Answer to Question One

(a)  
(i) The starting point in dealing with any ethical dilemma is CIMA’s Code of Ethics. The Fundamental Principles include two principles that are very directly relevant.

The principle of **integrity** requires the CIMA member to be honest and straightforward in any business dealings. Bribing a government official to grant a permit to which the entity might not be entitled clearly breaches this principle.

The principle of **professional behaviour** requires a CIMA member to comply with relevant laws and regulations. Bribing a government official would clearly be a breach of the law.

The CIMA Code of Ethics provides specific guidance on the matter of inducements. It is unacceptable to offer inducements to influence the judgment or decision-making process of an individual.

The Code of Ethics does not specifically forbid the payment of the bribe in these circumstances. N does not appear to be in breach of any of the Eastern European country’s laws or regulations. The permit has already been awarded and so N must be compliant. The bribe is not, therefore, being paid to influence the official’s judgment. It is a ransom payment intended to prevent the official from abusing his powers.

Paying this bribe also has a number of commercial implications. First of all, M plc is in breach of the UK’s recently enacted Bribery Act and could be liable to the adverse publicity and penalties that would follow on from prosecution and conviction. Secondly, the bribe itself is for a considerable sum amounting to 3% of N’s revenue. The local managers claim that this is a cost of staying in business and retaining the freedom to print the newspaper. It may be that the cost could be saved if reported the official to the police or to the government department in which the official works. People may feel the company is unethical and stop buying the paper or stop advertising in it.

(ii) There could be an argument that paying the bribe would be consistent with the local business culture in the Eastern European country. Such an argument could be used to justify interpreting the Fundamental Principles in such a way that the bribe could be paid. The moral issue then becomes one of whether M plc wishes to perpetuate the culture of...
bribery and corruption in that country. There would undoubtedly be a cost to standing up to the official, but that is possibly a cost that M plc could afford to bear.

From a purely commercial point of view, there is a danger that N will be closed down if the bribe is not paid and that the bribe is an acceptable financial cost. Payment could, nevertheless, be a commercial mistake. The official may increase the amount demanded as time passes and the cost may no longer be economic. The official will also have evidence that M plc committed a criminal act by bribing an official, which will give even greater power to extort payment. Given that a newspaper group must protect its reputation for honesty at all costs, it would be foolish to risk being caught up in a bribery scandal.

The payment of the bribe could also put M plc in breach of the UK’s Bribery Act 2010. This is new legislation and it may be that M plc could argue that it is the victim of extortion rather than in receipt of any improper advantage but that is unlikely to provide an adequate defence.

Note: CIMA’s rules on inducements are relevant but were not required in order to obtain full marks. Similarly, candidates were awarded credit for relevant points drawn from the UK Bribery Act, but it was not necessary to do so.

(b)

(i) The most important implication is that N’s credibility as a news publisher has been called into question. The newspaper has published an article that its journalist knew to be totally untrue (because there is no such charity in the Eastern European country) and that article passed through all of N’s quality control and checking processes.

The fact that the story involved a charity, with implications for seeking public donations, makes the event even more serious. The public tends to take scandals involving charities very seriously and that could deter advertisers from being associated with N. That could be even more costly than any loss of circulation.

The payment of the compensation and the public admission is likely to be publicised by N’s competitors. It is unlikely that the donation will be a significant cost in itself, but the harm to N’s reputation will be far more significant.

The fact that the article was plagiarised rather than fabricated from scratch indicates an even greater dishonesty and incompetence on the part on N’s journalist.

(ii) An information system could be developed to enable the editor to monitor the activities of journalists and to supervise the creation of news stories. Electronic diaries can be used to keep track of individual journalists’ movements so that the editor is aware of the stories that are under way and that a realistic amount of time is invested in each. If the diaries suggest that journalists are being pushed too hard or are overstretched then the editor can reduce workloads accordingly.

All evidence gathered by the reporting staff can be filed electronically and be made available to the editor and the newspaper’s legal department. Interviews can be recorded using digital recorders and any paper documents can be scanned or photographed with a digital camera. It would be difficult to fabricate such evidence and the fact that it is made available in this way will deter misbehaviour because the journalists will not know whether it is to be reviewed in depth or not. It should be a matter of policy that nothing will be considered for publication unless a complete evidence file has been prepared in this manner.

