

CIMA FINAL ASSESSMENT

Performance Strategy

November 2011

Time allowed

Reading and planning: 20 minutes

Writing: 3 hours

Answer ALL compulsory questions in Section A

Answer TWO of the three questions in Section B

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.

This question paper must not be removed from the examination hall.

Kaplan Publishing/Kaplan Financial

Paper P3

KAPLAN
PUBLISHING

© Kaplan Financial Limited, 2011

The text in this material and any others made available by any Kaplan Group company does not amount to advice on a particular matter and should not be taken as such. No reliance should be placed on the content as the basis for any investment or other decision or in connection with any advice given to third parties. Please consult your appropriate professional adviser as necessary. Kaplan Publishing Limited and all other Kaplan group companies expressly disclaim all liability to any person in respect of any losses or other claims, whether direct, indirect, incidental, consequential or otherwise arising in relation to the use of such materials.

All rights reserved. No part of this examination may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or by any information storage and retrieval system, without prior permission from Kaplan Publishing.

FORMULAE AND TABLES

Annuity

Present value of an annuity of £1 per annum, receivable or payable for n years, commencing in one year, discounted at r% per annum:

$$PV = \frac{1}{r} \left(1 - \frac{1}{[1+r]^n} \right)$$

Perpetuity

Present value of £1 per annum, payable or receivable in perpetuity, commencing in one year, discounted at r% per annum:

$$PV = \frac{1}{r}$$

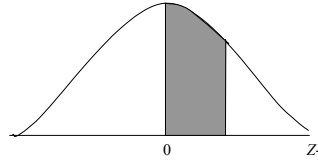
Growing Perpetuity

Present value of £1 per annum, receivable or payable, commencing in one year, growing in perpetuity at a constant rate of g% per annum, discounted at r% per annum:

$$PV = \frac{1}{r-g}$$

Area under the normal curve

This table gives the area under the normal curve between the mean and a point Z standard deviations above the mean. The corresponding area for deviations below the mean can be found by symmetry.



$Z = \frac{(x-\mu)}{\sigma}$										
	0.00	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
0.0	.0000	.0040	.0080	.0120	.0159	.0199	.0239	.0279	.0319	.0359
0.1	.0398	.0438	.0478	.0517	.0557	.0596	.0636	.0675	.0714	.0753
0.2	.0793	.0832	.0871	.0910	.0948	.0987	.1026	.1064	.1103	.1141
0.3	.1179	.1217	.1255	.1293	.1331	.1368	.1406	.1443	.1480	.1517
0.4	.1554	.1591	.1628	.1664	.1700	.1736	.1772	.1808	.1844	.1879
0.5	.1915	.1950	.1985	.2019	.2054	.2088	.2123	.2157	.2190	.2224
0.6	.2257	.2291	.2324	.2357	.2389	.2422	.2454	.2486	.2518	.2549
0.7	.2580	.2611	.2642	.2673	.2704	.2734	.2764	.2794	.2823	.2852
0.8	.2881	.2910	.2939	.2967	.2995	.3023	.3051	.3078	.3106	.3133
0.9	.3159	.3186	.3212	.3238	.3264	.3289	.3315	.3340	.3365	.3389
1.0	.3413	.3438	.3461	.3485	.3508	.3531	.3554	.3577	.3599	.3621
1.1	.3643	.3665	.3686	.3708	.3729	.3749	.3770	.3790	.3810	.3830
1.2	.3849	.3869	.3888	.3907	.3925	.3944	.3962	.3980	.3997	.4015
1.3	.4032	.4049	.4066	.4082	.4099	.4115	.4131	.4147	.4162	.4177
1.4	.4192	.4207	.4222	.4236	.4251	.4265	.4279	.4292	.4306	.4319
1.5	.4332	.4345	.4357	.4370	.4382	.4394	.4406	.4418	.4430	.4441
1.6	.4452	.4463	.4474	.4485	.4495	.4505	.4515	.4525	.4535	.4545
1.7	.4554	.4564	.4573	.4582	.4591	.4599	.4608	.4616	.4625	.4633
1.8	.4641	.4649	.4656	.4664	.4671	.4678	.4686	.4693	.4699	.4706
1.9	.4713	.4719	.4726	.4732	.4738	.4744	.4750	.4756	.4762	.4767
2.0	.4772	.4778	.4783	.4788	.4793	.4798	.4803	.4808	.4812	.4817
2.1	.4821	.4826	.4830	.4831	.4838	.4842	.4856	.4850	.4854	.4857
2.2	.4861	.4865	.4868	.4871	.4875	.4878	.4881	.4884	.4887	.4890
2.3	.4893	.4896	.4898	.4901	.4904	.4906	.4909	.4911	.4913	.4916
2.4	.4918	.4920	.4922	.4925	.4927	.4929	.4931	.4932	.4934	.4936
2.5	.4938	.4940	.4941	.4943	.4945	.4946	.4948	.4949	.4951	.4952
2.6	.4953	.4955	.4956	.4957	.4959	.4960	.4961	.4962	.4963	.4964
2.7	.4965	.4966	.4967	.4968	.4969	.4970	.4971	.4972	.4973	.4974
2.8	.4974	.4975	.4976	.4977	.4977	.4978	.4979	.4980	.4980	.4981
2.9	.4981	.4982	.4983	.4983	.4984	.4984	.4985	.4985	.4986	.4986
3.0	.49865	.4987	.4987	.4988	.4988	.4989	.4989	.4989	.4990	.4990
3.1	.49903	.4491	.4991	.4991	.4992	.4992	.4992	.4992	.4993	.4993
3.2	.49931	.4993	.4994	.4994	.4994	.4994	.4994	.4995	.4995	.4995
3.3	.49952	.4495	.4995	.4996	.4996	.4996	.4996	.4996	.4996	.4997
3.4	.49966	.4997	.4997	.4997	.4997	.4997	.4997	.4997	.4997	.4998
3.5	.49977									

