

STRATEGIC LEVEL
MANAGEMENT ACCOUNTING PILLAR
PAPER P3 – RISK AND CONTROL STRATEGY

This is a Pilot Paper and is intended to be an indicative guide for tutors and students of the style and type of questions that are likely to appear in future examinations. It does not seek to cover the full range of the syllabus learning outcomes for this subject.

Risk and Control Strategy will be a three hour paper with one compulsory section for 50 marks and one section with a choice of questions for 50 marks.

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SECTION A – 50 MARKS
ANSWER THIS QUESTION

Question One

Crashcarts IT Consultancy is a £100 million turnover business listed on the Stock Exchange with a reputation for providing world class IT consultancy services to blue chip clients, predominantly in the retail sector. In 2000, Crashcarts acquired a new subsidiary for £2 million based on a P/E ratio of 8, which it renamed Crashcarts Call Centre. The call centre subsidiary leased all of its hardware, software and telecommunications equipment over a five-year term. The infrastructure provides the capacity to process three million orders and ten million line items per annum. In addition, maintenance contracts were signed for the full five-year period. These contracts include the provision of a daily backup facility in an off-site location.

Crashcarts Call Centre provides two major services for its clients. First, it holds databases, primarily for large retail chains' catalogue sales, connected in real time to clients' inventory control systems. Second, its call centre operation allows its clients' customers to place orders by telephone. The real-time system determines whether there is stock available and, if so, a shipment is requested. The sophisticated technology in use by the call centre also incorporates a secure payment facility for credit and debit card payments, details of which are transferred to the retail stores' own computer system. The call centre charges each retail client a lump sum each year for the IT and communications infrastructure it provides. There is a 12 month contract in place for each client. In addition, Crashcarts earns a fixed sum for every order it processes, plus an additional amount for every line item. If items are not in stock, Crashcarts earns no processing fee.

Crashcarts Call Centre is staffed by call centre operators (there were 70 in 2001 and 80 in each of 2002 and 2003). In addition, a management team, training staff and administrative personnel are employed. Like other call centres, there is a high turnover of call centre operators (over 100% per annum) and this requires an almost continuous process of staff training and detailed supervision and monitoring.

A summary of Crashcarts Call Centre's financial performance for the last three years:

	<i>2001</i>	<i>2002</i>	<i>2003</i>
	<i>£000</i>	<i>£000</i>	<i>£000</i>
Revenue			
Contract fixed fee	400	385	385
Order processing fees	2,500	3,025	3,450
Line item processing fees	600	480	390
Total revenue	£3,500	£3,890	£4,225
Expenses			
Office rent & expenses	200	205	210
Operator salaries & salary-related costs	1,550	1,920	2,180
Management, administration & training salaries	1,020	1,070	1,120
IT & telecomms lease & maintenance expenses	300	310	330
Other expenses	150	200	220
Total expenses	£3,220	£3,705	£4,060
Operating profit	£280	£185	£165

Non-financial performance information for the same period is as follows:

	2001	2002	2003
Number of incoming calls received	1,200,000	1,300,000	1,350,000
Number of orders processed	1,000,000	1,100,000	1,150,000
Order strike rate (orders/calls)	83.3%	84.6%	85.2%
Number of line items processed	3,000,000	3,200,000	3,250,000
Average number of line items per order	3.0	2.9	2.8
Number of retail clients	8	7	7
Fixed contract income per client	£50,000	£55,000	£55,000
Income per order processed	£2.50	£2.75	£3.00
Income per line item processed	£0.20	£0.15	£0.12
Average number of orders per operator	15,000	15,000	15,000
Number of operators required	66.7	73.3	76.7
Actual number of operators employed	70.0	80.0	80.0

Required:

- (a) Discuss the increase in importance of risk management to all businesses (with an emphasis on listed ones) over the last few years and the role of management accountants in risk management. *(10 marks)*
- (b) Advise the Crashcarts Call Centre on methods for analysing its risks. *(5 marks)*
- (c) Apply appropriate methods to identify and quantify the major risks facing Crashcarts at both parent level and subsidiary level. *(20 marks)*
- (d) Categorise the components of a management control system and recommend the main controls that would be appropriate for the Crashcarts Call Centre. *(15 marks)*

(Total = 50 marks)

End of Section A

SECTION B – 50 MARKS

ANSWER TWO QUESTIONS

Question Two

The Information Systems strategy within the MG organisation has been developed over a number of years. However, the basic approach has always remained unchanged. An IT budget is agreed by the board each year. The budget is normally 5% to 10% higher than the previous year's to allow for increases in prices and upgrades to computer systems.

Systems are upgraded in accordance with user requirements. Most users see IT systems as tools for recording day-to-day transactions and providing access to accounting and other information as necessary. There is no Enterprise Resource Planning System (ERPS) or Executive Information System (EIS).

The board tends to rely on reports from junior managers to control the business. While these reports generally provide the information requested by the board, they are focused at a tactical level and do not contribute to strategy formulation or implementation.

Required:

- (a) Compare and contrast Information Systems strategy, Information Technology strategy and Information Management strategy and explain how these contribute to the business. *(10 marks)*
- (b) Advise the board on how an ERPS and EIS could provide benefits over and above those provided by transaction processing systems. *(10 marks)*
- (c) Recommend to the board how it should go about improving its budgetary allocations for IT and how it should evaluate the benefits of ERPS and EIS. *(5 marks)*

(Total = 25 marks)

Question Three

A listed services group with a UK Head Office and subsidiaries throughout the world reports in Sterling and shows the following liabilities in its notes to the accounts:

Liabilities: All figures are in £million	<i>Total liabilities</i>	<i>Floating rate liabilities</i>	<i>Fixed rate liabilities</i>	<i>Weighted average interest rate</i>	<i>Weighted average years for which rate is fixed</i>
£Sterling	98	98			
\$US	41	8	33	7.25%	5
Euro	4	4			
Total	143	110	33		

Maturity: All figures are in £million	<i>Total</i>	<i>Maturing within 1 year</i>	<i>Within 1-2 years</i>	<i>Within 2-5 years</i>	<i>Over 5 years</i>
£Sterling	98	73	3	18	4
\$US	41				41
Euro	4	1	1	1	1
Total	143	74	4	19	46

Interest rates are currently about 5%.

