SECTION A

Answer to Question One

(a)  
(i)  **Set goals**  
The first goal is to maximise the upside risk that the new factory will reduce the "carbon footprint" of the company’s products.  
F plc also needs to avoid the risk of negative publicity associated with the loss of established jobs in the UK.  

**Risk areas**  
The upside risk is that sales could improve if consumers believe that the product is more environmentally acceptable. There could also be less political and social pressure from environmentalists.  
The downside risk is that F plc will seem to be profiteering when it is revealed that jobs are being exported to a lower-wage economy. F plc may seem greedy.  

**Understand and assess scale of risk**  
These risks are likely to be significant. The production of fruit and vegetables “out of season” is one of the causes célèbres of the environmental movement. Even the fact that F plc is taking steps to reduce the damage that it is doing will possibly draw attention to the fact that their business model is unsustainable.  
The adverse publicity associated with the job losses in the UK may be embarrassing, although such stories tend not to have any long-term significance.  

**Response**  
F plc has a great deal of scope for managing and dealing with these risks. It may be possible to deal with them without incurring substantial costs.  

(ii)  
When F plc announces the move it should stress the environmental benefits that will be obtained from freezing the goods at the point of harvesting. Ideally, the company should aim to capture and shape the public discussion and focus on the fact that it is behaving responsibly.  

F plc should stress that it is creating skilled work in West Africa and that resources will be put into training and staff development. The fact that some UK staff will be found alternative positions in the company should be highlighted.
The company should ensure that the workforce is kept as fully informed as possible to minimise speculation and uncertainty. The risk is that feeding out scraps of information will also prolong any press interest in the negative aspects of the proposal. F plc undoubtedly has a substantial advertising spend and that may enable the company to influence the editorial position of some sections of the press.

F plc should be ready to deal with any concerns by conducting its own positive publicity campaign. For example, the health benefits of the products could be stressed in order to divert consumers’ concerns away from any negative publicity.

(b) The first question is whether the senior management of the colleges are prepared to commit themselves to meeting F plc’s needs. That should not be a problem because F plc will provide large numbers of students and so the courses will be a major source of revenue because of F plc.

The colleges have to demonstrate their ability to staff the courses. The college management teams should provide F plc with details of the qualifications and experience of the staff who will deliver the courses. The colleges must also ensure that those staff will receive sufficient continuing professional education to keep themselves up to date.

F plc should check on the supporting facilities that will underpin the courses. There should be adequate libraries with sufficient copies of the latest editions of the major textbooks. The colleges must also provide adequate IT support.

The course content should be agreed with F plc. F plc should identify the skills and knowledge that are used by the existing staff to ensure that both are built into the courses. These requirements should be written into formal syllabuses so that the colleges are committed to delivering that material.

F plc could offer students work experience opportunities in the course of their studies. That would give F plc the opportunity to evaluate the training that has been provided to date and so identify any shortcomings in knowledge or skills. F plc should also evaluate candidates’ aptitude before offering them full-time posts so that their competence can be explored and their confidence with the course materials checked. F plc should feed back any concerns arising from this contact with the students at the earliest opportunity so that changes can be made.

The courses should have independent external examiners. External examiners should be academics rather than employees of F plc, but the posts should be held by individuals who can contribute to the overall quality of the courses. Perhaps F plc should offer to meet the travel and accommodation costs of experts from abroad if there are no suitable candidates in the West African country.

F plc should be represented on the examination boards. That will provide additional assurance that the courses are being taught and examined to the highest standard.

(c) The first control will be the development of a detailed system design for the revised sections of the software. This will have to spell out the detailed changes that will have to be made to the existing system so that the systems development staff have a clear understanding of what they are being asked to do.

One major change is that the system will now have to be responsive to new requirements. The inventory management process will change. The logic underlying the inventory system will have to be specified very carefully and then tested thoroughly before it can be coded into the software.

The changes to the new system will have to be written by competent programmers and those changes should be documented carefully so that future updates and developments can be carried out.

