

## **CGMA NOVEMBER 2016 EXAM ANSWERS**

### **Variant 1**

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#### **SECTION 1**

##### *Part 1*

We can define sustainability as the responsible consumption of resources, so that future generations are not deprived. There are effectively two resources at stake here: food and antibiotics. By using the antibiotics we are ensuring a reliable and inexpensive source of dairy products. At the same time, we are risking the effectiveness of a key pharmaceutical product.

The first issue is whether we can actually do anything to halt the spread of resistant bacteria. The use of antibiotics has been an industry practice for many years and it will undoubtedly continue even if we stop dosing our herd. The only way that we can be certain of stopping the use of antibiotics would be an outright ban on their use, other than for clinical need. It would be unfair to expect us to volunteer to cease a practice that is in our commercial interests and enables us to protect jobs.

The second issue is whether the farming industry can actually cease the use of antibiotics. Intensive farming methods mean that there will always be a risk of disease spreading. If pre-emptive use of antibiotics stops then farmers will have to be alert to the incidence of infectious diseases and be ready to seek veterinary assistance. Ceasing the widespread use of antibiotics could, paradoxically, create an increased need to use these drugs as a clinical response to the diseases that would otherwise spread and destroy herds.

Finally, the pharmaceutical industry is constantly working on new products. It is in their commercial interest to develop newer and better drugs. The development of new antibiotics will enable the medical profession to treat diseases that are becoming resistant to established drugs. The dangers associated with the use of antibiotics on farms may have been exaggerated and we may be harming consumers by increasing food prices if we change our behaviour.

## *Part 2*

Larger companies will be in a stronger position with respect to lobbying for restrictions to changes in the rules. ADF is unlikely to have the same ability to influence the future direction of any regulations as the major farming corporations. However, it is highly unlikely that these lobbying activities will benefit only the lobbying companies. ADF can essentially do nothing and wait for the major corporations to attack any unpopular changes.

The major corporations are also far more visible than companies such as ADF. It may be that the farming industry as a whole will be criticised over these practices, but it is debatable whether many protestors will pay a great deal of attention to ADF when there are much larger companies inflicting far greater harm. That may not benefit the smaller companies because it is likely that any changes to the rules will affect the entire industry, but companies such as ADF are unlikely to be at any particular disadvantage. Smaller companies may be less capable of finding and exploiting loopholes in the rules. The major corporations may be faced with the same requirements but may be able to implement them in a different way.

Non-executive directors provide the boards of larger companies with a ready source of advice. The executive directors can consult the non-executives in the knowledge that they can take a relatively independent view of things while knowing a great deal about the business itself. ADF probably could not justify the cost of appointing non-executive directors and so the Board cannot draw on this level of expert advice. In the case of major issues that are being played out in public, such as the use of antibiotics, ADF can watch the behaviour of larger companies, knowing that their decisions will have benefitted from the advice of non-executives.

It is worth noting that the governance structures that apply to large companies were designed to deal with agency issues arising from having a separation between ownership and control. The shareholders of quoted companies were felt to require the protection of having independent non-executive directors to monitor the executive directors' actions. ADF's Board owns 90% of the company's equity and so the agency problems that affect quoted companies do not really arise. ADF's Board has greater freedom to follow its conscience, which may be a luxury that many larger company boards would envy.

## **SECTION 2**

### *Part 1*

The key objectives that the Board must pursue are affected by the fact that ADF is a family company. The basic issues are the same as for any other company, but the emphasis changes.

The key financial objective for any company's board, even a family company's, is the maximisation of shareholder wealth. ADF's Board must take risks into account when evaluating future cash flows. Unlike shareholders in quoted companies, it is unlikely that the shareholders in ADF can hold an adequately diversified portfolio. This heightens the threat arising from any financial risk, such as a penalty for the excessive use of antibiotics or a loss of revenue because of consumer concerns. The directors should also be aware that ADF's shareholders do not have the same scope for walking away by selling their shares as an exit strategy.

The moral question posed by this dilemma is over weighing up the financial dependence of the shareholders on ADF remaining profitable against the potential harm imposed on consumers. The fact that ADF's shareholders depend on profits to provide them with a living may mean that they can justify a slightly more aggressive stance on the question of inflicting externalities on consumers. The debate concerning antibiotics is about potential impact on consumer welfare, which may not necessarily materialise. The shareholders of ADF might argue that there are market forces at work, in which consumers prefer cheaper food, albeit at a cost in terms of health, and that it is unfair to expect them to forego profits when consumers are making an informed choice.

The non-financial objectives are also affected by ADF's status as a family company.

ADF employs more than 20 people on its farms, who depend on the company for the accommodation that is supplied as part of their remuneration. Using antibiotics helps maintain ADF's ability to remain in business and meet its commitment to those employees. The employees are relatively badly paid and are unlikely to have a great deal of savings and so the failure of ADF would be significant to them. ADF's Board would also have to consider the health implications for these employees of working in an environment where antibiotics are in frequent use.

