

CA FINAL

RISK MANAGEMENT

NOV 2020

PAPER ANALYSIS

CASE STUDY 1

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The Risk Management paper of CA Final Nov 2020 Exam was considered to be a challenging paper by most students who appeared for the Exam. It was challenging in the sense that people could not find the answers from the mapping sheet in the ICAI Study Mat. It was challenging in the sense that most of the questions were applicative wherein:

- you know where the Risk Register topic is in the study mat, but you have to write something else
- you know where RCSA is in study mat, but you have to write about the **application** of RCSA in that particular case study
- you know what is strategic risk—you can pretty much find it in the study mat, but you have to talk about the **key drivers** of strategic risk.

So, it was applicative-applicative-applicative all through out. Even the MCQs were more-or-less related to the case study and not to be found from the institute's mat. All case studies required use of the exam taker's brain & judgement rather than just reproducing content from the mat. My question to you is--- isn't that what case studies actually mean and should be like???

So, people were obviously surprised because they could not find the arbitrage opportunity that was there in the previous RM papers to date.

Was it different for other elective papers?

No, even the other elective paper have the same status. But RM is in the limelight more because most people are doing RM these days and they have heard stories of people enjoying arbitrage in the past. As students of the RM paper, you will understand and acknowledge that markets are efficient and arbitrage itself leads to wiping out of the available opportunity. You, as budding CA's with RM as your elective (or specialization) have to now upgrade your levels. You got to understand that ICAI's study mat and mapping-sheet are now matters of the past and just a hoax now forth. These wouldn't help you on standalone basis now—that's guaranteed. What's required of you now is that whatever topic you are doing-- along with in-depth knowledge of it, you got to keep an open mind about its concept—use your brain, general understanding & common sense involved in the topic--- be it regarding Risk Based Internal Audit, be it risk and control matrix (RCM), risk management strategies, reputation risk, governance risk, enterprise risk management, risk maturity of an organization or any other concept.

So this paper is causing a sea- change in the way in which Risk Management paper shall be set in future.

I have carried out a deep analysis of each & every Case Study-- provided multiple answers wherever there was a scope of ambiguity. It's a subjective paper and the answers are based on my judgement and are not provided by ICAI. As always, confusion arises (and will arise) when ICAI comes out with their suggested answers.

When they do, please look at them in detail and remember that ICAI's answers are supposed to be given more importance (even if it defies logic) than the answers that I have reproduced below.

Note:

- ✓ For Jan 21 exam, I will be sharing a number of insights in the coming days.
- ✓ Also, I have already announced fresh batches in both English and Hindi for RM to begin from 4th Jan Live at Home on the Ulearn Portal. These are obviously for the May 21 exams and beyond.

- Sanjay Sir

*STAY TUNED ON SSEI QFORUM
FOR ANALYSIS OF CASE
STUDIES 2-5*

CA FINAL RISK MANAGEMENT

NOV 20 PAPER ANALYSIS

Case Study 1 : CRPL

Synopsis:

1. CRPL is a **multichain retail outlet** in Chennai selling FMCG goods.
2. **Centralized Purchases** with inhouse software
3. **Centralized Accounting**
4. **Standard Policies** and Procedures across all stores.
5. Loyalty or discount points awarded to customers.
6. **E-Retailing** - In its online store, CRPL facing issues with **banks not settling payments of Rs.2,00,000 during a 3-month period** on account of **Hot-listed Credit Cards**.

Note – A hot list is a list of credit cards that are reported stolen, cancelled or compromised in some way.

7. Issues :

- i. There are **no access control restrictions** for entering the area in which bar-coding of products is done.
- ii. The store manager of the main store issued orders manually for a product which is fast selling from a nearby distributor on an urgent basis, **without getting approval from the manager** and it was later found that the **expiry date on the lot was due to expire in the next three days**.

