Strategic Level Paper
P3 – Performance Strategy
Examiner’s Answers

SECTION A

Answer to Question One

(a) The anticipated demand for the subsidiary’s products might not materialise. That means that the subsidiary itself might not be viable because Aybe does not seem to require the production capacity for any other reason. The likelihood of this risk is very difficult to predict because it appears that Aybe has very little experience of operating in Africa. The consequences of this risk are high because the subsidiary would effectively generate unnecessary costs and the position might be difficult to resolve.

The high level of inflation in the African country could lead to economic problems that could impact on the subsidiary’s profitability. The local government might respond in a way that harms the business. For example, increasing interest rates might push up the cost of borrowing and also suppress demand for the subsidiary’s products. The likelihood and consequences of this are difficult to predict because economic management is complicated and it may be difficult to obtain expert analysis of the manner in which this country’s government will react, but the risks are potentially high.

There could be logistical problems associated with sending materials to the African factory. The electronics industry is known to use large quantities of toxic materials and there could be local regulations in place to govern the import, transportation and handling of such materials. There could also be tariffs imposed on imports by the government which could increase costs incurred in Africa. In theory, the likelihood and the consequences of this should be able to be determined easily by referring to the appropriate government department, but the rules might be difficult to interpret in practice and it may require some practical experience before they are fully understood.

The fact that a joint venture partner has been taken on creates potential conflicts in the running of this subsidiary. For example, the partner may wish to set selling prices at a low level in order to maximise sales whereas Aybe might be concerned that this could undermine the product’s reputation and could lead to “grey imports” into established markets. It might be difficult to predict the likelihood of such disputes at the negotiation stage of the partnership because the partner may wish to sign the contract before making such positions clear. The consequences of a serious dispute with the partner could be significant if it means that the local government withdraws permission to trade.

The subsidiary will have to recruit a local work force in a country where there may be few potential staff who are experienced or even trained to work in an electronics factory. The use of inexperienced staff could increase costs and impair quality while they are working their way up the learning curve. There is also a risk of accidents, either in terms of injury
or pollution. The likelihood and consequences will be difficult to predict unless Aybe has
had prior experience of establishing subsidiaries under similar circumstances.

There will be currency risks involved in trading with other countries. If the African
country’s currency is weak against others they may get less money for their products than
they anticipated. Monitoring the currency fluctuations could be time consuming and
involve more complicated transactions to mitigate against the risk.

(b) With respect to the factory, the management information system (MIS) does appear to
have serious weaknesses. The MIS would not normally provide information about ad hoc
costs such as those associated with clearing the site, but there could have been provision
in the design of the MIS for such costs to be reviewed and verified externally before the
project was finally authorised. The MIS is clearly deficient with respect to tracking
progress on the project. There should have been regular reports of costs incurred to date
with comparisons to the costs that had been budgeted for that milestone. That suggests
that the suitability of the MIS is not considered and reviewed on an ongoing basis. If the
MIS had not been designed with the need to track major contracts then that facility should
have been introduced when the contract was agreed. The one strength of the MIS is that
the costs of the project were, at least, pulled together so that the overall overspend could
be tracked at the conclusion.

The MIS for the African subsidiary should have been developed at the very outset of this
project. Aybe has, for example, missed the opportunity to monitor and manage the initial
setting-up costs of the subsidiary. The system appears to be tracking inventory levels and
production costs, which are important functions, but there is no gathering of information
concerning sales. That means that the MIS is not really driving production decisions to
reflect likely demand. The company appears to be manufacturing goods for inventory in
the hope that the sales staff can find a buyer for whatever is made. It would be far more
desirable for the planning process to estimate demand for each product, drawing on
information gathered by the sales team, and to ensure that the forecast demand can be
met.

(c)(i) The subsidiary has to import goods supplied by DEC. These will be invoiced in the
subsidiary’s local currency and so DEC will be exposed to transaction risks. The
currency is likely to decline over time because of the anticipated inflation in the
African country. The African subsidiary will be exposed to an economic risk
because DEC will almost certainly have to reflect the declining exchange rates in
selling prices. That could make it difficult for the subsidiary to make a profit. This
risk will be almost impossible to mitigate and so it will have to be accepted. DEC
should be willing to support its subsidiary in the interest of establishing a long term
strategic position in that region.

The subsidiary will also be subject to currency risks when it attempts to trade with
the neighbouring countries. There will be a combination of transaction risks on
invoiced sales and economic risks if currency movements affect the selling prices
that have to be charged on those exports. These risks could be mitigated in part by
offsetting sales with imports from those countries if it is possible for the subsidiary
to source materials from there.

