

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

Time Allowed – 4 Hours

Maximum Marks – 100

CASE STUDY: 1

You have been recently appointed as Chief Risk Officer of a company which is in Steel Castings business. Name of the Company is ABC Electro Steel Castings Ltd. [in short, ABC].

You have been told that ABC is fully committed to strengthen its risk management capability on continuous basis in order to protect and enhance shareholder value. You have been told that the risk management framework ensures compliance with the requirements of amended Clause 49 of the Listing Agreement. The framework establishes risk management processes across all businesses and functions of the Company. These processes are periodically reviewed to ensure that the Management controls risks through properly defined framework.

You are also made aware that the Company has already undertaken an extensive Risk Management effort that includes introducing Risk Management Manual, compiling a comprehensive profile of the key risks to the Company, identifying key gaps in managing those risks and developing preliminary action plans to address those risks. This effort accomplishes the following goals:

- responds to the Board's need for enhanced risk information and improved mitigation plan;
- provides the ability to prioritize, manage and monitor the risk in the business; and
- formalizes the explicit requirements for assessing risks on an ongoing basis, including an effective internal control and management reporting system.

You are also given information that the Company uses raw materials to manufacture the steel castings. It is faced with the threat of pressure on margins on sales. To counter the threat, the Company has taken various steps which include backward integration which comprises coal mines and iron mines, and brownfield expansions, e.g. sinter plant, sponge iron plant, coke oven plant, power plant from waste head recovery. It also set up an R & D to expand its manufacturing capacities with a view to control costs.

You came to know that the Company is ISO-14001-2004 certified and is adhering strictly to the emission norms applicable for industry.

You are also told that with the thrust given by Government of India on water and water related projects and with the estimated growth in water requirement, the demand of DI Pipes is expected to grow substantially and the Company is confident of retaining its market share.

Labour relations have been excellent throughout the year in spite of number of unions. It is the result of such cordial and harmonious relations that not a single man-day has been lost in the last 8 years. The Company believes that labour relations will continue to remain excellent.

Descriptive Questions

- 1.1** Now, you have been asked to give a report to the Company's Management, which should contain the key risks affecting the Company. **(15 Marks)**

Multiple Choice Questions

Choose the correct answer from the following.

- 1.2 An excess payment made to a vendor, which is accounted correctly, would be categorized under which of the following risks?
- (a) Financial Reporting Risk
 - (b) Legal Risk
 - (c) Reputation Risk
 - (d) Financial Risk
- 1.3 In Information Technology General Controls, under change management, the risk of incorrect change is NOT mainly due to
- (a) Change being wrongly conceived by the user groups
 - (b) Change control audit trail not maintained
 - (c) Change is wrongly executed
 - (d) Change being carried out without approvals
- 1.4 Annual Report of the Board of Directors must include a statement indicating the development and implementation of a risk management policy for a company. This is mandated by
- (a) SEBI through 'Issue of Capital and Disclosure Requirements Regulations'
 - (b) Information Technology (Amendment) Act, 2008
 - (c) Companies Act, 2013
 - (d) Prevention of Money Laundering Act, 2002.
- 1.5 While taking a decision, the category risk profile bucket that would most likely to escape attention of the Management is
- (a) High Impact-Low Probability
 - (b) Low Impact-Low Probability
 - (c) High Impact-High Probability
 - (d) Low Impact-High Probability
- 1.6 Governance risks mean significant deficiencies that can impact the reputation, existence and continuity of the organization. Such deficiencies would NOT occur because of
- (a) Inappropriate practices adopted by the Board
 - (b) Inability of the Board to identify trivial risk facts that can impact business continuity
 - (c) Failure of the Board to direct and control the organization
 - (d) Collusion of management to override significant internal control mechanism causing financial losses

(2 x 5 = 10 Marks)

CASE STUDY: 2

About the Company

ABC Limited is a public limited company incorporated in the year 2003. It has the registered head office in Bhubaneswar, Odisha. The Company has iron ore mines situated in five places in the State. The main

business of the Company is extraction and sale of iron ore to many iron and steel industries both inside and outside states.

