 Examiner’s Answers

Note: Some of the answers that follow are fuller and more comprehensive than would be expected from a well-prepared candidate. They have been written in this way to aid teaching, study and revision for tutors and candidates alike.

These Examiner’s answers should be reviewed alongside the question paper for this examination which is now available on the CIMA website at www.cimaglobal.com/p3papers

The Post Exam Guide for this examination, which includes the marking guide for each question, will be published on the CIMA website by early October at www.cimaglobal.com/P3PEGS

SECTION A

Answer to Question One

Rationale

This question is based on both the common pre-seen scenario and the unseen scenario. Parts (a) and (b) draw on the health and safety risks associated with running a large organisation that has widespread operations. Part (c) deals with the management of currency risk for an entity that has global operations.

Part (a) draws mainly on Section B of the syllabus (Risk and Internal Control). This part asks for an evaluation of the health and safety risks associated with running a large retail organisation. Two aspects are considered. Part (i) focusses on the ability to identify and evaluate the risks to the entity. Candidates are required to focus on sources of high risk and to justify their selections to ensure that marks are awarded to material risks only. Part (ii) asks for an evaluation of the difficulties caused for management in terms of ensuring that health and safety matters are taken seriously. This reflects the paradox that arises whereby management is always responsible for health and safety even though one of the main sources of risk is staff indifference.

Part (b) draws mainly on section C (Audit and Audit of Control Systems). The first part of the question asks how the internal audit department might assist senior management in ensuring that staff are complying with health and safety instructions. Setting the internal audit department the task of checking compliance will help ensure that management is seen to discharge its responsibilities in the event of an accident. The question goes on to reflect on the fact that the entity is a multinational corporation and that cultural differences may make it
It is difficult for the internal audit department to enforce rules set by head office.

Part (c) draws mainly on section D (Management of Financial Risk). The entity has widespread and complex currency issues and those may well lend themselves to natural hedging techniques that would avoid the cost and complexity of financial instruments.

**Suggested Approach**

Part (a)(i) for the identification of two health and safety risks. The starting point is to consider two distinct risks that can be classified as having both a high impact and a high likelihood. There is no specific list of risks that will be accepted, but the risks must be sufficiently serious as to make them worth being concerned about. The suggested solution focuses on the risk of litigation and the risk of adverse publicity because both can be justified as both high impact and high likelihood. If candidates decide to focus on specific health and safety matters such as injuries associated with lifting and the risk of violent confrontation with a shoplifter then that will be accepted provided the reasons for those being potentially costly to the company are expressed. Part (a)(ii) offers the opportunity to discuss some of the difficulties associated with enforcing health and safety regulations. That is a difficult area for any employer because health and safety frequently creates some inconvenience to employees, such as the need to wear uncomfortable kit or the need to take care with work that may leave colleagues at risk. There is an added dimension because the company operates internationally and there may be cultural difficulties to be overcome in communicating the need to take health and safety seriously.

Part (b)(i) is looking for recommendations concerning the planning of a work programme that the internal audit department should undertake in order to reassure the board that health and safety regulations are in effect and are being complied with. The key is to think about the areas where the risk of non-compliance is greatest and to concentrate resources on those. For example, something as basic as concentrating attention on the stores that have the highest accident rates could maximise the likelihood that exceptions are being uncovered. Part (b)(ii) is looking for an appreciation of the cultural aspects of conducting internal audit investigations across an international group. Local staff and management may feel somewhat isolated and remote from head office and may resent the implication that the group’s values should be exported to their countries.

Part (c)(i) asks candidates to consider the implications of the inflows and outflows of currencies form buying inventory and trading with customers. That raises questions about the extent to which there are net receipts or payments in any given currency. It is unlikely that the cash flows are perfectly hedged, but it may be that there is enough of an offset for the overall exposure to be ignored. Part (c)(ii) asks candidates to consider the possibility of counter-trade. The point of this question is more about asking candidates to demonstrate some understanding of the basics of currency risk and the ability to identify opportunities from unusual situations. Even if a candidate is unfamiliar with the details of counter-trade it should be possible to take into account the possibility of simplifying the currency risks by exchanging commodities.

