SECTION A

Answer to Question One

Rationale
This question is based on both the common pre-seen scenario and the unseen scenario. Part (a) deals with the reputational issues associated with the organisers of a sporting competition accepting sponsorship from a fast-food company that sells unhealthy food and also from its decision to sell clothing that is sized for overweight customers. Part (b) deals with the governance of the entity that has been created to manage the games. Part (c) deals with the hedging of currency risks arising from the purchase of vehicles from a foreign supplier.

Part (a) draws mainly on section B of the syllabus (Risk and Internal Controls). The entity in question is faced with the conflicting objectives of raising revenue from as many different sources as possible, despite the fact that some of its clients will not wish to be associated with others. This could lead to a significant loss of revenue.

Part (b) draws mainly on section C of the syllabus (Audit and Audit of Control Systems). The paper provides a fairly detailed description of the entity’s governance arrangements focussing on the membership of the board and the backgrounds of those members, and asks candidates to express an opinion on the strengths and weaknesses of those arrangements.

Part (c) draws mainly on section D (Management of Financial Risk). The entity has to make a substantial payment in the future and it is considering the availability of hedge accounting as a factor in deciding whether or not to hedge the payment.
Suggested Approach

Part (a) asks candidates to think both about managing relationships with stakeholders and about the best way to resolve a public relations disaster. The entity in question has entered into some questionable transactions that undermine its credibility and candidates are asked to think about how best to manage the consequences. Suggestions have to be realistic and measured.

Part (b) requires an understanding of how an effective governance system might be structured and organised. The scenario offers a model for consideration that has both strengths and weaknesses. Candidates must recognise those strengths and weaknesses, reflecting the needs of the entity.

Part (c) focuses on the manner in which the reporting of risks may feed back into their management. Candidates should be aware of the reporting implications associated with currency risks and hedging because managers are often motivated almost as much by the perceptions of stakeholders concerning risks as they are by the risks themselves.

(a)

(i) Note: There is no specific list of three risks that must be evaluated. Credit will be given for the evaluation of any given risk provided it is shown in the course of that evaluation to be a significant risk.

Damage to GAMESCO’s reputation

Commercial organisations could discredit GAMESCO’s reputation by association. The likelihood of this appears to be very high because it has already occurred and the implications are already clearly serious because at least three major sponsors have threatened to withdraw. Many organisations may wish to align themselves to the Games in order to create a favourable impression of themselves or their products. In some cases that will be desirable because the company has a negative issue that it wishes to overcome. The Games are a popular sporting event that embody a host of positive values, including participation in exercise and maintaining a healthy lifestyle. The brand will carry a positive message. GAMESCO will appear to be cynically exploiting consumer confidence in its brand whenever it appears to be agreeing to promote or publicise a product that does not live up to the ideals of the Games. If GAMESCO damages its reputation in any way then that may undermine the appeal of the Games to the potential audience. Arguably, the incentive to watch is partly because of a sense of identification with the event in itself rather than simply interest in sport.

Sponsors must be granted a degree of control

Sponsors must retain a degree of control over the management and the promotion of the Games. They cannot risk their reputation being tainted by association with any negative publicity arising from GAMESCO’s actions. The likelihood of this is high because it would be rather reckless of sponsors to retain their association with this event in the case of serious controversy. The consequences could be serious if the threat constrains GAMESCO’s ability to manage the Games in the manner that the board sees as best. That was certainly the case with the acceptance of the Foodfast contract because this appears to offer significant revenues and even a popular amenity in the form of restaurants that will be popular with spectators. Sponsors will almost certainly reserve the right to reclaim their investment in the event of any major breach on the part of GAMESCO and that could seriously disrupt the company’s cash flow. GAMESCO could, for example, be forced to refuse potentially lucrative contracts because they have been offered by existing sponsors’ or lessees’ competitors.
Commercial activities may undermine the sporting ethos of the games
The Games appeal is largely associated with the sense of competitors striving to improve themselves through hard work. The Olympic ideals are generally found in other such major sporting activities. That appears to be likely because Country C’s government would not have made the tax concessions if the Games were being run as a commercial activity for profit. Sponsorship and the use of the Games brand for commercial gain may threaten that appeal, even if the sponsors and lessees do not have any negative associations in and of themselves, which would be a serious outcome. The danger is that the audience will become disenchanted with the Games brand being used to sponsor commercial activities and that may lead to reduced viewing figures and even demand for tickets. Sponsors and those with brand leases will be keen to maximise their own return from those investments and so GAMESCO will always be faced with an onslaught of commercial messages that may undermine the image of the Games.

