London School of Business & Finance

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ACCA

Paper P1

Governance, Risk & Ethics

Revision Mock Examination

June 2017

Answer Guide

Health Warning!	
How to pass	Attempt the examination under exam conditions BEFORE looking at these suggested answers. Then constructively compare your answer, identifying the points you made well and identifying those not so well made.
How to fail	Simply read or audit the answers congratulating yourself that you would have answered the questions as per the suggested answers.

Answer 1 – CSCC

Tutorial Help and Key Points

The scenario describes the governance and operational issues surrounding a large multinational listed company. The primary nature of the industry provides the scope to investigate environmental and key ethical areas as well as the typical aspects of risk and internal control. The case blends a high level overview of corporate activity with the detail of managing an individual project. This dual focus is in itself typical of examination questions requiring you to ensure you can absorb and respond to both strategic governance concerns and more tangible operational failures. The case does separate these two areas allowing different parts of the case to become the focus for different requirements in the question. In fact it reads in sequence with **parts (a)** and **(b)** being dealt with first, and **(c)** and **(d)** generally following. This sense of structure is again typical of the actual exam. However, the two areas of the case are large and so a number of points relating to a specific requirement are scattered throughout the narrative. This highlights the difficult skill of extracting relevant evidence from a body of text. The need to do this is vital in the exam and an essential element in gaining marks in each and every area of the question.

Part (a) of the question examines the global scope of governance in the sense that it is about an alternative form of governance. Understanding the differences and similarities between private and public sector institutions is part of understanding governance as a syllabus subject. The second part of the answer is designed to recognise the similarities rather than the differences suggesting that good governance has common characteristics regardless of the differing nature of institutions.

Part (b) draws on the agency relationship from a shareholders perspective. Understanding the role of Institutional shareholders is important. Although any practical solution to the question is acceptable the use of a formal framework provides the easiest route through to a good answer. The narrative of the case is structured to provide the evidence that would support the use of a formal model.

Part (c) is one of the most common questions set in P1. The roles of non-executive directors are examined often and these should be used to assess their contribution. The mark allocation would be split evenly between this text book knowledge and the need to support it through evidence from the question.

Part (d) includes the professional marks, in this case for producing a report. The 4 marks available are relatively easy to obtain and are reflected in the suggested solution. The report must be written from the perspective of the individual involved and should reflect the level and nature of the stated recipient. The first part should include reference to a standard model for internal control such as COSO. The second part, although requiring a risk definition, is really about stakeholders and ethics since these are the reasons that reputational risk is increased.

Marking Guide

(a)	Up to 5 marks for the distinction, up to 5 marks for the ways in which they affect governance structures. Overall total not to exceed the question total.	**Max 9 marks**
(b)	2 marks for each issue raised, suitably supported by the narrative.	**Max 12 marks**
(c)	1 mark for each role to a maximum of 4 roles. 1 mark for each specific contribution.	**Max 8 marks**
(d)		
(i)	1 mark for each relevant point made.	**Max 8 marks**
(ii)	Up to 2 marks for the definition. 1 mark for each additional relevant point made.	**Max 9 marks**
	4 professional marks awarded as described in the case scenario.	**Max 4 marks**
		Total: 50 marks

(a) Differences between state owned institutions and public listed companies

State owned institutions are funded exclusively by the government or taxpayers whereas public companies are funded through debt and equity. In this case the new listed company is funded through the $5billion raised in its Initial Public Offering.

State owned institutions are run by public officials as members of the board of trustees. This may include professional managers but in this case relates to ex-politicians running the enterprise. A public listed company is run by a board of directors who will all tend to be professional managers.

There is also a difference in ownership. Society or the public own the state institution whereas the shareholders own the public listed company. The ease of transfer of shares means that this ownership may be very fluid over time.

The objectives of the two organisations will also differ. The state owned institution will have a variety of objectives such as to provide employment or serve the public through public construction projects. The private-sector company has a single objective, to serve the shareholders. This need tends to be restricted to financial considerations.

Impact on governance structures

The UK Corporate Governance Code provides a basis for the governance structure of an organisation. The requirements of the Code can be translated in terms of their application to the state owned institution.

The first area is regarding the composition of senior management structures to run the company. The board of directors in a listed company must be balanced and skilled. The board of trustees may have any composition if there are no equivalent governance requirements. In the scenario the board of trustees has a limited scope and questionable skills base.

The UK Code highlights the need for nomination committees and provision of board support services such as the need for a company secretary. The governance arrangements of the state institution should include similar ideas if it is to be successful in its operation. There does not appear to be formalisation of recruitment or board support in information provision for the board of CSCC.

One key aspect of governance in a listed company is the need for adequate control and audit functions. This extends to the need to disclose such arrangements in the annual report. The lack of adequate internal control in CSCC suggests this governance arrangement is not given required attention.

The ability of the board to radically increase their remuneration at CSCC suggests that the equivalent provisions of section D of the UK Code do not exist. This requires the use of an independent and formal process for determining remuneration.

The final governance arrangement relates to the need to support shareholder relationships. In the state owned institution this could be translated as the importance of supporting ownership and stakeholder relationships by reporting to government on a regular basis and providing social reports as necessary.

(b) Reasons for Intervention

Hampel 1998 identifies a variety of reasons as to why Institutional Investors may intervene in a company within which they hold shares. All of these reasons are relevant to the situation at CSCC.

- **Poor strategy**

  In as much as the strategic direction of the company is the basis upon which rewards are created, shareholders will have a keen interest in the nature of strategy followed by the board. The internationalisation of the company's markets and the absence of promised internal customers is a deep concern. The quality of new clients and the basis for competing in terms of low cost strategies is very disconcerting.

- **Poor performance**

  The scenario states that the strategies being pursued have led to financial performance below market expectations and that share price is static. This poor performance will make shareholders more willing to intervene and ask difficult questions of the board.

- **Poor compliance**

  The lack of governance structures as outlined in part (a) may cause shareholders to question the appropriateness of senior management approaches to running the company. The general lack of governance regulation on the exchange does not assist although the shareholders should force change even if it is not generally followed by competitor companies. This would include the need for standard committees such as risk and audit.

- **Poor remuneration**

  The excessive pay demands of the directors is identified as being of concern and therefore a reason for intervention. The fact that the directors awarded themselves the increase is a part of this concern. This is often a major reason for intervention.

- **Poor composition**

  The unbalanced nature of the board and its population by individuals of questionable skills is another common reason for demanding change. The foreign investors will reflect on international companies and their balanced and skilled boards as a standard which CSCC should follow.

- **Risk and internal control**

  Excessive risk taking and poor internal control are also reasons for intervention given by Hampel. Excessive risk can lead to a failure in business ventures and a lack of control can affect costs. The poor project management that existed before the institution was privatised continued after the floatation and is reason for concern.

- **Poor CSR**

  This additional reason highlights the increasing interest of investors in ethical behaviour. The accusations of bribery and the poor CSR demonstrated on the SNCD project raise this level of concern and so the need to intervene.

(c) Assistance of NEDs

Higgs 2003 states four roles of NEDs. Each role can assist in improving the nature of governance at CSCC.

Strategy role

Independent directors are members of the board of directors to ensure that all decisions are made with the interests of shareholders in mind. The fact that they should outnumber executives means that this interest should be assured in the decisions reached. In CSCC the use of NEDs would reduce the accusation of self-interest being the basis for many decisions. The NEDs would also use their skills from outside the company in order to improve the quality of strategy pursued.

Scrutiny role

The largest failure in the company is one of control. This being the case, NEDs will be used to populate an audit committee. The role of such a committee is to ensure that control exists and that the shareholders receive the assurance they demand. Such a committee's independence should reduce any accusations of continued corruption by certain members of the board.

Risk role

NEDs can also be used to populate a risk committee. This committee could evaluate the viability of proposed projects ensuring they are selected for good commercial reasons. It would also consider threats to reputation and market related risk both of which are important to the existing NED at CSCC. The risk committee is used to develop appropriate risk strategies so reducing exposure and ensuring risk is kept within acceptable limits.

People role

NEDs will be used to formalise and ensure independence in the determination of reward packages. This highlights their role as members of the remuneration committee. As members of a nomination committee they will improve board balance, bring new expertise onto the board and retire those who have served out their usefulness at CSCC.

(d)

(i) REPORT

To: The board of CSCC

From: Yi Zhang, NED

Date: XXXXX

Subject: Internal control and Risk at SNCD

Introduction

I would like to use this report in order to draw your attention to the current situation at the SNCD regarding internal control and risk. In particular, I would like to make it clear that the levels of governance displayed in these areas fall well below the level expected by shareholders and that we should all reflect on this and improve as necessary.

Scope of internal controls

Within global governance regulation there are generally considered to be four aspects to creating and maintaining a sound system of internal control.

- **Control Environment**

  This relates to the vital importance of strategic management in providing a control infrastructure within which control systems can operate. This infrastructure includes the need to define roles; to provide adequate HR services such as training; and, above all, to provide leadership and create a strong corporate culture with a control focus. This we have failed to do. The endemic lack of control at the SNCD project evidenced by control failures and a lack of specific risk roles, such as health and safety managers, is of deep concern.

- **Control Activities**

  Control systems must exist throughout the organisation in every area of company activity. I believe there is a lack of control throughout many of the company's projects. In the SNCD project this can be seen in the reluctance of the local government to forward payments due to the poor quality of work carried out. It can also be seen in the increase in safety related failures on site.

- **Information and Communication**

  Adequate reporting is another important component in effective control to ensure senior management are aware of the success or failures in control throughout the company. The lack of awareness by the board regarding what is going on at the SNCD site demonstrates a lack of quality in this area. The fact I needed to visit at all is evidence that sufficient information does not exist at the top of the company.

- **Monitoring**

  The lack of information does not allow for effective monitoring. At the strategic level the lack of an audit or risk committee means that monitoring is left to the board and in this area there is a need for considerable improvement. At the operational level at the SNCD project the lack of health inspectors leads to a lack of monitoring the legal requirement to implement health and safety standards. This in turn has cost lives and must be improved upon in the future.

  Having addressed the scope of internal controls necessary to operate a sound system of internal control I would now like to discuss the nature and importance of risk management. This is also, clearly, an important area within which improvements must be made.

(ii) Reputational risk is the threat of negative perception of company activity from those who may impact upon the success of the organisation. This risk is intangible in many ways although its impact can affect corporate survival. It is important for all companies to guard against damage to reputation by ensuring they act with honesty and ethically with regard to stakeholder relationships.

The SNCD project creates the potential for reputational risk in a variety of ways. The poor perception from the local government by withholding payments for the project may affect current or future customers in their willingness to deal with CSCC. This creates a damaging market risk and threatens profits.

The damage caused by international reporting on the plight of the relocated villagers and the lack of compensation creates a perception of a lack of care being taken by CSCC in dealing with these stakeholders. We should use our position to talk to the local government about measures that could be taken to reduce this risk, possibly by increasing the level of payments.

The protesters who are accusing us of stealing their water supply are also creating a threat of negative perception. The truth of such accusations should firstly be investigated and if necessary we should re-evaluate the project's design to accommodate some element of sharing this important resource.

The environmental costs of any large project are often the cause of reputational risk. The SNCD project is no exception to this. It has a major impact on not just social aspects but also on local ecology. If these things have not already been considered then they most certainly should be – since many stakeholders are interested in this area.

Our own shareholders are often Institutional Investors who are deeply interested in ethical issues. The company's general reputation does not support a healthy relationship with these groups. The SNCD project should be used as a means to repair some of the damage to our reputation and not make this threat worse than it already is.

Our own employees are suffering through a lack of adequate safety management. Their protests could easily be picked up on by the local media and used against the company. Regardless of this we have an ethical and legal duty to support our employees and this should be recognised first.

Finally, the custodians of reputation are the board of directors and so it is for us to take control over this issue. We must take greater interest in key projects such as the SNCD project – if we do not our reputation will suffer both in the short and long term.

Conclusion

I believe the above provides a basis for open and constructive discussion among board members. I hope that it offers some guidance and wish again to impress upon you the urgency and severity of this issue. We cannot afford to fail. If we do, lives as well as the company's support from shareholders will be lost.

Answer 2 – Gulliver Inc

Tutorial Help and Key Points

This question blends internal control and ethical considerations regarding the environment. As a possible examination question it is straightforward in the sense that most of the marks can be gained through the use of standard frameworks for investigating the need for internal audit and the nature of an environmental audit. The final part of the question is taken from the periphery of the syllabus although it is likely to move more centre stage over the years as the examiner increases his interest in the association between the professional accountant and the important issue of environmental management.

Part (a) of the question could be answered simply using the scenario to identify the changes that have taken place and therefore the need to employ internal auditors. Such an approach is entirely appropriate although using a framework to organise your thoughts is often easier to do. In this case, Turnbull provides such a framework.

Part (b) is unusual in that it restricts the view of environmental audit to consisting of three stages rather than allowing you to identify any number of stages you feel are appropriate for describing the content of such a process. However, the examiner has decided that this topic should be standardised as consisting of three stages and so the question follows your examiner's approach. The issues that may be important in the development of each stage are so varied that any reasonable solution can be offered.

Part (c) is easier than it seems. The question firstly gives considerable assistance to identify possible accounting techniques, virtually explaining two of them without actually naming them. There are three major accounting techniques recommended in this area. However, to answer the question you could choose anything from your understanding of accountancy: DCF, for example, could have served as an example if the specific techniques on the syllabus were not known or used.

Marking Guide

(a)	1 mark for each issue or up to 2 marks if it is adequately explained.	**Max 10 marks**
(b)	1 mark for each stage and 1 mark for each issue described.	**Max 9 marks**
(c)	Up to 2 marks for each technique explained.	**Max 6 marks**
		Total: 25 marks

(a) Organisational factors to consider when establishing internal audit

Turnbull suggests a number of factors that an organisation may consider when deciding as to whether it needs to establish an internal audit function.

Scale and diversity

The larger a company is, the greater the need for formalisation of control activities in order to manage the increased propensity for failure. This likelihood increases still further as the complexity of operations increases. Gulliver Inc is firstly a listed company and this in itself suggests scale in operations. It is also increasing its complexity through its existing product mix and expansion into fertiliser markets.

Number of employees

An increasing number of employees in itself also suggests scale in operations. However, this factor probably relates more to the likelihood of control failure arising from human error and so would be less in an automated environment. It also highlights the importance of control to ensure employee safety. Gulliver is a manufacturing company and this in itself suggests human activity and so the need for internal audit to monitor employees. The nature of the company highlights the problem of safety and the need for internal auditors to monitor systems that deal with this area.