The Board will undoubtedly wish to consider the company's reputation, which will affect that of the family whose name it bears. Announcing that ADF will not use antibiotics unless there is a clinical need could strengthen the company's reputation and enhance the family name. Conversely, if ADF discontinues the use of antibiotics and runs into financial difficulties that could taint the family's reputation as business people and employers. In an extreme case, the failure of the business would cost the family an asset that would otherwise have been passed down future generations.

### *Part 2*

The most significant risk is that the system will prove ineffective in containing disease. The system collects data on three basic parameters (temperature, weight and milk yield). In the absence of more exhaustive tests, the system could either diagnose illness too late to help or trigger false positives. The danger is that the software will operate as promised, in which case the cost will not be refundable, but that the data it yields will do little to enhance herd management. In the worst possible case, we will expose one quarter of ADF's herd to disease before we realise that the system is not delivering its promises.

The experiment with the system cannot really be scaled financially. The hardware component is not very expensive, so it could just as easily be fitted to all four sheds. The cost of the software is the principal expense and that will be incurred whether we use it in

one shed or in all four. The software vendors have very little to gain from giving us a discount because we are using the system on only a quarter of the whole herd.

If the system works, the benefits will be significant. We can justify the cessation of the indiscriminate use of antibiotics, hopefully improving our reputation and possibly enabling us to charge more for our milk. Isolating sick cows at an early stage will enable us to minimise our veterinary bills for treating diseases by targeting a reduced number of cows, or we may simply send such cows to slaughter and avoid the need for costly veterinary treatment altogether. We can extend the system to the other three sheds at very little cost.

There may be unforeseen benefits to be had from gathering this information. For example, we might change the additives that we put in our silage and be able to track the effects on cattle weight and milk yields. There may be scope for adding other sensors to the system that enable us to test other variables. For example, we might test whether the ambient temperature in the sheds has an impact on milk yields. We could mix in other breeds of cows to compare yields with the Holsteins that we presently breed.

## **SECTION 3**

### *Part 1*

The question is actually very straightforward. Should you ignore your doubts? It would be simpler to do so, but there could be an argument that it would be unethical to do so. We might address this using the CIMA Code of Ethics.

Objectivity would imply that the facts should be interpreted in an unbiased manner without allowing the consequences of that interpretation to intrude. The temptation would be to argue that there is no specific reason to believe that the shed managers are not implementing the new policy. The shed managers might resist any investigation and so they might be pressuring you to ignore your suspicions. That interpretation lacks credibility and, at the very least, it requires some further investigation before it can be accepted.

Professional competence and due care requires you to consider your duties as a director. Board members are instrumental in establishing the control environment. Overlooking a possible breach in the rules sends the message that the Board does not mind if the rules are broken. There are wider implications to ignoring the rules that go beyond the breach itself. As a member of the Board, you should always be conscious of the consequences of your actions.

### *Part 2*

The internal auditor should start by interviewing shed managers and asking why the consumption on antibiotics has remained almost constant. That would send a clear signal that the Board is aware of the matter and is concerned. It may also avoid wasting time on an investigation if there is a reason for the additional expenditure. For example, it may cost significantly more to have the vet administer individual doses to specific cows than to medicate the herd as a group.

The next step could be to take a sample of cases in which individual cows have been treated since the ban came into effect. The starting point might be to identify cases that are at a higher risk of failing to have complied with the new rules. For example, the use of antibiotics might be compared and the sample could be biased towards the shed in which the largest number of injections had taken place. The internal auditor could then review the files relating to the selected cases. In each case, there should be a justification for the use of antibiotics, preferably a note from the vet that there was a need for antibiotics.

### *Part 3*

Arguably, ADF is in technical default, which leaves more scope for negotiation than if we had actually missed a payment. The bank manager has not actually commenced foreclosure proceedings, so the important thing now is for ADF to take the initiative.

The fact that we are looking for new customers implies that our cash flows are unlikely to improve in the short term. The new customers will expect to be supplied on credit and so we will have to wait until the due date for payment before we have any cash.

We should approach the bank in the knowledge that they have no particular desire to see a customer forced out of business. We should present a clear and honest assessment of our problems and an indication of the support that we will need to get through them.

It should be possible to negotiate a delay in the repayment if we can reassure the bank that their balance is not at serious risk. It might help if we have an up to date valuation on the property that we have pledged, or we might extend the pledge to include some land or another shed.

*Part 4*

A cash reserve would reduce risks. Any business could have unexpected cash outflows or suffer a loss in cash receipts. ADF might be in particular need of such security because it depends on a relatively small number of major customers for its cash revenues and the loss of just one of this could be a major problem in the short term.

The fact that ADF is a small family company also creates problems because there is less reason for a bank or other provider of finance to support it in the event of default. A major quoted company will create adverse publicity if a bank forces it out of business.

There is a cost to holding a cash reserve. It means that either debt or equity is being used to fund an asset that is not being used for any immediate purpose. Using the balance to settle some of the company's debt would reduce finance charges.

The fact that ADF has a significant holding of land will enable it to offer some credible collateral in the event that it has to seek funding in an emergency. Potential lenders might be willing to offer support in the event that ADF offers worthwhile security to bank the debt.