SECTION A – 50 MARKS

Question One

(a) Identify and evaluate FIVE risks affecting DEC’s new African subsidiary. (15 marks)

There many risks you could mention but you need only mention 5, some of which are illustrated below:

Demand risk

Currently demand in the African country is low and exports to other neighbouring African countries have yet to materialise, this means that there is a risk that there maybe insufficient demand to sustain the subsidiary. The product range is similar to that offered by Aybe elsewhere around the world and so it is unlikely that the excess production can be absorbed elsewhere. It is difficult to predict the likely demand that will occur but the consequence would be very high as huge costs would have been spent developing the subsidiary which cannot be recovered.

Inflation risk

There are high levels of inflation in Africa and this will have the impact of reducing the value of the African countryôs currency and therefore when exchanged back into DECôs own currency it would buy less domestic currency. In addition high inflation often leads to fundamental problems in the economy and therefore impacting on the profits generated by the subsidiary. For example to control inflation interest rates may need to be increased, therefore making it more expensive to borrow and reducing the countryôs disposable income leading to reduced demand for the subsidiaryôs products and falling profits. The management of a country by a government is difficult to predict as there are other instruments that could be used to control the economy, however the risks are very high as government decisions may result in economic growth or recession.

Legal risk

The old components used by the customers of DEC are legally required to be recycled as they contain toxic materials; there is a risk that this may not be complied with by the subsidiary but this risk can be minimised if there are controls in place to acquire old components from customers when new components are being sold to them. The consequence of non-compliance will have a major impact as there maybe fines imposed, and then perhaps leading to the subsidiary being shut down if it continued, furthermore harm to the reputation of DEC as an ethical and environmentally friendly organisation.

Logistical risk

There maybe risks to do with the shipment of raw materials to the subsidiary in the African country as they contain harmful toxic materials and so therefore the government may impose restrictions on the amount that is imported. This may mean that production will be restricted and therefore not enough components are made to support demand. Furthermore their maybe import tariffs imposed to reduce the amount of this harmful material coming into the country and therefore increasing costs to the subsidiary. Understanding the probability of this occurring can be resolved by referring to the appropriate legislation or speaking to the government department in charge, however in theory it may not be clear as to the correct interpretation of the legislation can only be truly understood by the practice of importing.

Joint venture risk

The subsidiary has been created with a government owned joint venture partner being a legal requirement. This may present a conflict of interest as the government may wish for the subsidiary to sell the components at a low price to benefit the consumers and maximise sales, but DEC's interests maybe to maximise profits by setting a higher price. There is a significant likelihood that this may happen as the African government can quite easily dictate terms to the foreign investor, as non-compliance would mean withdrawal of permission for DEC trade in their country. There is also a high probability that the DEC and the African government's style of management would be different when it comes to running a company and this may lead to irresolvable disagreements and again permission withdrawn by the African government for DEC to trade.

Labour risk

The labour force in this country is unknown and the subsidiary will require staff that have had experience working in an electronics factory. There is a risk that the labour force does not posses the skills, experience or aptitude to perform the work and as a result a very large learning curve to surmount. This could lead to an increase in waste and scrappage through defective work, many returns from customers and warranty claims. Furthermore an increase in injuries due to the poor handling of toxic waste by an inexperienced work force. It is difficult to predict the chance of all these occurring but it will be much reduced if Aybe has had experience of developing similar subsidiaries in similar countries.

Currency risk

Aybe manufactures in Eastern Europe and makes sales in Europe and the US and has customers in 20 different countries. This gives them a high exposure to foreign exchange risk. Adverse exchange rate movements may occur with transactions with the African country and this maybe more so given the expected problems with inflation. It is important that exchange rate movements are monitored closely and measures taken to reduce the exposure to adverse movements in the exchange rate with the African country. This may prove to be both expensive and time consuming.

