

CGMA AUGUST 2015 EXAM ANSWERS

Variant 5

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Section 1

From: Finance Manager
To: Manjiri Kamat, Director of Finance
Subject: Proposed second division

Commercial viability of Second Division

It could be argued that most soccer-playing countries have several divisions and their clubs generally remain viable. The smaller clubs can often operate on lower revenues because they have smaller grounds and their players and staff are paid less than the larger clubs. That in itself is an encouraging sign that the proposal is viable.

Veldoun's proposed Second Division has the advantage of an even lower cost base in the first instance, with clubs sharing facilities with larger clubs. Even if they have to pay for the privilege, it will be easier and probably cheaper to rent a share in a First Division club's stadium than to build a smaller stadium from scratch.

The Second Division teams will also be able to economise on players' wages because the competition will be less intense and they need not compete in salary terms for the very best players.

Unfortunately the parallel with the other countries who have lower divisions breaks down because of historical issues. Many of the smaller clubs in these countries have a long history and a dedicated fan base. There is no guarantee that the smaller teams will attract a similar following in Veldoun. Soccer is a new sport and so there is no tradition of parents taking their children to support a particular team and of teams being supported on the basis of family tradition. Veldoun's First Division clubs have all been established only very recently and they have all been established in specific cities with a view to capturing those living nearby to support them. New clubs taking up residence in the same cities may find that the potential supporters have already made an emotional engagement with the First Division side that is already there.

The only real incentive to support a Second Division team is that it is potentially cheaper to attend their matches. Even that is not entirely true because attending a soccer match is likely to involve a certain amount of travelling, which means that the ticket price is only a part of the total cost of going to a match.

If the smaller clubs do not manage to generate sufficient revenues then they will undoubtedly struggle when, after the initial phase of this arrangement, they have to build their own stadium. This will be necessary in the medium term because two teams sharing a ground is hardly a practical arrangement.

With only six clubs in the Second Division and the prospect of two being promoted, the clubs might be tempted to invest heavily in good players who might push them into the promotion zone. It will be attractive to retain any place in the First Division and so player signings might be made on the basis that the clubs are aiming to compete at the higher level.

Second Division soccer may well be as exciting to watch, but supporters might feel that they could just as easily watch First Division soccer, which will always be perceived as superior.

Risks

The risk to Glory is that the new clubs could draw some of their support away. Glory is highly successful in soccer terms, but that could actually remove some of the excitement from watching the team play. It may actually be more exciting to support a team that will not win all of its matches.

Kartar's behaviour may also alienate some fans just a little and they may gravitate towards any alternative club that establishes itself in Praree.

If Glory agrees to assist a Second Division club then it will have the distractions and problems associated with sharing a stadium.

There could be an upside for Glory if the relegation battle does spark interest in soccer because television revenues may increase for all clubs if more viewers watch televised matches. The converse of that is that television coverage may gravitate towards some of the lesser teams that are playing to avoid relegation.

Smaller clubs have a very different risk exposure. Relegation is a realistic threat for clubs in the bottom half of the First Division. That could spark an interest in attending matches and boost revenues. If the supporters believe that their clubs' matches matter more because they are in danger of being demoted then they may be more willing to take the time and trouble to attend in order to show their support.

The prospect of relegation to the Second Division could be a catastrophic threat to the smaller clubs. They have established an infrastructure in terms of facilities and players' contracts that will involve significant fixed costs. Agreed salaries will have to be paid in accordance with contracts. Stadium running costs will be difficult to reduce. It would be difficult to reduce costs without moving to a different stadium altogether and that would require the sale of the existing stadium, which is unlikely to have any use other than playing soccer.

Moving down to the Second Division is likely to discourage many supporters and so sales of tickets and merchandise will probably fall. Television revenues are also likely to be reduced.

