Institute of Chartered Accountants – Ghana (ICAG)

Paper 2.6

Corporate Strategy, Ethics and Governance

Final Mock Exam 1

Marking scheme and suggested solutions

DO NOT TURN THIS PAGE UNTIL YOU HAVE COMPLETED THE MOCK EXAM
PART A – ANSWER TO COMPSULSORY CASE STUDY

1 Hammond Shoes

Marking scheme

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

(b) 1 mark for each appropriate point up to a maximum of 16 marks
   Up to 4 further marks are available for the style, structure and clarity of answer

(c) 1 mark for each appropriate point up to a maximum of 10 marks

(a) Financial analysis

The financial analysis of Hammond Shoes (HS) is considered below under the key headings of profitability and gearing.

Profitability

The impact of the cheap imports can be clearly seen in Figure 1 as both revenues and gross profit have fallen significantly over the four years.

The gross and net profit margins have declined steadily over the years, as shown below

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>2012</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross profit margin</td>
<td>23.5%</td>
<td>20.0%</td>
<td>17.9%</td>
</tr>
<tr>
<td>Net profit margin</td>
<td>8.2%</td>
<td>4.7%</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

The company have failed to keep costs under control and, while sales have fallen by GHS150m over the four years (approximately a 18% decrease), cost of sales have only decreased by GHS75m (approximately 11.5%). It is likely that this has been caused by reacting to reduced demand by reducing labour. Given the redundancy payments required by law in Arnland and HS’s heavy use of local labour it is likely that this was a costly exercise.

The Return on Capital Employed (ROCE) has also plummeted from 24.14% in 2010 to just 6.45% in 2014.

Gearing

The capital structure of HS has changed significantly over the last few years, no doubt causing concern to this generally risk averse organisation. In particular:

- Long term borrowings have dramatically increased.
- Retained earnings are declining reflecting the higher dividends taken by the family.
- Traditionally the social values of the family have been reflected in the company’s very low level of gearing which was only 6.9% in 2010.
- By 2014 the company was much higher geared having risen to 22.5%.
- While this gearing level is still relatively low, the speed with which these changes have occurred should be of concern to the senior management of HS.

A further concern linked to gearing arises by considering the way the company manages its trade receivables and trade payables.
Goods in Arnland are normally supplied on 30 days credit and back in 2007 HS had no problem in meeting this, however, the time taken on average to pay their suppliers has more than doubled. Over the same period, trade receivables have slightly reduced as shown below:

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2012</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade payables (days)</td>
<td>28</td>
<td>43</td>
<td>63</td>
</tr>
<tr>
<td>Trade receivables (days)</td>
<td>38.65</td>
<td>38.93</td>
<td>36.50</td>
</tr>
</tbody>
</table>

This would indicate that HS appear to be using their suppliers as a source of free credit on top of the bank loads they have taken out in the last few years.

Financing costs have also risen over the last few years. This has directly affected profits and has also caused the interest cover ratio to plummet from 14 to 1.33.

This financial analysis backs up the worrying picture presented in the scenario. Profits are falling and HS is struggling to make the fast cost cuts needed to survive. It is becoming increasingly reliant on external finance which will undoubtedly be a cause of great concern to the owners (on ethical grounds) as well as to their suppliers who are unlikely to remain loyal to HS should the worrying trend of increasingly late payment continue.

**Investment analysis**

The senior management appear to have accepted that the company will continue to experience low sales despite investing in new production facilities. They then only anticipate a 30% chance of sales increasing if there are favourable changes in the environment. This pessimistic view of the company is reflected in both of the scenarios they have developed.

The lower labour costs and increased productivity are projected to provide net benefits of GHS15m over the first three years (GHS5 per year) in both scenarios.

The two scenarios then split to look at the likely outcomes depending on whether low demand continues (Scenario 1) or higher levels of demand are experienced (Scenario 2). The anticipated value of the benefits each of these scenarios would provide are shown below:

**Scenario 1:**

<table>
<thead>
<tr>
<th>Probability of continued low demand</th>
<th>0.7</th>
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</thead>
<tbody>
<tr>
<td>Net benefits per year</td>
<td>GHS5m</td>
</tr>
<tr>
<td>Total benefit for years 4-6 (GHS5 × 3)</td>
<td>GHS15m</td>
</tr>
<tr>
<td>Expected value of benefits (GHS15 × 0.7)</td>
<td>GHS10.5m</td>
</tr>
</tbody>
</table>

**Scenario 2:**

<table>
<thead>
<tr>
<th>Probability of higher demand</th>
<th>0.3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net benefits per year</td>
<td>GHS10m</td>
</tr>
<tr>
<td>Total benefit for years 4-6 (GHS10 × 3)</td>
<td>GHS30m</td>
</tr>
<tr>
<td>Expected value of benefits (GHS30 × 0.3)</td>
<td>GHS9m</td>
</tr>
<tr>
<td><strong>Total expected benefits (GHS15m + 10.5m + 9m)</strong></td>
<td><strong>GHS34.5m</strong></td>
</tr>
</tbody>
</table>

The total expected benefits of GHS34.5 is below the cost of the proposed investment GHS37.5. This suggests that this investment would not be financial viable unless the second scenario actually materialises in which case the total benefits would be GHS45m (GHS15m + GHS30m).