Risk profile

Different industries have different risk profiles. The riskier the company operations are, the greater the threat to control and therefore the greater the need for internal auditors to assist. Gulliver operates in a very risky industry and the contamination event proves this. The scope of market risks, reputational risks and environmental risks all suggest that internal audit is necessary to reduce these threats.

Structural change

If a company is going through a change process there is an inherent danger to control. The changes often require the establishment or restructuring of control system, and internal audit can be used to reduce the potential for control failure during this period. At Gulliver the company is establishing an internal audit committee. This change requires support from internal auditors to feed the committee with the information it needs in order to do its job. The changing product strategy of the company is another structural change that will require improved systems and will need monitoring.

Unexpected events and failures

A major failure in control systems may well be the trigger to improve auditing processes, and therefore to create the need to employ internal auditors. The contamination event has led to the need to think about employing internal auditors to reduce the likelihood of such an event recurring. Finlay Richardson understands the reputational risks involved and the need to ensure all aspects of operations are audited through environmental audit. The internal auditors will be used to assist in this environmental audit process.

(b) Three stages in environmental audit

- **Establishing metrics**

  The first stage relates to the need to establish targets or standards against which performance can be measured.

  These targets should relate to all areas of Gulliver's operations. They will include a blend of environmental and social issues including the need for targets in reducing the level of contamination in the water supply and targets for employee safety such as a reducing accident rate. The first issue therefore is the need to investigate the diversity of operations in order to determine the scope of such measures. A second aspect is to then determine what the level of improvement should be. The environmental expert will probably state the likely levels of water purity expected over the period of six months moving from poor to clear. Such targets must be considered for all aspects of operations.

- **Compliance**

  The second stage is to implement changes that should lead to performance improvement.

  After a given period the new performance levels are then measured and compared with the standard. Variances can be established and remedial action considered as necessary. There are many issues to consider. The nature of systems change that could give rise to improvements is one. This will include fixing the cracked pipe and establishing chemical flow monitoring systems for the future. The timing of recording results will need to be considered. This may be continuous in some cases or weekly/monthly in others. The identification of individuals to carry out this review work is important. In this case it will probably be the internal auditors.

- **Reporting and disclosure**

  The final stage will be to report on performance to senior management.

  In this case senior management is represented by the audit committee. Disclosure through the annual report on environmental audit performance is vital. This will provide shareholders and stakeholders with the assurance they need that Gulliver is dealing with environmental management in an effective way.

  The depth and scope of information provided must be considered. Gulliver will need to think about whether it wishes to report failure as well as success although the scenario seems to suggest an honest ethical approach is taken by this company.

(c) A number of accounting techniques developed specifically to assist in environmental audit could be used by Gulliver to monitor the nature of operations and the improvements they are making in pursuit of their environmental goals.

- **Impact accounting**

Impact accounting identifies and quantifies the ecological and social cost of company operations. It attempts to place a value on the company's environmental footprint. Impact for Gulliver would relate to costing the contamination of the water supply in terms of the cost of remedial action, and the more difficult to value cost of impact on individuals' health. The financial cost of fines and compensation payments could be used as a starting point for this analysis.

- **Flow accounting**

  This involves a management accounting process of reviewing company operations from input though to output and determining changes as necessary. The goal is to monitor and reduce the volume of inputs for a given level of output or to produce more for a standard level of input. Chemicals used in manufacturing are usually one-off critical natural capital meaning they cannot be replenished from the earth's natural store. Reducing levels of use therefore assists in sustaining the ability to continue manufacture into the future.

- **Triple bottom line**

  Accountants can produce the environmental report as part of the annual report. The triple bottom line suggests a three pronged approach to producing the usual financial statements accompanied by an environmental report and a separate social report. Gulliver will need both to provide assurance to the community about their water supply and to detail how Gulliver has helped the community to sustain itself during this period.

Answer 3 – Osiris Standard

Tutorial Help and Key Points

This question is a thorough examination of one area of the syllabus. Apart from requiring a depth of knowledge about risk assessment, it also requires appropriate skills in correctly determining the exact requirement of a question. Two of the three parts of the question have multiple content and so you need to identify these needs and then allocate their time accordingly. By concentrating on one area too much time can be wasted when no further marks can be gained. Time management is a critical skill in P1 and so correctly identifying how much time you spend in each area is important.

Part (a) requires three risks to be identified. There are only three risks in the question and so no marks will be awarded for any other risks named. The risk assessment framework is risk mapping. This is the only acceptable answer. Each risk should be assessed in terms of impact and probability in order to gain the marks. There is plenty of evidence in the question to support this assessment. Identifying possible solutions or general remarks in conclusion will also receive a reward since they are relevant to any assessment.

Part (b) is a standard question that has been asked in relation to both internal control and risk management. Its pedigree stretches back to the pilot papers. It is a very practical question and so any relevant management views will be acceptable. However, by focusing on the removal of auditing threats it is easier to create the volume necessary to gain all of the marks. There is clear evidence of the existence of auditing threats from both of the departmental managers in the narrative

Part (c) requires standard definitions or distinctions between terms. Risk management is full of such distinctions and terminology, any of which can appear on the examination paper. The question also requires an ability to split the marks between different sections. There is clear divisibility of marks in this question and so appropriate time should be spent on each section rather than over explaining the distinction and failing to deal with its application to the scenario.

Marking Guide

(a)	1 mark for identifying each risk. Up to 3 marks for explaining risk mapping as a technique (1 mark for a diagram if used). Up to 2 marks for each assessment of risk. 1 mark for any proposed solutions to the problem.	**Max 12 marks**
(b)	1 mark for each reason for using an external auditor.	**Max 7 marks**
(c)	Up to 3 marks for the distinction. Up to 2 marks for application to each of 2 department managers.	**Max 6 marks**
		Total: 25 marks

(a) Risk assessment framework

Risk mapping is a standard framework used to assess risk exposure. The model identifies the potential impact or level of negative effect on the company of a given threat or hazard. This may be scaled from high to low. It matches this impact against the potential likelihood or probability of an event arising. The risk is then placed at the intersection between its impact and probability level. The risk map is then used to determine the proposed risk strategy which may vary between acceptance and avoidance. The use of risk mapping requires consideration of risk attitude as well as the use of both objective and subjective risk assessment.

- **Financial risk**

  The company faces a substantial threat to the continued availability of funds. This liquidity issue relates to a potential inability to meet the substantial claims that will arise if the fire spreads to the holiday resort.

  Risk assessment

  The potential impact of the risk is very high. It could lead to the failure of the company if it is unable to meet the level of claims following the fire. The probability of such an event arising is very difficult to determine accurately. There appears to be a "perfect storm" of issues in the question. The concentration of insured properties, the once in one hundred and fifty year weather conditions and the underfunded fire service response make the probability of these collective events arising very low. The vagaries of the direction of the wind typifies the situation for the company. However, such remote events should be appropriately managed. In this case, improving risk management models in the future would offer a possible solution.

- **IT risk**

  The technology risk for this organisation is the threat of technology failure due to the impact of a computer virus eradicating the company's files. This software risk must be dealt with as part of a computer continuity policy including measures such as the use of an effective firewall.

  Risk assessment

  The scenario states that computer viruses are very common in a modern business context. This suggests a very high probability that attempts will be made to infect a company's systems. The probability of the virus breaking through the company's defences should however be very low if an effective firewall exists. The potential impact of a successful infection can be very great. The loss of key records of customers and insurance policies could lead to difficulty in continuing business operations. In this scenario the impact will be negligible and merely be considered in terms of recovery time. This is because backup or security copies of such data will certainly exists. This is why Helen is less concerned about the issue.

- **Reputational risk**

  This is the threat to the company's perceived ethical stance as viewed from the perspective of customers, shareholders, and other stakeholders. The negative impact of perceived failure in this area may be great, and could last for a considerable period of time.

  Risk assessment

  The scenario suggests that the impact of this threat to reputation is negligible and therefore low. This is because key stakeholders are unconcerned or unaware that the problem exists. This could however change if the media becomes interested in the issue. The probability of threats to reputation occurring at some stage in company activity is almost certain. The probability of these events arising is as remote as the tribal community itself. It is very difficult for the marketing manager to have perceived the potential problem in advance since it is so unlikely to occur. However, should circumstances change, he may be required to withdraw the advertising if the general population perceives the company as being insensitive to religious beliefs.

(b) There are a number of reasons as to why the company may favour the use of an external risk auditor rather than relying on those within the company.

The CEO identifies the potential lack of skills in the organisation to deal with this issue. The potential poor quality of risk management models to deal with their core insurance business may be evidence of this. The external risk auditor brings with him professional expertise in this area.

Self-interest can be avoided as an audit risk if external risk auditors are used. Both managers demonstrate a sense of self interest by being unwilling to inform their superiors of the risks they have exposed the company to.

Self review would become the nature of risk auditing if these department managers were used to carry out the process. They are unlikely to be self-critical if they are reviewing their own work. An external auditor would be more objective.

Over familiarity and so an unwillingness to criticise a friend may become an issue. Helen and Mobutu are friends and so are unlikely to criticise each other if either is selected for the task. The external auditor has no prior association with any manager.

Intimidation is also a relevant issue. The objectivity or detachment of the external auditor suggests this is unlikely to impact on his judgement. At Osiris Standard there is clear intimation between the marketing manager and the CEO. This will impact on the quality of work undertaken.

These auditor threats have equal application to the use of any colleague within the company and for any department head and so should be avoided. The integrity and confidentiality assurance of using an outsider suggests this is the route to be followed.

The quality of the auditors work through avoiding these threats creates a sense of trust and confidence that risk assessment will be carried out successfully. This confidence is important for the CEO as well as shareholders and stakeholders.

(c) Distinction between objective and subjective risk assessment

Objective risk assessment involves the use of formal tangible evidence to support the task. Subjective risk assessment relies on personal judgement and intuition and so is a more intangible approach. Objective risk assessment therefore includes the use of empirical evidence or documented quantified results to determine potential impact. Previous insurance claims could show the potential impact of fire damage for this company. Subjective impact relates to the scale of the disaster and so the potential spread of the fire during the coming days. Objectively probability of weather patterns arising can be considered through historical records and computer modelling. A high volume of such evidence exists to support probability determination. Subjectivity arises as to whether it is likely that the fire will spread to the resort and the likelihood of the local fire service being unable to deal with it.

Helen Kegame

Objectively Helen can look at evidence of previous attacks on the company. She can read media reports and view industry and national/international statistics as to the likelihood of such events arising. Subjectively she must assess the depth of controls necessary to deal with the issue in order to reduce the potential impact and probability. There is a large amount of subjectivity in considering the creative abilities of the hackers and their willingness to carry out the attack given the illegal nature of the activity.

Mobutu Kabila

Objectively there is very little evidence he can use to consider this issue. Being aware of the nature of mainstream religious symbolism would be a prerequisite although the obscure nature of the tribal religion makes an objective assessment that stretches into their religion unlikely. Subjectivity is the essence of a creative process. Subjective risk assessment would involve the creative team discussing the potential possibility of their being problems of this nature. It is not beyond belief that this issue will occur but, as stated previously, very unlikely.

Answer 4 – Fingerprints

Tutorial Help and Key Points

The multiple requirement of this question is unusual. Generally, the examiner creates questions that contain three sections so to have five sections in a question is a rare opportunity. Multiple sections lead to the need to write less about any given issue reducing exposure to the need to write in depth about a syllabus element. The challenge is to ensure you know something about each element. **Part (a)** of the question is drawn from a peripheral area whilst **(b)** is much more mainstream. There is also a sense of broad coverage in that three of the four areas of the syllabus are included for consideration.

Part (a). Transaction cost theory is a development of agency theory and, since agency is the foundation to two thirds of the syllabus, transaction cost theory must be understood. It is rarely considered by the examiner and so is always a remote tip for the exam but nevertheless needs to be dealt with. A standard framework of five issues can be used to fully investigate the issue.

Part (b) is often more marks that the 6 available here. 8 marks would be more standard to consider the 4 elements of reward. The reduced number of marks probably relates to the fact that the question identifies at least 2 of the elements reducing the knowledge element of the requirement. Some evidence of problems in this area is given and so must be used in the answer.

Part (c) is possible to answer without reference to the scenario although the marking scheme will penalise you if you do not draw on the events discussed or the specific problems for this particular chairman. It is an important part of the role of the chairman to ensure adequate dialogue exists with shareholders through high quality disclosure.

Part (d) is drawn from the internal control area of the syllabus. It is a short, straightforward question that again asks for examples to be drawn from the case. Any answer that does not refer to the scenario and the particular problems of the audit committee will receive very few marks.

Part (e) is the first of the 7 positions identified by Grey, Owen and Adams regarding corporate social positioning. Again, there is evidence in the case to support the answer and the use of a standard framework such as that provided by Milton Friedman would assist in creating a good answer. In general, an understanding and ability to describe each of the 7 positions is a requirement of the syllabus.

Marking Guide

(a)	1 mark for each relevant point made. Max 2 marks if no reference to the question is given.	**Max 5 marks**
(b)	1.5 marks for each element discussed.	**Max 6 marks**
(c)	1 mark for each relevant point made. Max 1 mark if no	**Max 4 marks**

	reference to the scenario is provided	
(d)	1 mark for each relevant point made in the context of the case.	**Max 4 marks**
(e)	1 mark for each relevant issue raised.	**Max 6 marks**
		Total: 25 marks

(a) Transaction cost theory

This relates to the cost or threat involved in transacting with the board of directors. The issue is considered from the position of the shareholders. There are a number of variables that can be used to assist in evaluating the strength or worth of the relationship.

- **Frequency of change**

  Footprint is going through a period of rapid change with a changing product portfolio and a series of acquisitions. Frequent change increases shareholder concern and raises the transacting cost.

- **Risk**

  The nature of the company is more risky than some potential investments in the shareholders portfolio. Risk increases through frequent change and the opaque nature of disclosure. This increases agency costs for the shareholders.

- **Asset specificity**

  The specific asset in this scenario is the move off-shore. This specific event creates a tipping point in the mind of the shareholder and therefore the need to intervene in order to ask difficult questions of the chairman and the CEO.

- **Bounded rationality**

  In circumstances where the abilities and skills of the board is brought into question shareholder concerns increase and the level of trust reduces. There is clearly a lack of scope to board skills and expertise which would increases criticism under this heading.

- **Opportunism**

  This final element relates to the perception of self interest in strategic decisions by the board of directors. The scenario states that there is an allegation of self-serving interest made by the shareholders increasing their distrust of the board.