Present value table

Present value of £1 i.e. $(1 + r)^{-n}$ where r = interest rate, n = number of periods until payment or receipt.

Periods (n)	Interest rates (r)									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	.990	.980	.971	.962	.962	.943	.935	.926	.917	.909
2	.980	.961	.943	.925	.907	.890	.873	.857	.842	.826
3	.971	.942	.915	.889	.864	.840	.816	.794	.772	.751
4	.961	.924	.888	.855	.823	.792	.763	.735	.708	.683
5	.951	.906	.863	.822	.784	.747	.713	.681	.650	.621
6	.942	.888	.837	.790	.746	.705	.666	.630	.596	.564
7	.933	.871	.813	.760	.711	.665	.623	.583	.547	.513
8	.923	.853	.789	.731	.677	.627	.582	.540	.502	.467
9	.914	.837	.766	.703	.645	.592	.544	.500	.460	.424
10	.905	.820	.744	.676	.614	.558	.508	.463	.422	.386
11	.896	.804	.722	.650	.585	.527	.475	.429	.388	.350
12	.887	.788	.701	.625	.557	.497	.444	.397	.356	.319
13	.879	.773	.681	.601	.530	.469	.415	.368	.326	.290
14	.870	.758	.661	.577	.505	.442	.388	.340	.299	.263
15	.861	.743	.642	.555	.481	.417	.362	.315	.275	.239
16	.853	.728	.623	.534	.458	.394	.339	.292	.252	.218
17	.844	.714	.605	.513	.436	.371	.317	.270	.231	.198
18	.836	.700	.587	.494	.416	.350	.296	.250	.212	.180
19	.828	.686	.570	.475	.396	.331	.277	.232	.194	.164
20	.820	.673	.554	.456	.377	.312	.258	.215	.178	.149