(ii) Ideally, GAMESCO should work with Foodfast to manage this threat so that it can retain the sponsors’ support without refusing Foodfast’s business. One positive step would be to work with Foodfast to announce a number of initiatives that will encourage healthier eating. For example, Foodfast could introduce a special “Games” menu that will contain fewer calories and saturated fats. GAMESCO could then argue that its association with Foodfast and similar companies was an opportunity to exert a positive influence that could improve the health of consumers, which would hopefully go some way to addressing the sponsors’ concerns.

GAMESCO could stress the fact that consumers had the right to eat what they like and that the lifestyle choices that lead to overweight consumers needing larger clothes were matters of personal choice. Doing so could be used to restore public sympathy for GAMESCO, which should be relatively easy because of the popularity of fast-food and comfortable clothes. With the correct management, any withdrawal by the sponsors could be made to look as if the companies are out of touch with consumer tastes and have a dictatorial approach. GAMESCO could effectively threaten the sponsors with the loss of reputation in the event that they disassociate themselves from the Games for the reasons that they have stated.

GAMESCO should respond to the newspaper story by arguing that it is offensive to mock those who cannot attain the level of fitness possessed by the athlete in the photograph. It should be made clear that the article was effectively poking fun at a large proportion of the newspaper’s readership, many of whom are likely to have been influenced by advertisements for Foodfast and other companies that are undoubtedly published in a popular publication. That will not necessarily deal with the immediate problem with the article, but it could deter the press from publishing similar stories in the future.

GAMESCO’s lawyers should review the sponsors’ contracts and should be asked to advise on whether the sponsors have a legitimate right to withdraw under these circumstances. Foodfast is a major company that is clearly engaged in legitimate business practices and a clothing manufacturer can hardly be faulted for selling clothes that are in sizes that the public wishes to buy. It would be potentially difficult to argue that these events seriously threaten the credibility of the sponsors by association and so their claims that GAMESCO is in any material breach of its commitment under the contracts may not succeed in court.

(b) Firstly, the Board does not appear to include any non-executive directors, apart from the Chairman. That may leave the Board open to accusations of a lack of oversight and accountability.

Apart from the Chairman and Chief Executive, the membership of the Board comprises six directors who have traditional “commercial” functions: Finance Director, Operations Director, Marketing Director, Commercial Director, Communications Director, Human Resources Director; many directors with responsibility for the sporting side: Venues Director, Athletes’ Services Director and four others, each representing a specific stakeholder group: the government, the city, competitors and the Games committee.
One director for each sporting event could mean there are huge numbers of directors on The Board. If The Board has 50 or 60 directors then this may make decision making difficult as the Board will be unwieldy. Too many directors may cause problems as this could be very difficult to manage.

From a purely managerial point of view, it could be argued that a commercially aware board is highly desirable because staging the Games will be a tremendous logistical and financial challenge. There is a limited amount of cash that can be raised from sponsors and other supporters and, in principle, there may be an almost unlimited call for money to be spent on sporting facilities.

With having so many sporting events having representation on The Board it may mean that athletes might be overenthusiastic in their provision of facilities.

The fact that the meetings aim to reach consensus should reduce the risk that any given interest group is being overwhelmed by weight of numbers. The fact that decisions can be reached by a simple majority means that the board cannot be bogged down by an intransigent member who wishes to fight for a particular position. On balance, given the range of interests represented by the board, this is the most effective means of ensuring that business can be transacted.

Having members with particular allegiance to the stakeholders will ensure that there is proper communication with C’s government, the city and the Regional Games Committee. These members will not have sufficient voting power to interfere with the management of the Games, but they will be able to ensure that there is a full and open communication with the stakeholders.

Monthly meetings are probably a reasonable frequency. Perhaps the projects that are under way will not be progressing at such a pace that a monthly meeting is necessary to discuss each in turn, but the Games are a large and complicated undertaking and GAMESCO will face fresh challenges on a regular basis.