(b) Reward Package

A reward package has four elements:

- **Salary**

  Salary is used to attract and retain directors. It should be a minimal element overall since it is not performance related. Benchmarking salary to equivalent companies in the same industry may be used as a way of determining the level to set. The move off-shore may suggest the need to re-evaluate this level of reward. Given the reduced bureaucratic constraint of good governance it may be felt that the CEO should receive less reward in this area.

- **Benefits**

  There are a range of benefits available as a part of reward, company cars and suitable accommodation may be included. The latter may be an issue in moving the company to another country. The pension is perceived as being excessively high and is inappropriate since it is tied to bonuses rather than salary levels.

- **Bonus**

  The shareholders perceive the bonuses awarded for increasing company profits to be excessively high. This is surprising given the successful performance of the company and so presumably the levels earned by the CEO are well beyond general market expectation. There is also a complaint concerning the scope of performance indicators used with concern over the lack of control measures such as liquidity and credit management. Both of these areas are very important for financial services companies.

- **Share options**

  Share options are long term incentives used to balance the motivational attraction of bonuses as short term motivators. Share options tend to mature after three years promoting the need for steady growth and focus on share price. The static share price will be of concern to both shareholders and the CEO. A large amount of the CEO's reward may be tied to this indicator. It may be that he is using excessive bonuses to compensate himself for not gaining through share options.

(c) Chairman's statement

The chairman's statement is always an important element in the annual report. In this scenario its importance relates to the following:

- **Shareholders concerns**

  The shareholders demand the chairman use the annual report to explain the company's strategy and the rationale behind the move off-shore. This is a specific request and the chairman should therefore respond in writing.

- **Leadership**

  The shareholders are concerned that the CEO is not being controlled by the chairman. There is a suggestion the chairman is scared of the CEO. The chairman's statement should be used as a vehicle through which the chairman can make it clear that he is the leader of the board and therefore in control of executive decisions.

- **Opaqueness**

  The shareholders complain of the opaqueness of company operations and financial reporting especially since the move overseas. The chairman cannot provide detail but can at least provide some assurance and guidance as to company position and prospects. In a better regulated governance regime this is a requirement of disclosure.

- **Accusations**

  The refusal to comment on the specific accusation of financial impropriety is difficult for shareholders to accept from their presumed independent champion. Although the chairman's statement is only annual and therefore too distant to support refuting this allegation in the short term, it should be used to reinforce statements of denial which may be made through immediate press releases. In this scenario the chairman refuses to provide assurance through either.

(d) The role of the audit committee

The audit committee should provide an independent review of the company's internal controls and disclosure. At Fingerprints, the audit committee cannot be independent since it is made up of board members and all of the board members are close friends of the CEO. This removes the committee's independence and therefore calls into question its integrity.

Jack Hampel is the CFO at Fingerprints; he is also chair of the audit committee. Since he is an executive director he should not be a member of the audit committee since its members must all be independent. The problem is exacerbated since financial control is the key aspect of the audit committee's deliberations and he is the head of this section.

The lack of use of internationally agreed accounting standards is a problem for the audit committee to assess. If such standards are internationally agreed and were in place prior to the move overseas there is no rationale in not continuing to use them. The international element removes the impact of changing location on the use of such standards.

The accusation of fraud is clearly a specific criticism of the audit committee. It should address this directly through a press release. The auditor constraint is a difficult related issue. Since both work for the shareholders the audit committee should allow the auditors to provide a statement in support of the integrity of the financial statements of the company.

(e) Milton Friedman suggests the Pristine Capitalist position includes three elements:

- **Focus**

The company believes singularly in the need to act in shareholders' best interests. This suggests a profit focus to the detriment of considering stakeholders' needs that in any way conflict with the need to maximise profits. The rationale behind such a position is the legal requirement for the company to act with due regards to shareholder's needs. The CEO is quite clear that he fully understands and accepts this.

- **Externalisation**

The Pristine Capitalist believes that social responsibility is the exclusive responsibility of the government. This means that it is for governments to use tax dollars to support the community rather than burdening the corporation with the need to consider CSR. The lack of regulation, employee welfare support and low taxation are all statements that identify the governments and therefore society's position in terms of what it accepts as an acceptable relationship with corporation. Fingerprints embraces this relationship as being appropriate and supportive of its operations. This is why the company moved offshore.

- **Support**

The Pristine Capitalist will emphasise that the corporation does support society already in the sense that it provides products that society demands. The fact that Fingerprints' products are only for the wealthy in society and so exclude all others is ignored. The company will emphasise that it provides jobs to employees. This is true although it also seeks to minimise their wage levels and this does not support their ability to thrive in society. The company has also destroyed jobs in its home country. Finally, the company will point to the fact that it continues to pay tax into society although, of course, this is at a very low level, another reason it initially decided to move overseas.

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Paper P1

Governance, Risk & Ethics

Revision Mock Examination

June 2017

Question Paper

Time Allowed	15 minutes	Reading and planning
	3 hours	Writing

This paper is divided into two sections:
Section A – This ONE question is compulsory and MUST be attempted
Section B – TWO questions ONLY to be attempted
Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

Section A – This ONE question is compulsory and MUST be attempted

1. Ceeland State Construction Corporation (CSCC) is ranked among the top twenty construction companies in the world. It was founded in 1957 as a state run institution under the control of the government of Ceeland, carrying out virtually all major public engineering projects such as building bridges, roads, office complexes, schools, hospitals and housing estates. For fifty years CSCC has been central to the development of Ceeland's national infrastructure, providing employment for thousands of citizens and allowing the vast but relatively poor country of Ceeland to provide essential amenities necessary in building its economy.

During this period the company, as a public sector organisation, was entirely funded by the tax revenues. The costing of individual projects prior to their initiation and the subsequent cost control associated with managing large scale construction projects was never considered a high priority. This was because the projects were always considered a necessity for the wider social good. Cost issues were therefore of secondary importance. The Board of Trustees, made up of government officials, generally had very little experience within the industry, being selected on the basis of their ranking within the governing political party, and were perceived as being more interested in the prestige that large engineering projects attract rather than the selection and control of the projects themselves. Wide spread corruption within the company was blamed for escalating project costs although so close was the enterprise to senior government officials that no Board member was ever personally accused or investigated.

In the last ten years government policy has changed. Previously the country was very inward looking and resistant to foreign involvement in its economic affairs. Now, the government of Ceeland has dramatically reduced bureaucratic barriers to foreign companies entering its markets and embraced capitalism rather than its previous socialist belief systems. One outcome of this change has been a growth in private sector competition for large scale governmental construction projects which CSCC used to be given automatically. In line with this changing world view, five years ago the government of Ceeland decided to privatise CSCC removing it from state ownership and floating it as a listed company on the newly opened Ceeland Stock Exchange. In order to attract foreign investors, the government guaranteed that CSCC would be favoured as the main construction contractor for future Ceeland national infrastructure projects creating an assured revenue stream through which Institutional Investor profits would flow. As a result of these promises a large number of overseas Institutional Investors were seduced into purchasing shares in the corporation and the floatation was successfully achieved. The total capital raised in the Initial Public Offering was in excess of $5billion. Since then many of these investors have begun to regret becoming owners of the company.

Immediately following privatisation, the Board of Directors, consisting entirely of the same individuals who had previously been Trustees, increased their own salaries ten-fold believing that these levels were more appropriate for one of the world's leading commercial construction companies. Shareholders, although alarmed at the increases, assumed that future returns would offset these rising agency costs and so did not vote against the increases at the company's first AGM. The following year, CSCC failed to win a number of construction tenders for large engineering projects in Ceeland. The government of Ceeland decided to award the contracts to foreign firms instead on the basis that their construction methods and expertise were far better than those of CSCC and were much more likely to bring projects in on time and within budgetary constraints. Since this time CSCC has not been awarded any public construction projects in its own country. This has forced the Board to venture abroad in search of revenues, winning contracts for public funded and private sector projects in a variety of other countries. Many of these projects have overrun in terms of time and cost attracting penalties from the customer that have reduced profits to a minimum. Subsequently shareholder returns since privatisation have been well below market expectations and share price has barely risen over the period.

The general perception is that, in order to win these contracts, many of which are very complex and in countries where political instability is common, the company's pricing is either too low or successful tendering is only achieved by bribing state officials. The World Bank has outlawed the company from tendering for projects in two countries because of these corruption allegations. The Board of Directors at CSCC refuses to comment and because the Ceeland Stock Exchange only has a minimum level of governance regulation, there are no typical governance structures through which shareholders can gain assurance of appropriate project control or risk management. They have demanded the company recruits truly independent non-executive directors to create balance on the board. In response, the Board have allowed one outside director, Yi Zheng to be recruited to the board.

He has immediately identified one project as being of particular concern to shareholders. It is the largest construction project in the region. The Shun Nanyan Community Development (SNCD) involves creating a gated housing estate with related amenities to serve a potential population of thousands. In effect, the company is building a privately run town including a business park, leisure facilities, two schools, luxury housing accommodation, independent water supply and three shopping malls. The project is being paid for by the local government although they are currently withholding instalment payments because the project is far behind schedule and the construction of two of the shopping malls has had to be halted because of concerns over the structural integrity of the buildings designed and constructed by the CSCC.

The board of the CSCC seem unaware and unconcerned over the rising cost of the project. Due to the lack of reporting from senior project managers on the site, Mr Zheng decided to visit the project location in person. On arriving he was met by a protest group of local villagers who have been forcibly removed from their homes and farms to make way for the new, exclusive gated housing estate. They are now living in a tented encampment on the surrounding hills unable and unwilling to abandon the area in which they have lived for many centuries. The local government has offered minimum compensation payments although the villagers argue the amounts are not enough for them to replace the livelihood and way of life they have been forced to leave. These protesters have been joined by other members of the local community who, although not affected by the relocation, accuse CSCC of diverting a local river to provide the new town with water. This river is essential for their agricultural farming needs and is a critical natural resource in an area prone to long periods of drought.

The plight of the protest group has made national and international news and is adding to the potential reputational risk facing CSCC. Foreign Institutional Investors with a keen interest in only supporting ethical investment are aware of this issue and asked Mr Zheng to investigate as a matter of urgency.

Once on site, Mr Zheng was immediately confronted by a group of employees representing CSCC construction workers. They wished to draw to his attention the number of injuries and deaths that had occurred on the site since the construction began. In particular, they said the lack of health and safety inspectors on site meant that many legal requirements regarding employee protection were being routinely ignored by the company and this was leading directly to increased accidents and injury.

Mr Zheng met senior construction managers at the SNCD and voiced his concerns over the treatment of project stakeholders. They told him that the lack of adequate project finance led directly to the need to make cuts in construction quality and employee welfare measures. They also felt that decisions regarding natural resource supply to the site and the impact on the local population were not issues that they had any authority to affect.

Required:

(a) Discuss the ways in which a state owned institution differs from a public listed company and explain how these differences affect their respective governance structures. Your answer should make reference to the scenario. (9 marks)

(b) Explain the factors that might lead Institutional Investors to attempt to intervene directly in the management of a company. Your answer should include reference to the situation at the CSCC. (12 marks)

(c) Discuss how non-executive directors may assist in improving the governance of the CSCC. (8 marks)

(d) Following his visit to the SNCD, Mr Zheng is writing a report to the rest of the board at CSCC about the SNCD project.

Produce this report to include:

(i) An explanation of the scope of internal controls necessary to meet the requirements of sound corporate governance. (8 marks)

(ii) A definition of reputational risk and its potential application to the CSCC regarding the SNCD project. (9 marks)

Professional marks will be awarded in part (d) for the structure, flow, clarity and persuasiveness of the answer. (4 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2. Gulliver Inc is a large listed chemical company that specialises in producing crop protection chemicals (herbicides, insecticides and fungicides) for farming communities across the world. The company employs a large workforce operating in relatively hazardous working conditions, processing biological and chemical substances in order to create a wide range of different pesticides.

Recently, as the company expanded its operations into chemical fertilizer production, the board of directors at Gulliver decided to establish an internal audit committee in order to help cope with the increasingly complex nature of chemical manufacture. Finlay Richardson, the non-executive chair of the audit committee is particularly keen that the committee extends its focus from traditional financial control review to embrace other aspects of operational control. This move has been prompted by an unexpected event at the Gulliver plant which has attracted unfavourable media attention.

The incident involved a pipe failure at the Gulliver processing facility. Leakage of poisonous chemicals from the cracked pipe went unnoticed for a period of months allowing seepage to enter the earth and contaminate an underground natural reservoir of water. This water source is accessed by local village communities through wells dug deep into the soil. As a result of the spillage many local villagers and employees have become ill and some have been hospitalised.

Once Gulliver became aware of the problem they informed community leaders and the press so to ensure people stopped drinking from the contaminated wells. An environmental expert, commissioned to investigate the incident, has recommended treating the water with a variety of expensive chemicals over a period of six months. The result of the treatment and the natural process of purification should remove the contaminants from the water. In the meantime, Gulliver is paying for water towers to be installed and serviced in the villages.

The cost of the treatment and water towers is significant and Finlay Richardson recognises the need to implement effective systems and monitoring activities to ensure no further leakage occurs. He has stated that such systems will form part of a wide ranging improvement in environmental management, embracing every aspect of company activity from the acquisition of ammonia, phosphates and other chemicals from suppliers, through chemical processing and on to the safe shipping of outputs to the company's customers. He believes that it is only through a comprehensive approach to environmental audit that the company's reputation can be salvaged and both shareholders and stakeholders given the assurance that they need that such an incident will not happen again.

As a qualified accountant, Finlay Richardson understands the important role that his profession can play in environmental management and audit. He believes that the impact of the company's operations on ecology and society can be lessened through improved accounting information flow to the audit committee. They will then be better placed to make decisions regarding investment in environmental management throughout the processing facility, from inputs through to outputs. A formal, professionally led approach coupled with a significant strengthening of disclosure to all organisational stakeholders, as part of the company's annual report, should ensure Gulliver restores its reputation as a company that takes its social obligations seriously. In order to meet this accounting need and to support the changes taking place at Gulliver, Finlay Richardson is about to recommend the company employs two internal auditors under his direct control.

Required:

(a) Discuss the organisational factors that may be considered when deciding whether to establish an internal audit function in this organisation.
(10 marks)

(b) Identify and explain the three stages of an environmental audit and explore issues surrounding the development of each stage in this scenario. (9 marks)

(c) Discuss accounting techniques that may be used to support the environmental audit process in this case. (6 marks)

(25 marks)

3. Unusual weather systems (the highest temperatures since records began one hundred and fifty years ago) have been blamed for forest fires sweeping through the Ceeland countryside. As a medium sized Insurance company, Osiris Standard is deeply concerned.

