

CMA JUNE, 2020 EXAMINATION
STRATEGIC LEVEL
SUBJECT: P3. PERFORMANCE STRATEGY

MODEL SOLUTION

Solution of the Q. No. 2 (i)

Calculations:

ROI

$$\text{Current ROI} = \frac{\text{Tk. 130}}{\text{Tk. 410}} = 31.71\%$$

$$\text{New ROI} = \frac{\text{Tk. 130} + \text{Tk. 11.5}}{\text{Tk. 410} + \text{Tk. 38}} = 31.58\%$$

However RI:

$$\text{Currently Tk. 130} - (15\% \times \text{Tk. 410}) = \text{Tk. 68.5}$$

$$\text{New Tk. 141.5} - (15\% \times \text{Tk. 448}) = \text{Tk. 74.3}$$

Comments:

Based upon the ROI the manager will reject the asset purchase since it reduces his divisional ROI. The manager will not look beyond this short-term result and see that the asset could bring a long-term benefit to the division.

As the RI results show the project should be accepted.

The risk of using ROI is that it encourages a short-term focus with managers not wishing to take any decisions that reduce their ROI for the present time period.

Additionally the manager will focus solely on the results for their own division, and will not look to see if the decision could benefit the company as a whole.

(ii) Ways in which these risks of dysfunctional decision making may be mitigated:

- Investment decisions could be made at a company level, hence removing the distorting perspective of investment centre managers.
- Investment decisions could be made based up on residual income targets as opposed to ROI (though this has other adverse consequences for performance evaluation).

(b) Two techniques, which do not take into account the time value of money are as follows:

Payback period - this method measures the number of years taken by the project to recoup the initial investment. Obviously, the shorter the payback period the better. Companies use this method frequently because it is easy to apply and comprehend. Use of the payback period does, however, have a number of drawbacks. The determination of the cut-off period is essentially an arbitrary decision. The payback period ignores cash flows, which occur after the cut-off date; it also ignores the timing of cash flows within the payback period itself. As a result, viable projects may easily be rejected.

In its favour, the payback period does allow for risk and uncertainty by attempting to recover the initial outlay in as short a period as possible.

Return on investment- using this method, the benefits of the project are expressed as a return on investment in terms of a rate per year.

This technique assumes that the investment is repaid over its economic life in a straight-line way. As with the payback period method, it is easy to apply and comprehend but it, too, does not take into account the time value of money. It does, however, provide a useful indicator, organizations obviously seek to invest scarce resources where they will derive the highest return.

- (c) Fraud is dishonestly obtaining an advantage, avoiding an obligation or causing a loss to another party. Those committing fraud may be managers, employees or third parties, including customers and suppliers. **There are three conditions for fraud to occur:** dishonesty, opportunity and motive.

Controls to prevent dishonesty include pre-employment checks; scrutiny of staff by effective supervision; severe discipline for offenders and strong moral leadership. Opportunity can be reduced by the separation of duties, controls over inputs, processing and outputs and by the physical security of assets, especially cash. Motive can be influenced by providing good employment conditions, a sympathetic complaints procedure, but dismissing staff instantaneously where it is warranted. A major reason why people commit fraud is because they are allowed to do so. The likelihood of fraud will be decreased if the potential fraudster believes that the rewards will be modest, or that the chance of detection or punishment will be unacceptably high. Therefore, a comprehensive system of control is needed to reduce the opportunity for fraud and increase the likelihood of detection. Fraud risk arises out of errors or events in transaction processing or other business operations where those errors or events could be the result of a deliberate act designed to benefit the perpetrator.

- (d) *Advantages and disadvantages of outsourcing*

The main potential advantages of outsourcing IT are: more accurate prediction of costs and more accurate budgetary control; using services only when necessary; improved quality and service; economies of scale available to the outsource service provider; the organisation is relieved of the burden of recruiting and managing specialist staff, especially where skills are in short supply; the outsourced service supplier has a better knowledge of changing technologies; saving management time and effort.

The main disadvantages of outsourcing IT are: the difficulty of agreeing an SLA that clearly identifies the obligations of each party; the loss of flexibility and inability to quickly respond to changing circumstances and the possibility of ending up with a less customised system; the risk of unsatisfactory quality and service, or even failure of the supplier; the risk of a lack of security over confidential or critical information; a short-term cost-savings focus may be at the expense of long-term strategy considerations; ignoring an unchanged overhead burden; poor management of the changeover or of the supplier; increasing costs of outsource provision over time, difficulty of changing the outsourced supplier or of returning to an in-house provision, and a loss of internal IM/IT/IS capability leading to dependence on outside suppliers.