The currency remitted back to DEC will be subject to significant transaction risks
because deliveries will be made on an ongoing basis but payments will only be
received every four months. These payments are infrequent and substantial and so
it may be sensible to hedge those risks using an option or a forward contract. The
fact that the payments are being made by a subsidiary means that DEC should be
sufficiently confident in collection to make a forward sale. The forward rates or
premiums on options will reflect the likely movement on the currency, but at least
there should be no unexpected losses. The one major consideration is whether
such instruments are available in the particular African currency.
The only alternative would be for DEC, or Aybe as a whole, to investigate whether it could import anything from the African country in order to create a natural hedge. There would be very little point in importing from the subsidiary itself, but there could be materials or other resources that could be purchased so that receipts and payments offset one another. One advantage of that would be that it would reduce the threat posed by the African government’s exchange control regulations.

(ii) Any gains and losses arising from transaction exposure will be treated as currency movements in the income statement and so there will be costs flowing through the income statement.

The economic exposure will have no direct accounting implications as such, although it will have an impact on the level of business and, so, the reported profit. Any natural hedges created through the offset of sales and purchases in foreign currencies will automatically work their way through the financial statements by creating offsetting movements on revenues and expenses.

Any financial instrument purchased by the company will have to be accounted for in accordance with IAS 39 Financial instruments: recognition and measurement or IFRS 9 Financial Instruments. The instruments themselves will have to be restated at their fair values if they are still held at the year end. That may create problems if the African country’s currency is not particularly well served by the markets and the financial instruments are bespoke or not particularly liquid. It may be necessary to determine fair values using a model rather than market rates. Hedge accounting may be appropriate.

(d) The most important safeguard is an adequate control environment. It should be clear to all staff that the board takes the bookkeeping and control aspects of the business very seriously and that any distortion or manipulation will be taken very seriously indeed. Having a clear policy on staff acting fraudulently would be helpful and having disciplinary procedures that cover these kinds of issues could act as a deterrent to employees.

If the company permits distortion at the corporate level then it will be more difficult to expect staff to respect honest reporting at the departmental level. For example, the illegal disposal of toxic goods that are purportedly collected for the sake of recycling sends a message to all staff that the company is prepared to compromise the truth when it suits.

Giving bonuses and other performance related incentives increases the risk of unethical behaviour. For example, the African sales staff may be more inclined to indulge in unethical behaviour in order to make sales and improve their bonuses. One response would be for the company to set thresholds in a realistic manner so that it is possible to earn a fair reward through honest business dealings. If necessary, there may have to be a transitional period designed to assist staff during difficult periods, such as reduced sales targets while the subsidiary is establishing itself.

The control system should make it difficult or impossible to manipulate entries in the books. For example, the fact that internal transfer prices were overstated should have been detected by the system. That should have been a simple matter of the African subsidiary checking the pricing of all incoming invoices and checking that they were in line with the orders.

The system should be supported by the internal audit department, who should be responsible for checking compliance with internal procedures and processes. The work undertaken by the internal audit department should receive the full backing of the board.
Answer to Question Two

(a) It is difficult to see any great merit in this proposal. It is unlikely to suit the interests of the shareholders, depositors or even the directors of the banks themselves.

The nature of the banking industry is that bank profits are affected by factors that are not necessarily within the directors’ control. Interest rates rise and fall in line with economic indicators, as does the demand for finance. There is not necessarily a clear and objective basis against which to measure the performance of the bank’s board or of the individual directors.

The only people who would be willing to work on this basis would be risk-seeking individuals who might not necessarily be the best people to be responsible for the running of a bank. The remuneration structure could mean that the board will take the view that the initial fee paid is a sunk cost and that they face very little downside risk if performance is poor. They may, therefore, put together a package of risky strategies on the basis that any success will contribute to their bonus and any failure will cost them very little.

The remuneration structure will clearly create the risk of directors adopting a short-term outlook with a view to maximising annual bonus payments. They may also be tempted to indulge in dishonest or manipulative reporting for the sake of their bonus.

The only major advantage of this proposal is that it may prove attractive to stakeholders. The recent bad publicity attached to bank directors and their bonuses may make it seem attractive to pay directors in a manner that appears to force them to justify their remuneration. The fact that the directors face the risk of a loss could also seem attractive to shareholders and the public at large.