(c) Hedge accounting has no impact whatsoever on the validity of any given hedging instrument. GAMESCO should focus on managing future cash flows and minimising risks rather than the accounting implications of doing so.

The only real significance of applying hedge accounting is that gains and losses on the hedging instrument will be taken to equity rather than the income statement. The fair values of the instrument will change regardless, but nothing will be recognised in profit until such time as the payment falls due, at which time any gains and losses on the settlement will be offset against the corresponding balance on the hedging instrument.

It could be argued that GAMESCO has to take particular care to manage stakeholders’ expectations concerning risk. The company does not really exist to make a profit and it will be wound up after the games. During the period leading up to the Games it is very likely that stakeholders will be concerned about any risks that could threaten the viability of GAMESCO’s plans. It may be desirable for the company to take particular care with the presentation of risk because the public may not fully understand the finer nuances of financial reporting or financial management and so it may be desirable to publish a steady stream of profit figures.

In the event that the instrument is purchased and hedge accounting is not applied, the directors could simply explain the situation in the event of any gains or losses on the hedging instrument before the contract is settled. The stakeholders should be prepared to accept and understand such assurances, if only because unsophisticated readers are unlikely to consider currency risks if they decide to read the financial statements.
SECTION B

Answer to Question Two

Rationale
Question 2 draws on section A (Management and Control Systems).
The question deals with the advantages and disadvantages of the matrix structure of
management, focussing on a relatively small company that has recently introduced this
approach.

Suggested Approach
Part (a) requires candidates to think about the implications of a management structure that
does not necessarily offer the certainty associated with a clear-cut reporting structure. An
account manager has been appointed to take charge of the company’s relationship with its
biggest customer. It is important to recognise that there is scope for conflict between that
customer’s needs and the needs of the other customers, which continue to provide most of
the company’s revenue.

Part (b) asks candidates to consider the best way to resolve the conflicts identified in (a). The
whole point of the system that has been introduced is to ensure that there is recognition of
competing and conflicting needs and opportunities. Clearly, there may be times when a
priority has to be identified and that will require some commercial awareness.

(a) L has effectively introduced a matrix management structure with respect to its dealings with
H. This has the potential for a number of upside risks. In particular, it means that H’s
interests will be kept under constant review by a designated manager. Thus, there is less
risk that H’s business will be lost because of an oversight or a breakdown in
communications. If any of the decision makers at H require anything then they know to
contact Peter and he will then be responsible for dealing with their request.

There are a number of downside risks arising from this arrangement. The most obvious of
these is that there may be a conflict between Peter’s role as an account manager and the
roles of the other functional managers within L. H is an important customer, but it accounts
for only 20% of sales by volume and so it could be argued that the smaller customers are,
collectively, far more important than H. Presumably, H is capable of negotiating significant
trade discounts and so the additional volume of business is unlikely to be particularly
profitable.

Peter’s role may be important, but there is a danger that it will lead to dysfunctional
behaviour on his part. He will be motivated to retain H’s business because that is the whole
point of his employment. H will be aware of that and may start to pressure him into granting
further discounts, extensions of credit and other concessions.

Peter has already disrupted transactions involving existing customers with whom L has an
established relationship. The most immediate threat is that those customers may cease
trade with L. It is also possible that such behaviour will lead to conflict between Peter and
the functional managers, which will waste time. The functional managers may also become
demotivated if their efforts are thwarted by Peter.

Junior staff will also be confused by contradictory instructions. If they are unsure whether to
obey Peter or their usual functional managers then they may delay acting in order to seek
clarification. Once they start to question instructions from their superiors then the overall control environment may be undermined.

(b) Firstly, there has to be clear communication between the account manager and the functional managers. It should be made clear that any conflict should be discussed and, if possible, resolved by compromise. If, for example, H wishes to place a large and urgent order then it may be possible to ask the production manager to increase output so that all potential sales can be made without disappointing existing customers. That will reduce the threat of disagreement between the account manager and the functional managers.

It should be made clear that any conflict that cannot be resolved by compromise should be dealt with in a manner that is in L’s overall best interests. It should be made clear that any dysfunctional behaviour will be regarded as a disciplinary matter. That will reduce the threat that the account manager will be tempted to act in H’s best interests rather than L’s.