Meteorologists' have said that, later this week, strong winds will fan the direction of the flames towards the country's mega rich holiday resort, where powerful government officials and media celebrities relax, enjoying luxurious hotel and leisure facilities by the sea. The meteorologists are certain in their forecasts although the potential impact from the flames reaching the resort is unknown. Osiris Standard insures most of the hotels and holiday facilities in the area and so the potential cost of meeting so many insurance claims simultaneously could put an immense strain on the company's finances. In the interim it must simply rely upon the under-funded local fire service to do their best in tackling the blaze. Funding for this service has been drastically reduced in recent years due to the country's stringent austerity measures imposed to help deal with a governmental financial crisis.

CEO, Joseph Nkunda, is enraged at the scale of the potential losses and why this structural risk has not been dealt with by senior management. He has called for a complete review of risk management and the computer risk models used by the company. He has suggested to the board that, unlike previous reviews carried out by individual department heads, the company employs an external risk consultant in order to secure the quality and independence of the risk review. He knows that the review is likely to highlight failures by some managers in identifying, quantifying and dealing with the full range of threats that the company is exposed to. He is concerned about the general lack of expertise in this area shown by many managers within the company.

One of these threats is to the company's computer systems. Helen Kegame, the head of IT at Osiris Standard, reported last month, that the company's IT systems had firewalls so strong that no potential computer hacker could get through to the company's databases or other critical technology resources. Hacking is a known and common problem for many industries. Today, she has received an e-mail from an anonymous individual who says he has infected Osiris Standard's computer systems with a computer virus which will detonate in six hours' time. Once this occurs all of the company's records regarding customers, their policies and premiums will be wiped from the systems. The impact of such an event could destroy the company. Although Helen knows that existing security measures will avoid this outcome, she is reluctant to report the matter to the board since she had already given assurance that such an event was unlikely to occur.

Her friend and colleague, Mobutu Kabila, has problems of his own. Mr Kabila is the marketing director. In a recent change to the company's marketing campaign, Osiris Standard has created a number of high cost TV commercials using a new computer generated imaginary animal as the central character in the adverts. The character has a striking resemblance to a religious icon which is part of the belief systems of a remote tribal community in the neighbouring country of Beeland. This community is outraged at the presumed insult to their religion through the use of the character in corporate marketing. Mr Kabila has apologised through a letter to the community for any potential offence although in private he doesn't accept that he could have possibly known about the similarities between the two figures. Very few people inside Beeland are aware that the tribal group exists and their religion is completely unknown outside of their regional heartland. The incident has failed to attract any media attention and the governments of both countries are disinterested. Mr Kabila is reluctant to take any further action regarding the matter and does not intend to tell Mr Nkunda about the situation. Mr Kabila is concerned that Mr Nkunda may use the incident as an excuse to remove him from office for incompetence since both men dislike each other and have clashed many times in the past. Mr Kabila has decided to wait and see whether the potential threat to the company's ethical stance increases over the next few days.

Required:

(a) Identify three risks facing Osiris Standard. Explain and apply an appropriate risk assessment model to evaluate each risk. (12 marks)

(b) Discuss why using an external consultant to carry out the risk assessment may be favoured over the use of department heads or their colleagues within this company. (7 marks)

(c) Distinguish between objective and subjective risk assessment and explain their importance to each department head in this case. (6 marks)

(25 marks)

4. Since Rick Johnson took over as CEO at Fingerprints Investment (FI) three years ago, the company has been transformed into an extremely successful financial services organisation. Its portfolio of products, aimed at wealthy investors, has increased five-fold using ever more complex financial instruments to guarantee customer returns well above those available through more well known, less risk seeking finance houses and banks. It has also aggressively taken over a number of smaller competitors to become a key player in the region.

Recently, Mr Johnson has delisted the company from the stock exchange in its home country and moved the organisation to the country of Ceeland where it is now listed on the local exchange. It is generally recognised that the Ceeland exchange lacks adequate governance regulation to protect the agency relationship. Stakeholders such as employees are dismayed given that many are unable or unwilling to relocate. Institutional investors are also deeply concerned, worried that Mr Johnson's motives are self-serving and that his board, consisting of personal friends of Mr Johnson's, does not have adequate scope or depth of expertise to manage the increasing size of the company.

These investors have sought meetings with the Chairman of FI to ask him to explain why the company has moved off-shore and to explain the rationale behind company strategy. The chairman, Bob Tucker, is unwilling to meet them, instead providing a short statement within which he gives the CEO his full backing. The Institutional Investors believe Mr Tucker is scared of his CEO. They point to the details of Mr Johnson's remuneration package in the annual report as evidence of this. The package includes a new pension right that is tied to the huge bonuses the CEO receives each year for increasing company profits. The shareholders view the pension right and the bonuses to be excessive and are demanding credit and liquidity to be used as measures for future performance targets. Since the company has moved off-shore the share price has been static with investors concerned over the level of control at the top of the company.

Shortly after the move the company released its first annual report under Ceeland legal and governance requirements. The report no longer contains either a Chairman's statement or adheres to internationally agreed accounting standards. Shareholders are incensed and have asked Mr Tucker and the CFO chair of the audit committee, Jack Hampel, to explain why this is the case. Neither will formally comment.

Mr Johnson is however willing to speak, stating that shareholders should be pleased with the profits generated at FI. As a Pristine Capitalist corporation he says that he understands what his primary objective is and that he is meeting this need, although the shareholders themselves must show faith in continuing to support the organisation so that the share price may rise to its rightful level. He says that the low taxation policy in Ceeland, access to a low cost workforce and the lack of bureaucratic regulation can only help the company make even more money.

Following the move overseas, a disgruntled finance manager, made redundant after refusing to relocate, has contacted the press to allege Mr Johnson and his board are perpetrating an accounting fraud and that profits and revenues have been materially misstated for years in order to give the impression that the company is very successful. Mr Johnson alone has replied to the allegation saying that the company is as transparent as the law demands in Ceeland and that he has nothing to hide. The Institutional Investors, unable to gain satisfactory answers from the company have asked FI's auditors to comment. They have refused to do so, saying it would breach client confidentiality between themselves and the audit committee of FI.

Required:

(a) Describe the nature of a trusting relationship between shareholders and the board at FI using transaction cost theory. (5 marks)

(b) Identify the components of a reward package and explain how the reward package of the CEO at FI might be improved. (6 marks)

(c) Discuss the importance of the chairman's statement in the annual report with reference to FI. (4 marks)

(d) Criticise the role of the audit committee in this scenario. (4 marks)

(e) Explain Mr Johnson's perception of the company's position from a Pristine Capitalist perspective (as described by Grey, Owen and Adams). (6 marks)

(25 marks)

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Paper P2 (International)

Corporate Reporting

Revision Mock Answers

June 2017

Answer Guide

Health Warning!	
How to pass	Attempt the mock examination under exam conditions BEFORE looking at these suggested answers. Then constructively compare your answer, identifying the points you made well and identifying those not so well made. If you got basics wrong then re-revise by re-writing them out until you get them correct.
How to fail	Simply read or audit the answers congratulating yourself that you would have answered the questions as per the suggested answers.

Question 1

Tutorial help and key points

This question is based on the classic parent sub ass question Hebrides in the class notes in the chapter on Basic Groups. If you struggled with this question, you probably need to rework that question to improve your basics.

Marking Guide

The marking scheme is given within the body of the answer.

(a)

Net assets	**S**		**A**	
	Acq	**B/S**	**Acq**	**B/S**
Share capital	100	100	160	160
Share Premium	300	300	40	40
Reserves				
(Opening 640 + 6/12 (300 PAT) = 790)	790	900	450	500
FVA (land)	600	600		
FVA (plant) (half year depreciation to y/e)	500	450		
PUP (180) (20%) (1/6)		(6)		
	2,290	2,344	650	700

Note that the acquisition reserves are required for the mid point of the year, whereas the dividend is after that and so is ignored when rolling forward from the year start to the year middle.

Also note that the half year depreciation is 6/12 (1/5years), ie $500k.

Associate

Note that under the examiner new 'roll forward' method applied to the associate, you do not need to calculate the associate goodwill. So you can now calculate the associate carrying value as follows:-

	Associate
Acquisition	600
Growth (700 - 650) 30%	15
Closing	615

(2 marks)

Goodwill

	$
Fair value of consideration (100)(70%)(5/2)$12	2,100 (shares)
Fair value of previous	250 (given)
Fair value of NCI	520 (given)
Fair value of net assets	(2,290) (na above)
Goodwill at acquisition	580
Impairment (see below)	(524)
Goodwill at statement of financial position	56

(4 marks)

Impairment (on the sub!)

Carrying value [580 gw + 2,344 na]	2,924
Impairment (balance)	(524)
Recoverable value [given (3)]	2,400

Group I/S

	Parent	Sub	Ass	Adj	Group
Revenue	14,000	1,900		(180)	15,720
Cost of sales	(8,000)	(1,050)		180	(8,926)
		PUP (6)			
		FVA (50)			
Gross profit					6,794
Operating expenses	(2,900)	(410)			(3,610)
	(300) (W5)				
Operating profit					3,184
Associate			6/12 (100) (30%)		15
Goodwill impairment				(524)	(524)
Profit before interest and tax					2,675
Interest	(900)	(190)			(1,090)
Speculating gain	140				140
Investment property loss (W6)	(150)				(150)
Profit before tax					1,575
Tax	(932)	(100)			(1,032)
Profit after tax		94			543
Non-controlling interest		20%			(19)
Non-controlling interest in goodwill impairment				20%	105
Profit attributable to members					629

(10 marks)

Group reserve movement

Opening reserves	9,900
PAM	629
Dividends	(700)
Closing reserves	9,829

(0 marks because not required)

Note that the goodwill impairment can be allocated directly to the sub to achieve the same result. However, it appears the examiner uses the above presentation in his answers.

Note that the speculating gain is on the 10% from $110k to $250k.

(W5) Share Based Payment obligation

= (3 directors) (100,000 options) ($5) (1/5years)

So SBP cost appears above in operating and an equivalent reserve below.

(W6) **Investment property**

This is simply an investment property the value of which has changed. The currency stuff is incidental.

Date	**G**	**Rate**	**$**
Year start	10m	25	400 to be moved from L&B
Year end	11	44	250 to be moved to Inv Prop
Loss to finance above			(150)

Group statement of financial position

Non-current assets	
Goodwill	56
Associate [see above]	615
Land and buildings (10,000 + 3,000 + 600 FVA – 400 (W6))	13,200
Plant and machinery (5,000 + 1,800 + 450 FVA)	7,250
Investment property (400 above – 150 loss)	250
Investment in other shares (190 + 500)	690
Current assets	
Inventory (1,000 + 400 – 6 (pup))	1,394
Receivables (1,500 + 250 – 35 (inter-company))	1,715
Bank (200 + 90 + 8 (cash in transit))	298
	25,468

(4 marks excluding goodwill and associate above)

Equity	
Share capital (2,000 + 175 (parent share issue nominal))	2,175
Share premium (1,000 + 1,925 (parent share issue premium))	2,925
Other components of equity (W5)	300
Retained earnings	9,829
Non-controlling interest	426
Non-current liabilities	
Loan (3,800 + 4,500)	8,300
Current liabilities	
Trade (600 + 140 – 27 (inter-company))	713
Tax (700 + 100)	800
	25,468

(4 marks excluding RE and NCI below)

Note: Parent share issue was consideration for the sub acquisition described in the opening paragraph. The parent manages to acquire 70,000 shares by issuing 175,000 shares with a value of $12 each, split $1 nominal and $11 premium.

Note: We strip $27k out of trade payables because that's the balance in there. The sub records a liability of $27k because after sending a cheque of $8k on a liability of $35k it still owes $27k.

Retained earnings

Parent	10,500
Speculating gain	140
W5	(300)
W6	(150)
Sub (2,344 - 2290) (80%)	43
Ass (700 – 650) (30%)	15
Impairment (524) (80%)	(419)
	9,829

(8 marks)

Non-controlling interest

Acq	520
Growth (2,344 - 2,290) (20%)	11
Impairment	(105)
	426

(3 marks)

Note that the impairment of goodwill is allocated between the ci and the NCI in accordance with share ownership (80%:20%).

(b)

1 mark per point (any reasonable comment on presentation will score)

Understanding

Presentation plays an enormous part in the understandability of financial reports. The more easily financial statements are understood the more the reader will get from them

Transparency

This simple concept is often referred to as transparency and is now considered a cornerstone to good corporate governance.

IASB

But clearly the IASB have a role in improving financial reporting transparency and have a development project on presentation aimed at making financial statements easier to understand.

Realised and unrealised

One barrier to understanding performance is the poorly defined distinction between realised and unrealised. The IASB propose to do away with this by presenting a single performance report.

Cohesiveness

Another part of the project aimed at making financial statements easier to use is cohesiveness. This new concept aims at making the three primary financial reports easier to scan across.

Example: Position

One good example is the equity presentation of position used by Pomegranate. Note how the performance report is already revenue less costs leaves profit for equity. Surely the position statement should be the same.

Proposal

So the position statement should be assets less liabilities equals equity in order to be cohesive with the performance report.

(c)

1 mark per point (any reasonable factor would score)

Encouragement (1) – Shareholders

Shareholders would certainly pressurize directors to ESR as evidence shows that it increases shareholder value.

Encouragement (2) – Competitors

Competitors would be putting pressure on world energy to improve its ESR because their better ESR would give them competitive advantage.

Encouragement (3) – Customers

Customers provide encouragement for companies to improve ESR. They can boycott a product when they doubt its green policies.

Encouragement (4) – Suppliers

Suppliers can pressurize companies to improve ESR. They may make ESR a necessary criterion for supply.

Encouragement (5) – Entrants

Entrants with genuine green credentials can force existing market players to improve ESR simply by threatening to enter a market.

Encouragement (6) – Substitutes

Green substitutes can make the original energy supplies, like World Energy, improve their ESR in an attempt to compete.

Encouragement (7) – Government

Governments make companies improve their voluntary ESR by threatening legislation.

Encouragement (8) – Directors

You never know, directors might even encourage each other to improve ESR simply because they are nice people.

