

SECTION A – 50 MARKS

Question One

(a)

- (i) Evaluate the risks arising from the outbreak of food poisoning to F plc's reputation in terms of their likelihood and impact of occurrence. (8 marks)**

- (ii) Advise the directors of F plc on the suitability of the two arguments proposed by the managers of the Meals Division for defending the company's reputation. (8 marks)**

(i)

Publicity risk

Likelihood

The food poisoning story is almost certain to continue and is already widely reported in newspapers and television. It is a high interest story because it has a significant impact on one of the most vulnerable groups of people being the elderly, and also on the health of the nation as a whole.

Impact

This will be very high as historically such food poisoning scares have stopped people consuming certain products for example mad cow disease or bird flu. The public will be especially concerned because F plc have appeared to be reckless in selling dangerous products to the public.

Regulatory risk

Likelihood

The government inspectors will be under great pressure to investigate this incident as they are responsible for enforcing the legislation for food safety. There is an almost certain likelihood of a detailed investigation taking place.

Impact

The results of the investigation are crucial and if the Meals Division is found guilty of food poisoning this will mean that the public at large will completely lose confidence in their products leading to a shutdown of the division. The media will also help in this downfall as it would be a newsworthy scandal. Even if Meals Division is exonerated the media is unlikely to give this much coverage as it is not newsworthy and furthermore the public may still have their suspicions about the food produced by Meals Division.

Legal risk

Likelihood

There appears to be not enough evidence to prove F plc's negligence even if they were guilty. It is also unlikely that the victims will have the necessary resources to bring a lawsuit against F plc. Therefore there is a low probability of this occurring.

Impact

If legal action is taken then this will have a significant damaging impact on F plc's reputation as the public will want F plc to answer these accusations. There will be a loss of goodwill as the case is heard in court and issues to with hygiene in the manufacturing process will be brought to public attention. If F plc loses the case then it will be official that the company was at fault and the company's reputation will suffer severely and maybe indefinitely. Even if F plc wins the case, the public may believe that they had the money to pay for better legal representation to see off these legal challenges brought against them.

Product risk

Likelihood

There is a very high chance that this food poisoning incident will be associated with all other products in F plc, affecting the quality reputation of the entire product range.

Impact

There will be a huge impact causing a severe loss in confidence as the consumer will be concerned for their own health and will completely withdraw from buying any of the products manufactured by F plc.

(ii)

All meat products contain these bacteria

The admission that in any event all of their meat products have a minimal level of bacteria will harm F plc's reputation forever and is unlikely to be restored. The public perception will be that they can fall ill by consuming these products even if it is a scientific fact about the presence of bacteria. It will be easy for competitors to form a campaign highlighting the dangers of consuming F plc's products because they have not been implicated in this food poisoning incident. Competitors will also be able to successfully increase their market share at the expense of F plc. Food law has not been broken by F plc in their products but this defence will only be seen by the public as hiding behind a technical legal point to conceal the truth.

Meals prepared negligently by the charity

The argument of blaming the charity for the food poisoning is a dangerous strategy to take as the public at large have much sympathy for charities especially those that are looking after the vulnerable elderly. It will be seen as an attempt to shift the blame away from themselves on to staff heating the meals up incorrectly, where as they should be taking responsibility for the meal themselves. Taking this approach will also give doubt to customers over the safety of the meal as it requires careful preparation or else they will be poisoned.

(b)

(i) Advise the board on the implications of the secret recipe being obtained by a competitor. (8 marks)

(ii) Recommend, stating reasons, suitable precautions for preventing the recipe from being obtained by a competitor. (6 marks)

(i)

Examiners Tip: Please note you can also present the opposite argument to this as long as it is justified to obtain all the marks.

F plc have a well-established brand and therefore even if a competitor had obtained the secret recipe the detrimental impact on F plc will be minimal. Customers will associate the 'great taste' of the pie only with F plc and are likely to continue purchasing the product. Furthermore there are huge barriers of entry for a competitor who has successfully replicated the recipe such as advertising and marketing costs to launch the new product.

In any event competitors can probably reverse engineer the product by analysing the chemicals in the pie and make a sensible guess as to its composition. They could quite easily come up with a close substitute without having the secret recipe. F plc enjoys the mystery of the secret family recipe.

(ii)

Recommended precautions:

Both employees to sign a non-disclosure agreement which will deter them from telling a competitor about the secret recipe because of the legal consequences but it still may not prevent disclosure.

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Provide more generous terms and conditions of employment for the employees, therefore making it unattractive to leave and work for a competitor with the secret recipe. This should be achieved more easily as they are long standing employees and clearly have loyalty to the company as well as finding it pleasant to work there.

