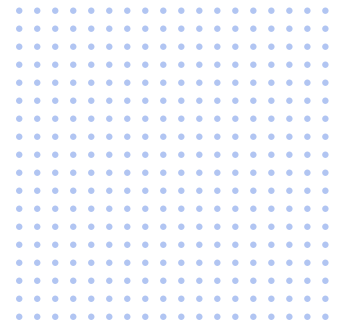




FOR CA FINAL EXAM PREPARATION

CA Final 2021 Question Paper · Paper 6A Risk Management

EXAM	YEAR	TYPE	SUBJECT
CA Final	2021	Question Paper	Paper 6A Risk Management
DATE			
December 2021			

Paper - 6 A

Roll No. Risk Management

DEC 2021

Total No. of Case Study Questions – 5

Total No. of Printed Pages – 31

Time Allowed – 4 Hours

Maximum Marks – 100

HRX

Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi Medium. If a candidate who has not opted for Hindi Medium, his/her answers in Hindi will not be valued.

The Question Paper comprises five case study questions.

The candidates are required to answer any four case study questions out of five.

Answer in respect of Multiple-Choice Questions (MCQs) are to be marked on the OMR

Answer Sheet as given on the Cover Page of the answer book.

Answers to MCQs, if written inside the descriptive type answer book, will not be evaluated.

Candidates should answer the Case Study Questions as selected by them in totality i.e.,

MCQ as well as descriptive Question of the same Case Study Question.

Candidates are not permitted to answer MCQs of one Case Study Question and the descriptive questions of another Case Study Question and vice-versa.

Candidates may use calculator.

HRX**P.T.O.**

(2)

HRX**Marks****CASE STUDY 1**

Chand Lighting Limited (CLL), a public limited company, is manufacturing and supplying filaments, elements, circuit boards and other accessories for electric and CFL bulbs manufacturers throughout the country since the year 2002. The turnover for the year ended 31st March 2019 was ₹ 100 crores. The demands of the customers are moving more towards LED lightings. Having this in mind, Mr. Suraj, the Managing Director (MD) wants to diversify the product range presently manufactured by CLL. To explore the possibility of the same, a consultant Mr. Aditya Balram (ABR) was engaged.

ABR after making his initial study, came out with the following observations :

- CLL can become lighting solutions provider, instead of accessories provider to other manufacturers.
- ABR projected that the turnover could be increased to ₹ 200 crores in the next five years.
- The management as well as the staff should stay motivated to achieve the targets.
- Necessary permissions to be obtained from the appropriate authorities.
- CLL might require a term loan of ₹ 10 crores and additional working capital limits of ₹ 2 crores, towards the proposed expansion.
- The bank would undertake the Credit Risk Rating (CRR) process in the proposed loan to CLL by measuring the internal rating assigned to CLL and assessing the likelihood that CLL would default on its debt obligations.

HRX

(3)

HRX**Marks**

- The LED bulbs could be exported to the neighbouring countries, and export sale proceeds can be received through USD instead of the currencies of respective countries.
- ABR explained to the management, the concept of forward contracts and money market hedging to save CLL from currency rate fluctuations.
- He cautioned CLL that some neighbouring countries might suddenly increase the tax rates without any anticipation and CLL could be caught unawares.
- CLL can open a separate web-portal for making online sales.
- He suggested (i) to strengthen the risk management processes with specific reference to various functional areas of operations (ii) to effectively engage in the process of assessing risks and (iii) prescribe policies and procedures to minimise loss associated with such risks.
- ABR also suggested to CLL to have a strong internal control (IC) system for the various activities carried out, as the core objective of internal controls is to reduce the inherent risk and keep the residual risk within the organization's risk appetite.
- To periodically review the bottlenecks identified in the various production and distribution processes and Enterprise Risk Management (ERM) approach must be embraced as this would assist in the evaluation and bridging of the gap between uncertainty and performance in CLL.

HRX**P.T.O.**

(4)

HRX**Marks**

- To have a strong Business Continuity Plan (BCP) drawn that would include tasks like establishing continuity strategies, planning for continuity of critical operations, continuity management etc. For this purpose, a formal Decision-Making Committee (DMC) is to be formed by the management to oversee the entire chain of activities involved in BCP.
- ABR suggested that CLL has options to be solution providers of variety of CFL products such as tube lights, candle bulbs, strip lights and spot lights.

