

CGMA AUGUST 2016 EXAM ANSWERS

Variant 4

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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 risk is that we will be acting on behalf of a client who has very little scope to change the situation. The wind farm has been erected and is operational. It is unlikely that it can be re-sited to avoid the risk to bird life and so the injuries will continue. We could find ourselves attempting to defend the actions of a client whose position is effectively entrenched and is likely to continue to cause damage. Even though we are only representing the client's position, we will be associated with this controversy.

Other clients may be concerned if events lead to the Black Ridge wind farm becoming a notorious case for environmentalists. Our role is to manage the press coverage and publicity. We will be seen to have failed in that respect. Editors will probably continue to run this story for as long as there is interest and that might be stimulated by protestors and other activists. The wildlife lobby might decide that the most effective approach to publicising its concerns would be to adopt this particular case and keep it in the public eye.

AEN's association with Black Ridge could affect other projects by association. We may develop an undeserved reputation for taking a reckless view of the impact of our wind farms on wildlife. We may find it difficult to win future bids for contracts against competitors who have lower profiles. We could attract the attention of wildlife campaigners who may object to other clients' proposals on the grounds that they may cause the same degree of damage as the Black Ridge project.

There could be an upside risk if we manage to handle this challenge. There is a natural tendency for news stories to fade from the public eye in any case and we may be able to present the facts in a way that supports that. For example, we might defuse the situation by permitting an independent inspection of the site and a proper survey of the extent of the damage to the local bird population. If we can show that the concerns have been exaggerated then we stand a realistic chance of having the campaigners move on elsewhere.

Part 2

The basic issue here is that the impact of wind farms on bird life is a highly contentious issue. If we publish the basis on which we evaluate that impact then we will risk giving

activists an opportunity to criticise us for being over-optimistic. The estimated impact of a project will be highly subjective and any basis can be contested. Activists can challenge our estimates at the proposal stage and they can revisit these if the project goes ahead and the actual impact of the wind farm can be seen. They can be selective in their criticism, focussing on cases such as Black Ridge and implying that we have been equally reckless in other cases.

We might address this concern by seeking an independent evaluation of the validity of our methods. The review itself will enhance our transparency and the results might improve the approach that we take to future projects. We can identify experts, perhaps from the academic community, who have little to gain from expressing unwarranted support for our approach. We might also benchmark our approach against that of other consultants in this area, with a view to improving industry practice.

The fact that we assess the damage to bird life at all is a tacit admission that we are prepared to tolerate some risk of harm to bird life. It is highly unlikely that any site will be entirely free of risk and so we will always be proceeding on the basis that the harm we will cause is within acceptable limits. Such an argument will always be unacceptable to activists and will create the opportunity for them to portray us as uncaring. It does not even matter in this case if our assumptions err on the pessimistic side because this will be presented as a matter of principle.

The only effective remedy to this would be to manage the terms of the debate. We cannot argue that wind farms cause no harm to the bird population, but we can argue that all life, both human and animal, can be improved by the reduction in emissions that are associated with greenhouse gases. While it may be undesirable to damage wildlife, we might argue that most human activity does so to some extent and that society must often balance gains and losses. We can demonstrate our responsibility by arguing that we would not proceed with a project that entailed significant losses in terms of biodiversity, such as building a wind farm that was likely to affect the migration of rare bird species.

SECTION 2

Part 1

Evaluating the risks to future cash flows is really a matter of identifying specific scenarios and evaluating the impact that the beacons might have, both upside and downside.

The most immediate impact might be that fitting beacons to turbines might affect the price paid by the electricity companies for wind-generated electricity. The purchase of energy from sustainable sources is a strategic issue and the electricity companies might be deterred if wind farms are seen to be highly destructive to wildlife. This risk seems low at present because there are very few viable alternatives to wind power. Wind farms are presently in place and operational and so the decision to use this technology, with the associated threats to wildlife, appears to have been accepted. It is unlikely to be politically acceptable to reduce the payment for this source of electricity.

Proposals to erect new developments might attract objections because of the threat to wildlife and so the decision to invest in this technology could simplify the planning process. Arguably, that is not necessarily a significant upside risk because the proposal could be submitted without the beacons and a later decision could be made to add them if, and only if, the plan was subject to credible objections. A further issue might be that the nature of the objections could change in some cases because local residents are often concerned about the impact of wind farms on the quality of their lives. The prospect of wind turbines being fitted with sonic bird scarers could raise even further concerns and increase the validity of objections.

Operational wind farms could be the target of protestors, who may attempt to interfere with their operations in response to damage to the local wildlife. There is, however, no guarantee that the fitting of beacons will affect the likelihood of a protest at any given location. The protestors might choose a site on the basis of its location or its proximity to a sensitive area. In any case, the beacons have not been tested on every species of bird in Breesland and may not be totally effective. If they are, they could have the effect of frightening birds away from habitats and so they could do even more damage to populations of certain species than the injuries that would otherwise have occurred.

Finally, there could be an increase in the market value of wind farms if they can be shown to be less destructive to wildlife and are, therefore, more socially acceptable. This upside risk could lead to an increase in share prices or the value of farms and other developments that have turbines which have been fitted with beacons. This upside may not be sufficient to justify the investment because large wind farms, where the potential gain is the greatest, will require many beacons and so the cost will be significant. Again, a vendor could decide to retrofit beacons at a later date once the potential controversy over impact is known and so the potential cost can be understood.