- iii. Sometimes, based on the requirements of another store, goods were transferred from one store to the other, It was noticed, on a particular-day, **100 quantities of a product were transferred from one store to another. The receiving store accounted for only 80 quantities.** There were no procedures to acknowledge the receipt and delivery of goods from one store to the other.
- iv. The salesmen were given a leeway of **allowing a discount upto 2% on the sale price.** It was found that some salesmen were giving a **constant 2% discount to all the customers with whom they dealt with.**
- v. CRPL's policy is that the **cash collections of each day, must be deposited on the next working day into the bank account.** Such cash was required to be kept in the safety locker by the cashier of the store. On three days in the past three months, there were **cash shortages to the tune of ₹ 5 lakhs in four stores.** The respective cashiers said that they have correctly calculated the cash collections and kept the cash in the safety lockers, but in the next **morning the cash was found to be in shortage.** One **locker key** was with the **cashier** and the other was with the **managing director.**
- vi. On some days when the general manager was not available, the **purchase manager passed the payments to the suppliers.**
- vii. CRPL's credit policy allowed a credit of **₹50,000/- only** for customers who have purchased **more than ₹3 lakhs** on an average in the **past three years.** It was noticed that **two customers purchased more than ₹1 lakh on credit.**

8. Extracts of Risks faced by CRPL :

- i. Risk of **inadequate training** to the employee of CRPL.
- ii. The risk of CRPL being affected by **natural calamities.**
The probability of flash floods affecting the main store was estimated at
 - a. **1% p.a.** and
 - b. the loss caused thereon would be **₹ 25 Lakhs.**
The premium quoted by the insurance to cover such event was **₹ 30,000/- p.a.**
- iii. The risk of certain products **being discarded after the expiry date** due to slow moving of the products.
- iv. Risk of **theft** of products by employees resulting in **breach of confidence** and **loss of money.**

9. Advise and explanations offered by consultant :

- i. risks are those uncertainties of outcome, whether an opportunity or threat, arising out of actions and events,
- ii. the importance of capturing and recording the incidents that would adversely affect the operations of CRPL,
- iii. the need for a proper and periodic risk management process which would enable the management to deal with risks by reducing their likelihood or downside impact as the same aims to protect the value already created by the company, but also enhances its future opportunities,
- iv. the commitment required of the Board to fix the quantum and extent of risk that it is willing to take to pursue the objectives, in other words known as Risk Appetite and,
- v. the need for implementation of proper controls and ensure their working to alleviate the issues faced by CRPL.

He advised them to have values, attitudes, competencies, and behaviour which would in-turn determine the company's commitment and style of Operational Risk Management.

10. Children theme park project

- In the main store, adjacent to the building, CRPL is maintaining a garden having an area of 5,000 sft., which is company-owned. It was observed that an average of 1,000 customers visited the store per day and out of them 150 families visited with children.
- To tap the potential, Mr. Deepak, the Managing Director (MD), suggested a proposal to build a children mini theme park in that area. Only children with age group of 3 to 12 would be admitted from whom entrance fee would be collected. This project is expected to have a life of 5 years and the initial project cost is estimated at ₹2.50 crores.

Objective Questions

- 1.1. In which of the following processes of Risk Management, the Risk Register would least likely be considered ?
- A. Risk Analysis
 - B. Risk Identification
 - C. Risk Ranking
 - D. Risk Treatment

Answer : B is correct.

Explanation :

Risks which are already identified are noted down in the risk register along with their causes, consequences, ownership, inherent score, controls, residual score, process, action for further mitigation, action owner, due date, etc.

Sanjay Sir's Comment :

Beautiful Question - it is too subtle for most people to answer - Average performance would have been poor.

- 1.2. Which of the following is not a characteristic of Risk Appetite ?
- A. In the normal course, evaluating the Risk Appetite is out of audit scope.
 - B. Risk Appetite is understanding control and other response activities.
 - C. Risk Appetite provides a standard against which a risk can be compared.
 - D. Internal auditors can do a consulting activity of assisting the Board in fixing the Risk Appetite.

Answer : B is correct.

Explanation :

Controls and other response activities are not a part of determining Risk Appetite. When assessed risk exceeds risk appetite, Response techniques are decided upon.

Page 8.4 clearly speaks out Option A, C and D.

Sanjay Sir's Comment :

This is a straightforward Question. So much discussion has taken place on Risk Appetite during classes, as well as the 21 audios that I had shared prior to the RM exam, that you should have got Option B.

Average performance should be Good in this question

1.3. *He advised them to have values, attitudes, competencies, and behaviour which would in-turn determine the company's commitment and style of Operational Risk Management.*

The advice of Mr. Kannan could be better termed as:

- A. Risk Culture**
- B. Risk Focus**
- C. Risk Framework**
- D. Corporate Governance**

Answer : A is correct.

Explanation :

Refer page 8.6 - Key 6 - embed ERM into the Business Fabric of the organization.

