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Serial No.....

Institute of Certified Management Accountants of Sri Lanka
Strategic Level
May 2015 Examination

Examination Date : 17th May 2015 **Number of Pages :** 06
Examination Time: 1.30 p.m. – 4.30 p.m. **Number of Questions:** 05

Instructions to Candidates

1. Time allowed is **three (3) hours**.
2. Total: **100** Marks.
3. Answer **all** questions in Part I and **three (3)** questions from Part II.
4. The answers should be in **English Language**.

<u>Subject</u>	<u>Subject Code</u>
Risk & Control Strategy and Policy	(RSP / SL 4 – 404)

PART I

Answer **all** questions

Question No. 01 (40 Marks)

SabreTec is a listed company that designs and installs high technology control capital equipment used by multinational manufacturing companies to capture the production numbers. SabreTec, almost 90% of its sales are exported. SabreTec has sales offices in Europe, Asia, the Pacific, Africa, and North and South America and employs about 300 staff around the world. SabreTec has annual sales of USD 200 million but the sales value of each piece of equipment sold is about USD 2 million so the sales volume is relatively low. Sales are always invoiced in the currency of the country where the equipment is being installed. The time between the order being taken and the final installation is usually several months. However, a deposit is taken when the order is placed and progress payments are made by the customer before shipment and upon delivery, with the final payment being made after installation of the equipment.

The company has international patents covering its technology and invests heavily in research and development (R&D, about 15% of sales) and marketing costs to develop export markets (about 25% of sales). SabreTec's manufacturing operations are completely outsourced in its home country and the cost of sales is about 20%. The balance of costs is for installation, servicing and administration, amounting to about 15% of sales. Within each of these cost classifications the major expenses (other than direct costs) are salaries for staff, all of whom are paid well above the industry average, rental of premises in each location and travel costs.

Area managers are located in each sales office and have responsibility for achieving sales, installing equipment and maintaining high levels of after-sales service and customer satisfaction. Although the head office is very small, most of the R&D staff is located in the home country, along with purchasing and logistics staff responsible for liaising with the outsource suppliers and a small accounting team that is primarily concerned with monthly management accounts and end of year financial statements.

SabreTec has a majority shareholding held by Nimal Perera, an entrepreneur who admits to taking high risks, both personally and in business. The Board of four is effectively controlled by Nimal who is both Chairman and Chief Executive. The three other directors were appointed by Nimal. They are his wife, who has a marketing role in the business, and two non-executive directors, one an occasional consultant to SabreTec and the other a long-time family friend. Board meetings are held quarterly and are informal affairs, largely led by Nimal's verbal review of sales activity.

Nimal is a dominating individual who exercises a high degree of personal control, often bypassing his area managers. Because the company is controlled by him, Nimal is not especially concerned with short-term profits but with the long term. He emphasises two objectives: sales growth to generate increased market share and cash flow; and investment in R&D to ensure the long-term survival of SabreTec by maintaining patent protection and a technological lead over its competitors.

Nimal is in daily contact with all his offices by telephone. He travels extensively around the world and has an excellent knowledge of SabreTec's competitors and customers. He uses a limited number of non-financial performance measures, primarily concerned with sales, market share, quality and customer satisfaction. Through his personal contact and his twin objectives, Nimal encourages a culture committed to growth, continual innovation, and high levels of customer satisfaction. This is reinforced by high salary levels, but Nimal readily dismisses those staff not committed to his objectives.

The company has experienced rapid growth over the last 10 years and is very profitable although cash flow is often tight. A high margin is achieved because SabreTec's is able to charge its customers premium prices. The equipment sold by SabreTec enables faster production and better quality than its competitors can offer.

Although budgets are used for expense control and monthly management accounts are produced, they have little relevance to Nimal who recognises the fluctuations in profit caused by the timing of sales of low volume but high value capital equipment. Nimal sees little value in comparing monthly profit figures against budgets because sales are erratic. However, Nimal depends heavily on a spreadsheet to manage SabreTec's cash flow by using sensitivity analysis against his sales and cash flow projections. Cash flow is a major business driver and is controlled tightly using the spreadsheet model.

The major risks facing SabreTec have been identified by Nimal as:

- Adverse movements in the exchange rate between the home country and SabreTec's export markets, which SabreTec treats as an acceptable risk given that historically, gains and losses have balanced each other out;
- The reduction in demand for his equipment due to economic recession;
- A failure of continued R&D investment to maintain technological leadership; and
- A failure to control costs.

Nimal considers that the last three of these risks are addressed by his policy of outsourcing manufacture and continuous personal contact with staff, customers and competitors.

You are required to:

- (a) Identify and evaluate the existing controls within SabreTec (including those applied by Nimal).
(12 Marks)
- (b) Write a report to the Board of SabreTec recommending improvements to the company's corporate governance, risk management strategy, and internal controls.
Note: You should use examples from the case to illustrate your answer. (16 Marks)
- (c) Identify the exchange risks faced by SabreTec and recommend the methods that could be used to manage those risks.
(12 Marks)

(Total 40 Marks)

End of Part I

Part II

Answer any **three (3)** questions

Question No. 02 (20 Marks)

As a CMA member, you have recently been appointed as the Head of Internal Audit for CDE, a multinational listed company that carries out a large volume of internet sales to customers who place their orders using their home or work computers. You report to the Chief Executive, although you work closely with the Finance Director. You have direct access to the Chair of the Audit Committee whenever you consider it necessary.

