

CGMA AUGUST 2016 EXAM ANSWERS

Variant 2

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CIMA will not accept challenges to these answers on the basis of academic judgement.

SECTION 1

Part 1

The arguments are generally in favour of AEN building the biodigester.

This development gives AEN the opportunity to diversify its operations into the biodigester market. AEN offers a range of services, but they are all linked to demand for wind turbines. Biodigesters may be more acceptable to stakeholders because they need not be built on hilltops or other prominent areas that have a strong and consistent wind flow. They may also be attractive to farmers who already have wind farms and are attracted to the idea of increasing their revenue from sustainable energy generation.

The biodigester is also directly consistent with AEN's mission statement and strategy. It is a positive NPV project that will create wealth for its shareholders. It is also an opportunity to stimulate growth in the alternative energy market through the generation of sustainable electricity. It would be a significant change of direction with respect to the business model, though. AEN provides consultancy and other services and this project involves the operation of the plant. The company's engineers are experts in design and implementation, but not necessarily in ongoing operations. It should be possible however to hire suitable staff to bring those skills to the project.

The project creates an opportunity to test the design at a relatively low cost. The site is being provided free of charge. There may be synergies with the existing work being undertaken for this client, such as the ability to use the existing electrical cables. This specific proposal is more likely to be successful, even if the profits are to be shared equally with the farmer.

The intellectual property will be worth more if AEN can show this test build to potential buyers. Selling the idea as it stands might yield relatively little because potential buyers may be reluctant to pay top price for an unproven idea. AEN might then be in a position where it is under less pressure to find a buyer for the patent because it can always use its experience to build and operate biodigester plants. There will also be less risk of ideas being stolen through reverse engineering if AEN keeps the technology under its own control.

Part 2

AEN has a low gearing ratio of only $12.3/(86.7+12.3) = 12\%$. On that basis, the company could easily afford to borrow in order to take advantage of the lower cost of debt compared to equity. The company also pays tax and so it would be able to take advantage of the tax

relief available on paying interest on debt. Finance charges are a tiny proportion of operating profits, so the debt is unlikely to have a significant impact on profit.

The B\$8m that is required is not a massive loan and so it would have very little effect on the overall gearing. Having said that, the loan might have to be secured and the biodigester itself is unlikely to be suitable collateral because it is effectively a building that is constructed on the farmer's property. The bank might insist on a mortgage against AEN's existing property and that could be inconvenient if it affected future plans to raise finance or even the prospective sale of the building. The loan could, therefore, create a disproportionate problem for AEN.

The company's strategy statement suggests that the shareholders are committed to promoting sustainable energy as well as earning profits and so they might be willing to invest equity into the project. The directors own a significant proportion of the shares and the employees are also involved in a share ownership scheme, so there may not be many "external" shareholders to convince. The company paid a substantial dividend of more than B\$100m last year and so it might be possible to raise the equity by reducing the level of the dividend paid. The directors and the employees can agree to do this without them worrying about any negative signalling effect of reducing the dividend.

It is unlikely that it will be worth organising a share issue for the sake of raising B\$8m. The issue costs would be significant for a share issue of that size, unless there was a small group of investors who would be willing to invest in a small tranche of new shares. It might, for example, be possible to settle the construction costs by giving the builder an agreed block of shares in lieu of a cash payment. A rights issue would be too unwieldy to extend the share ownership by that tiny amount.

SECTION 2

Part 1

The CIMA Code of Ethics provides one possible framework for analysing this matter.

In order to understand the ethical issues, we need to clarify the ethical dilemma that faces us. Essentially, we are seeking to change the government's behaviour. In order to do so, we have to present the government with persuasive arguments to the effect that the revision of a proposed policy would be in the national interest. While that may be the case, we appear to be primarily interested in promoting AEN's interests to enhance our receipts under the grant scheme. The main issue is that our arguments may be intended to benefit us rather than assist the government to pursue the national interest.

It would be a breach of integrity to present our own interests as the basis for maximising the value of the grant scheme. We are supposed to be straightforward and honest and yet we are suggesting that the timing of the grant's availability should be changed so that we can benefit from a payment. We have already decided to invest in this project and so the proposed revision to the timing would be simply to reduce the cost of a decision that we have already taken. Our claim to be interested in sustainability will be undermined by the fact that we are effectively diverting funds that might otherwise have offered a genuine incentive to another company to behave in a sustainable manner.

The principle of objectivity suggests that we should not allow bias to impact on our professional judgement. If we lobby for a change in the conditions in the grant just so that we can benefit from an unnecessary financial incentive then that is a clear violation of this principle. We cannot claim to be truthful if our motivation for recommending a change is to generate income for ourselves. We should declare an interest in any such outcome, although that would undoubtedly discredit our arguments in the process.

Professional behaviour suggests that we should not act in a manner that discredits our profession. In this case, we will be risking discrediting the lobbying aspect of public relations. Lobbyists are at risk of being blamed for undemocratic and dishonest behaviour. If politicians and officials can be persuaded to change their views in response to pleading by interested parties then the electorate may feel that their representatives are behaving in an unacceptable manner. Implicating lobbying as an activity in a scandal will undermine the whole public relations industry.

