Answer to Question One

(a)  (i) The Board’s composition has a bias towards the executive members. There are four executive directors, plus a Company Secretary and only one non-executive. Insufficient attention is being paid to the potential contribution that non-executive directors might make in terms of the overall management of DEF. The lack of non-executive directors means that there can be no supervision in the form of an audit committee or remuneration committee to exercise oversight of the executive directors.

Understandably, the executive directors all have very specific job titles. The focus is on facilities, finance and commercial matters. This emphasis on operational and commercial aspects of the business may exclude adequate consideration of other issues, such as social and environmental matters or DEF’s responsibilities as an employer.

The chairmanship of any entity is extremely important. DEF’s chairman is in post for only two years, which does not permit time for a new chairman to establish an agenda and then to see it through. That could lead to inconsistent pursuit of different strategic directions with every change of chairmanship. This problem is made worse by the fact that there are no other non-executive directors in place to ensure a degree of continuity from one chairmanship to the next.

The fact that each new chairman is appointed by a different LSG in turn may also be a problem because different LSGs may have different interests in DEF. For example, if employees tend to live in and travel from one of the local states then that LSG will view DEF as a major employer and that could have implications for the manner in which it would like DEF to develop. It would be far better if each of the four LSGs could appoint a non-executive director.

(ii) Strictly speaking, the Chairman (and the Board as a whole) should act in the interests of the shareholders and not of the entity itself. It is not for the directors to decide not to pursue any business proposition that could be in the shareholders’ interests.

Having said that, the LSGs who own DEF may be interested in more than just the profitability of the airport. The closure of the airport could be costly in terms of employment or the profile of the four states. Thus, the fears about Max’s motives should be reported to the LSGs in order to ensure that any decision is fully informed with respect to the implications for the local population.
The fact that Max has not revealed the identity of the client suggests that the Board should be cautious. Max could represent a competitor who is trying to gather information or may represent a party who does not have the resources to purchase the 51% stake. It may be that the Board would be justified in withholding information from Max until it becomes clearer that they will not harm the company by divulging anything to him.

If Max demonstrates that a viable offer will be forthcoming then the Chairman should call a meeting of the LSGs to decide whether or not to take matters further. The Chairman should make full disclosure of all relevant facts and should also present any fears concerning the future of the workforce or the viability of the airport.

(iii) The mission statement provides a sound basis for marketing because it promises a great deal to customers. In that sense, it could support DEF’s commercial activities.

DEF is committed to outperforming all other regional airports, which ignores the fact that it may prove impossible to do so. Other airports may have advantages that will make it difficult or impossible to compete on quality of service. For example, DEF’s location may make it more susceptible than other airports to delays or flight cancellations and that will affect its ability to compete. This commitment could, therefore, prove extremely costly. Aiming for the highest quality may involve unnecessary cost. Airlines and their passengers may prefer a simple service that is efficient and cost-effective. There may also be a commercial argument for offering an acceptable service, given that the main factor affecting passenger choice is the location of the airport itself. Passengers may have little real choice of airport if they wish to travel to a location in the vicinity of DEF.

The reference to “best people” could be interpreted as elitist. If employees do not believe that DEF is treating them as the “best” then they could feel resentful.

Promising high ethical standards and good corporate citizenship may be incompatible with the fact that air travel is frequently viewed as having an adverse impact on the environment. It is not necessarily for DEF to defend the morality of air travel, but this claim could leave the company open to challenge.

(b) (i) The biggest risk is that DEF may find that other airlines wish to pay in US$ if they discover DEF’s new policy. International airlines are likely to have significant receipts and payments denominated in US$ be hedged to deal with those cash flows. It may be more convenient for an airline based in, say, Malaysia to pay DEF in US$ than to make payments in D$. If DEF’s US$ receipts significantly exceed its requirements for the bureau de change then it could have an unexpected and unwelcome exposure to movements on the US$.

Managing the US$ account could prove time-consuming and expensive. There could be significant bank charges for deposits and withdrawals.

In theory, this arrangement will give DEF a natural hedge between its US$ revenue and outgoings. It is, however, debatable whether it will obtain a significant benefit from this hedge because the cost of the US$ being exchanged for D$ was already hedged by the fact that any strengthening of the US$ was passed on to passengers in the form of a less attractive rate. DEF will always gain from the sale of US$ through the bureau de change provided it never buys such large quantities that it is left with significant holdings of US$ at a time when the currency is dropping in value.

It is highly likely that DEF already had a partial hedge in the form of passengers arriving from the US who wished to exchange US$ for D$ while at the airport.