Sanjay Sir's Comment :

It is exactly about cultural issues that I had shared - a short write-up on the morning of the RM exam in mytelegram channel. In case you don't have the same, it is reproduced below with the portion highlighted(Tone from the top). *Average performance would be good.*

1. Risk is the possibility that events can happen and they will affect the organisations ability to create, preserve and realize value for stakeholders.

2. The objective of risk management is to help organisations create a comprehensive response to risk management. Organisation should be proactive and agile when a situation arises and deal with the same in a value creative/ preservative manner in a cost efficient manner.

3. **Tone from the top**

It is the duty of the board and senior management to establish cultural values with high regards to ethics and ensure that the interests of all stakeholders and optimally prioritised and addressed .

They got to clearly speak out organisations mission, vision, objectives and strategies. They need to articulate the setting up of policies and procedures for risk identification and assessment throughout the organisation.

They need to clearly speak out organisations risk appetite at entity level and then broken down to business unit and functional level such that there is respect for risk management from the PEAK to the TAIL.

management

4. **Then entire structure of communications wrt risk management**

- BOARD OF DIRECTORS
- RISK COMMITTEE
- AUDIT COMMITTEE
- SENIOR MANAGEMENT
- CRO
- BUINESS LINES
- PROCESSES

This needs to be streamlines so that any exceptions can be brought to the notice of the board.

5. There needs to be optimal capital allocation of risk appetite to different busines lines and products. Remember the overarching principle to create , preserve and realize value for stakeholders while staying within the risk appetite defined.

6. Risk- Likelihood × consequence

Heat map needs to be prepared

Control measures got be assessed discretely via RCSA and continuously via KRI's.

Reporting of losses encountered got to be in place.

7. Risk maturity of an organisation will decide upon organisations audit plan and then EEM implementation.

8. The three lines of defence -

- Business unit level...Risk takers
- Risk management committee...Risk managers
- Risk Assurance....Auditors

These 3 are the pillars of RM.

9. Top level risks present in all organisations-

- STRATEGIC
- OPERATIONAL
- FINANCIAL
- GOVERNANCE
- LEGAL AND COMPLIANCE.

- 1.4. In his study, Mr. sumit, would least likely be concerned with which of the following ?
- A. Online shopping
 - B. Frequent changes to prices of the products
 - C. Compliance with rules and regulations
 - D. Failure in supply chains

Answer : B* is correct.

Explanation :

- A. **Online Shopping** - Online Shopping is a cause of concern owing to the hotlisted credit card payments not settled
- C. **Compliance with Rules and Regulations** - is a cause of concern as centralized policies are not being complied with as evident in issue 2, 3, 4, 6 and 7 of Mr. Smith.
- D. **Failure in Supply Chains** - This is a cause of concern owing to issue 2, where goods supplied by distributors are nearing expiry date and also issue 3 relating to inter store transfers. It also relates to issue 6 relating to suppliers' directly made payment by Purchase Manager

Option B - Frequent change in the price of products - it is not the cause of concern as there is no mention about frequent price changes except the discounts allowed in issue 4.

Sanjay Sir's Comment :

It would be cruel if ICAI mentions Option D as the answer, thereby stating that the discounts allowed in issue 4 result in frequent price changes. ***Average performance would be poor.***

- 1.5. CRPL could not realize the money of ₹ 2 lakhs on the credit card transactions described in the case study. The best management practice to avoid similar occurrences in the future would be:
- A. Before accepting the order, verify the card number against rejected cards history.
 - B. Before processing the order, verify the card number against rejected cards history.
 - C. Before dispatching the goods, verify the settlement made by the banker.
 - D. Verifying the card number against rejected cards history after rejection of the transaction by the banker.

Answer : B is correct

Explanation :

Firm should accept the order and then check the validation of the card number on the bank's API. Once verified, processing should begin. This way, order acceptance is smooth and no Frictions caused at customer's end. Since resources are expended in order processing, we are getting confirmation from the bank's API before processing - this results in saving our resources.

Option A can be done, but it would hurt customer experience.

Option C can be done, but it is difficult to synchronize dispatch with settlement in practical life.