Once a story has been filed for review the newspaper should undertake a web search on similar stories. Apart from the possibility of detecting plagiarism, knowing whether this is the first story of its type will help the editor to decide how much prominence it should have.
and how it should be structured. This is effectively a clerical operation that should be undertaken by a member of support staff and the results should be copied to the editor.

There is also software available that can be used to trawl the web for similarities that are worth investigating. That software should be used as a matter of routine and any undue similarities or high scores should be investigated.

(c)

(i) N was acquired as a going concern when M plc purchased 80% of its equity. One of the classic defences against expropriation would be to borrow heavily from local banks in the Eastern European country. If those loans are secured against N's local assets then any government expropriation would take very little in the form of equity. This borrowing is unlikely to have a significant impact on M plc's gearing and any funds raised locally by N will release equity that can be diverted into the group.

The fact that N has a significant local investor means that the investor has an incentive to use local knowledge to protect N's interests. Ideally, M plc should organise N so that E has very little to gain and everything to lose in the case that N is nationalised by any new government.

The fact that M plc is a news group may be used to deter the new government. The newspapers and other media in the rest of Europe could be used to attack the new government if it carries out its threat so that public opinion can be directed against this action. N may lose all of its advertising revenue in the case that such a campaign deters advertisers.

It may be possible to develop a good relationship with the prospective governing party. N could even pledge its support for the party in return for the withdrawal of the threat to nationalise the newspaper.

It may be possible for M plc to make N worthless in the event that it is nationalised. Ideally, any key staff sent in from outside of the Eastern European country after N was acquired should be left in place and locals should not be trained to take over. In the event of any nationalisation these staff can be withdrawn and production will be disrupted. Similarly, any updated software that N has introduced in order to modernise production should not be made available in the event of nationalisation. All backup disks and all passwords should be returned to the UK for safekeeping. The cost of replacing that software may make it uneconomic to take the company over.

(ii) E’s offer may be the only way to be certain of recovering something in the event of a nationalisation. The original investment is a sunk cost and so should have no further bearing on the decision as to whether to accept E’s offer.

The fact that the loss may not come about means that the small offer being made by E should be weighed against the potential profits that would be foregone in the event that the threat from the new government could be managed. Retaining some chance of a successful business against the opportunity cost of E’s offer could remain a positive NPV investment.

The fact that the Eastern European country is associated with bribery and corruption could create the possibility that E has stirred up the rhetoric in order to win control of N. Perhaps the threat is an empty one because very few governments wish to antagonise and deter foreign investors.

M plc’s shareholders may be unhappy to see the subsidiary sold off under these terms and so any agreement with E could undermine the board’s credibility.
M plc cannot rely heavily on any future advice received from E because he has created a clear conflict of interest by attempting to buy the remaining equity.
SECTION B

Answer to Question Two

(a)

(i) There is a difference between the risk profiles of shareholders and executive directors. Shareholders should hold diversified portfolios, in which case they are subject only to systematic risk. Directors cannot diversify in the same way because each director has only one career and can generally only be an executive director of one company at a time and so the directors are subject to total risk.

A director who is offered an investment that has a positive NPV at the shareholder’s required rate of return may implicitly evaluate that investment at a higher rate that reflects total risk and so may reject it.

If the directors hold options then the value of those options is directly related to the total risk of the underlying security and so the directors could be motivated to accept riskier securities in order to increase the value of their options. There is a huge potential gain if the option is in the money when it is time to exercise it, but there is no symmetry because there is no specific loss other than the expiry of the options if it is out of the money. This means that there is effectively only an upside risk to the directors with respect to their options and that may make them less risk averse in project evaluation.

(ii) The most obvious advantage of V’s ESOS is that the options only have value if the share price rises. Increasing the share price is one aspect of maximising shareholders’ wealth. Certainly, the directors will have a clear incentive to increase the share price through hard work and initiative.

The fact that the options will take three years before they can be exercised means that the directors will be forced to think in terms of the medium term future rather than simply short term gain.

