CGMA NOVEMBER 2016 EXAM ANSWERS

Variant 5

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SECTION 1

Part 1

From a strategic point of view, this arrangement has us losing profits at an accelerating rate. We have agreed a significant discount to Louise and she is capitalising on that to help expand her business. As her business grows, we will be diverting more of our milk and our profits will decline further. The advertisement for new staff suggests that Louise plans to expand significantly, which will take even more of our milk for this arrangement.

From a strategic point of view, it would have been desirable to have set a fixed price for sales to Louise so that we had some diversification in the event that the supermarkets cut their prices still further. Unfortunately, we are giving her a price based on normal selling prices less a discount so any price reduction will benefit her further at our expense. We could find ourselves in a situation where we are selling to Louise at a loss. If we argue that we did not make a specific commitment to pass on any such price cuts then we might benefit being able to leave Louise's price fixed in the event of a cut by the supermarkets.

There could be a strategic opportunity open to us if we can open up new markets. We may be able to start supplying the cheese industry on the basis that Louise makes very high quality cheese from ADF milk. Cheese makers may be less aggressive in their pricing than the supermarkets whom we sell to at present. It may be difficult to persuade Louise to endorse us, though, because she might see that as assisting a potential competitor.

We risk alienating key employees in the event that we end up in a dispute with Louise. She is married to a shed manager and it is reasonable to expect that she will have a number of other spouses on her payroll. Perhaps those employees would be unlikely to resign in protest, but we are already concerned that nearby dairy farms will poach our staff. Conversely, having this arrangement with Louise might deter the shed manager from leaving because it might affect his wife's business.

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Part 2

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

From the perspective of professional competence and due care, we are failing to protect ADF's interests by allowing this arrangement to persist. We first granted the 5% discount at a time when Louise's needs were modest and the absolute cost of the arrangement was manageable. It seems unrealistic for us to feel obliged to risk the existence of the business because of a badly drafted agreement. It should be possible for us to reach a more sustainable agreement with Louise.

We might argue that the contract is unenforceable because we made a verbal promise. While verbal contracts are valid, they can be difficult to enforce if there is a dispute as to what was actually said. Such an argument would breach the principle of integrity, which requires us to be straightforward and honest. It is not really acceptable for us to deny having agreed to those terms just because they no longer suit us. We might, however, take this opportunity to discuss matters with Louise. It could be argued that she will lack integrity if she forces us to honour this promise under these circumstances.

We could argue that professional behaviour applies to the compliance with relevant laws and regulations. Arguably, contract law would not automatically enforce a contract that was based on a mutual misunderstanding of the facts. Our commitment is undoubtedly generous, but we had no idea that it would cost so much in the long term. There would be a strong legal argument that the commitment to the 5% discount would never have been made if ADF's Board had realised that Louise's needs would grow to the extent they have. We could argue that she actually has quite a weak legal case and that she should agree to modified terms.

The concept of objectivity would suggest that we should not be intimidated by Louise's marriage to our shed manager. The shed manager's employment is actually a separate issue. We should decide how best to deal with this contract in terms of ADF's best interests. If there is a dispute, we should make it clear to the manager that we do not expect it to affect his continuing employment. In the same spirit, Louise should not attempt to bully us on the basis of the impact on employees' families.

SECTION 2

Part 1

WAC should be valued on an earnings basis. Asset values will not be appropriate. The company's tangible assets will probably bear very little relation to the value of the company as a going concern. The intangible assets will be valuable, but will be impossible to value in any objective way. Perhaps we could attach a value to the company's assets, simply as a bargaining ploy. It might help us secure a slightly better price if we argue that we are acquiring very little in the way of tangible assets in return for our investment.

We might use the price/earnings approach as a starting point. If we can identify a quoted company that manufactures cheese then we can obtain its price/earnings ratio from the financial press. We can then determine WAC's earnings from its most recent financial statements and multiply those by P/E. This approach would take account of the risks affecting the cheese-making industry. It would only allow for future earnings growth to the extent that WAC's growth was expected to match that of our selected quoted company.

We might take tailor our valuation more to WAC by taking a more realistic view of the company's expected earnings growth. It is at a stage in its development where it is growing rapidly and that might mean that the P/E approach is a little conservative. If we took WAC's earning per share and applied the dividend growth model, using our quoted company's cost of equity, then we would have a fairly defensible valuation. The "true" value would probably fall somewhere between this figure and that obtained from the P/E ratio.

We could apply these earnings bases to Louise's profit share in lieu of salary. This calculation would be complicated by the fact that the result would be a present value of future earnings. Arguably, we should focus on the amount that she actually gets paid in any given year and consider whether her initial earnings seem reasonable, based on our estimated profit for the coming year. If we extrapolate that as a trend then we can establish how quickly it will be before she is paid an amount that we would regard as excessive. If that is a long-term prospect then we may have to factor in the fact that she is taking the risk that she will not achieve those earnings.