In cost terms, the costs of in-house provision need to be compared with outsourcing.

The costs of in-house provision can be estimated quite easily, comprising staffing and equipment costs, maintenance, accommodation, etc. For outsourcing, cost estimation is more complex because many costs are 'hidden'. A transactions cost approach will consider not only the direct costs of the outsource supplier but also costs associated with negotiation, monitoring, administration, insurance, etc. These hidden costs involve time commitments, opportunity costs and are associated with legal, moral and power conditions.

Understanding these costs and conditions may reveal that it is more economic to carry out an activity in-house than to accept a market price which appears less costly but which may incur transaction costs that are hidden in overhead costs.

(e)

Risk treatment (also called risk response) is the process of selecting and implementing measures to modify risk that has been identified. This may include risk control/mitigation, risk avoidance, risk transfer, risk financing (e.g. insurance), etc. Risk response involves determining and documenting:

- A policy of defining the organisation's attitude to a particular risk and the objectives of the risk response.
- Individual accountability for the management of the risk, with a nominated person having the expertise and authority to effectively manage the risk.
- The management processes currently used to manage the risk.
- Recommended business processes to reduce the residual risk to an acceptable level.
- Key performance measures to enable management to assess and monitor risk.
- Independent expertise to assess the adequacy of the risk response.
- Contingency plans to manage or mitigate a major loss following the occurrence of an event. Risk treatment (or response) enables the Board to see easily which risks have been addressed and those where risk management procedures remain outstanding, and in both cases which individuals are responsible.

Risk treatment (or response) may be:

- *Avoidance*: Action is taken to exit the activities giving rise to risk, such as a product line or a geographical market, or a whole business unit. These are high risk events.
- *Reduction*: Action is taken to mitigate (i.e. reduce) the risk likelihood or impact, or both, generally via internal controls. These risks occur more frequently but have less impact.
- *Sharing*: Action is taken to transfer a portion of the risk through, for example, insurance, pooling risks, hedging or outsourcing. These are significant risks, which occur rarely.
- *Acceptance*: No action is taken to affect likelihood or impact. These have low impact even when they do occur, which may be frequent. Each response needs to be considered in terms of its effect on reducing the likelihood and/or impact of the risk. A comparison of gross and net risk enables a review of risk response effectiveness and possible alternative management options.

This permits management by exception. It will enable a board of directors to better understand and react to:

- The nature and extent of risks facing the organization.
- The extent and categories of risk which it regards as acceptable for the organisation to bear
- The likelihood of risks materialising.
- The costs and benefits of risk responses. Consideration of these factors enables the Board to have evidence that they have carried out their responsibilities for risk management.

Solution of the Q. No. 3

(i) An internal audit contributes to the effectiveness of internal controls by ensuring that **internal controls take into account the risks facing the organisation and that risks are reduced to a level acceptable to the board.**

The focus of risk-based internal auditing is to be able to provide assurances to the audit committee that risk management processes are operating as intended. This is achieved by ensuring that the risk management system has a sound design; that management's responses to risks are adequate and effective in reducing risks to an acceptable level; and that a framework of controls is in place to mitigate risks.

Whilst managers are expected to put in place controls to mitigate risk, they are also expected to deliver financial performance and this may place managers in a conflict of interest. This may lead them to minimise controls where they see these as unnecessary, costly or restrictive. As a result of this potential conflict, the internal audit function has an important role to play in ensuring that controls are in place.

Although it is management's responsibility to identify and manage risks, to effectively assess the adequacy of internal controls, **internal auditors need to have expertise in risk management: how risks are identified, assessed and managed.** The risk management system will itself need to be audited in order to ensure that it can be relied upon. Internal audit matches its audit programme with the degree of risk maturity in the organisation.

Risk management will inform the priorities for the internal audit plan. In particular, internal audit should identify high risk matters and control deficiencies so that actions can be taken to improve those controls and so avoid, reduce or mitigate risks.

ii) The internal audit department is a vital element of the control environment in any large entity. The directors rely on internal audit to ensure that formal control processes and procedures are operating as they should. The directors cannot observe the workings of these systems for themselves unless the entity is very small and so the internal audit department provides vital feedback.