Once the system has been written it will be necessary to develop a suite of tests that can be used to test its operation. The algorithms that will be used are potentially very
complicated and so it may be difficult to create a realistic set of tests for this package. Care will have to be taken to ensure that tests reflect the complexity of the decisions that have to be taken by the system.

The new system will require the introduction of data collection and transmission facilities in West Africa and so that may require particular care. The system will have to be understood and applied by staff who have had no prior connection with F plc. Particular care will have to be undertaken with regard to the creation of help files, training materials and the interface.

All staff involved with sales and logistics will have to be trained in the operation of the revised system, regardless of whether they are new to the company.

(d) Currency risks
F plc’s operating expenses will be denominated largely in the West African host country’s currency. The fresh vegetables will be purchased from local farmers and the wages and other factory running costs will be paid locally.

F plc’s income will be largely denominated in GBP from sales to UK supermarkets.

Borrowing in GBP will avoid further increasing the company’s exposure to any strengthening of the West African currency. Interest payments will be in the same currency as revenues and so there will be a degree of hedging.

Non-currency risks
There is another financial risk in terms of the company’s ability to secure and service any further borrowings that are required. The GBP loan will require the pledge of UK assets, which means that there will be less collateral available to secure any further funding that F plc requires.

Borrowing in West Africa will involve pledging an asset that is unlikely to be of great interest to UK lenders because of its location and so it is less likely that F plc will be risking committing collateral that may be required for some other purpose.

Establishing and operating in a foreign country creates the risk of assets being expropriated. If the loan is provided by a UK bank then the West African government will be able to exert far more pressure on F plc because it will always have the ability to take the factory, secure in the knowledge that F plc can do very little in return.

If the West African government provides the finance then F plc will be protected to some extent because F plc would be very unlikely to meet its loan commitments in the event that the factory was confiscated.

The West African government may also feel that it has a vested interest in supporting F plc in other ways in order to protect its loan. It would not be in the government’s interest to be over-demanding with respect to regulations if that would threaten F plc’s ability to service this loan.

The fact that the government is a major stakeholder would protect F plc from any corruption in the activities of government officials.
SECTION B

Answer to Question Two

(a)

(i) Managing value streams involves paying far greater attention to the ways in which H adds value. H’s services are sold on the basis of an integrated service that breaks down distinctions between specialisms and so it seems illogical that the internal management process should emphasise those distinctions. Managing value streams would encourage decision makers to focus on the creation of added value rather than increasing the individual’s reported contribution to that added value.

The biggest change would therefore involve rethinking the way in which H conducts business. Staff time and media capacity are both commodities that should be managed and utilised for the good of H as a whole. “Ownership” of those resources may be costly if it means that decisions are being based on irrelevant information such as sunk costs. Managers should be motivated to think in terms of opportunity costs instead.

(ii) One major change would be to switch to a marginal costing system. Charging overheads to departments is encouraging waste and dysfunctional behaviour. The fact that H must provide an integrated service means that there is very little point in determining the notional profit provided by any given department. H will probably have to maintain a department even if it is found to contribute very little to total profit or even runs at a loss.

The consultancy operates an expensive city-centre site and it would be better to review the total fixed cost of doing so as a separate management exercise rather than spending time charging out elements of those fixed costs to departments. Ideally, those costs should be kept under review so that they can be minimised wherever possible. The management accounting system could track the use of space (in terms of, say, occupancy levels) in order to make the most efficient use of space. There should be no overt charges for the use of those facilities because that may lead to suboptimal decisions. From time to time there ought to be a review based on ABC principles to determine what drives these central costs and whether they could be reduced in any way.

As an alternative to the above:

One major change would be to implement ABC for the reporting of overhead costs. That would ensure that overheads are linked to the activities that actually generate the revenue and so costs will be more realistic. Cost drivers should be linked to controllable decisions made by managers rather than reflecting, say, the fact that a group of staff happens to occupy a slightly larger space.