Also its NPV is positive and a successful income will yield greater return when subsidies come into effect. Indeed success might persuade the government to row back on subsidies.

Part 2

We should consider the specialism of the lobbying company. Just as AEN has expertise and experience of dealing with local government, our lobbyist should be capable in the area of dealing with central government. It may be difficult to establish a track record as a lobbyist because lobbying is frequently conducted quietly and in private and lobbyists may be reluctant to identify the area in which they have succeeded in bringing about change. We may have to approach a shortlist of lobbying companies to decide which would be best suited to our needs.

We need to establish how the lobbyist will proceed when representing us. For example, will they name AEN or will they claim to be acting on behalf of the industry in general? We need to ensure that anything they do or say will not come back and embarrass us. For example, we need to ensure that they do not offer any form of inducement that will make AEN appear corrupt in the event that the lobbying is ever made public. Even obtaining access to senior politicians can be fraught with problems and we need to ensure that there is no hint of impropriety.

We need to brief the lobbyist on the arguments that we feel would be helpful to our case. The lobbyist might, however, have to advise us the best way in which to present those arguments in order to achieve our goal. The politicians have to explain any changes that they wish to incorporate into any proposals and they cannot argue on the basis of increasing the wealth of a commercial entity. We have to express our arguments in ways that support the aims behind the scheme, perhaps arguing for the benefits that incentivising a particular behaviour might bring about.

We need to agree the basic commercial issues associated with this arrangement. For example, what is the timescale? We need to set a budget for the chargeable hours and the total fee that we are prepared to tolerate. We might wish to set a schedule for regular meetings so that we can determine progress and whether a change of direction might be necessary. For example, the lobbyist might discover at an early stage that the scheme will be very similar to that desired by AEN in any case.

SECTION 3

Part 1

If we do not identify the intended readership, our report will simply be a collection of facts and figures. Defining the intended users means that anyone reading the report should be able to understand questions of recognition criteria and materiality. For example, a report that is intended to inform the local community would be expected to focus on emissions that will have an impact on the immediate vicinity and might not be expected to be a full disclosure of matters that are indirectly related, such as sustainability. The identification of readers is crucial to making sense of the report and holding the reporting entity accountable.

If we identify the stakeholders then we might open ourselves up to calls for further disclosure. Interested parties might then claim that we have chosen not to address their needs and might use that as the basis to lobby for a more inclusive report. Such a debate would be difficult without an explicit recognition of the report's intended users because we might then argue that our initial report was sufficient for all needs. An explicit statement of the intended readership will make our report easier to compare with that of other reporting entities in terms of the nature and extent of any disclosures.

Part 2

Our overall contribution to sustainability will be difficult to measure because of the need to identify an appropriate reporting entity. We might argue that we are a consultancy and that our impact on the environment is limited to the operation of our consultancy activities, including heating and lighting our offices and having our consultants travel to clients. Alternatively, we might choose to hold ourselves accountable for the impact of our clients' operations on the environment. Even that is a complicated question because our role is often to facilitate a decision that has already been taken by a client.

It is clear that the issues that draw most attention are the production and emission of "greenhouse" gases, such as carbon dioxide and methane. If we are to identify our impact on the environment then we will have to be clear about our net impact. For example, there will be a carbon footprint associated with building the turbines for a wind farm, digging the foundations and completing the building work. That would have to be reported in the interest of transparency, although it could be offset against the savings arising from the replacement of traditional electricity with wind power.

Part 3

The principal skill that internal audit can bring to this task is the checking of compliance. There should be measurable outputs in terms of energy generation and observable inputs in terms of resources being consumed. The internal audit department can compare the basis on which we measure our performance with established good practice, identifying the technical approach to measuring performance. This will then enable the audit team to look at the outputs in terms of meter readings or data gathered by control software.

Some factors, such as emissions, may be a matter of estimation rather than measurement. For example, the carbon footprint of building and delivering a turbine is not directly under AEN's control and it might even be impossible to obtain direct measurements from the manufacturer. The internal audit department can look for comparable disclosures online and from trade association sources. It may be impossible to do more than acknowledge that the figures being published are credible.

Part 4

The starting point would be the reporting criteria established by the Global Reporting Initiative and other bodies. If we are in compliance with independent standard-setting bodies' recommendations then it should be clear that our report is balanced. The internal audit

department can also compare the extent of our disclosures with that of other entities in order to establish whether we are in compliance with industry best practice. The focus of that comparison should be the matters that are published, as opposed to our performance.

Internal audit could also conduct an independent evaluation of any calls for further disclosure. Pressure groups, such as environmental campaigners, might argue that we could do more to make ourselves accountable and any calls for further disclosure might be considered on their merits. The internal audit department need not accept that every request for information is legitimate, but there could be value in exceeding the minimum requirement and industry norms. Internal audit can also consider the commercial advantage to AEN of prompting additional disclosures that might encourage clients to spend more.