ABR came out with the following projections :

Sales/Products ₹ (in Crores)	Year 1	Year 2	Year 3	Year 4	Year 4
LED Tube Lights	37	39	41	45	48
LED Candle Bulbs	36	37	39	43	47
LED Strip lights	43	45	47	51	57
LED Spot lights	36	37	40	43	48
Total Sales	152	158	167	182	200

After further analysis, ABR had weighed two options as below :

Manufacturing Options	Net Revenue	Risk-weighted assets
LED Spot Lights	₹ 42 lakhs	₹ 1.5 Crores
LED Strip Lights	₹ 62 lakhs	₹ 2.1 Crores

Based on his calculations, ABR suggested to go ahead with the production of LED Strip Lights.

HRX

(5)

HRX

Marks

The management has requested you to answer the following :

Multiple Choice Questions

Choose the most appropriate answer from the answer options.

2×5

=10

1.1 The CRR process proposed to be employed by the bank would be :

- (A) Borrower of Default
- (B) Probability of Default
- (C) Credit Rating Default
- (D) Exposure at Default

1.2 The caution given by ABR would MOST likely fall under :

- (A) Sovereign Risk.
- (B) Expropriation Risk.
- (C) Exchange Control Risk.
- (D) Taxes, Rule and Regulation Risk.

1.3 What would be the % of increase / decrease over the projected total sales for Year 5, if there is (i) an increase in sales figures of LED Strip lights by 12% and (ii) a decrease in sales figures of LED Spot lights by 10% for that year ?

- (A) Increase of 1.02%
- (B) Increase of 3.42%
- (C) Decrease by 2.40%
- (D) Decrease by 1.01%

HRX

P.T.O.

(6)

HRX**Marks**

- 1.4 The foreign buyer to whom the exports were made may intend to pay through dollars. If the Spot rate between INR and USD is ₹ 74 to a dollar and the three months forward rate is ₹ 75 to a dollar, what is the forward premium percentage ?
- (A) 4.05%
- (B) 5.33%
- (C) 5.41%
- (D) 16.22%
- 1.5 The gap between the inherent risk and residual risk shows the strength of the control and is known as the :
- (A) Risk Score.
- (B) Vantage Score.
- (C) Control Score.
- (D) Risk Weighted Score.

Descriptive Questions

- 1.6 What is an Enterprise Risk ? List the items that the ERM process would comprise of with reference to CLL. **4**
- 1.7 Do you agree with ABR's suggestion for producing LED Strip Lights ? **6**
Give answer with reasons. Would your answer be different if the net revenue from LED Strip Lights is ₹ 60 lakhs ? Show your workings.

HRX

(7)

HRX

Marks

- 1.8 Explain the advantages and disadvantages of entering into a contract to exchange a certain amount of one currency for a fixed amount of another currency, at a particular date. 3
- 1.9 What are the chain of activities that would be overseen by DMC ? 2

CASE STUDY : 2**About the Company**

Best Kitchen Private Limited (BKPL) is a specialist company in setting-up modular kitchen for homes. It was incorporated in the year 2014.

Products of BKPL

A typical modular kitchen comprises of compartments of cabinets, shelves, drawers, sinks, chimneys, and racks fitted in a kitchen. Such components are modular in nature and can easily be dismantled, reassembled, or replaced. Working convenience, strategically storing the products used in the kitchen, aesthetic look and ease of maintenance are some of the features that make the concept of modular kitchens so popular.

BKPL offers several types of modular kitchen catering to the dynamic needs of the customers. BKPL is famous for its innovative and modern designs and styles which are made-to-order according to the specifications of each customer. The demand for installation is growing up and BKPL is not able to cope up with the increasing demand.

BKPL is also getting the orders through its website.

HRX

P.T.O.

(8)

HRX**Marks****Purchase of raw materials and handling scraps :**

- a. Some of the parts used in the modular kitchen are being imported and the management knows that there are foreign exchange exposures in such transactions. The manager of the Purchase Department, Mr. Krish, is given the task of finding out the quality alternatives from the local market keeping in mind the supportive schemes of the Government.
- b. The left-over materials, such as, pieces of granite, aluminum, and plywood materials, -are stored separately in the assembly room. Mr. Girish, manager of the Marketing Department, has been telling the management that there is a market for such left-over of materials.

