Strategic Level Paper

P3 – Performance Strategy

Senior Examiner’s Answers

SECTION A

Answer to Question One

(a)

(i) SPD could be accused of causing accidents in the event of a crash involving one of these cars. The fact that Q claims that the electronics make it possible to drive safely may encourage drivers to take risks that are greater than the board’s ability to prevent the loss of control. SPD’s reputation may be damaged because of accusations that it is encouraging irresponsible driving. The customers who buy this are likely to be high profile individuals whose behaviour, including their driving habits, is likely to be of interest to the media.

In the event of a crash there is a risk that the driver will accuse SPD of negligence in the fabrication of the board. SPD has very little control over the manner in which the board will be installed or maintained afterwards. If a component is damaged or deteriorates in any way or is somehow disconnected from the other systems in the car then it may fail to prevent an accident. In the event of a crash there may be little or no evidence to prove that the board was manufactured properly.

SPD will become heavily dependent on this contract. The workforce has to increase by more than 20%, thereby increasing SPD’s fixed costs. In the short term SPD may lose business from existing customers because it does not have sufficient technicians to service new orders. If Q switches supplier for its board or ceases production of this car then SPD might be left with the difficult choice between carrying surplus staff and making staff redundant.

SPD has to depend on a third party for a crucial component of the system. That creates two possible problems. The first is that the supplier may prove to be unrealisable and so SPD will struggle to keep up with demand. The second is that SPD may be dependent on this third party for quality control. In the event that a circuit board fails it could be impossible to establish who was to blame.

(ii) The reputation risk could be managed by actively warning drivers of the system’s limitations. That could involve insisting that the owner signs an acknowledgement that the system cannot prevent all crashes. This warning could be repeated in the owner’s handbook or even on a plaque on the dashboard. Any promotional material published by Q should stress that the system is designed to enable drivers to be even safer when driving within their limits.

SPD could insist that the circuit board is designed to “fail safe”. It could have a diagnostic routine programmed into it which will check that it is functioning correctly
whenever it is switched on. In the event that this routine fails the circuit board will immobilise the engine.

Q could be asked for a firm contract for this board. The contract should allow for penalties in the event that Q fails to order an economic quantity every year. Alternatively, SPD should consider employing trainees who will not require the same degree of skill as its present staff. The work on the Q contract is essentially routine assembly and so it may be possible to second less expensive staff from another division for this work.

SPD should ask Q to accept responsibility for the work done by the third party. Any lost business due to delays or failures to meet delivery deadlines should be compensated. SPD will also have to insist on its own quality control procedures over this component. That may involve having the right to request details of the technical specification of the part.

(b)

(i) Project selection should take account of the size of the project and also the risks attached. It would be sensible to bias the sample towards large projects that have exceeded their budget or appear to be in danger of doing so.

Analytical review could be conducted to establish whether there are any patterns to overspends. For example, are there any departments or divisions that consistently overrun costs?

The internal audit department should select projects at different stages of implementation. Current projects should be investigated because any problems that are uncovered may be brought to management’s attention and resolved. Completed projects give the internal auditor the opportunity to look back over the whole project and establish whether it was implemented in line with expectations.

Given Aybe’s history of cost overruns, it would make sense for the auditor to check actual costs incurred against the plan. In the case of projects that are underway this comparison could be against the budget to the present stage of completion. For completed projects it could be for the project as a whole.

One possibility that the auditor should consider is whether all of the recorded expenditure should have been charged to the project. Managers may be tempted to charge operating costs to projects in order to ease pressures on other budgets. The charges made to the project account should be reviewed carefully and compared to the initial project documentation.

Particular care should be taken over projects that have exceeded their budget. The auditor should analyse a number of such projects in order to establish where the variance from budget arose. Managers should be interviewed in order to establish whether there was a valid explanation for these variances. At the very least, the auditor should form an opinion on whether the overspend was the result of a genuine forecasting error, carelessness or a deliberate understatement in the initial authorisation process.

(ii) Managers may be concerned that any future projects will be the subject of a post-completion audit that has a negative outcome for their careers. Any major project is open to the risk that unforeseen problems will cause an overspend. If the audit process is viewed as holding colleagues accountable for unavoidable variances then managers may be deterred from requesting funding.