If the directors cannot trust the internal audit department to report honestly and accurately then they will have no way of knowing whether their policies and instructions are being carried out. That is a major issue in terms of good corporate governance because the shareholders hold the directors responsible for the governance arrangements and expect them to run the company in an effective manner. Cases where problems have arisen because of compliance failures by managers and staff have tended to reflect badly on the board.

Mr. Alam's behaviour is also sending a very clear signal to Sharif Ltd's staff. If breaches are not reported and acted upon then staff may decide not to comply. If the internal audit department, whose very existence is to report compliance failures, does not act then the staff will start to become demotivated and lazy. If Sharif Ltd's board does not act quickly and decisively then its ability to manage the company effectively will be seriously compromised by this audit failure.

iii) The first thing would be to review the records maintained by the depot. These should indicate that the inspections were carried out and the mechanic should have signed as proof. This test will not actually prove that the tests took place because the mechanic could have signed the documents recklessly, but the signature does at least prove that the staffs are willing to accept responsibility for the inspections having been carried out.

Internal audit could review the records relating to repairs and breakdowns for each depot. This would be a useful analytical review exercise that could identify any depots that were at a higher risk of not carrying out adequate inspections. Ideally, the cost of repairs should be separated from the cost of routine maintenance.

During branch visits the internal audit staff should be aware of the work being done by the depot mechanics. The depot staff may behave differently during an audit visit, but it would be reassuring to see whether the mechanics were inspecting vehicles.

The auditor could supplement these observations by asking the mechanics and the drivers to explain the maintenance procedures in order to establish indirectly whether they volunteered information about the regular fluid checks.

The internal auditor could conduct a spot check on the fluid levels of a sample of vehicles at the depot. These should focus on vans that have recently been checked. If the fluid levels are low then there is a strong likelihood that the checks were not carried out.

Solution of the Q. No. 4

(a) (i) The main categories of currency risk are as follows:

- Transaction risk which affects the short-term cash flow of the entity, as a result of a movement in exchange rates between the delivery of goods/provision of service, and settlement;
- Economic risk which may be tactical or strategic, and relates to the projected cash flows of the business, as a result of a movement in exchange rates between a decision and its implementation;
- Translation risk which does not affect the cash flows of the entity, but can affect their attribution (e.g. higher interest payments as a consequence of higher gearing) and hence the value of the equity.

Methods of managing risk include offsetting borrowings or deposits, forward exchange contracts, currency options and – for long-term risks – an appropriate capital structure.

(ii) Domestic companies are not exposed to either transaction or translation risk. They are, however, exposed to economic risk, most notably

- the arrival of an overseas-based competitor, prompted by a strengthening of the domestic currency;
- movements in the world price of important commodities, compounded by movement in the value of the domestic currency vis-a-vis other currencies.

These are not easy to hedge. What opportunities will tend towards borrowing/ raising capital denominated in foreign currencies; if domestic currency does strengthen, foreign currency gains will be made. Sources of supply from overseas might also help, but the problem could arise anywhere.

(b)

(i) The exchange rate between TK. and the French franc can be calculated as follows:

Spot-8.5768	2 months-8.5932	3 months-8.6015
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The value of the first order is Tk. 350,000 X 8.5768, that is FFr 3,001,880.

So, MJS can expect to receive at 8.6015, to yield FFr 3,001,880/8.6015, that is, TK. 348,995.

(ii) The Uganda order is worth \$225,000 in 3 months' time. This could be sold forward at 1.4873, to yield TK. 151,281.

Alternatively, the exporter could borrow \$221,675 ($225000 \times 100 / 101.5$) and pay interest of \$3,325, the total being repaid when the \$225,000 is received from Uganda. The \$221,675 would be worth TK. 148,575, on which interest of TK. 1,857 would be earned, bringing the total to TK. 150,432.

On this basis, use of the forward exchange rate is the more beneficial.

(iii) Purely in terms of exchange rate risk, the exporter would be advised to accept the US dollar arrangement. This being a new customer, however, in a part of the world going through significant change, there may well be credit and political risks. The exporter should quantify these, and weigh them against the profitability of the product.

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