The ESOS will deter directors from leaving because they will have at least two years’ worth of options that will lapse under their terms of employment. That should encourage a degree of continuity of senior management and make it more expensive for another company to poach board members.

ESOS options can only be exercised on a specific date, which means that the directors are motivated to deliver sustained increases in the share price. A sustained growth will mean that the options are more likely to be in the money when the decision has to be taken as to whether they are exercised or allowed to lapse.

There is a risk that the directors may be motivated to withhold dividends because the payment of a dividend will always reduce the share price when the shares become ex-dividend. Retaining earnings may not maximise shareholder wealth, but it could increase the share price to the directors’ advantage.

(b) Any form of feedback-based control system is designed to ensure that positive impacts are encouraged and reinforced and negative impacts are discouraged and penalised. Feedback measures and controls performance by referring to actual outcomes. From the shareholders’ point of view, that suggests that the directors are incentivised to work towards producing regular progress towards a specific goal such as increasing profit or share price.

The simplicity of such a scheme makes it easier to understand the directors’ motives. A more complicated appraisal and performance scheme may simply create more
opportunity for the directors to indulge in dysfunctional behaviour or otherwise play games in order to maximise their rewards at the shareholders’ expense.

From the shareholders’ point of view, it may be that maximising reported earnings is suboptimal and that a more complicated set of benchmarks would be preferable. On the other hand, a simple benchmark does have the advantage of making the directors accountable for a specific aspect of performance. A simple control and feedback mechanism may be more effective simply because it has the potential to work.

There is a risk that linking pay to reported earnings will simply lead to creative accounting and the overstatement of earnings figures.

Reported earnings is also a relatively short term indicator for most entities. The directors are being encouraged to adopt a planning horizon of twelve months which could mean that longer term cycles, such as the development of new products or the acceptance of longer term projects will be overlooked because a high NPV project may be a short term loss maker. The shareholders will have to ensure that they look out for evidence of such actions rather than simply taking the reported figures at face value.
Answer to Question Three

(a) The whole point of this type of tendering process is to ensure that each bidder has an incentive to tender at the lowest possible acceptable price. Doing that requires that the bidding parties know as little as possible about one another and that the bids themselves are kept secure.

There are a number of areas of concern in this case:

- The winning bidder withdrew what would have been the lowest offer and replaced it with a higher bid. There could be an innocent explanation for that, but it is a matter of some concern that the bid was replaced because it could indicate a knowledge of the other bidders’ tenders. If that is the case then there could have been some collusion between the bidder and a member of staff in Z’s buying department. Alternatively, the bidder could have colluded with the other companies that were most likely to have placed bids for this contract.

- The winning bid was not the lowest one submitted. That could imply some favouritism on the part of the selection committee. There may be a perfectly valid justification for rejecting a lower bid, but it seems strange that a bidder for a major contract would submit a tender for a product that is not fit for purpose.

- The process was not particularly secure. The bids themselves were addressed to a relatively junior manager and were not stored under conditions of great secrecy. The chief buyer could easily have opened incoming bids and put them in replacement blank envelopes without that being obvious to anybody.

- The internal auditor was not involved until very late in the process and most of those present at the opening were directly involved in the project. The internal audit department could have taken a more active role in the whole process of safeguarding bids and in opening them under secure conditions.

(Examiner’s note: Only three factors were required.)

(b) The internal auditor should attempt to establish who had access to the sealed bids after they had been received. It would be an easy matter for anybody who had access to the safe to type a label and put the bid in a new envelope. It would not be particularly difficult to forge a colleague’s signature (or for the chief buyer to sign the envelope).

The easiest way for the auditor to determine who had access would be to visit the buying department and to note the location of the safe and the occupants of the office in which it is located. The auditor should use indirect, open-ended questions to determine whether the safe is normally kept locked when the office is occupied and who has access to the key or combination.

The opened envelopes, which should have been retained, should be examined and the chief buyer asked to confirm that all of the signatures were genuine. That would effectively mean that the chief buyer was accepting personal responsibility for the bids that were considered.