The audits need not create such an effect if they are conducted properly and the results used correctly. For example, the auditors should discuss any findings and recommendations with the managers responsible before they submit their findings. That means that managers will not view the audit as a sinister process that could lead to a negative report that may misrepresent the facts.
It would also improve the audit process if the senior managers to whom the reports are addressed take care to discuss any concerns with the subjects of the report. That way the managers responsible for any overspend will be able to defend their stewardship, perhaps arguing that problems arose could not reasonably have been foreseen or were uncontrollable. The key to acceptance will be that senior management makes a fair and measured response to any issues that the audits uncover. It is perfectly acceptable to take remedial or even disciplinary action where that is warranted, but it should not be an automatic response to any overspend.

(c)

(i) Aybe’s present position is for 25 x 150 = 3,750 tonnes
On completion, Aybe will buy for US$7,800 and will sell for US$8,310 = a gain of US$510 per tonne
Total profit = 510 x 3,750 = US$1,912,500

(ii) The Production Director’s suggestion seems rather inconsistent with the logic behind hedging in the first place. The logic behind hedging was to ensure that Aybe knew well in advance exactly what it would pay for this commodity at a future date. Unwinding this position is effectively speculating that the price will not rise.

There is always a possibility that markets will be volatile during periods of uncertainty, such as the aftermath of this earthquake, but that does not in itself mean that the production director has the ability to “outguess” the markets unless Aybe’s position in this market gives it access to information that is not generally available.

Purchasing an option would reduce Aybe’s downside loss. The problem is that Aybe is effectively gambling on the fact that there will be a seller who is willing to write an option with an acceptable striking price that will not cost more than the savings. The proposal offers the opportunity for a short-term book gain but would leave Aybe exposed to adverse movements in the market.

(iii) The decision to hedge commodity prices should take account of the behaviour of competitors because that will determine the extent to which changing costs can/should be passed on to the customer. If Aybe’s competitors have hedged and Aybe unwinds its protection then there is a risk that Aybe will either have to set loss-making prices in order to stay competitive or risk being underpriced by competitors who have a cost advantage.

That argument may oversimplify the issues because hedging will normally involve a cost and so continuously hedging may not yield any long-term benefits because the hedged prices will tend to follow the underlying cash markets anyway. Aybe may be able to undercut competitors slightly if it does not hedge even if they do because it may, on average, have a slight cost advantage.
Answer to Question Two

(a) IS relies on the data in its computer systems for a variety of purposes.

If the data at the branch was lost or corrupted then all records of all bookings would be lost. That would make it impossible to take bookings until the file could be recreated or customers would be arriving to discover that their vehicles had been double-booked. Taking the system off-line and refusing bookings could cost J a great deal of repeat business.

The loss of the files will also make it difficult to know when the vehicles that are out for rental are due back. That information may be recovered by manually collating the rental agreements, but that will be a time-consuming and expensive process.

The computer files are J’s only record of all minor damage to the vehicles at the branch. If the files are lost then all of the vehicles will have to be inspected and new files drawn up. There could also be disputes with customers over any damage to returned vehicles. J will not be able to insist that it was caused by the customer if the files are lost.

If J cannot prove that the details of drivers’ identities were checked before letting a driver take a car then any loss or damage may turn out to be uninsured. The insurance company may choose to insist that the company proves that any drivers are competent and licensed before paying out in respect of a serious claim.

The loss of identification details may also mean that the police are unwilling to investigate any reports of overdue cars. If J cannot furnish details of names and addresses then it will be difficult for the police to stand any realistic chance of finding a stolen car.

(b) Notebook computer

Plugging an unauthorised PC into the network could expose J’s files to viruses, Trojans and similar threats. J’s systems will be protected from external threats by firewalls and similar safeguards and some of those will be circumvented by the direct connection.

It is unacceptable for a member of staff to download data from the system. Legally, J is responsible for the privacy of the customers whose details are recorded on their computers and that will be compromised if unauthorised copies are made. There is also a severe danger that the manager had some ulterior motive, such as the sale of the data to a competitor.

J could suffer a great deal of bad publicity if the manager’s notebook is lost or stolen and that becomes public knowledge. Customers could be exposed to the threat of identity theft because their names, addresses and personal details will fall into a thief’s hands.

The fact that this was done by the branch manager may mean that branch staff are left with the impression that it is acceptable to be lax over the security of the branch network.

PC

The PC is not the standard machine selected by J’s IS department. It may not be capable of running all necessary software effectively and could slow down the branch network. If that is the case then the branch will become less efficient and could take longer to serve customers.

The fact that the operating system is the wrong version means that the IS department’s help desk will not be able to deal with any queries from the Southtown branch. A great deal of time could be wasted if there is ever a problem arising from the PC and the IS department is not told about the unauthorised machine.
The fact that the machine is using an old version of the software may mean that transactions are being recorded incorrectly. It could also mean that the software risks corrupting the database in the server whenever it makes changes.