Required:

(a)

- (i) Evaluate the main sources of financial risk for this group (assuming there are no offsetting assets that might provide a hedge against the liabilities).
- (ii) Quantify the transaction risk faced by the group if Sterling was to depreciate against the \$US and Euro by 10%.
- (iii) Evaluate how transaction risk relates to translation risk and economic risk in this example.

(13 marks)

- (b) Discuss the use of exchange traded and Over The Counter (OTC) derivatives for hedging and how they may be used to reduce the exchange rate and interest rate risks the group faces. Illustrate your answer by comparing and contrasting the main features of appropriate derivatives.

(12 marks)

(Total = 25 marks)

Question Four

ZX is a UK-based retailer and manufacturer that also owns a limited number of outlets in the USA, but is anxious to expand internationally via the use of franchising agreements. The enterprise plans to open five franchised shops in each of France, Italy, Germany, Belgium and Holland over the course of the next twelve months. ZX will provide loan finance to assist individuals wishing to purchase a franchise, the average cost of which will be £100,000. Loans will also be available (up to a maximum of 50% of the purchase price) to cover the cost of the franchisee acquiring suitable freehold or leasehold premises. The total sum required for the property loan facility is estimated by the treasurer of ZX to equal £4.8 million. The opportunity cost of capital in the UK is 10% per annum but, in recognition of the lower rates of interest available in the Eurozone, ZX will only charge the franchisees a fixed rate of 7.0% each year on all loans. Repayments will be made in equal Euro-denominated instalments.

ZX charges commission to the franchisees at a rate of 1% of sales revenue, and also earns a net margin of 12% (of retail value) on the products supplied to the outlets from its UK manufacturing plant.

Planned sales from the new European outlets equal £26 million over the next twelve months, but the enterprise recognises that its profits are dependent upon both sales revenue and the extent of loan defaults amongst franchisees (if any). Estimates of the likelihood of a range of scenarios are detailed below:

<i>Probability</i>	<i>Sales</i>	<i>Number of loan defaults</i>	<i>Comment</i>
0.1	10% below plan	Two	Economic difficulties reduce sales and cause problems for some franchisees
0.3	20% below plan	Four	Severe economic problems lead to low sales and higher loan defaults
0.4	As per plan	Zero	"Base case"
0.2	As per plan	One	The weak German economy causes problems for one franchisee

Loan default is assumed to mean total write-off and ZX expects 80% of the new franchisees to take full advantage of the loan facilities offered to them.

The current Euro : Sterling exchange rate is £1.3939/€ and the Euro is expected to strengthen against Sterling by 5% over the next twelve months.

In addition to the cash required to fund the foreign loan facility, a further £3.65 million of working capital will be required for the expansion project and the Treasury Department of ZX requires a minimum annualised return of 15% on all overseas projects.

Required:

- (a) Use the table of possible scenarios given above to calculate the expected Sterling value of the additional profit that ZX will earn if all the store openings are completed as planned and the foreign exchange rate forecast is fulfilled. (You should use the average exchange rate over the year for the calculation.)

You should evaluate whether this profit yields the return required for international operations.

(7 marks)

- (b) Discuss the risks that ZX might face in choosing to expand into Europe via the use of franchising.

(8 marks)

- (c) Evaluate methods of managing/minimising the risks involved in granting Euro denominated loans to the franchisees.

(10 marks)

(Total = 25 marks)

Question Five

You have recently been appointed as Head of the Internal Audit function for a large UK listed company that trades internationally, having worked within its finance function for two years prior to your new appointment.

Your company has also appointed a new Chief Executive, headhunted from a large US corporation where she had held the post of Vice President, Finance.

Required:

As part of the new Chief Executive's orientation programme, you have been asked to prepare a detailed report which provides key information on the principles of good corporate governance for UK listed companies.

You should address the following in your report, remembering that her background is in US governance and procedures.

- (a) The role and responsibilities of the Board of Directors. *(5 marks)*

 - (b) The role and responsibilities of the audit committee. *(10 marks)*

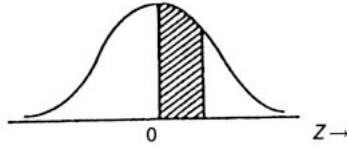
 - (c) Disclosure of corporate governance arrangements. *(10 marks)*
- (Total = 25 marks)*
-
-