It must be noted, however, that the projection covers only the first six years and, given that the last upgrade was carried out twenty years ago, it is likely that net profits would continue for many years beyond these six. However, it becomes increasingly difficult to predict net benefits beyond that six year timescale.

(b) The question does not require that you use a particular framework to answer this question. The answer below uses the TOWS matrix as it can be linked clearly to the SWOT analysis provided in the scenario. You may have chosen to use an alternative framework such as the Ansoff matrix or the strategy clock. Such approaches are equally valid and you will still earn marks if you chose to use such a method.

The TOWS matrix is a positioning approach to strategy which builds upon the SWOT analysis and categories strategic options under the following headings.

- **SO** strategies employ strengths to seize opportunities.
- **ST** strategies employ strengths to count or avoid threats.
• WO strategies address weaknesses so as to be able to exploit opportunities.
• WT strategies are defensive, aiming to avoid threats and the impact of weaknesses.

The alternative strategic options that Hammond Shoes (HM) could consider are discussed within this framework below.

**Employ strengths to seize opportunities**

• HS could attempt to exploit the opportunities of increased customer spending and consumerism in Arnland through building on its strong retail expertise. This could be achieved by selling complementary goods or competing products in its stores and thus obtaining a cut of the profit margins of its competitors and helping to preserve the long-term future of the shops.

• An additional strength of HS is that it owns land both in Petatown and in the disused factory in the north. Along with the retail expertise these two strengths could take advantage of the opportunity of rising consumerism by developing retail villages on this land. There is a strong trend towards ‘safe’ shopping experiences of this kind in Arnland and this development would provide customers with this valued and sought out experience. There are currently no HS retail stores in either of the towns where these sites are located and so this strategy could be combined with the product diversification described above.

• The opportunity of the internet as a preferred method of purchasing could be addressed though the application of the company's software expertise to the development of an innovative e-commerce site. This would also provide the company with the opportunity to make sales outside of Arnland, opening up markets that have never been within the reach of HS and perhaps significantly widening the customer base.

**Employ strengths to count or avoid threats**

• A key threat to HS is that is facing competition from organisations with lower production costs who can undercut the prices that HS need to charge. Presuming that HS cannot lower its production costs, it could compensate for this by employing its strengths in retail, shoe design and distribution software. It might be possible for innovative production and retail systems to be combined and extended in order to provide economies of supply. This might lead to a reduction in storage and supply costs which would reduce the overall costs faced by HS.

• A further strength of HS is its extensive property portfolio which could perhaps be used to provide short term finance to HS. This may see the company through to a time where overseas production becomes just as expensive as domestic production due to the rising cost of fuel and pressure to raise the pay and conditions overseas. By selling or leasing some of its property HS might be able to remain in business until these changes occur and the competitive playing field is once again levelled.

**Address weaknesses so as to be able to exploit opportunities**

• The weaknesses of outdated production facilities and the cost of production could be simultaneously overcome by investing in the upgrade of production machinery. This would improve productivity, and so reduce unit costs, while also reducing energy costs through the use of modern equipment. The board has suggested that overcoming these weaknesses would allow HS to continue to compete in their existing market.

• The opportunity of appealing to the rising number of green consumers in Arnland might also be exploited through the reduced energy costs achieved through the overcoming of the current production weaknesses. The energy efficient process would be likely to raise the appeal of these products to ethical consumers who may already have some support for the company given that its products are produced locally rather than transported many miles at significant cost to natural resources. The marketing department of HS could incorporate details of their 'lowered carbon footprint' in order to increase the appeal of their products to this segment of the community.

• The weakness of the expensive production process could be converted into a strength by building on the negative publicity recently given to the competitors that use cheap and exploited labour. This could be done by ensuring the country of origin is a key message in HS’s manifesto, backed up by details of its commitment to local jobs and communities and minimising energy consumption and pollution via short shipping distances. This may lead to an
increase in appeal of the products to people who are willing to pay a premium for ethically sourced products.

Avoid threats and the impact of weaknesses

- The threat of cheap imports and the high cost of labour weakness could possibly be avoided were HS to consider diversifying into footwear products which have lower raw material demands or where a premium can be charged due to either product quality or appropriate branding. For example, children's shows use less raw material and, on the whole, require less precision. This is an appealing market as children's feet grow quickly meaning that their shoes must be regularly replaced and parents wish to avoid the permanent damage to their children's feet which could arise as a result of wearing inappropriately sized shoes. Retail strengths such as the extensive product knowledge of HS staff and excellent customer care could be employed to support this approach. Re-branding of HS as primarily a children shoe supplier would reinforce the new message, while a scaled back selection of adult shoes would still be available as cross-sale products which could be purchased impulsively by parents visiting with their children.

- Other possible niches might be high quality fashion shoes for which customers may be prepared to pay a premium. Appropriate marketing and a degree of exclusivity would be required to support this approach. Aside from the premium that can be charged, this market is also appealing as customers who buy shoes in line with fashion are likely to make replacement purchases regularly as the fashion seasons come and go.

(c) An organisation's mission is its basic purpose; what it is for and why it exists. It defines the overall direction and purpose of an organisation. A mission statement is a formal document that states the organisation's mission. They are published within organisations to promote desired behaviour: support for strategy and purpose, adherence to core values and adoption of policies and standards of behaviour. Critics, however, argue that they are can be full of generalisations and little more than public relations exercises that are ignored in practice. Most organisations tend to take the approach of using a short strap-line backed up by a more in-depth details of what the organisation is about, its stakeholders and how it wishes to interact with those stakeholders.

