Introduction

There are three sections to the assignment you are required to complete each part, the assignment is worth 20% of the overall assessment for the subject. The assignment can be completed as a group assignment with the maximum number of students in a group to be 3.

The Assignment is to be uploaded into moodle by the Friday end of week 11.

Please place all group members’ names and student ID on the front page and load for all students in Moodle.

The assignment is designed to allow each group to provide their knowledge of a number of aspects of the course. Some of information will require further research.The assignment contains the following sections the marks assigned to each question are indicated.

Section A

Case study operational risks -20 marks. A short presentation is required 5 to 10 minutes, THIS WILL BE HELD IN WEEK 12

Section B

Financial Risk Management -Situation analysis 20 marks

Section C

Three (3) Shortanswer questions 3 -20 marks.

**Section A – 20 marks**

CASE SYNOPSIS

The case relates to risk assessment in a multinational organization which a joint venture between entities in two different countries. It is loosely based on a real world situation and so, the organization’s name and potential identifying information are disguised.

The case is about a multinational company that is owned by Chinese and Japanese partners in a joint venture relationship. The company has been in business for a number of years and operates one ferry boat carrying passengers and cargo between China and Japan. The business is competitive (low barrier to entry), seasonal (most income received in second half of year), directional (higher volume from China), and skewed (high income from cargo shipments). The ferry boat is aging and the company is concerned about the replacement cost.

Also, all payments are made in foreign currencies (US Dollars or Japanese yen) which are converted into the local currency at year end. The company currently absorbs all foreign exchange losses but may not be able to do so indefinitely. The company is concerned about its market position and is interested in performing a risk assessment, using elements of the COSO/ERM framework, to help identify threats and potential risk mitigating strategies. Page 106 Journal of the International Academy for Case Studies, Volume 19, Number1, 2013

INTRODUCTION

Shanghai-Tokyo International Ferry Co. Ltd or ShangTIF Co. (the company) was founded in 1985 and is a joint venture between Shanghai Ocean Shipping Co. and a Japanese private citizen. Shanghai Ocean Shipping Co., the Chinese co-owner, is one of the major multinational enterprises in the world specializing in global shipping, modern logistics, and ship building and repairing. The Japanese co-owner is one of the wealthiest people in the world with business interests in various industries. However, he prefers that his name remain confidential and private.

Having achieved his initial goals, the Japanese co-owner is not interested in providing any additional capital infusion into the business. ShangTIF is located in Shanghai, China and operates a 345 person ferry boat that transports passengers and cargo across the Sea of Japan (or East Sea). The ship has one primary route, China to Japan and it makes round trips between Shanghai and Tokyo, Japan. The ferry boat departs from Shanghai on Thursdays and arrives in Japan on Mondays; it departs Japan on Tuesdays and return to Shanghai on Thursdays.

**COMPANY STRUCTURE**

ShangTIF is headed by a general manager Mr Charles Chan who joined the company at its inception. He is supported by various departments including Accounting, Marketing, Reservations, and Human Resources. Key executive levels within the company are the chief financial officer, a marketing director and the human resources manager. Ms Suzanne Chin serves as the chief financial officer and assistant general manager. Mr Chan has a good relationship with the owners but is expected to be succeeded by Ms Chin in case his employment is terminated for any reason with the organization.

Since the company operates in Japan, each department including the crew has at least one Japanese speaking employee. The company rents its corporate offices in Shanghai as well as a satellite office and reservation centre in Japan. It leases docking spaces in both China and Japan from its owners. The company has a total of 30 employees in both the Shanghai and Tokyo offices. Overall, ShangTIF operates from a simple corporate structure as depicted in its organization chart below: Page 107Journal of the International Academy for Case Studies, Volume 19, Number 1, 2013

An important element of the company is the passenger crew. Since one of the joint venture partners is in a similar business, the crew is rented from this parent company. However, the rental cost is increasing each year and the company wants to manage its overall expenses. It is interested in exploring ways to streamline staff in order to reduce both personnel and occupancy costs.

**INDUSTRY PROFILE**

The ferry business is highly regulated and government approval is needed in order to operate a route. ShangTIF is registered in China and is limited to its one route, China-Japan, and has no expansion plans beyond its current destinations. As a Chinese registered company, Shanghai TIF is required to use the Accounting Standards for Business Enterprises or China GAAP for accounting and reporting purposes. Although the business is regulated it is also competitive since the barrier to entry is fairly low. However, as a ferry company, ShangTIF must comply with international maritime safety regulations.