Expansion proposal :

Since there is a constant increase in demand for BKPL's products and to cope-up with the changes happening in this type of industry, the management seriously exploring of expanding its business operations, by (i) modernising as well as increasing the production capacity, (ii) opening branches in more cities and (iii) employing more qualified personnel.

However, the management was not sure whether the market would remain buoyant always. Some volatile situations such as increase in prices or ban on import of some raw materials may occur which could affect the entire plans and workings, and the competitors may offer more product ranges with lesser price. Besides the above, BKPL may be subjected to more rules and regulations to adhere to in the proposed expansion.

HRX

(9)

HRX**Marks****Bank loan proposal :**

For the expansion proposal, BKPL is contemplating to borrow an amount of ₹ 5 crores for a period of 4 months in the coming 6 months' time from now. The current rate of interest is 8% p.a., but it may go up in 6 months' time. BKPL wants to hedge itself against the likely increase in interest rate. BKPL's bankers quoted a Forward Rate Agreement (FRA) at 8.3%.

Mr. Surya, the Chief Financial Officer (CFO), intends to suggest to the bankers to benchmark (i) BKPL's assets to fixed rate of interest and (ii) its liabilities to floating rate of interest.

Risk Management program :

Due to the proposal for expansion of the business operations, the management wanted to implement a suitable risk management system. Such a risk management system should look at the big picture and identify not only short-term risk factors but also long-term factors impacting the entire value chain of business activities and connected communities.

It was noticed by the management that Mr. Krish, instructed his department employees not to share information relating to the risks identified or encountered by his department with the employees of the marketing department.

The MD decided to ensure the effectiveness of the internal controls used in BKPL and for this purpose he employed the services of an internal auditor.

HRX**P.T.O.**

(10)

HRX**Marks****Investment activities :**

BKPL has invested in hedge funds of two companies, viz., R Company Ltd. (RCL) and S Company Ltd. (SCL) respectively. There is a i) 70% probability that RCL would give a positive return and ii) 60% probability that SCL would give a positive return.

The MD wanted to invest more in this section, but the management lacks in the understanding of the nuances of the shares and funds market.

The management has requested you to answer to the following questions :

Multiple Choice Questions

Choose the most appropriate answer from the given options.

**2×5
=10**

2.1 The instructions of Mr. Krish would fall under which of the following Risk

Maturity levels :

- (A) Risk Naive.
- (B) Risk Aware.
- (C) Risk Defined.
- (D) Risk Managed.

2.2 Which of the following statements is not true about internal controls (IC) ?

- (A) IC focuses on identification of threats and opportunities.
- (B) IC is sub-set of risk management.
- (C) IC is operational and transactional driven.
- (D) IC assists in countering threats and taking advantage of opportunities.

HRX

(11)

HRX**Marks**

2.3 The foreign exchange exposure would least likely be classified under which of the following broad categories ?

- (A) Translation Exposure.
- (B) Transaction Exposure.
- (C) Country Specific Exposure.
- (D) Operating Exposure.

2.4 What is probability that the hedge funds invested in RCL and SCL both would give a negative return ?

- (A) 42%
- (B) 28%
- (C) 18%
- (D) 12%

2.5 The suggestion intended to be made by Mr. Surya to the bankers is best known as :

- (A) Embedded Option Risk.
- (B) Basis Risk.
- (C) Price Risk.
- (D) Position Risk.

HRX**P.T.O.**

(12)

HRX

Marks

Descriptive Questions

- 2.6 A holistic understanding is essential about risks and uncertainties. In this context, describe VUCA with characteristics and approaches with examples drawn from the Case Study. **6**
- 2.7 What are the business opportunities presented to BKPL by the external and internal environments which should find place in Risk and Opportunities Disclosures in the annual report of BKPL ? **5**
- 2.8 With regard to the proposed bank loan contemplated by BKPL, what will be the final settlement amount if the actual rate of interest after 6 months happens to be (i) 8.5% p.a. and (ii) 7 :5% p.a. ? **4**

(Note to candidates : Calculations to be based on completed months, instead of number of days.)

