

CGMA MAY 2016 EXAM ANSWERS

Variant 3

The May 2016 CGMA exam can be viewed at

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SECTION 1

Task 1

Contractor

The first thing that we should do is to check our contract for the building work. It may be that the overruns and delays are sufficient for us to claim that the contractor is in breach of contract, which would make it possible for us to threaten to terminate the contract. We do not necessarily have to take this step, but we will be in a much stronger position if we could replace the contractor with another company. Our position will be further strengthened if we can identify a suitable replacement for the contractor.

We should arrange a meeting between the contractor's senior management and Dreempark's, preferably at Board level. We should present the internal auditor's findings in a non-confrontational way and explain that we would not be prepared to continue in this manner. We should indicate that any further payments that are not specifically covered by the terms of the contract will be deemed to be the contractor's responsibility.

We should not seek to recover past payments from the contractor because doing so may cause the relationship to deteriorate further. We should ensure that it is in the contractor's best interests to complete the contract in the agreed manner, without tolerating bribery.

Ministry

The first step is to arrange a meeting between Dreempark's chief executive and the Minister of Tourism. During that meeting, the Minister should be informed that Dreempark is unhappy with the behaviour of the officials. The Minister should be asked to seek clarification from the officials who have delayed work and forced the additional payments, so that there is little scope for claiming that the officials are merely enforcing the relevant laws and regulations.

Dreempark's CEO should argue that the problems arising during the construction phase of this project are a matter of grave concern to the Board because they suggest that there could be further extortion once the park is opened for business. The Minister should be warned that Dreempark is prepared to stop construction and to find an alternative site in a more sympathetic country in the region. The Minister will probably take such a warning very seriously because the loss of the Dreempark project will be regarded as a major political issue. The Minister will not wish to be held responsible for such a loss of future revenues and jobs.

Putting the officials under the scrutiny of the Ministry of Tourism is likely to be the only effective way to curb these problems because the officials' self-interest would motivate them to continue to abuse their power.

Task 2

It might be tempting to tolerate the payments if they are viewed as the most cost-effective basis for keeping construction on schedule, but it would be highly unethical to do so. We could explore the arguments for this position in terms of the ethical principles in the CIMA Code of Ethics.

The principle of integrity requires us to be straightforward and honest. These payments involve us obtaining a dishonest advantage. Even if the official's claims are possibly spurious, we should comply with the law and answer all requests for information. The fact that the requests are often spurious does not alter the fact that the official has the right to raise them. If we answer all legitimate requests for clarification promptly and press for a formal response then the official will learn that we are not to be intimidated. We can use legitimate means to deal with any delays or other sanctions applied by the official in rejecting our responses.

The principle of objectivity requires Dreempark to form its own opinion on the legitimacy of the payments. We appear to have permitted the contractor to make too many decisions on our behalf. This may have been legitimate in the earlier stages of the contract because agents usually have some freedom to make decisions on behalf of their principals. The fact that we are now aware that there is a potential problem means that we must act to take control of our cash flows and of our finances and to respond in a robust manner to any further claims. It is clear that we do not (and cannot) trust the contractor to make decisions about payments for consultancy services and so we are obliged to bring this within Dreempark.

Professional competence and due care has been breached. Dreempark's Board is under both statutory and contractual obligations to safeguard the company's assets. It is perfectly legitimate to put systems in place to enable employees and agents to make limited decisions, but those decisions must be kept within safe parameters imposed by the Board. There is sufficient evidence to indicate cause for concern about past payments and it may be appropriate for the Board to seek to recover these. Regardless of that decision, all future payments on this project should be directed at the satisfactory completion of the contract.

The principle of professional behaviour requires us to obey the law. The payment of a bribe is against the law in Dreempark's home country and is also defined as unacceptable in the company's formal procedures. No matter how we attempt to justify these payments, they are a clear breach of the law. Arguably, the concept of "professional" behaviour implies that self-interest should be set aside in order to maintain society's interests. By paying a bribe, even one that has been disguised to look like a legitimate payment, we are perpetuating a culture of dishonesty. Having Dreempark stand up to the official will make it easier for others to do so.

SECTION 2

Task 1

In the short term, Dreempark is risking a further delay in the completion of the park by continuing with the foreign construction workers. The protest will make it difficult for construction workers to come and go and will also interfere with deliveries of materials and construction equipment. The building site is large and it will be impossible to prevent protestors from gaining entry and causing further disruption.

There is the potential for a public relations outcry if the plight of the foreign construction workers is reported in the media. Their working conditions appear to be unacceptable, with low wages and very basic living conditions. Even though Dreempark is not their direct employer, we will be seen to be profiting from their poor treatment.

On the upside, using the foreign workers for the remainder of the project will save costs, particularly on the construction work itself. There are also indirect savings. For example, Dreempark might be forced to contribute to the cost of repatriating these workers because the contractor is unlikely to agree to do so. We may also be faced with the cost of compensating these workers for the loss of earnings, given that we are effectively making them redundant and sending them back to a developing country.

In the longer term, continuing with these workers will send a message concerning our intentions for staffing the parks once they open. The parks will require large numbers of workers for relatively unskilled work, such as cleaning and grounds maintenance. If we agree to replace the construction workers then we may be forced to hire local workers to operate the parks once they are ready for business.