Overall, the proposal is unlikely to benefit DEF greatly.

(ii) Internal hedging arrangements are generally less expensive than external. The purchase of financial instruments generally involves premia, professional fees and commissions. In many circumstances, internal hedging arrangements can cost little or nothing to organise. For example, a company operating in the Eurozone that is forced to accept payments in
US$ may hedge its exposure by importing materials that are priced in US$. Any devaluation of the US$ will reduce the revenues but also the costs.

Offsetting or matching currencies is a simple concept which means that internal hedging is also potentially easier to understand. Many financial instruments are extremely complicated and may be sold by financial institutions who have little incentive to make the risks and rewards easy for non-experts to fully appreciate.

Internal hedging can sometimes be used to deal with economic exposure, which is not always open to being remedied by way of financial instruments. The fact that costs and revenues are likely to be pushed in the same direction means that there is less risk of being undercut by an overseas competitor. Financial instruments can be invaluable in dealing with very specific and short-term exposures, such as a large receivable denominated in another currency, but long-term fluctuations in costs or revenues cannot be adequately dealt with by means of derivatives.

(c) It is unlikely that these payments will leave the shops exposed to any significant currency exposure because the amounts of any given currency are likely to be relatively small and the balances will be converted to D$ on a daily basis.

The biggest risk is that of staff fraud. The fact that some takings are in foreign currency may make it difficult to reconcile till operators’ daily takings. If the software in the tills can deal with the foreign currency takings then there is still a risk that the till operators will charge the customer the correct D$ amount and settle the balance using their own D$. Then they could take the more valuable foreign currency to exchange for themselves. The fact that there will be rounding errors in calculating change may also introduce discrepancies which could increase the risk of theft of takings.

Transactions involving foreign currencies may take longer and cost the retailers business. All of the customers using this facility will have limited time available because of the need to get to departure gates in time for boarding.

The costs of keeping the system up to date with the exchange rate for every major currency could be significant. There could also be substantial banking charges incurred for making fairly small deposits of some currencies on a daily basis.

There is a significant risk that staff will accept forged bank notes. It will be relatively easy to pass forged notes to a shop assistant who does not handle that currency on a regular basis.
Answer to Question Two

(a) (i) The Chief Executive’s logic is consistent with the Council’s legal and moral duty to provide their staff with a safe working environment. Workplace injuries are frequently preventable, given the necessary commitment on the part of all managers and staff. Establishing a “zero tolerance” policy should help to ensure that safety remains a priority.

If the Council is aiming to eliminate all workplace injuries then a policy will have to be decided for dealing with injuries that do occur. That policy will have to set out a procedure for the investigation of the factors that led to the injury. If injuries are not investigated fully and those investigations are not acted upon then the Chief Executive’s views will not be taken seriously.

There will be significant costs associated with investigating minor injuries such as shallow cuts and abrasions. Supervisors may become demoralised if they are held accountable for “trivial” injuries that may have been due to staff carelessness rather than a failure of supervision.

(ii) Given the number of employees and the range of occupations undertaken, it would be virtually impossible to eliminate all injuries. A responsible employer should assess the risks associated with all tasks and take all reasonable steps to manage risks. For example, staff whose jobs involve lifting heavy objects should be trained in lifting techniques and should also be taught how to determine whether an object can be lifted safely. There could still be a possibility of accidents due to lapses in concentration or other unavoidable problems.

The biggest danger in accepting that injuries cannot be eliminated altogether is that such an attitude may lead to complacency. Given the health and safety issues involved, it is desirable for all staff to work towards a perfect record if possible.

There is also a possibility that the Director of Operations’ statement could be used against the Council in the case of an injured employee seeking compensation. Any evidence that the Council had decided to accept the risk of workplace injuries could be used in support of an allegation of negligence.

(b) (i) The internal auditor has reason to believe that records are being falsified that could threaten the health and safety of staff at the depot. If members of staff stop reporting minor cuts and bruises then the Council will not be aware of risks that could result in a more serious accident, such as a safety issue with a particular machine. That could lead to avoidable accidents occurring because the need for repairs or modifications was not apparent.

Remaining silent about these allegations could be viewed as a breach of the requirement to apply professional competence and due care.

Going over the head of internal audit by reporting directly to the Chief Executive or another senior officer would breach the duty to demonstrate professional behaviour. She is subordinate to her head of department and he has ruled that the matter is to be taken no further. Any report that cannot be substantiated could lead to a waste of time and effort and could undermine the credibility of internal audit.