The secret recipe should be written down and kept in a safety deposit box in a bank. This would prevent the need to write the recipe down somewhere where it could be accessed easily, mislaid or stolen.

(c)

(i) Evaluate the head of internal audit's statement that the divisional management accountant should not comment on the allocation of internal audit resources. (6 marks)

(ii) Discuss the validity of the head of internal audit's assertion that the external auditor should be prepared to cooperate with the internal audit department. (6 marks)

(i)

The internal audit department is answerable directly to the Board and should not need to be answering to the divisional management accountant. This maybe a political movement by the management accountant designed to misdirect the internal auditors or divert their attention away from looking into his work. However it does not appear that the management accountant is acting in bad faith and simply trying to ensure that the best interests are being served.

In this case we can see that the IT system has some weaknesses and the management accountant is simply bringing it to the attention of internal audit, and asking them to assess the risks and make recommendations.

The head of internal audit in fact appears to be difficult and unreasonable. He could address the management accountants concerns and amend the audit programmes to take into account this area over the next few months.

The management accountant appears to be reasonable and justified in his comments and should be considered by internal audit.

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(ii)

External auditors are instructed by law to undertake their examination of the company independently and without influence or bias from anyone in the company. Requests from the internal audit cannot be accepted if they breach the statute law requirement of being independent. External auditors approach to examining the company should not be disclosed to the internal audit department as this will enable internal auditors to cleverly cover up any issues or problems occurring in the company.

However it is common for external auditors to make use of the work carried out by internal audit and also seek the assistance of the internal auditors to collect evidence, but this is unlikely to be reciprocated and provide the internal auditors with information or support.

(d) Evaluate the views of certain board members concerning there being no need to manage F plc's currency risks. (12 marks)

Arguments for not managing the currency risk

Many of the raw ingredients needed to manufacture F plc's products are readily available to purchase across many different countries and so unfavourable currency movements can be avoided by purchasing from other suppliers in different countries. For example beef can be sourced from South America or the UK.

Competitors of F plc will be facing the same kind of price pressure for example seasonal price fluctuations of fruit and vegetables, if this is the case then all manufacturers will have to pay the same price for pineapples in December for example.

Competitors are unlikely to use currency risk management devices because of their complex nature and the cost involved in using some of them like options, therefore F plc does not need to engage also in using them.

Arguments for managing the currency risk

We can use hedging devices such as futures or money market hedge to fix prices and have stability of costs leading to being more competitive in times of unfavourable currency movements.

The supermarkets form the majority customers of F plc, and who are notorious for putting their suppliers under pressure to reduce prices as far as possible, and will not accept adverse spikes in currency exchange rates for cost increases. Hedging will even out these sudden movements in currency and provide F plc with stable profits over the long term.

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Conclusion

Currency risk can have a huge negative impact on profits and threaten in some instances its solvency. However if F plc were to use hedging devices they would need to employ experts to administer them properly. This could become quite complicated and expensive to both employ experts and administer the purchase and sale of hedging devices.

F plc could follow the recommendations of the Board to manage the currency risk and this would involve minimal costs with currency management, and furthermore F plc have a choice of many different national and international suppliers they can use in times of adverse currency risk, and will allow them to take advantage of any price reductions.

In the long term F plc should seek to use a natural hedge to try and even out cash flow needs for currency.

SECTION B – 50 MARKS

Question Two

(a) Evaluate the risks to the quality of service offered to C's clients arising from the competitive nature of the firm's culture. (12 marks)

Ambition and promotion of staff

C has a strong culture of 'up or out' for all employees as they must continue to progress in their careers or be asked to leave. This puts a lot of pressure on staff to put their career progression ahead of the quality of service they provide their clients, resulting in poor quality of work by staff.

The dangers here are that staff whilst working in teams are more concerned about their contribution in the project and how they appear to superiors, who are in a position to promote them, rather than focussing entirely on the needs of the client. This could mean that some procedures or processes are ignored by staff to try and ensure that the project is delivered within budget in order to get noticed for promotion. This may mean that the client is exposed to risks of errors in the design, only discovered after the building is completed.

Behaviour of partners

The behaviour of partners may also open C up to risk as they will apply more pressure on staff to create ever increasing profits. Partners may also end up 'low balling' or undercharging for work as there is a culture of aggressive bidding at C, and then to make the work profitable under allocate resources to complete the work. The partner would then put more pressure on assigned staff to meet the budget resulting in unpaid overtime, insufficient time to complete the work and fabrication of incomplete work. This will again expose clients to the risk of problems with the end design of the building as tests and reviews were not properly carried out.

Architects and building contractors

Architects and building contractors recommend to their clients good firms of structural engineers and so C will take every precaution not to upset these individuals.