End of Question Paper

Maths Tables and Formulae follow on pages 9-11

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	.4834	.4838	.4842	.4846	.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	.4991	.4991	.4991	.4992	.4992	.4992	.4992	.4993	.4993
3.2	.49931	.4993	.4994	.4994	.4994	.4994	.4994	.4995	.4995	.4995
3.3	.49952	.4995	.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 ie $(1 + r)^{-n}$ 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%	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	.990	.980	.971	.962	.952	.943	.935	.926	.917	.909	.901	.893	.885	.877	.870	.862	.855	.847	.840	.833
2	.980	.961	.943	.925	.907	.890	.873	.857	.842	.826	.812	.797	.783	.769	.756	.743	.731	.718	.706	.694
3	.971	.942	.915	.889	.864	.840	.816	.794	.772	.751	.731	.712	.693	.675	.658	.641	.624	.609	.593	.579
4	.961	.924	.888	.855	.823	.792	.763	.735	.708	.683	.659	.636	.613	.592	.572	.552	.534	.516	.499	.482
5	.951	.906	.863	.822	.784	.747	.713	.681	.650	.621	.593	.567	.543	.519	.497	.476	.456	.437	.419	.402
6	.942	.888	.837	.790	.746	.705	.666	.630	.596	.564	.535	.507	.480	.456	.432	.410	.390	.370	.352	.335
7	.933	.871	.813	.760	.711	.665	.623	.583	.547	.513	.482	.452	.425	.400	.376	.354	.333	.314	.296	.279
8	.923	.853	.789	.731	.677	.627	.582	.540	.502	.467	.434	.404	.376	.351	.327	.305	.285	.266	.249	.233
9	.914	.837	.766	.703	.645	.592	.544	.500	.460	.424	.391	.361	.333	.308	.284	.263	.243	.225	.209	.194
10	.905	.820	.744	.676	.614	.558	.508	.463	.422	.386	.352	.322	.295	.270	.247	.227	.208	.191	.176	.162
11	.896	.804	.722	.650	.585	.527	.475	.429	.388	.350	.317	.287	.261	.237	.215	.195	.178	.162	.148	.135
12	.887	.788	.701	.625	.557	.497	.444	.397	.356	.319	.286	.257	.231	.208	.187	.168	.152	.137	.124	.112
13	.879	.773	.681	.601	.530	.469	.415	.368	.326	.290	.258	.229	.204	.182	.163	.145	.130	.116	.104	.093
14	.870	.758	.661	.577	.505	.442	.388	.340	.299	.263	.232	.205	.181	.160	.141	.125	.111	.099	.088	.078
15	.861	.743	.642	.555	.481	.417	.362	.315	.275	.239	.209	.183	.160	.140	.123	.108	.095	.084	.074	.065
16	.853	.728	.623	.534	.458	.394	.339	.292	.252	.218	.188	.163	.141	.123	.107	.093	.081	.071	.062	.054
17	.844	.714	.605	.513	.436	.371	.317	.270	.231	.198	.170	.146	.125	.108	.093	.080	.069	.060	.052	.045
18	.836	.700	.587	.494	.416	.350	.296	.250	.212	.180	.153	.130	.111	.095	.081	.069	.059	.051	.044	.038
19	.828	.686	.570	.475	.396	.331	.277	.232	.194	.164	.138	.116	.098	.083	.070	.060	.051	.043	.037	.031
20	.820	.673	.554	.456	.377	.312	.258	.215	.178	.149	.124	.104	.087	.073	.061	.051	.043	.037	.031	.026

CUMULATIVE PRESENT VALUE OF £1

This table shows the Present Value of £1 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%	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	.990	.980	.971	.962	.952	.943	.935	.926	.917	.909	.901	.893	.885	.877	.870	.862	.855	.847	.840	.833
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.793	4.611	4.439
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	17.226	15.679	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

Formulae

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:

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

SOLUTIONS TO PILOT PAPER

Note:

In some cases, these solutions are more substantial and wide ranging than would be expected of candidates under exam conditions. They provide background on theorists, frameworks and approaches to guide students and lecturers in their studies, preparation and revision.

SECTION A

Answer to Question One

Requirement (a)

The Turnbull report (ICAEW, 1999) recognised that profits were in part a reward for successful risk taking, and that the purpose of internal control was to help manage and control risk, rather than eliminate it.

The report requires a risk-based approach to establishing a system of internal control and that all listed companies have an embedded internal control system that monitors important threats. Risks are defined as any events that might affect a listed company's performance, including environmental, ethical and social risks. For each risk, boards need to consider the risks and the extent to which they are acceptable, the likelihood of risk materialising and the ability of the organisation to reduce the incidence and impact of the risk. A major responsibility of the board is to review the effectiveness of internal control. It is required to make a statement on internal control, that is the process for identifying, evaluating and managing significant risks.

Management's role is a delegated one from the board to ensure that internal controls are adequate but the ultimate responsibility lies with the board. It needs to ensure regulatory compliance. It also needs to manage risks (negative consequences) but also to ensure that opportunities are taken up (positive consequences, such as avoiding the risk of missed opportunities). To be effective, risk management should be embedded in the organisational culture. Management needs to put in place systems to identify, assess, monitor, manage and report risk and the management accountant has an important role to play in this process.

Management accountants have a role in developing and maintaining management control systems that accommodate both strategic and budgetary (feed forward) and financial and non-financial performance control (feedback) mechanisms. While this typically emphasises a concern with variance (between plan and expectation, or between plan and actual result), management accountants can play a part in identifying risk, assessing the consequences of risk through the application of quantification and analytic techniques. They can also develop internal control systems to help manage risk and incorporate risk reporting into management information systems.

Requirement (b)

There are various methods of identifying, evaluating and managing risk that Crashcarts could employ. Methods include using experience and judgement, brainstorming, scenario analysis, PEST/SWOT analysis, interviews and surveys, and statistical analysis. Some organisations use professional risk managers, either as internal consultants or as bought-in advisers. A common method is the Risk Register which lists each significant risk and the management action taken in relation to each risk. A simple but appropriate method for assessing risk is the likelihood/consequences matrix (see below). However, this simple version can be enhanced by Crashcarts using a 3x3 or larger matrix. The risks can be assessed by using probability techniques to assess likelihood and financial and non-financial performance information to quantify the consequences.

Requirement (c)

Methods for analysing risk

The *likelihood/consequences matrix* is the simplest and most effective method to categorise risk and prioritise risk management.