Relegation may prove difficult to reverse. Clubs that have been demoted may struggle to retain players. Contracts may specify that players have the right to leave if their club is demoted. It may be difficult to sign suitable replacements, who would be capable of guaranteeing that a demoted club would be promoted back at the end of their first year in the Second Division.

Section 2

From: Finance Manager
To: Rachana Chakraborty
Re: Ground sharing opportunity

Hi

Leadership challenges

The biggest challenge will be in maintaining a separation between the two entities. The intention behind the creation of a Second Division was that larger clubs would offer smaller clubs a physical space from which to operate for the first two years or so. Kartar is effectively suggesting that the new club will be an extension of Glory in many ways, with player exchanges, etc.

Kartar's proposal could create a number of conflicts of interest for Glory's leadership. For example, will we be keen to see the new club promoted to the First Division? If it matters to us whether the new club is promoted or stays in the Second Division then we might be tempted to manipulate the terms of our relationship, perhaps by lending better quality players or by recalling key players already on loan.

The arrangements will also prove a distraction for Glory's senior management. For example, it is going to be necessary to ensure that both clubs have adequate access to training facilities and that clashes for the use of the stadium are resolved. It may be necessary for us to negotiate match timings with our opponents because it may be impractical to simply claim priority whenever our partner club requires the stadium.

Kartar's mentorship

Sanjay appears to be a soccer fan and a Glory supporter. That might make him inclined to listen to Kartar's advice. Nevertheless, Kartar has no specific background or training in soccer, other than his chairmanship of Glory. Soccer is a sport that is frequently discussed and commentators and supporters often feel that directors and managers are mistaken and that they are holding their clubs back. Sanjay may not feel that Kartar has done a particularly good job with Glory.

Sanjay appears to have the same interests in the sport as Kartar, but has been less successful so far. Both are wealthy business owners. Both appear to be interested in managing a soccer club. Sanjay may be a little jealous of Kartar and be unwilling to accept his advice. Kartar is clearly going to be the dominant party in this working relationship and it would be natural for Sanjay to resent being offered a mentor when he is clearly keen to establish himself as a club owner.

Kartar's behaviour also appears to be at risk of alienating Sanjay. Kartar appears to be keen to exert some control through ownership of shares by proxy and through the contract with Glory. Sanjay is very likely to see that Kartar has an agenda and it is unlikely that any advice that is offered will be unbiased.

Loan from Glory

According to our latest financial statements, Glory is fairly cash rich and has a fairly low gearing ratio. We could probably afford to make this loan if we decided to proceed.

The loan itself is unlikely to yield any significant return. Sanjay is unlikely to pay a punitive interest rate at this early stage in the establishment of the club. As with any lending arrangement, the best outcome would be the return of our money with the agreed interest and no more.

Any money that we lend will be at risk. Sanjay's initial outlays will be on signing players and setting up the club, none of which will have any residual value if the venture fails. There appears to be no intention of buying a stadium.

The one thing that the loan might buy, and so benefit Glory, is influence. Money is likely to be tight for any new club and so we may find ourselves in a position where we might be able to negotiate repayment terms that offer some other concessions from Sanjay.

Ethics

We might as well use the CIMA Code as our starting point.

The main issue is objectivity. The spirit behind the rules is likely to be that there could be significant abuses if the same individual had a leading role in two soccer teams. For example, Kartar could assist Sanjay's team to obtain promotion and might then be in a position to abuse any influence over the teams. For example, the two sides could be playing against one another and Kartar may decide that Glory should lose in order to boost Sanjay's ranking in the league.

There is a question of integrity. Kartar appears to be buying influence in an underhand and devious manner. If he is personally barred from investing in Sanjay's team then he should accept that he is effectively forbidden from achieving the same effect in an indirect manner.

We also have the question of professional behaviour. Kartar appears to be buying influence over Sanjay's club using money that belongs to the shareholders of Glory and of Glorious Energy Group. Even though he is a minority shareholder in both, the money does not belong to him personally and he should not be using it to further his influence over the sport of soccer.

