

## **CGMA NOVEMBER 2016 EXAM ANSWERS**

### **Variant 2**

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#### **SECTION 1**

##### *Part 1*

This is the type of forecasting situation in which the Delphi method, or a variation of it, will be the most effective. We should aim to find out as much as we can about the thoughts and opinions of the people who can influence the supermarkets' buying practices. This will be a difficult task because decision makers may be reluctant to speak too openly about their intentions because public opinion may be rather confused. Consumers may feel some sympathy for the farmers, but they are also used to buying cheap milk in the supermarket and may be unwilling to actually pay more.

ASF is unlikely to have the influence required to talk to the decision makers themselves, but most industries have trade associations that represent members' interests. Industry journals and websites may offer helpful guidance as to when the price increase is likely to occur. The politicians who take an interest in agriculture and consumer affairs may also make public comments, either in the national press or on government websites. The Board could conduct a search using internet search engines for recent comments by those whose opinions count.

It may be worth looking at any parallels that can be drawn between present circumstances and those that were in force at the time of any previous price increases. We have observed certain key facts, such as milk being sold at uneconomic prices and concerns about price fixing. What happened when those facts were observable before? Historical precedents may help us to understand how the various decision makers are forced to respond to the various pressures.

We should also conduct a reality check by looking at the extent to which the public is expressing an opinion on milk prices. If there are frequent references to this story on social media sites and other sources then that will be noted by decision makers. If the public is not commenting then there may be less pressure to address the concerns raised by farmers. We should also check that the comments are actually in favour of supermarkets paying more, just in case consumers are focussing on the benefits of low shelf prices.

## *Part 2*

Valuation models essentially focus on assets or future cash flows. In the short term, ADF's future cash flows will be evaluated in a pessimistic manner because it is presently selling its single product at a loss. That same logic would suggest that the assets are also diminished in value because they are essentially committed to dairy farming. In the event that the family decided to sell ADF then it would probably be worth very little in the short term. There is, however, a strong possibility that the business' fortunes might improve in the longer term.

The present milk market is regarded as unsustainable and selling prices are expected to improve. This will return ADF to positive cash flows and the company will have a more realistic valuation. This expectation is realistic partly because milk is essentially a staple part of Hiland's diet and so food retailers will always require a certain quantity of milk. Fresh milk would be difficult to import because of the logistics of transporting milk, which has a brief shelf life. That prospect should be sufficient to offer some hope to ADF's shareholders and also to assist in any hypothetical valuation exercise.

ADF is larger than most of the other independent dairy farms and so it should have more of the resources required to deal with any short-term losses while the market is out of equilibrium. It may also enjoy economies of scale which means that it will return to profit more quickly once prices start to increase. ADF enjoys a high yield per cow and so there is reason to believe that the Board is capable of running the farm more efficiently than competing farms, which is further reason to believe that ADF can return to profitability.

ADF can also be evaluated on the basis of its assets. Most of its property is in the form of land that is used to grow grass and other crops for silage. Presumably, ADF could move out of dairy and start to cultivate other crops that offer greater potential. In the event that dairy farming does not offer scope for making profits, ADF already has the necessary skills and resources in place to grow other crops that suit the climate. ADF's assets may also have other potential uses. It may be possible to develop the land for building homes or industrial premises. The farm cannot be particularly remote or isolated because the milk is collected for further processing on a daily basis.

## SECTION 2

### *Part 1*

The first issue is that the Cooperative's Board has effectively appointed itself. We are being asked to trust these four individuals without first having had the opportunity to consider them on their merits. They may, indeed, be capable of running the Cooperative effectively, but they are not necessarily the best qualified or most suitable appointees. A number of major decisions have already been taken, such as the entry criteria for members and the product range that the Cooperative will produce, with no prior consultation.

It is reasonable to assume that the four Board members know one another, otherwise how did they come together to establish the Cooperative? If the four are connected to one another, even because of friendship, then there is a danger that decisions will not be adequately discussed and debated because of a sense of "groupthink". That would be a particular problem if the Chairman is connected to the other three because the Chairman is expected to provide a sense of oversight. There will also be a lack of accountability because the four may support one another, making it difficult for members to use their votes effectively.

The fact that the Board members are unpaid is a mixed blessing. Clearly, it implies that member's cash will not be used to pay substantial directors' remuneration. It also implies, to their credit, that the directors are keen to fulfil their roles out of a sense of commitment to the industry. Taking a realistic salary would, however, create a greater sense of accountability towards the Cooperative. Members would be entitled to expect them to devote sufficient time and effort to the Cooperative's business, even if that interfered with the running of their own farms.

The reference to an annual meeting may be a little worrying because the members may feel that is too infrequent. On the other hand, the Cooperative itself will probably not require a great deal of managing once it is properly established and so more frequent meetings may prove a waste of time. There is also an argument that having the members meet frequently to discuss business could lead to a lack of continuity in decision making. Granting each member a vote should mean that the Cooperative Board is accountable during the meetings themselves.