(b) The nature of banking is that strategies can commit the bank to a long-term position that may be difficult to unwind. For example, mortgage loans mean that the bank has committed funds for up to 25 years. That suggests that strategic reviews should be conducted rather more frequently than once every four years. It is also unsatisfactory that non-executives do not normally challenge the executive directors’ strategic decisions. Non-executives have an important role to play in providing the executives with feedback and constructive criticism to ensure that important decisions are not taken lightly.

The bank’s lending policy appears to be very risky. The logical approach to mortgage lending is to advance a conservative proportion of the value of a property. That means that the bank’s loan will automatically be secured against an asset that is likely to be realised for more than the value of the loan in the event of foreclosure. The mortgagee’s equity also gives an incentive to work hard at maintaining repayments in order to avoid losing a valuable asset.

In the event of a major downturn in the economy, mortgage holders might find themselves struggling to meet these large mortgage repayments and the bank might find itself foreclosing on a large number of loans. It will end up owning large amounts of property that will have declined in value and may be difficult to sell without discounting it even further. The only real protection the bank has against this scenario is an economic forecast that predicts that house prices will rise at a rate well in advance of the general rate of inflation.

The bank faces risks in the form of long term revenues. If house prices do continue to rise much faster than wages then it will become increasingly difficult for customers to be able to afford houses. That will cause mortgage applications to dry up and the bank will either have to find other outlets for lending or rely on interest from existing loans. The bank
should, perhaps, consider alternative products that could be used to generate returns without undue risk. These could include shorter-term loans.

The bank may have to consider the implications of its changing shareholder base. In the past its shareholders were prepared to invest for the long term in the form of steady and predictable profits. The present investor base is rather more speculative and seeking short term growth. The bank should ensure that it keeps the shareholders informed of what is realistic in the present climate because unrealistic expectations in the past have been met by extreme risk-taking by the banking industry. The board may come under pressure to, say, securitise its mortgage portfolio in order to realise profits in the short term.
Answer to Question Three

(a)(i) The biggest advantage is that N will receive a known £ amount for the $ that it will receive. N will be able to determine the overall profit that it will make from this sale after allowing for the cost of the forward contract itself.

Once the contract has been agreed the arrangement is relatively simple to manage.

The biggest disadvantage may be that it could be difficult for a small company to arrange a forward contract for such a small amount. The management time that would be required for such an arrangement might outweigh the potential savings.

The arrangement is also binding on N. If the customer defaults or pays late then N will still be required to sell the $ amount and that could prove expensive and inconvenient.

The absolute amount of this sale is relatively small and so the maximum currency risk is also likely to be small. Overall, the risk is unlikely to justify the time and fees involved.

(ii) The current spot rate for the sale of $ is 1.6050 and the discount is 2.5 cents.
Selling forward will yield \(\frac{1,755,250}{1.6050 + 0.025} = 1,076,840\).
Accepting the spot rate on completion would yield \(\frac{1,755,250}{1.6635} = 1,055,155\).
N gained \(1,076,840 - 1,055,155 = 21,685\) by selling forward.

(b)

(i) Even if N has no direct dealings with US suppliers or customers it will be exposed to movements in the $. If the £ strengthens against the $ then it will become cheaper for N’s UK customers to import competing products from the US.

N may use materials or components that are sourced from the US. The cost of those components will fluctuate in line with the $.

N’s ambitions to export to the US will be directly affected by exchange rates. If the £ strengthens then US customers will have to pay more $ for a product and so N will find it harder to compete. The only alternative would be to fix the price in $ and for N to bear the risk.

(ii) Economic exposure is very difficult to quantify because the relationships are not always obvious. For example, imported parts or materials could be sourced from local suppliers and so it will not always be clear that they will be more expensive if, say, the $ strengthens. Some products will have alternatives that could come from different countries and so the impact of a currency change could be mitigated by moving to a slightly more expensive supplier from a different country and so the cost might not be linear.

Currency movements can reduce competitor’s selling prices, but some markets might not be particularly price sensitive. For example, an imported competing brand might not take sales unless the price reduction is significant. In some cases the competitor might not cut selling prices in pursuit of volume and could be happy to accept existing market share and simply take a larger profit from each sale.

In some cases there could be market imperfections that make it difficult for price changes to have an impact. For example, transport costs or the lack of distribution channels might make it difficult for competitors to import goods.