(a)

(i) B may be exposed to the threat of legal action and be forced to pay compensation for injuries. B has large numbers of employees who are moving heavy inventory as part of their day to day activities. Items will be lifted by hand and there will also be mechanical equipment such as forklift trucks. Any carelessness or inattention on the part of an employee could lead to that employee being seriously injured or causing an injury to a colleague. The fact that such risks are very visible and obvious means that injuries are reasonably foreseeable and it will be difficult for B to disclaim liability.

Health and safety matters can also lead to significant adverse publicity. The public is often willing to believe that commercial entities put profit before safety because it can be expensive to prevent accidents. That will be especially true given that B has staff at risk in many different countries and multinational companies are often accused of paying...
insufficient attention to the welfare of foreign staff. Serious accidents can have some news value because of the human interest aspect and so a news editor may be willing to publicise such cases. The fact that B is in competition with other retailers may mean that any adverse publicity could lead to some customers seeking alternative sources.

(ii) It can be difficult to encourage any member of staff to take health and safety seriously because that will usually involve some inconvenience. For example, staff may not be willing to wear high visibility clothing when working in the warehouse because it is simpler not to do so. Employers often have to impose disciplinary sanctions in order to ensure compliance.

Supervisors and managers may be tempted to overlook breaches in policies because health and safety can interfere with operations. For example, if staff are not permitted to lift heavy items until they have been trained to do so safely then it may be necessary to tolerate a stoppage or slowing in operations until a trained member of staff can be found to replace an untrained employee.

There are practical issues in imposing a uniform policy around the world. For example, language difficulties may make it difficult for staff to read warning labels. Some health and safety advice may be difficult to translate accurately because of its technical nature. Equipment may not be readily available in some countries or may be difficult to wear in some climates. For example, safety boots may be difficult to find or may be very uncomfortable in hot weather.

Local cultures can also play a part in discouraging safe practices. Staff in some countries may regard wearing safety equipment as unmanly.

(b)

(i) The audit should be conducted at every location around the world in order to demonstrate B's commitment to the health and safety regulations. However, the audit departments at regional offices should conduct a preliminary review to enable the visits to be tailored to distinguish those that require a light touch from those that require a more intrusive visit. For example, stores that have good records with respect to industrial accidents will not require nearly as much attention as those that have poorer track records.

Low risk locations may involve including health and safety to be raised as a matter for discussion at the next routine audit visit. The audit team could discuss performance with the store manager and could review the log of industrial accidents and attempt to draw out any issues arising from that.

High risk locations, such as stores in the country at which the accident reported in the press occurred, may require a specific visit to deal with health and safety. Audit staff should be trained and also equipped with the safety equipment required to operate in the operational areas of stores such as warehouses and freezer units. Audit teams should then make surprise visits to check that all staff at work at the time of the inspection are properly equipped and working in accordance with the rules. Audit staff should be instructed to note any exceptions and the names of the staff involved and their supervisors recorded. The audit team could also be instructed to review footage from the security cameras to check that the procedures appear to have been in operation at random points in the past.

Any breaches should be flagged in the report and senior management should make it clear that such breaches are unacceptable. The direct interest of head office will show that local managers cannot overlook safety. There should also be follow-up visits to address the breaches and check that they have been remedied.
(ii) The internal audit function should always be presented as a constructive service within an entity that is there to help and advise. It is always undesirable for internal audit staff to antagonise or intimidate the staff who are subject to audit.

Having said that, the internal audit department has a responsibility to check compliance with company procedures. Staff do not have the right to opt out of compliance, even if they disagree with the procedures laid down by senior management. It may be necessary for the internal auditor to conduct reviews that will result in reports that are considered unpopular or that lead on to complaints from head office. If the internal audit department shirks the responsibility to conduct audits in those circumstances then there is very little point in having an audit department.

It may be that the internal auditor can reduce the threats created by cultural differences by communicating the purpose of the audit carefully and reducing the threat of escalation. The internal audit process will always be less threatening if the auditor develops a good working relationship with the staff being audited and discusses any findings before the report is submitted. The internal auditor can take care to ensure that the auditees’ opinions are incorporated into the report for consideration alongside the auditor’s findings.