The Company has decided to diversify its business in trading of shares. Also, the Company is considering the possibility of setting up a Non-Banking Finance Company. For these purposes, the Company is in the process of doing feasibility studies.

Risk Manager

The Company has approached you, being a senior Risk Manager to look into the proposals. The role performed by you would include:

- To gather regular risk management related information from external and internal sources.
- Identify the problems and provide possible solutions to the various issues arising in the risk management.
- To effectively manage specific risk circumstances.
- To monitor the risk of Anti-Money Laundering (AML).
- To monitor the investment portfolio and to analyse the unfavourable movements.
- Advise and make recommendations to the management in the matters of identifying the risks and quantifying the same.
- Help the management in designing and implementing various risk management strategies and their related processes in the banking & investment portfolio and to suggest improvements.
- Get updated with the advances happening in the relevant software technology.
- Have a detailed understanding and knowledge of the credit, operational and market risks of the portfolio and also the software tools used to assess them.
- Understand and reduce the exposures in financial risks by using strategies such as hedging, credit default swap, insurance etc.
- Proactively analyse the market trends for finding out opportunities in expanding the portfolio.
- Adhere to various laws, procedures relating to the financial operations.
- Gather various information relating to the operations of NBFC in India including credit risk management and the underlying Guidelines of RBI with respect to capital adequacy norms, provisioning etc.

Required by the Risk Manager

In order to have a better understanding of the risk factors involved thereon, the Risk Manager needs a better understanding on the following issues:

- i. The purchase order for a script would be authorised by a manager. The risk manager is bothered about authorising the order for a wrong script, instead of the intended one by the manager. Thus, he is interested to learn the controls placed and if any weakness is found he wants to strengthen the same.
- ii. A machine learning program dynamically responds to change in data / situation by changing the rules that govern the behavior and the algorithm "learns" from new data inputs and gets better over time. The risk manager tries to explore the possibility of employing a new software towards the same.
- iii. Calculation or measuring the loss in the value of the portfolio in a given period of time for a distribution of historical returns.

- iv. The risk manager is interested to find out as to how the portfolio would fare during the period of a financial crisis. He is also interested to build the stress testing capabilities and to explore the ways of using them to meet the broader risk management and business objectives.
- v. The rules and regulations existing in a foreign country and also the risk factors involved with reference to the investment climate of that country that are to be considered before buying shares of a foreign company.
- vi. While applying for a bank loan for the expansion of the portfolio, the parameters of credit risk that the bank might consider and also the credit scoring model that might be applied by the bank, while approving such loan to the company. The Company would be offering some of its immovable properties as collateral to the proposed loan with the bank.
- vii. The certainty equivalence is a guaranteed return that the management would accept rather than accepting a higher but uncertain return. The risk manager would like to explore the possibility of "certainty equivalent" technique.
- viii. Effectively employing big data analytics in analysis of various transactions to study the patterns of investments and also the possibility of using block-chain technology in ensuring the veracity of the transactions.

Descriptive Questions

- 2.1** You are appointed as a risk management consultant and you are expected to give your valuable inputs by answering the following.
- (a) When Risk Manager was monitoring the risk of AML operations, he finds out some major risks for which he wants to use Big Data technologies. Briefly explain how big data analytics help in improve the existing processes in Anti- Money Laundering operations. **(4 Marks)**
 - (b) The Manager is looking at the viability of Credit Default Swap contracts. He learnt that it has similarities with credit insurance. Discuss the differences between CDS and credit insurance. **(6 Marks)**
 - (c) In the present days, banks face a lot of problems in collections from customers resulting in increase of NPAs. Hence the banks make attempts to mitigate the risks of lending to unworthy borrowers by reviewing their five C's of Credit. Briefly explain Five C's of Credit which bank will review if ABC Ltd. applies for Bank Loan for the expansion of the portfolio. **(5 Marks)**