(b) Discuss, in respect of the extension to the factory and the new African subsidiary, the strengths and weaknesses of DEC's management information system. (9 marks)

It is clear that DECôs management information system (MIS) has some fundamental problems to address. It is fails to provide any information for budgeting the costs involved in setting up the new subsidiary in the African country. When the MIS was being designed there should have been provisions to assist in budgeting for capital expenditure to develop the subsidiary, which should include an independent review and verification of these costs to be reasonable before authorisation.

Other weaknesses include the inability to track the progress of the development of the subsidiary, as there are no regular comparisons made between actual costs and budgeted costs. The system doses appear to be tracking inventory and production costs in the subsidiary but there is no flexing of budgets for actual levels of output, feed forward or feedback controls such as rolling budgets or variance analysis. Without these it is not possible to properly evaluate costs and to see if milestones are being met. However actual costs are al least being pooled together in the MIS to allow us to consider whether there has been an overall overspend once the project has been completed.

There is no information pertaining to the level of sales and customer demand, meaning that production is not being co-ordinated to meet expected levels of demand and that components are being stockpiled in the hope that the items will be sold eventually. This will inevitably lead to unnecessary costs being spent on materials, production and storage. It is far better to have demand forecasts based on expected sales drawn from the sales team and running production levels to meet demand.

(c)

(i) Discuss the methods DEC and the African subsidiary could use to mitigate the foreign exchange risk when trading with other foreign countries. (10 marks)

DEC has to supply the subsidiary with materials to manufacture the components which are invoiced in the subsidiaryøs currency. This means that DEC is completely exposed to any adverse exchange rate movements, however because of the expected increase in inflation in the African country, the subsidiaryøs currency will weaken in value against DECøs currency and therefore the risk is minimised.

The selling price charged by DEC to the subsidiary will have to be lowered as it would mean that the subsidiary will find it difficult to make a profit as more and more money would be needed to pay for DEC due to inflation. DEC would have to oblige if it wants the subsidiary in the long term to establish a strong market share and strategic position in the African region.

If the subsidiary attempts to trade with neighbouring countries then it will face currency risks on the sales and economic risk if it is not able to cover costs. These can be offset by entering into forward contracts to fix the exchange rate used for the sale or offset any imports of materials sourced from that country, if possible against the sales being made to that country. The forward contract maybe an expensive option, given that there are low levels of sales expected to be made by the subsidiary.

DEC receives payment from the subsidiary every four months and which are substantial amounts of money for the sale of material. DEC should consider using a hedging device such as forward contracts, options or money market hedge to minimise exposure to adverse movements in the exchange rate. However such instruments may not be available in the African country.

The other option is to consider creating a natural hedge such as importing goods or services which would be valuable to DEC or the rest of the Aybe organisation. This would mean that the need for currency would be minimised, only required to pay for any small differences after taking into account the values of the imports and exports being netted off. This would also serve the purpose of reducing any intervention needed by the African country to introduce controls over exchange.

(ii) Discuss the accounting implications for both DEC and the African subsidiary of each method identified in (i). (6 marks)

Both DEC and the subsidiary will have gains and losses on transactions which will be treated as currency gains or losses in the income statement. Economic risk exposure will manifest itself as reduced sales and therefore impacting profit in the income statement.

Any imports being used to offset sales will be flow though to the income statements and statements of financial position of both entities, as expenses offsetting revenues, accruals or prepayments.

Hedging devices entered into by DEC and the subsidiary will have to be accounted for in accordance with IAS 39 and IFRS 9. The devices will have to be restated at the fair value at the year end provided that they are still. This may have a large adverse impact on the subsidiary because of the expected inflation in the economy. The alternative is to use cash flow hedges. This is where the cash flows of the item being hedged change as the market prices change. The change in the fair value of the hedging financial instrument is taken to equity initially, and when the actual transaction occurs, the change is then moved to the income statement. This would not have such an adverse impact on the income statement of the subsidiary.

