CGMA AUGUST 2016 EXAM ANSWERS

Variant 3

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

SECTION 1

Part 1

The most immediate benefit is that AEN's shares will be traded on a public market, making them readily tradable. This will make it easier to seek fresh equity in the future because external investors may be prepared to become shareholders if they can realise their investment. At present, AEN's primary source of equity would be retained earnings, making it difficult to raise finance for expansion other than through borrowing. This may not be a particularly important benefit in the short term because AEN is funded mainly by equity and so it has substantial borrowing capacity.

The quotation will make the shares held by employees and board members more valuable. In the short term, it will give managers and staff a more immediate incentive because their efforts will be visible in the share price. In the longer term, it may offer an exit strategy for those staff, so that they can realise their investment in the event that they decide to move on. If they remain simply in order to protect their interests in the company's equity then they may be blocking the influx of fresh talent and ideas.

Being a listed company will make it will easier for AEN to grow through acquisition. It will be possible to negotiate mergers on the basis of an exchange of shares with the target company. The quotation will provide a logical starting point for the worth of AEN's shares for negotiating purposes. It will also make any such approach made by AEN far more credible.

The quotation will give AEN greater credibility in business terms. The fact that it is willing to adhere to the regulations imposed by the exchange will be seen as an important signal by potential clients. It suggests that AEN has no fears concerning the additional publicity and scrutiny that any listing will bring. The listing will, in itself, bring publicity in the business press and so raise AEN's profile.

Part 2

AEN has little in the way of recognisable assets, so the equity should be valued on the basis of profits or dividends. Prospective shareholders will implicitly value the company as a stream of future dividends and so the starting point will be to establish how they will estimate that income. Past dividends can be reported as a matter of historical fact and so they provide a sensible basis. In the simplest case, a stable rate of growth might be assumed because that simplifies the calculation of the net present value of the future dividend stream.

The future dividends must then be discounted at an appropriate rate. Ideally, a suitable comparison can be drawn with a quoted company in AEN's line of business. The advantage of that is that the cost of equity is set by market expectations and the rate applied by the markets to the comparative company should offer an insight into how the market perceives the sector where AEN operates. The comparative company's beta coefficient will reflect the risk associated with investing in this type of company as part of a diversified portfolio.

The valuation exercise should focus on realistic estimates of market sentiments rather than simply historical facts. The rate of growth in past profits may be a better surrogate for market expectations because the Board may apply a slightly different dividend policy to AEN once the company is quoted. The market might view trends in past profits as more sustainable because the directors could be reluctant to set excessive expectations for future dividend payments once they are accountable to a diverse range of external shareholders. When the company was run as a private operation, the Board was essentially accountable to a body of shareholders who could see the operation of the company for itself, taken at face value.

The issue price should offer a discount to the result of any model results. This is to encourage potential shareholders to invest. It is common for share prices to rise immediately after an initial public offering, so the discounted share price will help ensure that the issue is taken up. It also allows a certain margin for any troubling news that could affect AEN's share price immediately before the issue.

SECTION 2

Part 1

Dr Whittaker's background means that he will have an understanding of the industry that AEN operates in and be able to understand the risks and other management issues well. His range of experience has been very narrow, however, having worked for the same company for over 30 years before retiring. That may mean that he will be looking at AEN's management on the basis of what would have happened at Lassiter Turbines rather than on the basis of a broad exposure to the renewable energy industry. His place on Lassiter's Board was extremely brief and so his experience with the industry may be more technical than managerial.

The prior relationship with AEN's chief executive may be an issue because the primary role of the non-executive directors is to oversee the actions of the executive board. The markets may not be aware of the friendship and so it may not affect market perceptions, but the actual value of the non-executive directorship may be undermined. In reality, it is unlikely that many potential appointees from within the industry will be completely unknown by every member of the executive board and so this situation is not particularly unusual. The fact that there are unlikely to be any personality clashes will also help the smooth operation of the Board.

There may be concerns that Dr Whittaker will be overcommitted with his recent appointments to two other board positions. The danger is that he will be unable to find the time to assist AEN, despite the fact that the major changes taking place due to the listing will make his support even more important. Again, external perceptions are key because market sentiment may not reflect the actual situation. Having said that, he has retired from full-time employment at a relatively young age and so he may well have the necessary time and energy to balance his various commitments.

The biggest concern is the suggestion that Dr Whittaker will engage in project work for AEN, which will undoubtedly undermine his independence. His role should be to focus on the strategic management, with a particular emphasis on accountability. If he starts to work with AEN's staff on projects then he will lose that sense of distance. It is less of an issue for him to use his contacts to make introductions because he will be a member of the company's Board and there is no harm whatsoever in him acting as an ambassador for the company.

Part 2

The CIMA Code of Ethics offers a potential basis for analysing this conflict.