### *Part 2*

From a strategic point of view, we need to establish some critical success factors for this venture, otherwise there is a danger that the Board will lack direction.

The most immediate concern is obtaining a sufficient body of members to make the Cooperative viable. There has to be clarity as to how many of the 100 potential members will have to join in order to ensure that the Cooperative has sufficient funding. It will also be necessary to ensure that there are sufficient quantities of milk available to maintain economic production levels. Clearly, potential members will have to consider the short-term issues associated with selling to the Cooperative rather than the supermarkets because they will not wish to risk cancelling supermarket contracts only to discover that the Cooperative will not be able to buy their milk.

There has to be a clear schedule for the factory project, covering the location, construction and employment of suitably qualified staff. The members are unlikely to have sufficient cash to spare to make their initial investment, only to see some delay in the completion of the factory. Ideally, it should already be clear where the factory will be located and how quickly it can be brought online. It may even be appropriate to collect a small advance from members to finance a feasibility study of that location to establish whether there are suitable employees available in that area.

Product development is a further issue. We need to have a clear and well-researched marketing plan that covers what will actually be manufactured from the milk purchased from members. There has to be evidence that there is a potential market for, say, more powdered milk. Decisions will have to be made as to whether the powdered milk or cheese will be branded and promoted as a new product or sold to, say, the food industry as a bulk ingredient. If it is to be branded then the brand name and marketing approach will have to be established.

The Cooperative will have to set targets for identifying a key customer or customers. Ideally, there will be a range of customers who will be prepared to pay a realistic price for the Cooperative's products. This may require some lateral thinking. For example, it is debateable whether the Cooperative should become dependent upon Hiland's supermarkets for custom because they have already demonstrated that they are capable of acting ruthlessly. In the short term, there has to be a marketing plan for the process of promoting the new product to potential customers.

## **SECTION 3**

### *Part 1*

The first question we need to consider is the volatility of the H\$ relative to the home currencies of our customers in the Far East. Movements in the exchange rates will affect our ability to make a profit at any given selling price when expressed in the home currency. Past volatility might be sufficient to give us an insight as to whether we would make a profit or a loss at any given price point when we take past ranges of exchange rates into consideration. Ultimately, we will have to charge foreign customers more if rates move against us and remain unfavourable.

The second question is our volatility relative to other countries that sell dairy products. If, for example, the New Zealand Dollar weakens then it will become less expensive for foreign customers to import from New Zealand rather than Hiland. We are selling a fairly basic commodity and we will be exposed to price changes because we cannot differentiate Hiland milk from that of other countries. We should have already gathered some information on those rates because they can also have an impact on domestic milk sales (for use in products such as cheese and butter) in Hiland.

### *Part 2*

There could be cultural issues because we are selling a product that is likely to appear to be inherently Western. Some governments may be keen to protect national cultures and so they may be reluctant to encourage the import of foods that embody other countries' tastes. Apart from the cultural issues, there are also economic aspects arising from the need to import dairy products because the local climate does not lend itself to domestic production. If large populations develop a taste for Western food then it could affect the balance of trade.

There are also potential health issues, which could provoke a government response. Dairy products tend to contain a lot of fat and so they encourage weight gain, even obesity. Consumers may also suffer harm from the effects of eating products that trigger reactions through lactose intolerance. The government will ultimately bear the cost of dealing with the consequences of ill health and lost production.

### *Part 3*

At present, ADF is a family business, which creates scope for a high degree of trust. Even the body of shareholders who own 10% of the shares without having a management role are linked by family connections and should be inclined to trust ADF's Board. The introduction of external shareholders would make the Board far more accountable to its owners, even if the new shareholders who invest are in the minority. That could create a situation where the Board has to defer a final decision on a strategic matter until the external shareholders have been informed and have voiced their opinion.

There is also the question of trading cycles and the need for short-term profits. At present, the shareholders are all well aware of the commercial risks that can affect ADF's progress. If there is a temporary problem then the Board can take a long-term view on the best way to resolve it. External shareholders might be inclined to panic and sell their shares, signalling a lack of confidence to markets.

### *Part 4*

If the Board's focus is on maximising shareholder wealth then it would be possible to focus on systematic risks, as measured by the Beta coefficient. The shareholders can diversify the unsystematic risks and so they do not feature in the cost of capital. That implies that ADF's

shareholders will hold their shares as part of a diversified portfolio, which is unlikely in the case of most members of the Anderson family. The Board members themselves will be exposed to total risk because of their substantial shareholdings and so they will not be inclined to ignore unsystematic risks.

The other consideration is that ADF has non-financial objectives. For example, it would be unfair to risk the employees' jobs by ignoring unsystematic risks. Most company directors would also take the view that their own personal wellbeing and that of their families might be affected by a failure to address total risks. ADF's creditors would also expect the company to manage all risks responsibly, even though they probably are diversified through lending to a wide range of borrowers. Distinguishing systematic from unsystematic risks can also be difficult in some cases and so the Board may ignore risks that the market would expect to have managed.