Multiple Choice Questions

Choose the most appropriate answer from the given options:

- 2.2** OECD has developed set of principles for better corporate governance. The principle of Disclosures and Transparency would NOT include
- (a) Overseeing the process of disclosure and communications
 - (b) Foreseeable risk factors
 - (c) The financial and operating results of the company
 - (d) Company Objectives and non-financial information
- 2.3** Bad credit history has the impact on borrower's future. A BCO score is a powerful measure of the creditworthiness as a lender might refer. If FICO score is 750, the chance of default is
- (a) 1%
 - (b) 2%

- (c) 8%
 - (d) 61%
- 2.4 Risk measures are expected to correctly reflect diversification effects and facilitate effective decision making. This is achieved in
- (a) Stress testing measures
 - (b) Coherent risk measures
 - (c) Full revaluation methods
 - (d) VaR conversion methods
- 2.5 The following one is not the property for a coherent risk measure of
- (a) Subadditivity
 - (b) Homogeneity
 - (c) Monotonicity
 - (d) Monatomicity
- 2.6. Which one of the following that a company would LEAST likely choose as a common risk management objective when framing the risk management approach?
- (a) Enhance the level of risk maturity
 - (b) Allocate capital more efficiently
 - (c) Build safeguards against earnings-related surprises
 - (d) Achieve a better understanding of risk for competitive advantage
- (2 Marks x 5 = 10 Marks)**

CASE STUDY: 3

ABC Limited, a listed company, announced the appointment of AG as the company's first lead independent director. Despite opposition by few shareholders, the management offered justifications for the new structure to be more independent and investor friendly. Investors liked the idea and the announcement brought positive sentiments to the falling stock prices which increased to ₹ 75.10, the next day of the announcement. It proved that investors were optimistic about the future of the company and expected better financial results. AG was actually appointed and responsible to response to the present state of affairs of the company. The company had been actually witnessing and struggling in the months to address certain corporate governance challenges. Proxy advisory firm, XYZ, raised alarms and questioned executive compensation package in the years of falling performance. A small shareholder filed a law suit against Board of Directors misuse of corporate funds.

RG, the present Chairman and CEO, was working with the company since last sixteen years and was a close family friend of promoters. His leadership style being democratic was liked and praised by everyone. He was often found meeting people at all levels within the organisation and called for trying new things. His philosophy diminished conflicts and tensions in pursuit of goal setting and achieving. He believes that as long as dividend is paid to shareholders and earnings per share increases, the market values the stock. In the last AGM, he said "The recent decline in financial performance is taken as a publicity stunt by few self interested groups. The company is on its way towards bright future ahead".

The Income Statement Summary of ABC Limited for last three years:

Particulars	Year 2017	Year 2018	Year 2019
Revenue (₹ Crores)	13938	13696	13373
Expenses (₹ Crores)	9608	9420	9119
Operating Income (₹ Crores)	4330	4276	4254
Stock Price (₹)	65.64	61.00	58.4

Shareholding pattern at the end of Year 2019:

Type of Shareholder	Percentage Stake
Promoters	51.60
Mutual Funds	7.25
Domestic Financial Institutions and Banks	24.75
Foreign Institutional Investors	10.40
Corporate Bodies	4.60
Individuals	1.40
Total	100

Descriptive Questions

- 3.1 What should RG and other members of the BOD do? (4 Marks)
- 3.2 Identify the type of governance risk involved in ABC Limited? (4 Marks)
- 3.3 The shareholding of foreign institutional investors is 10.4 percent. Which risk do they face and suggest appropriate tools to measure it? (7 Marks)

Multiple Choice Questions

Choose the most appropriate answer from the given options:

- 3.4 Which of the following is called Governance Risk?
- Risk of management override, deliberate acts of omission
 - Ineffective and unethical management of a company by its executives and managerial levels
 - Inability of management to meet its process related objectives
 - Management interference in day-to-day operations.
- 3.5 Which of the following is not an index for Country Risk Analysis?
- Democracy Index
 - Global Peace Index
 - Human Perception Index
 - Gini Coefficient
- 3.6 is necessary to evaluate all types of risks impacting all categories of stakeholders and find solutions to pre-empt the threats before the risk occurs.
- Stakeholder Risk Management

- (b) Country Risk Management
- (c) Shareholder Risk Management
- (d) Enterprise Risk Management

3.7 OECD Guidelines for corporate governance does not include

- (a) Disclosures and Transparency
- (b) Role of shareholders
- (c) Responsibilities of the board
- (d) Institutional investors, stock markets and other intermediaries

3.8 Opportunities under Risk and Opportunity Disclosure in the Annual Report would not include

- (a) Value realization of by-products by exploring new areas
- (b) Creating differentiation through acceleration of new product development
- (c) Securing raw material supplies
- (d) Volatility in financial markets and fluctuations in exchange rates

(2 x 5 = 10 Marks)

CASE STUDY: 4

ABC Ltd. is a Delhi based company. It was established in 2009 and deals in the manufacturing business of high-end electronics distributed through retail superstore. The company is currently going through a rapid growth phase. Its products are receiving good response from the market. The company is experiencing the challenges of retaining good sales employees and developing an efficient financial system. Ravi Narain is the CFO of the company.

ABC Ltd. has an outdated computerized accounting system which does not look out the changes made after the month end.

ABC is looking to develop a more effective and efficient financial system and considering implementing an incentive plan for sales employees who are currently paid a flat salary.

ABC Ltd has a turnover of ₹ 800 crores in 2016-17 and was listed on Indian Stock exchange in 2014. Ajay and Pawan are the newly appointed directors of Finance and Human Resource divisions respectively.

Ajay is a street smart finance professional and he played a critical role in the areas of budgeting and forecasting, finance and asset management. He has a team of 25 people including Jatin and Mohit who directly reports to Ajay.

In spite of a limited salary, Ajay maintains a lavish style of living. Jatin maintains the journal entries according to Ajay's directions. One day HSBC bank notified Ravi Narain that Ajay's personal credit card balances were being paid off by ABC's account. Since, Ravi Narain was busy for Board Meeting confirmed that this might be reimbursement of his Travelling Expenses.

Jatin records the internet sales from the company's retail outlet as well as carries out following functions:

1. Reconciliation of accounts receivable sub-ledger to general ledger
2. Mailing checks to vendors
3. Coding and recording of cheques received for deposit

Ravi normally never reviews financial details as he trusts Ajay.