CASE STUDY : 3**About Real Products Limited (RPL)**

RPL offers to its client's hardware solutions, including chip manufacturing, planning and integration for a variety of uses. It operates throughout the globe, but most of its business is located in Asia Pacific region. RPL is more comfortable taking the risks for which it has strong controls.

HRX

(13)

HRX

Marks

Recent observations by the Board of RPL

In a recently concluded Board meeting, while reviewing risk management practices of RPL, one of the Board members indicated about the increased threat of new and severe non-financial risks which are now challenging basic assumptions about control effectiveness. For example, RPL so far has relied on automation to speed up processes, lower costs, and reduce manual errors. At the same time, the risks of large-scale breaches and violations of data privacy have increased dramatically, heightening during the COVID-19 crisis as digitization accelerated substantially. With less risk of manual errors but greater risk of large-scale failures, RPL will require to adjust their risk appetites and associated controls to reflect evolving risk profiles.

The Chief Risk Officer (CRO) of RPL agrees with the view of the Board member. He informed the Board that risk management strategies require revision and it should also cover the event of a major control breakdown, so that RPL is able to switch quickly to crisis-response mode, guided by an established set of procedures.

He further agreed that RPL has done little to prepare for crisis, seemingly taking an attitude that it won't happen here and hence risk culture also need to be improved. There is a consensus that RPL will need to build crisis-preparedness capabilities systematically. As the COVID-19 crisis has demonstrated, companies with well-rehearsed approaches to managing through a crisis have been more resilient to shocks.

HRX

P.T.O.

(14)

HRX**Marks**

The CRO further briefed the Board that preparation in this respect would involve identifying the possible negative scenarios unique to RPL and the mitigating strategies to adopt before a crisis hits. That includes periodic simulations involving both senior management and the Board. There is a plan to maintain and periodically update a detailed crisis register. Their strategies would typically include details on when and how to escalate issues, preselected crisis-leadership teams, resource plans and road maps for communications and broader stakeholder stabilization.

Investment activities of RPL

RPL is a cash surplus company and as a part of investment policy approved by the Board it has made investment in equity, bonds, risk free securities, mutual fund and REITs. A team of professional in the treasury is managing the investment. Internal auditor has pointed out several control weaknesses and lack of development of risk appetite in the context of control culture of the company in this area. The management has directed the CRO to ensure that stress tests are built around changes in market rates and prices that result from pre-specified economic scenarios, including both actual historical and hypothetical market events.

The CRO agreed that not only stress test should become regular feature of risk management but also stress test results should be used at all levels of RPL, from the trading desk to the Board to monitor and control risk.

The financial instruments including financial assets and liabilities that RPL holds are continuously exposed to fluctuations in markets, such as currency exchange rates, interest rates, and stock prices of investments. Therefore CRO has decided to measure the effect of market fluctuations on the value of financial instruments and derivatives by using Value-at-Risk (VaR) Analysis.

HRX

(15)

HRX**Marks**

The CRO also informed the Board that he will also report to the Board on a quarterly basis reporting 'at risk' measure such as Earnings-at-Risk (EaR), Earnings-Per-Share-at-Risk (EPSaR), and Cash-Flow-at-Risk (CFaR).

Outsourcing option with RPL

RPL management has been making efforts to reduce operating costs over a period but has got very little success. Outsourcing of some of the activities may lead to reduction in operating costs. However, the management is not sure about the risk that may arise due to outsourcing. What are the key activities that can be outsourced and what should be looked at Board level before Service Level Agreement (SLA) is entered into with a party that will provide outsourcing services.

Multiple Choice Questions

Choose the most appropriate answer from the given options.

**2×5
=10**

3.1 CRO has decided to measure the effect of market fluctuations on the value of financial instruments and derivatives by using Value-at-Risk (VaR) Analysis. Among the following which one CRO did not use as a basic approach (s) for calculating VaR

- (A) Parametric.
- (B) Historical simulation.
- (C) Monte Carlo simulation.
- (D) Differential method.

