



## Strategic Level Paper

# P3 – Performance Strategy November 2012 examination

## Examiner's Answers

*Note: Some of the answers that follow are fuller and more comprehensive than would be expected from a well-prepared candidate. They have been written in this way to aid teaching, study and revision for tutors and candidates alike.*

These Examiner's answers should be reviewed alongside the question paper for this examination which is now available on the CIMA website at [www.cimaglobal.com/p3papers](http://www.cimaglobal.com/p3papers)

The Post Exam Guide for this examination, which includes the marking guide for each question, will be published on the CIMA website by early February at [www.cimaglobal.com/P3PEGS](http://www.cimaglobal.com/P3PEGS)

## SECTION A

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### Answer to Question One

#### **Rationale**

This question is based on both the common pre-seen scenario and the unseen scenario. Part (a) deals with the risks associated with a holiday company advising its customers to travel to foreign destinations where they may run the risk of becoming involved in a civil disturbance. Part (b) deals with the process of developing a new IT system that can communicate with suppliers' systems. Part (c) deals with the difficulties of evaluating the effects of currency movements on consumer demand.

Part (a) draws mainly on Section B of the syllabus (*Risk and Internal Control*). This part asks for an evaluation of the risks associated with advising individuals on the choice of a holiday destination, bearing in mind the possibility of unforeseen political turmoil. Part (i) focusses on the problems associated with identifying and evaluating risks. This is a topical area given the number of disturbances that have arisen across much of the world in the past few years. Part (ii) asks for recommendations concerning the procedures that the company could put in place to provide the basis for an effective response to any problems that arise once customers have travelled to their destination. Part (iii) asks for an evaluation of the implications of "no win – no fee" legal services offered by law firms for potential defendants.

Part (b) draws mainly on section E (*Risk and Control in Information Systems*). The first part of the question asks how the IT system creates risks for the company. This is a business that relies heavily on on-line sales and that reliance is likely to increase over time. Part (ii) asks for a discussion of the process of developing and upgrading the system so that it can

communicate with suppliers' systems more effectively.

Part (c) draws mainly on section D (*Management of Financial Risk*). The entity sells foreign holidays and so its selling prices are affected by foreign currency movements. That may mean that the entity will face changing demand for its services because of currency movements.

### **Suggested Approach**

Part (a)(i) asks for an evaluation of the difficulties associated with a risk exposure that is difficult to measure. At any given time there is, in principle, the possibility that political unrest will break out in any given country. That creates a major dilemma for a holiday company because it cannot eliminate the risk to its customers unless it offers a very limited choice of destinations. However, there is also the risk that customers will claim that the company was reckless if they are caught up in a conflict because they will be able to point to the existence of warning signs prior to their date of travel. The starting point is to establish that this is a low probability high impact risk. The implications of both of these aspects, plus the likelihood that any adverse outcome will be reviewed with the benefit of hindsight, ought to be explored. Part (a)(ii) is looking for sensible and realistic suggestions as to how a travel company might prepare for the possibility of a disaster, whether natural or political, affecting its customers while they are on holiday. The main issue to bear in mind is that the travel company is likely to be working in conjunction with one or more governments in the event of such a disaster. The travel company's primary role would be to inform the government about the number of UK nationals in the country and also their locations. It is unlikely that the company will be asked to provide any more direct assistance than that and so suggestions should be restricted to steps that might actually be undertaken. Part (a)(iii) asks for some suggestions as to the threats created by lawyers who are prepared to operate on the basis that they will only charge a fee if any claim is successful. Commercial entities have generally been at an advantage in their dealings with customers with whom they are in dispute because very few people can afford to pay for legal advice or to take a case to court. Answers to this part should explore the implications for the defendants in such cases. Customers may be more aggressive and more inclined to push for a settlement. Claims may be encouraged by the advertising and publicity for these services. Management time may be taken up with defending spurious claims.