Defining a mission statement also allows an organisation to communicate its core values, either within the mission statement itself or in subsidiary statements, web resources or corporate reports. Core values inform customers and suppliers about the way an organisation chooses to carry out business.

Hammond Shoes (HS) appears to have very strong values (such as secure jobs and good working conditions) however, it would seem that these values are not well communicated – even internally to its own senior management. This was illustrated by their suggestion of closing the Petatown production plan and outsourcing production to reduce costs. The quick dismissal of this proposal by the Hammond family highlighted their continuing commitment to the community of Petatown, a core value of which the senior management were seemingly unaware.

Explicate statement of the core values of HS would help the organisation to prevent future misunderstandings and ensure that business is carried out in the way the organisation believes it should. Such a statement would also communicate these values to external parties such as customers and suppliers. Some customers may share similar values and so chose HS as a way of supporting local business.

Objectives are statements of specific outcomes the organisation wishes to achieve. They should translate the mission into specific goals relating to the more operational running and should be consistent not only with the overall message of the mission but also with each other. Often such objectives are expressed in financial terms (eg profit levels) or in marketing terms (eg target market share), however JS and W recognise that unquantifiable objectives (eg being a leader in technology) are equally valid. HS has a number of such objectives including the provision of education for employees and providing good working conditions. However, not all objectives should be of this kind and it is necessary that management do have some quantified and prioritised objectives to work towards rather than constantly work towards vague, immeasurable objectives.

Setting up such objectives would provide HS with the opportunity to bring the work of the various departments, managers and employees into line with the overall objectives and develop an
understanding of how their roles fit into the organisation’s mission at an individual level. The scenario illustrates a lack of communication of the objectives down through the organisational layers and represents a key weakness of the business that could be responsible for any number of internal failings. For example, linking the requirement to pay suppliers within 30 days to the core objective of fair treatment of suppliers may have prevented the payment of suppliers slipping to over 60 days. As is stands, HM fails to meet this important corporate objective.

Overall it can be seen that HS do not have a clear mission statement backed up by clearly defined objectives. This needs to be considered urgently, and alongside the strategy review, to ensure this is fully in place and communicated when the new strategy goes live.
1 Joe Swift Transport

Marking scheme

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

(a) The suitability, feasibility, acceptability technique can be used to assess the attractiveness of EVM as an acquisition target.

Suitability

Suitability relate to the strategic logic of the strategy – it should fit the organisation's current strategic position and should satisfy a range of requirements.

Acquiring EVM would appear to be a suitable strategy for Swift. This is based on a number of considerations:

- The Ambion market is mature and highly competitive. This pushes down profit margins.
- The Ambion government is hostile to road transport. This has led to high taxes and restricted working practices which again push down margins.
- Acquiring EVM would provide Swift with access to a new market in which demand is growing, competition is immature and the government are investing in road transportation.
- Acquiring EVM will increase the overall size of the group, allowing increased economies of scale to be exploited which purchasing trucks and other equipment.

However, suitability of the acquisition may be reduced in light of any potential culture clash that may arise between the two companies involved. These may arise for a number of reasons:

- Swift has no experience of operating or acquiring foreign companies.
- Swift has no experience of trading in Ecuria.
- Although EVM is now a private company, the mindset may still be that of the government organisation it once was. Changing these practices, although potentially leading to higher profits, may be complex and could lead to reputation-damaging labour disputes. This may be unavoidable if Swift attempt to force the Ambion style working practices upon them, and may lead to conflict that could be impossible to resolve.

Acceptability

The acceptability of a strategy depends on expected performance outcomes and the extent to which these are acceptable to stakeholders. Acceptability can be evaluated by considering return, risk and shareholder reactions.

Return

- EVM delivers a Return on Capital Employed (ROCE) of 18.4%. This is very similar to the ROCE of Swift Transport and appears to be a strong performance for the sector. This should be acceptable to Swift shareholders.

- The gross profit margin at 20% is higher than that of Swift, however, its net profit margin of 7.5% is lower. This may raise concerns over suitability. The low net profit margin may be due to EVM still carrying high costs from its state owned days. However, it is possible that Swift will be able to improve the profit margin through economies of scale and by implementing competences gained at Albion. This would make the prospect more acceptable.
Risk

- Liquidity (as demonstrated by the current ratio of 1.14% and the acid test ratio of 1.05%) is much lower than that of Swift. Swift will have to determine why this is the case.
- Gearing (30.9%) is much lower for EVM than for Swift. This may indicate a more conservative approach to long-term lending.
- The interest cover ratio (5) is half that of Swift. This could indicate lower profitability and higher business taxation.

Stakeholders

- Swift is still a private run company and the family are major shareholders making opposition to the acquisition from the shareholders unlikely.
- Drivers may not be in full support of the acquisition.
- Joe has openly criticised the government who may now respond, for example they may impose taxes on foreign investment.

Feasibility

Feasibility is concerned with whether the strategy can be implemented and if the organisation has sufficient strategic capability (resources and competences) to deliver it. Swift has the funds in place and its competences are one of the main factors driving the acquisition. This would suggest that the acquisition is a feasible strategy for Swift to pursue.