These regulations cover fire protection, safety regulations, navigation systems, Page 108 Journal of the International Academy for Case Studies, Volume 19, Number1, 2013 cargo operations safety, and environmental issues. The company has implemented all safety standards and the applicable certificates are on file to evidence compliance. ShangTIF also needs governmental approval from both operating countries (i.e., Japan and China) in order to operate its business.

The approval process is relatively easy and a number of ferry companies have entered the marketplace competing primarily on prices. In order to compete successfully ShangTIF relies on its competitive advantage of quality and outstanding customer service including timely delivery. Since it transports passengers as well as cargo, it is considered a passenger ferry and so receives favourable treatment from customs because of the passengers on board. This allows it always be on time with its cargo deliveries.

If classified as a cargo company, the ship must be docked offshore and linger in a queue which could take up to seven days as it waits to unload its freight. Therefore, ShangTIF considers its product a premium service and charges a higher rate than its competitors. However, its cost structure is also higher than its competitors.

**BUSINESS OPERATIONS AND FINANCIAL INFORMATION**

ShangTIF operates its business using only one ship. The ship was purchased in 1985 for 28 million Renminbi (Rmb) and it has a 35 year useful life. The replacement cost for a similar ship ranges from 200-300 million Rmb. The ship is overhauled annually for 10 days at a cost of 5-6 million RMB. It undergoes weekly inspections and any minor repairs on Fridays when it is at its home pier in Shanghai. Since this is the only ship, it must be kept in top condition at all times. The configuration of the ship allows for 250 containers in the bottom and 354 passenger spaces.

ShangTIF earns 205 million Rmb in annual revenue, with cargo shipments accounting for 88% of the total. This includes surcharge revenue which is earned on the export tax charged to shippers. Its annual passenger volume is 10,000 even though it takes two days to complete each journey between China and Japan. This compares unfavorably to air travel between the two countries which takes approximately two hours. However, the company is in a niche market and its ideal passenger is an individual who is afraid to fly or simply has extra time and wishes to enjoy the scenery.

ShangTIF’s business is highly seasonal, with the first half of the year being lower and the second half much higher. Typically, the period of May-June historically has the lowest volume levels and the month of August experiencing the highest volume levels. This generally places a strain on the company’s resources as it is unable to meet all its cargo shipment demands. The business is also highly directional in that the China to Japan route has a higher occupancy rate for cargo than the return trip.

This gives the company some pricing power and it generally charges a higher price for cargo heading to Japan. This imbalance in cargo space does impact the company since it must cover its fixed costs regardless of the cargo levels. As a result, it offers discount to Chinese exporters if they will guaranteed cargo coming back from Japan. Page 109 Journal of the International Academy for Case Studies, Volume 19, Number 1, 2013 Japan is located in an area known as ‘The Ring of Fire’, an area with many natural disasters such as earthquakes and volcanoes.

A major earthquake or volcanic activity could impact the company’s operations. For instance, the 2011 Japanese earthquake had a negative impact on the company’s passenger volume as the Chinese curtailed their travel to Japan. This equated to a reduction of approximately 3,000 passengers in the first half of 2011 with a corresponding revenue shortfall of 1 million Rmb. The rising cost of fuel is also having an impact on the company’s business. Fuel costs ranges from 30-40 million Rmb annually and is currently 30% of the company’s total costs. This cost is greatly impacted by the worldwide and local demand for crude oil.

ShangTIF sources cargo through two channels, its passengers or a forwarding agency. The company’s marketing department works with tour operators to identify higher wealth passengers who might be inclined to take a leisurely two day journey by sea. It works with the forwarding agency to find related cargo. The company’s reputation in the market place for good customer service and prompt arrivals makes it easy to attract shipments.

The company accepts payments for all services in US dollars for exports and in Japanese Yen for imports. At year end, it converts these currencies into its reporting currency, Rmb, using the current exchange rates. This results in a currency loss since the Rmb is stronger relative to the US dollar and Japanese Yen. (China and Japan agreed in December 2011 to begin direct trading of their currencies thus eliminating the need for businesses to first convert their currencies into US Dollars. This could impact ShangTIF in the future but it was not a known event at the time of the case).

