Strategic Level Paper

P3 – Performance Strategy
May 2014 examination

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 August 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 risks associated with developing an IT system that is tied to the entity’s strategy. Part (b) deals with the management of interest rate exposure. Part (c) deals with the implications of simplifying a divisional structure.

Part (a) draws mainly on section E of the syllabus (Risk and Control in Information Systems). Part (b) draws mainly on section D (Management of Financial Risk). Part (c) draws mainly on section A (Management and Control Systems).
Part (a) starts with a description of a major company that is considering switching to a virtual operation in which sales orders are communicated directly to suppliers. The question asks candidates to consider the IT implications for both the entity and its suppliers. This is clearly a critical aspect of the proposed business model. This question requires an understanding of the need to plan and manage IT projects.

Part (b) deals with the measurement and discussion of an entity’s interest rate risk. It should be stressed that this is not about gearing, but deals with the implications of using fixed and variable rate loans. Candidates should be able to identify the risks associated with both fixed and variable rate loans.

Part (c) asks about a proposed merger between the two operating divisions of a major entity. One intriguing aspect of this question is that the two divisions could potentially serve a very similar group of users. That would simplify the merger, but would still leave many of the problems associated with changing lines of reporting and, perhaps, reducing staffing levels because of the merger.

(a)

(i) P will have to determine how the new business model will change its IT needs.

At present, when a customer wishes to place an order, P will have to check product availability at a limited number of locations, primarily its warehouses.

The new model will require some form of algorithm to determine the most appropriate location for goods, taking account of the possibility that some of the goods are held and sold directly from P’s warehouses whereas others will be sold directly by suppliers. Many of the goods that P sells will be generic and so it is unlikely that there will be a single supplier, so the customer’s location may affect the most appropriate source. For example, if a customer places an order for plastic pipe then there could potentially be several suppliers and the system will have to choose the cheapest, taking account of shipping and other costs.

Pricing will require a further set of calculations because P will have to deal with up to three sets of currencies: its own, the customer’s and the supplier’s. That will further complicate the sales management process and will require the system to monitor exchange rates in real time.

The new arrangements will require much more processing time for each sale than the present policy of shipping from the nearest warehouse. P’s systems will have to have sufficient processing power to cope with this workload or the company will lose business through crashes and failures in the system.

P will also be placing many more purchases with some of its suppliers, with an associated increase in the complexity of processing incoming purchase invoices. Each invoice will have to be matched to its associated purchase order. The system will have to allow for the possibility of disputes, such as when customers complain that they did not receive the goods that they ordered and so P cannot automatically settle invoices without some further process, such as the receipt of payment from the customer.
(ii) Suppliers will, first of all, have to be capable of handling electronic data interchange (EDI). That may be a software issue rather than hardware, but their systems will have to be able to cope with accepting shipping instructions from P. That may require changes to routines such as credit control and pricing because they will need to fulfil all orders at the price agreed between P and the customer.

The need to generate packing slips and delivery notes using P’s stationery will require changes to both hardware and software. At the very least, it will be necessary to have two sources of stationery, with a system in place to switch to P’s stationery when supplying P’s customers. Many suppliers will have a dramatic increase in the number of transactions, with the switch from making wholesale sales to P to making retail sales directly to P’s customers. The system will have to be capable of supporting such transactions, not just in terms of volume, but in terms of scheduling differences in the logistics.

Some suppliers will have to cope with the additional burden of scheduling the logistics of making retail deliveries, with the need to be able to organise collections and deliveries to retail customers. Their systems will have to be modified to cope with the booking collections from transportation companies and couriers. That could be far more complex than the creation of packing lists and shipping arrangements for bulk deliveries to P.

Some suppliers will have to have systems that can prepare the necessary documentation for exports. Formerly, sales to P will have been domestic sales or restricted to one particular country. This will be a particular issue for manufacturers of branded goods that may formerly have been distributed through P.