(b) Porter suggests that some nation's industries are more internationally competitive than others and this is due to the conditions in that country that may help firms to compete. This means that the location of the company can play a big part in establishing international competitive advantage. Porter's Diamond consists of four main determinants of competitive advantage, along with chance and government which exist outside the diamond.

Factor conditions

These are factors, such as skilled labour and infrastructure, that are necessary for firms to compete in a given industry.

Significant factor conditions in Ecuria are the work ethic of the people, and the government investment in the transport infrastructure.

Demand conditions

The home demand conditions are how firms perceive, interpret and respond to buyer needs.

In Ecuria, there has been a rapid growth in the transport of goods due to the moved to a market economy. The people of Ecuria are traditionally demanding and have a passion for promptness and precision which has shaped the operations of EVM.

Related and supporting industries

Competitive success in one industry is often linked to success in related industries.

The case study does not provide any evidence that there are internationally competitive industries related to logistics. The absence of internationally successful related and supporting industries is an important factor to take into account when Swift decide whether to move a large part of its logistics business to Ecuria.

Firm strategy, structure and rivalry

Nations are likely to display competitive advantage in industries that are culturally suited to their normal management practices and industrial structures.

EVM was created by the nationalisation of the state-run haulage system. There were few competitors initially and raising finance is difficult due to the structure of the capital markets in Ecuria. As a result, most of EVM's competitors are small, family run firms that offer a local service.

Rivalry is also important as Porter suggested that there is a relationship between the creation and sustainability of competitive advantage and intense domestic rivalry. There is little evidence of rivalry in Ecuria. When there is little domestic rivalry, firms are generally happy to rely on the home market.
In addition to the four main determinants, competitive advantage will also be determined by chance and government. Chance factors are developments outside of the control of firms and the nation’s government, such as wars or falls in foreign demand.

Government helps to shape the diamond overall by creating policies which affect all four of the determinants. Ecuria’s government has influenced factor conditions by investing in infrastructure, and has influenced firm structure and rivalry via its policies on capital markets.

2 GreenTech

Marking scheme

(a) 1 mark for each relevant point (strength, weakness, opportunity or threat) up to a maximum of 8 marks  
(b) 1 mark for each relevant point about Lewis-Read’s proposal, up to 3 marks
1 mark for each relevant point about Fenix’s proposal, up to 3 marks
1 mark for each relevant point about Ag Wan’s proposal, up to 3 marks
1 mark for each relevant point justifying the selection of Ag Wan’s proposal, up to a maximum of 3 marks

(a) SWOT analysis of greenTech

Strengths

Financial position – greenTech has grown steadily, and has been consistently profitable since its foundation. As a result it has accumulated a cash surplus of GHS17m.

Competitive strategy – greenTech has followed a clearly defined strategy, as a focussed differentiator, in a specific market niche.

Core competencies – greenTech has accumulated significant technical know-how and competencies in ‘green’ technologies.

Management team – The management team have been in place since the company was founded, and so greenTech has a stable management team with extensive knowledge of the business.

Established brand – Market research indicates that 70% of the global electronics industry uses greenTech components somewhere in their products. This should mean that greenTech has established a strong brand name in the market, which in turn can support its strategy as a focussed differentiator.

Weaknesses

Low marketing expenditure – Although marketing expenditure has increased significantly from 2012-4, it is still very low, being just over 0.3% of revenue in 2014.

No marketing spend on fully assembled green computers – greenTech does not spend any of its marketing budget on promoting fully assembled green computers. Although these currently only generate a small proportion of greenTech’s revenue, they could be an opportunity for growth if they were marketed better.

Ordering process – The current process for ordering and configuring computers has a number of deficiencies which result in greenTech losing potential sales.
**No manufacturing capacity** – greenTech has no manufacturing capability and so is vulnerable to problems in the chain.

**Management team** – The management team have been in place a long time now but there is a danger they are running out of ideas for the company. greenTech has accumulated a large cash surplus, but it does not appear to know what to do with it.

**Opportunities**

**Government policy** – The government has just announced a preferential procurement policy for energy efficient computers. This should allow the ‘green’ segment of the market to continue to grow.

**Growth of green consumption** – Society is becoming more environmentally conscious, and so consumers are increasingly looking to buy environmentally friendly products. This is likely to increase the number of people looking to buy ‘green’ components.

**Growth into new sectors** – Although greenTech has so far concentrated on selling to the electronics industry, the increase in environmental awareness should mean that companies in other industry sectors look to produce products that are quiet, recyclable and low emissions. This should provide opportunities for greenTech to supply components for them.

**Interactive technology for developing prototypes** – The current process for producing fully assembled computers is not interactive. However, technological developments should allow customers to construct virtual prototypes of the computers they want, and, in future, possibly also other electronic equipment.

**Threats**

**Supplier bargaining power** – Because greenTech has no manufacturing capability it is vulnerable to suppliers increasing their prices or to other problems which could occur in the supply chain.

**Competitive rivalry** – Although greenTech’s sales are increasing, it is still a relatively small company and so is unlikely to be able to compete with the established global suppliers of fully assembled computers.

**Barriers to entry to new markets** – The fact that there are already large global suppliers who supply the market for fully assembled computers may act as a barrier to entry into the market. These global suppliers will benefit from economies of scale in production and distribution, for example, which greenTech is unlikely to be able to match.

(b) **Briefing paper**

The purpose of this briefing paper is to provide an evaluation of each of the three proposals put forward for the future development of greenTech. It will then identify the chosen strategy and explain why this is the best strategic option for greenTech to pursue.