		Consequences	
		Low	High
Likelihood	High	Spare operator capacity	Loss of clients at end of 5 years
	Low	Staffing changes	Out of stocks
		Reduced line items	Reduced orders Failure of suppliers Systems failure

Quantification can be used to identify, for example, the impact of gaining/losing a customer, price changes, changes in the out-of-stock rate and so on. The impact of spare operator capacity and out of stocks on lost income is shown below:

	2001	2002	2003
Spare capacity			
Number of operators	70	80	80
Capacity (operators x orders)	1,050,000	1,200,000	1,200,000
Actual number of orders	1,000,000	1,100,000	1,150,000
Spare capacity (orders)	50,000	100,000	50,000
Cost per order (Operator costs/order capacity)	£1.48	£1.60	£1.82
Cost of spare capacity	£73,810	£160,000	£90,833

Out of stocks

Number of incoming calls received	1,200,000	1,300,000	1,350,000
Number of orders processed	1,000,000	1,100,000	1,150,000
Out of stocks – orders	200,000	200,000	200,000
Average number of line items per order	3.0	2.9	2.8
Out of stocks – line items	600,000	581,818	565,217
Income per order processed	£2.50	£2.75	£3.00
Income per line item processed	£0.20	£0.15	£0.12
Lost income per order	£500,000	£550,000	£600,000
Lost income per line item	£120,000	£87,273	£67,826
Total lost income from out of stocks	£620,000	£637,273	£667,826

Note: Different results may be presented as a result of rounding differences.

Although both are risks, the financial consequences of out-of-stocks are much higher.

The major risks facing the subsidiary are:

- The loss of clients and the inability to win replacement (in the event of loss) and/or new clients (increased business), particularly in an environment where call centre operations are increasingly being transferred to lower cost off-shore locations.
- The number of out-of-stock situations in its retail clients, which are causing substantial lost income, both to Crashcarts and to its retail clients, although there may be a need to increase staffing if the number of out of stocks was reduced. The question implies that lost orders are solely a result of the difference between calls received and orders placed.

Both of these represent significant lost opportunities.

- A further issue is the need to replace or update the technology after five years (or even before!)

The major risks facing the parent are:

- Reputation risk may face Crashcarts if the Call Centre subsidiary lets its clients down by not being able to provide its service, as it is heavily reliant on external suppliers to maintain its infrastructure. As an IT consultancy to the retail sector, Crashcarts may also face a reputation loss if its subsidiary is unsuccessful.
- Given the reducing profits of the subsidiary, Crashcarts may also face impairment of its goodwill, which may need to be reflected in its Balance Sheet under FRS 10.
- Fraud in the subsidiary is also a major risk, given the subsidiary's ability to obtain credit and debit card information from the retail stores' customers.

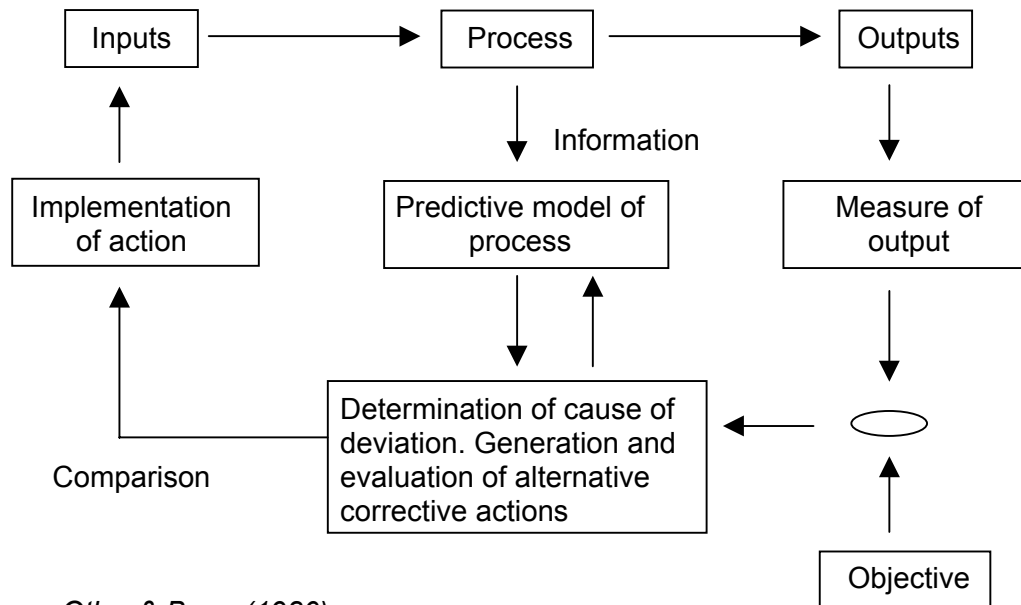
The diversification into Call Centre operations presents a risk to the parent that needs to be assessed, monitored and managed. There is a need to protect shareholders' investment (reputation, physical assets, profitability and so on) as well as interests of clients. The major risks to the subsidiary are not carried through to the parent as the consequences of failure of the subsidiary will not impact the parent significantly (goodwill is fairly minor in relation to group turnover), other than the reputation risk.

Requirement (d)

Components of Management Control Systems (MCS)

The main elements of an MCS are input, process, output, measurement, comparison to target, corrective action and predictive model (see diagram)

Necessary conditions for control



Source: Otley & Berry (1980)

Management control can be considered in relation to both feedback (taking corrective action ex post) and feed forward (taking action ex ante).

One feature of relevance to MCS design is the use of appropriate responsibility centres and the centralisation/decentralisation of responsibility to those centres. There is no information about the controls that Crashcarts exercises over the subsidiary but the main board and the audit committee need to oversee the subsidiary's operations and performance.