P will have to consider the possibility that suppliers will exaggerate the extent of any problems that are identified with this proposal. They may not be keen to accept the proposal but may be forced to go ahead with it as P is such a large customer. The suppliers’ attitudes are not really part of the formal feasibility study, but they may distort the information that they provide to P in order to prevent the switch.

(b)

(i) P plc’s interest risk exposure can be summed up as follows:

- Floating rate loans GBP 560m, LIBOR + 50 basis points.
- Fixed rate liabilities GBP 440m.

Average interest rate 6.3%.
Average remaining life 2.8 years.

P plc has a lower interest rate than C plc, which suggests that it is regarded more favourably by lenders. That may mean that P plc will always be able to obtain a slight advantage in terms of borrowing costs.

P plc has a higher proportion of floating rate debt. That suggests that P plc is more exposed to short-term movements in rates. The fact that P plc’s 2017 loan has a higher interest rate suggests that the market expects rates to rise in the next two years. If interest rates rise as expected then the cost of servicing P plc’s floating rate debt will increase.

P plc’s fixed interest debt has a shorter average life remaining. That means that P plc has a little more flexibility than C plc. In the event that interest rates fall, P plc will be able to refinance at a lower fixed rate sooner than C plc or will be able to replace its fixed interest debt with floating rate.

**Workings**

\[
\text{Average interest rate} = \frac{(6.0 \times 100/440)}{440} + \frac{(6.4 \times 340/440)}{440} = 6.3% \\
\text{Average remaining life} = \frac{(2 \text{ years} \times 100/440)}{440} + \frac{(3 \text{ years} \times 340/440)}{440} = 2.8 \text{ years}
\]
(ii) Interest rates will have a significant impact on P plc’s revenues. The company sells building and plumbing materials, which means that many customers will be making long term investment decisions. That could push up the cost of capital in customers’ NPV calculations when interest rates are high, which could deter many of them from investing in construction projects. High interest rates also tend to depress property values, which makes the potential value of a completed building project smaller, and again deters a customer from proceeding with a contract. Such economic pressures will reduce demand for P plc’s product ranges.

P plc also operates SBUs that effectively offer home improvements. Interest rates will have an impact on consumer confidence. Also consumers will often borrow to finance that type of expenditure. Banks may be reluctant to lend if they face liquidity concerns and so they might be reluctant to finance consumer loans.

P plc also faces its own cash flow issues arising from interest rate movements and bank liquidity. The loans will have to be refinanced. If the banks are facing liquidity problems then P plc may find it difficult to obtain replacement finance. Also the rates charged may increase. There will be indirect costs, such as the cost of management time associated with dealing with any such problem.

(c)

The merger is likely to lead to some efficiencies and some inefficiencies and the directors will have to identify both the costs and savings.

There are likely to be savings if the two divisions have a number of customers in common. If, for example, there are large building companies who buy both plumbing and building supplies from P then there could be major synergies arising from merging the divisions. There would only be one relationship to be managed by the sales team or by the account managers. There could also be major savings in terms of distribution and delivery if deliveries of both plumbing and building supplies can be combined.

The complexity of combining the two divisions may lead to inefficiencies if one large entity is created out of two smaller ones. There could, for example, be a need for an additional layer of management in order to ensure that the merged entity remains controllable. That will add to the cost of managing the company and will also complicate decision making.

The costs of the merger will have to be considered. Reducing staffing levels may lead to redundancies and there could be other restructuring costs, such as consultancy fees.

The likelihood of potential savings being realised should be considered. It is possible that staff reductions will prove difficult to implement if managers resist redundancies, perhaps by creating posts or by delaying dismissals.
Turn over for the Answers to Section B
SECTION B