**Lewis-Read’s proposal**

Lewis-Read is suggesting a **market penetration** approach, in which greenTech **gains market share** through **increasing its marketing activity**.

Lewis-Read’s proposal only seems to focus on the **market for fully assembled green computers**.

**Growth opportunities** – The logic behind their proposal is likely to be that this **market will grow rapidly**, as domestic and commercial customers look to buy more environmentally friendly computers.

This growth will be further enhanced by the **government’s procurement policy** which will promote energy efficient computers.

**Low start point** – At the moment, greenTech’s **sales of fully assembled computers are very low**, and greenTech does not devote any of its marketing expenditure to promoting ‘green’ computers. This lack of marketing and promotion may well explain the relatively low sales of fully assembled green computers. Consequently, Lewis-Read’s proposal would be that greenTech **increases its marketing expenditure** in order to take advantage of the opportunities in a growing market.
Competing with customers – However, if greenTech starts selling computers directly to home users and companies it will be competing directly with two of its customers, who are medium-sized computer manufacturers. GreenTech needs to be aware of the risk that these two manufacturers will stop using greenTech as a supplier if it becomes a direct competitor. It needs to consider the potential loss of sales to the manufacturers compared to the potential new sales from marketing its own fully assembled green computers more vigorously.

Fenix’s proposal

Fenix are suggesting a **product development** approach, in which greenTech aims to offer a **more comprehensive product range**.

**Buy manufacturing capability** – A key aspect of the Fenix proposal is that it looks to **protect greenTech’s supply chain**. Currently greenTech has no manufacturing capability and so is vulnerable to a supplier raising prices, terminating its contract with greenTech, or even going out of business.

Fenix argues that if greenTech had its own manufacturing plant it would remove these risks. Also, having its own manufacturing plant might allow greenTech to reduce its supply costs compared to having to buy in components.

**Acquisition** – greenTech will either have to set up its own manufacturing plant or acquire one. Fenix suggests that acquisition is the more practical option, because it will take a lot of time and money to set up a manufacturing plant organically. Acquiring an existing manufacturing company will provide a much quicker solution, although, since greenTech’s management have no experience of making acquisitions, it will also bring its own problems.

In addition, as acquisition could prove to be expensive. There are a lot of costs involved in buying a new company, particularly if the directors of the target company resist the acquisition. Although greenTech have a large surplus, the management will have to ensure they have sufficient funds available to finance the acquisition.

Evidence suggests that over half of all acquisitions fail. If greenTech implements this strategy, it must be prepared to face a number of challenges, such as compatibility problems and resistance from the target company and its customers, if it is to succeed.

**Professor Ag Wan’s proposal**

**Exploiting core competencies** – Professor Ag Wan’s proposal suggests that greenTech should look for ways of using its **core competencies** with green technology in other industries, or with other products.

Professor Ag Wan is suggesting that greenTech finds **new uses for existing products and knowledge**.

**Change in approach** – However, this requires greenTech to make quite a significant change to the way it looks at itself: instead of being a supplier of components, it will now become a **supplier of ideas and technology**.

However, making this move will allow greenTech to compete in the market for green technology as a whole, rather than being restricted to a single market sector: electronics.

**Rise of green consumers** – There is an increasing number of consumers who want to buy from companies which demonstrate ‘green’ credentials and have sustainability policies. This growth of ‘green’ consumers will support greenTech as it exploits its competencies in green technologies.

**Government policies** – Government policies will also support the growth of the green technology market. For example, as tougher laws on emissions and waste disposal, the demand for green products should increase.

**Market research** – If Professor Ag Wan’s proposal is to be successful, then greenTech will need to identify suitable new market sectors to move into. Therefore, greenTech should use some of its surplus cash on market research to identify the most lucrative potential markets to enter.

**Justification of selection**

**Lewis-Read’s solution is not suitable or feasible**

**Feasibility** – Lewis-Read’s solution aims to take advantage of the large potential market for green computers, recognising that it is currently under-promoted and under-sold. However, the computer market is very competitive, and dominated by global brands, and so it is unlikely that greenTech will have sufficient marketing funds available to make a significant impact in the market.
Suitability – In the first instance, greenTech might be able to maintain a niche position, selling its ‘green’ computers at a premium price. However, it is likely that the major suppliers could soon produce computers that compete directly with greenTech, meaning greenTech no longer differentiates itself from its competitors, forcing it to reduce its prices.

By producing its own computers, greenTech would also potentially come into conflict with the two medium-sized computer manufacturers it currently supplies components to. This could mean they stop buying components from greenTech.

Fenix’s solution is not acceptable

Fenix’s suggestion would have the benefit of reducing greenTech’s reliance on its suppliers, and could allow it to reduce costs. However, it would involve greenTech acquiring another company, and historically greenTech has grown organically rather than by acquisition.

GreenTech has no experience of acquiring or integrating companies, and the management team seem quite conservative and risk-averse. Therefore the risks involved in making an acquisition are unlikely to be acceptable to them.

Ag Wan’s solution

By contrast, Professor Ag Wan’s solution which allows greenTech to continue to exploit its key competencies and know-how is acceptable. It is feasible because it does not appear to require any significant funding or additional resources. And the fact that it allows greenTech to use its competencies in a new and exciting way, which could be motivating for staff, also make it a suitable strategy.

