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 complications arising from the fact that T Railways is in public ownership, providing a vital utility in the form of public transport. That creates the possibility that the company will be subject to potentially conflicting aims and objectives. Part (b) deals with the risks associated with asking staff to apprehend criminals who steal from the company. Part (c) deals with the risks associated with different forms of borrowing that might be used by the company.

Part (a) draws mainly on Section A of the syllabus (*Management and Control Systems*). This part discusses the fact that the entity in question is faced with a number of performance indicators that are potentially in conflict. The entity is in public ownership, which means that it cannot go back to first principles and determine which of the indicators is most consistent with maximising shareholders wealth. This is a common situation and one that can happen in both the commercial and not-for-profit sectors.

Part (b) draws mainly on section B (*Risk and Internal Controls*). The company employs revenue inspectors who are required to apprehend passengers who are not in possession of a valid ticket until they can be arrested by the police. This has led to allegations that staff are being exposed both to the risk of injury and to accusations of assaulting those who have been detained.
Part (c) draws mainly on section D (Management of Financial Risk). The company has to make important decisions concerning the choice of debt for long-term financing. Both fixed and variable rate instruments carry risks (the former potentially leaving the company uncompetitive if interest rates fall and competitors are on a variable rate).

**Suggested Approach**

Part (a) asks candidates to think about the nature of the performance indicators and the possibility that they will lead to dysfunctional behaviour by the company’s board. The fact that the indicators may be in conflict will make matters more complicated because management may feel that their decisions have to favour one stakeholder over another or that a suboptimal decision will have to be implemented in order to strike a balance between the effects on the different indicators. This can be contrasted with the relative simplicity of a profit-making entity whose primary duty will always be to maximise shareholder wealth.

Part (b) requires some thought about the risks arising from a relatively simple and easily understood scenario. Staff who are forced to apprehend thieves are at risk of injury if the culprit resists arrest and may also be open to the threat of criminal proceedings themselves if a customer claims to have been injured. If fare-dodging passengers could leave the train without any action by the train staff then the company could lose significant revenue. Dealing with this risk requires a balanced and delicate response from the company.

Part (c) requires an understanding of the risks associated with different forms of borrowing. At present the entity is financed largely with a very soft loan provided by government and so the directors have very little direct experience of having to manage relationships with lenders.

(a) T Railways is presently owned by the government. Nationalised industries often have a host of confused and potentially conflicting objectives. For example, the national interest could be served by running the rail system at a loss in order to reduce the need to build roads. The government’s ownership will also make any perceived dissatisfaction with the railway network a political matter.

Privatising the railways will give T Railways’ management a single objective, the maximisation of shareholder wealth. T Railways will be freed from the need to consider the national interest in broader terms. If the government wishes to serve such interests then it can always offer a subsidy to enable the privatised company to reduce fares or continue with uneconomic services.

The need to provide a safe environment that is accessible to all will be a matter of complying with the spirit and the letter of the law and also good customer perception. Customers will welcome the provision of access for the disabled.

The privatised company will be free of the financial constraint associated with breaking even in cash terms. The creation of wealth can be monitored in terms of the ability to operate at a profit and responsible use of borrowing can be used to enable investments in positive net present value projects.

Having multiple performance indicators can lead to confusion when evaluating new strategies. For example, investing in improvement to the service could stimulate demand for rail travel, which could have the effect of greater overcrowding on trains. In the same vein, the provision of access systems for infirm passengers could create delays that could impair punctuality.

Pressing for targets on punctuality could have an adverse effect on safety. Drivers and control staff who are struggling to meet times are more likely to cause a Signals Passed at Danger situation. It may also create the impression that T Railways is choosing its own convenience over eliminating the errors and inefficiencies that were causing the delays in the first place.
The basic problem of multiple performance indicators is that most changes will require a decision to be made on whether an improvement on one measure justifies accepting an adverse change in another. Different stakeholders will be affected by each and there could be a further complication because some will have a higher profile and so will be able to draw more attention to their complaints if they disagree with a change.

It could be argued that all entities have to balance conflicting objectives, even when there is a clear profit motive. For example, improving staff safety can conflict with maximising shareholder returns. Balanced scorecards are used to great effect in the real world as one way of dealing with such conflicts.

(b)

(i) The risks associated with this policy are both likely to occur and to have the scope for a serious impact. Ticket inspectors are likely to encounter many passengers who have not purchased a valid ticket. Many of those will agree to purchase a ticket from the inspector, but there will always be cases where the passenger refuses to cooperate.

Detaining a passenger could create the risk that the passenger will react violently and injure either the ticket inspector or another passenger. Such injuries will have to be compensated. The incident could also discourage passengers from travelling by train.