Part 2

WAC will be a subsidiary of ADF. We should classify inappropriate behaviour as anything that benefits Louise at the expense of the ADF Group. Her decision to switch milk supplier will improve her rewards because she will be entitled to a total of 45% of the profit when we take her equity and salary into account. Our 75% ownership will give us control over WAC, so we can simply monitor purchases and have the company buy its milk from us. We should pay close attention to monthly management accounts and the bookkeeping records now that we are aware of this potential problem.

If Louise is entitled to 20% of profits then she might attempt to maximise short-term profits in order to boost her salary. For example, she might underspend on sales and promotion because the immediate costs would depress her salary. One response would be to install a member of ADF's Board as CEO of WAC and take control of strategic decisions. Louise would then be free to concentrate on making cheese, which is the primary source of added value.

Louise may not wish to have a colleague know the secrets of making her cheeses, despite the contract. Having a single person with that knowledge means that it would be relatively easy for Louise to pay that person to leave with her in the event that she moves on. We should insist that a member of ADF's Board is trained in the cheese-making procedures and that the details are recorded securely on paper. We should also make it clear that we will

dismiss Louise if she develops any other cheese and sells their recipes rather than making them through WAC.

One concern might be that Louise could easily resign and start another cheese company. Doing so might make sound financial sense, even if she does so while the 30% retention can still be withheld. She would be entitled to 25% of any dividends paid by WAC and would have 100% of the earnings from any new venture. We could include a condition in her contract that she will not work for, or create, another cheese company if she departs from WAC.

SECTION 3

Part 1

There is no single approach that can be guaranteed to produce an accurate forecast. The best thing to do would be to draw on as many different forecasting methods as possible and hope that there is some consistency in their results.

We should draw on any forecasts published by industry groups or trade associations. There is almost certainly a trade body that supports the dairy industry and it almost certainly publishes industry outlooks.

We should look at media trends and predictions. It may be that cookery programmes are supporting demand for high quality cheese and that a switch to, say, DIY shows will lead to consumers spending their disposable income on home improvements rather than expensive cheese.

We might ask major customers for an indication of their intentions. They are unlikely to give a commitment, but they will also be keen to ensure that we can meet their needs.

Historical trends in demand are worth tracking, both for the industry and for WAC. This is a simple basis for forecasts and it might act as a reality check.

Part 2

Rather than getting bogged down in models, we should look at the nature of the business itself.

One consideration would be a move to mass market. We could start talking to major food manufacturers about the possibility of them making our cheese in bulk for the supermarkets. In the meantime, we should work at attracting good publicity so that WAC is known as a desirable brand. This is a practical suggestion that seems to have been the approach taken by Candybar Dreams.

Another possibility would be to consider branching out into other lines of produce, not necessarily dairy products. Ideally, we would make those products ourselves, so that we can maximise the profit. We might think about complementary products to sell alongside our cheese, such as fine butter. WAC has developed a reputation for making high quality, luxury foods, which could be the basis for licencing the WAC brand name to other companies. We could lay the groundwork for this by registering as many trademarks as we can think of, such as Wellchester Biscuits, Wellchester Jam and so on.

Part 3

The most obvious strategic consideration is the nature of the loan conditions. If WAC had to pay a lot for interest because it is a recently formed company then it might make sense for ADF to inject cash to enable the loan to be paid off. That would require ADF to take out a loan because it is unlikely that the shareholders will be willing to participate in a rights issue.

WAC's future cash flows will have to be considered. If ADF is confident that the dividends from WAC would service any additional loan that ADF takes out then this would be a cost-saving strategy. If WAC is in any danger of failing then it would make more sense for ADF to leave the debt in the subsidiary, with a view to leaving the company to fail in the event of a default. This strategy would, however, be rather ruthless and would only have a point if ADF's Board would be prepared to permit WAC to fail with unpaid debt.

Part 4

The most likely scenario might be that ADF sells its shares back to Louise. She might be both willing and able to buy WAC back, partly because she has the expertise as a cheese-maker and could be motivated by the freedom to pursue new lines. The downside to ADF would be that she would almost certainly expect a significant discount in order to encourage her to buy WAC back. They could get some of their money back, but would almost certainly have to write off a significant part of their initial investment.

The alternative would be to find another buyer who is interested in acquiring WAC. There may be another business, such as a food retailer, who would see significant synergies in owning a high-class food manufacturer. There could be more scope for selling the shares at a realistic price and ADF might even make a profit. It would be necessary to seek Louise's agreement to this transaction, otherwise she would be able to discourage potential buyers. All she would have to do would be hint that she might leave.