Periods (n)	Interest rates (r)									
	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	.901	.893	.885	.877	.870	.862	.855	.847	.840	.833
2	.812	.797	.783	.769	.756	.743	.731	.718	.706	.694
3	.731	.712	.693	.675	.658	.641	.624	.609	.593	.579
4	.659	.636	.613	.592	.572	.552	.534	.516	.499	.482
5	.593	.567	.543	.519	.497	.476	.456	.437	.419	.402
6	.535	.507	.480	.456	.432	.410	.390	.370	.352	.335
7	.482	.452	.425	.400	.376	.354	.333	.314	.296	.279
8	.434	.404	.376	.351	.327	.305	.285	.266	.249	.233
9	.391	.361	.333	.308	.284	.263	.243	.225	.209	.194
10	.352	.322	.295	.270	.247	.227	.208	.191	.176	.162
11	.317	.287	.261	.237	.215	.195	.178	.162	.148	.135
12	.286	.257	.231	.208	.187	.168	.152	.137	.124	.112
13	.258	.229	.204	.182	.163	.145	.130	.116	.104	.093
14	.232	.205	.181	.160	.141	.125	.111	.099	.088	.078
15	.209	.183	.160	.140	.123	.108	.095	.084	.074	.065
16	.188	.163	.141	.123	.107	.093	.081	.071	.062	.054
17	.170	.146	.125	.108	.093	.080	.069	.060	.052	.045
18	.153	.130	.111	.095	.081	.069	.059	.051	.044	.038
19	.138	.116	.098	.083	.070	.060	.051	.043	.037	.031
20	.124	.104	.087	.073	.061	.051	.043	.037	.031	.026

Cumulative present value of 1.00 unit of currency per annum.

Receivable or payable at the end of each year for n years $\frac{1 - (1 + r)^{-n}}{r}$.

Periods (n)	Interest rates (r)									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods (n)	Interest rates (r)									
	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.968	4.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

Pre-seen Case Study

Background

Aybe, located in Country C, was formed by the merger of two companies in 2001. It is a listed company which manufactures, markets and distributes a large range of components throughout Europe and the United States of America. Aybe employs approximately 700 people at its three factories in Eastern Europe and supplies products to over 0.5 million customers in 20 countries. Aybe holds stocks of about 100,000 different electronic components.

Aybe is regarded within its industry as being a well-established business. Company Ay had operated successfully for nearly 17 years before its merger with Company Be. Company Ay can therefore trace its history back for 25 years which is a long time in the fast moving electronic component business.

The company is organised into three divisions, the Domestic Electronic Components division (DEC), the Industrial Electronic Components division (IEC) and the Specialist Components division (SC). The Domestic and Industrial Electronic Components divisions supply standard electronic components for domestic and industrial use whereas the Specialist Components division supplies components which are often unique and made to specific customer requirements. Each of the three divisions has its own factory in Country C.

Composition of the Board of Directors

The Board of Directors has three executive directors, the Company Secretary and five non-executive directors. The Chairman is one of the five independent non-executive directors. The executive directors are the Chief Executive, Finance Director and Director of Operations. There is also an Audit Committee, a Remuneration Committee and a Nominations Committee. All three committees are made up entirely of the non-executive directors.

Organisational structure

Aybe is organised along traditional functional/unitary lines. The Board considers continuity to be a very important value. The present structure was established by Company Ay in 1990 and continued after the merger with Company Be. Many of Aybe's competitors have carried out structural reorganisations since then. In 2008, Aybe commissioned a review of its organisational structure from a human resource consultancy. The consultants suggested alternative structures which they thought Aybe could employ to its advantage. However, Aybe's Board felt that continuity was more important and no change to the organisational structure took place.

Product and service delivery

Customers are increasingly seeking assistance from their component suppliers with the design of their products and the associated manufacturing and assembly processes. Aybe's Board views this as a growth area. The Board has recognised that Aybe needs to develop web-based services and tools which can be accessed by customers. The traditional method of listing the company's range of components in a catalogue is becoming less effective because customers are increasingly seeking specially designed custom made components as the electronics industry becomes more sophisticated.

Financial data

Aybe's historical financial record, denominated in C's currency of C\$, over the last five years is shown below.

	<i>Year ended 31 December:</i>				
	2009	2008	2007	2006	2005
	C\$m	C\$m	C\$m	C\$m	C\$m
Revenue	620	600	475	433	360
Operating profit	41	39	35	20	13
Profit for the year	23	21	16	9	5
Earnings per share (C\$)	0.128	0.117	0.089	0.050	0.028
Dividend per share (C\$)	0.064	0.058	0	0	0

Extracts from the 2009 financial statements are given at Appendix A. There are currently 180 million ordinary shares in issue with a nominal value of C\$0.10 each. The share price at 31 December 2009 was C\$0.64. No dividend was paid in the three years 2005 to 2007 due to losses sustained in the first few years after the merger in 2001.