Option D is laughable.....remember the proverb " Don't cry over spilled milk" - "*aab pachtaaye hoth kyaa jabb chidiya chuugayi khet!!*"

Sanjay Sir's Comment :

When we claim to be specializing in Audit and specially bank Audit, it is wrong for anyone to raise raise flag over such common sensical questions. ***Average performance would be average***

DESCRIPTIVE QUESTIONS

1.6. What are the specific controls that you would suggest for the issues observed by CRPL ?

Answer :

1. There are no access control restrictions for entering the area in which bar-coding of products is done.

Proper access restrictions should be in place for strategic areas like area of bar-coding of products and only designated personnel should have access. This will amount to accountability.

2. The store manager of the main store issued orders manually for a product which is fast selling from a nearby distributor on an urgent basis, without getting approval from the manager and it was later found that the expiry date on the lot was due to expire in the next three days.

This is a clear cut violation of standard policies and procedures i.e. the policy regarding Standardized Purchases. Firm has to ensure strict adherence to the policy. Distributors should not access orders from Store Managers.

Proper system should be in place for situations like this- Store manager should not have been able to issue an order without proper approval from manager. If manager is not available, a system or checklist should be in place before issuing the order. Expiry date problem would have come to notice if it were on the checklist.

3. Sometimes, based on the requirements of another store, goods were transferred from one store to the other, It was noticed, on a particular-day, 100 quantities of a product were transferred from one store to another. The receiving store accounted for only 80 quantities. There were no procedures to acknowledge the receipt and delivery of goods from one store to the other.

Inter-store transfer should have proper procedure & documentation process for acknowledging the delivery, receipt and physical check of the material received.

- 4. The salesmen were given a leeway of allowing a discount upto 2% on the sale price. It was found that some salesmen were giving a constant 2% discount to all the customers with whom they dealt with.**

Periodical checks (random sample selection or salesman wise data) on discounts being offered by salesman to customers.

There should be some provisions for call recording, detailing the nature of negotiations and these could be checked on a random basis.

- 5. CRPL's policy is that the cash collections of each day, must be deposited on the next working day into the bank account. Such cash was required to be kept in the safety locker by the cashier of the store. On three days in the past three months, there were cash shortages to the tune of ₹ 5 lakhs in four stores. The respective cashiers said that they have correctly calculated the cash collections and kept the cash in the safety lockers, but in the next morning the cash was found to be in shortage. One locker key was with the cashier and the other was with the managing director.**

Cash collections should go through more than one layer of checks (not just the cashier). The key to the safety locker should be with just 1 person for 100% accountability.

They could also arrange for daily cash collections by bank such that only a nominal amount of cash stays overnight - they could also explore the possibility of installing cameras showing counting of cash and access to locker.

- 6. On some days when the general manager was not available, the purchase manager passed the payments to the suppliers.**

This is a clear cut violation of centralized policies and procedures. Firm has to ensure compliance of it's policies and procedures. Purchase manager should not have the authority to make payment to suppliers under any circumstance whatsoever.

- 7. CRPL's credit policy allowed a credit of ₹ 50,000/- only for customers who have purchased more than ₹3 lakhs on an average in the past three years. It was noticed that two customers purchased more than ₹ 1 lakh on credit.**

Systems should be such that credit should not have been extended (by the system itself) to customer beyond the permissible limit (50,000 in this case). Or system should flag the same on real-time basis when the limit crossed.

1.7. The proposed theme park project, as suggested by Mr. Deepak, is estimated to have

- i. an annual cash inflow of ₹ 75 lakhs and**
- ii. cost of capital is 10%.**

Identify which of the three factors, viz., initial project cost, annual cash inflow and project life in years, the project is most sensitive if the variable is adversely affected by 10% ?

(Use annuity factors: for 10% = 3.7908 and 11% = 3.6959)

Answer :

Step 1 – Calculation of Expected NPV

Expected Life of the Project	–	5 years
Discount Rate	–	10%
Initial Investment	–	Rs. 250 lakhs
Annual cashflows	–	Rs. 75 lakhs
PVAF (10%, 5)	–	3.7908
Therefore, Expected NPV	=	Rs. (75×3.7908 – 250) lakhs = Rs.34.31 lakhs

Step 2 – Sensitivity with respect to each factor :

Case 1 : Sensitivity with respect to initial project cost

Initial Project Cost = Rs. 250 lakhs (given)

Upward shock of 10% = Rs. 25 lakhs.

Total Cost = Rs. (250 + 25) lakhs = Rs. 275 lakhs.

Therefore, new NPV = Rs. (75×3.7908 – 275) lakhs = Rs. 9.31 lakhs.