(c)  

(i) B is trading in many different currencies and is both a buyer and seller in many of those. For example, B is likely to be buying Japanese electronics for sale around the world and paying in Yen but could also be selling goods priced in Yen through its Japanese stores. B will only be exposed to the net flow in Yen and so it will be well hedged. The nature of B’s business is that it will be making regular purchases from most of its suppliers, for settlement in the relatively short term. If it places a regular order for shellfish from UK suppliers then those balances will probably be settled within 30-50 days and so there is relatively little chance of currency movements in the short term. Sales will often be for cash and so the transaction risk on sales balances will be even less significant.

The scale of its operations should make it easier for B to source alternative supplies in response to currency movements. If it becomes more expensive to import beef from Argentina because of a rise in the Argentine peso relative to the E rise then B can consider importing from the USA or another country that has not been affected in the same manner.

The central treasury operation will make it far easier for B to determine its net exposure in any given currency.

(ii) The advantage of counter-trade is that the exchange rate can effectively be fixed in terms of commodities. B has agreed that a specific quantity of clothing can be exchanged for a specific quantity of flour or sugar and that is a known amount.

In this case, the commodities are generic and so it does not matter whether the sugar is sourced from the Caribbean or Europe. B can buy essentially the same product from a different source if prices change because of currencies or whatever.

The contract should be good for the South American supplier, which will make that supplier more loyal to B. If the local currency is volatile then the value of a staple commodity should automatically adjust itself as the currency rises and falls. That will reduce the risk of the supplier being unable to make a profit and leaving B without a source of clothing for its stores.

It is possible that these commodities could be exposed to substantial swings that have nothing to do with currency rates. B could deal with that threat by buying futures when such volatility appears possible. B’s position as a major trader will mean that the company will have good insights into the threat of such movements.

It is possible that the South American supplier could resell the flour or sugar on the international markets and that might cause some speculative pressures, but it is unlikely
that the contract will involve sufficient quantities to have any meaningful impact on market prices.
SECTION B

Answer to Question Two

Rationale
Question 2(a) draws on section A (Management and Control Systems). Part (i) deals with the calculation of a relevant ROCE figure that can be used to inform strategic decisions about a subsidiary. Part (ii) asks for a discussion of the relevance of ROCE to the decisions that have to be taken in the management of the subsidiary.

Part (b) draws on section B (Risk and Internal Control). The question deals with the risks created by the sale of a technical product to customers who are likely to reject perfect inventory because of their inability to distinguish good items from defective.

Suggested Approach
Part (a) requires candidates to think about the most relevant figures that should be incorporated into the calculation of ROCE. There are issues associated with the valuation of property and of plant and equipment that may lead to performance being massively overstated unless care is taken to adjust for information as necessary.

Part (b) asks candidates to use their common sense in order to arrive at practical recommendations for dealing with incompetent quality control processes conducted by management.

(a)

(i) Retaining existing lathes

Net operating profit before tax = 32+2 = 34

Economic value of business assets = 33 + (52-29) = 56

ROCE = 34/56 = 61%

(ii) New equipment

Net operating profit before tax = 34-(40 x 25%)+(30 x 20%/120%) = 29

Economic value of business assets = 56 + (40-25%) = 86

ROCE = 24/86 = 28%

The economic value of business assets should value the factory site at the amount offered by the potential buyer. That recognises the opportunity cost of the resources tied up in the factory site.

Under the new equipment heading it is necessary to adjust for the effects of the capital value of the lathes and the additional depreciation that will be charged.

The new lathes will hopefully reduce or even eliminate the wasted output that has been scrapped for no good reason. Previously variable production costs were inflated by 20% because of unnecessary scrappage.
(b)

(i) It is clear that ROCE overstates T Forge’s performance at present because no value is attributed to the lathes and other heavy equipment. The directors are essentially being evaluated on profits that have been generated using resources for which they are not being held accountable.

The board is also being permitted to value the site at its historical cost, with no adjustment being made for the opportunity cost associated with its occupation by the factory.

This raises questions about the manner in which “performance” is to be evaluated. If the directors are to be evaluated on the basis of asset turnover then it may be slightly misleading to use an inflated market valuation to compare T Forge with other manufacturers. If they are to be evaluated in terms of their ability to generate shareholder wealth then they should be held accountable for the opportunity cost of holding the factory rather than selling it for development.