Aybe's bank has imposed an overdraft limit of C\$10 million and two covenants: (i) that its interest cover must not fall below 5 and (ii) its ratio of non-current liabilities to equity must not increase beyond 0.75:1. Aybe's Finance Director is comfortable with this overdraft limit and the two covenants.

The ordinary shareholding of Aybe is broken down as follows:

	<i>Percentage of ordinary shares held at 31 December 2009</i>
Institutional investors	55
Executive Directors and Company Secretary	10
Employees	5
Individual investors	30

The Executive Directors, Company Secretary and other senior managers are entitled to take part in an Executive Share Option Scheme offered by Aybe.

Performance Review

Aybe's three divisions have been profitable throughout the last five years. The revenue and operating profit of the three divisions of Aybe for 2009 were as follows:

	<i>DEC Division</i>	<i>IEC Division</i>	<i>SC Division</i>
	C\$m	C\$m	C\$m
Revenue	212	284	124
Operating profit	14	15	11

Financial objectives of Aybe

The Board has generally taken a cautious approach to providing strategic direction for the company. Most board members feel that this has been appropriate because the company was unprofitable for the three year period after the merger and needed to be turned around. Also, most board members think a cautious approach has been justified given the constrained economic circumstances which have affected Aybe's markets since 2008. While

shareholders have been disappointed with Aybe's performance over the last five years, they have remained loyal and supported the Board in its attempts to move the company into profit. The institutional shareholders however are now looking for increased growth and profitability.

The Board has set the following financial objectives which it considers reflect the caution for which Aybe is well known:

- (i) Dividend payout to remain at 50% of profit for the year;
- (ii) No further equity shares to be issued over the next five years in order to avoid diluting earnings per share.

Capital budget overspends

Aybe has an internal audit department. The Chief Internal Auditor, who leads this department, reports directly to the Finance Director. Investigation by the Internal Audit department has revealed that managers with responsibility for capital expenditure have often paid little attention to expenditure authorisation levels approved by the Board. They have justified overspending on the grounds that the original budgets were inadequate and in order not to jeopardise the capital projects, the overspends were necessary.

An example of this was the building of an extension to the main factory at the DEC division that was completed in 2009 at a final cost of nearly C\$3 million which was almost 50% over budget. The capital budget for the extension was set at the outset and the capital investment appraisal showed a positive net present value. It subsequently became apparent that the site clearance costs and on-going construction expenditure were under-estimated. These estimates were provided by a qualified quantity surveyor who was a contractor to Aybe. The estimates supplied by the quantity surveyor were accurately included in Aybe's capital investment appraisal system which was performed on a spreadsheet. However, no regular checks were carried out to compare the phased budgeted expenditure with actual costs incurred. It came as a surprise to the Board when the Finance Director finally produced the capital expenditure project report which showed the cost of the extension was nearly 50% overspent.

Strategic development

Aybe applies a traditional rational model in carrying out its strategic planning process. This encompasses an annual exercise to review the previous plan, creation of a revenue and capital budget for the next five years and instruction to managers within Aybe to maintain their expenditure within the budget limits approved by the Board.

Debates have taken place within the Board regarding the strategic direction in which Aybe should move. Most board members are generally satisfied that Aybe has been turned around over the last five years and were pleased that the company increased its profit in 2009 even though the global economy slowed down. Aybe benefited from a number of long-term contractual arrangements with customers throughout 2009 which were agreed in previous years. However, many of these are not being renewed due to the current economic climate.

The Board stated in its annual report, published in March 2010, that the overall strategic aim of the company is to:

"Achieve growth and increase shareholder returns by continuing to produce and distribute high quality electronic components and develop our international presence through expansion into new overseas markets."