Question 2

Tutorial help and key points

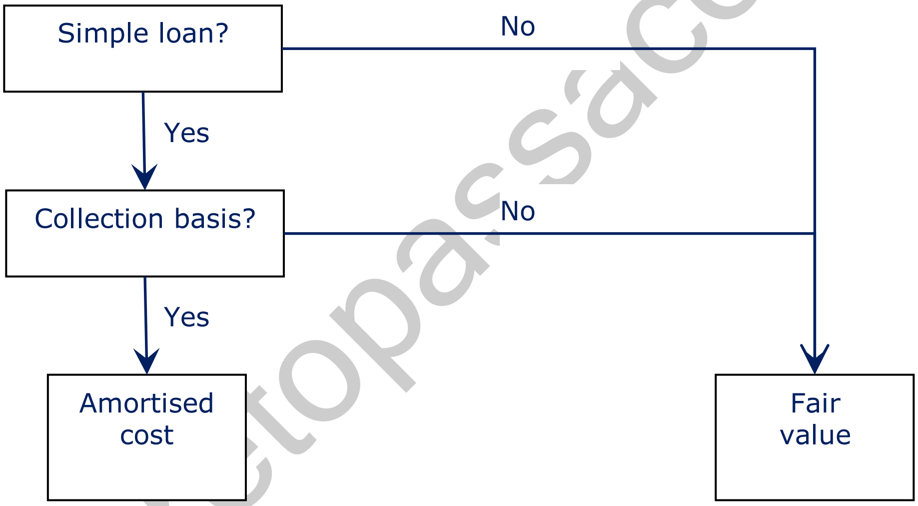
Maybe you recognised this question from my (Martin Jones) article in Student Accountant.

Marking Guide

The marking scheme is given within the body of the answer.

(a) (i) IF RS 9

IFRS9 uses two questions to classify financial assets (FAs):



Question (1) Simple loan?

IFRS9 is effectively asking: 'Is the FA a loan and does the loan have interest and principal repayment with no other terms?'

Cash flow characteristics

The technical name for this question is the cash flow characteristics test.

Question (2) Collection basis?

IFRS9 is effectively asking 'Are you holding the FA in order to collect that interest and principal repayment?'

Intent

So IFRS9 is looking at the intent to keep (collection basis) or the intent to sell (speculation basis).

Business model

The technical name for this test is the business model test.

Yes/No

IFRS9 requires two 'yes' for amortised cost but only requires one 'no' for fair value.

Amortised cost

Carrying an asset at amortised cost means initial recognition at initial fair value and then unwinding.

Fair value

Carrying a FA at fair value means marking the asset to market at each measurement point.

Default

The gains and losses then default into the income statement (IS).

FVTPL

This recognition method is often referred to as FVTPL (Financial asset at fair through profit and loss: see iasplus.com for example).

Extended model

So in summary, IFRS9 allows two simple recognition and measurement methods (amortised cost and fair value) based on two simple tests. However, the basic model is extended by two options discussed below. They are the FATOCI option and the Fair Value Option.

Strategic equity

If you hold an equity investment and can show long-term strategic intent, then the gains and losses can go to the OCI.

FVTOCI

So often this this strategic equity is called FVTOCI (Financial asset at fair through other comprehensive income).

FVO

Finally there is the fair value option. This gives directors the option to carry FA that should be carried at amortised cost at fair value instead.

Mismatch

However this is only permitted if there is an accounting mismatch. An accounting mismatch occurs if there is a FL at fair value and a related FA at amortised cost.

(a) (ii) Debenture

IFRS9 uses the following questions:

Q1 Simple loan? Yes

Q2 Collection basis? Yes

So IFRS9 would initially suggest amortised cost for both portfolios.

FVO

However, one portfolio has an accounting mismatch, so directors should exercise the fair value option and carry this portfolio at fair value.

Treasury Bills (T-bills)

The T-bills are not held on the collection basis. The T-bills fail the business model test, so the T-bills would be carried as FVTPL.

Convertibles

The convertibles are not simple loans. The convertible fails the cash flow characteristics test so the convertibles are also FVTPL.

Majority

The majority of the equity investments are held for trading so these too are FVTPL.

Strategic equity (Target)

But the intent to keep the Target equity means this investment is FVTOCI.

Transfer

If Margery loses the takeover race for Target then Margery would be forced to sell the Target equity. This would require a transfer from OCE (other components of equity) to RE (retained earnings).

(b) Financial Instrument (FI) project

The FI project has four components:

(1) FA: Financial asset (IFRS9) [completed].

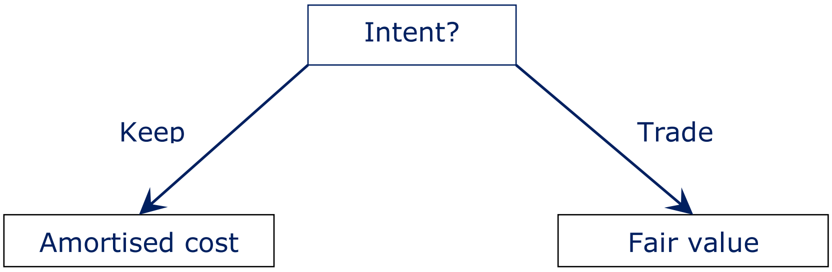
(2) FL: Financial liability (IFRS9) [recently completed].

(3) Impairment (IAS39) [WIP].

(4) Hedging (IAS39) [WIP].

Financial liability

Until recently IAS39 used the following:



IASB proposal

The IASB propose to stick with the above (and in truth have already moved the above into IFRS9 in late 2010).

Impairment

IAS39 has two recognition criteria:

1. (O) Objective evidence.
2. (R) Reasonable reliable estimate of recoverable amount.

This means impairments are only recognised when they happen. The IASB call this the "incurred loss" model. The trouble is that it results in losses piling up in bad years, when in reality some losses had been predicted from the start.

IASB proposal

So the IASB are working on a new model they call the "expected loss" model. But they are having a nightmare to lock this down as allowing uncertain future expectations makes measurement a challenge. Essentially, the IASB propose to stick with the criteria above but the IASB proposed to clarify the required fair value discounting.

Hedging

IAS39 is frankly a mess as regards hedging where it uses two conflicting methods:

(1) Fair Value hedging.

(2) Cash Flow hedging.

This was provided the hedge proved "effective". The effectiveness test involves an arbitrary 80%/125% criteria.

IASB proposals

Initially IASB proposed to rip that up and have a nice simple model. But now they have decided to stick with current model plus extended disclosure. However, at least the IASB propose to dump the effectiveness test (80%/125%).

Question 3

Tutorial help and key points

Lovely mix question covering various issues.

Marking Guide

The usual 1 mark per point. Any relevant and well expressed point will score.

TRANSACTION 1

Proposal

The proposed treatment of the loan stock is incorrect. Although the loan carries no cash flow interest, there is a cost to the company because the loan stock is redeemable at a higher value than the issue proceeds.

Financial instrument

The obligation is of course a financial instrument; more specifically it is a financial liability. These are carried at fair value if there is a clear intent to trade the loan. This would be very unusual and is not the case here.

Amortised cost

So the financial liability is carried at amortised cost. This is the fair value of the consideration received plus the unwinding of the premium on redemption.

Unwinding

Each year the carrying value of the loan stock increases by the amount of the unwinding charge, so that at the date of redemption the carrying value is equal to the amount payable of $128.8 million (80 x 1.61).

Interest

Interest of $8 million (80 x 10%) should be charged to the current P/L Account for the year ended 31 July. This amount is also added to the carrying value of the loan stock so that this is shown at $88 million in the balance sheet.

Quoted Price

The liability is not carried at fair value. So the quoted price of the loan stock is probably of little direct relevance to the company. However, it is likely to be relevant to the users of the financial statements.

Disclosure

So IFRS (IFRS7) require the company to disclose the fair value of the loan stock, which is its quoted market value. Therefore a note to the financial statements should show that the fair value of the loan stock is $94.4 million (80 x 1.18) at 31 July.

TRANSACTION 2

Pension accounting

K needs to calculate the charge to the income statement and also the net asset or liability that will be recognised in the balance sheet:

Movement on asset and liability

This is as follows:

	$m
Scheme assets	
Opening	0
Cash contributed	60
Expected return on plan assets	6
Expected closing	66
Actuarial gain (balancing figure)	9
Actual closing (given)	75
Scheme liabilities	
Opening	0
Current service costs	66
Interest cost	12
Expected closing	78
Actuarial loss (balancing figure)	0
Actual closing (given)	78

Income statement

The following would be charged to the I/S:

	$m
Current service cost	(66)
Interest cost	(12)
Expected return on assets	6
Total charge to the P & L	(82)

Other comprehensive income

The actuarial gain would go into the OCI.

Actuarial gain	9

Position statement

And the net liability of $3m (75 - 78) would go into the B/S.

TRANSACTION 3

Lack of control

Until 1 October we held 50% of the equity share capital of L. This shareholding did not enable K to control the operating and financial policies of L because the other shareholders could and did combine to prevent us from exercising control.

Influence

However, our 50% shareholding did enable us to exercise significant influence over the company and therefore it would be treated as an associate in the consolidated financial statements up to 1 October. The equity method of accounting must be applied for this period.

Control

The purchase of an additional 30% shareholding on 1 October increased our shareholding to 80%. This gave K control over L and therefore L must be treated as a subsidiary in the consolidated financial statements from this point.

Summary

So L is treated as an associate for the first 2 months and as a subsidiary for the remaining 10 months of the year. So time apportionment would be necessary on the I/S with the sub appearing on the B/S at the year end.

Goodwill

The position statement must also recognise the goodwill related to the acquisition of the subsidiary. In order to do this the group must measure not only the fair value of the consideration for the 30% when control is obtained but also the value of the previously held 50% at this same point.

Loan

The loan takes place after acquisition between parent and sub. So must be removed entirely from the FS (I/S and B/S).

TRANSACTION 4

Disposal

The disposal would generate a profit on disposal. This would be calculated by comparing the sale proceeds to the derecognised carrying values coming off the B/S. Coming of the B/S would be the net assets, goodwill and NCI.

Summary

Time apportionment would be required on the income statement to recognise the control over the first 10 months. The sub would *not* appear on the balance sheet of course.

Segmental reporting

It sounds like M was not part of the core business. In that case it must have been doing something different to the parent. So a segmental report would be required to split results between the business areas.

Discontinued

It follows then that the group have now stopped doing whatever M was doing. So the sale of M results in a discontinued operation.

Recognition

Therefore a single line, bundling the loss on the operations of M, the profit on disposal of M and the related tax, would appear at the bottom on the income statement under the heading discontinued operation. The detail would be relegated to the notes.

TRANSACTION 5

Sale and operating leaseback at an overvalue

This is a very complicated transaction with multiple components.

Operating leaseback

Firstly, the lease really is an operating leaseback. The lease life of 10 years compared to a useful life of 30 years make that clear.

Sale

Therefore the sale really is a sale; risks and rewards are transferred from K to X during the sale and stay out during the leaseback.

Disposal

So K will derecognise the property and recognise a profit on disposal.

Cash inflow

So the cash inflow is partly sale proceeds. But it also appears that the cash inflow is partly loan proceeds as well. It seems likely that K has received $550k for selling the property and that the extra $300k on top represents a loan:

Dr	Bank	850
Cr	Disposal (sale proceeds)	550
Cr	Loan	300

Profit on disposal

A profit on disposal will be recognised in the I/S:

Sale proceeds (above)	550
Carrying value (500-60)	(440)
Profit	110

Cash outflow

Like the cash inflow, the cash outflow must also be split into its component parts:

Dr	Rent (operating costs)	50
Dr	Loan (capital + interest)	50
Cr	Bank	100

Loan repayment

Even the $50k loan repayment is complex because it is part interest payment and part capital repayment:

Year	Opening	Interest (7%)	Instalment	Closing
1	300	21	(50)	271

So the $50k is $21k interest and $29k capital repayment.

Question 4

Tutorial help and key points

Very broad current issues question with a strong flavour of corporate social responsibility.

Marking Guide

The usual 1 mark per point where any relevant and well expressed point will score.

(a)

Market Mechanism

The market mechanism defined in the introduction is the flow of information from directors to the market.

(EMH) Efficient Market Hypothesis

This idea is usually analysed by reference to the EMH. The EMH suggests that information flows freely from the company to the market.

Evidence

The EMH is really old so there is plenty of evidence, but it is all conflicting.

Evidence for EMH

The evidence in favour of EMH is that share prices hardly move after announcement because the market already knew the announced information before the announcement. This evidence was used by Fama in 1970 in ground breaking work on the EMH.

Evidence against EMH

But there is loads of evidence against EMH. Perhaps the best is ENRON.

ENRON

ENRON was famously manipulating its p/l and B/S using all manner of creative accounting (like 'special purpose vehicles').

CFS

But also famously, the ENRON CFS did say that cash was flooding out of ENRON but, somehow the market did not see that. This was at least in part because of the low quality US FRS made US fs hard to read.

Need

This clearly shows that high quality accounting standards are needed to help the market mechanism which otherwise does not work effectively.

(b)

Benefit of Users

Accounting standards are really for the benefit of users. High quality standards lead to high quality FS that users can use.

Benefit to preparers

But there are benefits of high quality standards to preparers. One is that preparers can get their message across if they use high quality accounting standards.

Cost to Preparer (1)

There are lots of costs of accounting disclosures. Perhaps the most obvious is the greater the disclosure, the bigger the FS and so the more paper consumed.

Cost to Preparer (2)

But also the greater the disclosure, the more accountants required to create the FS. And each accountant costs money.

Cost to Preparer (3)

In a similar way the greater the complexity of disclosures means that each accountant must be more qualified and therefore cost more.

Cost to Preparer (4)

Then the combination of increased volume and complexity of disclosure will lead to increased audit cost.

Benefit to User (1)

There is one big benefit to the user of increased disclosures. The greater the disclosures, the better the shareholders understand the investment.

Benefit to User(2)

Following on from that, the greater the understanding of the investment, the better the shareholders can assess the performance of directors.

Benefit to User(3)

Also, the better that shareholders understand their investment, the more accurately they can value their shares.

Benefit to User (4)

Finally, the greater the disclosure, the more difficult it is to fool users with creative accounting.

(c)

Increasing Disclosure

There has been an increase in disclosure in FS since the clay tablets from 5,000 years ago in Ancient Iraq. Here are a few since 1990:

1. CFS

There was a massive leap in the quality of FS when CFS were first disclosed in the early 1990s.

2. Risks

In the late 1990s a standard brought in the requirement to disclose risks and this resulted in even more shareholder understanding.