Main controls:

As risks – or rather the causes of risk – should drive controls, the main elements of the control system in Crashcarts should include (but not be limited to):

- number of clients (especially increases and potential losses);
- non-financial performance, especially key performance statistics on calls received, orders and line items processed;
- financial performance compared with target;
- client contract performance, contract review and client satisfaction;
- systems failure appears to be managed through maintenance agreements for all infrastructure; however supplier performance needs to be monitored;
- employment procedures, training, performance appraisal and monitoring of staff to reduce staff turnover and improve morale;
- strategic plan, budgets, targets, management reporting (financial and non-financial), expenditure authorisation;

- insurance;
 - procedure manuals (for example access, password protection, data validation, virus protection, data back up, transaction audit trails and so on);
 - health and safety (for example fire safety, ergonomics, stress-related illness and so on);
 - use of risk consultants, internal audit, external audit;
 - reporting to the main board's audit committee should take place;
 - embed risk management in culture.
-

Answer to Question Two

Requirement (a)

Information Systems (IS) strategy determines the information requirements of an organisation and provides an “umbrella” for different information technologies that may exist. The IS strategy follows the organisational business strategy and needs to ensure that the appropriate information is acquired, retained, shared and made available for use in strategy implementation in areas such as financial, non-financial, competitive, human resources and so on.

Information Technology (IT) strategy defines the specific systems that are required to satisfy the information needs of the organisation, including the hardware, software, operating systems and so on. Each IT system must be capable of obtaining, processing, summarising and reporting the required information. The most sophisticated forms of IT system are the Enterprise Resource Planning System (ERPS) and Executive Information System (EIS).

Information Management (IM) strategy is concerned with methods by which information is stored and available for access. This will consider methods of flat or relational database use, data warehousing, back-up facilities and so on. The IM strategy will ensure that information is being provided to users and that redundant information is not produced.

Requirement (b)

Transaction processing systems typically collect data from sales and purchase invoices, stock movements, payments and receipts, and so on in order to provide the information necessary for accounting systems (debtors, creditors, stock) and financial reports. They are largely oriented to line item reporting and profit reporting based on the organisational structure. They rarely provide profitability information by product/service groups, customers and so on.

A more outward-focused approach may help the organisation to be more competitive, either by looking more broadly along its supply chain and/or by considering information available from the market place generally or from specific competitors. This is a *strategic* management accounting approach. The reports from junior managers suggest a lack of strategic planning and a lack of top management consideration of “big picture” matters. Applying Porter, for example, the organisation needs to determine whether its strategy is cost leadership, differentiation or focus, and how its IT can support that strategy.

An ERP system helps to integrate data flow and access to information over the whole range of an organisation’s activities. ERP systems typically capture transaction data for accounting purposes, operational data, customer and supplier data which are then made available through data warehouses against which custom-designed reports can be produced. ERP system data can be used to update performance measures in a Balanced Scorecard system, can be used for activity-based costing, shareholder value, strategic planning, customer relationship management and supply chain management.

Executive Information Systems (EIS) provide high level views of an organisation by aggregating data from various sources from within the organisation and from external sources. *Ad hoc* enquiries generate performance data and trend analysis for top level management. Ease of use is an important feature so that enquiries can be made without a detailed knowledge of the underlying data structures.

Requirement (c)

The IT budget is increased annually without any links to the services provided by IT. (*Answers should mention activity-based or zero-based budgeting compared with incremental methods.*) The introduction of ERPS and EIS would require a business case with all hardware, software, facilities and personnel costs identified, together with the benefits that could be achieved by the company from the information those systems would generate.

Best practice for both IT budgets and for an ERPS/EIS business case would be to determine user requirements in the light of the organisational strategy and need for information (the IS strategy). User requirements should lead to the design of systems (hardware and software) needed to meet those requirements (IT strategy). The type of system and the risks faced would then determine system design and security considerations (the IM strategy). A best practice model such as Information Technology Infrastructure Library (ITIL) should be used in design, development, testing and management phases of any IT development.

Answer to Question Three

Requirement (a)

This group has a small proportion (23%) of fixed rate liabilities – all \$US - at average rates (7.25%) that are higher than current levels (5%). The group is also exposed to exchange rate fluctuations for these liabilities. Most liabilities (77%) are floating rate (110/143) and although most of these (98/110) are in Sterling, if interest rates increase the group will be subject to those fluctuations. As the group has subsidiaries around the world, it will be subject to exchange rate fluctuations, in relation to transaction, translation and economic risk.

Interest rate risks arise as a result of borrowing over long time periods to invest in assets where a company either borrows at a fixed rate or a floating rate. The risk arises from differences between the rate at which interest is to be paid by the group relative to movements in market rates of interest.

Exchange rate risks arise as a result of purchasing and selling goods and services across national borders and the relative mix of monies owed to, and owing by, a company in different currencies and the effect of changes in relative exchange rates between currencies.

Depreciation by 10%: it is not necessary to know the exchange rates used in the Notes to the Accounts. At any exchange rate, if the £ devalues by 10%, the Sterling figure in the Accounts will be 90% of what it should be. Therefore, the new conversion will be (£41 million + £4 million)/0.9 or £50 million. The transaction risk is therefore £5 million (£50 million - £45 million)

Transaction risk arises from transactions already entered into or for which there is likely to be a commitment in a foreign currency, as a result of exchange rate movements in the home country's currency. This is typically for imports and exports, but also applies to borrowings in a foreign currency which requires interest and principal repayments. Transaction risk may be addressed by invoicing customers in the home currency or by hedging activity. The risks can be hedged by netting payments, by forward contracts, and so on. FRS 13 requires disclosure of derivatives and financial instruments in Notes to the Accounts. The Board needs to approve policy in relation to hedging.

Translation risk arises because financial data denominated in one currency is expressed in another currency and is reflected in the movement of exchange rates between balance sheet dates, which distorts comparability. This typically happens when the accounts of foreign subsidiaries are consolidated into the home currency. It affects the balance sheet (assets and liabilities) and profit and loss account. This risk cannot be adequately addressed by hedging techniques.