(d) Discuss the safeguards that should exist within any company to prevent the unethical manipulation of transactions. (You should refer to examples from DEC in your answer.) (10 marks)

There should be a strong control environment in the company to help prevent unethical manipulation of transactions. A strong control environment is the attitude, awareness, actions of directors and show how important and serious internal controls are to the employees of the business. It is the management style, the way the company is organised and corporate culture and values that will dictate the control environment. Management should make it clear that manipulation of transactions in the accounts is not acceptable and is a serious offence met with serious consequences. This should be made abundantly clear through on going training of staff, workshops, staff handbooks, presentations, seminars, conferences, emails and the company website. Clear policy of disciplinary procedures should be in place for all fraudulent activities carried out by staff which may also act as a deterrent.

Management should lead by example and should be held accountable for any unethical actions they may take. Staff are more likely to adhere to rules if management do the same, for example toxic material from old components is properly disposed of and not just illegally dumped.

The bonus and remuneration system should be used to encourage ethical behaviour from sales staff. For example the bonus system could include credit given for proper collection and disposal of customerӳ old components when new sales are made.

Internal controls should be in place to prevent unethical manipulation of transactions occurring. For example the over inflation of internal transfer prices by the manger in DEC should have been highlighted by internal control procedures such as checking the price charged on the invoice to be in line with the order.

There should be an internal audit department carrying out regular reviews of the internal control system, highlighting any weaknesses and recommending improvements. The internal audit department should be supported by management and be given access and resources to complete their tasks. It maybe expensive to employ a comprehensive internal audit department and so it maybe cost effective to use a consultancy which specialises in providing these services as and when they are needed.

SECTION B – 50 MARKS

Question Two

(a) Evaluate the proposal made by the governor of the central bank. (10 marks)

The proposal by the governor of the central bank in country B would not improve the banking industry in fact it may encourage a risk taking culture.

The banking sector much like other sectors is not only affected by decisions taken by the directors but also factors and events outside of their control such as interest rates, inflation, consumer demand, the media and market confidence. It is difficult to measure the performance of the Board or any individual director as there is no true isolated objective which can be used to measure them against, to which they can only affect, without any impact from uncontrollable factors.

The remuneration structure would mean that the directors will view the fee to become a director as a sunk cost that has to be paid, and after that the real focus will be on investing in projects with the potential of earning high profits to obtain their bonuses.

The problem with this approach is that there are no penalties in place for directors if they decide to invest in high risk projects but a very large upside in bonuses being earned if for example the high earning, high risk project becomes realised. This could mean that only risk takers would become directors of banks leading to a culture of maximising short term annual bonuses and then leaving the bank and perhaps even taking dishonest and unethical decisions such as manipulating profit to achieve this.

However this proposal does have the advantage of making directors more accountable for their remuneration and needing to justify the bonuses they receive. This would be attractive to shareholders, the general public and the media.

(b) Evaluate the risk management strategy in B Bank (except for consideration of directors' remuneration). Your evaluation should include recommendations for changes that will lower the bank's exposure to risk. (15 marks)

The last major Board strategy meeting for the bank took place 4 years ago which is very infrequent for any business let alone the banking sector. In this time period many things could have gone wrong without any effort taken to correct them this can result in losses being made. Strategies need to be revisited on a more regular basis to ensure that they are on target to meet the objectives of the bank. For example the bank may invest in issuing mortgages to customers over 15 to 25 years which is a long time for the banksô money to be tied up, however regular reviews of this strategy must be carried out to ensure that it is generating good profits and any risks such as over lending compared the value of the property are mitigated.

Non-executives are not carrying out their duty to challenge strategies and provide consultation and judgement as to the effectiveness of the strategies being considered. They should recommend how to improve these and point out the risks in decisions taken by directors and so all decisions are taken with great thought and consideration.

The bank appears to be advancing mortgages greater than the value of the property, some by up to 125% of the current value, the reason why they are doing this is because they hope that property values will surpass this value in any event within the next 10 years. This is an extremely risky position to take as it is not known for certain that this will be the case and there is a chance that the downward trend of property values may continue. The reason why this is risky is because if the customer cannot keep up mortgage repayments then the bank would not be able to recover its entire loan by repossessing and selling the property, as the property is worth less than the loan.