Subordinate staff should be free to state that any instruction contradicts policy or a previous request. It should then be the functional or account manager’s responsibility to seek a compromise so that subordinate staff have an agreed instruction. That will avoid the stress and confusion that will arise for junior staff if they are caught between competing managers.

Ideally, the account manager should have been appointed from within L and it should be made clear that the appointee’s continued employment is not conditional on retaining H as a customer. An internal appointee will, hopefully, have a more immediate loyalty to L than to H. The assurance of continuing employment will reduce the extent to which H might pressure the account manager.

There should be a clear policy for resolving conflicts between managers. It may be that the appropriate functional manager should make the final decision, on the basis that the business from H is worth only 20% of the company’s sales by volume, and those may be subject to a substantial discount because H is the company’s largest customer. That should lead to a consistent response to any conflicts between managers.
Answer to Question Three

Rationale
Question 3 draws on section D (Management of Financial Risk). It deals with the implications of internal and external hedging techniques and also the need to maintain a good relationship with foreign governments.

Suggested Approach
Part (a) focusses on the risks arising from four possible approaches for hedging two foreign currency balances. These include leading a payment as well as the more obvious financial instruments that might be used. Candidates also have to consider leaving the risk unhedged altogether. There is sometimes a tendency for candidates to focus too much attention on the purchase of financial instruments with which to hedge risks. It is important to consider whether the risk is worth hedging at all and whether there are any viable internal hedging techniques, that may prove less complicated and less expensive.

Part (b) deals with the need to manage relations with foreign governments. This is a slightly unusual case because it deals with the potentially emotive question of importing a valuable artwork from the country in question. In the past, questions have tended to deal more with the issues arising from foreign direct investment and so this question may offer a bit of a challenge, although the secret is basically to think in terms of ways in which the foreign government’s interests may be used to exert some influence in order to prevent problems.

(a) Leave the transactions unhedged

Risks
There is a degree of natural hedging built into this approach. R’s net exposure to gains and losses is on the W$1m difference between the receivable and payable for the first three months. Thereafter, R will be exposed to movements on the W$8m payable. Interest rates on W$ are lower and so the markets expect the T$ to weaken, which could mean that there will be a loss on the settlement of the payable.

Costs
There is no direct cost associated with leaving the separate balances unhedged.

Use options

Risks
The options will leave R with no downside risk on either position, but there is an upside arising from the possibility that there is no need to exercise the options in the event that rates move in R’s favour. The exercise prices are set at the expected rates according to the rates on forwards and so there is an expectation that R will have little or no incentive to exercise the options. The premiums are, however, quite significant and so it seems that the options’ writers are seeking quite a significant amount of compensation for accepting this risk, which implies that there is a significant expectation that the rates will be volatile over the three and six month periods.

Costs
There will be a premium on each of the options, which will cost R a total of S$1.00m + 1.1m = S$2.1m. That sum is payable immediately, and so R will have to fund those payments for the lives of the options.

Sell and buy forward

Risks
The forward contracts will virtually eliminate the transaction risks on the currencies. There could be a counterparty risk arising from the possibility that the counterparty to the
transaction will default. These contracts also mean that R is committed to the purchase or sale of W$, which may be a problem if the underlying transactions fall through or are postponed for some reason.

**Costs**
Provided the transactions are completed on time, there will be no specific cost. It is possible that the counterparty will require some form of security or margin payment and that could involve some cost to finance that arrangement.

**Lead the payment**

**Risks**
The only exposure to currency risk arises from the net amount of W$1m outstanding for the first three months. There will be no currency balance left outstanding thereafter. There is, however, the risk that R will have no means to force the auction house to hand over the painting because the funds will already have been paid.

**Cost**
*Either of the following is acceptable.*

R will suffer an opportunity cost because it will be paying W$8m three months early. The interest foregone = W$8m × 3.6% × 3/12 = W$72,000. For the sake of consistency, that payment will have a net present value of W$72,000 / (1+(0.036 × 6/12)) = W$70,727 or T$156,519

Or

R will suffer an opportunity cost because it will be paying W$8m three months early. The interest foregone = W$8m × 3.6% × 3/12 = W$72,000. For the sake of consistency, that payment will have a net present value of W$72,000 / (1+(0.036 × 3/12)) = W$71,356 or T$156,987

(b) Many countries regard the export of art as a serious matter because of the implications for national culture. The fact that R is paying millions of dollars to a wealthy individual means that the painting’s sale may attract a great deal of attention. It may be that art lovers in W will regard this as a matter of national pride and will attempt to persuade the government to block the export.