As part of the ongoing ABC analysis, H should take the opportunity to consider whether costs are justified. It may be that identifying cost drivers will establish that certain expenses are difficult to justify. For example, if it is established that it is unnecessary to have a meeting space because presentations tend to occur at clients’ offices then perhaps H should relocate away from the city centre. One of the problems at present is that budgets appear to be broadly incremental and that fixed costs are taken as given. The shift to ABC might involve a degree of ZBB in budgeting central overhead costs.

The client should be the focus in terms of recording costs and revenues rather than the department. Every client should be the responsibility of a designated senior account executive who manages all of the services given to that client. Staff should log the time spent on chargeable work for billing purposes. Senior management should receive regular reports of the contribution made by each client, with supporting details such as the value of unbilled work in progress or chargeable hours that have not been billed because of client retention issues.
There should be a centralised budget for advertising purchases. Campaigns are likely to be planned well in advance and there should be a designated department that is evaluated on its ability to buy space as cheaply as possible. Any unexpected purchases should be reported separately so that the buyer is not penalised by the loss of any possible discount.

(b) The biggest difficulty is the uncertainty that this will create in the short term for staff at all levels, particularly managers. Changing the management accounting system will change the basis on which individual contributions are assessed and reported and staff may be afraid that this will have an adverse effect on their careers.

Communication is the key to dealing with staff concern. If possible, the board should make it clear that it is not intended that the elimination of waste will involve redundancies. Hopefully, the changes will empower staff and that positive message should be stressed.

H may require new systems in order to track relevant information. It is possible that the information that is required to make the best possible decisions will be difficult to identify at an early stage and later changes may be more expensive to incorporate.

Determining information needs may require detailed discussions with functional managers in order to determine what is important. For example, it may emerge that creative professionals need sufficient free time to keep abreast of trends and to read and absorb other companies' work and that aiming for high staff utilisation rates would be inappropriate.

The reengineering of these processes may prove financially expensive. The danger is that there may not be sufficient waste or dysfunctional behaviour to justify the expense.

H's board should engage a consultant to report on whether H is a good candidate for such a process. Ideally, H should also try to gather information from similar businesses which have organised themselves in this way to establish whether there has been a net benefit.
Answer to Question Three

(a) The total cost of all activities should be measured against budget and previous years. That cost should be broken down according to whether it relates to sweeping or emptying bins and by the nature of the expense within that (e.g. labour or vehicle running costs) so that any costs can be identified and managed.

The breakdown of the total should be linked to the cost drivers in order to measure trends or spot anomalies. For example, the cost of running tractors should be divided by the number of tractors or the number of kilometres travelled to determine the cost per vehicle or vehicle-kilometre. Much of this information should be readily available from existing management accounting records maintained by the town.

It may be possible to break costs down to reflect the cost of cleaning specific beaches or stretches of beach. If so, that might indicate whether a particular stretch is costing a disproportionate amount of time and money because of issues over location or problems such as rocks or soft sand. It may be possible to reduce costs by closing such beaches to the public during quieter parts of the holiday season to reduce costs. Analysing costs in this way will almost certainly require staff to maintain logs for a period in order to show how time and resources are being applied.

Any deviations from budget should be investigated, as should any fluctuations in the measures over time.

Comparable statistics should be obtained from other towns in order to determine whether there is scope to benchmark. There is no reason for other towns to withhold that information because the nature of any competition is unlikely to be affected by expenditure on cleaning services.

For the purpose of any comparison the total cost should be related to the number of beaches being cleaned and the length of the beaches in order to adjust for the scale of the operation.

(b) The quantity of refuse collected by each means (sweeping v emptying bins) should be measured in order to reflect the output from the service.

The number of complaints lodged by holidaymakers and residents should be monitored. Those relating to the cleanliness of the beach should be highlighted as an indicator of public perceptions.