There is also a risk that the passenger will be injured by the ticket inspector or will make a false claim to that effect. That could lead to a claim for damages against T Railways. There is also a risk that the ticket inspector will be accused of using unreasonable force in detaining the passenger and will be charged with a criminal offence. Any such charges could be pressed against T Railways because a corporate policy had led to inciting a criminal act. The ticket inspector will be alone and there may be no suitable witnesses to corroborate any defence that is offered.

Ticket inspectors are likely to be demotivated by a policy that requires them to risk their safety and leaves them open to other sanctions. They could require protection in the form of training, which would be expensive, and protective equipment which might make them appear threatening.

The police force may also refuse to support T Railways in such cases. The police may feel that the time and effort required to respond to an emergency call, arrest the passenger and process that arrest is not justified by the severity of the offence.

(ii) Ticket inspectors should ask passengers who refuse to pay to give their name and address so that TCL can make a formal request for payment. Even if that request does not lead to a satisfactory outcome it will create a formal record that the passenger has refused to pay on one occasion and further action can be taken against customers who refuse to pay repeatedly. Passengers should be asked for identification to support the information that they provide, otherwise it will be easy to give a fictitious name and address.

If the passenger refuses to cooperate with a request for identification then the ticket inspector should inform the train driver to stop at the next station. Station staff should be asked to meet the train and the passenger should be asked to leave the train. The fact that there is more than one member of staff present will give TCL some corroboration of the facts. If the passenger refuses to leave the train then the train should be kept at the station and the police should be called. The passenger’s behaviour has now been established to be disruptive and the police can remove the passenger and press criminal charges in addition.

The ticket inspector should be asked to write a formal report on any such incident so that there is a record in case of complaint. Any closed circuit video footage of the incident should be identified and archived to provide further evidence.
(c)

(i) From a purely economic perspective, the minister’s arguments are much weaker than those of the consultant. The minister appears to be ignoring the nature of the financing arrangements, whereas the consultant is taking those into account.

The government has no incentive to push T Railways into administration in the event of non-payment of interest. This would be counter-productive because T Railways is wholly owned by the government. Also, pushing the company into liquidation would be very damaging to the country because it would close down the railways.

The debt is undated and so there is no need for T Railways to set aside any cash for its repayment.

All of T Railroad’s EBIT will be paid to the government, either as interest, tax or dividend. It makes little or no difference to the government what form the payment takes and so increasing the interest element at the expense of a lower profit has no effect on T Railways’ financial performance. Politically, it will look better if T Railways does make a smaller profit given that it is a nationalised industry and so the government would almost certainly prefer to be paid in interest rather than dividend.

T Railways has large hidden reserves in its financial statements. The business owns many valuable assets that are carried at historical cost. In the event that the company runs into difficulty, it would be relatively easy to raise additional loan finance to cover the deficit or to reschedule the loan repayments with the government department responsible for the loan.

It could be argued that the minister’s arguments are valid with respect to the perceptions of stakeholders and commentators who read the financial statements and take the figures at face value.

(ii) Restructuring in advance of the privatisation will enable investors to see how the privatised company will be financed. Under privatisation, T Railways will be exposed to more of the risks associated with raising finance on a commercial basis and shareholders will be keen to see whether lenders are willing to support it.

While the new shareholders would be keen to see the very “soft” government loan left in place indefinitely, it would be undesirable for the government to lend to T Railways on this basis after privatisation and so the early repayment will avoid any ambiguity.

Replacing some of the loan with equity should create the impression of a more responsible pattern of borrowing. At present, long term loans have a book value that is 180% of equity. It is unlikely that investors would be prepared to tolerate such a level of borrowing.

The fresh government equity will be sold in the process of the privatisation in any case, so there is no cost to the government in agreeing to this arrangement.

(iii) The risks associated with floating rate debt are partly associated with the prospect of volatility in financing costs and partly with the wider implications for the business when interest rates change.

The consultants may have a view that floating rate debt is cheaper and that the lower rate will continue throughout the life of any borrowings.

The fact that much of T Railways’ business is unaffected by interest rate movements is a further argument in support of floating rate debt. Passengers on TCL’s services have very little choice but to continue to buy the company’s services in the event of a fare increase forced by rising interest rates. Passengers still need to travel to work and so demand for
that segment of the business will be less affected by the effects of rate increases on the wider economy. That may not be the case for freight services if some of T Railways’ commercial customers are forced to cut back because of a slowing down of the economy.