Any report to a third party would reach the internal auditor’s duty of confidence. As an employee, she has a duty not to divulge any information to a third party. The fact that she
is a CIMA member, as so bound by CIMA’s Code of Ethics for Professional Accountants, makes that duty even more significant.

(ii) The internal auditor should consider whether she has reason to believe that any inaction on her part is likely to lead to a serious risk to life or health. If the records that are being suppressed relate to trivial cuts and bruises and are unlikely to leave staff exposed to more serious risks then she should almost certainly do nothing further.

It would be possible for her to approach the depot manager and seek an explanation as to whether these allegations are true. If the manager makes a genuine commitment to report honestly then the problem will be resolved.

If her review of the facts suggests that the depot’s reporting practices are significantly increasing the risk of severe injuries then she should take matters further. The depot had two out of only three severe injuries for the Council as a whole. Failing to act on such information could be viewed as criminal negligence on her part.

Any report should be made in the first instance to an appropriate senior Council officer, possibly addressed to the Chief Executive in the first instance. She should only report to a third party, such as the Health and Safety Executive, if the risk is high enough to justify the breach of confidence and the internal report is ignored.

If she does go over her Head of Internal Audit then she may feel it necessary to resign.

*There is not necessarily a “correct” response to an ethical dilemma. Marks will be awarded for the logic applied in the answer.*
Answer to Question Three

(a) This system is too important to the efficient running of T to dispense with a post-implementation review. The review offers the opportunity to check that all users feel that their needs are being met. The review also ensures that the system is performing in accordance with the system specification.

In a sense, it is possible that many of the results that would have been obtained from a formal review will come to light if users are dissatisfied. To that extent, the cost and effort of a formal review could be avoided. That assumes, though, that users will understand what features and performance they should be expecting from the new system. Some problems will not necessarily be apparent to users, who may not try every feature or be able to identify slow-running or inefficient user interfaces.

This system is far more sophisticated than anything that T’s staff have had to work with before and so they may not be aware of what it is realistic to expect. There is also a degree of urgency because the help desk facility will only be available for three months. The system is also extremely important to T’s operations and its control over cash and inventory. Many of the controls that have been conducted manually in the past are now dependent on the new IT system.

The fact that the system is a standard package reduces the risks of not conducting a review because any major bugs should have been identified by other users and correct by the vendor. That does not alter the fact that the system has been adapted slightly and also installed on T’s hardware, both of which could have led to problems.

(b) The internal audit department is independent of the design and implementation of the system and so the auditors should be able to conduct an honest and objective review.

The internal audit department will also be well qualified to identify the important areas that will determine the success or failure of the new system. Their understanding of the previous control system and the running of the company as a whole will mean that they know which aspects of the system are critical to T’s success.

T’s previous system was not particularly sophisticated, which suggests that the internal auditors may not be that well qualified or experienced to review the new system. They may miss important areas that would be more within the expertise of a qualified IT consultant. T’s internal audit department may have little or no experience of the operation of computer assisted audit techniques, which may be the only means of conducting certain compliance tests.

(c) A parallel run is the most stringent test possible of the software and the input of data. Differences between the figures produced in the parallel run will indicate:

- programming errors in the new system
- errors in the inputting of the initial data when the present position was entered into the new system
- input errors due to problems with the new system’s interface, such as staff not understanding what is to be input and where
- errors in the old system

The differences will have to be reconciled before their reason can be identified, but a successful parallel run will bring major errors to light very quickly. By implication, failure to conduct such a run will increase the risk that these errors will remain undetected in the short run.

If there is a problem with the system then it may not come to light for some time. A parallel run has the ability to highlight errors within one reporting period. The discovery of
processing errors is rather urgent because the more transactions that require correction the more difficult and expensive it will be to restore the accuracy of files.

The initial setting up of files would be an ideal opportunity for a fraudulent member of staff to make changes in order to conceal theft. The lack of a parallel run reduces the opportunity to discover such changes.