It is better to take a more conservative approach to mortgages to safeguard against such losses occurring. The bank should lend only up to a proportion of the current value of the property, for example 70%, and so in the event of a recession when the property values may fall, there is still scope to recover the full loan value if the customer fails to keep up mortgage repayments.

However if property prices do rise by 7% over the next 10 years, faster than the rate of wage inflation, then customers will find it increasingly difficult to obtain mortgages as salaries will not be large enough to secure them. This will cause mortgage applications to fall and the revenue from mortgages to vastly reduce. The bank should look at alternative ways to lend money to obtain income, such as short-term lending but ensure that the risk exposure is minimised by securing the loan against an asset.

The make up of the shareholders has changed for the bank. It is no longer dominated by pension funds that were interested in long term steady predictable returns but now mainly made up of hedge funds looking for fast short term financial gains. The bank should ensure that they are not pressured by the hedge funds into taking high risk speculative investments in the hope of obtaining short term gains, but instead manage the expectations of all shareholders that in the foreseeable future moderate returns can be expected as conservative risks are being taken in these uncertain times.

Question Three

(a)

(i) Discuss the advantages and disadvantages of the use of a forward contract by N, and (8 marks)

Advantages of forward contract

The exchange rate is fixed and so therefore N will know exactly how much sterling it will receive when the dollars are received from the customer.

It is specifically tailored to exactly the amount of currency needed to be hedged.

It will allow N to budget the amount profit it will make on the contract after the costs of the forward contract.

It will allow N to budget the subsequent expenditure after the monies are received from the customer.

It is very simple to set up and administer and there are also short maturity dates which is ideal for N as it only needs the hedge for 90days.

Disadvantages of forward contract

It is a binding contract and therefore must be honoured. For example if the export deal falls through with L, N will still have to fulfil the forward contract it has arranged. This could be expensive and inconvenient.

N cannot take advantage of favourable exchange rate movements between the dollar and sterling as it is in a binding contract.

There are also bank charges to pay on arranging the forward contract which can become quite expensive.

It may be difficult for a small company like N to arrange a forward contract.

(ii) Calculate for N whether, in retrospect, purchasing a forward contract was actually beneficial for the company. (4 marks)

Using forward contracts

We are given discounts which you would add to the current spot rate to achieve the forward rates. The discounts are in ñcentsò and so therefore you must divide them by 100 to covert them into ñdollarsò being the units used in the spot rate.

Therefore:

£ / US $ spot	1.6000	-	1.6050
Discount (add)	0.023	-	0.025
3 month forward	1.623		1.63

Use $1.63 as opposed to $1.623 as this will give you the least amount of sterling on conversion. The bank always wins!

Therefore:

$1,755,250 / $1.63 = **£1,076,840**

Using the spot rate

The spot rate on completion in 90 days time to be used is $1.6635 rather than $1.6585 as this will give you the least amount of sterling on conversion. The bank always wins!

Therefore:

$1,755,250 / $1.6635 = **£1,055,155**

Conclusion

N will earn more through using the forward contract. The extra amount it would earn is £1,076,840 - £1,055,155 = £21,685; however we have not been given any information about the costs of arranging the forward contract which would of course reduce the gain.

(b)

(i) Explain why N's competitive position could be exposed to movements on the US$. (4 marks)

The exchange rate movements between £ and US$ will in any event affect N even though it does not directly trade with customers or suppliers in the US, this is because imports become cheaper if the £ strengthens against the $, therefore UK customers of N can buy cheaper substitutes from the US.

The materials used by N to manufacture it's products may actually be sourced by their supplier from the US, this means that N will pay more or less for it's materials depending on whether the £ strengthens or weakens against the $.

If the £ does strengthen against the $ then customers in the US will find it more expensive to purchase N's products, therefore making it difficult for N to compete in the US. The only alternative would be to fix the price in $.

