Standards (IND AS) must be properly incorporated in its financial statements.

1 Mark for each correct point = Max. 3 Marks

The various statutory provisions related to Risk Management disclosures applicable to Go Where Ltd, a listed company are as follows-

- Section 134 of Companies Act 2013 requires the board of director to confirm in Director's Responsibility Statement that they have laid down IFC and such IFC are adequate and were operating effectively. Also, they should include a statement on development and implementation of risk management framework for the company, including identification of risks, which as per Board's opinion could threaten the very existence of the company.
- The provisions of Audit Committee are also applicable to the company. Section 177 instructs the Audit Committee to review the risk management procedures implemented by the management.
- As per Schedule IV of Companies Act 2013, Independent Directors should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible.
- Also, Clause 49 of Listing Agreement indicates that disclosures are to be made by the board of directors on risk management, that whether the company has laid down any procedures to inform board members about the risk assessment and mitigation procedures.

Or

- As per Regulation 21 of SEBI (LODR) Regulation 2015 for applicable to top 500 listed entities determined on the basis of market capitalisation, as at the end of the immediate previous financial year the board of directors shall constitute a Risk Management Committee and shall define the role and responsibility of the same Committee and may delegate monitoring and reviewing of the risk management plan to the committee and such other functions as it may deem fit such function shall specifically cover cyber security.

1 Mark for each correct point = Max. 4 Marks

4.7

	Diesel Car		Petrol Car	
Cost of Purchase (A)		₹ 2,75,00,000		₹ 2,75,00,000
No. of Car Purchased	25		30	
Useful life	12 years		12 years	
Km per year	5,00,000		6,00,000	
Total Kms	15,00,00,000		21,60,00,000	
Total Revenue (B)	15,00,00,000	₹ 1,50,00,00,000	21,60,00,000	₹ 2,16,00,00,000
(Total Km x Rate per Km)	x ₹ 10		x ₹ 10	
Mileage	15 Km per litre		12 Km per litre	
Total litres to be consumed	100,00,000 litre		180,00,000 litres	
Cost per litre	₹ 70.00		₹ 73.80	
Total cost of diesel (C)	₹ 70.00	₹ 70,00,00,000	₹ 73.50	₹ 132,30,00,000
	x 1,00,00,000		x 1,80,00,000	
Net Revenue (B) – (A) – (C)		₹ 77,25,00,000		₹ 80,95,00,000

2 Marks for each correct calculation = Max. 4 Marks

Decision: Since the Net Revenue in case of petrol car is more as compared to diesel car, it is advisable to purchase petrol engine cars from financial perspective.

1 Mark

However following non financial factors should also be considered while making the purchase decision-

Environmental Factor: Since petrol and diesel are scarce resources, it is a good practice to make best efficient use of it. Since petrol is giving a lesser mileage as compared to diesel, there is more consumption of petrol which also increases environmental pollution. Since the difference between the two alternatives in Net Revenue is not much higher, the decision should be taken considering other factors as well.

2 Marks

Note: Students can also mention any other factor drawing reference from the facts given in the Case Study.

ANSWERS TO CASE STUDY: 5

Descriptive Questions

5.1 The major risks being faced by the company due its activities are as follows:

- Credit Risk:** Since due to stiff competition from other companies XYZ Ltd. has liberalized its credit policy it is facing the Credit Risk or Default Risk from its buyers.
- Liquidity Risk:** Further due to non-payment of receivables by the customers XYZ Ltd. can also face Liquidity Risk i.e. non-availability of enough Cash and equivalents to meet its committed payments.

- (c) Foreign Exchange Risk: Since the company is involved both in Imports and Exports it is subject to Foreign Exchange Risk. **1 Mark for each Correct Point = Max. 2 Marks**

Risk Management Framework for the above identified Risks

Risk	Risk Arising From	Measurement	Management
Credit Risk	Trade Receivables	• Aging Schedule • Altman Score • VaR	• Credit Insurance • Credit Default Swap • Factoring • Collateral
Liquidity Risk	Trade and other payables	• Aging Schedule • Preparation of Cash Budget	• Borrowing facilities from Bank • Disposal of short-term Securities.
Foreign Exchange Risk	Trade Receivables and Payables	Cash flow forecasting	• Forward Contracts • Future Contracts • Option Contracts • Money Market Hedge • Swap Arrangements

1 Mark for each Correct Point = Max. 4 Marks

- 5.2** The other major risk is being faced by the XYZ Ltd. is Governance Risk as in recent time company is facing some Governance Issues. **2 Marks**

- 5.3** First Statement of CEO indicates 'Risk Appetite' and second statement indicates 'Risk Capacity'. **2 Marks**

- 5.4** Since TTC plc is making FPI through the shares of XYZ Ltd. it is subject to Country Risk. **1 Mark**

Broadly speaking the country risk management process involves the following steps:

- Identification of Risk: First and foremost, step in country risk management is identification of risk. The various quantitative and qualitative techniques can be used to identify the risks.
- Analysis of Risk: Once the risk is identified the next step is analyse the same from various angles.
- Evaluation of Risk Management Techniques: Evaluation of various techniques to manage the risk is carried out.
- Selection of suitable techniques: Once various techniques have been evaluated next steps comes of selection of most suitable technique to manage the risk.
- Implementation of Techniques: The techniques to manage the risk are implemented.
- Control: Once the selected techniques are implemented they need to be reviewed on periodic and if required they are revised.

1 Mark for each Correct Point = Max. 4 Marks

Multiple Choice Questions

- 5.5 (B) 2**
- 5.6 (C) 2**
- 5.7 (A) 2**
- 5.8 (B) 2**
- 5.9 (D) 2**