In the short term T Railways has no real competitors on local rail services who could undercut TCL by using fixed rate debt and thereby avoiding price rises in the event of increases in interest rates. In principle, some of the other countries’ rail services travel through T on long-distance services and could compete with TCL on a price basis.
Answer to Question Two

### Rationale

Question 2 draws on section C (Audit and Audit of Control Systems).

Parts (a) and (b) deal with the importance of the control environment.

Part (c) asks candidates to discuss the creation of an internal audit department within an entity that has a weak control environment.

### Suggested Approach

Part (a) requires candidates to think about the importance of the control environment. It calls for a brief discussion in order to lead into part (b), which asks candidates to consider the common situation whereby employees are interested only in the actual business process and have little or no real interest in the underlying administration or accounting. While it is fair to argue that the business model is probably the driving force behind any profits, the company also has to ensure that transactions are properly accounted for or there could be serious repercussions, including a failure to collect revenues from customers.

Part (c) asks candidates to consider the best way to introduce internal audit to this entity. The company has a successful business in place, but a slack attitude to control. Thus, there has to be some sensitivity, otherwise employees may feel disenchanted when the internal auditor is appointed. There is also a need for management to be assertive in order to deal with the fact that the audit department will have to be seen to be well supported, otherwise there will be no change.

(a)

The control environment is essentially a reflection of the attitudes of senior management towards the operation of the system. If management is seen to condone control weaknesses and compliance failures then the staff at more junior levels will tend to interpret that as an indication that controls do not matter.

It is clear that G’s senior management has tolerated a situation in which the staff are concerned only with the technical success of the production process. That has led to problems with the bookkeeping and administrative arrangements, which could prove very costly to the company. The delays and errors in those areas could disrupt cash flows and irritate customers. The fact that the accounts staff are demotivated means that there is a risk that they will leave and so time and energy will have to be invested in appointing replacements.

(b)

G has been successful because its staff have tended to focus on the quality of the product and the customer satisfaction with the product itself is evidence of that. It may be that the relaxed working relationships mean that staff can focus on product innovation and quality management and that has enhanced the company’s reputation. Any changes that are introduced will have to be undertaken with some sensitivity in case they lead to staff becoming demotivated in the process and so it may not be constructive to use the threat of disciplinary action in the first instance.

The fact that the new Chief Executive is keen to improve the administrative side of the company could be communicated to all staff as a positive step that will make the company more secure and efficient. The company will be unable to function, and to provide employment in the process, if it is unable to pay for materials or to bill customers properly because of accounting errors or lost documentation. It should be possible to communicate a positive attitude and encourage staff to view the accounting aspects of the company’s
operations as an extension of the whole organisation. The same attitude could be taken towards budgets and variance reports because they can help to ensure the smooth and efficient running of the organisation.

The threat of disciplinary action may help to demonstrate that the Chief Executive takes these matters seriously and should send a clear message to staff. The problem is that the workforce is motivated and hardworking and so it may be counter-productive to make that threat unless other approaches have been tried and failed. Quite apart from damaging relations with the workforce, if G threatens to discipline staff and does not carry out that threat then the impression that errors and delays are acceptable will be reinforced.

The threat of swift and decisive action may motivate and encourage the bookkeeping staff. The fact that the Chief Executive is prepared to take action against employees who make their jobs more difficult could make the bookkeeping staff feel valued and reassured that there will be a change for the better.

(c) Firstly, the board should decide the level of commitment that it is going to make to internal audit. A half-hearted attempt will lead to an under resourced and ineffective department. A realistic staffing level should be decided before anything further is done and the associated costs should be budgeted for.

The terms of reference should be decided. Those will include the powers that will be enjoyed by internal audit and the internal auditor’s access to the board. It will be easier to recruit an experienced Head of Internal Audit if it can be shown how the department will be viewed within the organisation as a whole.

The Board should recruit the Head of Internal Audit before interviewing for the other audit staff. That will enable G to offer the Head of Internal Audit the opportunity to have some say in recruitment to ensure that suitable staff are taken on. G should use a recruitment agency to identify suitable candidates because agencies are likely to have access to lists of potential applicants who are interested in moving on to new challenges.

The remainder of the audit team should be recruited, perhaps using an agency, under the Head of Internal Audit’s overall supervision. The team members should have appropriate skills and qualifications, including membership of a professional body, or be working towards a qualification if they are to be employed in a junior role.

The department should be based in a suitable location, with realistic provision for administrative support such as secretarial support. If internal audit is not shown to be adequately resourced then its credibility will suffer in the eyes of the other staff.

The Board should provide internal audit with a statement of the department’s powers to request information and documents. Giving internal audit a formal charter within the organisation will help to ensure the department’s credibility and its freedom to conduct meaningful investigations.

