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. Part (a) deals with the control implications of switching from a periodic to a continuous count for inventory. Part (b) deals with the potential role of internal audit in integrating newly acquired businesses and also in ensuring the implementation of the board’s strategies. Part (c) deals with the management of currency risk using natural hedging.

Part (a) draws mainly on section B of the syllabus (Risk and Internal Control).
Part (b) draws mainly on section C (Audit and Audit of Control Systems).
Part (c) draws mainly on section D (Management of Financial Risk).
Suggested Approach

Part (a) describes the two main approaches to inventory counts and asks candidates to consider the implications of switching from one to the other. Candidates should consider the nature of the business and the items that it carries in inventory. For example, non-specialist staff may find it difficult to identify specific items of inventory. Also, fraudulent misstatement could be a problem because of valuable metal used in plumbing supplies.

Part (b) requires a focus on the role of internal audit. The fundamental role is to ensure compliance. The scenario raises specific matters that may threaten the implementation of management policies and so the role of internal audit will be particularly important.

Part (c) asks for a consideration of the extent to which different currency risks may offset one another. This will be a complicated area in practice and so the best approach is to identify the factors that may be taken into account in evaluating the hedging opportunities.

(a)

(i)

P will be able to avoid the disruption associated with a single annual/periodic inventory count. It will not be necessary for P plc to lose two days’ business for the sake of the inventory count. Staff may be utilised during quiet periods to complete part of the annual cycle without disrupting sales.

Any problems with P plc’s inventory management systems or with staff theft will be revealed by the ongoing counts. The present arrangements might not highlight such problems until the year end when the annual inventory count occurs.

P plc will be able to target high risk items that can be counted more frequently than the annual count implied by the traditional model.

Continuous inventory counts may prove a distraction because they require frequent small tasks to be completed. The continuous inventory counts will only be a small part of managers’ responsibilities and so they may be overlooked.

It may be easier to overlook problems arising from continuous counts because errors will be discovered in isolation. An annual count will tend to draw more attention to the total value of any difference from book stock.

(ii)

One designated manager should be given overall responsibility for managing the process at each warehouse. That will reduce the risk that the counting exercise is overlooked or set aside in the face of day to day work pressures.

The manager in charge should organise counts so that staff are not aware of the number of items that they should expect to find. That will make it more difficult to conceal shortages by overstating the count when items are missing.

Counters should work in teams of two to ensure some supervision. The count teams should comprise staff from different sections so that there is less scope for collusion.

Count teams should include at least one person who has the ability to identify the specific items of inventory. Many of P plc’s products may be difficult for a lay person to identify.

The count manager should compare actual and book counts immediately. If there is a significant difference then a different team should be sent to recount those items. That will ensure that there is a difference and that the count team has not simply made a mistake.

When there are differences then the items should be flagged for recounting in the near future. That may highlight areas where staff are negligent or dishonest.
(b)

(i)

An audit visit within six months of the takeover will highlight the fact that P plc has purchased control and that it wishes the newly acquired subsidiary to change. The internal audit team will send a visible message to the subsidiary’s management and staff.

The internal audit team will be able to submit reports on the progress the subsidiary has made in changing to the new procedures and will highlight areas where more work is required, which will send a message that they are expected to make changes as soon as possible. The audit team will also be able to offer advice on P plc’s approach and on any implementation issues that have arisen in the first six months.

The internal auditor will be able to pass information on to the subsidiary’s staff during the audit and that may reduce the uncertainty associated with being taken over. Subsidiary staff may find such a visit reassuring and so P plc may reduce the risk of, say, key staff looking for other jobs and resigning because of a fear of more redundancies.

Subsidiary staff and management may view the quick visit as unduly assertive. It highlights the fact that the subsidiary has lost control to its parent company.

The auditors will have to be very careful to avoid any misunderstandings that undermine morale. Subsidiary staff may be hyper-sensitive to any sense of criticism implied by the work done by the audit team.

The internal audit department may be guilty of conducting a very “generic” visit to each newly acquired subsidiary. The fact that little or no time has been taken to learn about the new business and to reflect on areas of strength and weakness will mean that the visit may not be properly planned to fit the circumstances. It will however give the audit team the chance to plan its approach for the future and meet the staff in the subsidiary.