One of your internal audit teams has been conducting a review of IT security for a system which has been in operation for two years and which is integral to internet sales. The audit was included in the internal audit plan following a request by the Chief Accountant. Sample testing by the internal audit team has revealed several transactions over the last three months which have raised concerns about possible hacking or fraudulent access to the customer/order database.

Each of these transactions has disappeared from the database after deliveries have been made, but without sales being recorded or funds collected from the customer. Each of the identified transactions was for a different customer and there seems to be no relationship between any of the transactions.

You have received the draft report from the Internal Audit Manager responsible for this audit which suggests serious weaknesses in the design of the system. You have discussed this with managers who have told you that such a report will be politically very unpopular with the Chief Executive as he was significantly involved in the design and approval of the new system and insisted it be implemented earlier than the IT department considered was advisable. No post-implementation review of the system has taken place.

You have been informally advised by several managers to lessen the criticism and work with the IT department to correct any deficiencies within the system and to produce a report to the Audit Committee that is less critical and merely identifies the need for some improvement.

They suggest that these actions would avoid criticism of the Chief Executive by the Board of CDE.

You are required to:

- (a) Explain the role of internal audit in internal control and risk management. **(05 Marks)**
- (b) Analyze the potential risks faced by CDE that have been exposed by the review of IT security and recommend controls that should be implemented to reduce them. **(05 Marks)**
- (c) Explain the ethical principles you should apply as the Head of Internal Audit for CDE when reporting the results of this internal review and how any ethical conflicts should be resolved. **(10 Marks)**

(Total 20 Marks)

Question No. 03 (20 Marks)

A merchant in the UK has agreed to sell goods to an importer in the USA at an invoiced price of USD 150,000. Of this amount, USD 60,000 will be payable on shipment, USD 45,000 one month after shipment and USD 45,000 three months after shipment.

The quoted foreign exchange rate (USD per GBP) at the date of shipment are as follows.

	\$ / £
Spot rate	1.690 – 1.692
One-month	1.687 – 1.690
Three-month	1.680 – 1.684

The merchant decides to enter in to appropriate forward exchange contracts through his bank to hedge these transactions.

You are required to:

- (a) (i) State what are the presumed advantages of this.
- (ii) Calculate the sterling amount that the merchant would receive.
- (iii) Discuss the wisdom of hedging in this instance, assuming that the spot rates at the dates of receipt of the two instalments of USD 45,000 were as follows.
- First installment 1.694 – 1.696
 - Second installment 1.700 – 1.704

(10 Marks)

- (b) (i) Explain how foreign exchange transactions using futures would differ from those assumed in above.
- (ii) Describe what other types of contract (apart from those in foreign currencies) are available on the market and how they can assist the financial management of commercial undertakings.

(10 Marks)

(Total 20 Marks)

Question No. 04 (20 Marks)

A large doctors' practice, with six partners and two practice nurses has decided to increase its income by providing day surgery facilities. The existing building would be extended to provide room for the surgical unit and storage facilities for equipment and drugs. The aim is to offer patients the opportunity to have minor surgical procedures conducted by a doctor at their local practice, thus avoiding any unfamiliarity and possible delays to treatment that might result from referral to a hospital. Blood and samples taken during the surgery will be sent away to the local hospital for testing but the patient will get the results from their doctor at the practice. It is anticipated that the introduction of the day surgery facility will increase practice income by approximately 20%.

You are required to:

- (a) Identify the additional risks that the doctors' practice may expect to face as a consequence of the introduction of the new facility.
- (b) Critically discuss the role of systems based internal auditing in relation to the assessment of risk management procedures in any organization.

(10 Marks)

(Total 20 Marks)

Question No. 05 (20 Marks)

- (a) A recent phenomenon in internal audit is the tendency of companies to outsource their internal audit function to the major accounting firms. One of the major reasons for this appears to be the perceived cost benefit.

You are required to discuss the advantages and disadvantages of outsourcing the internal audit function. **(10 Marks)**

- (b) The purpose of a financial statement audit is to add credibility to the reported financial position and performance of a business. The Securities and Exchange Commission requires that all entities that are publicly held must file annual reports with it that are audited. Similarly, lenders typically require an audit of the financial statements of any entity to which they lend funds. Suppliers may also require audited financial statements before they will be willing to extend trade credit (though usually only when the amount of requested credit is substantial).

You are required to identify & explain the primary stages of a Financial Statements audit.

(10 Marks)

(Total 20 Marks)

End of Part II

Present value table

Present value of 1.00 unit of currency, that is $(1 + r)^{-n}$ 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	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

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	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.079	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

End of Question Paper