The initial reports submitted by internal audit will have to be seen to receive the Board’s endorsement in order to underpin the directors’ support. That could involve requesting a follow-up to deal with any weaknesses or compliance failures. The Board should not take disproportionate action, otherwise the internal audit department will be viewed as a threat, but it should be clear to all staff that the internal audit reports will be read and taken seriously.
Answer to Question Three

Rationale
Question 3 draws mainly on section E (Risk and Control in Information Systems). It deals with the potential competitive advantage that may be obtained from a sophisticated information management system that provides the board with suitable information that can be adapted and reorganised in order to meet the company’s needs.

Suggested Approach
Part (a) requires some thought about the nature of the business that the company finds itself in. It is a supermarket chain that sells virtually the same products as its competitors at similar or identical prices. The chains may be able to differentiate themselves in terms of product placement and through giving targeted discounts using voucher and cash-back schemes. The company in question does not have that facility and so its managers have to consider the extent to which this puts it at a significant disadvantage.

Part (b)(i) deals with the problem that affects virtually every IT project appraisal, namely that the value of the resulting improvements in terms of better information may not be known until after the investment has been made. The new system could be purchased and there may be little or no improvement in sales.

Part (b)(ii) asks for some practical suggestions to overcome the difficulties identified in (b)(i). The competitors’ business model is partly about merchandising through stores that are open to the public. It would cost relatively little to copy some of the competitors’ behaviour in the short term in a sample of stores to determine whether there is a real impact on sales.

(a) It could be argued that L’s presence as a major supermarket company is evidence that it is capable of competing with the other companies in the industry. L’s business model requires it to keep costs to a minimum so that it can afford to offer customers lower prices. L’s present system is less expensive, it is compatible with the business model.

L’s competitors can use the data gathered through their EPOS terminals to understand their customers' behaviour. They can organise merchandise so that customers who come into a store to buy a list of specific products may buy more than they intended. L’s competitors can experiment with different store layouts and can track the effects on the sales of relocated products in more or less real time. The fact that this effect is potentially counter-intuitive means that customers will be unaware of the impact on their buying decisions and so it may prove highly effective.

Two of L’s competitors can also gather information through their loyalty card records. For example, if one of the other supermarket chains cuts its prices or runs a new advertising campaign and previously loyal customers make smaller or less frequent purchases then the data collected from loyalty cards will pick that up. That makes it possible for them to study the effects of changes in the retail environment on the behaviour of particular groups of customers. L does not have the ability to track changes in individual buying habits in that level of detail and so the company may be a little vulnerable because it may be less well equipped to deal with competitors’ actions. Having said that, its existing technology could be of some value in identifying problems. For example, the inventory control system will make it relatively easy to identify increasing wastage on perishable lines and slower sales for all lines of inventory. L can also use details gathered from credit and debit card billings as the starting point for tracking individual customers who pay by card rather than cash.
(b)

(i) The main problem with any investment in information management systems is that the potential benefits cannot be accurately predicted. A new software suite may equip L to increase sales, but the amount of new business will be impossible to foresee.

It is debatable whether L’s competitors derive any real benefit from their more sophisticated information management systems. Feedback from the focus group meetings suggests that the competitors’ merchandising policies displease customers because they cannot always find the products they want. L could obtain much of the motivational benefit of loyalty cards without any of the associated administrative costs by giving away discount vouchers at the point of sale.

Asking customers their opinions, as has already been happening through the focus groups, may prove misleading. Customers may not realise the extent to which their subconscious buying decisions are influenced by store layout or by feedback from the loyalty card systems. Furthermore, it costs them nothing to claim that they are attracted by savings from vouchers and such claims may encourage L to offer a similar incentive.

Other information sources may be equally biased. For example, the software vendor has an incentive to overstate the benefits offered by an upgrade to L’s existing information management systems. The competitors may argue in public that their systems generate significant and commercially valuable information, but such claims may be rhetoric intended to impress their shareholders.

(ii) One approach would be to extend L’s market research to target customers who tend to shop at the competitors to establish why they do not shop at L. They could undertake market research, perhaps targeting areas close to competitors’ stores to get a better understanding of why their competitor’s customers tend to shop elsewhere. The results could then be linked to the types of information that could be collected from the competitors’ information systems to establish whether they could be the source of some competitive advantage.

L could experiment with the benefits to be had from the strategic arrangement of products by copying the competition. L could use researchers equipped with camcorders to record the order in which goods are organised in competitors’ stores. Three or four of L’s stores could be reorganised in exactly the same manner in order to establish whether sales are increased. If there is a persistent increase in sales then it is realistic to argue that there is an observable and quantifiable effect to be had from observing patterns.