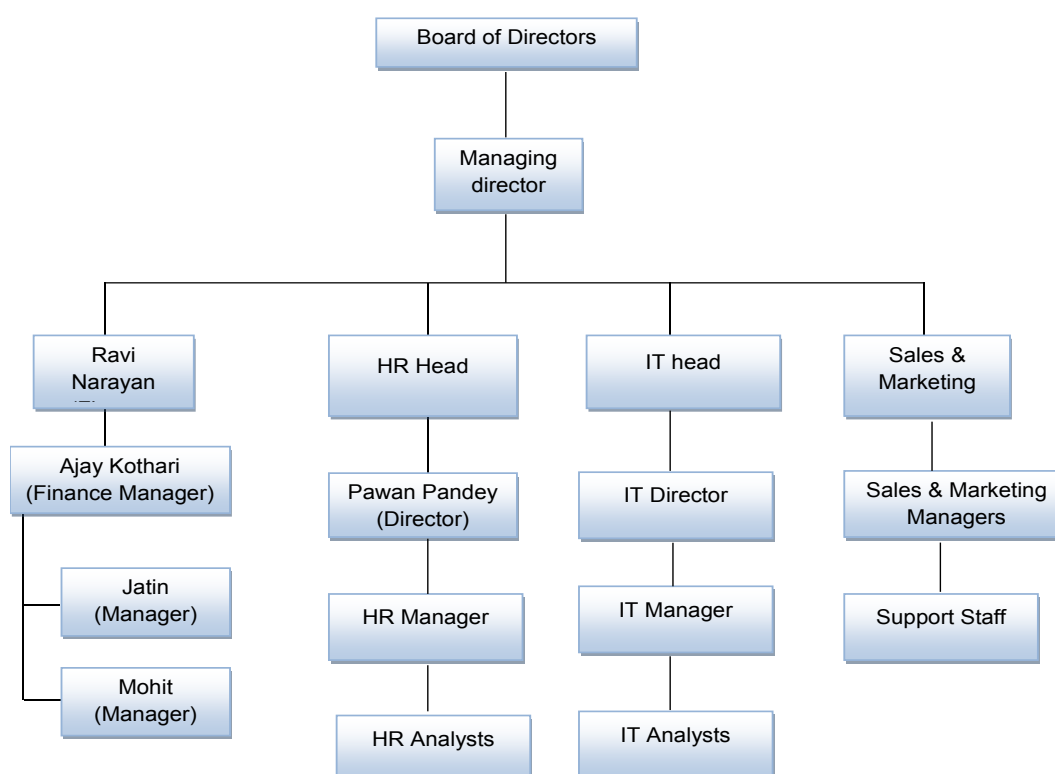
On the Human Resource front, to overcome the problem of retaining the sales employees, the company has recently hired Pawan as the HR director who is known for developing good HR policies to manage people effectively and motivate them to perform well.

Pawan advised the management to implement a compensation plan of base salary and bonus instead of fixed monthly salary. Sales incentive compensation is based on the performance of sales employees. The performance can be measured by looking at the revenue they generate for the employees. The management liked the proposal advised by Pawan and the compensation plan is finalized which was as follows.

Base Salary: ₹ 35,000/month

Commission: 5% of Sales exceeding ₹ 10,00,000/month + 5% extra commission on sales made over and above ₹ 20,00,000/-

Consequently, the present organization structure comes out as follows:



After passing some time, the Board of Directors started realizing that the company is facing liquidity crunch. Also, the introduction of new compensation plan resulted in unhealthy competition among employees.

Some employees were less willing to provide assistance to struggling co-workers and would prefer to improve their own productivity. It also promoted an environment of excessive risk – taken by the sales employees for pursuing short term profits.

The company has a system of identification of risk but only at the functional level and not for processes. Further these Risks are not communicated among various organization levels.

Descriptive Questions

- 4.1 Identify the Risks that may be possible and their nature. (2 Marks)
- 4.2 Scaling of these identified risks based on ICAI Guide on Risk Based Internal Audit. (2 Marks)

- 4.3 Any three to four approaches to identify and assess the risk. (4 Marks)
- 4.4 Course of action to be followed to treat these risks. (2 Marks)
- 4.5 Matters on which Risk Governance Framework can define a policy statement. (4 Marks)
- 4.6 Risk Maturity Level and reasons for the same. (1 Mark)

Multiple Choice Questions

Choose the most appropriate answer from the given options:

- 4.7 As per the risk has been defined as resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
- (a) Basel II
 - (b) ICAI - SA 315
 - (c) CIMA
 - (d) None of these
- 4.8 Which of the following is not the classification of risk as stated by Enterprise Risk Management?
- (a) Knowledge risk
 - (b) Operational risk
 - (c) Financial risk
 - (d) Residual risk
- 4.9 Which of the following is not the risk type that often overlaps or is caused by operational failure?
- (a) Regulatory Risk
 - (b) Financial Risk
 - (c) Credit Risk
 - (d) Legal Risk
- 4.10 Technique involving acceleration of payments of hard currency and delaying payments of soft currency payables to hedge forex exposure is called
- (a) Netting
 - (b) Managing Blocked Funds
 - (c) Leading and Lagging
 - (d) None of these
- 4.11 More risk in a project can be incorporated by decreasing
- (a) estimated future cash inflows from the project
 - (b) initial investment in the project
 - (c) required rate of return of the project
 - (d) internal rate of return of the project
- (2 x 5 = 10 Marks)