There could be copyright issues if J did not have a license to install further copies of that piece of software. In that case, the branch manager has left J open to accusations of software piracy.

Adding a CD/DVD drive to the branch network makes it easier for staff to add unauthorised and unlicensed software to the system. In fact, it appears that this has happened already and so the IS department will have to check all of the PCs at the branch for unauthorised changes.

The fact that branch staff are willing to tinker with the computer network in this way is worrying because it implies an unhealthy attitude towards IS controls and possibly the control environment as a whole. If this is left unchecked then the branch staff may be willing to make further changes to the system that are even more serious in the future.
Answer to Question Three

(a) This method of control appears to be loosely based on the concept of beyond budgeting because branches are not given clear and specific budgets and performance is measured against a sense of potential throughput. Having said that, it is not truly beyond budgeting because managers and employees are not being empowered to work towards the best interests of M. Instead, the system simply puts branches and, indeed, individual members of staff in direct competition with one another.

The system does appear to have had the effect of putting the sales force under some pressure to generate additional sales. Having said that, the company is becoming dominant in its market and so it will become increasingly difficult to deliver growth. It may be time to think in terms of a different strategy in order to exploit this position, such as moving towards higher margin sales or into new product ranges.

The constant pressure to generate sales will mean that local branches do not spend time thinking about local market conditions and plan to maximise sales over the longer term. Customers may lose confidence if the shops are constantly changing their prices and promotions and they are forced to hurry considered purchases in order to avoid the loss of a short-lived discount.

The sales staff in bigger cities that have more than one branch appear to be competing directly with M’s other branches. That means that time and effort are being wasted because these branches should really be working together against M’s competitors. For example, M’s branches may be attempting to undercut one another on branch sales promotions instead of using their advantage in terms of advertising and profile to raise margins.

The constant and unremitting pressure to deliver sales may lead to aggressive sales tactics that will put customers off. Customers will not return or recommend the company if M’s staff do not take the time to advise the properly and simply attempt to pressurise them into buying. The sales staff may also indulge in dysfunctional behaviour such as selling unsuitable phones or contracts in order to generate sales figures, even though customers may return their phones or cancel their contracts once they realise that they have purchased something unsuitable.

The fact that employees are under such pressure will create bad publicity if a former employee complains and demands compensation for harm to his or her health. Apart from the potential loss of sales, that could make it more difficult for M to recruit sales staff in the future.

(b) The biggest ethical issue to come out of this scenario is that of professional behaviour. M’s directors have created a working environment for their staff which is unpleasant and potentially very unhealthy. This is due to the deliberate decision not to set realistic and challenging targets. Instead, all staff are effectively competing with one another. The company’s personnel records indicate that some employees thrive in this environment, but those who do not suffer through poor health and stress related illness. It is perfectly acceptable for a business to aim to maximise its profits, but M appears to be attempting to do so at the expense of its workforce rather than through the provision of a genuinely good service to its customers.

M’s behaviour is also unprofessional in terms of employment law. Threatening staff with transfer or even dismissal when they have done nothing wrong is almost certainly illegal. This amounts to disciplinary action against employees who have done nothing wrong, they have simply failed to exceed the performance of colleagues at other branches.

M’s directors also appear to be failing in terms of professional competence and due care. The company is very much sales-led, which is not in itself a bad thing, but it appears to be focussing on short-term sales volume to the exclusion of any other factor. The strategy has not been revised to reflect the company’s success in terms of its market
position. A competent board would reflect on the strategic direction and would revise the targets that it set for its staff accordingly.

M also has a duty to its customers, who are unlikely to be receiving particularly good service from shop staff who are so focussed on day-to-day sales. For example, there is a positive disincentive to deal with after-sales queries or even to take the time to sell a customer the best package.

It could be argued that M’s management lacks integrity in the sense that senior management has a duty to be responsible for setting targets and direction and also for the promotional activities that should be undertaken within shops. Senior management has abdicated that responsibility and passed it down to junior staff.
Answer to Question Four

(a) (i) The contract with E involves very large numbers of quite small transactions that will be settled quite quickly. The short period of time between entering into a transaction and its settlement means that there is relatively little opportunity for exchange rates to move against N. The fact that routine transactions involve both receipts and payments implies that there is a tendency for revenues and expenses to hedge one another. It could, therefore, be argued that the transaction risk is not particularly severe.