Management may have less confidence in the output from the system if it has not been tested by means of a parallel run. They may be reluctant to make changes if they were prompted by the output from the new system. That could cost the company some strategic initiative if time is spent verifying the information that led to the opportunity.
Answer to Question Four

(a) LIBOR remains at 4.1%
Interest and commission due to W = £50m x (5.0% + 0.2%) = £2.6m
Interest due to P = £50m x (4.1% + 0.8%) = £2.45m
Net sum due to W for years 1-4 = £0.15m
Net present value = 3.387 x £0.15m = £508,050

LIBOR falls to 3.9%
Net sum due to W for year 1 = £0.15m (see above)
Years 2-4
Interest and commission due to W = £2.6m (see above)
Interest due to P = £50m x (3.9% + 0.8%) = £2.35m
Net sum due to W for years 2-4 = £0.25m
Net present value to W = £0.15m x 0.935+(0.25m x (3.387-0.935)) = £753,250

LIBOR rises to 5.6%
Net sum due to W for year 1 = £0.15m (see above)
Years 2-4
Interest and commission due to W = £2.6m (see above)
Interest due to P = £50m x (5.6% + 0.8%) = £3.2m
Net sum due to P for years 2-4 = £0.6m
Net present value to W = £0.15m x 0.935 + (-0.6m x (3.387-0.935)) = (£1,330,950)

(b) (i) W is exposed to the risk that interest rates will rise to the point where it will make net payments to P. The bank could lose money on this arrangement if it pays more to finance the facility offered to the customer than it receives in interest. That appears to be a significant risk in this case because W’s own swaps department envisages that there is a realistic possibility that rates will rise to the point where W will make a significant net loss from this arrangement.

The likelihood of an interest rate increase is difficult to predict, but the term structure of interest rates gives an unbiased forecast of the market’s sentiments concerning rates. Thus, W may be able to identify a “most likely” outcome.

W is also exposed to the possibility that P will default. P has a sound credit rating and the swap arrangement requires that only the net sum due should be paid, so that appears to be a relatively minor risk.

(ii) The most obvious way for W to offset this risk would be to find a counterparty for a matching swap. In that case, W would be able to organise things so that the cash flows from one party offset those of the other, with a small net sum due to W in commission. That may be difficult in this case because the market forecasts suggest that it may be difficult to find a counterparty who is willing to speculate on interest rates falling.

Alternatively, W could attempt to hedge by obtaining more fixed interest finance to offset the risks associated with variable rate borrowing. The biggest difficulty with that is that W is a bank. Banks generally exist to take deposits on which they pay variable rate interest. Thus, W’s position will already be heavily exposed to variable interest rates.

(c) P has the opportunity to cancel the risks associated with movements on interest rates by effectively converting a variable rate loan to a fixed rate. The cost of doing so may be that W will charge a slightly higher fixed rate than if P had sought a straightforward loan and W will also charge a commission. The costs are still lower than those that will be payable if it attempts to repay the existing variable rate loan early and replace it with a fresh fixed rate loan.

P will lose out on the possibility of a reduction in interest rates, even if such a decrease is unlikely. The cost of borrowing may have a significant impact on P’s cost structure and its
competitive position. If competitors have fixed rate borrowing then they will not have an increase in costs if interest rates rise.
Section A – Question One – Compulsory

Question One  This question is based on both the common pre-seen scenario and the unseen scenario. It draws on themes that have been discussed in the context of airport management and travel in recent years, most notably the changes that are being brought about by the encroachment of low-cost airlines and the impact of economic factors on the demand for leisure and business travel. Candidates should be able to answer this question on the strength of the information provided in the paper, but even some very basic desk research on the pre-seen case should help them.

This question is split into three main parts:

Part (a) covers aspects of sections A, B and C of the syllabus – management and control systems, risk and internal control and audit and audit of control systems. It covers aspects of the higher-level strategic management of the entity, bringing in the composition of the board, the board’s responsibility to the shareholders and the implications of the mission statement.

Part (b) is drawn from section D of the syllabus – management of financial risk. It deals with the management of currency risk, focussing on the role of internal hedging techniques.

Part (c) is drawn from section C of the syllabus – review and audit of control systems. It deals with the risks associated with accepting cash payments in the form of foreign bank notes, with implications for the reconciliation and recording of takings.

Section B – answer two of three questions

Question Two Part (a) is drawn from section B of the syllabus – risk and internal control. It deals with the management of the risks associated with workplace accidents, with consequent implications for the inevitability of the risks and the need for avoidance. Part (b) is drawn from section C of the syllabus – review and audit of control systems. It deals with the ethical dilemma faced by an internal auditor who has discovered the falsification of health and safety records.

Question Three This question is drawn from section E of the syllabus – risk and control in information systems. It deals with the issues associated with implementing and testing a new information system.

Question Four This question is drawn from section D of the syllabus – management of financial risk. It deals with the use of swaps for the management of interest rate risk.

This question is partly calculation and part theory.

Part (a) asks for calculations of the net present value of the cash flow generated from the swap. Part (b) looks at the risks and mitigation of the risks of the swap from bank vs perspective and part (c) looks at the benefit of the swap.