

CGMA AUGUST 2017 EXAM ANSWERS

Variant 3

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CIMA will not accept challenges to these answers on the basis of academic judgement.

SECTION 1

Part 1

Unethical behaviour

AutoAuto has to be very careful in terms of its response to these allegations because there are really two issues. The factory's treatment of its staff is inhumane and unethical and AutoAuto has to distance itself from that. AutoAuto has not wilfully exploited the factory staff, but it does have a responsibility for the work that is being done on its behalf. The principle of objectivity requires that AutoAuto should not be driven by bias or conflict of interest and there is no guarantee that the allegations made in the documentary are true. It would be desirable for Christina Marchel, the Board member who inspected the original factory, to fly out and investigate what has happened and for her to report back to the Board as a matter of some urgency.

The integrity principle requires companies to be straightforward and honest. AutoAuto's CSR report states that it conducts "frequent" audits of suppliers' factories in order to check that they are meeting the "highest standards with respect to the treatment of labour". AutoAuto is in breach of integrity unless it can demonstrate that it conducted adequate audits, in which case it will have to explain why the results were misleading. AutoAuto also needs to commit itself to resolving those concerns in moving forward in terms of future audits and investigations.

The principle of professional competence and due care is important here because AutoAuto does appear to have taken some precautions. There was a factory inspection by a board member and she was satisfied that AutoAuto's products would be made in safe and humane conditions. The fact that the inspection was carried out by someone so senior indicates that the company has taken this matter seriously and has taken reasonable skill and care. It is, however, quite a well-known phenomenon for low-cost manufacturers to show their customers a different factory to the one that will actually be used and so AutoAuto's competence may still be in doubt.

Finally, the principle of professional behaviour requires that AutoAuto should take immediate action in response to these accusations. AutoAuto should acknowledge that the relevant laws and norms that should apply with respect to health and safety should not be those of the host country where the workers are being abused. Those norms are likely to be viewed as exploitative and unacceptable to AutoAuto's customers and shareholders. AutoAuto should ensure that the people who actually make its products are paid sufficient to afford a reasonable standard of living, while being treated in a manner that customers would deem reasonable, regardless of their backgrounds.

Part 2

Resignations

One or more resignations would send a very clear signal that AutoAuto's Board sees the abuse of workers as unacceptable. This might address any remaining concerns that AutoAuto did not take the allegations made in the documentary seriously and could offset some of the damage to the company's reputation. It does seem like a very extreme response, which might be unnecessary given that the company can make amends in different ways. In the short to medium term, AutoAuto could made a public commitment to the employees featured in the documentary and ensure that their ongoing wellbeing is publicised.

Resignation could keep these allegations at the forefront of the news reporting and might damage AutoAuto's reputation by prolonging the coverage. AutoAuto sells its products to manufacturing companies which operate on a worldwide basis, including low-cost countries. Resignation is unlikely to be necessary in order to maintain AutoAuto's ability to generate revenues because sales on a business to business basis are less likely to be driven by emotional considerations. The customers who buy cars will not necessarily know that the electronic systems that operate their satellite navigation and cruise control are supplied by AutoAuto.

Resignation would undoubtedly be viewed as evidence that the directors who left had been personally negligent or complicit in failing to prevent this abuse. That would seriously damage the outgoing directors' careers because they would undoubtedly struggle to find equivalent jobs in other quoted companies. It is unlikely that the directors would resign under such circumstances unless they were compensated for leaving. This is a well-known phenomenon and it is also commonplace for the compensation to become a matter of public outrage. It would probably do AutoAuto's reputation far more harm to compensate the board members for leaving quietly than it would do to keep them in place because the compensation would be viewed as a reward for incompetence.

From a governance point of view, requiring board members to resign will also deter potential replacements from coming to the company. Any company can become involved in a damaging news story and so any board member risks being associated with such bad publicity. Company directors may feel that they have too much to lose in terms of their own careers to accept a job in a company that insists on such a high degree of personal responsibility. The share price could fall if AutoAuto is unable to recruit senior and experienced industrialists to the company's board.