The contract with N involves a small number of very large receipts of Euros. The fact that K will undertake work and then wait for anything up to a year before settling the balance means that N is exposed to the possibility that the Euro will weaken against its home currency.

The two risks differ because there are large numbers of small transactions in the contract with E and a small number of large transactions in the contract with N. That changes the approach to be taken to managing the risks because it may be worth actively managing risks associated with a large transaction that will be outstanding for some time.

(ii) It may be tempting to simply accept the transaction risks associated with the contract with E. The fact that there will be a large number of small transactions spread over a long period means that gains and losses may tend to cancel over time.

N should, however, take some steps to protect itself. There will be a net receipt of Pesos over the life of the contract. The currency is weak and so this net revenue is likely to decline in value over time.

The most effective way to deal with this risk would be to offset the remainder of the net inflows with an outflow denominated in Pesos. It may be possible to do so by importing parts or materials that can be sourced from E, such as engines. Alternatively, N could borrow Pesos in order to establish the subsidiary. That would mean that any decline in the revenue from the contract would be offset by a decline in the capital amount owed to the lender.

The exposure on the contract with N is far greater. It may be advisable for N to use a derivate instrument in order to limit the downside risk. It is unlikely that there will be much of an opportunity to sell currency forward for the whole four years, but there may be instruments that can protect N’s position on a year by year basis. For example, N could purchase a put option for one year ahead in order to reduce the potential loss that might arise when converting the next royalty payment into its home currency.

It may be possible for N to take out a series of loans denominated in Euros as a hedge, with capital repayments timed to coincide with the due dates for the receipt of royalties. That would only be advisable if N required to raise debt in any case, otherwise the company would simply be paying interest and increasing gearing unnecessarily.

(b) The first suggestion is to find an investor in E to provide a significant proportion of the equity for the subsidiary. If the economy is unstable then local knowledge will be vital in understanding exactly what needs to be done in order to avoid problems with the government and other regulators. The local partner will be far more motivated to assist and advise N on the problems of trading in E than, say, a local consultant or legal advisor would be.

The fact that the company is partly owned by a local investor would reduce the risk of expropriation because the company is only partly foreign owned. Furthermore, a successful local business person is more likely to have contacts who can be used to negotiate on behalf of the company in the event of any problems with the government.

The problem with taking on a local investor is that N will lose outright control over its activities in the country. It may also prove more difficult to wind up the company at the
conclusion of the contract because the local investor may wish to carry on the business in some way with a different range of products.

The second possibility suggested is to finance the company heavily with borrowing from a bank in E. That would mean that the bank would have a direct incentive to intervene if the government took any action that threatened the subsidiary’s ability to service the debt. In the event that there was a serious problem, N would have very little equity in E and could theoretically withdraw from the country without suffering undue losses.

The problem with this strategy is that N may not necessarily wish to borrow because of the impact on gearing. Furthermore, the bank in E may not be willing to grant a loan unless it was guaranteed by the holding company. In other words, N might not be able to hide behind limited liability and go into default over the loan. It would also create bad publicity for N if it permitted a group member to fail without settling the debts due to its creditors.
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 split into three parts:

Part (a) is drawn from section B of the syllabus – *risk and internal control*. It asks candidates to evaluate the risks associated with the development of a high-tech assembly that is designed to ensure the safe operation of a sports car.

Part (b) is drawn from section C of the syllabus – *review and audit of control systems*. It asks candidates to design an approach to post completion audits of the company in the pre-seen case and to discuss the implications that these audits might have for the company's capital budgeting process.

Part (c) is drawn from section D of the syllabus – *management of financial risk*. It deals with the question of hedging movements on commodity prices using derivative financial instruments. It explores candidates' understanding of the advantages and disadvantages of hedging.

**Section B – answer two of three questions**

**Question Two** is drawn from section E of the syllabus – *risk and control in information systems*. It tests candidates' understanding of the importance of controls in systems and also the implications of compliance errors. It places these issues in the practical context of a branch of an entity that is heavily reliant on its information systems.

**Question Three** is drawn from section A of the syllabus – *management control systems*. It introduces a potentially divisive and dysfunctional management accounting system and tests candidates' ability to evaluate the effects of the system for the company as a whole and also the ethical issues that such an approach to management may have.

**Question Four** is drawn from section D of the syllabus – *management of financial risk*. It deals with the financial risks of operating overseas and links those financial risks to some of the more common methods available for the management of those risks, including internal hedging techniques such as netting and sourcing of finance.