The partners of C will then avoid giving negative views on new building techniques which may not be appropriate. This means that C may recommend materials which are more expensive and safer but not necessary for the building in question. The client would never know of this mistake and so C's reputation is intact, but if a second opinion was sought then this may expose the money wasted by C unnecessarily.

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In addition C may sign off projects where they have under allocated resources leaving the client with the risk of a structurally unsound building, and therefore putting lives at risk when the building begins to weaken or collapse. This will severely harm C's reputation and open C up to lawsuits for negligence.

(b) Evaluate the strengths and weaknesses of C's governance arrangements with respect to the partnership and its management committee. (13 marks)

Strengths

The management committee is made up of experienced experts being engineers who understand the complex and important issues affecting the firm. Their term on the committee is limited to 3 years means which means that it is unlikely that they will introduce any strategies which may be beneficial to them and harmful to the firm as they will return to the firm to work with these strategies.

There is no remuneration benefit for people serving on the management committee and therefore there will be no aggressive political manoeuvres to try and get on to the management committee. This means there can be an unequivocal focus on developing the firm.

Both the committee and the firm will benefit as there will be a mix of partners who have had these experiences and therefore having a better understanding of the firm and direction.

Weaknesses

Partners contact with architects and building contractors will be reduced if they serve on the management committee, and this interruption may be viewed as detrimental to their careers in trying to develop business relationships and obtain referrals for work.

The management committee may suffer as a result of partners still trying to maintain their relationships with architects and building contractors to continue to try and obtain profitable work.

Partners may try to look for excuses not to serve on the management committee because it will not give them any benefit to do so. This will defeat the whole objective of all partners participating; instead those partners who may be willing to serve on the committee may not be the best candidates.

There will be a lack of continuity of leadership as the managing partner is changed every year.

The important strategic decisions are still left to the firm and not to the management committee and so the committee may only be focussed on short term goals.

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A simple majority vote (more than 50%) is needed to make changes to strategic decisions. This may be difficult to achieve given that there are 45 partners.

Question Three

(a) Advise the directors on the matters that they would have to consider in order to determine the extent of G's economic exposure. (5 marks)

Economic exposure is difficult to measure because it includes many factors affecting the economic viability of a company. The main things are generally included are costs and selling prices for the company, suppliers and competitors.

Competitors may not reduce their selling price even if it becomes expensive for customers abroad to purchase their items. This is because they may be 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 G purchase from its suppliers which source them from abroad may not increase the price that they charge G even if the exchange rate moves adversely for them where they have to pay more. This maybe because they are keen to keep G as a customer and afraid that a price increase would mean that G may go to a competitor, however this is making the assumption that 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 G's product and therefore the price that G 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.

(b) Evaluate the validity of the directors' concern that "the translation gains and losses on the US\$ bank balance are visible to shareholders, whereas the offsetting of economic exposure is not and so their hedging policy may be misunderstood". (10 marks)

Translation gains and losses occur when the company's foreign currency assets and liabilities have to be translated into home currency for incorporation in the financial statements. Translation risk does not affect the cash flows of the organisation; but shareholders may be concerned that the company is at risk if the US\$ declines against the R\$.

The offset of economic exposure is not visible on the financial statements and so shareholders may well believe that the company is not doing anything about this.

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The directors could explain to the shareholders their strategy to offset economic exposure, i.e. by using hedging devices. However it is a complex area to try and explain and can be misunderstood. It is important that the shareholders believe the directors are making decisions in the best interests of the shareholders (maximising wealth) and have confidence that they are safeguarding the assets of the business by hedging against currency risk.

(c)

(i) Calculate the 95% daily value at risk (VaR) of G's US\$ bank balance. (3 marks)

(ii) Use your answer to (c)(i) to calculate the 95% 30 day VaR of G's US\$ bank balance. (2 marks)

(iii) Advise the directors on the relevance of the VaR statistic to their consideration of the risks associated with retaining this US\$ bank balance. (5 marks)

(i)

In economics and finance, value at risk (VaR) is a measure (a number) saying how the market value of an asset or of a portfolio of assets is likely to decrease over a certain time period (usually over 1 day or 10 days) under usual conditions. It is typically used by security houses or investment banks to measure the market risk of their asset portfolios (market value at risk), but is actually a very general concept that has broad application.

VaR has two parameters:

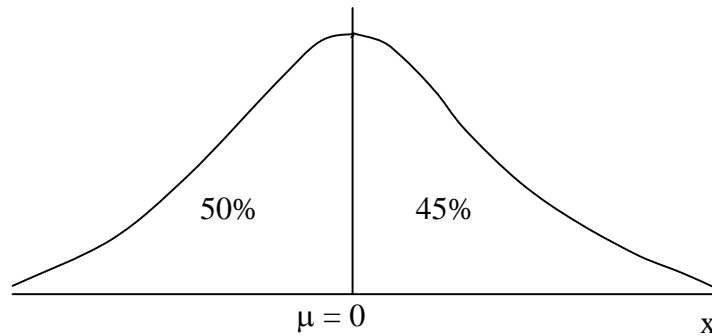
- The time horizon (period) to be analysed (usually 1 to 10 days).
- The confidence level of the estimate. Popular confidence levels usually are 99% and 95%.