The basic issue is that we can offer a forecast that is mathematically correct because it extrapolates historical trends. We have reason to doubt the assumption implicit in that forecast that the past trends are likely to continue. Our motivation for applying this approach appears to be to simplify the task of preparing the forecast, which may also make it easier to justify the projections if they turn out to be optimistic. We also appear to be attempting to exploit the fact that the past trend in the results will probably yield an optimistic valuation.

This is clearly a breach of the principle of integrity, which requires us to be straightforward and honest. The suggestion is that we will publish a calculation that we know to be potentially misleading, presented as based on fact. Investors will be encouraged to buy shares that are priced in terms of the result of the forecast and so any misleading assumptions will be costly to them. We should clearly base our projections on the facts as we know and understand them and cannot rely on the fact that past trends can be extended mathematically.

Objectivity suggests that we should not allow our results to be affected by conflict of interest. Clearly, the Board members hold shares and so overstating the predicted profit will increase the value of their investment or permit AEN to issue fewer shares and so restrict the dilution of their equity. There is also the economic incentive associated with wishing to avoid being held responsible for any overstatement of projected profit. There is some value in the counter-argument that the potential shareholders should allow for the possibility that any prediction should be read with caution.

Professional competence and due care suggests that AEN's Board should apply its knowledge and skill to any task. The extrapolation of historical trends is a rather lazy and potentially negligent approach to this task. This could easily be regarded as a deliberate attempt to mislead in the event that this forecast is ever the subject of a legal case. Any professionals on the Board could be in breach of the standards imposed by their professional bodies.

SECTION 3

Part 1

Share prices reflect a “fair” rate of return on the expected future cash flows from investing in the company. That fair rate varies in accordance with the risks associated with the investment. Portfolio theory indicates that much of the total risk can be diversified away, leaving only the “systematic” risk that reflects the security’s sensitivity to risks affecting the markets as a whole. The market does not, therefore, reward shareholders for the total risk associated with the securities because it is possible to eliminate the unsystematic risks that are specific to the company itself.

The staff are unlikely to have sufficient wealth to invest in a properly diversified portfolio because that would imply investing in at least 19 other companies in addition to buying shares in AEN. They are also further invested in AEN because they depend on the company for their full-time employment. This suggests that an even greater degree of diversification is required. They would probably require a very substantial discount in order to compensate for that overpayment.

Part 2

The logic behind the motivation argument is that the share ownership will give the shareholders an economic incentive to work harder in order to maximise the share price. This does seem rather optimistic because each individual employee is unlikely to own sufficient shares for any increase in profits or dividends to have a significant impact on their wealth. The employees will have to share the effects of any additional effort with their colleagues and the other shareholders, so any additional effort that yields revenue will translate to a minimal additional reward for the employee responsible for that effort. There will also be a free rider effect because any given employee will benefit from the work done by colleagues and some may decide not to contribute because the hard work is being done already by others.

Having the employees buy shares could create a sense of ownership that is not simply economic. The employees may feel a sense of identity that instils a sense of loyalty through even a small partial ownership. Giving the employees a financial inducement to buy shares through a discount would further reinforce the sense that the company wishes them to participate through share ownership. As shareholders they would also have the right to vote at general meetings and express their views on the company’s direction.

Part 3

The efficient markets hypothesis suggests that share prices reflect all available information. The capital markets might infer that any transaction involving an employee, particularly a senior member of staff, is evidence that the staff member is trading on the basis of inside information. The sale of shares by an employee could be motivated by a range of motives, including a simple need to realise cash. The markets will, however, consider the possibility that it implies a concern about knowledge obtained at work. Certainly, a concerted move by a number of employees would suggest that they are responding to bad news such as the loss of a contract.

The markets might not necessarily be aware of the relationship between a buyer or seller of shares and AEN. They are also highly unlikely to respond to any great degree to small transactions on an infrequent basis. There is a financial cost to market participants who overreact to events because they are potentially selling shares that are under-priced and incurring transaction costs in the process. Very few employees will be in possession of price-sensitive information that is not otherwise available to the market.

Part 4

The share price is very much a matter for the shareholders rather than the company itself. If the share price is volatile then this means that an investment in the company is risky and that could reduce the share price. A lower share price has no direct effect on the company unless it wishes to sell new shares. The volatility could, however, raise the interest of the financial press and that could be harmful to the company's overall reputation.

The share price is a measure of market confidence and that can affect the reputation of the directors. If the share price is concerning the shareholders then the Board could be the subject of criticism and that might lead to the threat of their replacement. That could motivate dysfunctional behaviour whereby the directors act to reassure the shareholders in the short run rather than creating long-term wealth. If the directors are nervous about their jobs then they may be more inclined to adopt a short-term strategy designed to produce immediate results.