If R cannot obtain an export licence then the painting’s value may be reduced substantially. Essentially, the resale market for the painting will be restricted to buyers who are willing to leave it in W.

Ideally, R should have investigated the likely reaction of the government to this sale before bidding at the auction. That could have involved talking to the relevant government officials and also looking at any recent transactions involving significant pieces of art.

It may be possible to negotiate a clause that makes the sale conditional on the grant of an export licence. Unfortunately, that will have the effect of transferring the risk to the vendor and so that might prove unacceptable.

R should be ready to argue that the sale of the item will benefit the good cause that is the recipient of the previous owner’s generosity. It may be possible to mount a public relations response to any attempt to delay the export of the painting.
Answer to Question Four

**Rationale**
Question 4 draws on section E (*Risk and Control in Information Systems*). Part (a) effectively asks for some thought about the potential benefits to be had from “big data” and part (b) asks about the potential risks associated with investing in new data gathering technology.

**Suggested Approach**
Part (a) asks about the potential benefits that might be had from the introduction of electronic meters that permit an electricity supplier to track customers’ consumption in real time. That has potential implications for data gathering as well as the simplification of accounting for electricity billings.

Part (b) requires some thought about the risks that will arise from the investment in this new technology. One of the motives for the investment has been the ability to enhance error checking and fraud detection. Having said that, recent history has suggested that new technologies are rarely impossible to hack as a host of devices, such as mobile phones, bank ATMs and DVD videos have shown very clearly.

(a) Smart meters will offer the potential to dramatically reduce operating expenses. E will not require meter inspectors to visit customers’ homes. There will be far fewer transactions involving call centre staff and so numbers can be reduced there too.

The new meters may reduce customer fraud and so enhance revenues. The fact that they are electronic and not mechanical will make it far harder to tamper with readings.

E will be able to gather a great deal of information about individual customers. At present, E can tell how much electricity is being drawn from the grid, but it cannot identify the specific customers who are using it. The new meters will make it possible to identify customers whose demand changes in response to, say, a major sporting event. That may make it easier for E to predict demand in advance of such events and so plan more easily.

E may also be able to gather valuable marketing information. For example, some customers will have larger increases in consumption when the weather is cold. E could target such customers with offers of alternative pricing plans or discounts on home insulation.

(b) *The following are indicative risks only. Credit will be awarded for any realistic risk.*

**Customer fraud**
If customers learn how to interfere with the meters then E may lose significant amounts of revenue. The new meters may be more difficult to manipulate, but history suggests that electronic safeguards can be defeated. For example, mobile phones can be unlocked and dvds can be pirated despite safeguards.

E could compare patterns of energy consumption within neighbourhoods and could identify customers whose readings seem low. Those customers’ meters could be inspected for any modification. E should publicise any criminal prosecutions as a deterrent to other customers.

**Installation**
The installation of these new meters will be a significant undertaking. E will have to arrange access to every customer’s home in order to fit the new meters. The logistics of this will be complicated because of customers’ work patterns and availability because of work and so on.
The old system will have to operate in parallel with the new while this work is being undertaken and so staff will be stretched.

E may offer discounts or rebates to customers who offer access at convenient times. The discounts should be self-financing if they are funded out of the cost savings of managing a customer’s account once the smart meter has been installed.

**IT issues**

It will be difficult for E to fully test this system before installation. There will be large numbers of smart meters in the system and they will be communicating over long distances. There could be unforeseen problems with data being corrupted or lost. If that happens then the original meters will have been removed and there will be no effective way to put the system back.

It would be ideal if E could select a system that has already been used successfully by another electricity company. It would be preferable to apply a proven system even if there are more up to date versions of the technology that might offer enhancements.

**Financial cost**

There will have to be a significant investment in this new system and the anticipated benefits may not be realised. The shareholders and other stakeholders may be concerned that E is taking a reckless risk by making a substantial investment in a new technology. An adverse outcome could mean lower profits or higher prices for consumers.

E could possibly transfer some of the risk by paying a third party to design and implement the new system. The contract could specify penalties for any shortcomings in the operation of the new system.