(ii) It is important to remember that ROCE is a historical measure and decisions really require the focus to be on future events. ROCE ignores cash flows and also the time value of money. Companies must be profitable in order to create wealth for the shareholders, but there is no direct link between maximising ROCE and maximising shareholder wealth.

The comparison of the company with the new investment and without it may lead to suboptimal decision making because ROCE is almost certain to decline in the aftermath of a major investment to replace a fully depreciated asset. The new lathes are expected to generate a positive net present value and so it may be better to base the decision about investment on the NPV criterion.

(c) First of all, T Forge should invite its major customers to send their engineers to the factory for training. The manufacturing processes should be explained in some detail and the source of the marks, which are nothing other than an inevitable result of the manufacturing process, should be explained. These visitors should be shown evidence of a roller that carries these marks that can be tested and found to be free of any structural fault.

If there is any specialised equipment that can be used to test for cracks and genuine flaws, such as ultrasonic scanners, then T Forge could provide customers with that apparatus and should offer training in its use. That would enable customers to carry out valid tests for damage, without having to resort to pointless visual inspections.

It would be useful to have a sample of T Forge’s products tested independently for strength and accuracy in terms of dimensions. The tests should be carried out by an acknowledged expert in this field. The report should directly address the question of the marks left by the lathes and should highlight the effects, if any, on the strength of the rollers. It may be useful to have an independent expert test all rollers prior to despatch and for their quality inspection report to be submitted with the delivery records.

T Forge’s terms of trade should make it clear that even perfect rollers can carry cosmetic markings and that the customer agrees that these are not a valid basis for rejecting a delivery. The customer should agree to pay for any items supplied by T Forge unless it can be demonstrated that there is an actual failure in a component.
Answer to Question Three

**Rationale**
This question draws mainly on section E (Risk and Control in Information Systems). It deals with the implications of data security, with particular reference to the very typical real-world scenario of security being breached by a very low-tech means (in this case, data being taken home on a memory stick).

**Suggested Approach**
Part (a) requires an understanding of the importance of the control environment and of the controls that should prevent data from being lost in the manner described. The emphasis is on the common sense understanding of control rather than detailed technical knowledge.

Part (b)(i) continues this theme by asking candidates to recommend a practical response to deal with the threat of reputation loss arising from the lost files. Part (b)(ii) asks for controls that could be implemented to prevent a recurrence.

(a) There appear to be major shortcomings within U's control environment. The analyst's behaviour suggests that staff may be overworked, which will lead to errors and possibly short-cuts such as taking files home.

The fact that the analyst was afraid to admit to the loss of the files adds to the sense that the environment is unsupportive and punitive.

Staff should have been trained on the sensitivity of personal details in a company such as U. The information that has been lost may be very personal in nature and could lead to losses because of identity theft and related fraud. Such training should have reduced the risk of a member of staff leaving a file of customer records on an unsecure PC.

Staff should not be permitted to connect personal disk drives to U's computers. There is a danger that these will carry viruses or other malware. Ideally, staff PCs should not have open USB sockets to reduce the risk of this occurring. Any files that need to be shared with colleagues can be transferred over the firm’s network.

The files themselves should not be accessible in their entirety. Only accounts staff need details of credit card numbers and so access to those should be restricted to them. Fields within files should be made available to U’s staff on a strictly “need to know” basis. The analyst did not need to know customers’ names and full postal addresses. It would have been sufficient to have identified customers by a user number and provided the analyst with a buying history for each.

(b)

(i) The first priority is to make a public announcement that all affected customers have been informed about the loss of their records. That will reduce the speculation about the loss and may reduce the number of claims from customers who have not been affected by the loss.

U should close all affected accounts and assist customers to create replacements. That will prevent customers’ claims that they are having unauthorised charges to their accounts.

U should offer to assist customers who open replacement credit card accounts in order to prevent fraudulent charges. U should reimburse any fees or charges and should also offer a discount or a voucher as a goodwill gesture for the inconvenience.
U should take steps to remedy the control weaknesses and should announce the fact that security has been improved. The fact that sensitive data could be compromised in this way will be a concern to all customers, particularly given that U initially refused to assist affected account holders.