CASE STUDY: 5

Quality Paper Mills Limited is an unlisted company formed in the year' 2004 having the head office and factory situated at Visakhapatnam. It was manufacturing and selling papers. The manufacturing of paper was based on bamboo and soft wood.

Some key Profitability Ratios for the FY 2012-13 were:

Percentage of profit after tax to:

Sales	1.84
Fixed Assets	0.83
Capital Employed	1.09
Net-worth	2.01
Equity Capital	3.27

Due to various issues such as, insufficient availability of raw materials, labour unrest, power problems, environmental pollution etc., the Company stopped production in the month of March, 2013.

The Company owned a total land of 38 acres as on 31st March, 2013 in which the factory and office were situated which was allotted by State Government in 2003 and was eligible for Tax holidays for the period of 10 years from the commencement of operations. It made distressed sale of 5 acres of vacant land for ₹ 3 crores and settled the Bank dues, outstanding wages and statutory liabilities during September 2013.

Extract from Balance Sheet as on 31st March, 2019

₹ (in crores)

Investments (in the form of shares, debentures, units in mutual funds)	2.00
Land (at cost)	3.00
Other fixed assets	1.50
Liabilities	Nil
Equity capital	1.00

Mr. Ajit, Managing Director and Chairman of the Company, the person who started this company in way back in 2004. Though he well known person both socially and in the industry because of his dynamism but in the year 2010 his name appeared in Money Laundering case. In the year 2015 his name was in news due to allegation of insider trading of the shares of a company which was likely to be acquired by a MNC conglomerate.

In April, 2019, Mr. Ajit, got the approval of the Board to revive the Company. He appointed a project consultant to conduct a feasibility study and also to come out with alternate proposals.

The consultant, after a 3-month study, came out with the following proposals.

Proposal 1:

To demolish all the buildings and construct residential villas, apartments and independent houses and sell them to the public.

Projections of Proposal 1

Project time	3 years
Total sales price	₹ 30 crores
Cost of construction	₹ 20 crores
Other expenses (including interest)	₹ 6 crores
3-year Term Loan from Bank	₹ 10 crores
Profit	₹ 4 crores

Suitable modifications to be done in Memorandum and Articles of Association of the Company. Necessary approvals to be obtained from the Town Planning authorities of the State government.

Proposal 2:

To commence paper manufacturing using sugarcane bagasse, which is used as a substitute for bamboo and soft wood for the production of paper pulp. It is estimated that 30% wet bagasse could be obtained from crushing sugarcane. There are a lot of sugar mills that are around the place and it may not be a problem to obtain such raw material. After removing pith (waste fiber) and leftover sugar from the wet bagasse, it could be converted to pulp. Since sugarcane production is seasonal, suitable preservative arrangements for the bagasse are to be undertaken.

Since the Company was already producing paper using bamboo and soft wood, it was suggested to have 20% of total production by using the existing machinery after sufficient reconditioning. The consultant also suggested to manufacture (i) boards and (ii) newsprint paper besides production of papers, as there is a growing market both in India and foreign countries.