Furthermore, Professor Ag Wan’s solution seems to accept that most of greenTech’s current activities are will fellow electronics companies or enthusiasts, and it will continue that tradition. Transactions are likely to remain primarily business-to-business.

3 Genetically modified plants

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<thead>
<tr>
<th>Marking scheme</th>
<th>Marks</th>
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<tbody>
<tr>
<td>(a) 2 marks for each appropriate point for each of the three stakeholders (government, lobby groups, local community) up to a maximum of 6 marks</td>
<td>6</td>
</tr>
<tr>
<td>(b) 3 marks for each appropriate point for each of the three stakeholders (government, lobby groups, local community) up to a maximum of 9 marks, plus 1 mark for the overall conclusion</td>
<td>10</td>
</tr>
<tr>
<td>(c) 1 mark for each dimension up to a maximum of 4 marks, plus 1 mark for the overall conclusion</td>
<td>4</td>
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(a) Responsibility to the government

Legal obligations – B has a duty to comply with all the legislation which is currently in force in its country. This will include employment laws and health and safety laws, for example governing the working conditions in which B’s staff work.

However, B does not have any direct responsibility to the government in respect of the seeds it produces. Not only are B’s seeds not genetically modified (GM), but also the national government has not actually passed any legislation banning the research and development of GM crops.

Financial obligations – B has a responsibility to pay corporate taxes on its profits and account for the relevant payroll taxes on its staff.

Innovation and leadership – Although the primary responsibility in developing the non-GM technology is to the international community and to poorer farmers as a whole, rather than the government, B
might be seen to have a secondary responsibility to the government as an industry leader. If B can develop the new technology and develop it so that the seeds can be produced on a commercial scale, this could be a source of new jobs and additional revenue for the government. Moreover, it will establish B's country as the leader in this field, generating prestige and a favourable international reputation.

Responsibility to environmental lobby groups

**Explain seeds are not genetically modified** – The lobby groups’ opposition to B’s work comes from the fact that they believe B’s seeds are genetically modified. However, as this is incorrect, B should explain to the lobby groups that it is not genetically modifying the seeds.

Although B does not have to explain any details of its work which could be commercially sensitive, it should nevertheless explain the nature of its work sufficiently to illustrate that it is not genetically modifying the seeds in the way the lobby groups believe. Although B cannot stop the lobbyists opposing its work, it does have a responsibility to ensure that the lobbyists are aware that it is not actually genetically modifying seeds.

**Highlight the potential benefits of its work** – There is a danger that by trying to stop B developing the seeds, the lobby groups will be preventing the development of a product which could be beneficial to society as a whole.

To this end, B should highlight the potential benefits of its seeds, and, in particular, how they could be a major benefit to populations in the developing countries of the world.

Responsibility to the local community

**Explain the nature of its work** – In the same way that B needs to explain to the lobby groups that it is not genetically modifying seeds, so it also needs to explain this to the local community to try to reduce their opposition to its work. Again, B needs to explain that opposing its work could prevent B from developing a product which could be very beneficial to society as a whole.

**Responsibility as an employer** – B is also likely to have a responsibility to the local community as an employer of local people. As an employer, B contributes jobs and income to the local community, and it should consider the potential impact on the local community if its moves to a new country.

**Good corporate citizen** – More generally, B has a responsibility to the local community to be a good corporate citizen. For example, as a research and development company with highly skilled staff, B could support some educational initiatives in local schools and colleges.

(b) One of the main problems B seems to be facing is that key stakeholder groups do not really understand the nature of its work. Therefore, educating them about its processes will be crucial for B to improve relationships with them.

The government

**Explain benefits** – B should explain to the relevant government minister the potential benefits that the research could bring to the country. It is vital that B explains that its process does not involve genetic modification, and therefore offers a possible commercial alternative to GM crops.

If B carries on with its research, and subsequently produces its seeds in commercial quantities, this could have significant economic benefits for the country. B could generate significant export earnings, and as production grows, the local economy would also benefit through the creation of jobs and supporting services.

**Explain the science** – The government is likely to employ scientists of its own, particularly as it is currently conducting an enquiry into the safety of GM crops. B’s scientists should try to develop good relationships with the government scientists to explain that B’s technology is safe, and that its processes do not involve genetically modifying the seeds.

**Co-operate with government enquiry** – It is also important that B is seen to be co-operating with the current government enquiry into GM crops. This might make the government and other key stakeholders view B more favourably, and it will give B the opportunity to show its processes do not involve genetic modification of crop seeds.

Nonetheless, B should not disclose information which is commercially sensitive, because this could allow competitors to obtain details of its work, and develop similar processes of their own.
Environmental lobby groups

**Explain processes do not involve genetic modification** – The lobby groups remain convinced that B's work does involve genetically modifying crops, and B has to persuade them this is not the case. It is likely that the lobby groups, like the government, have scientists working for them, so B could look to explain the principles of their work to the scientists to get them to appreciate that B's processes do not involve genetic modification.

**Explain wider benefits** – As well as explaining its processes, B should be looking to explain the wider benefits of its work. If it can develop pest-resistant seeds, this will allow farmers (particularly in developing countries) to grow better crops and hopefully also improve their standard of living. This could also bring wider environmental benefits: if the farmers can improve the yield of their current land, this might reduce deforestation rates and erosion, because there will be less pressure to bring extra land under cultivation.