The level of exposure might be difficult to measure in some cases because companies might have natural hedges in place. For example, a company that
exports to the Eurozone might import materials priced in Euros so that any movement in the Euro will tend to have a neutral effect.
Answer to Question Four

(a) K’s dependence on IT is a major factor. The company cannot generate revenue and could even fail if it is deprived of its systems for any length of time. The auditor will be keen to see that K’s management understands the risks that are involved. K should have taken adequate precautions in the form of security and backup of the main system.

The IT system effectively manages assets and records. There is a lack of segregation of duties because the system makes sales, takes payments and records the transactions. If the system can be accessed and changed then it would be possible to programme fraudulent changes that diverted takings and adjusted the records to suit. General controls will have to be maintained at a very high order.

Systems maintenance will be a significant issue. The technology used by consumers, both hardware and software, will be changing over time. K will have to keep abreast of all such developments. The process of updating and change will make the system vulnerable to fraud and error.

K’s system has valuable data that could be of immense value. Apart from the payments being made the system has customers’ personal details which are valuable for committing identity fraud. The system is online and is, therefore, a potential target for hackers. The system should have all appropriate safeguards in place to prevent such attacks.

The auditor’s expertise should also be considered. Is the auditor capable of auditing such a specialised IT system? It may be necessary to bring in an independent expert. If the auditor cannot obtain the necessary assurance then it may be necessary to resign the audit altogether.

(b) There is a huge reputation risk. This type of fraud may attract press attention and K’s name will be associated with dishonest behaviour.

There is an even greater risk that the credit card companies will refuse to permit payments to K. Or they will increase security so that customers making payments to K will be asked to confirm their intention to make that payment. K’s business model depends on receiving card-based payments. The loss of cooperation from the credit card companies would be sufficient to put K out of business.

If K allows a download then it will have to pay a royalty to the copyright holder even if the customer’s payment is refunded.

The first step would be for K to investigate the past claims in order to determine whether there is a pattern. If claims have tended to be associated with, say, a particular country then it might be worth suspending service to that area until the breach can be discovered.

It will be impossible to alleviate these risks entirely because of the nature of the product. There is no physical delivery and so purchasing downloads would be very attractive to someone using a stolen credit card.

Allowing customers to pay using a third party such as Paypal may help to alleviate customers’ concerns.

K could reduce the threat by gathering information about customers when making sales. For example, every computer has a unique IP address. If a sale is made that is subsequently discovered to be fraudulent then that address should be blocked from making further payments.

Customers might be asked to register for the service, with verification of their identity through emailed confirmations. Such a registration process might deter some fraudulent customers.
The Senior Examiner for Performance Strategy offers to future candidates and to tutors using this booklet for study purposes, the following background and guidance on the questions included in this examination paper.

Section A – Question One – Compulsory

Question One is based on a pre seen case study and on an unseen case study. Answers could draw on both. The unseen scenario is about an African subsidiary of the company discussed in the pre seen case study.

The subsidiary faces many problems not least an information system which is poor. There are of course many risks involved in setting up a subsidiary in another country and the answer requires expansion of those.

The subsidiary trades with other countries so there are issues of foreign currency exchange and hedging. There are also ethical issues with toxic substances and suggestions of inflated invoices.

Section B – answer two of three questions

Question Two focuses on the banking industry, just before the banking crises of 2007/08. The aim is not to analyse the crisis itself, but to identify areas where risk management may have been weak at the time. Elements of the UK banking industry may be seen in the scenario, although this is not necessary to answer the question, as areas of poor risk management strategy are noted in the scenario. The issue of directors’ remuneration in (a) is potentially novel and designed to provide a “twist” on standard questions in this area.

Question Three is based on a company making its first major foreign currency hedge and tests candidates’ knowledge of basic hedging through to more complicated techniques (and why these are not required in this situation).

Part (a) asks for a fairly basic forward exchange contract, although with a slight twist in that the amount is to be received from a customer in the customer’s home currency rather than the currency of the selling company. Clear thinking is necessary to ensure that exchange rate movements are correctly interpreted in this situation.

Part (b) asks for an understanding of the reasons for currency fluctuations and an understanding of economic risk.

Question Four is based on an Internet music download company such as “Napster”, although with a few variations.

Part (a) focuses on the audit of IT systems, with an emphasis on the problems that IT can cause auditors. There is a detailed scenario from which many valid points can be drawn. So while the question may not be within the practical skill set of most candidates, the scenario itself will provide points to include in the answer.

Part (b) asks candidates to link information technology to business strategy and show on the former can support the latter. Again, the scenario provides sufficient examples for a well-prepared candidate to accumulate a pass standard.