

## **STRATEGIC CASE STUDY MAY 2018 EXAM ANSWERS**

### **Variant 4**

**The May 2018 exam can be viewed at**

<https://connect.cimaglobal.com/resources/may-strategic-case-study-variant-4-questions>

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### **SECTION 1**

#### **Requirement 1 – currency risks**

The basic risk is that 70% of Couchweb's revenues are fixed in terms of a variety of foreign currencies for the next 18 months. These will vary from month to month in response to changing exchange rates, which will make cash management difficult and will complicate the interpretation of the management accounts. This has not been a major problem recently because the M\$ has been weakening slowly, which means that foreign currency subscriptions will have tended to increase in value when converted to M\$. Different currencies will, however, have varied at different rates and some may have weakened against the M\$, costing Couchweb revenue.

The most difficult concern at the moment is that Couchweb faces a strengthening of the M\$, which means that foreign currency subscription payments will buy fewer M\$ when the currency has strengthened. Evaluating the risk depends on us being able to predict the timing and the extent of the currency movement. Exchange rate movements are complicated because governments take a great deal of interest in the variables that affect their economies. Mayland's government may not be willing to see the currency change in accordance with market expectations and so the movement could be more or less pronounced than expected or may not happen at all.

There is a related risk arising from the two-year cycle for setting prices. If the monthly subscription is set in terms of M\$ and then converted to local currencies, then foreign subscribers could see quite significant changes in their monthly subscriptions. If, as expected, the M\$ strengthens then the cost of a Couchweb subscription will increase in overseas markets when the subscription rates are next revised. The price increase could discourage subscribers from retaining their subscriptions or could encourage local competitors to offer cheaper services. Couchweb clearly views the fact that prices

are fixed for two years at a time as one of the ways in which subscribers are encouraged to continue their support and so a different policy may not be attractive.

The evaluation of this currency risk really depends on the elasticity of demand in the different markets. If a monthly subscription in Mayland costs the equivalent of four cups of coffee then, presumably, the costs are roughly comparable in other markets. Increasing subscriptions by even quite a large percentage will cost subscribers very little in absolute terms. Some subscribers will leave on principle because they no longer believe that Couchweb offers value for money, but others will take the view that they enjoy watching the content and that it is worth paying the extra. The fact that rates have not changed by much in recent years means that Couchweb has no current experience of managing a price increase and so it will be difficult to estimate the loss of business.

## **Requirement 2 – hedge accounting**

Hedge accounting requires that the hedging arrangements meet the detailed requirements set out in IFRS 9 *Financial Instruments*. It might be possible to designate the revenues from future revenues as highly probable forecast transactions, which would make it possible to create a cash flow hedge, as defined by the IFRS. Applying that definition could be complicated by the fact that future revenues can be estimated, but they are by no means certain. Couchweb will have to review its figures to determine whether subscriptions are generally sufficiently robust and predictable to apply hedge accounting. It would be possible to apply hedge accounting only to those income streams that do appear to be predictable.

The other key issue is whether a hedge instrument can be identified and acquired so that it is likely to be effective. There may not be many hedge instruments available to meet Couchweb's requirements because there will be a steady flow of subscription income and an adequate hedge would probably require a significant investment of time, effort and possibly cash in obtaining derivatives. The hedge would have to be organised well into the future to offer any real benefit in terms of financial reporting. Those hedges would have to be reassessed on a continuing basis.

Hedge accounting is essentially a means of reducing translation risk, which is hardly an issue affecting Couchweb. Couchweb will have very few foreign currency assets at any given time, and they will be very short lived. For example, foreign currency subscriptions collected by card companies will be paid within a few weeks and will be unlikely to fluctuate significantly. The risks described above are variations on economic risk, which is a matter for the company's market capitalisation and share price. That risk is not reflected in the financial statements and so an accounting response is not relevant to Couchweb's needs.