The following exchange rates existed at the time of the case:

Rmb/Yen – 12.477

Rmb/US Dollar – 0.1547

US Dollar/Yen – 80.605

The company absorbs all losses which may not be sustainable into the future. Overall, the company’s accounting transactions are fairly simple with no fair value or related party issues. The chief financial officer believes that the current accounting information system is adequate for the company and has no plans to upgrade it.

**CALL TO ACTION**

The company is concerned about its industry position and is interested in performing a risk assessment to identify the threats to its business and the potential treatments. Since there is no risk manager or audit personnel on staff, you are tasked with this assignment. To achieve this goal, you need to:

1. Identify at least 10 business risks facing ShangTIF and the business objective (at least 2 risks per objective) impacted.

1. Define the business risk and using language applicable to the company
2. Employ judgment to prioritize the risks identified using the qualitative measures of high, medium and low.
3. Provide a brief justification for the ranking using information provided in the case.
4. Indicate the risk response strategy (i.e., Avoid, Reduce, Share or Accept) that management could use to address the identified risks.

2. Suggest control activities that management could implement to address the risks identified.

(Note: control activities are usually risk reduction strategies which may not be necessary for all risk responses)

3. Organize your responses using the format below: Entity’s Objective Specific Risk Risk Ranking/ Justification Risk Response Control ActivityCase Study

How would you describe the organisations risk environment?

What advice would you give to management?

What risks would you consider the most urgent?

What changes would you recommend to management, include areas of organisational culture and governance in you report.

**Section B - 20 Marks**

You are the bank manager for a regional bank and you have a number of relatively large corporate organisations as clients. Recently you attended an internal training session organised by head office of the bank, at the training you learnt about some new products that the bank was introducing, including interest rate swaps, currency swaps and other forms of derivatives.

The following day you have a prearranged with James Lincoln the Chief Executive of Diamond Corporation Ltd (a diamond mining corporation and client of the bank), James indicates that he has a view that interest rates will fall and while he has a fixed interest loan comprising debentures issued for his business of $5,000,000, his company is paying 7% on these debentures he would like to be in a position to take advantage of the fall in interest rates and change the interest rate to a variable rate.

The following day, you are at a lunch with a friend Luke Washington, the Chief Executive of Random Trading Pty Ltd the company is not a client of your bank. Luke indicates that his company wants to borrow $5,000,000 for growth.

Luke also indicates that he is nervous about the having an exposure to potential rises in interest rates and asks your advice as to what he can do to reduce his perceived risk situation.Luke has received quotes from his bank to borrow the 5 million at a fixed interest rate of %10 or on a floating basis of BBSW plus 1%. He feels that 10% is too high and would be happy if he could fix his interest rate below 10% which he has been quoted from other bank.You say that you have an idea that may give him a better solution and that you will come back to him with a possible solution.

After returning to your office you remember you recent training on the new products and decide to investigate further, you review the information you have acquired about two companies which you summarise as follows;

**Diamond Corporation**

Debenture Loan amount; **$**5,000,000

Interest rate fixed at 7% for a further 3 years

Other information; credit rating of AAA

**Random Trading**

Loan amount required; **$**5,000,000

Term 3 years

Fixed rate loan; 10%

Variable Interest rate at BBSW plus 1% (Bank Bill Swap Rate)for a further 3 years

Other information; credit rating of ABB

Note BBSW (bank bill swap rate) is currently 5%.

Required

As the bank manager

1. What possible solution could you provide that would hedge the perceived interest risk at both companies? Provide a short note to each company outline the actions they should take, subject to approval by your bank, to achieve the interest rate exposures in line with each companies view on future interest rate movements .
2. Prepare a proposal document for the banks managementand risk committee for approval outlining the solution with a diagram explaining how your solution would help address the risk perspective of both organisations. It includes the bank making 0.5% from the arrangement.
3. Explain how
   1. Both organisations will potentially benefit from the arrangement
   2. What the overall net interest position could be for the companies

**Section C - 20 marks**

Research the following financial off balance sheet instruments

1. Foreign Currency forwards exchange contract
2. Interest rate option
3. Currency swap

Provide a review of each instrument identifying and defining the instrument, explain how the instrument is used to manage risk in each case and provide a practical situation in which the application of the instrument may be used to mitigate a Financial Risk for a fictitious company. One page for each instrument (4 – 5 paragraphs)