Part (b)(i) is looking for a discussion concerning the commercial implications of an unreliable on-line booking system. There is an obvious risk that customers will be dissatisfied if their holiday bookings are cancelled. The charter airlines and hotels may also feel that the company is an unsuitable trading partner because of these systems problems. There is also an upside risk because the provision of an on-line booking facility will offer the opportunity to cut costs also stimulate demand (even a bad system will do so, although a good system would do so to a greater extent). Part (b)(ii) is looking for practical advice concerning the process of upgrading the system, bearing in mind the need for it to engage and interact with suppliers' systems. Answers should reflect the reality of this business rather than simply seeking a checklist of bullet points about systems development.

Part (c) is essentially about economic risk. Answers should focus on the main issues. The company does not operate in a vacuum. Competitors may be forced to raise their prices and suppliers may be forced to cut their margins in the event of adverse currency movements. There is also the possibility that certain currency movements may simply encourage customers to switch to unaffected destinations that are no less profitable. Finally, demand for holidays may not be particularly elastic.

### **(a)**

- (i) The biggest problem is that any civil disturbance is likely to occur very quickly and without warning. If such problems were predictable then the national authorities would be able to take preventative action.

When problems do break out then it may not be immediately apparent whether they will be significant. Governments will rarely be keen to give the impression that they are not in

control and so any news that is broadcast may play the problem down. Conversely, those responsible for the difficulties will have an interest in overstating the strength of feeling and the effects of their actions.

The difficulty for companies in the tourism business is that it will not always be clear whether the risks are great enough to justify cancelling holidays. The cost of doing so will typically be extremely high and there is always a risk that this will subsequently prove to have been an overreaction if tourist resorts are left unaffected. Political protests tend to be associated with large cities and not tourist areas and it may be difficult to assess the specific risks to tourists from press and other reports.

For example, the UK Government offers travel advice, but the Government may not wish to risk offending the government of a friendly country by advising UK citizens not to travel there.

V will appear reckless in the event that tourists are affected by civil unrest. Any criticisms of the company will be based on hindsight as to how the threat actually worked out.

- (ii) Firstly, V should make sure that it has contact details for all the hotels and tour operators' offices that it uses. V should keep a detailed register of the location of all customers and that should be constantly updated. In the event of a problem that will make it easier to ensure that the customers can be contacted and advice offered. For the same reason, V should take details of all mobile phone numbers and email addresses.

V should note details of passports so that it can notify the appropriate governments of the location of their nationals. It may be difficult for tourists to communicate with their embassies or consulates. There is no guarantee that all customers will have UK passports and so V should have contact details for the UK embassies of any other nationalities who travel with it.

V should compile details of appropriate contacts in every country to which it sends customers. For example, it will be easier to advise customers about repatriation arrangements if V can talk directly to local airports in order to assess safety and security.

V should ensure that it has a senior manager available to take responsibility for the management of any problems. That person need not be on the company's premises, but should have access to the company's offices and to any facilities that are required, including files of contact details.

V should consider employing a recognised security expert to train the staff responsible for any emergencies. That is partly because the company's own staff may not fully appreciate everything that ought to be planned for and partly because it will create greater confidence in any advice that is offered.

- (iii) In the absence of these no win – no fee services V can deal directly with customers who have a grievance. Those customers are at a disadvantage because V has trained customer services managers to negotiate a settlement. If customers are dissatisfied with the outcome of any negotiation then they will be reluctant to proceed to legal action because of the financial risks associated with losing the case. They will typically have to pay their own lawyer a retainer and then meet their own legal costs in full if they lose. That means that V is unlikely to be pursued by a customer in the event that a claim is refused because very few customers will have the financial resources to take legal action.

No win – no fee contracts protect the customer from any downside risk. V may feel that it is necessary to settle exaggerated or speculative claims in order to avoid the bad publicity associated with defending a case. These law firms may exploit the fact that V (and similar businesses) may choose to settle quickly even if there is only a small chance that a court would uphold the claim. They may, therefore, choose to pursue cases where there is no real argument that V Ltd was at fault and so V may feel that it is necessary to compensate customers even when the company has no real case to answer.