U should quietly change its policy of denying all responsibility for claims of fraudulent charges. Care will have to be taken in case customers attempt to deny liability for genuine purchases in the hope that U will cancel their balance. It is hardly acceptable for U to claim that customers are mistaken about false charges when the company has been responsible for the loss of data.

(ii) The company should make it very clear that the removal of files without authorisation is a serious breach of company rules and that any offenders will be dealt with. The threat should hopefully deter any recurrence and will also ensure that there is no doubt that files cannot be taken home.

If it is ever necessary for files to be taken home there should be a provision made for secure custody of the data. Files could be encrypted and staff could be issued with a company laptop that is password protected and equipped with all relevant anti-virus and firewall software.
Answer to Question Four

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<th>Rationale</th>
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<td>Question 4 draws on section D (Management of Financial Risk). Part (a) deals with the theory of purchasing power parity and its relevance to exporters. Part (b) deals with the risk of buying using “grey imports” from a neighbouring country. Part (c) deals with the steps that the government might introduce in order to protect revenues from tariffs.</td>
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<th>Suggested Approach</th>
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<td>Part (a) requires an appreciation of the logic behind purchasing power parity and the fairly obvious barriers that might affect the operation of PPP in practice.</td>
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<td>Part (b) deals with the risks that a retailer would run in buying from an indirect source via another country in order to exploit price differences.</td>
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<td>Part (c) asks about tariffs from the perspective of the government rather than the company. The question is looking for the ability to develop logical tests that might be applied in order to deal with avoidance in this area.</td>
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(a) Purchasing power parity theory (PPP) suggests that a commodity will sell for the same amount across the world, regardless of the currency in which it is priced. That is because of arbitrage. It is illogical that customers will buy goods in their home country if they can buy them elsewhere and import them more cheaply.

There is considerable evidence that PPP does not hold in reality. There are some fairly obvious reasons for that. With very few exceptions, it is unlikely to be convenient to buy goods from across an international border. Travel and transportation costs will frequently exceed any savings.

There can be artificial factors, such as tariffs and differential pricing practices by suppliers.

(b) The only benefit is the obvious one that G will possibly be able to reduce its costs. Those savings will make it easier to compete with other retailers who are using the same sources.

The fact that this behaviour is illegal in G’s home country means that the company may be open to prosecution. The staff who are responsible for making the arrangements may also be held personally responsible, which will harm G’s reputation if any of them are prosecuted. Staff may refuse to act illegally, which could undermine discipline in G and could lead to problems in processing partially completed transactions.

G’s contract will be with foreign intermediaries, who may offer a lower standard of service than the manufacturer. Any disputes over quality or delivery may lead to G being unable to obtain an adequate resolution. The intermediaries may not offer the full range of new designs and may not be able to meet all of G’s requirements for volume.

The manufacturers may be unwilling to encourage G to buy from intermediaries because they will lose the benefits of differential pricing in the two markets. They may report G to the authorities or take G to court to prevent it from stocking or selling these “grey imports”. The manufacturers may then refuse to sell goods to G in the future in order to deter other retailers from copying this practice.

(c) The government can inspect the retailer’s books to determine where it obtains its goods. Given that most of the fashion clothes appear to be imported, there ought to have been
duty paid on virtually all of the retailer’s purchases. The total duty paid should be roughly equivalent to the total purchases multiplied by the rate of duty.

The retailer is unlikely to record all transactions accurately in its bookkeeping records if it is defrauding the revenue authorities. The government should check that the purchase records are accurate by going back to basic records, such as sales recorded by individual shops. There should be a realistic relationship between the level of sales and the level of purchases. If the gross profit percentage is very high then that would suggest that purchases are being understated.

The customs authorities should conduct spot checks of vehicles crossing into the country as a matter of routine anyway. Customs officers should be instructed to look out for goods despatched to the competitor by anyone other than the original manufacturer. Any such goods should be seized and the relevant paperwork investigated to determine whether duty has been paid.

The revenue authorities can conduct spot inspections of goods being delivered to the competitor’s premises. Again, the origin of the goods should be investigated for unpaid duty.

The authorities can always levy an estimated charge on the competitor and force the competitor to prove that such a payment is not appropriate.