HRX**P.T.O.**

(16)

HRX**Marks**

3.2 The CRO would submit Stress Testing Report to the Board on a regular basis starting from the next quarter. In your opinion which one of the following is incorrect with respect to Stress Test Reports ?

- (A) They show the potential present value impact of pre-specified scenarios or extreme market movements.
- (B) They are used to better capture event risk.
- (C) They are a useful complement to VaR analysis.
- (D) They are separate and has no connection with VaR Analysis.

3.3 RPL has parked its cash surplus into equity, bonds, securities, mutual funds and REITs. Internal auditor has pointed out several control weaknesses including lack of development of risk appetite in the context of control culture of the company. Which one of the following is incorrect with respect to risk appetite ?

- (A) Risk appetite is a single, fixed concept.
- (B) Risk appetite must be integrated with the control culture of the organisation.
- (C) Risk appetite must take into account differing views at a strategic, tactical and operational level.
- (D) Risk appetite should be developed in the context of an organisation's risk management capability, which is a function of risk capacity.

HRX

(17)

HRX**Marks**

3.4 Assuming RPL's Board decides to outsource option, which one of the following combinations of risks would arise as a result of outsourcing ?

- (A) Strategic risk and reputation risk.
- (B) Strategic risk, legal risk and contractual risk.
- (C) Concentration risk, contractual risk and systematic risk.
- (D) Strategic risk, reputation risk, legal risk, contractual risk, concentration risk and systematic risk.

3.5 The treasury head of RPL has given a risky portfolio of INR 100 crore to his junior to manage it effectively. The portfolio has expected return of 15% and standard deviation of 25%. The risk free rate is 7%. Suppose that risky portfolio includes the investment in the given proportions : Stock P - 20%, Stock Q -30% and Stock R-40%. Which one of the following is correct about the Sharpe Ratio of the portfolio ?

- (A) .032
- (B) 0.375
- (C) 0.40
- (D) 0.30

HRX**P.T.O.**

(18)

HRX

Marks

Descriptive Questions

- 3.6 CRO of RPL has decided to measure the effect of market fluctuations on the value of financial instruments and derivatives by using Value-at-Risk (VaR) analysis to monitor and control risk. Do you agree that VaR is a flexible risk measure ? Provide cogent reasons to support your answer. **3**
- 3.7 What would you include in a brief note to the Board if you have been asked to explain “at-risk” measures, such as Earnings-at-Risk (EaR), Earnings-Per-Share-at-Risk (EPSaR), and Cash-Flow-at-Risk (CFaR) ? **3**
- 3.8 A newly appointed independent director of RPL has approached you to suggest any four tests he should be aware of while reviewing risk appetite statement of RPL. Frame four questions that the independent directors can ask in a Board meeting which will help him in reviewing risk appetite statement of RPL ? **4**
- 3.9 The management of RPL has hired you to write a brief Note on the matters that must be reviewed before outsourcing decision is approved. Also include into your Note, the key areas that must be included in SLA before it is signed. **5**

HRX

(19)

HRX

Marks

CASE STUDY 4**About the company and its business**

There has been a phenomenal growth in the Quick Service Restaurant (QSR) format in India. The QSR format seems to be the perfect mix of maintaining decent consumer connects with being lucrative. Thus, over the years it has become an integral part of the Food and Hospitality Industry. Mashkin Foods Limited (MFL), although is a new entrant but within a short span of time, has established itself as a challenger to exiting players due to its focus on four factors : quality, cost, hygiene and localization of menu. With a healthy demand outlook and improvement in economic activities after second phase of Covid-19, MFL is expected to witness substantial growth. It is also expected that operations of large segment of the unorganized market would get streamlined into organized market.

Past performance of MFL

During first and second phase of Covid-19, MFL's performance came down substantially because of the curbs due to resurgence in Covid-19 cases. But stringent standard operating procedures (SOPs) and the resilient convenience channel helped it in faster recovery after curbs were lifted. MFL revenue has also started rising by setting platform for online booking.

The Board has taken a decision to onboard the customers using its own platform rather than using services of aggregators. This is going to create a huge intangible in terms of loyal customer base. Probably, the next challenge for the management to overcome is to understand how different disasters could impact businesses.

HRX

P.T.O.