Dealing with claims from these lawyers will be a distraction from the business of running V. The company may have to employ more staff in its legal department than would otherwise be necessary simply because of the additional correspondence that such claims will generate.

The fact that these law firms advertise their services aggressively will create a “blame culture” in which customer will seek compensation for events that would otherwise be written off as accidental or simple bad luck. That may lead to V having to spend time and effort on preventing potential claims by, for example, introducing excessive and disproportionate health and safety procedures to avert the threat of claims.

(b)

- (i) The most obvious risk is the upside risk arising from the fact that more than 60% of revenue comes from online bookings. Clearly, online booking is a significant part of the attraction to V’s customers, even if the directors believe that they are attracted by the personal advice on offer in branches.

The fact that V does not always make bookings immediately with the hotels and airlines is a major source of concern because of the threat of lost bookings. Presumably there is a possibility that customers could book the same holiday externally with a third party who has a more current system and so V could lose customers to competitors.

The fact that V’s site is five years old is a concern because of security issues. It is possible that V’s system can be broken into or that customers’ details could be lost. There have also been improvements in the design and facilities offered by web pages during that time and so V’s site may appear to be less appealing to customers.

- (ii) The first step is to identify a suitable consultant to advise on this upgrade. V’s IT Director may be in a position to provide overall strategic management, but the director may not have the time or the expertise to manage this project on a day to day basis.

V will have to ensure that any software that it purchases meets the industry standard. One of the major aspects of this upgrade is to enable the company’s systems to integrate and work with those of suppliers. V should meet with the major airlines and hotel chains to identify ways in which the integration of V’s systems could be enhanced. V should enquire as to whether there are likely to be any changes in the foreseeable future so that these can be incorporated into the new system.

V should study the websites of competitors to identify features that could usefully be added to the company’s system. A marketing expert, either from the company’s sales department or an external consultant should advise on ways to design the site to boost sales. Ideally, the proposals should be tested on a sample of V’s customers to ensure that the system is accessible and attractive.

Once the system has been designed it should be tested in some detail before it goes live. The interface with the suppliers’ systems should be tested rigorously to ensure that bookings go through without difficulty.

- (c) Customer demand will depend on price and whether they can easily change where they want to holiday. It will also depend on how V reacts to currency movements. V’s economic exposure arises because of the potential impact of currency movements on demand for its products. To a certain extent, V is protected by the fact that it is industry practice to pass much of the risk of changes in costs on to customers in the form of supplements and so customers cannot avoid supplements by shopping around. Unfortunately, that could change very quickly if one or more of V’s competitors abolishes supplements and renders V uncompetitive. The fact that all travel businesses offer the same holidays, as provided by the same tour operators, means that V Ltd may struggle to compete if other businesses undercut it on price. V does not know what other companies

will do so it cannot predict how this will affect demand for holidays. This may mean its holidays will be expensive compared to other operators and customers could go elsewhere to purchase holidays

Supplements pass some of the cost of currency fluctuations on to customers. However if it becomes more expensive to go on holiday then customers may simply stop travelling. Customers will be conscious of the strength of the SK\$ and its impact on their holiday spending money. If the SK\$ weakens then holidays in the home country will start to appear more attractive and V does not appear to offer any SK-based holidays.

It is possible that some currency movements will have an impact on specific destinations without affecting V. For example if the Turkish Lira strengthens then it will be more expensive to travel to Turkey, but customers might simply switch to alternative destinations. Thus, certain changes will affect the mix of holidays sold rather than the number of holidays or even their profitability.