3. SBP (IFRS2)

More recently the standard on SBP (share based payment) gave a much better feel for how much directors really cost.

4. FI (IFRS9)

Most recent is the brand new standard on financial assets. It removes all the nonsense names in IAS39 (eg. Available for sale) and simply uses FA at amortised cost or FA at Fair Value.

5. FVM (IFRS13)

Looking forward to the proposed standard on the Fair Value Measurement, we see that this has three methods of FVM and required the disclosure of method used.

6. Control (IFRS 10 & IFRS 12)

IFRS10 defines control and then IFRS12 requires the disclosure of the relationship in the FS.

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Paper P2 (International)

Corporate Reporting

Revision Mock Examination

June 2017

Question Paper

Time Allowed	15 minutes	Reading and planning
	3 hours	Writing

This paper is divided into two sections:
Section A – This ONE question is compulsory and MUST be attempted
Section B – TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

Section A – This ONE question is compulsory and MUST be attempted

1. At the year start, Pomegranate purchased 10% of the equity of Satsuma. The investment was classified as one in which the gains should be reported through the profit or loss. The cost of the investment was $110,000.

Exactly half way through the year, Pomegranate acquired another 70% of the share capital of Satsuma and 30% of the share capital of Artichoke. Pomegranate acquired 70% of Satsuma by way of share for share exchange. Pomegranate issued five of its own shares for two Satsuma shares. The market value of Pomegranate's shares was $12 on that day. The share issue has not yet been recorded. The fair value of the previously owned 10% equity had risen to $250,000 at the point that control was attained. Artichoke shares were acquired for $600,000 cash consideration.

It is the group's policy to value the non-controlling interest at fair value, which at acquisition was measured at $520,000.

The summarised draft financial statements are as follows:

Income Statement or Profit and loss account for the year ended 31 March (including a movement on reserves)

	Pomegranate	**Satsuma**	**Artichoke**
	$000	**$000**	**$000**
Revenue	14,000	3,800	1,820
Cost of sales	(8,000)	(2,100)	(1,400)
Gross profit	6,000	1,700	420
Operating expenses	(2,900)	(820)	(220)
Operating profit	3,100	880	200
Interest	(900)	(380)	(70)
Dividends received from Satsuma	32		
Profit before tax	2,232	500	130
Tax	(932)	(200)	(30)
Profit after tax	1,300	300	100
Dividends paid	(700)	(40)	(0)
Profit retained	600	260	100
Retained earnings brought forward	9,900	640	400
Retained earnings carried forward	10,500	900	500

Statement of financial position as at 31 March (equity presentation)

	Pomegranate		Satsuma		Artichoke	
	$000	$000	$000	$000	$000	$000
Non-current assets						
Land & building		10,000		3,000		800
Plant & machinery		5,000		1,800		700
Investment in Artichoke		600				
Investment in 10% Satsuma		110				
Investment in other shares		190		500		50
		15,900		5,300		1,550
Current assets						
Inventory	1,000		400		70	
Receivables	1,500		250		170	
Bank	200		90		40	
	2,700		740		280	
Current Liabilities						
Trade	600		140		60	
Corporation tax	700		100		30	
	1,300		240		90	
		1,400		500		190
Non-current Liabilities						
Loan		(3,800)		(4,500)		(1,040)
		13,500		1,300		700
Share capital ($1 nominal each)		2,000		100		160
Share premium		1,000		300		40
Retained earnings		10,500		900		500
		13,500		1,300		700

The following information is relevant:

(1) At acquisition the fair value of all Artichoke's assets was reasonably represented by the book value. The same was true of Satsuma with the exception of some land and plant. These had fair values of $600,000 and $500,000 above book values. The plant had a remaining life of five years. Depreciation is charged to cost of sales.

(2) In the post-acquisition period Satsuma sold goods to Pomegranate at $180,000. Transfer transactions were calculated to give a margin of 20% (mark up of 25%). Satsuma held one sixth of these goods in inventory at the year end.

(3) Goodwill related to the Artichoke acquisition was subject to a brief impairment review at the year end and this was sufficient to confirm that there was no impairment. However, a similar review of the goodwill related to Satsuma revealed that there may be an impairment. So a more detailed review was conducted which revealed a value in use of $2,400,000 and a net realisable value of $960,000. Goodwill impairment is separately discloseable on the face of the income statement.

(4) The current account between Pomegranate and Satsuma did not agree due to cash in transit from subsidiary to parent of $8,000. Pomegranate recorded a

receivable of $35,000 at the year end. Dividends were paid in the last month before the year end.

(5) At the year start, four Pomegranate directors were each given 100,000 options each. These were valued at $5 each at the year start and $6 each at the year end. The options vest after five years from the year start, provided that the directors remain with the group. It is expected that one director will leave and the others will remain.

(6) Pomegranate purchased investment property land in a foreign country for 10 million Grotniks(G) at the year start. The same property was valued at 11million Grotniks(G) at the year end. The foreign exchange rate has moved from 25G:$1 to 44G:$1 from the year start to the year end. The cost of the investment has been translated into $ and included in land and buildings at that cost within the statement of financial position.

Required:

(a) Income statement (Profit or loss report) and statement of financial position (balance sheet) for the group for the year ended 31 March. The statement of financial position should be presented using the usual assets and liabilities presentation rather than the equity presentation used in the question above. (Answer should be presented to nearest $1,000.) (35 marks)

(b) Discuss how the presentation of financial statements is important in the context of understanding financial reports and how presentation could be improved. (7 marks)

(c) Discuss the factors that pressurise companies to improve their presentation of environmental and social reporting that lies alongside their financial reporting. (8 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted

2. Margery holds a number of different financial assets and is concerned by the effect of the implementation of International Reporting Standard 9 (IFRS9).

Margery carries two portfolios of debenture loan assets. Both portfolios are currently held at amortised cost. Both portfolios are managed with a view to collecting the cash flow interest and then the nominal cash flow at the end of the contract. All the assets in both portfolios attract interest at market rate plus an interest premium and there on no further features within the contracts. However, one of the portfolios of debenture loan assets has similar characteristics to debenture loan liabilities carried by Margery at fair value. The directors of Margery are concerned this may result in an accounting mismatch and wonder if there is a solution to their problem in IFRS9.

Margery also holds a number of Treasury Bills for speculating purposes. These are long dated loan asset investments which are simple loans attracting only interest and capital repayment. However, Margery has no intent to wait for capital repayment. Also Margery holds a number of convertible loans assets. These attract interest and capital repayment like normal loans but the assets give Margery the right but not the obligation to convert the debt asset to equity at the end of the contract.

Further Margery has a wide portfolio of equity investments. By far the majority of these equity assets are held for trading. However, an equity investment in Target limited is held with the intent of purchasing the entire equity of Target. Currently Margery holds only 12% of the equity, but this equity holding has been built up over a number of months and Margery hopes eventually to be in a position to force a takeover. So the intent is to keep this Target equity. However, there is a rival building up equity in Target and obviously both cannot win the race to takeover Target. So Margery would like to understand what would happen if Margery lost the race for Target and was forced to sell to the rival.

Required:

(a)

(i) Discuss the principles of IFRS9 Financial Instruments as regards the classification of financial assets. (12 marks)

(ii) Explain how the financial assets described above would be classified and recognised under IFRS9. (6 marks)

(b) Discuss how the above relates to the development of the wider financial instrument project and briefly explain the issues in the other components of the financial instruments project. (7 marks)

(25 marks)

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Question 3 begins on page 8.

3. Killer (K) is an engineering company and a listed company with a number of subsidiaries. The accountant has prepared the first draft of the financial statements of the group for the year ended 31 July. The draft statements show a group profit before taxation of $50 million. The statements are due to be approved by the Directors on 15 December. Your assistant has written you a memorandum concerning transactions that have arisen during the year. The memorandum outlines the key elements of each transaction.

Transaction 1

On 1 August at the year start, the company raised finance of $80 million by issuing 80 million $1 loan stock units. On this date $80 million was credited to long term liabilities. The loan stock was quoted on a major stock exchange. The loan stock pays no interest but is redeemable on 31 July five years from issue at a price of $1.61 per $1. This represents an effective interest rate of 10% each year. On 31 July at the current year end, the stock had a quoted price of $1.18 per $1. The accountant proposes to make no further entries in the financial statements since nothing is due to be paid until four years from now. The accountant expresses the view that the quoted price of the stock is of no relevance to the company, only to the stockholders.

(5 marks)

Transaction 2

During the year the directors decided to form a defined benefit pension scheme for the employees of the parent company and contributed cash to it of $60 million. The following details relate to the scheme at 31 July:

	$m
Present value of obligation	78
Fair value of plan assets	75
Current service cost	66
Interest cost – scheme liabilities	12
Expected return on pension scheme assets	6

The only entry in the financial statements made to date is in respect of the cash contribution which has been included in trade debtors. The accountant has said that she does not know how to deal with the pension scheme in the consolidated financial statements. Directors wish to immediately recognize any actuarial gain.

(5 marks)

Transaction 3

On 1 Aug at the year start, K purchased 50% of the equity share of L. This investment gave K a reasonably significant influence over the operating and financial policies of K. However, on more than one occasion since 1 Aug 1999, the other shareholders have combined to prevent L embarking upon a course of action that was proposed by K.

On 1 October, K purchased a further 30% of the equity shares of L. This additional investment gave K control over the operating and financial policies of L.

On 1 October, K made a medium-term loan of $100 million to L. The rate of interest chargeable on that loan was 12% per annum.

(5 marks)

Transaction 4

Following K's additional investment in L, the directors of K took a strategic decision to concentrate on the core business of the group. Following this decision, K sold all its shares in another subsidiary M on 31 May shortly before the year end. The parent K had held 70% of subsidiary M. The proceeds of sale were credited to a suspense account in the books of K. No further entries have been made in connection with the sale. Income tax will be payable in connection with the sale.

(5 marks)

Transaction 5

On 1 Aug at the year start, K sold a freehold property to X, a finance company. K had purchased the property for $500,000. On 1 Aug K had accumulated total depreciation of $60,000. The property had at least 30 years of useful life remaining at that time.

X paid $850,000 cash for the property on 1 Aug. On that day the market value of the property was $550,000.

From 1 Aug property was leased back by K on a ten year operating lease for annual rentals (payable in arrears) of $100,000. A normal annual rental for such a property would have been $50,000. The effective rate of interest is 7%.

(5 marks)

Required:

Discuss the appropriate accounting treatment for the above transactions and the effect of the above transactions on the current financial statements (show calculations as necessary).

(25 marks)

4. Whilst acknowledging the importance of high quality corporate reporting, the recommendations to improve it are sometimes questioned on the basis that the marketplace for capital can determine the nature and quality of corporate reporting. It could be argued that additional accounting and disclosure standards would only distort a market mechanism that already works well and would add costs to the reporting mechanism, with no apparent benefit. It could be said that accounting standards create costly, inefficient, and unnecessary regulation. It could be argued that increased disclosure reduces risks and offers a degree of protection to users. However, increased disclosure has several costs to the preparer of financial statements.

Required:

(a) Explain why accounting standards are needed to help the market mechanism work effectively for the benefit of preparers and users of corporate reports. (9 marks)

(b) Discuss the relative costs to the preparer and benefits to the users of financial statements of increased disclosure of information in financial statements. (8 marks)

(c) Discuss the development of increased disclosure of information in financial statements. (6 marks)

Quality of discussion and reasoning. (2 marks)

(25 marks)

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Paper P3 Business Analysis

Revision Mock Examination

June 2017

Answer Guide

Health Warning!	
How to pass	Attempt the examination under exam conditions BEFORE looking at these suggested answers. Then constructively compare your answer, identifying the points you made well and identifying those not so well made.
How to fail	Simply read or audit the answers congratulating yourself that you would have answered the questions as per the suggested answers.

Question 1

Tutorial help and key points

Start by analysing the case study carefully, picking out particular facts and issues to help you quickly understand Churchill's current position:

- First look at the numbers, Churchill is not doing badly, but not well
- Read the scenario
- Have a section for internal factors
- Have a section for external factors
- Remember that strategy is about achieving objectives, so look to see if any are stated

When you write up your answer, remember to keep the points

- Clear
- Brief

(a) 1 mark for each relevant point:

...up to a maximum of 25 marks.

I will look at the financial position as well as using PESTEL and five forces to evaluate the external situation.

Internal perspective

Financial position

Sales revenue has risen 16.3% between 2011 and 2014 which is positive.

It should be remembered that this figure may be artificially boosted by the two US stores which were operating during this time period.

Operating profit fell by 20.6% during this same time period. This may also be due to the US stores which had higher than expected costs and were eventually closed.

The impact of the above was that gross margin fell from 9.3% to 6.3% between 2011 and 2014. This may improve now that the loss-making stores have been closed.

During the same period, net profit fell from 6.9% to 5.7%. This fall is obviously less than the reduction in gross profit but rather than being as a result of good cost control, it appears to be due to a reduction in product development.

Reducing product development spending may prove to be good in the short term (profit up) but poor in the long term as the bulk of ice cream sales are from products less than three years old.

The total market size in Aicults grew by just 3.8% in the period 2011 to 2104 so it looks as though Churchill's market share grew. However, again it must be remembered that Churchill's data includes non-UK revenue so this may not be an accurate comparison

Churchill were very highly geared at the start of the period in 2011 and have reduced this steadily. Although this is good, this reduction, coupled with the failed investment in the US may be why product development has gone down.

Cost card

Ingredients represent 44% of the total cost of the ice cream. This is very high but reflects what Churchill use to differentiate themselves, the quality of their ingredients.

On the other hand it is not clear why labour should represent 28% of the cost. Churchill have invested heavily in a new factory so it would expected that labour costs would be lower.

Finally it should be noted that Churchill aim to make a 10% margin on sales ($0.25 out of $2.50), yet their gross margin has fallen to 6.3%. This may indicate that the price being charged is too low.

Strengths and weaknesses

Churchill have concentrated on selling ice cream in the Seirtsac region. This is a strength since it means they can build up a brand name within a particular region. It also means that distribution costs (likely to be significant for a refrigerated product like ice cream) can be kept down

Supporting this is the fact they sell ice cream to theatres and cinemas in Seirtsac, this will increase brand awareness.

Churchill operate a number of ice cream parlours. This is a strength since they will get to keep all the revenue generated rather than having to share the proceeds with a retailer.

Another advantage of this strategy is that they can try out new products on customers visiting their shop. This is a low risk way of developing new products, something that is very important in the industry.

Churchill have used franchising as one of their methods of growth. This is a strength since it means they can grow quickly at relatively low cost.