Hence, fall in NPV = Rs.(34.31 – 9.31) = Rs. 25 lakhs.

[Of course, it could have been directly done]

Therefore, Percentage fall = $(25/34.31) \times 100 = 72.86\%$

Case 2 : Sensitivity with respect to annual cash inflow

Initial Project Cost = Rs. 250 lakhs

Annual Cash inflow = Rs. 75 lakhs (given)

Downward Shock of 10% = Rs. 7.5 lakhs

Net Cash inflow = Rs. (75–7.5) lakhs = Rs. 67.5 lakhs.

Therefore, new NPV = Rs. (67.5×3.7908 – 250) lakhs = Rs. 5.879 lakhs.

Hence, fall in NPV = Rs.(34.31 – 5.879) = Rs. 28.431 lakhs.

Therefore, Percentage fall = (28.431/34.31)×100 = 82.86%

Case 3 : Sensitivity with respect to project life

Initial Project Cost = Rs. 250 lakhs

Annual Cash inflow = Rs. 75 lakhs

Project Life = 5 years (given)

Downward Shock of 10% = 4.5 years

Expected NPV for 4 years =

PVAF (10%,4) = 3.16987 :

Hence, (75×3.16987 – 250) = Rs. (12.26)

Expected NPV for 5 years = Rs. 34.31

Using Linear Interpolation, Expected NPV for 4.5 years = [(34.31 – 12.26)/2] = Rs. 11.02 lakhs

Hence, fall in NPV = Rs.(34.31 – 11.02) = Rs. 23.29 lakhs.

Therefore, Percentage fall = (23.29/34.31)×100 = 67.88%

Step 3 – Summary of the Results of Sensitivity Analysis

10% adverse shock in Factor	Percentage Fall in NPV
Initial Investment	72.86%
Annual Cashflows	82.86%
Expected Life of the project	67.88%

Step 4 – Conclusion

Cashflow factor is the most critical since the percentage fall is the highest.

Sanjay Sir's Comment :

This is THE easiest sum on sensitivity analysis. Even here, ICAI seems to have committed a mistake. It is my guess that instead of project life, they wanted us to carry out sensitivity with the discount rate. That's the reason why PVAF (11%, 5) is also given because, if you shock Kc of 10% upward by 10%, you get 11%. In fact, you cannot calculate NPV for 4.5 years. We have just done it with the sake of doing it.

- 1.8. Write the risk actions and risk responses for the risks faced by CRPL as extracted from its Risk and Control Matrix.

Answer :

Sl.	Risk faced	Risk Action	Risk Response
1.	Risk of inadequate training to Employees	Employees are most instrumental for smooth running of any business/firm and hence its most important to ensure that they are well trained in their respective fields. Risk of inadequate training could be managed by Outsourcing the training aspect to an expert agency/consultancy that specialises in employee training.	Transfer/ Share
Alt 1.	Risk of inadequate training to Employees	CRPL should engage in rigorous training	Manage/Reduce

		<p>of employees in house by senior managers and outside consultants. It should also carry out regular tests or appraisals of such trainings.</p>	
2.	Risk of being affected by natural calamities	<p>Risk of natural calamity can be either transferred by buying insurance for appropriate coverage or it could be Accepted. In this case, the cost benefit analysis says otherwise (Expected loss = $0.01 \times 25,00,000 = \text{Rs } 25000$ vs $\text{Rs } 30000$ premium). Hence, it would be prudent to accept the risk.</p>	Accept/Retain
3.	Risk of discarding products-expiry date issue	<p>Products that carry the risk of expiry need special attention and strategy for reducing resulting losses. This would include but not be restricted to proper demand assessment, automated system</p>	Manage/Reduce

		for handling order-flow to ensure demand-supply-expiry match, agile system and periodical review for slow moving items with short shelf life	
4.	Risk of theft by employees	This action is taken to reduce the likelihood as well as impact of the risk. In this case, addressing the root cause is important- proper vigilance/ security system should be in place for ensuring that employees or anyone else is unable to steal without getting caught. Also, engagement with employees is important by way of conducting workshops or huddle sessions to increase their confidence and loyalty towards the organisation.	Manage/Reduce
Alt 4.	Risk of theft by employees	CRPL can protect themselves by	Transfer/Share

		<p>purchasing employee theft insurance. Employee theft (also called employee dishonesty) coverage is a type of crime insurance. It compensates a business for financial losses caused by property thefts committed by employees.</p>	
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