We use the normal distribution and the following formula to find a percentage using a z value given to you within the normal distribution table provided in the exam.

$$Z = \frac{x - \mu}{\sigma}$$

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In this question the mean is assumed to be zero and here you need to think of losses in the portfolio. The losses cannot go less than zero. This is important to establish as it will affect the $\delta Z \delta$ value calculation.



Therefore with a 95% distribution, only half of the distribution bell is used which means $(95\% - 50\%) = 45\%$. The $\delta Z \delta$ value of 45% from the normal distribution tables is 1.65.

Mean (μ) = 0

Standard deviation (σ) = R\$450,000

$Z = 1.65$

$$Z = \frac{x - \mu}{\sigma}$$

$$X = (R\$450,000 \times 1.65) + 0$$

$$X = R\$742,500$$

(ii)

$$\text{The 30 day VaR} = \text{Daily VaR} \times \sqrt{30} = R\$742,500 \times \sqrt{30} = R\$4,066,840$$

(iii)

Interpretation

In any one day of trading, there is a 95% chance of the losses being R\$742,500 or less. In another words there is a 5% chance of losses being higher than R\$742,500 in any one day of trading. This is relatively small risk in relation to the size of the portfolio. This useful to know as it will be evidence to show how the decision was reached in holding funds in US\$, especially if the company suffers a loss greater than afore mentioned.

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Risks with using VaR

It is at the end of the day a measure based on historical data which may not be an indication of future variability. If there is an unexpected global event (e.g. an act of terrorism or natural disaster on the USA) it may cause currency rates to change adversely for G. However VaR is widely used in the financial world and reasonable to use it in this type of decision.

Question Four

(a) Evaluate the difficulties associated with preventing and/or detecting this fraud. (10 marks)

Collusion

There were segregation of duties but this was defeated through collusion by two members of staff. Segregation of duties is a very strong control but no control is fool proof and can be overridden through abused authority.

Senior members of staff

This fraud was very difficult to detect and prevent because there was a senior member of staff involved. It is unusual to find a head of a department stealing from the college as he is normally a highly respected and trusted member of staff.

Falsification of records

There were strong controls in place but were broken due to falsification of a record in the personnel department and human error. Humans are careless, distracted easily, misunderstand, make mistakes and falsify records. It is not possible to design a system that can prevent 100% of these problems.

Small amount fraud

It was difficult to detect because it was a small amount of money that was stolen in the payroll compared to the total value of payroll. The college has huge number of lecturers and so it would be difficult to detect, and the only people who could have spotted it were the perpetrators.

(b) Advise the college on the weaknesses in its systems and procedures. (8 marks)

New additions

New staff recruited being put on the payroll should have additional authorisation and not just the head of department. This is to ensure that those appointed are experienced and qualified for the job as well as preventing fraud or error in payroll.

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Budgeted teaching time

The college should try to obtain value for money from their teaching staff by budgeting the teaching time for all classes. This should be part of the normal budgeting process and should be reviewed by a senior member of staff such as the vice principal rather than department heads.

Pass keys

These should be tightly controlled and only given to authorised personnel such as security. They should not be given to anybody and if staff require access then security should unlock doors for them rather than staff borrow pass keys.

Computer passwords

Passwords should not be easily guessed and so should not be made up by staff but issued to them. Staff should be made responsible and vigilant over their electronic identities and all entries made with them. This will motivate them to ensure they completely log out of computer systems and so no access is possible after they have finished.

(c) Discuss the suggestion that the human elements of control systems are frequently more important than the software elements in ensuring that records are correct. (7 marks)

Authorisation

The human being can give considered authorisation which is very important as this is a decision that computer may not be able to give with effective control. Software will be able to do tasks such as highlight differences but would not be able to decide whether an entry should be accepted. For example if you had access to all login IDø and passwords then you can make the computer accept any transaction even if it was complete nonsense.

Physical security

This is down to the ability and carelessness of the human being responsible for the physical control. For example if you failed to lock your car door when you left the car park then access can be gained very easily by a passing burglar.

Standing data

Human judgement is required when making changes to standing data as computer software will accept any changes as long as it has been authorised by the correct member of staff.

Non-technical fraud

Most fraud involving computers tends to be non-technical, for example the input of fictitious purchase invoices leading to unauthorised payment. This can easily be detected by human beings reviewing these invoices before payment is made.