To a certain effect the savings associated with loyalty cards could be replicated on a smaller scale. For example, for a limited period L could give customers a £3 voucher in return for a £40 shop to see whether that increases sales volume. It would also be possible to estimate the effects of targeted vouchers by giving customers vouchers that are linked to the goods in their baskets. A customer who buys a particular brand of coffee could receive a voucher for money off their next purchase in order to see whether sales increase.

Essentially, anything that L can do to move towards the sales and promotional techniques used by the competitors should make it easier to determine whether upgrading the information management system is likely to improve sales.
Answer to Question Four

Rationale

Question 4 draws on section D (Management of Financial Risk). Part (a) deals with the calculation of the effective swap rates enjoyed by two parties to an interest rate swap. Part (b) deals with the implications of agreeing to a swap that does not cover the whole period of the loan. Part (c) deals with the question of counterparty risk in this particular scenario.

Suggested Approach

Part (a) requires some basic calculations, based on a common topic.

Part (b) requires some thought about the impact of leaving the final 4 years of a 14 year loan unhedged. What risks will that create?

Part (c) is looking for the ability to look at the basic information in the scenario to highlight the fact that the party seeking the swap is actually quite a poor credit risk.

(a) The swap arrangements will be as follows:

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<th>Z Counterparty</th>
<th>Total</th>
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<tbody>
<tr>
<td>Now</td>
<td>LIBOR + 2%</td>
<td>3%</td>
</tr>
<tr>
<td>Wants</td>
<td>6%</td>
<td>LIBOR + 1%</td>
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<tr>
<td>Difference</td>
<td></td>
<td>2%</td>
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<tr>
<td>Paid to bank</td>
<td></td>
<td>0.5%</td>
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<tr>
<td>Saving</td>
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<td>1.5%</td>
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<table>
<thead>
<tr>
<th></th>
<th>Z Counterparty</th>
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<tbody>
<tr>
<td>Pay own interest</td>
<td>(LIBOR + 2%)</td>
</tr>
<tr>
<td>Receive</td>
<td>LIBOR + 2%</td>
</tr>
<tr>
<td>Pay</td>
<td>4.5% to counterparty + 0.5% to bank</td>
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<tr>
<td>Net cost</td>
<td>5%</td>
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(b) Ideally, the swap would match the two parties’ requirements exactly so that Z could have the protection that it wishes. In this case, Z will be faced with switching from an effective fixed rate under the swap to a variable rate at the end of year 10. The unprotected segment of the loan is in the distant future and so it is impossible to predict how variable rates may change during the next decade. Z could be faced with a hefty variable rate when the swap expires.

The corollary to the uncertainty is that the swap will hold for the next ten years and so the net present value of any future cash payments for the period from year 11 to year 14 will be relatively small. If that is a major concern, then Z could attempt to hedge the risk in some way. For example, putting funds on deposit at a variable rate over the next ten years will mean that the cash balance will increase more if interest rates increase and that will provide a means of offsetting any additional interest costs.

If Z does not enter into this swap arrangement then it may not find an alternative counterparty until it is too late. Interest rates may rise or the prospect of an increase may leave potential counterparties unwilling to swap a variable rate in return for a fixed rate loan. It would be far better to protect the company against interest rate risks for the next 10 years than to risk leaving the company exposed to risks for the whole of the remaining 14 years.
The most important issue is that the worst possible case if Z defaults is that the counterparty will be left with the fixed rate liability that it was attempting to avoid through the swap arrangement. Presumably, the counterparty believes that interest rates are likely to fall and so wishes to obtain variable rate debt. If Z fails then the counterparty will have to pay interest at 6%. At that stage it may be possible to obtain a further swap with a different variable rate borrower, but that may be more expensive if the counterparty’s expected fall in interest rates has occurred.

Z is a poorer credit risk than the counterparty, so there is some risk of default. The higher rates that Z has to pay and the fact that Z finds it necessary to offer the whole of the interest rate saving to attract a counterparty mean that Z is a poorer risk.

The fact that Z’s directors did not consider the implications of interest rate movements when taking out a 14 year loan is a worry in itself. The counterparty would feel rather more confident if it was dealing with a management team that had a better understanding of financial management.

Banks frequently act as the counterparty rather than acting as the intermediaries between the two sides of a swap. The fact that Z’s bank did not offer to take the arrangement on directly with Z and so enjoy the whole of the potential benefit rather than just 25% suggests that the bank does not wholly believe in Z’s solvency.