Key factors of Proposal 2:

₹ (in crores)

Cost of new machineries	10.00
Infrastructure development expenditure etc., (laying of roads and conversion of meter-gauge rails to broad-gauge rails in the factory)	3.00
Cost towards revamping old machineries	1.25
Initial cost towards purchase of raw materials	1.00
Renovation expenses of staff quarters, office and factory buildings	2.30
Other expenditure	2.45
TOTAL COST	20.00

This was proposed to be met as under:

Fresh share capital from existing shareholders	2.00
Sale of 8 acres of unused land	6.00
Sale of Investments	2.00
Bank Term Loan (₹ 6 crores) and Working capital loan (₹ 4 Crore)	10.00
Production can be commenced in Sep. 2020	

Projections made:

Financial Year	2020-21	2021-22	2022-23	2023-24	2024-25
	₹ (in crores)				
Sales	5	15	25	36	47
Income after interest, tax and depreciation	-1.00	0.90	1.50	2.40	3.00
Net Assets	2	6	10	14.40	18.80

Following projected data is related to current items

Current Liabilities	₹ Crore	Current Assets	₹ Crore
Creditors for Purchase of Raw Materials	2.00	Stock of Raw Material	1.00
Other Current Liabilities	1.00	WIP	1.00
		Finished Goods	1.00
		Receivables	3.00
		Other Current Assets	2.00

The vision of Mr. Ajit is to look forward to the things that the Company could do and not look back at things that could not be undone.

Hence, he gave his consent to Proposal 2, but he was not prepared to sell the investments and unused land. Rather Mr. Ajit is interested in raising this amount through additional loan of same amount and offering these assets as collaterals.

Descriptive Questions

5.1 He approaches your Bank for additional loan of ₹ 8 crore, You as a Risk Manager of the bank have been requested to give a detailed analytical report on proposed lending covering the following aspects:

(i) Main Risk that will be faced by bank in the proposed lending and what are its components.

(6 Marks)

(ii) Amount of Loan that you seem to be justified keeping the various factors.

(2 Marks)

(iii) Expected loss on the amount of term you recommended if the probability of default is 4% and Loan Given Default (LGD) is 80%.

(3 Marks)

(iv) Calculate the Maximum Permissible Bank Finance (MPBF) as per the Tandon Committee Recommendations using the norm of a current ratio of 1.33.

(4 Marks)

Multiple Choice Questions

Choose the most appropriate answer from the given options:

5.2 Which one of the following would LEAST likely be included as a source of market risk?

(a) Natural disasters

(b) Recessions

(c) Political turmoil

(d) None of the above

5.3 The managing director wanted to know the difference between Risk Capacity and Risk Appetite. It can be BEST described as

(a) Risk Appetite is the overall ability and financial boundary above which the Board can play their business bets; whereas Risk Capacity is the hard stop limit above which the Board would like to restrict its business actions.

- (b) Risk Capacity is the overall ability and financial boundary within which the Board can play their business bets; whereas Risk Appetite is the hard stop limit within which the Board would like to restrict its business actions.
 - (c) Risk Appetite is the overall ability and financial boundary above which the Board can play their business bets; whereas Risk Capacity is the hard stop limit within which the Board would like to restrict its business actions.
 - (d) Risk Capacity is the overall ability and financial boundary above which the Board can play their business bets; whereas Risk Appetite is the hard stop limit above which the Board would like to restrict its business actions.
- 5.4** A company's decision to move into immature or emerging markets or to launch products outside its core competencies is BEST known as
- (a) Uncertainty
 - (b) Ambiguity
 - (c) Complexity
 - (d) Volatility
- 5.5** In case of Impact of Business Risk, the Impact area of 'customer' has the following nature of impact on
- (a) Morale
 - (b) Loyalty
 - (c) Loss of confidence
 - (d) Defaults
- 5.6** According to ISO 31000 on keys to ERM implementation, which one of the following keys would provide an opportunity to change and further tailor ERM processes?
- (a) Leverage existing resources
 - (b) Winning support and sponsorship from the top management is a precursor
 - (c) Building ERM using small but solid steps
 - (d) Focus on a simple risk model with small number of Top Risks
- (2 x 5 = 10 Marks)**