(20)

HRX

Marks

Proposed action plans -

With the changed business mix, the management believes that there should be a Business Continuity Plan (BCP). A proper strategy for BCP is also the need of the hour but what should be included in BCP strategy is not clear to the in-house team of MFL. The in-house team is also not clear about the contents that should be included in the BCP.

Further, considering the growing size of the business, the Chief Financial Officer (CFO) also wants Business Impact Analysis (BIA) of the Company. With the help of the BIA and risk assessment in hand, the risk management team can identify a proper recovery strategy.

Observations of the Board of MFL

MFL follows an organization model comprising three lines of defense. However, it has legacy organizational silos as a result of which effectiveness of each line of defense is inadequate. Liquidity risk management is one of the key concerns of the Board. While reviewing liquidity risk management process of MFL, the Chairman of the Audit Committee has remarked that understanding of three lines of defense is very important in risk management. Each line—the business, the independent risk management function, and the internal audit function—has specific responsibilities with respect to the end-to-end liquidity risk management process, from overall governance, strategic planning, risk appetite setting, risk identification, assessment and management, through reporting, as well as internal controls. The direction given by the Chairman is to leverage the three lines of defense to align and integrate management of liquidity risk.

HRX

(21)

HRX

Marks

MFL and its subsidiary company

MFL has recently formed a subsidiary that would exclusively work in food delivery business. The CFO has indicated that working capital facilities will be availed from a new generation digital bank that can support the growth potential of the Company. CFO and his team would prepare the proposal for working capital loan assessment and get an approval from the Board before submission to the bank.

Few independent directors of MFL are from non-financial background and they have asked the CFO to explain the terms like Maximum Permissible Bank Finance (MPBF), sanctioned limit, drawing power (DP) operating limits etc. and also the working capital loan assessment process in the next Board meeting.

Further, CFO wants to take permission of the Board for making investment in Zero Coupon Bond (ZCB) of AAA rated corporates. The Board has asked the CFO to make presentation on risk involved in this investment before the permission is granted.

New business opportunity for MFL

Over the last two years MFL has created a team of programmers. It all started with own online platform but they have now started getting orders from other businesses who want to develop online platform. MFL has got one such project for developing online platform that will be completed in a few year's time. Payments from the customer are expected at the end of the project.

Expected cash flows of MFL

MFL is financed on the basis of INR MIBOR +1% markup. It can deposit surplus cash for INR MIBOR – 0.25%. The estimated cash position is :

3 to 6 months	6 to 9 months	9 to 12 months	12 to 24 months
INR 10 Million Deficit	INR 15 Million Deficit	INR 20 Million Deficit	INR 5 Million Surplus

HRX

P.T.O.

(22)

HRX**Mark:**

As is evident from the above table there is a cash shortage up to Month 12 and MFL will draw under the financing facility. The risk for MFL is that if the money market rate increases, as a result of which interest payable will increase. From month 12 there is a cash surplus. The risk for the MFL then is that if the money market rate decreases and as a result interest receivable from the future deposits will decrease.

For the time being the CFO and his team has decided to eliminate interest risk by using Forward Rate Agreement (FRA). However, they will also consider Interest Rate Swap (IRS) and Collar in Future.

The quotes from the bank for FRA are as under :

Period	FRA quote
1 × 4	2.01- 03%
2 × 5	2.10-12%
3 × 6	2.20-22%
4 × 7	2.28-30%
5 × 8	2.37-39%
6 × 9	2.43-45%
9 × 12	2.60-62%
12 × 24	2.82-84%

But the Board has made it clear that these would be approved only after proper understanding of valuation and functioning of such instruments. The CFO has promised to make a presentation to the Board of Directors in this respect.

HRX

(23)

HRX

Marks

Multiple Choice Questions**Choose the most appropriate answer from the given options.****2×5****=10**

- 4.1 Which one of the following is incorrect with respect of assessment of working capital requirements of MFL ?
- (A) MPBF is also called sanctioned limit.
- (B) MPBF is also called DP.
- (C) DP can vary across the quarter.
- (D) MPBF is bifurcated into cash credit component and loan component.
- 4.2 CFO of MFL wants to make investment in ZCB of AAA rated corporates after analyzing risk involved in it. Which of the following risks will not affect a listed ZCB ?
- (A) Reinvestment Risk.
- (B) Default Risk.
- (C) Credit Risk.
- (D) Market Risk.
- 4.3 CFO has decided to eliminate interest risk by using FRA and with due consideration of IRS. Which of the following is incorrect with respect to various dates in a basis swap ?
- (A) The final payment date and the end of the contract is always called termination date.
- (B) The final payment date and the end of the contract is called termination date except overnight indexed swap.
- (C) Re-fixing dates are calculated from the dealing date.
- (D) Value date and effective date are the same.