The major weakness of using franchising is that they will have to share revenues with the franchisee.

Churchill do not use advertising, this will make it difficult to build up a brand name.

Poor IT information is a weakness, since it has led to stock outs in summer months, meaning less revenue.

Opportunities and threats

25% of Churchill's sales come through leisure outlets (theatre and cinema). It is likely that they have contracts with these outlets and so the threat of new entrants is low.

There are a number of factors outside Churchill's control that will affect sales, the most important of these is the weather.

The major threat to Churchill is from the US premium chains, these could potentially take Churchill's customers since they aim at the same market segment.

Conclusion

Churchill have a strategy that seems to be working in Seirtsac.

However it will be difficult for them to grow much further if they continue with this strategy. This means they will fail to meet Richard Smith's target of $25million in sales.

Overseas expansion has not worked and so Churchill may look to exploit opportunities within Aicults.

(b) 1 mark for each relevant point:

- up to 5 marks for discussing suitability
- up to 5 marks for discussing feasibility
- up to 5 marks for discussing acceptability
- up to 2 marks for a sensible conclusion

...up to a maximum of 16 marks.

1 professional mark is awarded for each of the following

- Report format
- Using SFA headings (or any other suitable model)
- Conclusion
- Contents of conclusion following on from points discussed

To	Richard Smith
From	An Accountant
Date	Today
Subject	Evaluation of current strategic position for Churchill

The proposed expansion into selling to supermarkets can be evaluated using the SFA approach developed by Johnson and Sholes.

Suitability

This examines whether the proposed strategy fits in with the current strategy.

Churchill want to expand profits and from the analysis in a) it is clear that this is most likely to come from within Aicults, selling to Aicults supermarkets would fit in with this aim.

Churchill's factory operates at 75% capacity so it would be wise to increase sales to utilise it fully.

On the other hand, there appear to be significant barriers to entry to the industry. First Churchill will be competing against large US brands who will be able to reduce prices and spend more on marketing than Churchill can.

At the moment Churchill cannot always deliver inventory to their own stores. Inventory management would be a threshold competence demanded by the supermarkets.

It appears as though some radical change in strategy will be required in order to meet the target of $25million revenue.

Feasibility

The factory currently has 25% spare capacity, but it is not clear if this would be sufficient to meet demand from the national supermarket chains.

Churchill presumably have little knowledge of product distribution outside of Seirtsac. This would be vitally important in order to keep supermarkets around the country well-stocked.

In order to market their brand known to shoppers outside Seirtsac, Churchill will need to invest in marketing, something they have no experience of.

The fact that less money is being spent on product development may indicate a shortage of cash. Putting in place all the distribution, information systems required by the supermarkets could prove to be too expensive

Although gearing is coming down, it is still quite high. This might mean banks would be reluctant to lend Churchill funds to help their expansion.

Since the company is privately owned it will not be able to raise funds from shareholders.

Acceptability

The strategy needs to be acceptable to high power stakeholders.

The supermarkets are key players, since they need to agree to stock the ice cream.

Since the supermarkets already sell own label product it is not clear why they would agree to stock what would be a rival product.

There is also a danger that Churchill are forced to put the supermarkets ahead of their own needs, for example when scheduling manufacturing.

The other major stakeholder group are the owners of Churchill. This expansion is a very big risk due to the investment needed and yet the profit levels may be low due to the power of the supermarkets.

They may also resent the way in which Richard has tried to reduce their power and may be hostile to strategies that he suggests.

Conclusion

The proposed expansion is suitable in that it will help Churchill expand, however it may not be feasible due to a lack of funds and the margins may be too low to justify the risk.

I would recommend that Churchill seek alternative methods of growth.

If I can be of any further assistance, please do not hesitate to contact me.

(c) 1 mark for each relevant point:

...up to a maximum of 10 marks.

The idea behind integrated reporting is to provide information to all stakeholders, not just shareholders.

The first three categories are aimed at the shareholders / debtholders of Churchill, in this case the Churchill family. They would also be of interest to the franchise holders since the future success of each franchise will be influenced by these.

Financial capital would refer to the equity that has been invested by the Churchill family.

Manufactured capital would refer to the factory built by Churchill, but could also include any new information systems that are developed.

Intellectual capital would refer to the new products that are being designed by Churchill. Reporting this separately would highlight its importance to the company's strategy.

Human capital refers to the knowledge of staff, but particularly their ability to implement strategy. This is very important at this time for Churchill given they are considering a major change in strategy.

Social and relationship capital refers to how Churchill deals with external stakeholders. There are a number of key aspects for Churchill.

The relationship with farmers is very important since the high quality milk used is one of Churchill's differentiators.

The relationship with the franchise holders is also important and so Churchill should report on any new developments.

If Churchill does starts supplying supermarkets then they will need to provide information on how well they are meeting customer needs.

Natural capital is probably less important to Churchill, but they may wish to make available information on how environmentally friendly their factory and distribution network is.

Question 2

Tutorial help and key points

Be careful that you understand exactly what you are being asked to do in the two parts of this question so as to avoid repetition or answering the wrong part of the question, neither of which will score marks.

You are asked to look at specific problems the organisation is having and ask you to advise them on how to solve them.

Remember that although you are using Harmon, you still have to think about what is appropriate for KJR.

When using a model like Harmon, you must justify why you are saying a process is complex etc.

(a) 1 mark per point to a maximum of 12

Note there is a maximum of 3 marks for each of the four areas.

Whatever strategy a company follows, it must be efficient and effective. It appears that this is not the case with a number of KJR's business processes.

KJR's competitive advantage is that they repair the appliances, so anything that affects their ability to do this means they are being ineffective. This will make it impossible to justify the higher prices they charge and they will lose the market share they have built up.

Training staff

There appear to be a number of problems here. Firstly staff are not able to repair the appliances, as noted above, this reduces the company's effectiveness.

As well as upsetting existing customers, this may have an impact on their reputation, making it more difficult to get future customers.

The current training method seems inefficient, if staff are being trained how to repair appliances it means they cannot be repairing appliances for customers.

This means that either the work will be delayed (this may be one of the causes for the increased backlog), or that more staff will need to be employed to cover those on training courses.

Repair scheduling

The weaknesses here again have the potential to remove the competitive advantage of KJR. If a cooker or a fridge is not usable for a week it could have serious implications for a family. Any unnecessary delays here will damage KJR's reputation.

It appears as though staff are choosing easier repairs to do and leaving more difficult ones. From the customer's point of view, it should make no difference if the repair is hard or easy, they have paid a premium to have any repair carried out.

Similarly there is no reason why repairs cannot be carried out at the weekend, it appears as though the repair staff do not want to work at the weekend. Customers may resent having to take days off from work.

Purchase and repair of vehicles

This is currently being carried out by a member of the admin staff who has other duties to perform. She may not be able to devote enough time to this as is needed and this may be the reason for the backlog.

The main problem here is that if these vehicles are not available then repair work might not be able to be carried out for customers. This may be another reason for the current backlog in appliance repairs.

It also appears that the method of dealing with local car dealers and garages is inefficient. KJR will probably end up paying full-price for everything and not being able to achieve economies of scale.

In addition, the garages may charging for unnecessary work since the admin staff member is unlikely to visit the garage to see what is happening.

Payroll

The current system is not effective since it has produced errors leading to KJR being fined by the tax authorities.

It seems strange to have payroll being carried out by the IT department since this means the staff need to be knowledgeable about IT and about tax, a combination that may be difficult to find.

In addition, it seems inefficient to have two full-time IT staff working on something basic like payroll. There are presumably other things they could be working on which would add more value.

(b) 1 mark per point to a maximum of 13

Note there is a maximum of 3 marks for each of the four areas.

Harmon's process-strategy matrix can be used to identify how processes can be made more efficient and / or more effective.

Training staff

This is highly important since repair work represents KJR's competitive advantage.

Training requires judgment about what training staff should receive and how they should receive it.

Harmon says that in this case KJR should concentrate on improving the effectiveness of the staff.

One possibility would be to reduce the range of new appliances sold. This would mean less training would be required. Unfortunately this will probably reduce the company's effectiveness overall since they will be selling a smaller range of products than their rivals.

A more realistic approach is to improve the training. One method would be to use a knowledge management system. Each member of the repair staff would be issued with a laptop with guides to repairing all the appliances the company sells. This would allow them to be trained only when the need arose.

This could be updated by the repair staff as they come across new issues and so would always be up to date.

Repair scheduling

This is also highly important since it allows staff to timetable visits to customers.

The process should be simple since similar types of repair should take similar amounts of time.

This process could be automated which would make it more efficient and effective. Since repair work is KJR's advantage it would wise to have the bespoke software written by members of KJR's IT department.

Purchasing and maintaining vehicles

This is complex since KJR are a nationwide company and keeping track of all the vehicle requirements and maintenance schedules will be complicated.

The process is of low importance since the customer is probably unaware of what is happening with this process.

This would be better if outsourced to a nationwide specialist in fleet management. This specialist will probably obtain economies of scale for delaying with car dealers and with garages, making the process more efficient.

They will also be able to use their specialist knowledge to see what repairs are need so making the process more effective (and reducing the backlog of servicing).

Payroll

This process is simple since there are rules that govern deductions from salaries for various taxes.

The process is of low importance since it will not affect KJR's competitive advantage.

KJR should buy a generic software package. This will be more effective since it should have no errors in it (so no more fines).

It should also be more efficient than having two members of staff working full-time. These members so staff could be used to help develop the scheduling software noted above.

Question 3

Tutorial help and key points

External analysis comes up frequently in the exam so you must be able to identify issues and discuss them.

Part (a) of the question asks you to perform an environmental analysis, this might mean using PESTEL or five forces (or a mixture), be guided by the contents of the scenario. In this case there is little information relevant to five forces so PESTEL has been used.

Part (b) focuses upon advantages of using scenario planning to Airtitie. Remember to keep points brief.

(a) 1 mark for each relevant point up to a maximum of 15 marks.

Political

Governments are keen to encourage low-cost carriers, this should lead to increased revenue in the future.

Governments may decide to take action against airlines since they are viewed as a major contributor to climate change, this may lead to higher costs.

The threat of terrorist activity has led to a reduction in the number of routes flown, this will lead to lower revenue.

If customers feel security measures are too time-consuming they may seek alternative methods of transport leading to lower revenues.

Economic

Fuel costs make up 25% of Airtite's costs, if prices were to rise then overall costs would increase.

Social

Much of the increase in air travel in the past came from increased demand from families and retired people, this has led to increased revenue.

The number of families is expected to fall in the future and this will reduce demand and revenue.

Retired people may have lower incomes in the future which will lead to lower demand and revenue.

Air travel is widely regarded as safe, this should lead to higher revenues in shorter journeys as customers may prefer to fly rather than drive.

The number of high profile incidents may make customers view air transport as dangerous leading to lower revenues.

Technological

Newer aircraft are designed to be more fuel efficient, this will lead to lower costs.

The rise of online booking has led to reductions in sales staff, this leads to lower costs.

Price comparison websites make it easier for customers to identify the lowest fares leading to lower prices and revenue

Environmental

Even if governments take no action, there is a threat that customers might stop using airlines and move to less environmentally damaging modes of transport.

Conclusion

Airtite will be protected from some of these threats since they do not fly to unsafe parts of the world and their low prices means that falls in income may not affect them as much as other airlines.

There are some threats such as fuel price rises which they cannot avoid.

Overall it looks as if the future will be difficult for Airtite and other companies within the industry.

(b) 1 mark for each relevant point up to a maximum of 10 marks

Scenarios are useful when there is high environmental uncertainty as a result of complexity or rapid change as is the case in the airline industry.

These complex and rapid changes make it difficult to consider all the possible factors that might influence future strategy.

Scenario building attempts to identify the major factors that will affect the future.

Such an approach would concentrate John's mind on the most important environmental factors. Fuel prices and taxation are both important in this context, combining a high degree of uncertainty and high potential to disrupt Airtite's budgets.

The chosen factors, or drivers of change are assessed for the ways in which they might interact with each other.

This then means a number of potential outcomes can be generated identifying what the environment could look like in the future.

Scenario planning simply identifies these possibilities, it makes no effort to provide any probabilities for their likelihood.

Airtite could then draw up a response for each of the scenarios, this may be time-consuming.

The main advantage of this is that if something key in the external environment changes, Airtite have already decided on a response. This is very important in the airline industry as the environment can change rapidly.

Another advantage is that identifying the main environmental factors means the management at Airtite are more likely to identify if they are changing.

This awareness of changes should assist the company to react better to external changes.

Question 4

Tutorial help and key points

This needs a discussion on how a particular model could be used to help implement change. Remember that although the model is important, it is the application of the model which is key.

Also remember to put in definitions of stages of the model, there are usually marks for these in the exam.

1 mark for each relevant point:

To John Dixon

From An Accountant

Date Today

Subject Change models

The environment

The first part of the business lifecycle model is to identify changes in the external world that impact on the organisation.

In this case, stakeholders are complaining that the quality of life in the city is being damaged because of the emphasis of the police.

Since some of these stakeholders are key players (particularly the mayor), John should consider changing the police force strategy to one more acceptable to them.

The POPIT model

This model looks at the different areas that will be impacted by the change.

People

This looks at how people will be affected by the change.

The most obvious group being affected are the police officers. The emphasis will change from solving serious crime to reducing low-level crime.

Additional training may be required in order to identify potential crimes before they occur.

Another group affected are employees at the courts of justice. They are worried about increased workloads and so additional staff might need to be recruited.

Organisation structure

This looks at areas such as the way departments are organised as well as performance rewards.

At the moment there is little sharing of information between districts. This will need to change since pooling information will make the entire force more effective.

Senior police staff will continue to focus on serious crime if this is the way their performance is judged. As part of the change, measures that reflect the emphasis on petty crime will need to be introduced.

Processes

This looks at the business processes that allow the organisation to operate.

As noted above, instead of waiting for a crime to occur and then solving it, the emphasis will change to one of prevention.

This will almost certainly involve keeping more records of suspicious activities and potential issues

Information Technology

The increased amount of information being recorded as well as the increase in the number of people who will need to access it will almost certainly require some kind of database to be established.

Police officers will also need to be able to access the database on a regular "real-time" basis to check on and update information.

Design the business change

At this stage, John will need to look at business process improvement, redesign and re-engineering.

The advantage of having used the POPIT model is that he will be able to see how all the elements go together.

For example, as far as the courts of justice are concerned, business process improvement will mean there will be little change to what they do, except for areas such as staffing levels.