(ii)

The auditor in charge of the investigation will have to talk to HR and senior management to ensure that planning is under way. The staff reductions will not just concern those who lose their jobs. The remaining staff will have to do more. It would be very tempting for local management to conduct a superficial exercise to consider reductions and to report back that none will be possible.

The audit team has to make it clear that the reduction in staffing is a matter of policy that has been decided by P plc. One function of internal audit is to ensure that management policies are adhered to. The message should be that subsidiary management are under the supervision of P plc’s board with respect to this policy until it has been implemented.

The audit team will have to discuss the approach that is being taken to the process to avoid any legal or personnel issues. The audit staff should be aware of why each decision has been made to make sure no personal issues have been brought to bear on the decisions. Care has to be taken to ensure that the subsidiary does not breach any employment law in the process of making staff redundant. The audit team will have to ensure that the wording of all announcements and all correspondence adheres to good practice, ideally after having been reviewed by a specialist from the HR department. Any errors could lead to the subsidiary being accused of discrimination. The internal auditors may want to consult P’s legal team just to ensure everything is watertight.

The internal audit department should also discuss the commercial logic of the proposed reduction. It is important to avoid leaving some departments understaffed. Internal politics within the subsidiary may lead to some department heads protecting the interests of their staff at the expense of others.

The internal audit team can also make use of this time to understand the importance of many of the staff so they will know who to talk to in the future.
(c) The first step would be to gather information about transactions denominated in foreign currencies. Ideally, P plc will have matching inflows and outflows in each currency. In the unlikely event that all such receipts and payments tend to offset one another then there will be little or no net exposure.

The treasurer should allow for any links and relationships between currencies. For example, some currencies are tied to the USD and so they should be considered together for the purpose of this exercise.

Transactions will be recorded initially in P plc’s home currency, with any gains and losses recorded when the transactions are settled. The treasurer should consider whether there is a significant net gain or loss on the currency gain/loss account.

These reviews should cover a significant period. There could be large foreign currency transactions on an irregular basis or periods when the currency markets change very little and so a short period’s figures might not highlight a serious exposure.

The treasurer should discuss the effects of currency movements with the marketing director. In particular, the question is whether P plc is aware of losing revenue because of currency rates. If business is being lost because P plc’s home currency is strong then that will not be apparent from the bookkeeping records.

The treasurer is unlikely to find a perfect hedge that has arisen spontaneously. As part of this review, the treasurer should consider the extent of any exposure that can be tolerated.
Please turn over for the Answers to Question two
SECTION B

Answer to Question Two

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<th>Rationale</th>
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<td>The question deals with the risks arising from the management of foreign direct investment. The company in question is planning to develop a holiday resort in an area that has some environmental sensitivity. Part (a) draws on section B (Risk and Internal Control). Part (b) draws on section D (Management of Financial Risk).</td>
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<th>Suggested Approach</th>
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<td>Part (a) asks candidates to consider the risks arising from building in an area that has attracted the attention of the environmental lobby. There are risks to the entity’s reputation and there may also be financial threats. Part (b) asks candidates to consider the most appropriate approach to maintaining an acceptable relationship with the government. The entity has been criticised for acting in a manner that appears to be corrupt and so the government may be reluctant to grant any favours.</td>
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(a)

The most immediate risk is that planning permission will be withheld. The risk is high because the government may be concerned about the bad publicity associated with L Corporation and may decide that it would appear weak if planning consent is granted. The adverse publicity also suggests that the government could be accused of favouritism with respect to L Corporation and so it may decide to refuse permission in order to refute that claim. That would leave L Corporation having purchased the land without having any realistic prospect of making any use of it. The land could be resold, but potential buyers are likely to be aware that L Corporation is a motivated seller and so the selling price may be depressed.

Planning permission may be granted, but it may be conditional on minimising the disruption to the environment. This has a high risk of occurrence because the land is a recognised habitat and is also recognised as an area of natural beauty. L Corporation is also the sort of high-profile foreign business that would attract the attention of environmentalists and other pressure groups. The restrictions could be expensive to implement and they may constrain the extent of the development. The potential revenues from the resort may be damaged by the adverse publicity.