The internal auditor should attempt to establish whether there is any form of relationship between any member of the buying department and the winning bidder. Even those who could not access the safe would possibly know who had bid from the covering letters, which were kept separately, and that could have permitted the winner to gather information that led to submitting a higher winning bid. The purchase ledger should be checked to determine whether Z had any previous dealings with the winning bidder.

The reasons for the rejection of the cheaper bid should be investigated. The fact that the bus was slightly smaller could be a reason for rejection as could the specification for the modifications, but these might not be material to the selection. If the buses were large enough and within the parameters of the tender document and the materials were of an acceptable specification then the cheapest bid should have been accepted.
The advantages include:

- The internal auditor should be independent of those who are being investigated. It would be difficult to identify anybody else outside of the buying department with the necessary understanding of the process.

- The internal auditor will have the necessary skills to undertake the investigation and also knows and understands the entity’s culture and systems. An external auditor could undertake the investigation, but would not have this insight.

- The entity can be assured of the internal auditor’s discretion and so there should be very little risk of the facts leaking out without the board’s permission. Internal audit staff are generally professionally qualified and are also trained to be discreet.

The disadvantages include:

- Using the internal audit department in this way could make it more difficult for the internal auditors to maintain a good working relationship with those under audit. Internal auditors are generally reluctant to investigate potential fraud because it may undermine their relationship with line staff.

- The audit could be very time consuming and could be a major distraction from the ongoing schedule of internal audit activities. The internal audit department’s time is a valuable resource and it will generally be allocated to specific tasks as part of a plan.

- The fact that the evidence has been gathered by the company’s own staff could undermine its credibility if, say, the company seeks compensation as a result of the investigation or pursues criminal charges. If there has been any staff fraud then the police will require a clear and unambiguous chain of evidence and the fact that colleagues have been involved in the initial investigation may interfere with their ability to build a criminal case.

(Examiner’s note: Only two advantages and two disadvantages were required.)
Answer to Question Four

(a)

(i) The first step is to restate balances in terms of £:

<table>
<thead>
<tr>
<th>Paying office</th>
<th>UK</th>
<th>France</th>
<th>US</th>
<th>Japan</th>
<th>T</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receiving office</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>£0.9m</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td></td>
<td>£1.0m</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>US</td>
<td>£1.9m</td>
<td>£1.7m</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>£1.3m</td>
<td></td>
<td>£1.4m</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>£3.2m</td>
<td>£2.6m</td>
<td>£1.4m</td>
<td>£1.0m</td>
<td></td>
</tr>
</tbody>
</table>

The next step is to establish the net sums payable and receivable:

<table>
<thead>
<tr>
<th>Paying office</th>
<th>UK</th>
<th>France</th>
<th>US</th>
<th>Japan</th>
<th>Net payments due</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receiving office</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>France</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>US</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>£2.2m</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>£1.7m</td>
</tr>
<tr>
<td></td>
<td>£2.3m</td>
<td>£1.6m</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

The simplest thing would be for the UK office to pay the US office £2.2m = US$3.5m and the Japanese office £0.1m = ¥13.6m.

The French office will pay the Japanese office £1.6m = ¥216.8m.

(ii) The most obvious advantage is that multilateral hedging will reduce transaction costs. The various subsidiary companies will avoid the need to convert cash or pay bank charges. There will also be much smaller losses because of dealer’s turns because there will be far fewer purchases and sales throughout the group.

There may also be a slight hedging effect because individual group members will be protected from currency risks to an extent.

There is a potential cost in that the tax authorities may be suspicious of inter-company transactions that have no direct commercial logic. For example, the French subsidiary will be claiming tax relief on charges totalling £2.6m (€2.9m) even though the related payment was only £1.6m. Furthermore, the French company will be making a large payment to a Japanese group member without having undertaken any work for that company. This could start to look like a tax evasion exercise. These problems could be even more serious if there are exchange controls in operation so that it is necessary to demonstrate that any money leaving the country is required to meet a binding commitment.

The fact that a notional/indicative exchange rate is used to convert the balances could mean that some group members feel that they are losing out to other companies if the precise rate is in the other companies’ favour.
(b) A € bank account would effectively act as an internal hedge for the London office’s € receipts and payments. There is a sense in which the cash flows would create a small €-based economy for that subsidiary.