HRX

P.T.O.

(24)

HRX**Marks**

4.4 What Collar transaction would be done by MFL for hedging a float rate borrowing ?

- (A) Buy a Floor and sell a Cap.
- (B) Buy a Cap and sell a Floor.
- (C) Buy both Cap and Floor.
- (D) Sell both Cap and Floor.

4.5 Which one of the following is incorrect with respect to IRS assuming MFL wants to hedge interest risk on a float rate borrowing ?

- (A) Using IRS also allows benefiting from the lower interest rate during the life of the IRS.
- (B) IRS synchronizes cash flow flows.
- (C) IRS can be used to access a market where otherwise access is not possible due to poor credit rating.
- (D) IRS would require periodic valuation in the accounts.

Descriptive Questions

4.6 Periodic 'check the box' kind of review of controls and risks is inadequate for MFL. In line with the directions of the Chairman of Audit Committee, you have been asked to advice how to leverage the three lines of defense to align and integrate management of liquidity risk ?

6**HRX**

(25)

HRX**Marks**

- 4.7 The Board of MFL has asked you to identify and briefly explain actions that should be taken before BCP is written. Also explain briefly various elements that should form part of a BCP strategy ? **4**
- 4.8 What are the contents of BIA and what benefits it is likely to provide to MFL ? **3**
- 4.9 What action should CFO and his team should take to hedge interest risk that is likely to arise in MFL ? **2**

CASE STUDY : 5**INTRODUCTION**

The Tamil Nadu Government, by a Notification issued in June, 2018, banned the manufacture, storage and use of plastic products such as cover plastic carry bags, plastic plates, coffee, tea, water cups, water pouches and packets irrespective of their thickness w.e.f. 1st January, 2019, chiefly because of short-term and long-term environmental damage and health hazard when such products are used in daily life.

Carryon Plastics Private Limited (CPPL) is situated in an industrial estate at Coimbatore. The Company was manufacturing plastic carry bags, cups and plates of various sizes and thickness, since the year 2010.

Mr. Peter is the Chairman of CPPL and he looks after production, marketing, sales and accounts. Mr. Peter analysed various issues of the ban and the implications the same would have on the future of the Company.

HRX**P.T.O.**

(26)

HRX**Marks**

There were no sales since January 2019 and the value of stock in hand on 31st December, 2018 was ₹ 2 crores. CPPL has proposed to sell the closing stock at a throwaway price.

Alternate Plans :

The Chairman came across a recent innovation which used plastics for laying roads.

It was also decided to explore the possibility of manufacturing biodegradable cloth, paper and jute bags and also for producing cups and plates made of lotus leaves and outer cover of Arecanut tree flowers.

As the ban did not cover plastic used for packing of milk and milk products (dairy products), oil, medicine and medical equipment, the machinery hitherto used for manufacturing plastic products can to be reconditioned to manufacture such exempted items.

Mr. Peter has proposed the following product mix for the manufacture of items from biodegradable materials :

Products to be manufactured from	in%
Jute	10
Cloth	35
Lotus leaves	5
Outer cover of Arecanut	10
Paper	40

HRX

(27)

HRX

Marks

Project Cost

Item	₹ (in crores)
Cost of new machinery	2.00
Reconditioning of existing machinery	0.80
Raw materials cost	0.50
Cost of Training to workers	0.20
Working Capital Required	1.50

The required funds are proposed to be obtained by raising a 10-year term loan of ₹ 4 crores from the Bank (on mortgaging immovable properties of directors and hypothecation of new machinery) and the balance from the shareholders.

Even before the new project is implemented, Mr. Peter considered the possibilities of manufacturing products made of Lotus leaves (Project A) or Coconut fiber (Project B). For both the projects, initial investment is ₹ 10 Lakhs and the discount rate is 10 percent.