Section 3

Share price

It would be appropriate to point out that valuation models are generally based on quite significant assumptions and that they should not be applied in a mechanical manner, as both Sanjay and Kartar appear to be doing.

Profit-based models effectively assume that the entity will generate profits, from which dividends may be paid. The wealth created from making profits will tend to be returned to the shareholders and so it makes sense to relate the company's value to a multiple of earnings.

In this case, the basic problem is that Sanjay has no valid basis for predicting future profits. Budgets and projects are all very well, but the creation of the new Second Division is basically a whole new business in an unproven industry. Projections of future profits are always open to challenge, even when there is no reason to believe that either party has a vested interest.

The multiplier is also very relevant. Share prices of established businesses are observable and the markets have had the opportunity to incorporate all part information, included reported earnings, into the share price. It is debatable whether P/E ratios drive share prices, but they may be stable in some cases. The markets have not yet had an opportunity to determine an appropriate multiple for Praree City's share price.

In the same vein, the asset basis for valuing a business effectively sets a baseline for the price because the entity can be broken up and the assets realised. In this case, there are no assets that would have any realisable value.

Communication

We need to reassure Glory's supporters because they may be concerned that the proposed arrangements could damage Glory. A soccer club's success depends on winning matches. If Glory loses any games then the supporters may be concerned that resources are being diverted to Praree City, to the detriment of their own club. Those concerns could arise even if Glory continues to win matches if supporters believe that the club is taking risks with its future. For example, lending a promising reserve player to Praree City will leave Glory exposed if it needs that person to stand in for an injured first team player.

Supporters will have to be reassured that sharing resources will not lead to them being inconvenienced. For example, both Praree City and Glory could have clashing home matches and the supporters may be unhappy if a weekend match is rescheduled to a weeknight in order to enable Praree City to have the stadium.

Finally, the supporters will have to be reassured concerning Kartar's intentions. Kartar provides Glory with a degree of financial stability. His interest in Praree City is likely to become a matter of public knowledge sooner or later and so supporters may be concerned that he plans to leave Glory and take his financial support to a new challenge.

Should Glory's fans support Praree City?

In the short term, it would be desirable to encourage supporters to attend Praree City's home matches, if only to create some atmosphere and to generate some initial cash flow. Most of Glory's fans will live fairly locally and so it would be realistic to promote Praree City's home games as an opportunity to see more live soccer.

There could be problems for Glory if supporters started to attend Praree City's home matches instead of travelling to Glory's away matches. Even if doing so makes very little financial difference, the team will be at a psychological disadvantage if they have fewer travelling fans to support them.

In the longer term, Praree City could be promoted and could become an independent entity with its own stadium in Praree. That could create a sense of rivalry between the two clubs and that might stimulate attendance for both teams. The loss of some fans to Praree City in the short terms could be compensated by the longer term prospect of "derby" matches where two local teams are packing grounds to capacity.

Ignoring the commercial issues, most soccer fans would be quite aggrieved if their clubs did not recognise their commitment to the team. Any message that suggested that it would be desirable to see some fans support Praree City could cause a great deal of bad feeling.

Evaluation criteria

The evaluation criteria should be low key. Ideally, the relationship between the clubs will be almost invisible and the liaison team will not have to distract Glory's management.

The basic criterion should be the number of times Glory's directors and senior managers are forced to intervene in any disagreement. The liaison team should identify the potential sources of conflict and should approach their counterparts at Praree City to reach a compromise. For example, the gym may not have sufficient capacity to enable both teams to use it at once. Some form of timetable should be negotiated that permits both teams to train effectively without undue inconvenience.

It might be more useful to evaluate the liaison team's performance in terms of procedures that have been agreed and implemented rather than disputes that have been settled in Glory's favour. There is nothing to be gained from any disagreement and a win-win outcome will always be desirable in the longer term. Goodwill between the clubs can continue even if Praree City thrives and becomes a fully independent and successful First Division club.