The company will generally receive more Euros than it pays out and so there will tend to be a positive balance. Unless there is an overdraft facility the company will have to leave a balance in € to avoid running out of cash that can readily be used to settle € liabilities.

The only exposure for the London subsidiary will be on the net sum left in €. Whenever a reasonable balance has accrued the funds can be converted to £ in a reasonably efficient manner. W can keep forward rates under review to determine whether it would be desirable to leave the € on deposit in order to benefit from any forecast gain.

The account will also reduce bank charges. It will be much cheaper to make transfers and to bank receipts in the account’s native currency.

The only real question is whether this is the most efficient way for W to manage its € receipts and payments. It may be more cost-effective for the group treasury department to channel these transfers via a subsidiary in the Eurozone. There is nothing to prevent a record being kept of the net sum due from, say, the French subsidiary for payment to the UK company. That would generate all of the benefits for the group without the cost and inconvenience of opening and servicing a foreign current bank account.
The Senior Examiner for Performance Strategy offers to future candidates and
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 revolving around the protection of an entity from corruption and
unethical behaviour on the part of a number of stakeholders, including government, employees
and a related party. This is in the overall context of the creation and expansion of an overseas
subsidiary.

Part (a) draws mainly on Section B of the syllabus (Risk and Internal Control). This part asks for
the application of CIMA’s ethical guidance, primarily in the form of the fundamental principles, to
the question of whether a bribe should be paid in order to retain a permit that is required to
continue in business. The matter was, perhaps, complicated by the fact that the request for the
bribe was made by an official in a country where bribery and corruption are endemic. Thus, the
payment of a bribe would be perfectly consistent with the country’s culture.

Part (b)(i) also draws mainly on Section B of the syllabus (Risk and Internal Control). It asks for
a discussion of the risks to a newspaper publisher’s reputation of one of its journalists being
caught plagiarising and fabricating a news story.

Part (b)(ii) draws mainly on section C (Review and Audit of Control Systems). It asks for some
consideration of the ways in which IT might be used to deter the copying and distortion of news
stories. Candidates are free to consider the ways in which evidence can be collated
electronically and stolen copyright material may be traced back to its original owner. This could
be familiar to some candidates given the prevalence of software in further and higher education
that achieves similar objects, although there would be no need to have been exposed to such
scrutiny to be able to attempt this question.

Part (c) draws on section D (Management of Financial Risk). It asks candidates to consider the
ways in which a newspaper company might be able to manage the risk of expropriation by a
foreign government that has threatened to nationalise foreign businesses. In this case the
nature of the business could have a direct bearing on the management of this risk.

Section B – answer two of three questions

Question Two This question draws on section A (Management Control Systems). Part (a) deals
with the agency/control issues arising from executive share option schemes. This links the
material in this paper to concepts of risk and return and the manner in which executive directors
may be motivated.

Part (b) deals with the need for simple and unambiguous feedback in the process of exercising
control over the board’s performance and also the possibility of dysfunctional behaviour arising
from rewarding executive directors with profit related bonuses.

Question Three This question draws mainly on section C (Review and Audit of Control
Systems). It relates to the possibility of dishonesty in the management of a tender for a contract
to supply a major capital item. Part (a) asks for an explanation of the factors that could have
prompted such suspicions. Part (b) develops this by asking about the work the internal audit
department would undertake. Finally, part (c) asks about the role of the internal audit function in
investigating this type of irregularity. The internal auditor’s responsibilities with respect to fraud
require careful consideration and so there is some scope for developing an argument.

Question Four This question draws mainly on section D (Management of Financial Risk). It
asks candidates to discuss two internal hedging techniques (multilateral hedging and the use of
a foreign currency bank account, both in terms of their application and their specific advantages and disadvantages. Part (a)(i) tests the ability to apply netting of balances in a simple case and part (ii) asks candidates to consider the advantages and disadvantages of using this technique. Part (b) asks for a discussion of the advantages and disadvantages of opening a foreign currency bank account to deal with recurring transactions in a frequently used currency.