SECTION 2

Part 1

Strategic direction

This is clearly a major strategic decision. Many of the formal models that can be used to frame strategic choices allow for competencies in making strategic choices.

At present, AutoAuto's strategy seems to have two dimensions. The company creates intellectual property through its expertise in product development and it manufactures products that exploit that expertise. Of these, the creation of intellectual property is the key to AutoAuto's success because that is the aspect that is unique to the company. With regard to skills and competencies, the product development is wholly driven by the ability of AutoAuto's staff and the company's ability to protect the intellectual property that they create. Ceasing manufacturing would simply change the value chain through which AutoAuto generates revenue from its intellectual property.

AutoAuto should start by considering whether it has any unique skills and competencies that it applies to create value from the manufacturing process. For example, has AutoAuto developed any particular skills in handling the logistics and quality control aspects of contracting out the manufacturing? If it has, then it would lose its ability to create value from manufacturing because car manufacturers will not necessarily pay more for knowledge such as knowing which manufacturing companies are good at making sensors. If AutoAuto has developed useful skills in managing production then it probably would be wasteful to cease OEM manufacturing.

AutoAuto should also consider the skills that its customers can apply to the licensing agreement that is under consideration. The motor industry has a long tradition of using brought in components and products and so vehicle manufacturers might be willing to pay a royalty or licence fee in order to make their own versions of AutoAuto's products. Vehicle makers do not necessarily have the same manufacturing skills as an electronics company. Also, AutoAuto is ordering products in greater bulk because it supplies several manufacturers and so it might be able to supply at a discount. There could be a danger that vehicle manufacturers will start to develop their own electronics if it is inconvenient or expensive to produce AutoAuto's designs under licence.

The fact that there are several major vehicle manufacturers will make this decision very difficult to implement because AutoAuto will have to negotiate with each separately. There will be an even greater difficulty in the event that AutoAuto ever wishes to reverse this decision. AutoAuto will have to ensure that it has the ability to predict the likely impact of this change on its profits and revenues. It will also have to ensure that it has the necessary negotiating skills to ensure that it can reach a satisfactory agreement with all of its major customers.

Part 2

Share price changes

Ultimately, every decision should be judged on whether it maximises shareholder wealth. The impact of operational decisions on share price can be judged on the basis of their effects on share price, provided the market is sufficiently well informed to determine the impact of those decisions on future cash flows. If markets are efficient then their predictions will be unbiased, but that does not necessarily mean that they will be correct. If, for example, the market has insufficient information concerning the underlying business model to fully appreciate the impact of a decision then it may react incorrectly in the short term, with the share price correcting itself as time passes and new information becomes available.

The fact that the share price fell in 2014 could be due to a misunderstanding on the Board's part. The fact that AutoAuto did not release any other information at that time does not alter the possibility that there was other relevant news. For example, the share price could have fallen because a competitor announced a new product that threatened AutoAuto's market share. Or it could have been wider issue that affected share prices generally and so the movement should not be understood in isolation.

Capital market changes are difficult to interpret in any case. The share price had been rising steadily, before an upward blip during the month before the announcement. There are random factors at work that can confuse matters. The fact that the share price fell in 2014 could be due to the possibility that the markets believed that AutoAuto was making a mistake. That does not necessarily mean that the same attitude would hold in 2017 because the business environment is likely to have changed since then. The directors cannot base a decision on the historical market reaction because the same announcement could trigger a share price rise in the current environment.

If the Board genuinely believes that it should pursue a policy that will be misunderstood by the market then it should ensure that analysts are properly briefed. The briefing should be a dialogue, with the analysts having the freedom to express their opinions. If they believe that the Board's intentions are flawed then AutoAuto might take further steps to educate them and address those fears. Ideally, the Board will find a way to support that assurance with a specific assurance, such as structuring the changes so that their profit-related bonuses will be reduced if the proposed change is unsuccessful.