The suggestion that hedge accounting could eliminate Couchweb's currency risks suggests a failure to understand hedge accounting. Hedge accounting essentially permits companies to report gains and losses on certain financial instruments in a manner that offsets corresponding losses and gains on the item being hedged. A company that faces currency risk should consider whether it could and should hedge against that risk, simply to protect itself against volatility in its cash flows. The decision to hedge should not be influenced by the availability or otherwise of hedge accounting because the accounting treatment does not, in itself, affect cash flows. At most, hedge accounting permits gains to be recognised in income or losses to be debited to reserves until such time as there is a corresponding loss or gain to offset them against.



## **SECTION 2**

### **Requirement 1 – integrating databases**

The present arrangements mean that Couchweb can analyse subscribers' viewing habits, but it can do so only anonymously. Couchweb can create a profile of the programmes that a subscriber likes and can offer recommendations whenever that same user name is used to log in, but Couchweb cannot follow that up with, say, a personalised email. Knowing details of postal addresses would also give Couchweb useful demographic information, such as whether subscribers tended to come from urban or rural areas. There could also be a relationship between the type of bank card used and the subscriber's financial position, which could be of value in marketing.

Combining the databases will give Couchweb greater control over subscriber histories. For example, subscribers who leave and then return to Couchweb will not be identified because Cardbill will treat them as new subscribers. Couchweb will be unable to tell whether some subscribers turn over their memberships, perhaps by leaving during the summer months when they are on vacation or able to enjoy the outdoors. Being able to identify customers will also ensure that they cannot take unfair advantage of any offers or discounts offered to new subscribers by cancelling an existing subscription and taking out a discounted replacement.

Being able to access emails and other personal details would help Couchweb to develop surveys that go into greater detail than simply offering subscribers the opportunity to leave reviews about programmes that they have watched. Such contact could also help Couchweb to build customer loyalty. Being able to gather better insights into subscribers' opinions could enable Couchweb to reduce the numbers lost to cancelled subscriptions. It would also be possible to experiment with promotions, such as discounts for subscribers who recommend Couchweb to friends, hopefully with the ability to measure success rates. This information could possibly be augmented to build up a better understanding of subscribers, who could be asked to furnish Couchweb with details of their ages, genders, and number of viewers per household.

The combined database would also give Couchweb direct access to data relating to payments. For example, customer complaints about missed payments or unwarranted service interruptions will be easier to investigate and rectify. It will also be easier for Couchweb to manage cash flows because it will have a clearer understanding of the dates that payments were made. There could even be scope for speeding up receipts if Couchweb is no longer directly reliant on Cardbill for that data.

### **Requirement 2 – bidding**

The most immediate problem is that ITServ's Board may be unhappy that their company will lose its status as a quoted company in order to become a subsidiary of Couchweb. They will undoubtedly see this as a setback in terms of their careers, especially as they may lose their jobs in order to make way for Couchweb's appointees. The ITServ Board members might advise their shareholders to reject the offer on the grounds that the company will prosper far more as an independent business. They could also vote themselves personal protection in the form of "golden parachutes" so that they will receive significant bonuses should they lose their jobs for any reasons.

The simplest way to deal with this problem would be for Couchweb to be open about its plans for the company, including the members of its Board. Couchweb is acquiring ITServ for its expertise and so it might be able to offer the Board the opportunity to

remain in place in return for an increased salary. If some Board members will be replaced then Couchweb should make it clear that a generous severance package will be offered. The final decision will, in any case, be taken by ITServ's shareholders and a realistic offer should be sufficient to guarantee success.

The other major issue is the manner in which the share offer should be structured. The starting point would be the relative market capitalisations of the two companies, with Couchweb shares being offered pro rata for ITServ's. Unfortunately, there are speculators who will buy ITServ shares as soon as the bid is announced in the hope that Couchweb will pay a premium for the company. ITServ's shareholders will also be aware that there will be synergies that will encourage Couchweb to pay a little more for the company and that could complicate the bid. There could also be concern amongst Couchweb's shareholders that we will pay too much for the company.

