

CGMA AUGUST 2016 EXAM ANSWERS

Variant 5

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SECTION 1

Part 1

The analysis of profit is always going to be complicated because the three service lines are closely related. AEN offers a full range of services and clients might be attracted to the company because it can address most issues that arise from their projects. In that sense, it may be misleading to separate the profits because neither department would be as profitable if one was to be discontinued and perhaps none would make much profit. The focus should be on maximising overall profit rather than tracking changes in individual departments.

It could lead to dysfunctional or divisive behaviour to focus on the profit contributed by each service line. The risk is that managers will start to base decisions on factors that might maximise their profits rather than the profits of AEN as a whole. For example, it might make commercial sense to lowball on a bid for an initial contract in the hope of selling other services on top, but that could prove unpopular with managers whose profits will be reported on that basis. Considering the business' interests as a whole will require considerable trust between managers and the Board.

The upside to calculating profits by line of business is that we will be able to make a conscious decision about the extent to which cross-subsidy or cross-fertilisation may be useful. In the event that a part of the business is making only a very small profit or is running at a loss then we need to be certain that that is a state of affairs that we can afford to continue. It may be that there are alternative approaches to bring in business for the other lines without having to offer the full range of services. We also need to be able to be conscious of the need to motivate all managers, otherwise there would be a risk of free riding behaviour, which would also be demotivating.

The analysis may also identify issues that might otherwise be overlooked, such as the extensive software costs that are attributable to engineering. The discipline of breaking the results down by service line will encourage some thought to be given to the reasons for costs being incurred and there may be efficiencies that should be explored. While it would be possible to achieve the same results without analysing profit by line of business, the process will give departmental managers an incentive to study the figures and agree to their analysis. There will also be an element of accepting responsibility and perhaps of encouraging a reduction in expenditure in the process.

Part 2

Monthly performance figures are unlikely to yield a great deal of information if they are prepared on the basis of Joshua's document. AEN tends to work on the basis of fairly

substantial projects that can easily span more than one monthly reporting period. This means that the management accounts could prove potentially misleading if, say, a department is billing substantial hours that are unlikely to be invoiced until a later month. The department will appear to be loss-making, even though it is operating profitably. The alternative is that the departmental analysis could be adjusted for accrued revenue and associated costs and that would be a complicated and expensive calculation.

Monthly reports could encourage dysfunctional behaviour, such as cutting corners to fit a completed contract into a particular month. The analysis prepared by Joshua suggests that monthly figures are highly volatile and managers may become concerned that they will be asked to account for themselves month by month. Looking at longer reporting cycles, even quarterly figures, might make the reports more meaningful. A longer period could mean that the figures are prepared too late to offer much chance to address problems.

Monthly profit figures are probably not the most sensible basis for monitoring performance given the nature of the business cycle. It would be far better to identify a series of performance indicators that might reflect performance in a meaningful manner. For example, the number of chargeable hours worked, regardless of whether invoiced. We might identify suitable measures for each service line that best reflects their business model. For example, new clients signed in the month might be particularly important for engineering but not for legal if the legal department gets most of its business as referrals from engineering.

Direct comparison of the departments' performance could also be complicated and rendered misleading because of AEN's natural cycle. For example, a new project could start in the engineering department, where the technical feasibility would be established, then it could lead to time being charged by legal for the application process and, perhaps, by public relations. This need not prevent the figures posted by each line of business from being studied and discussed, but differences could be due to the inputs to different projects being out of sync between departments. The real comparison should be actual v budget.

SECTION 2

Part 1

There is no specific definition of social responsibility, but a good basis for its definition is that most entities create positive impacts and negative effects. Social responsibility involves making the most of the positive while keeping the negative within reasonable limits. For example, most manufacturing processes create goods for consumers and wealth for shareholders, but also consume resources that may be scarce. It may be necessary to abandon certain activities altogether because the social cost is excessive in comparison to the benefits. For example, there may be too great a risk to employees.

The work undertaken by any lawyer is essentially about protecting and enforcing the legal rights of the client. Societies have laws to facilitate social and economic relationships. These laws make it easier to resolve disputes, and so protect important rights such as those associated with property ownership or rights granted under contracts. Disagreements over the application or interpretation of laws require legal counsel. In terms of social responsibility, lawyers can ensure that rights are respected and that society as a whole benefits in the process.

The case for public relations is a little more complicated. This service is essentially about communicating an argument so that it is clearly understood. There are so many ways in which information can be broadcast and so many factors affecting the manner in which information is disclosed that public relations is often necessary to avoid an event or a proposal from being misrepresented or misunderstood. There is a danger that public relations companies will themselves misrepresent arguments and mislead the public in the process. As with lawyers, public relations consultants can often find themselves in adversarial positions, with both sides of an argument each receiving support from its chosen public relations adviser. From a social responsibility perspective, public relations can reduce the risk of facts being misrepresented to the detriment of interested parties.

In terms of AEN's clients, there would be very little chance of many of the projects designed by the engineering department being implemented without the legal and public relations departments. The problem is that most developments will be perceived as being against someone's interests. Those "injured" parties may not always be justified in their objections or they even may be acting against society's interests. AEN's legal and public relations consultants give land owners and others the ability to build wind farms that would otherwise be impossible because of the selfish interests of objectors.