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## SECTION B

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### Answer to Question Two

#### Rationale

Question 2(a) and (b) draw on section A (*Management and Control Systems*). Part (a) deals with the distinction between feed forward and feedback in the strategic direction of a company. Part (b) addresses the question of whether strategy ought to be updated frequently or put in place as a long-term goal for management.

Part (c) draws on section B (*Risk and Internal Control*). The question deals with the role of the non-executive director who is not an industry expert.

#### Suggested Approach

Part (a) requires candidates to think about the relevance of strategic management. Clearly, strategy requires the directors to be forward looking and responsive. Having said that, there may be an argument that forward looking direction requires an understanding of past performance if it is to be effective. Similarly, frequent updates to corporate strategy may create the risk that management will become confused and frustrated in keeping abreast of the latest developments and their implementation in terms of day to day operations.

Part (b) asks candidates to think about whether non-executive directors should have a voice. Again, this requires some thought about the role of the board and the non-executive directors in particular. Non-executives coming in from a different background may challenge existing ideas and opinions. If that provides some fresh approaches to running the business then it will lead to improvement. If it is based on ignorance and misunderstanding then it will be a distraction.

The nature of this business is that it makes fairly basic components for sale to other manufacturers. It should be borne in mind that this leaves the board with fairly limited scope for developing new strategies.

- (a) K's basic argument is that the board ought to be forward looking, with a view to setting a strategic direction for H. That is a far more constructive approach to running the company than focussing on past performance. Part of her concern may be due to the fact that the half-yearly reports are really just an amalgamation of the monthly management accounts that have already been considered by the executive directors during their monthly meetings.

The Production Director's response is logical because the present arrangements appear to focus on looking at H's present position and reflecting on the effectiveness of its strategies. That is not as pointless nor is it as backward looking as K suggests. H's management team is aware that the board will be looking at performance on a half-yearly basis and so there will always be an incentive to perform well in terms of working towards the company's strategic objectives. Presumably the main board has agreed that six months is a suitable interval over which to review progress, although it is also clearly only a brief period in terms of the company's product life cycle.

The Production Director could be correct in the sense that feed forward control is largely about determining corrective action on the basis of predicted results. Strategic management should be largely about setting targets and developing tactics to achieve those results. Feed forward control is more appropriate to the monitoring of the effectiveness of tactics.

It is to be hoped that neither director is arguing too strongly for one approach to managing H. K is not necessarily asking that the board does not use historical information in order to

inform its deliberations and the Production Director does not appear to be arguing for all board meetings to be backward thinking.

- (b) It could be argued that the board ought to provide senior and middle management with a clear strategic direction. Strategies ought to have clear and specific objectives that give management something to work towards. For example, H's board may ask management to develop plans that will increase production capacity by 50% over the next three years.

Once a strategy has been put in place it should be kept under review and changed if necessary. However, changes should be kept to the minimum, otherwise management will become confused and may be demoralised. H's board should aim to motivate management by demonstrating commitment to the strategy rather than actively engaging in making changes to it. Otherwise, strategic management may be driven by day-to-day changes and circumstances and H will have no real direction.

H is a manufacturing company that requires complex and expensive technology. Many changes in strategy will prove expensive to implement. H exists to service demand for components from a wider industry. Many aspects of strategy will be set by H's customers and H will have to be responsive to the industry's demands. It would make considerable sense for H to consider progress towards implementing strategies on a half-yearly basis but it is unlikely that it will be feasible for the company to make meaningful changes of strategic direction twice per year.

On balance, it appears that K's arguments have been influenced by her experience in the service sector, where it is likely to be possible to be far more innovative because the costs of following different strategic directions are likely to be lower.

- (c) The Production Director's arguments raise significant questions about the role of the non-executive director. It would make little sense for K to have a seat on the board if she was not judged capable of making a meaningful contribution to the board's work.

It could be argued that non-executive directors have a significant role to play in providing oversight of the workings of the board as a whole. To an extent, it would be desirable for the non-executives to maintain some distance from the active management of the company, even at the strategic level, because they will then be capable of being a little more impartial in their oversight. K's role could be more concerned with making sure that the executive directors have a clear and consistent direction in mind for the company, rather than in participating in developing a strategy herself.