Part 2

There are two potential dilemmas here. The first is that we can earn additional revenue from our beacon if we publicise its availability and effectiveness. Our shareholders' wealth would increase at the expense of that of our clients'. The second is that we may reduce the damage that wind farms cause to wildlife. This would enhance one aspect of the sustainability of the wind farm industry at the expense of clients' shareholders.

We might use the CIMA Code of Ethics as a basis for analysing this question.

Taking the question of forcing clients to buy our product could be a breach of integrity. We have already demonstrated our beacon to them and given them every opportunity to evaluate its effectiveness. It is legitimate to present a product to potential customers and to attempt to persuade them of its benefits. The proposal from our Public Relations Department is that we should actively encourage third parties to apply pressure to potential buyers. Good

business practice generally aims for a “win-win” outcome for both seller and buyer and so this does not seem like a viable or fair way to conduct business.

We do have to apply due care in maximising our shareholder wealth. We have developed a product using corporate funds and we will only recoup that investment if we can make sales. All that is being suggested is that our beacon be publicised more widely so that consumers and other interested parties can be aware of the choices that are available. It may be that consumers or electricity companies would be willing to carry some or all of the additional costs of equipping wind turbines with beacons. We cannot control the actions of third party activists and we certainly cannot control them, so we are not directly responsible for any pressure that is applied.

Professional behaviour suggests that we should avoid discrediting the industry group with which we are associated. It could be argued that suppressing news of the existence of a product that will reduce damage to the bird population is unprofessional. There is very little economic incentive for our clients to adopt this device and so they would prefer that we did not publicise its existence. We have already spoken to a number of people and there are many people within AEN who are aware of the beacon. If one of them leaks information then we could be in danger of discrediting the wind farm industry because it will be known that we are capable of preventing harm, but are choosing not to do so because of cost. Making society aware of the costs and benefits of this technology would, at least, permit a debate about the costs and benefits that it will bring and, hopefully, consensus on when it would be appropriate.

SECTION 3

Part 1

This is essentially a new business and so the critical success factors have to be determined at a high level.

The most immediate critical success factor would appear to be the ability to manufacture the product at an acceptable price. The market appears to accept the potential value of the beacon itself, but feels that it is too expensive to justify the expenditure. We have to cut our selling prices while still generating a realistic margin. The factory's owner must be capable of maintaining this price or we will be left with an unsatisfied demand and we may lose the advantage of being first to market.

The reliability of the products is also important because it will soon become apparent if there is no appreciable decrease in injuries. The beacons will be installed on turbines which are themselves exposed to the elements and so they will be sensitive to the weather. Presumably they will also draw their power from the turbines on which they are located and that may mean that there will be fluctuations in current and voltage. The manufacturer will need to manufacture large quantities of these devices without cutting corners and with high quality control.

Part 2

The most obvious KPI concerning price will be the contracted price per unit. We need to ensure that the contract offers us realistic protection against price increases, but without compromising quality. For example, how frequently will the contract come up for renegotiation, or what circumstances might lead to grounds for a price increase?

The prices also have to be sustainable and we need to see evidence that the factory can maintain these prices while staying in business. For example, is it paying production staff realistic wages, or is there a risk that it might be put out of business or rendered unusable because of exploitation claims?

Reliability can be measured in terms of the specification of the units received and their ability to pass AEN's initial quality control processes. For example, is the radar system operating to the required sensitivity to enable it to detect incoming birds without wasting energy?

The ongoing reliability will also tell us a great deal about overall build quality. How many units require rectification or replacement over, say, the first 12 months?

Part 3

It could be argued that AEN might view this instrument as offering a cash flow hedge. We have a series of highly probable forecast transactions that will occur at monthly intervals. If we assume that the hedging instrument meets the rules set out by IFRS 9 *Financial Instruments* then we will be able to offset any movement in the value of the hedged instrument against the amounts payable to the factory owner. The gains or losses on the hedging instruments will go to other comprehensive income until such time as the underlying purchases are recognised. At that point, the corresponding losses or gains will be brought into the income statement.

Hedge accounting will only be effective against translation risks. The hedging instruments themselves may hedge against transaction risk, but that would be the case regardless of whether they are reported under hedge accounting or not. The hedging instruments (and thereby hedge accounting) will be ineffective against economic risk, which is the most serious threat of all, because a strengthening of the B\$ will make it more expensive for overseas customers to purchase the beacons and the instruments will fix their cost price in terms of B\$.

Part 4

Hedge accounting can affect the variability of the cost of our purchases because the hedge should eliminate the effects of currency movements. There will, however, be a cost to buying and managing the financial instruments and those costs will have to be reported as an expense. Overall, AEN will be less profitable, but with a greater consistency in earnings from period to period. Using hedge accounting will avoid us reporting gains and losses on the hedge instruments immediately, which could be significant because the instruments may be purchased and held in anticipation of purchases that will not occur until the following accounting period.

The impact on profit may be considered in terms of the profit that AEN would report in the event that it did not hedge these purchases using forward contracts. The currency markets are generally highly efficient, which means that instruments are fairly priced. The expected outcome of any investment in a hedging instrument, ignoring dealing costs, is that we will break even because we are unlikely to be able to beat the market and buy or sell mispriced securities. In other words, if we choose not to hedge this series of purchases there will be months in which we might suffer currency losses and others in which we might obtain gains, but they should even out over time. Hedging and hedge accounting is unlikely to have a predictable impact on our reported earnings.