Part 2

The main risk is that neither legal nor public relations can guarantee success. The client may be unhappy to receive an invoice for work that failed to prevent the rejection of an appeal or the publication of critical press coverage. That risk could affect AEN's overall reputation because the consultants assigned to the project may be visible to the public eye through appearances at planning committee meetings or press conferences. A high-profile failure could lead to work being offered to other firms in place of AEN.

Paradoxically, successes may also tarnish AEN's reputation. If a particular case is highly controversial and AEN succeeds in obtaining final permission then it may create a degree of notoriety. It will not be healthy for AEN to be regarded as the consultant who can impose wind farms on local residents who are clearly offering valid objections. Nor will it be healthy to be associated with more aggressive clients who are keen to push their rights to the exclusion of those of all other parties. Ideally, we wish to build a reputation for engineering excellence, with the convenience of offering associated services.

The workload of legal and public relations may be more variable and difficult to predict than for engineering projects. AEN can canvas for engineering work and there will be some scope

for scheduling the work while negotiating the contract. The workload associated with the other activities could suddenly increase in the event of an adverse finding by a planning committee or a news event affecting a client. This means that AEN has to ensure that there are sufficient legal and public relations staff on hand to deal with at least a modest peak in demand, even though not all of that capacity will be necessary on a day to day basis.

As indicated in the Hatton Heights project, the workload associated with legal and public relations projects can be difficult to manage and it may not always be realistic to make a full recovery of the fees. The cost of preparing an appeal or of managing a news story can be significant and the client might object to us making a full recovery if the cost appears excessive. We would be justified in making a full charge, but the associated bad publicity could be harmful to AEN's overall best interests. We may, therefore, have to forfeit some of the potential upside risk associated with a major case because we will appear to be greedy or lose custom through word of mouth.

SECTION 3

Part 1

The most logical starting point would be to review the profitability of the department since AEN's creation. The business will own little or nothing in the way of assets and its value will be based on the contacts and the reputation of its consultants. It will not have had the opportunity to pay dividends. Thus, profit-based models will be the only really viable starting point for setting a price for the company.

If we can identify at least one quoted public relations company then we can observe its price earnings (P/E) ratio. This would indicate the extent to which the markets value these companies in terms of their earnings. This would be an appropriate comparison because AEN's Public Relations Department is well established with a sound reputation, in line with those of its quoted counterparts. The only serious risk is that breaking away from AEN might reduce the future profitability of Public Relations, but any such error would be in AEN's favour and so it would offer us a realistic starting point for any negotiation.

Part 2

AEN's shareholders might be a little confused as to why the company is choosing to contract by selling off Public Relations and then doing nothing to replace that capability, as evidenced by distributing the proceeds of the disposal. Having said that, the cost of establishing a new line of business would not necessarily be particularly expensive. The basic cost would be the recruitment of suitable qualified consultants and the provision of accommodation, with the Public Relations offices newly vacated. We could, therefore, distribute the proceeds as a windfall to reward the shareholders while still planning to expand into a new area of replace Public Relations.

The fact that the founders are still major shareholders means that we need not be unduly concerned about reassuring the shareholders. The founders can demonstrate their confidence in the company's future by leaving their equity in place. AEN does not appear to be a quoted company and so any dissatisfaction on the part of the shareholders would really be a matter for discussion at the general meeting rather than a decline in the share price. This threat will be offset in part by the block of votes held by the founders, who will be able to vote against any undesirable resolutions.

Part 3

The primary challenge in restarting public relations services would be the recruitment of suitable consultants. This is a fairly specialised field, in which it would be useful to have contacts with particular editors and reporters. We may be in a position to recruit consultants from other firms, even Joshua Pederson's, on the basis of a slightly higher salary offer. We have an established reputation as a good employer and we would provide new staff with realistic career opportunities.

There could be a challenge in building up revenue from this venture, particularly if Joshua is using existing contacts. If Joshua publicises the separation then it will be apparent that we have lost our experienced staff. We can overcome this to some extent because much of our new business will be from land owners who are planning to build their first and only wind farm. The market may not have a very long memory in that case. We can also draw on the stream of clients coming in for engineering and legal advice as our starting point.

Part 4

The biggest advantage is that we will be able to continue to offer all three lines of service in a seamless manner. We will be able to offer clients an introduction to a public relations firm whom we know to be excellent and that might enable us to attract engineering or legal clients who also require PR. We may also be able to charge a commission for such referrals

and that could offer us a fairly low-risk stream of revenue. We would retain the ability to refer clients to other firms in the event that their quality of service declines.

There could be a risk that our Legal Department starts to consider whether it should remain with AEN. If it appears that it will still get the legal work associated with AEN's client base in return for a commission then the Legal staff could make more as an independent entity. Furthermore, we would have far less control over the quality of service provided to AEN's clients if we are referring them to an independent public relations company. We could be blamed for any ensuing disasters if our staff appear to be at fault.