The local community

**Press and media stories** – Many people in the local community will not understand the detail of what B does, but will only be aware of B's work through the stories reported in the press and the media. It is therefore important that B increases its communications with the media, so that they can present B's side of the story as well as is opponents' views. To this end, B could hold regular press releases, and possibly could even invite some journalists to see some of its processes, to highlight that they do not involve genetically modifying any crops. Again though, B has to strike a balance between giving people more information and preserving commercial sensitive details.

**Local government** – The local government could be another important stakeholder in the local community, so B should also look to improve communications with it. If the local government (and in particular any local government scientists) accept that B's work is safe and doesn't involve any genetic modification, then the local community may also be more likely to accept it.

**Support community projects** – B might also be able to improve its relationship with the local community by getting more involved with local people. For example, it could sponsor some local events, or provide some financial support to community projects.

(c) **Legal**

B has no legal obligation to be based in one country as opposed to another. Therefore, if it chooses to move to another country it is free to do so.

Clearly, B will still need to comply with the laws and regulations of the country it moves to, but it is unlikely these will be more rigorous than those it currently has to follow.

One issue which B will need to be aware of, however, is that if there are any international standards governing genetic engineering processes and practices, then it will need to ensure it complies with these whichever country it is based in.

**Ethical**

The main ethical issue in this scenario appears to be that the lobby groups feel that B's work is unethical because it allegedly involves the genetic modification of seeds. B's own directors know that their work does not involve genetic modification, and so the ethical objections are not justified on scientific grounds. However, it is likely that the lobby groups will continue to object to B's work, wherever it is located.

B's motive for moving to a new country is that it the new country is more supportive of biotechnology research and development. So there may be a perception in this country that the greater good of being able to produce seeds which help to feed people better outweighs the concerns that some groups have about genetic modification. In which case, if relocating helps B develop the product and then produce it commercially, the move should be supported.

**Economic**

Demand for genetically modified food is growing worldwide, and this looks to provide B with good opportunities for economic growth. B has an economic objective to generate a profit for its owners and so if moving to a new country helps it to grow and achieve more profit, then that is a valid reason for moving.
Moreover, if B grows and becomes a successful business, its success will also benefit its new host country. The government will benefit from tax revenues, and the local economy could benefit through B’s investment in it, and through the demand for supporting goods and services.

Ultimately, if B becomes very successful, it could prompt other similar companies to move to the country, and could lead to the development of a biotechnology cluster there. This again would be economically beneficial to B’s new host country.

**Philanthropic**

Although the new country has a more tolerant attitude to research and development than B’s current country, some locals may still be unhappy about the potential impact of a new business on their amenities and their way of life. However, B should be keen to work with the local community so that the community supports it rather than resents it.

One of the ways B can gain the local community’s support is by improving people’s quality of life, and *giving something back to society*. For example, B could support some local education projects: either by helping to fund new schools or colleges, or by running some education programmes for local farmers.

### 4 LAS corporate headquarters

**Marking scheme**

<table>
<thead>
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<tbody>
<tr>
<td>(a) 1 mark for each other party up to a maximum of 4 marks</td>
<td>4</td>
</tr>
<tr>
<td>(b) 1 mark for the purpose of a mission statement and 1 mark for each advantage, up to a maximum of 3 marks</td>
<td>4</td>
</tr>
<tr>
<td>(c) 2 marks for each actual or considered breach of the Code of Ethics up to a maximum of 8 marks, plus 4 marks for the advice</td>
<td>12</td>
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<td>20</td>
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(a) **Stakeholders** – The other parties with an interest in LAS’s annual report will be its other stakeholders (in addition to its shareholders.)

Stakeholders are groups or individuals who have an interest in an organisation’s strategy. Shareholders are one stakeholder group, but other stakeholder groups are likely to include: customers, employees and management, suppliers, local communities, interest and pressure groups.

(b) **Purpose** – A mission statement conveys an organisation’s fundamental objectives. Although there isn’t a standard format that mission statements have to follow, they can highlight the purpose of an organisation; what its values are; what the commercial logic and nature of its business is; and the policies and standards of behaviour that underpin the way it does business.

**Advantages**

**Analyse purpose and values** – LAS’s stated purpose when it was founded was ‘to trade in Empire commodities.’ However, this is no longer relevant, since LAS is now an international property company.

In order to prepare a mission statement, LAS would need to analyse what it believes the key purpose and values of the company currently are, and this analysis could be helpful for LAS’s strategic planning (for example, it may suggest new strategic options.)

**Communication to external stakeholders** – The mission statement will help communicate LAS’s identity and purpose to the different countries and markets in which it does business. Understanding its values and beliefs could help potential customers decide whether to choose LAS to manage their property business in preference to competitors.
Motivation for staff – If the mission statement is published throughout the company so that all the staff are aware of it, this could help motivate the staff by making them feel their work is significant and is contributing to the corporate values.

(c) Code of Ethics – IFAC’s Code of Ethics highlights five fundamental principles dealing with integrity; objectivity; professional competence and due care; confidentiality; and professional behaviour. The Finance Director’s suggestion will only constitute a breach of IFAC’s Code if it contravenes one of these principles.

Although the decision to move the headquarters was made by the Board of LAS as a whole, the Finance Director must take some responsibility for it: partly because he made the original decision, and partly because, as a member of the Board, he shares in the collective responsibility of the Board.