L Corporation may find it difficult to engage contractors to undertake the work. This is likely to happen because of the allegations that L Corporation has not proceeded with its plans on other developments in the past. That could delay the completion of contracts, which will increase the uncertainty surrounding this project. It may also mean that L Corporation has to pay substantial deposits and accept significant penalty costs in the event of cancellation because contractors may be concerned that they will suffer irrecoverable costs. These payments could disrupt L Corporation’s cash flows and have an impact on the return from the investment.
(b) Firstly, L Corporation should consider engaging a public relations company from Sealand to act on its behalf. L himself appears to undermine the company’s credibility and Sealand’s government may prefer to be distanced from him.

One of the first acts of this firm should be to distance L Corporation from the claims of friendship with Sealand’s prime minister as made by L. If this claim is left in the public domain then it will embarrass the government whenever any decisions are made in Sealand’s favour. It may be possible to argue that L’s comments were taken out of context or were not meant to be taken literally.

Ideally, L Corporation should demonstrate good faith in this project. For example, it may be possible to obtain limited permission to build the first phase of the resort or the construction of some of the infrastructure, such as connecting the site to the electricity grid [1]. Doing so would signal that L Corporation intends to undertake this development and will generate wealth in the country.

The allegations concerning the proposals that have been abandoned in other countries should be addressed. It may be possible to demonstrate that the company has behaved responsibly and has created employment regardless of the extent to which the original plan was implemented.

L Corporation should take great care to avoid any controversy until matters settle down. It should not conduct any operations that would harm the wildlife or impair the scenery and so avoid assisting any campaigners who wish to take action against the company.

L Corporation should consider making some initial investment in Sealand. For example, the establishment of an office in the country’s capital or in the city closest to its site would create jobs and would demonstrate a commitment to the country. Ideally, it would create other jobs, perhaps by moving some of its existing administrative operations to Sealand. Doing so would create the implicit threat of job losses in Sealand if planning permission is withheld.

L Corporation make some immediate commitments to demonstrate to Sealand’s government that it is making a serious commitment to the country. It could, for example, open bank accounts in Sealand and despoit funds there. L Corporation should also start to employ local people as soon as possible.
Answer to Question Three

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<th>Rationale</th>
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| Question 3 deals with a charity that has been asked to consider restructuring. The first part of the question deals with the implications for strategic control, whilst the second deals with the implications for IT management.  
Part (a) draws on section A (Management and Control Systems).  
Part (b) draws on section E (Risk and Control in Information systems). |

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| Part (a) requires some thought to be addressed to switching from an approach in which there are geographical areas, each of which is under the control of a single manager, to a system that focuses more on functional management. The biggest impact is that it will become far more difficult to establish norms because each manager will have a far more specific role and there will be no scope for comparison.  
Part (b) requires consideration of the IT issues arising from home working. |

(a)

The most obvious benefit is that resources will be directed away from management and administration and towards the provision of services. At present, the charity has considerable resources invested in the office building that is not really used to support the work in any direct manner. The paid employees are also largely concerned with preparing and reviewing reports that do very little about the actual work of the charity.

The proposed restructuring would encourage the volunteers to become better trained and more involved with the pupils whom they wish to support. That would foster a greater sense of satisfaction and could encourage more volunteers to give time to C.

The restructuring will also give much greater flexibility. The paid employees can use specialists as and when they need in order to deal with projects such as the creation of a suitable web page. The fact that staff are working from home and presumably communicating by email means that C can recruit additional staff who do not necessarily live in a particular area and so the best person for the job can be recruited regardless of his/her location.

The donor is essentially proposing a network structure. That may lead to a degree of fragmentation in terms of supervision and management. The focus is likely to be on the completion of tasks rather than on the management of the routine activities of the charity. Individual employees have their own areas of responsibility and interest and may not be as interested in the day to day activities. The fact that they are working from home may also mean that they are less visible and so less motivated. It may be useful to mitigate these risks by calling the managers together for regular meetings.
The first risk is poor housekeeping. The full-time staff will be working remotely and so they may be lax about tasks such as virus protection and backing up. Individuals may not understand the threats or may be lazy when it comes to IT security. That could lead to the loss of irreplaceable data. One response would be to insist that all staff complete a training programme on securing PCs. That would prevent anybody from claiming to have misunderstood the threat and so ensure greater accountability. C could also have all new PCs set up by a professional so that all software and hardware could be configured to operate correctly. The administrator account on each machine could be password protected so that staff cannot replace or remove software.