(ii) Discuss why exposure to economic risk as a result of exchange rate fluctuations is hard to quantify. (9 marks)

It is hard to quantify economic risk exposure as a result of exchange rate fluctuations because there are other influencing factors that are relevant. For example competitors may not reduce their selling price even if it becomes expensive for customers abroad to purchase their items. This is because they maybe established recognised brands which have an inelastic demand and so are happy to take a smaller market share but take a large profit per unit sold.

The goods N purchase from its suppliers which source them from abroad may not increase the price that they charge N even if the exchange rate moves adversely for them where they have to pay more. This maybe because they are keen to keep N as a customer and afraid that a price increase would mean that N may go to a competitor, however this making the assumption there are close substitutes and reliable suppliers available.

Distribution channels may not be available to all exporters and therefore importers will have reduced or no alternative to N's product and therefore the price that N charges can remain the same even if the exchange rate moves adversely for the importer.

The quantity, quality and reliability of an exporter maybe more important to an importer than if the exchange rate moves adversely against them and so are willing to pay more even if other alternative exporters are available and cheaper.

Question Five

(a) Discuss FIVE factors that the external auditors should consider when performing a risk assessment of K's IT systems. (15 marks)

IT is very central and important to the success of K as it conducts its entire business through its website. If the website or IT systems in K are not operational for any significant duration of time there will be a huge loss in revenue from potential customers who want to subscribe and also lost goodwill from existing customers who become frustrated by not being able to use the services. The auditors will be interested to know what precautions K has taken in securing the system against any malfunctions or downtime and also their understanding of the impact of this risk.

The entire system is maintained from one computer system at K's head office, there is clearly no segregation of duties between sales, taking payments and recording transactions. This system is open to fraud as it would be possible to create a program to divert monies away from K to the fraudster and delete any kind of audit trail. The auditors will be interested to see what kind of general controls are in place to prevent this occurring.

Technologies used are at risk of changing and evolving on a frequent basis and therefore K must have controls in place to ensure that they are keeping pace with the latest developments in hardware and software and that which is being used by their customers. In addition these changes will make the system susceptible to fraud and error and so the auditors will be interested in what measure they have taken to safeguard against this.

The system contains valuable assets being the music library and in addition customerƒs personal details and credit card details. There is a risk of identity fraud be committed by hackers as the system is not standalone but on-line and so auditors will be interested to know what safeguards are in place to prevent this occurring.

There is a risk that the auditors themselves may be a factor here as they should have the expertise to be able to carry out this audit with competence. If they are lacking experience then they must ensure they have access to an external expert who can provide them with the assistance that they require or else the auditors must not carry out the work.

(b) Evaluate the risks to K of such complaints explaining how those risks could be alleviated. (10 marks)

Kƒs reputation is at risk as this type of fraud will more than likely attract huge media interest and even though K is not perpetrating the fraud it will be tarnished with the fact that it is an untrustworthy company looking to defraud individuals. In addition there will be a huge loss in customer goodwill.

There is a risk that credit card companies will refuse to allow K to take payments and this would mean that Kƒs customers will not be able to purchase music from them resulting in K inevitably going bust. If the credit card companies allow K to take payments then they may insist on asking all customers to confirm that they genuinely intend to make the purchase and verify their identity, this will become very inconvenient for customers and result in lost goodwill.

In addition there are royalties that need to be paid to copyright holders in any event even if customers are refunded their monies.

To alleviate these risks K will have to review the fraudulent claims to see if there is any identifiable pattern, and if for example they originate from a particular country, maybe suspend all services to that country until it is resolved. It will be difficult to completely eliminate all such risks as the product is data and does not take a physical form which can easily be distinguished and identified.

K should use a specialised third party who deal in internet transactions such as PayPal who have security controls in place to deal with such fraud, and will boost customer confidence in that there identity will not be stolen if music is purchased from K.

K could gather unique information about itõs customers such as IP addresses and block any fraudulent users, in addition introduce a registration process that will ask new customers to verify their identity through email confirmations.