The town council should conduct market research to ask beach users what they think about the amenities provided and the questions should include some discussion of the cleanliness of the beach. That should be repeated regularly throughout the holiday season, partly because the problem may change in response to peaks and troughs in the number of users and partly because the use of the beach may change depending on whether families are using it for play during the summer holidays or older couples are simply walking on the beach when the weather is cooler at the beginning and end of the holiday season.

The number of incidents attended by the beach first aiders should be analysed to highlight injuries such as cuts caused by broken glass.

The town council should conduct detailed audits of the beach itself by inspecting areas immediately after the sweeping operation and also during the day. That will require setting a standard for the audit, such as deciding what constitutes a piece of litter (for example, should a small shred of paper that would be difficult to filter out of the sand be counted in the same manner as, say, an empty soft drinks can?).

Compliance with the town council’s standards should be monitored. For example, there should be a check to ensure that the bins are actually emptied according to the schedule. Any deviation should be investigated to establish whether that is due to staff failure or because the schedule is impractical.
In general, effectiveness audits are more difficult than economy and efficiency audits.

Economy and efficiency is a matter of cost accounting. The cost of providing the cleaning services is largely a matter of using traditional accounting techniques to analyse data that would be collected for financial reporting and management accounting purposes anyway. There are some subjective decisions that may have an impact, such as identifying relevant costs, but even those problems are largely questions of definition.

Effectiveness involves making some difficult decisions about measuring performance. Surrogates, such as the quantity of litter uplifted, can lead to dysfunctional behaviour because that could encourage more frequent emptying of bins at the expense of sweeping. Sweeping will not necessarily collect a huge quantity of material but it might remove dangerous objects such as broken glass.

It may also be necessary to set targets for the end result of the cleaning activities and that could be difficult. What is an acceptable level of litter? What matters more, perceptions of litter or actual cleanliness? The two could differ because many users may not be aware of litter on the beach.
Answer to Question Four

(a)

(i) K requires P$2m in 8 months’ time. It can deposit P$ at 13% per annum, so it should deposit P$2m/(1+(.13 x 8/12)) = P$1,840,491 for 8 months.

K should borrow P$1,840,491/2 = GBP920,245 immediately in order to create this bank balance.

In 8 months, the UK bank loan will equal GBP920,245 x (1+(.10 x 8/12)) = GBP981,595. That balance should be settled using the funding that has been organised in order to finance the purchase of the equipment.

This series of transactions is equivalent to buying P$2m forward at a rate that is discounted relative to the present spot rate. Thus, K will have a fixed cost that is equivalent to today.

(ii) There are likely to be significant professional and banking fees involved in this arrangement. The UK bank may require a fee for granting the loan and it will be expensive to transfer those funds to the foreign bank. This is not likely to be a particularly routine transaction and so the costs are likely to be disproportionate.

The foreign bank will require a small fee for making the final transfer to the vendor. There could be fairly substantial compliance costs associated with opening the account (e.g. in the UK there are major legal requirements relating to anti-money laundering). The foreign bank appears to be in a relatively small country that does not have its currency freely traded, at least on the forward markets. There may be far more serious risks of bank failure in that country than would be normal, say, in the UK. The biggest risk is that the foreign bank will fail and leave K without the funds with which to buy the equipment. The loan from the UK bank will still have to be repaid as agreed even if the funds deposited overseas are lost.

Given that the direction of the interest rate differential suggests that the foreign currency will fall against the GBP there is a risk that K will lock itself into a rate and the currency will fall even further than predicted.

(b)

(i) Paying the P$2m would mean that the cost of the equipment was fixed at the GBP1m implied by today's spot rate. That is more expensive than the rate that could be obtained with the money market hedge, but it avoids the risks associated with the hedge.

The risk associated with the immediate payment is that the vendor may fail in the meantime and so K will lose its payment in any case. The question of relative risk is whether the foreign bank is more or less likely to fail than the vendor. In general, banks are more secure than manufacturing businesses.