Economic risks are largely reflected in the worth of a business, based on the discounted cash flows payable to shareholders, which may reduce as a result of exchange rate movements, influencing the competitive position of the business. These risks are not reflected in Notes to the Accounts and are largely addressed by contingency planning and portfolio/diversification strategies although they can be minimised by using local agents or participating in joint ventures.

Requirement (b)

A *derivative* is an asset whose performance is based on the behaviour of an underlying asset (commonly called underlyings, for example shares, bonds, commodities, currencies, exchange rates). Derivative *instruments* include options, forward contracts, futures, forward rate agreements and swaps. *Hedging* protects assets against unfavourable movements in the underlying while retaining the ability to benefit from favourable movements. The instruments bought as a hedge tend to have opposite-value movements to the underlying and are used to transfer risk.

Exchange traded derivatives have lower credit risk, higher regulation, higher liquidity and the ability to reverse positions. However they are not always flexible.

Over the counter derivatives are tailor made to allow perfect hedging but do suffer from low regulation, high credit risk and the inability to reverse a hedge.

A *forward contract* is an agreement to undertake an exchange at a future date at a set price. This minimises the uncertainty of price fluctuations for both parties. Unlike options, both parties are committed to complete the transaction. The main forward markets are for foreign exchange. This is relevant in relation to the liability to repay a given, but unknown from the question, number of \$US defined at the point in time in the past when dollars were borrowed, for this the current £ equivalent is £41 million.

Forward rate agreements (FRA) are used for hedging interest rate risk. They are agreements about the future level of interest rates, and compensation is paid based on the difference between the rate of interest at a predetermined time and the level when the FRA was established. A *cap* is a hedging technique used to cover interest rate risk on long term borrowing, by which a borrower can benefit from interest rate falls but can limit exposure if interest rates rise. Cap compensates the purchaser if market interest rates rise above an agreed level. *Floor* compensates the purchaser should interest rates fall below an agreed level. Interest rate *collar* has both a cap and a floor. This is

relevant in relation to the floating rate liabilities in \$US (£8 million) and Euros (£4 million).

A *swap* is an exchange of payment obligations to reduce exposure to interest rate changes, particularly over the longer term where a swap can run the lifetime of a loan. The swap could be an interest rate swap (for example between fixed and floating rate obligations) or currency swap where interest payments are in different currencies. Swaps reduce exposure to rising interest rates, enable the matching of interest rate assets with debts, and enable lower overall interest rates to be achieved when markets fluctuate. This is relevant in relation to the long term \$US loan that has a fixed rate of interest of 7.25% and a swap may enable a reduction in that rate.

Answer to Question Four

Requirement (a)

Assuming that 80% of the franchisees take up the maximum loan facility, then the loans granted by ZX are equal to:

(100,000) x 25 x 0.8 + 4.8 million	=	£6.8 million
Interest cost to ZX @ 10% per annum	=	£0.68 million
Interest received by ZX @ 7.0% per annum	=	£0.476 million
Net cost per annum	=	£0.204 million

The average loan per franchisee equals £6.8 million/25 or £272,000

Forecast revenue from sales commission if planned levels are achieved = £0.26 million

Forecast net margin (12%) from supplying goods with a retail value of £26 million

	=	£3.12 million
	Total =	£3.38 million
Net profit if targets are fully met	=	£3.38 - £0.204 million
	=	£3.176 million

Adjusting for estimates under the different possible scenarios gives:

0.1 x [(0.9 x 3.38) million - 0.204 million - (272,000 x 2)]	=	£0.2294 million
plus		
0.3 x [(0.8 x 3.38 million) - 0.204 million - (272,000 x 4)]	=	£0.4236 million
plus		
0.4 x 3.176 million	=	£1.2704 million
plus		
0.2 x [3.176 million - 272,000]	=	£0.5808 million
Total expected profit	=	£2.5042 million

The current exchange rate is $\square 1.3939/\text{£}$ and this is forecast to move by 5% to $\square 1.3242/\text{£}$. This gives an average exchange rate over the year of $\square 1.3591/\text{£}$.

The sterling value of the expected profit is thus:

$$\begin{aligned} &= \text{£}2.5042/1.3591 \text{ million} \\ &= \underline{\text{£}1.8425 \text{ million}} \end{aligned}$$

Capital invested at the project launch equals $\square 6.8$ million + $\text{£}3.65$ million. Using the current exchange rate of $\square 1.3939/\text{£}$, this gives $\text{£}4.878$ million + $\text{£}3.65$ million, totalling $\text{£}8.528$ million.

The required return is 15%, that is $\text{£}1.2792$ million. In yielding $\text{£}1.8425$ million, the expansion therefore does meet the Treasury's requirements.

Requirement (b)

The risks that might arise from selecting this type of expansion are both financial and non-financial in nature, although it should also be recognised that franchising can also serve to reduce risks in comparison with those that might arise if expansion was via wholly owned subsidiary outlets.

Franchising reduces risk by ensuring that it is the franchisees that bear the capital cost of the new shops. Consequently ZX requires minimal levels of additional capital to fund the expansion programme, despite the fact that it is offering loan funding to the franchisees.

Nonetheless, the provision of these loans will give rise to two particular risks. The first is a credit risk, which is reflected in the anticipated default levels. This risk may be exacerbated because debt collection/credit regulations and procedures may differ across countries even within the European Union.

The second is a foreign exchange risk because funds will have to be converted from Sterling to Euros, and the interest and capital repayments are also denominated in Euros. There are methods that may be used to manage the risks of the foreign loans, and will be discussed in the answer to *requirement (c)* of this question.