SECTION 3

Part 1

Economic risks

The purchase consideration will take the form of a number of shares, with the number being granted increasing in proportion to any decrease in AutoAuto's share price.

Paradoxically, this arrangement will reduce the overall risk associated with the value of the consideration because the upside risk (to AutoAuto) has been eliminated. If the share price decreases then the value of the consideration will be fixed at 10% of AutoAuto's current market capitalisation. Unfortunately, the value will increase in the event that the share price rises, although the impact in either case is borne by AutoAuto's present shareholders and not directly by the company itself. The key risk will be the economic risk arising from currency movements. AutoAuto's revenues and cash flows could be affected by changes in exchange rates and that will affect the share price. Translation and transaction risks should not be material.

Economic risk is difficult to measure, although there are plenty of data sets that might be used to link AutoAuto's share price to historical movements. It may not be possible to discern a simple relationship between the US's strength and the share price because overall strengths and weaknesses in the US may mask more specific rate movements in different currencies that affect the company. For example, individual suppliers and customers may be subject to more pronounced rate movements. The risk will also be affected by the expected volatility in the future rates, which further confuses matters.

Part 2

Currency risk and overseas subsidiary

The present arrangements involve AutoAuto contracting manufacturing to external suppliers, which may be selected on the basis of their costs after translation to US\$. In other words, if a supplier's prices increase because of a movement in exchange rates then AutoAuto can source its manufacturing from an alternative supplier located where the currency is less of an issue. The acquisition of a foreign subsidiary will mean that AutoAuto is committed to buying goods from that company and will not be able to hedge through the ability to change the source of supply. The risks may be mitigated by the fact that the subsidiary will probably have to import parts and materials and so the only costs that are directly related to currency movements will be for labour.

The new subsidiary will introduce translation risks into the preparation of AutoAuto's consolidated financial statements. While those may not necessarily matter in terms of cash flows, they may create the perception that AutoAuto is subject to currency risks and that could affect the share price. There could also be a problem with transaction risks because AutoAuto will have to make payment in Solderchip's home currency. These payments could increase or decrease in value thanks to rate movements.

Part 3

Human capital

The bad publicity means that Solderchip's factory is likely to be targeted by the press, who will be looking for a follow-up story to the documentary. The risk of such an intrusion means that it would be irresponsible for AutoAuto to leave itself open to further criticism. From a purely economic point of view, it may make good business sense for AutoAuto to offer a higher level of care for these employees than would be the case under more normal

circumstances. The fact that Solderchip is located in a developed country means that we will be under a huge legal duty of care in any case.

It could be argued that AutoAuto should treat all of its employees equally and should not require the threat of press comment to pay greater attention to welfare. Overspending on staff welfare could be viewed as a waste of the shareholders' money, which is unethical. The danger is that the threat of criticism can never be eliminated because even the most responsible employers must motivate and encourage staff to work hard and to achieve targets. It will always be possible to observe or record events in such a way that there is the risk of criticism.

Part 4

CSR

AutoAuto is acquiring a skilled and experienced workforce that can assist in the development of the company's strategy with regard to creating wealth for its shareholders. The fact that this subsidiary is located in a developed country could be presented as an indication of AutoAuto's willingness to subject itself to strict employee welfare laws. The new subsidiary's employment practices, such as its commitment to diversity and equality, should be described. Its record on related matters, such as health and safety, might be stressed in response to recent criticism.

From a materiality perspective, perhaps the CSR report ought to say something about the plight of the manufacturing staff who have lost their jobs because of the acquisition of Solderchip. Creating jobs in the developed world at the expense of the developing world may be viewed as unsustainable by some. AutoAuto could highlight any action that it took to support the employees of its former contractors, provided that such support was actually offered. Perhaps AutoAuto could argue that it does not have sufficient confidence in its ability to treat people fairly in certain countries and so it has been forced to withdraw.