Redundancies – The relocation of LAS’s headquarters to London will mean that 80 employees in Ghana lose their jobs, and they are unlikely to be able find replacement jobs. Consequently, the decision to relocate is likely to have an adverse impact on these 80 employees. However, the fact that people are being made redundant does not necessarily make the decision to move LAS’s headquarters unethical. Sometimes difficult decisions have to be made in the best interests of an organisation.

Fiduciary responsibility – The Directors are obliged to act in a way which is most likely to promote the success of the company for the benefit of its shareholders. In this case, it appears that there are genuine business reasons to relocated to London: for example, finance can be arranged more cheaply, and some of LAS’s transactions costs would be lower.

Given this, it seems that the Finance Director is simply carrying out his fiduciary duty to the shareholders by suggesting the relocation to London.

Objective decision - There is no indication that the director has been forced to suggest London as an alternative site for the headquarters, nor that he has any self-interest in doing so. Given that LAS’s business is spread relatively thinly across 28 different countries, there is no apparent reason why a location in any of those countries would necessarily be more suitable for the headquarters than London.

Therefore, the decision to move to London appears to be made for objective business reasons: driven by lower financing costs.

Advice

Consequently, although the suggestion will have adverse consequences for the 80 employees who will lose their jobs, the suggestion does not appear to constitute a breach of IFAC’s Code of Ethics.

Nonetheless, the Directors need to ensure that when the relocation does occur, the employees who are losing their jobs are treated fairly and in accordance with legal requirements; for example, in relation to the notice periods they are granted and the level of redundancy pay they receive.

5 SPQ

<table>
<thead>
<tr>
<th>Marking scheme</th>
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<tr>
<td>(a) 5 marks for the explanation of internal controls and 5 marks for the explanation of risk management up to a maximum of 10 marks</td>
<td>10</td>
</tr>
<tr>
<td>(b) 2 marks for each ethical principle that applies up to a maximum of 6 marks and 4 marks for a full discussion of how difficulties could be resolved</td>
<td>20</td>
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(a) **Internal audit's role**

Internal audit's evaluation of an organisation's systems and processes is part of the process by which an organisation gains assurance that its **business risks are being effectively managed** and that **internal controls are operating** as planned.

**Risk management process**

Part of internal audit's remit is to review the **risk management strategies established by management**, the **risk culture** of the organisation and the **reliability of risk assessments** being made. Internal auditors may be able to place reliance on the risk assessments made when planning their own work; however if they are not satisfied, they will have to make their own judgements and report on the inadequacies of the current system to the board and audit committee.

**Internal control**

Internal audit will also be concerned with how the **systems established by management** to respond to, and manage, risks are working and their work on internal control systems is part of this.

Internal audit will be concerned initially with the **design of internal controls** and the **adequacy of the framework** for reducing risks to acceptable levels. Internal audit will also be concerned with the **operation of controls**, using a combination of **risk assessment and detailed testing**. Not only will internal audit provide a check on operation, it may improve the chances of some controls operating effectively; staff may be more likely to operate controls well if they know that their work might be audited.

**Recommendations**

The recommendations internal audit make will feed back into the **design and operation of risk management and internal control systems**. The recommendations will have regard for the organisation's **strategic objectives** (including the requirement that costs of control are reasonable given benefits) and also the organisation's **risk appetite**.

(b) **Ethical principles**

**Integrity**

The Head of Internal Audit (HIA) is being asked to tone down the criticisms and therefore produce a report that is **potentially misleading** to the audit committee. It may affect the decisions and recommendations the committee makes about the company's risk management procedures and framework if committee members do not have a correct understanding of the **level of risks**.

**Objectivity**

The HIA is coming under pressure from others to modify internal audit's recommendations because of **political pressures** within the company. **Ethical objectivity** requires a consideration of the impact on affected third parties who are unable to influence the decision.

**Competence**

If internal audit does produce a toned-down report and major problems continue, the **competence of the HIA and the rest of the internal audit department** may be called into question when the problems are discovered, possibly by external audit.

**Resolving difficulties**

**Reporting weaknesses to the chief executive**

This course of action would be proper in the sense that the chief executive is the HIA's **immediate superior**. If the chief executive is convinced about the seriousness of the problems, it may be easier to get them corrected. However the chief executive's **previous attitude** suggests that he may forbid the HIA to issue the audit committee with the report in its current form. The chief executive's **previous involvement** also means that the HIA could justifiably bypass him.
Reporting weaknesses to the audit committee

This would resolve the issues of not supplying the audit committee with information and aspersions being cast on internal audit’s competence, and also mean that the HIA had taken a robust attitude to the pressures placed on him. However if there is a conflict between the audit committee and the chief executive, it might jeopardise the chances of the necessary improvements being made.

Discussion with audit committee chair might be a better response than submitting the report directly. As head of the audit committee, the chair has responsibility for ensuring the findings of internal audit are properly actioned, and practically he may be able to advise how best to present the recommendations.

Discussion with finance director

Alternatively the HIA could first discuss the matter with the finance director, as he should be aware of the concerns the chief accountant has. The difficulty might be that the finance director may feel loyalty to the chief executive and report the conversation to him.

Recommendation

As a first stage, the best solution would be to discuss the matter with the audit committee chair for his advice on the best way to proceed. Although this is not a formal report, notes should be taken of this discussion. Subsequent action can be agreed at this meeting.