Answer to Question Two

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<thead>
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<th>Rationale</th>
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<tr>
<td>Question 2 draws on section B (Risk and Internal Control). The question deals with the management of serious risks that are essentially impossible to prevent. The scenario describes a retail environment in which one customer dropped an item that tripped and injured another.</td>
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<th>Suggested Approach</th>
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<td>Part (a) asks candidates to consider the nature of the business. Clearly, it is never acceptable to risk injury to a customer, but some accidents are unavoidable no matter how many precautions are taken. This part requires a sensible discussion of the implications of accidents such as the one described.</td>
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<td>Part (b) asks candidates to describe a realistic response to this risk. The requirement focuses on dealing with the aftermath of accidents rather than their prevention. The key is to ensure that the company’s exposure to claims is managed and restricted.</td>
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(a) As a retailer the company is likely to have a large number of customers on its premises. Shops have a number of hazards that could cause injury. Steps and stairs could lead to quite serious falls. Tripping hazards can be created by merchandise falling from hangers or being replaced carelessly by other shoppers. Shoppers can leave their own bags and other property unattended while they are trying on clothes. The whole point of retail is to encourage customers to concentrate on the goods available for sale and so customers may not be fully aware of their surroundings at all times. Any carelessness will increase the risk of an accident.

Any injury is likely to be a serious matter for H. Customers are likely to claim substantial compensation simply because it will often be in H’s interests to settle claims quickly and with the minimum of publicity. It will often be difficult to determine the extent of an injury. H will find it difficult to disprove a claim that, say, a customer is suffering from severe back pain after a fall.

The existence of no-win, no-fee legal services will further increase the potential costs arising from alleged injuries. Also, customers may do their utmost to make any allegations of negligence public so that they create the impression that H is an unsafe place to shop.

H will be required to carry public liability insurance, which will offset the immediate cost of any claims against the company. The insurer will, however, review the cost of that cover in the light of any claims and so the cost of an accident may prove significant even if some of the risk is transferred to the insurer.

(b) Firstly, all staff should receive at least basic training in health and safety matters, so that everybody knows the basics of providing a first response. Staff should be told not to render any form of first aid unless they are qualified to do so through some accredited qualification. That should avoid the risk of a customer’s injury being made worse by a well-meaning staff member who does not know the correct course of action.

There should be a formal definition of a reportable incident, with a low reporting threshold. If a customer falls or sustains an injury that, say, requires a sticking plaster then it should be reported, even if the customer refuses to leave a name or wait for treatment. A formal register of
accidents will provide evidence that the shop staff were aware of the incident and the facts as they were observed will be available to H in the event of a claim being lodged against the company. A written record that is prepared at the time will be a far more reliable basis for a defence than a vague recollection obtained after a claim has been made. Furthermore, as happened in the case of Frank’s accident, staff might leave the company and could be difficult to contact in the future.

Staff members who are not qualified first aiders should not be permitted to assist any casualties. Their role should be to summon assistance and to ask other customers to move to a different part of the store. Unqualified staff could aggravate injuries and might leave the company open to further claims of negligence.

H should encourage as many of its staff as possible to take a formal first aid course so that they have some formal qualifications. There should be a list of trained staff in a prominent place in the shop so that a first aider can be summoned in the event of an incident.

The store manager should be summoned to any incident and should be responsible for completing the accident register. The presence of a senior member of staff may prove reassuring and it will also create the most reliable evidence in H’s defence. The manager should ensure that any witnesses, both staff and other customers, are identified and that they provide written statements in the event of a serious incident. Footage from the store security cameras should be reviewed to check whether it shows the accident and the company’s response.
Answer to Question Three

Rationale

Question 3 draws on section C (*Audit and Audit of Control Systems*). It deals with the discovery of staff fraud by the internal auditor and the implications for the control environment of senior management refusing to investigate that fraud.

Suggested Approach

Part (a) focuses on the implications of a serious compliance error for the internal auditor. In this case, the situation is made worse by the fact that there seems to be fraud involved. Part (b) deals with the further complications that would arise if senior management ordered the internal auditor to take no further action in circumstances which suggest that there may have been fraud, but that the stolen item has been replaced quietly.

(a) There are two significant issues arising from this sequence of events.

The first problem is that there is evidence that the music department has not been completing its annual inventory check on assets. That is an important check because it will highlight the loss or theft of any assets that are not used on a day to day basis. The review will also ensure that assets are inspected at least once a year and so any damage or deterioration will be noted.