It may be possible for the non-executive directors to offer some fresh insights that would not have occurred to their colleagues on the executive board, without compromising their independence. K comes from a completely different background and may be able to ask questions that would not be considered by the executive directors. From time to time it is healthy to challenge accepted norms and to ask whether things could be improved. K clearly has an entrepreneurial outlook and that could raise questions about whether H could identify new revenue streams or meet customer needs in a different way.

If the non-executives are to provide effective oversight then they should not be constrained by the executive directors. They should be permitted to raise questions about any aspect of the company's management. The executive directors should recognise that the search and appointment process should ensure that only competent and capable people are appointed to the board and should respect the non-executives accordingly.

### Answer to Question Three

#### Rationale

This question draws mainly on section D (*Management of Financial Risk*). It deals with the question of whether entities should take exchange rates as given or whether they should consider actively speculating on future rate changes. It uses the possibility of an arbitrage profit to explore the logic underlying pricing mechanisms.

#### Suggested Approach

Part (a) requires the ability to make some calculations that demonstrate that a money market hedge would yield a guaranteed surplus because of some anomalies in the figures presented in the question. Part (b)(i) requires an explanation of the results. Part (b)(ii) requires the ability to recognise that arbitrage profits cannot be made with any consistency unless a substantial investment is made in data and trading infrastructure. These parts of the question are essentially looking for a common-sense understanding of the manner in which markets work.

Part (c) asks for a discussion of the operation of the treasury as a cost centre rather than a profit centre. Again, this is a matter of using common sense to offer an opinion. There is not necessarily a correct answer to this issue and it would be acceptable to argue that there are opportunities to profit from speculation, although the suggested answer argues otherwise.

(a) Principle of borrowing, depositing and selling resulting balance forward

Borrow GBP £10m

Convert to USD at spot rate =  $\text{GBP}10\text{m} \times 1.556 = \text{USD } 15.560\text{m}$

Deposit at 5.12% for three months. Interest =  $\text{USD } 15.560\text{m} \times 5.12\% \times 3/12 = \text{USD } 0.1992\text{m}$

Total deposit by end of three months =  $\text{USD } 15.560\text{m} + 0.1992 = \text{USD } 15.7592\text{m}$

Sell USD forward =  $\text{USD } 15.7592\text{m} / 1.499 = \text{GBP } 10.5131\text{m}$

Interest on GBP borrowings =  $\text{GBP } 10\text{m} \times 5.08\% \times 3/12 = \text{GBP } 0.127\text{m}$

Total repayment =  $\text{GBP } 10.1270\text{m}$

Gain =  $\text{GBP } 10.5130 - 10.1271 = \text{GBP } 0.3861\text{m}$

(b)

- (i) U has clearly identified the possibility of an arbitrage profit that could be exploited without risk to the company. Interest rate parity suggests that if the USD is expected to strengthen against GBP then the interest rate offered for USD deposits should be lower than the rates on GBP. The fact that it wasn't made it possible to borrow in GBP, deposit in USD, sell the resulting USD forward, all in the knowledge that the resulting GBP balance would be more than enough to settle the GBP loan.

Any business opportunity that offers a positive return in absolute terms from zero investment with zero risk must be highly desirable. U has found such an opportunity through good luck. Simple economics suggest that markets will not offer positive returns to participants who do not invest anything and who do not take any risk and so such opportunities will either require great skill to identify or considerable good luck.



- (ii) In practice, arbitrageurs draw attention to anomalies by moving funds to exploit them and the inconsistencies are quickly corrected to make further profits impossible. That explains why U's treasurer did not ask U to act on her discovery. Professional arbitrage companies use electronic trading to seek out these opportunities and exploit them. U discovered the opportunity by chance, but it is unlikely that she would have been able to put the various trades in place quickly enough to beat the professionals.