There could also be problems arising from accessibility if all files are being maintained on individual machines because it will only be possible to obtain a copy of a colleague’s work if he or she is at home and can email it. That could lead to delays in collating reports and inefficiencies in management. Data could also be lost in the event that a computer was stolen by a burglar. One response would be to upload files to a common storage space on the Cloud or to a server on a PC that is left connected to the web at all times. That would ensure access and would also provide a degree of backup because the remote files could be mirrored.

The volunteers will, presumably, have to use their own computers, which may belong to their employers or be their own property. Volunteers’ computers may contain sensitive information about the pupils who are being supported by the charity. As part of the benefit of being a volunteer it may be cost effective for C to purchase a computer for each volunteer. This would not be expensive and would resolve any compatibility issues.

C should have a code of conduct for maintaining such files, such as a requirement for the volunteers to encrypt all personal files relating to the charity’s work. C should provide encryption software so that the volunteers are not left to make their own arrangements, which may prove to be unsuitable. The code should also consider the implications of volunteers using computers that have been provided by their employers and that might be accessible through their employers’ networks or may be liable to inspection by their employers’ IT departments.

Encryption will help with such an arrangement. The volunteers should also be encouraged to consider using a removable disk, such as a USB drive, to store C’s data. In that event the removable drive can be kept securely and pupils’ privacy can be protected, although backup and the threat of loss could become an issue.
Answer to Question Four

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<td>Question 4 draws on section D (<em>Management of Financial Risk</em>). The first part of the question deals with the parity relationships and the possibility of arbitrage opportunities. The second part deals with the risks associated with opening a bank account in a foreign country.</td>
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<td>Part (a) asks candidates to consider the relationships that should exist within markets and between market prices. Part (b) requires a discussion of the risks arising from banking funds in a country that has a weak currency and also has exchange controls in place.</td>
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(a)

(i)

If R uses the EUR cross rate the S$ 200,000 will cost 200,000/2.4350 = EUR 82,136
The cost in B$ will be 82,136 / 0.2970 = B$ 276,552

If R uses the USD cross rate the S$ 200,000 will cost 200,000/3.5600 = USD 56,180.
The cost in B$ will be 56,180 / 0.2154 = B$ 260,817
It would be cheaper to use the USD cross rate

(ii)

There should be no difference between the USD and EUR cross rates. There is clearly an inefficiency in the market rates that could create the potential for arbitrage. The banks offer the same rates for EUR and USD, so the discrepancy is in the rate offered on the S$. One way to exploit this would be to convert USD 1m to S$, which would give S$ 3.56 million. Converting those to EUR would give 3.56 million / 2.4500 = EUR 1,453,061.
The EUR would be worth 1,453,061 / 0.3000 = B$ 4,843,537, which would be worth 4,843,537 x 0.2154 = USD 1,043,298.

Assuming that R had access to USD 1 million it could convert that sum to a slightly higher amount by converting it quickly to S$, then EUR and finally back to USD. The gain would be higher in practice because it would be able to use a direct rate from EUR to USD rather than suffering the spread on EUR to B$ and back to USD.

This opportunity only exists because Banks E and A have inconsistent rates on offer for the S$. Once Bank A noticed that customers were converting USD to S$ it would start to wonder whether the rate that it was offering was unduly generous and the rates on offer would fall very quickly. It would be worth R monitoring the rates because it appears that the banks pay insufficient attention to the S$ and so arbitrage opportunities may arise from time to time, but exploiting those would be a distraction and R would have to have funds ready to exploit the differences. Arbitrage is never a long term opportunity as the time the opportunity exists is very short as the markets will react quickly to make the rates consistent.
There is an upside risk because the bank offers a slightly more generous rate. Having said that, R would need to tie up USD 100,000 in order to keep the account active, and the loss of interest would probably outweigh the potential savings. Also, there is no guarantee that the bank will always offer a superior exchange rate. R would need to maintain a balance that was large enough to make the monthly payments and maintain the minimum threshold. That could lead to cash flow problems because depositing cleared funds in the foreign bank could require a lead time. If R ever decides to switch to a supplier in another country it will be faced with the challenge of repatriating its balance. That may not prove impossible, but it could be time-consuming and expensive. R also needs to be conscious of the risk of default. The bank is based in a developing country that may have very lax banking regulations. If the bank fails then the local government is unlikely to guarantee R’s balance. In the meantime, R will still have to fund ongoing purchases or its supplier will refuse to release the goods.