Issues to be addressed :

As, there is going to be an abrupt change in the manufacturing of products, the following aspects are to be carefully taken care of :

- The market for the new products,
- ways of cost savings through a better management,
- issues relating to competition start-up disruption, competition and regulatory requirements and
- the probability of success of the product mix and the possibility of changing combination, if there is need in the future.

HRX

P.T.O.

(28)

HRX**Marks**

CPPL is going to enter an unexplored area which in turn means that it would be taking a lot of risk, as the uncertainty in the business cannot be predicted. The degree of uncertainty and the impact of the risk outcome combined together form the magnitude of the risk. The management of CPPL would like to know the overall effect that these would have on the company. Mr. Peter felt that a proper risk assessment covering the entire operations of the Company is required as it is very important to have more systems and controls over its operations which have to be tested periodically for their efficiency and effectiveness.

As the risk management consultant of the Company, you are required to answer the following questions :

Multiple Choice Questions

Choose the most appropriate answer from the answer options.

**2×5
=10**

5.1 CPPL decided to explore the possibility of manufacturing biodegradable jute bags in place of plastic bags. The risk measures are meant to correctly reflect diversification effects and should facilitate effective decision making.

The answer to this would be found in the theory of :

- (A) Delta- Normal Method.
- (B) Coherent Risk measures.
- (C) Bootstrap Simulation.
- (D) Full Revaluation Method.

HRX

(29)

HRX**Marks**

5.2 CPPL has a proposal to buy hedge cover of ₹ 25 lakhs from the bank. If the Credit Default Swap spread is 40 basis points, then the company would have to pay to the bank annually an amount of :

(A) ₹ 1,00,000

(B) ₹ 1,000

(C) ₹ 10,000

(D) ₹ 40,000

5.3 After the Government Notification banning production of plastic bags, CPPL has decided to sell the closing stock at a throw away prices and quickly shift to production of products from jute. Which of the following is the MOST important objective of Post-loss Risk Management ?

(A) to reduce the apprehensions of the stakeholders.

(B) to treat the loss exposures in the most cost-effective ways.

(C) to meet the legal obligations.

(D) to continue the operations.

HRX**P.T.O.**

(30)

HRX**Marks**

5.4 For improving their risk governance, the Board of Directors of CPPL would MOST likely perform which of the following under sound risk governance practices :

- (A) approves the risk appetite framework and ensures it is directly linked to the business strategy, capital plan, financial plan and compensation.
- (B) meets, at a minimum quarterly, with the firm's supervisor to discuss the scope and coverage of the work of the risk management function.
- (C) reviews the third-party opinion of the design and effectiveness of the overall risk governance framework on an annual basis.
- (D) is involved in the setting of risk-related performance indicators for business units.

5.5 It is estimated that there is probability of 20% delay in completing a particular stage of the proposed project, once in every two months. Assuming that the proposed project is expected to be completed in 6 months, what is the probability that the project gets delayed in the sixth month ?

- (A) 20%
- (B) 5%
- (C) 12.50%
- (D) 60%

HRX

(31)

HRX

Marks

Descriptive Questions

- 5.6 Explain the specific benefits of the Risk Management Plan to the Board of Directors of CPPL who shall be responsible for framing, implementing and monitoring the same. **6**
- 5.7 CPPL's operations consist of various business functions and there are various activities that are specific to each functional area of operation. Explain briefly the business functions which can be assessed from a risk perspective. **5**
- 5.8 Possible net cash flows of the alternate Projects A and B and their probabilities are given as below. Calculate the expected net present value (single period) for each project. Based on your calculations, which Project that you would suggest ? (Please give your workings) **4**

Project A			Project B	
Possible Event	Cash Flow (₹)	Probability	Cash Flow (₹)	Probability
A	8,00,000	0.25	4,00,000	0.31
B	10,00,000	0.15	20,00,000	0.14
C	12,00,000	0.28	16,00,000	0.25
D	14,00,000	0.21	12,00,000	0.18
E	16,00,000	0.11	8,00,000	0.12

Note : Discount Factor 10% for 1 year = 0.909

 HRX