On the other hand, it appears as though the IT systems will need to go through Business Process Re-engineering.

Key players such as the police chiefs should be asked to participate in designing these changes so that the final outcome is acceptable to them.

Similarly, the keep satisfied stakeholders, perhaps in this case the newspapers, should be made aware of proposed changes so that they will support them when implemented.

Change implementation

At this stage the changes are implemented.

A key issue here is stakeholder management, particularly of the high interest stakeholders.

Public opinion will be important and so the newspapers can play a role in explaining what the changes are and how they will help.

Similarly, John and the Police chiefs are vital in communicating to the police officers and courts of justice why, the changes are needed.

Benefits realisation

The final stage of the lifecycle is to ensure that expected benefits actually occur.

In this case, statistics relating to petty crime will need to be collected before any changes take place, as well as afterwards so that improvements can be measured.

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Paper P3 Business Analysis

Revision Mock Examination

June 2017

Question Paper

Time allowed	15 minutes	Reading and planning
	3 hours	Writing

This paper is divided into two sections:
Section A – This ONE question is compulsory and MUST be attempted
Section B – TWO questions ONLY to be attempted
Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

DO NOT OPEN THIS PAPER UNTIL YOU ARE READY TO START UNDER EXAMINATION CONDITIONS.

Section A – This ONE question is compulsory and MUST be attempted.

1. Churchill Ice Cream is a medium-sized family owned company, making and selling a range of premium ice cream products, based in the country of Aicults. Its origins were in the middle years of the twentieth century, when John Churchill saw an opportunity to supply a growing consumer demand for luxury products. John has been followed into the business by his two sons and the Churchill family has dominated the ownership and management of the company. In 2011 there was recognition of the need to bring in outside management expertise and John reluctantly accepted the need to relinquish his position as chairman and chief executive of the company. Richard Smith, formerly a senior executive with one of the major supermarket chains, was appointed as chief executive. Within one year of Richard's appointment he had recruited Churchill's first sales and marketing director. Richard was consciously looking to reduce the dominance by the Churchill family and make the company a more marketing orientated business able to meet the increased competitive challenges being faced.

Churchill's distinctive strategy

Churchill Ice Cream is in many ways an unusual company, choosing to both manufacture its premium ice cream and sell its products through its own stores. Specialist ice cream stores or parlours had started in the US and soon spread to Aicults. Customers can both buy and eat ice cream in the store. John Churchill saw the growing demand for such specialist ice cream stores and created a unique store format, which quickly established the Churchill brand. Most of these stores are owned by the company, but there are also some smaller franchised outlets. By 2005 it had 40 ice cream stores owned by the company and a further 18 owned by franchise holders. Franchise stores typically are in less attractive locations than their company-owned equivalents. All stores are located in and around Seirtsac, the capital city of Aicults.

The logic for manufacturing its own ice cream is a strongly held belief that through sourcing its ingredients from local farmers and suppliers it gains a significant competitive advantage. In 2010 Churchill opened a state of the art factory. This has proved to be very successful and is currently operating at 75% capacity. Making its own ice cream also has enabled it to retain control over the unique recipes used in its premium ice cream product range. John Churchill summed up the policy saying 'We are no more expensive than the market leader but we are much better. We use real chocolate and it is real dairy ice cream. Half our expenditure goes on our ingredients and packaging. It's by far our highest cost.' Dairy ice cream, as opposed to cheaper ice cream, uses milk, butter and cream instead of vegetable oils to blend with sugar and flavourings. These ingredients are blended to produce a wide range of products. Churchill has also developed a product range with no artificial additives hoping to differentiate itself from the competition.

Ice cream is still heavily dominated by sales in the summer months. In fact the peak demand in summer is typically five times the demand in the middle of winter.

Equally serious is the impact of a cold summer on impulse ice cream sales. This has a number of consequences, which affect the costs of the product and capacity usage at both manufacturing and retail levels.

Product innovation is a key capability in the ice cream market and 40% of industry sales are made from products less than three years old. Churchill's products are made at the new purpose built factory and supplied quickly and directly to its own ice cream stores and other retail outlets. Unfortunately, detailed and timely information about product and store performance has suffered through a delay in introducing a management information system. Consequently its stores often face product shortages during the peak summer months.

In 2013 Churchill became the sponsor and sole supplier to a number of high profile summer sporting events held in Seirtsac. Churchill also supplies eight million tubs of ice cream each year to Seirtsac based cinemas and theatres. As a consequence, Churchill is now an established regional brand with 90% customer recognition in the Seirtsac area. Churchill itself does not use advertising. In John Churchill's words, 'There is no point in advertising your product if consumers are unable to buy the product.'

It also has major ambitions to become a national and eventually an international brand though facing significant competition from two global chains of US owned premium ice cream stores. Their high profile moves into Aicults market was backed with expensive advertising and succeeded in expanding the demand for all premium ice creams.

Churchill's international strategy

Churchill, in seeking to increase its sales, has had no success in moving into foreign markets. In 2012 it tried both setting up its own ice cream stores abroad. Its attempted entry into the US market was by using the established Churchill ice cream store format. Two stores were opened in New York, but the hopes that the emphasis on classic quality and style and the slogan 'tradition with taste', would prove successful did not materialize. Sales were positive but operating costs were much higher than expected and the stores were closed with significant losses at the end of 2014.

Possible entry into the supermarket industry

Ice cream is bought in two main ways: either from retail outlets such as supermarkets for later consumption at home or on impulse for immediate consumption from a range of outlets, including ice cream stores such as Churchill's.

Churchill is keen to start selling to Aicults supermarkets. Four major Aicults supermarket chains dominate the take home market. Each of these chains is currently experiencing reduced profits and have publicly said they are trying to reduce supply costs. Each of the supermarkets sells their own brand of premium ice cream, sold under their own name (known as own label products). Supermarkets currently account for 41% of the sales of ice cream in Aicults.

At the moment, global manufacturers with significant global brands dominate this segment of the industry.

In John Churchill's opinion 'If you want to buy a tub of premium ice cream and you go to a supermarket you have a choice of two American brands or its own label. I think there should be an Aicults brand in there. Our prices are competitive, at least £1 cheaper than our rivals and our aim is to get Churchill ice cream into every major supermarket.'

Table 1 Financial information on Churchill Ice Cream ($'000)

	2011	2012	2013	2014	2006 forecast
Sales	14,100	15,300	16,000	16,400	16,700
Cost of sales	12,790	14,250	14,990	15,360	15,760
Operating profit	1,310	1,050	1,010	1,040	940
Product development	340	530	560	110	500
Net profit	970	520	450	930	440
Fixed assets	10,910	10,400	9,670	8,880	8,320
Gearing (%)	105	130	111	86	67
Number of UK outlets					
Own stores	39	41	40	40	39
Franchised stores	11	13	16	18	20
Total UK market size	96,300	97,000	97,500	98,000	100,000

Table 2 Typical product cost breakdown of a Churchill half-litre tub of premium ice cream

	$
Labour	0·63
Ingredients	1·00
Packaging	0·25
Overheads	0·28
Distribution	0·09
Total cost	2·25
Sales price	2·50
Net profit	0·25

Table 3 Sales breakdown for Churchill's premium ice cream

Sales to own stores	60%
Sales to franchise stores	15%
Sales to leisure outlets	25%
Sales to Seirtsac region	90%
Sales outside Seirtsac region	10%

Summary

Overall, Churchill has a distinctive strategy linking the manufacturing of premium ice cream with its distribution through the company's own ice cream stores. This has secured them a regional reputation for a quality product. It has had little success to date in penetrating the major supermarket chains with the Churchill brand and in moving its distinctive ice cream store format into foreign markets.

Despite this, Richard Smith has set three clear strategic goals to be achieved over the next five years. Firstly, to become the leading premium ice cream brand in

Aicults, secondly, to increase sales to $25 million and finally, to penetrate the supermarket sector with the Churchill product range.

Required

(a) **Analyse Churchill's strategic position from a financial, internal and external perspective.** (20 marks)

(b) **Write a report to Richard Smith which evaluates whether Churchill should sell to supply the major supermarkets.** (16 marks)

Professional marks will be allocated in part (b) for the clarity, structure, logical flow and tone of your answer. (4 marks)

(c) **Richard Smith recently attended an ACCA talk on integrated reporting. Explain how Churchill could use this to report to stakeholders.** (10 marks)

(50 marks)

Section B – TWO questions ONLY to be attempted.

2. KJR is a small company founded in 2009, which sells domestic appliances such as cookers and fridges.

All of KJR's competitors, including online retailers, only retail these items. If there are any repairs that need doing, the customer has to contact the manufacturer. This allows the retailers to keep costs and prices down. It is well known within the industry that many customers choose a retailer based on prices.

KJR offer a complete service, when the customer buys the appliance they are entitled to two years of free repairs. Offering this allows KJR to charge a higher price than their rivals. The reliability of modern appliances is such that most do not need any repair work allowing KJR to keep the premium paid by the customer.

Over the last few years KJR has grown rapidly into a nationwide company which has led to increased revenue but also to increasing customer complaints.

The backlog of repairs has steadily been increasing over the last year and customers now have to wait for up to ten days for a visit.

Another complaint is that even when staff visit they are not always able to repair the appliances. One engineer said, "the problem is that there are so many products we sell and they are all constantly being updated, it is hard to keep up".

KJR has traditionally trained staff by sending them on regular training courses held every three months at their head office. Here they are shown how to repair the latest models.

KJR are looking at some of their business processes. The company feels that the current methods of carrying them out may be inefficient and ineffective.

Repair scheduling has been the subject of numerous complaints by customers. The current procedure is that after a customer contacts KJR, the details are sent to the nearest office to the customer. Each repair engineer goes through the requests and arranges their diary of appointments for the next five days. This allows each engineer to choose repairs that fit in with their particular skills and preferences to plan a repair schedule. This has led to customer complaints that some unpopular repairs (that are time-consuming or difficult) can take more than a week before an appointment is made. It is also hard to get a repair done at the weekend so customers have to take a day off during the week.

Purchasing and maintenance of vehicles driven by repair workers is carried out by a member of the KJR's administrative staff. If a new vehicle needs to be purchased she contacts a local dealer close to the relevant office and arranges for a new vehicle to be purchased. Similarly if there is any maintenance to be done, she contacts a local garage. Due to her other work commitments, there is currently a backlog of vehicles requiring maintenance.

KJR have developed their own payroll system over the years. This is for historical reasons since the original Finance Director was also in charge of IT and so the IT department have always maintained the company's payroll system. Last year KJR were fined by the country's tax service for not deducting enough income tax from employees' wages. At the moment two employees work full-time on maintaining and updating the company's system.

Required

(a) **Identify and explain the weaknesses in KJR's current business processes of training staff, scheduling repairs, purchasing and maintaining vehicles and payroll.** **(12 marks)**

(b) **Use Harmon's matrix to suggest an alternative approach to each of the business processes discussed above.** (13 marks)

(25 marks)

3. Airtite was set up in 2000 as a low cost airline operating from a number of regional airports within Europe.

John is now looking to develop a strategy which will secure Airtite's growth and development over the next 10 years. He can see a number of environmental trends emerging which could significantly affect the success or otherwise of any developed strategy. 2014 had seen fuel costs continue to rise reflecting the continuing uncertainty over global fuel supplies, although they now appear to be falling. Fuel costs currently account for 25% of Airtite's operating costs. Conversely, the improving efficiency of aircraft engines and the next generation of larger aircraft are increasing the operating efficiency of newer aircraft and reducing harmful emissions. Concern with fuel also extends to pollution effects on global warming and climate change. Many people have expressed their concern that air travel is damaging to the environment which has led to various protests. Co-ordinated global action on aircraft emissions cannot be ruled out, either in the form of higher taxes on pollution or limits on the growth in air travel. On the positive side European governments are anxious to continue to support increased competition in air travel and to encourage low cost operators competing against the over-staffed and loss-making national flag carriers.

Other factors that have changed since Airtite commenced business is the rise of online ticket sales as well as price comparison websites. Airlines are widely recognized as the safest form of transport, however a number of recent incidents have gained much negative publicity. Concerns over terrorist activity have led to many airlines reducing the number of routes to some parts of the world. In addition, many customers view the resulting security measures at airports to be too time-consuming.

The signals for future passenger demand are also confused. Much of the increased demand for low cost air travel to date has come from increased leisure travel by families and retired people. However families are predicted to become smaller and the population increasingly aged. In addition there are concerns over the ability of countries to support the increasing number of one-parent families with limited incomes and an ageing population dependent on state pensions.

Finally, air travel will continue to reflect global economic activity and associated economic booms and slumps together with global political instability in the shape of wars and natural disasters.

John is uncertain as to how to take account of these conflicting trends in the development of Airtite's 10-year strategy and has asked for your advice.

Required

(a) **Using models where appropriate, provide John with an environmental analysis of the conditions affecting the low cost air travel industry.** (15 marks)

(b) **Explain how the process of developing scenarios might help John better understand the macro-environmental factors influencing Airtite's future strategy.** (10 marks)

(25 marks)

4. John Dixon is the recently appointed Chief of Police for a major city in the UK. He has inherited a major problem in that its residents are very concerned with various forms of antisocial behaviour and minor crimes carried out by a small number of people, which makes living, working, travelling and socialising in the city centre unpleasant rather than life threatening. The city's residents have recently voted for it being one of the five worst cities in the UK in which to live. There is little or no contact between the police and these residents.

The city is split into a number of police districts, each with its own senior officer in charge. Their focus is on the response to emergency calls and solving serious crimes in their district rather than the less urgent crimes affecting everyday living in the city. Response times and serious crime solution rates are the traditional measures by which their performance is measured and leave them open to criticism of simply reacting to events. There is little sense of being part of a city police force and, consequently, little sharing of information and experience between the different districts. The failure in policing antisocial behaviour in the city is seen as being largely the result of a shortage of resources.

There are also important internal and external groups varying in their support or resistance to any necessary change in policing strategy. Key players include the mayor of the city anxious to improve the reputation of the city, the city's press, traditionally used to highlighting police failures rather than successes and finally the courts of justice, which are reluctant to take on the increased workload that any moves towards reducing antisocial behaviour would produce.

John is aware of the complexity of the problem he faces in changing the way the city is policed to improve the quality of life of its citizens. He has, however, an impressive track record as a change agent in previous appointments and is confident that he can bring about the necessary change.

Required

Using the business change lifecycle (which includes POPIT) model of strategic change, provide John with a brief report on the issues to consider when changing the way the city is policed in order to improve its quality of life.

(25 marks)