Aybe's Chief Executive said in the annual report that the strategic aim is clear and straightforward. He said "Aybe will strive to maintain its share of the electronic development, operational, maintenance and repair markets in which it is engaged. This is despite the global economic difficulties which Aybe, along with its competitors, has faced since 2008. Aybe will continue to apply the highest ethical standards in its business activities."

In order to facilitate the achievement of the strategic aim, Aybe's Board has established the following strategic goals:

- 1 Enhance the provision of products and services which are demanded by customers;
- 2 Invest in engineering and web-based support for customers;
- 3 Maintain the search for environmentally friendly products;
- 4 Pursue options for expansion into new overseas markets.

The Board has also stated that Aybe is a responsible corporate organisation and recognises the social and environmental effects of its operational activities.

Concern over the rate of growth

Aybe's recently appointed Director of Operations and one of its Non-Executive Directors have privately expressed their concern to the Chief Executive at what they perceive to be the very slow growth of the company. While they accept that shareholder expectations should not be raised too high, they feel that the Board is not providing sufficient impetus to move the company forward. They fear that the results for 2010 will be worse than for 2009. They think that Aybe should be much more ambitious and fear that the institutional shareholders in particular, will not remain patient if Aybe does not create stronger earnings growth than has previously been achieved.

Development approaches

The Board has discussed different ways of expanding overseas in order to meet the overall strategic aim. It has, in the past, been reluctant to move from the current approach of exporting components. However the Director of Operations has now begun preparing a plan for the IEC division to open up a trading company in Asia. The DEC division is also establishing a subsidiary in Africa.

APPENDIX A

Extracts of Aybe's Income Statement and Statement of Financial Position

Income statement for the year ended 31 December 2009

	2009
	C\$million
Revenue	620
Operating costs	(579)
Finance costs	(4)
	——
Profit before tax	37
Income tax expense	(14)
	——
PROFIT FOR THE YEAR	23

Statement of financial position as at 31 December 2009	2009
	C\$million
ASSETS	
Non-current assets	111
	——
Current assets	
Inventories	40
Trade and other receivables	81
Cash and cash equivalents	3
	——
Total current assets	124
Total assets	235
EQUITY AND LIABILITIES	
Equity	
Share capital	18
Share premium	9
Other reserves	8
Retained earnings	75
	——
Total equity	110
	——
Non-current liabilities	
Bank loan (8% interest, repayable 2015)	40
	——
Current liabilities	
Trade and other payables	73
Current tax payable	8
Bank overdraft	4
	——
Total current liabilities	85
	——
Total liabilities	125
	——
Total equity and liabilities	235
	——

End of Pre-seen Material

SECTION A

This question is compulsory

QUESTION 1

Unseen material for Case Study

African subsidiary plans

The establishment of a subsidiary company for Aybe's DEC division in Africa is dependent upon winning a contract with the African government to provide specialist electrical components to domestic water desalination systems that are vital to the development of the country. The new government of the African country have designated the supply of fresh water as a top priority as the country struggles to come to terms with years of drought and civil war.

The management accountant for the DEC division has been tasked with establishing the overall cost involved in setting up a factory in one of the African country's larger cities, which has been earmarked by the government as a 'new enterprise' zone. Road and rail links are currently being upgraded to cope with the volume of heavy traffic, although the transport links are understandably expected to be below the normal standard Aybe is used to. Deliveries of materials for building, and in the future, components for the desalination equipment will need to be imported from overseas. They will be shipped to the country's main port and driven by road to the location of the factory.

The risk management group within Aybe has identified several significant areas of risk that are likely to influence the costs of establishing the factory in this country. These risks, and the associated costs, are as follows:

<i>Cost item</i>	<i>Expected cost of factory construction</i>	<i>Extra cost if start is delayed start due to heavy wet season</i>	<i>Extra cost if site clearance difficulties arise due to weak local infrastructure</i>	<i>Extra cost if factory construction delayed due to local labour difficulties</i>	<i>Worst case scenario</i>
	<i>C\$m</i>	<i>C\$m</i>	<i>C\$m</i>	<i>C\$m</i>	<i>C\$m</i>
Materials	12.0	1.0	0.6	0.0	13.6
Own labour	8.0	2.0	2.0	0.8	12.8
Subcontract labour	6.0	2.0	2.0	2.0	12.0
	—	—	—	—	—
Total	26.0	5.0	4.6	2.8	38.4
	—	—	—	—	—
Estimated probability		0.4	0.3	0.2	

In addition to the above costs, Aybe plans for a C\$4m 'contingency fund' to protect itself against unexpected cost overruns. It has been estimated that should the initial factory costs of the African subsidiary exceed C\$35m then the company will not be able to secure sufficient funding to proceed, and as a result the project will be shelved.