The annual check is a visible sign that the college has a sound control environment. Staff are reminded that the records are important and subject to check. The fact that the check has not occurred will leave staff in the music department feeling that the controls do not matter.

The second problem is that the asset appears to have been stolen by a member of staff. It was signed out by someone who has since left the college. Such suspicions of criminal behaviour must always be taken very seriously, otherwise the college will create the impression that it is acceptable to steal. The music department’s technician believed that the instrument had been signed out and not returned, so at least one member of staff is aware of the possibility of staff fraud.

The fact that the technician had not reported these suspicions to the Head of the Music Department or to the college authorities is a worrying matter. Staff should feel that they are able to report dishonest behaviour and that any concerns will be taken seriously.

Taking both issues together, it seems possible that the staff in the Music Department have chosen not to conduct the annual check on assets in order to avoid taking any responsibility for the missing item. The clarinet may not be the only item that they knew to be missing and so the internal audit department should consider a more detailed investigation of that department’s asset register.

(b) (i) The explanation from the Head of the Music Department lacks credibility. It is unlikely that the music department is so large that a musical instrument could have lain unnoticed for two years, even if it had been misplaced. The fact that the technician who assisted the internal auditor with the initial investigation was evasive when it came to this item suggests that staff knew that the item was missing.

The most realistic explanation of the facts is that the Head of the Music Department contacted the former colleague to ask about the clarinet. The instrument was probably not in the college, but was returned during the four day period from the auditor’s report and the subsequent
In other words, the Head of the Music Department appears to have covered up a fraud. Insisting on a pointless inspection of the clarinet at a later date indicates, at best, a misunderstanding of the point of the control and, at worst, an attempt to bully the internal audit department into ceasing its investigation. The control environment depends upon senior members of staff understanding the purpose of controls and taking any exceptions seriously.

The Principal’s behaviour is equally suspicious. The instruction to take no further action leaves the auditor with no choice other than to accept a weak explanation. That suggests that the senior management of the college would prefer to conceal any potential dishonesty rather than pursue the guilty party.

The Head of the Music Department and the Principal are both very senior members of the college and both are responsible for supervision of staff. Their attitudes towards the system and any breaches will reflect the importance that they attach to staff honesty and the protection of college assets.

The fact that the clarinet is unlikely to be particularly valuable in itself is not the issue here. A procedure that is intended to prevent the theft and abuse of college property has not occurred. That, in itself, is a serious breach. That breach has been compounded by the sense that little real action is being taken even though the circumstances suggest the possibility of theft.

The College Principal’s behaviour implies that senior management do not regard controls as important and that the internal audit department’s findings need not be taken seriously. That will undermine the auditor’s authority in any future assignments.

(ii) The Head of Internal Audit should ensure that the department’s response is appropriate and proportionate. The first issue that has to be addressed is the basic compliance error. The Music Department has either failed to conduct an annual asset inspection or it has done so in such a careless manner that a missing instrument has been overlooked. That fact has to be documented in the audit report relating to the wider audit investigation and highlighted as a serious matter.

The question of the potential dishonesty is a more difficult matter. The Head of Internal Audit should review the audit working papers to evaluate the facts that have been documented and the evidence that has been gathered. It would probably be inappropriate to accuse the member of staff who took the instrument of theft. The College Principal and Head of Music have clearly decided to treat these events as a misunderstanding and there is no real evidence upon which to press criminal charges.

The fact that the College Principal and Head of Music both appear to have been unsupportive suggests that the Head of Internal Audit should consider approaching a higher authority, such as the convener of the college’s governing body. The issue that must be addressed is whether the Head of Internal Audit can count on the support of senior management. It may be necessary for the Head of Internal Audit to assert the department’s position in order to ensure that it is taken seriously.