ZX faces a potential risk in being unable to attract the desired number of franchisees because of cultural differences and an insufficiently powerful brand name. The most successful franchise operations are global in scope, but are linked to well-recognised brands, and the brand is used to ensure that the "customer experience" is common across the globe. European retailers may be less familiar with both the franchising concept and the ZX brand, and both of these threats pose a risk to the expansion plans. Unless the search for franchisees has been preceded by an extensive marketing campaign in the targeted countries, it is quite possible that fewer than twenty five suitable franchisees will be forthcoming.

A further risk associated with this method of expansion is that of control. It is vital that the company image, product delivery and store layout/design are uniform and clearly recognisable. ZX faces the risk of finding that some franchisees "know best" and want to put their own individual stamp on the business. Controlling the supply of goods that are sold in each store is just part of the process of managing this type of risk. Other key requirements are good staff training schemes, standardised advertising, store displays and labelling and so on.

In trying to move into five countries simultaneously, ZX is probably being rather ambitious. Despite the fact that all of the target markets are within the European Community, they are culturally quite distinct, and all are different from the UK and USA where ZX already has shops. The company therefore faces the risk of trying to cope with excessive diversity at the same time as rapid expansion and such complexity may prove very difficult to manage. From an operational perspective, the precise location of stores must also be carefully monitored to avoid them competing against one another for business. Germany is a large enough country for five shops to be geographically spread out, but it might not be possible to say the same of Belgium, for example.

The company must also assess the impact of the expansion upon its UK operations. There is a risk that domestic operations will be ignored or sidelined in the search for growth, and if the company is dependent upon the UK for the bulk of its earnings, then care must be taken to minimise such risks. Additionally, the company should assess the relative merits of investing capital overseas rather than in the UK via a comparison of the rate of return earned in each location, and the respective risks associated with the different options. Rapid growth of UK franchise operations might be less risky and also more profitable.

Requirement (c)

The risks associated with the provision of the loans are of three types: credit risk, foreign exchange risk and interest rate risk. Each will be discussed in turn.

Credit risk arises because, in providing loan finance to a third party, a company such as ZX cannot be certain that the counter-party will not default on the loan. The risk can be minimised or managed in a number of different ways. At the most basic level, ZX can ensure that its credit rating procedures are up to date and effective. For new business accounts such as those of the franchisees, it may be difficult to obtain good credit ratings and the only source of information may be basic references from credit reference agencies and banks. In such cases, ZX could protect its position, at least in part, by implementing its own credit scoring system and taking a charge over the assets of the new business in return for provision of the loan(s). A fixed charge over the property is probably the most suitable form of charge.

Another method which can be used to reduce risk once the loans have been in place for some time, is to sell the loan book on to a third party. This is unlikely to be a practicable proposition in this case however, as the total value of the loans outstanding is rather small.

The foreign exchange risk faced by ZX is threefold in nature. There is a transaction risk in the provision of the initial capital sum, and the payments received over the life of the loan, as well as a translation exposure in respect of the value of the loans outstanding at the end of each financial period. Lastly there is an economic exposure because the earning power of the company will be affected by long run trends in the Euro: Sterling exchange rate.

The Euro is forecast to strengthen against Sterling and because the loans are classed as an asset on the balance sheet, if the exchange rate forecasts are correct, the value of the asset is potentially increasing over time, which might be thought of as reducing the company's risk. On the other hand, the value of any write-downs caused by changes in credit risk may also increase over time, thus increasing the likelihood of future earnings volatility.

Both the translation and transaction risks arising from the loans could be minimised or reduced by creating a reverse exposure in the form of a Euro denominated liability. ZX could fund the loans to its franchisees by itself taking out a Euro denominated loan for the capital required. In this way, any changes in the exchange rate over time will result in equivalent changes in the balance sheet value of the associated asset and liability, thus cancelling one another out. At the same time, the Euro payments from franchisees can be used to fund the capital and interest payments on the borrowing by ZX. In this way, the company avoids the cost of regular transactions to convert Euro back into the home currency. The method would only create a perfect hedge, however, if ZX was able to borrow the exact sum of money at the interest rate of 7%, and there were no defaults by franchisees. In practice, this is very unlikely.

An alternative way of reducing the foreign exchange risk would be for ZX to use EU based suppliers to provide the goods for sale in its European stores. This would reduce the forecast output at the UK manufacturing plant, and thus have an opportunity cost, but at the same time it would mean that ZX would have trade creditors that were calling for payment in Euros, and the monthly receipts from franchisees could be used for this purpose. It is unlikely that the transaction risk could be wholly eliminated in this way, but it could certainly be reduced.

Any outstanding transaction exposure that remains after utilising the methods outlined above, can be hedged via the use of forward rate agreements, options or futures. Forward rate agreements enable a company to fix the exchange rate on a transaction at an agreed future date. This creates cash flow certainty, but there is a price to pay for the agreement, and it is also binding. An option allows a company to gain the right to buy/sell a foreign currency at an agreed exchange rate before a set expiry date. The option must be paid for up front, but if exchange rates move favourably, there is no further penalty for failure to exercise the option. Futures contracts are available in only a limited number of currencies, including the Euro, and contract sizes vary from currency to currency. A currency future represents a contract to buy or sell a fixed amount of a specified currency in the future for a price that is determined today.

Futures are, therefore, very similar to forward contracts, but the market for them is much smaller because their appeal is limited by the use of the fixed contract amounts. Forward contracts can be tailored to suit the needs of the individual client, whereas if the transaction exposure does not exactly match contract sizes, use of the futures market will still leave some transaction exposure. In conclusion then, it is likely that ZX will be able to reduce, but not completely eliminate, its foreign exchange transaction exposure.