The very nature of arbitrage means that the trades themselves are risk free, but there are considerable costs associated with arbitrage operations. Arbitrageurs must pay a great deal for real-time market data, which is a substantial fixed cost. There is also substantial investment in the IT systems and other facilities. It is entirely possible that there will be too few opportunities offered by the market to generate an adequate return to cover those costs and provide a realistic return on investment.

The anomalies that arise tend to be far smaller than those discovered by U. Arbitrage requires very large transactions to generate sufficient profit in absolute terms to make the process worthwhile. Participants must be sufficiently liquid to meet margin requirements and to have the confidence of the institutions who have to accept the bids being made.

The financial institutions which create the markets have an incentive to avoid creating arbitrage opportunities and they are clearly going to use sophisticated systems of their own to avoid doing so. There will also be competition from other arbitrageurs, all of whom will be attempting to move more quickly than anybody else so that they enjoy all of the profit.

- (c) Generally, the treasury department provides a service to the entity, by managing cash flows and dealing with banks and other sources of finance. The treasury aims to reduce the costs borne by the entity and the intention is that these savings will more than offset the cost of running the department.

The treasury can only become a profit centre if it develops a revenue stream. Normally that involves speculating in the financial markets in order to generate gains. There are two competing arguments relating to speculation:

- One is that the treasury department has considerable expertise. Speculation is a zero sum game that involves being able to out-think the market and buy or sell mispriced financial instruments. The treasury department could use its natural advantage over other market participants, who have a lesser understanding and inferior data to trade at a profit.
- The counter-argument is that active trading in the markets involves leaving positions exposed to loss and so there is a risk. Losses can arise when trades are unsuccessful. The entity would be bidding against counterparties who may be even more skilled and better informed.

It is generally difficult to make a consistent profit from speculation. Markets are generally efficient and most participants – even trained corporate treasurers – should accept that the market prices are correct. Active trading will increase costs and also increase risks for the entity.

## Answer to Question Four

### Rationale

Question 4 draws on section C (*Audit and Audit of Control Systems*). Part (a) deals with the question of auditor independence. Part (b) deals with the implications of the internal auditor acting in a biased manner. Part (c) deals with the planning of an audit assignment.

### Suggested Approach

Part (a) requires an understanding of independence. In this case it is clear that the auditor's bias is due to a natural inclination to feel some sympathy for the subject of the audit.

Part (b) requires some thought about the problems that a lack of independence will create for the board. If the directors cannot trust internal audit staff then they have no way of telling whether the entity is acting in accordance with their expectations.

Part (c) is looking for the ability to suggest specific and relevant audit tests for dealing with a specific matter.

- (a) An independent auditor would report honestly, without any bias or conflict. Independence is an attitude of mind that involves making a truthful report regardless of the consequences.

In this case, F appears to have identified with the Depot Manager, despite there being no particular reason for doing so. F has been sympathetic to the Depot Manager's position and that sympathy has resulted in a distorted internal audit report.

F's duty was to investigate compliance with a specific rule concerning maintenance and to report the results to senior management. It was not part of F's duty to consider whether a truthful report would harm the Depot Manager's career. The responsibility for deciding whether to take action against the Depot Manager lay with D's board and F should have provided a full report on the circumstances. That report could have included a summary of the Depot Manager's predicament arising because of the absence of the mechanic.

F should not accept responsibility for the impact of a truthful report on the Depot Manager's career. The Depot Manager could have dealt with the fact that there was inadequate cover when the mechanic was absent by reporting the situation to head office. The Depot Manager should not have asked F to deal with this omission retrospectively by lying in the internal audit report.

- (b) 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.

F's behaviour is also sending a very clear signal to D'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 D's board does not act quickly and decisively then its ability to manage the company effectively will be seriously compromised by this audit failure.

- (c) 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 staff 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.

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