At a practical level, the Internal Audit Department should conduct a subsequent inspection of the procedures relating to the existence of portable equipment. That would include a review of departmental registers to ensure that signatures for items that had been signed out were current and also a physical inspection of a further sample of items. This work would be partly as a response to the events in the Music Department but would also be a signal to the College as a whole that the Internal Audit Department takes compliance seriously.
Answer to Question Four

Rationale

Question 4 draws on section D (Management of Financial Risk). Overall, the question asks about the implications of hedging against exchange rate movements. The company in question imports its raw materials from a specific supplier who insists on being paid in its local currency. The question deals with the fallacy of a treasurer who has evaluated the usefulness of currency options by measuring the impact that options would have had on past trades. It also asks about the economic exposure for a company that can pass on costs arising from currency rate changes to its customers.

Suggested Approach

Part (a) requires some rational thought about the relevance of the treasurer’s arguments. The analysis is flawed because past exchange rate movements happened to favour the exercise of the options. Had rates moved less or in the other direction then the company would have lost money because of this hedging strategy.

Part (b) asks candidates to consider the extent of the company’s economic exposure. This requires an understanding of the business. Demand is price inelastic and so extra costs can be passed on to customers. There is no competition, so there is no need to be concerned about managing costs.

(a)

(i) M has a fixed commitment to import goods from a foreign supplier. That effectively creates a transaction risk that runs from one annual contract to the next. Goods must be accepted and paid for regardless of currency movements. M appears to be constrained in its choice of supplier because of the need to acquire very precise colours and quality of fabric. If M switches to an alternative supplier at home or from another country then it may be impossible to match the schools’ requirements for those colours.

The exchange rate must be fairly volatile, which increases the risk. The treasurer’s analysis indicates that the use of options would have led to quite a substantial saving compared to accepting spot rates even after dealing costs have been taken into account. That would suggest that M has incurred quite a substantial loss from accepting spot rates in the past year.

Offset against that is the fact that M makes monthly payments and so the volatility in the rates should tend to cancel in the medium term. If M was making a single large payment each year then the movements in the rates could create a more substantial transaction risk.

(ii) The effectiveness of a hedging strategy cannot really be evaluated on the basis of ex-post outcomes, as the treasurer suggests. The currency options are essentially insurance policies that pay the buyer in the event of an adverse change in exchange rates. As with any insurance, the intention is that a risk is transferred to a third party in return for a fee and the value of the arrangement should be evaluated in terms of reduced exposure.

The price of an option will take account of the market’s expectations concerning future exchange rates, and M is unlikely to negotiate a premium that offers a realistic chance of reducing the total cost of settling its liabilities. Furthermore, the cost of the options will include an element for profit and so the chances are that the option will prove a slightly more expensive means of settling invoices over time.

The treasurer’s analysis suggests that M’s exchange rate has suffered a series of unexpected adverse movements throughout the twelve months for which the analysis was
prepared. By definition, it is unlikely that a consistent pattern of unexpected movements can be predicted and it is certainly unrealistic to extrapolate that particular adverse trend. In effect, the gain that would have arisen from the purchase of options was the result of random events that affected currencies during the period of the treasurer’s analysis. There is no reason to believe that such gains would occur with such consistency in the future. In the unlikely event that they did then the price of options would increase to reflect the probability of losses incurred by the option writers.

(b) M is in a very strong position with respect to pricing. It sells a product that its customers are effectively forced to buy. Private schools are generally very conservative with respect to dress codes and parents will be forced to buy their children the official uniform. Children grow and so they will require a new uniform at least once a year. Parents will regard the cost of the uniform as part of the overall cost of sending their children to private school. M’s sales are relatively inelastic and so increased costs can probably be passed on without having much impact on volumes.

If a competitor finds a source of woollen fabric from within M’s home country or from a supplier in a country with a less volatile exchange rate then M could also switch suppliers in order to avoid being at a disadvantage in terms of cost. In the short term it has an annual contract with its current supplier, but M’s significant profit margin means that it could possibly afford to absorb some additional currency losses in the event that a competitor threatened to dislodge it from some of its traditional markets.

It would be naïve for M to ignore changes in its cost prices, including currency movements. However, there is very little to prevent it from passing on costs to its customers provided M continues to sell to this market niche. The company should, however, monitor trends in factors such as the popularity of expensive private schools and the willingness of parents to pay a premium for such an education.