The single direct payment will almost certainly minimise the bank charges and other professional costs associated with settling the cost of the equipment.

The cost of this arrangement will be that K is tying up the funds for eight months without any return. The cost of that should be evaluated in terms of K's weighted average cost of capital rather than simply the interest paid.

(ii) The prospect of offering to pay the vendor in GBP effectively asks the vendor to accept the currency risks in place of K. If the vendor is an active exporter then it may have a policy of invoicing in its own currency to avoid such risks and so K may be unlikely to persuade it to accept this arrangement.

The vendor may be tempted by the fact that the relative interest rates imply that its currency will fall by a sizeable amount. That fall is probably greater than the amount
implied in 1(a) above because the comparison is being made between borrowing in GBP and depositing in P$. It is, however, dangerous for companies to base decisions on the belief that they can predict currency movements. If a manufacturer actually could predict currency gains and losses then it would make more sense to speculate on the currency markets than to endure the risks associated with manufacturing.
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 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 outsourcing and foreign direct investment. It also draws upon some of the environmental debates that have affected companies in the food business.

Part (a) draws mainly on Section B of the syllabus (Risk and Internal Control). This part asks for the application of the CIMA risk management cycle to a significant overseas investment that will have the effect of exporting jobs from the home country. The focus is on the entity’s reputation. This has been a common issue facing many successful businesses. The scenario raises questions of human resourcing, corporate social responsibility and press relations.

Part (b) also draws mainly on Section B of the syllabus (Risk and Internal Control), but focuses more on dealing with risks rather than their identification. The question deals with the quality control over college courses. It is to be hoped that most CIMA candidates will have some familiarity with formal tuition for both their CIMA classes and any courses taken prior to CIMA and so they should be able to draw on those experiences. Failing that, the scenario deals with the provision of an important service and the need to ensure that the service provider delivers appropriate support.

Part (c) draws on section E (Risk and Control in Information Systems). The entity plans to make a significant change to its business model and it requires major changes to the information system in order to support that. Those changes must be implemented and tested thoroughly and, ideally, in such a way that operations are not disrupted when the new factory is opened and the inventory management process changes.

Part (d) focuses on section D (Management of Financial Risk). It asks candidates to consider the risks associated with two alternative funding strategies, one of which will offer security against government interference and expropriation. Candidates are expected to identify both the financial and non-financial risks and to deal with both.

Section B – answer two of three questions

Question Two This question draws mainly on section A (Management Control Systems). An entity has been unwittingly stifling itself because its heavy reliance on traditional management accounting practices has led to dysfunctional behaviour. The entity has been exploring lean management accounting and lean manufacturing techniques in order to explore ways to remedy matters.

Part (a)(i) of the question sets the scene by asking candidates to consider the implications of a shift from creating value for the enterprise as opposed to maximising departmental profits. Part (a)(ii) builds on this by asking candidates to suggest changes to the reporting system in order to facilitate that changed mindset.

Part (b) asks about the manner in which this change should be introduced, given that any change in the measurement of performance will create stresses and pressures and so the associated uncertainty may be quite harmful.

Question Three This question draws mainly on section C (Review and Audit of Control Systems). It relates to value for money audit in a local government setting. This is an important aspect of the syllabus. The question provides sufficient lead for candidates to consider the manner in which economy and efficiency and also effectiveness audits may be carried out and also asks for some discussion of their relative difficulty.
Quite apart from the importance of value for money audit in itself, this question tests transferrable skills such as the ability to identify relevant performance measures that are appropriate to any management accounting scenario.

**Question Four** This question draws mainly on section D (*Management of Financial Risk*). It presents a situation in which an entity has to make a future payment in a foreign currency that cannot be purchased in advance using forward contracts or any of the traditional financial instruments. It is, however, possible to construct a money market hedge.

The question raises important questions about the management of foreign currency exposures. The future payment can be fixed, but at what risk? Does a transaction or linked series of transactions that prevents currency risk make commercial sense? Does passing the risks to another party make sense?