Asian trading company

The trading company in Asia has recently been established. It has committed to a joint venture with a local manufacturer to build a factory unit that will produce cheap electrical components for use in a variety of commercial appliances. The decision to enter this agreement was made after considering the cheaper labour and material rates in Asia.

The local management in Asia are 94% confident that the total investment needed will be C\$28,000,000, with a standard deviation of C\$3,200,000 based on their past experience of such projects.

Computer systems

Aybe is planning to utilise an external provider to install and maintain a company wide resource planning system to include the two overseas operations. The Director of Operations investigated the cost of purchasing and running the system internally, but concluded that initial set up costs and the additional requirement of a dedicated IT support team were prohibitive. The Board of Directors voted on the use of an external provider for the provision and maintenance of the system, and the vote was carried by a small majority.

The invitation to tender has been issued and they have received four tender documents from interested parties. Upon reading the tender documents, some of the directors have expressed the following concerns:

- the cost saving (compared to internal provision) is not particularly significant, and
- the members of the IT department could be gainfully employed during the year on maintenance of all of the systems of Aybe as well as various other ad-hoc projects as and when they arise.

The Director of Operations has reaffirmed his belief that outsourcing the contract for the resource planning system is the best course of action for Aybe, as there are several other benefits associated with outsourcing.

New directors

The company have recently promoted two members of the senior management team onto the Board of Directors. These directors will be responsible for each of the overseas operations. The Board as a whole is concerned about the lack of clear codes of corporate governance in the African and Asian countries, and as a result, are planning to run the overseas companies in line with the principles-based corporate governance codes of their home country, Country C.

Required:

- (a) (i) **Construct an Expected Value (EV) table showing all possible outcomes (and associated costs) facing Aybe in the establishment of the African subsidiary, along with the combined probabilities of occurrence. Using this table calculate the EV of the costs of the project, and comment upon your result. (7 marks)**
- (ii) **Calculate and comment upon the Value at Risk (VaR) of the Asian joint venture investment. (3 marks)**

- (b) Discuss THREE risks that Aybe faces with the overseas expansion plans, and recommend risk mitigation strategies that the company could take to reduce risk to an acceptable level. (12 marks)
- (c) Evaluate the argument put forward by the Director of Operations that outsourcing the provision and maintenance of the company wide resource planning system is the correct course of action. (12 marks)
- (d) Prepare a report for the two new directors of Aybe. The report should cover the following areas:
- (i) The Board's responsibilities for audit and internal control, along with an explanation of how these can be met, and
 - (ii) A description of how the Board can review the effectiveness of the internal control systems within the company. (16 marks)

(Total: 50 marks)

SECTION B

Answer TWO from three questions

QUESTION 2

SSC is a large textiles company with a stated objective to adopt the highest standards of internal control because it believes that by doing so it will not only provide shareholders with confidence in its governance but also enhance its overall reputation with all stakeholders

In recent years, however, SSC's reputation for internal control has been damaged somewhat. The audit statement of last year was qualified over issues of compliance with financial standards. The previous year there was an unfortunate incident regarding safety of one of the products.

This incident concerned an employee, Miss B, expressing concern about the compliance of one of the company's products with an international standard on fire safety. She raised the issue with her immediate manager but he said, according to Miss B, that it wasn't his job to report her concerns to senior management.

When she failed to obtain a response herself from senior management, she decided to report the lack of compliance to the press. This significantly embarrassed the company and led to a substantial deterioration in SSC's reputation.

The specifics of the case concerned a fabric produced by SSC, which, in order to comply with an international fire safety standard, was required to resist fire for ten minutes when in contact with a direct flame. According to Miss B, who was a member of the quality control staff, SSC was allowing material rated at only five minutes fire resistance to be sold labelled as ten minute rated.