Ideally, the bid should be detailed from the outset, with clarity as to how it will be structured. Couchweb should keep its interest confidential until the bid is formally announced and it should be made clear that it is a fair offer to all parties. Couchweb could point out that ITServ is merely an alternative to creating an IT infrastructure and that it will not pay an excessive amount for it. The share offer should give ITServ's shareholders an incentive to accept without diluting Couchweb's equity by much.

## **SECTION 3**

### **Requirement 1 – internal audit’s response**

The lead internal auditor should have discussed the findings from the investigation with the managers responsible for the department concerned. That discussion should have made the facts very clear and also their implications for Couchweb. The specific failings that had been observed should have been noted in the report with their significance. The internal auditor could have offered advice as to how the IT security might be improved and strengthened and the managers’ responses noted. The auditor could have agreed a timescale for ensuring that the problems had been rectified and that could have been incorporated into the final report.

A follow-up visit could be scheduled for after the agreed rectification date and the internal auditor could have investigated whether the new processes were in operation. The auditor would hopefully have confirmed that the system was operating as promised at the end of the initial investigation and could discuss any remaining problems with departmental managers. A supplement to the initial report could then be written to confirm that the system was now operating correctly. The fact that the auditor had returned in this manner would send a very powerful message to the subjects of the report that any compliance errors will be taken very seriously.

### **Requirement 2 – internal audit’s role**

The role of internal audit is generally about compliance. Couchweb’s operations are governed by formal systems and the Board uses internal audit to check that the systems are operating correctly. In order to fulfil this role effectively, the Internal Audit Department has to be independent of the departments that are being audited. The fact that the auditor has recommended changes and then returned to ensure that those changes are in effect could cause a loss of independence. The danger is that the auditor will discover that the recommendations made have not been successful and this will create a conflict of interest with regard to reporting.

The auditor also needs to maintain a healthy working relationship with the managers and staff who are the subjects of audits. There is a risk that an unduly aggressive report and follow-up could undermine the working relationship between the audit team and managers. Given that the problem discovered in this case appears to have been due to carelessness rather than a major flaw in the system, it might have been sufficient to have asked managers to be more vigilant in the future. The prospect of a return visit, with fears that the auditor will be keen to find something to report on, would possibly create a sense of apprehension, even though internal audit should be seen as a constructive service.

### **Requirement 3 – change management issues**

The internal audit staff are trained in conducting compliance tests. They should understand the controls that they are checking, but they are not necessarily skilled in developing skills on their own initiative. The auditors will require considerable training in IT security so that they have the necessary expertise to make the significant shift from testing the operations of established controls to the development of new controls. It may be necessary to recruit additional staff or to second IT specialists from elsewhere in Couchweb to Internal Audit for the duration of this project. Staff will also require training in hacking and related techniques so that they can test the effectiveness of their new systems.

Asking the internal audit staff to implement the new system will require further training in presentation skills and similar matters. Auditors should be good communicators and good at working with staff in any case, but they will not necessarily be used to giving orders and providing teams with guidance. Staff will have to be trained in developing coherent and comprehensive systems documentation that can be followed and can be used to develop updates. The Board will also have to ensure that all managers are aware that Internal Audit has the authority to make these changes.

#### **Requirement 4 – dealing with change management issues**

IT security can range in complexity from basic physical security and protection of passwords through to complicated programming. The Internal Audit Department will have to be assured that they will not be required to do anything for which they do not have the necessary skills and training. The Board will also have to ensure that they give Internal Audit sufficient time to organise themselves and get ready for this new role. The Board will also have to make it clear that IT security is increasingly complex and will always be vulnerable and so the Internal Audit Department will not necessarily be held responsible for any further data breaches.

The audit staff will also require some assurances for the conclusion of this project. For example, will there be redundancies if additional staff are recruited and then found to be surplus to requirements. The Board will also have to demonstrate its commitment to traditional compliance audit because the diversion of resources away from that could be misinterpreted as a suggestion that internal audit is irrelevant. The role of internal audit will also have to be clearly defined for going forward. The responsibility for ensuring IT security will have to be passed on to line management after the conclusion of this project, otherwise the auditors will be unsure whether they should be auditing or maintaining the systems.