ZX's economic exposure appears to be substantially increased by the expansion plan, because all of the target countries lie within the same currency zone. This means that the company's earnings will be more sensitive, longer term, to what is happening in the EU economies. The only way to minimise this risk is to diversify internationally through opening shops outside the European Union, but this may create other more significant risks instead.

The interest rate risk faced by ZX is created by its decision to provide fixed rate loans to the franchisees, the price of which is based on European interest rates rather than those in the UK. ZX may, therefore, find that if interest rates rise, the cost of subsidising the foreign borrowers will increase, and so profits will fall. Interest rates and exchange rates tend to move approximately in line with one another, and so if the Euro is expected to strengthen relative to Sterling, then it is likely that European interest rates will remain below those in the UK.

If, however, the UK economy is perceived to be strong, and the Bank of England chooses to increase UK rates in order to dampen demand, then the UK based opportunity cost of capital to ZX will rise, and the effective subsidy to borrowers will rise.

One possible way in which ZX could reduce this interest rate risk is by tying the rate charged to UK interest rates. In other words, offering a variable rate rather than a fixed rate loan. This would, however, create an alternative form of interest rate exposure, because the company could now not benefit from a reduction in the subsidy if UK interest rates fell. The importance of the risk needs to be assessed in terms of the significance of the capital tied up in the loans, which could be regarded as a form of strategic investment by the company. For small loans, the cost of arranging interest rate hedges may far exceed the potential savings that they may generate. Ultimately, the decision on hedge/don't hedge is one for the Board of Directors, and will be dictated at least in part by their overall appetite for risk.

Answer to Question Five

Report

To: Chief Executive
From: Head of Internal Audit
Re: UK Corporate Governance

Requirement (a)

In the light of recent financial scandals in both the USA and Europe, regulations on corporate governance in the UK remain subject to ongoing review. The latest amendments to regulations were published in the form of a revised version of the Combined Code on Corporate Governance, issued in July 2003. This report is based largely upon the contents of that document, and assumes that the reader is familiar with US regulations, particularly recent changes such as the Sarbanes-Oxley Act, but has had less exposure to current UK requirements in respect of both control systems and disclosures in relation to corporate governance.

The report deals with three main areas that are subject to regulation – the role and responsibilities of the Board of Directors; the role and responsibilities of the audit committee and disclosure of corporate governance arrangements.

The principles of good corporate governance that were laid down in the Combined Code can be broken down under a number of headings including financial reporting, internal control and disclosure. At the most fundamental level, the Board of Directors is required to present a “balanced and understandable” assessment of the company’s position and prospects that confirms that the company is a going concern, or qualifies the statements accordingly. Insofar as the contents of the financial report are defined by a mix of company law and accounting regulation, compliance with the regulations is likely to (but not inevitably) result in satisfactory fulfilment of this requirement. It is important to note that this requirement extends beyond just the annual report into other interim and price sensitive reports, as required by regulators. In other words, good

corporate governance means that financial information entering the public domain should be understandable and facilitate performance assessment by analysts.

In relation to internal control, the Combined Code requires the board to maintain a “sound” control system and review, at least annually, the effectiveness of that control system. Financial, operational, compliance and risk management controls should all be included in the review. There is, however, no requirement for the board to report externally on the findings of this review. As part of the process of ensuring effective internal controls, the board is required to appoint an audit committee of at least three members, all of whom should be independent non-executive directors.

The disclosure requirements of the Combined Code include a statement of compliance, together with details of board membership and responsibilities. The annual report must also contain acknowledgements by the board of their responsibility for preparation of the accounts, and confirmation that they have reviewed the effectiveness of the company’s internal control system.

Requirement (b)

The audit committee is appointed by the board of directors and, in larger companies must have at least three members, all of whom should be independent non-executive directors. At least one individual should have both relevant and recent experience.

Good corporate governance requires that the role and responsibility of the audit committee should be documented and include each of the following:

- Review the content of the financial statements and other public announcements in respect of the company’s financial performance to ensure their integrity.
- Monitor the internal audit function and review its effectiveness. Where no such function is in place, the committee should annually review whether there is a need for one.
- Review both the internal control and risk management systems.
- Monitor the independence of the external auditors and satisfy itself in respect of their integrity and qualification to do the job. The committee should recommend to the shareholders, via the board, the reappointment or removal of the auditors as appropriate.
- Taking careful note of ethical guidelines, develop a policy in respect of the supply of non-audit services by the external audit firm, and report to the board any apparent conflicts of interest.
- Confirm the arrangements that are in place to ensure that members of staff in the company can report concerns in relation to financial improprieties in the organisation. The arrangements should ensure confidential investigation and follow up of any such complaints.

Requirement (c)

A brief summary of the requirements was included in the answer to (a), but more detailed requirements include the following disclosures within the annual report:

- Details of members of the board (including non-executives), their collective responsibilities and the attendance records of individuals in respect of the board meetings;
- Names of the Chief Executive, Chairman, Deputy Chairman and senior independent director;
- Membership details in respect of the nomination, audit and remuneration committees, together with a description of the work of these committees;
- Terms of reference for each of the above committees;
- Information about how the board has ensured that they understand the views of major shareholders in respect of the business;
- A statement acknowledging their responsibility for preparation of the accounts;
- A statement that the Directors have undertaken a review of the effectiveness of the company's internal control system;
- Methods used to evaluate the performance of the board and its sub-committees;
- An explanation of the board's viewpoint in cases where it has chosen not to accept the audit committee's recommendations in respect of reappointment or removal of the external auditors;
- Explanation of the non-audit services provided by the external auditor (where appropriate) and the steps taken to ensure that audit objectivity and independence is retained.

This report is a brief summary of the regulatory requirements, which differ in a number of ways from those applicable in the USA. If you wish to discuss any of the issues raised by this report in more detail, or would like to see examples of current UK reporting practice, please do not hesitate to contact me.