In her statement to the press, Miss B said that there was a "culture of carelessness" in SSC and that this was only one example of the way the company approached issues such as international fire safety standards.

Required:

- (a) **Define reputation risk and evaluate the potential effects of SSC's poor reputation on its financial situation. (5 marks)**
- (b) **Analyse the elements of an effective internal control system as described in the Turnbull report and discuss where SSC differs from this standard. (12 marks)**
- (c) **Identify the key roles of an audit committee and discuss how the existence of such a committee could have assisted in achieving an internal resolution to the incident regarding fire safety standards. (8 marks)**

(Total: 25 marks)

QUESTION 3

Assume that you are treasurer of QW plc, a company with diversified, international interests. The company wishes to borrow £10 million for a period of three years. Your company's credit rating is good, and current market data suggests that you could borrow at a fixed rate of interest of 8% per annum or at a floating rate of LIBOR + 0.2% per annum. You believe that interest rates are likely to fall over the next three years, and favour borrowing at a floating rate.

Your company's bankers are currently working on raising a three-year loan for another of their customers, ER plc. This company is smaller and less well known than QW plc, and its credit rating is not as high. ER plc could borrow at a fixed rate of 9.5% per annum or a floating rate of LIBOR + 0.5%. ER plc has indicated to the bank that it would prefer a fixed-rate loan. Your bankers have suggested you engage in a swap which might benefit both companies. The bank's commission would be 0.2% of the benefits to the two parties. Your counterpart in ER plc suggests that the commission fees and swap benefits should be shared equally.

Assume that interest is paid at the end of each twelve-month period of the loan's duration and that the principal is repaid on maturity (i.e. at the end of three years).

You have been in post for twelve months, having been recruited from a large financial institution. You have a keen interest in using financial derivatives (such as futures and options) to both manage risk and generate revenue. Some board members have expressed concern that your activities may be involving the company in unnecessary risk.

Required:

Write a report to the board which:

- (i) explains the meaning and use of financial derivatives in general terms, and the advantages and disadvantages of their use for companies such as QW plc (8 marks)**
- (ii) describes the characteristics and benefits of interest rate swaps compared with other forms of interest rate risk management, such as forward-rate agreements and interest rate futures (8 marks)**
- (iii) explains the course of action necessary to implement the swap being considered with ER plc, and calculates and comments on the financial benefits to be gained from the operation. (9 marks)**

(Total: 25 marks)

QUESTION 4

TTS produces a variety of garden furniture and equipment including benches, chairs, fences, greenhouses and sheds. All production is located in one factory, although there are three separate raw material stores in outlying buildings.

Management accounting systems report production on a marginal cost basis. Matching of stocks to estimated sales takes place every six months, and production is amended accordingly at that stage.

Computer inventory is updated overnight, following orders made and production carried out in the past day. The hardware is relatively old, with the inventory software itself being a Windows package but running an 'old' DOS database. Given the lack of change to products and production facilities over the last 10 years, there has been no need to upgrade or amend the package.

Raw materials are ordered using email and telephone systems from 55 main suppliers. Order quantities are confirmed within seven days, and stocks arrive any time within the next two weeks. Average raw material stock normally represents six weeks' production. Raw material stocks are delivered to the start of the production line from the three separate stock locations; delays sometimes occur in moving raw material stock around the manufacturing facility.

Following production, finished goods are stored in the main factory awaiting customer order and eventual delivery. The product lines do not change year-to-year; garden furniture tends not to be a particularly innovative industry.

Required:

- (a) Explain the concept of JIT. (7 marks)
- (b) Identify the risks involved in implementing JIT in TTS and suggest methods of overcoming those risks. (10 marks)
- (c) Explain the changes that need to be made to TTS's information systems to allow JIT. (8 marks)

(Total: 25 marks)

You May contact QQ:139169828 MSN: q7jw00001@hotmail.com For More Information !

CIMA P3 PERFORMANCE STRATEGY

You May contact QQ:139169828 MSN: q7jw00001@hotmail.com For More Information !