The bad publicity arising from using these construction workers may continue. Potential visitors from the host country may feel that Dreempark does not wish to be part of their society if it insists on employing foreign workers. The fact that Dreempark aims to offer a common experience at every park may start to be perceived as an implicit rejection of local cultures, which might be distasteful to visitors. On a wider level, the perceived mistreatment of the construction workers may have an adverse effect on Dreempark's reputation around the world. Visitors may be reluctant to be associated with a venture that is seen to exploit workers from developing countries.

Task 2

The biggest problem with debt is that Dreempark's gearing ratio is already $1,956/(1,956+1,558) = 56\%$. That is a high ratio and it may be undesirable to borrow further. Lenders may take the view that the leisure industry is potentially exposed to fluctuations in the economy because customers will not buy holidays when consumer confidence is poor. Any volatility in operating profit will make it difficult for Dreempark to maintain its existing debts and further borrowing may make the problem even worse.

Dreempark operates globally, which means that the company has foreign subsidiaries to own and operate its foreign parks. This may complicate the task of servicing existing debt and meeting additional calls for cash. There may be issues associated with repatriating funds from foreign subsidiaries if doing so might undermine the rights of creditors in the relevant host country. Lenders may be suspicious of guarantees signed by fellow group members that would have to be enforced through foreign courts.

An equity issue will reduce overall gearing, which will make the consolidated financial statements appear more credible. The biggest problem is that the amount required is unlikely to be large enough to justify the issue costs associated with a rights issue. The additional labour costs may well be a strain on working capital, but the fact that the project is well under way means that the basic funding for the project is already in place. The

shareholders may be unimpressed that they are being asked to buy additional shares in order to rescue the company from an unforeseen contingency.

The question of whether the company is an attractive equity investment is also worth considering. Dreempark's return on capital employed of $781 / ((1,956 + 1,558) / 2) = 22\%$ is consistent with that of the previous year's $693 / ((1,894 + 1,216) / 2) = 22\%$. That steady rate of return implies a relatively low risk. Looking forward, the construction of a new park complex is a major expansion and the company is already attracting a global audience. The new parks may not prove successful in attracting additional revenues to Dreempark and so the additional equity may not prove successful.

SECTION 3

Task 1

The wording of our proposed statement is actually very consistent with the typical corporate response in these circumstances. There is no doubt that the public will be sceptical of the claim that the CEO knew nothing of these bribes, but the alternative would be to admit to deliberate wrongdoing. If the CEO admits to full knowledge of the bribes then that will implicate the rest of the Board and all of the executive directors will have to resign. Furthermore, a full admission would implicate the CEO in a criminal offence that would possibly leave him at risk of formal charges. This would be a rather excessive response.

The resignation of the CEO is a symbolic gesture, but it is an important gesture. By resigning, the CEO is acknowledging that the Board is responsible for every aspect of the management of the company, even when tasks have been delegated to others. The fact that an act of omission led to the payment of an illegal and unacceptable bribe is sufficient to call the Board's stewardship into question. The CEO's resignation is sufficient to demonstrate that the Board as a whole can be made accountable for Dreempark's actions.

Task 2

In the short term, the share price will almost certainly fall because of speculative forces. The market will evaluate any potential news event and market participants who see this announcement may deem it likely that others will view this as a concern and so they will sell, in the expectation that they will be able to buy the shares back at a discount. Once the market has a chance to establish the scale of this event and the likelihood of further revelations the share price will start to rise, partly because those who sold at the top of the market will start to buy shares back at the bottom.

The long-term significance for the share price depends on the extent to which the CEO is recognised as a major contributor to Dreempark's success. He has been in post for six years and he is experienced in this industry and so his departure may be viewed as bad news for Dreempark. The extent of any loss in share price will be tempered by the fact that the markets will allow for future eventualities, such as the loss of key members of the management team. The markets may have picked up rumours of problems in the host country and of the possibility of a scandal and so the share price may have already allowed for the possibility of this announcement. The departure of Ken Hinkel also allows the possibility of a replacement, who may be even better qualified and more suitable.

Task 3

The basic argument here is complicated because it will appear that Ken Hinkel is being rewarded for either dishonesty or incompetence. The shareholders and the press may feel that the company should act to withhold this payment or that he should agree to forego the payment.

From a public relations perspective, this payment will be a disaster for Dreempark. The fact that the payment will be viewed as undeserved will accentuate the sense that Dreempark has behaved in a corrupt manner with regard to the bribe and then again with the payment to Ken Hinkel.

From The CEO's point of view, he has a contractual right to receive this payment. He could argue that it is unfair for him to suffer a serious financial penalty when he has essentially been in breach of his duties in a symbolic sense only. It would be reasonable for him to withdraw his resignation under these circumstances and to fight to keep his job. The cost of him doing so would almost certainly be significant for Dreempark and it will be cheaper to permit him to stay on.

Task 4

Golden parachutes deal with an important agency issue.

The shareholders can diversify specific risks away and so are faced with the systematic risks of their investments in the company. The directors are heavily invested in the company by virtue of their careers and also through financial stakes arising from shares and executive stock options. This creates a serious agency problem because the directors are exposed to total risk, whereas the shareholders are not. The effect of this is that the directors may become unduly risk averse when developing strategies and selecting projects. Offering a golden parachute protects the shareholders from such risk aversion because the directors know that they will receive a substantial compensation in the event that they are forced to step down because of unforeseen circumstances, such as the failure of a project that had been evaluated and found to be promising.

A quoted company's directors are likely to regard their careers as their most valuable asset. If they lose their jobs then they may be regarded as less desirable by other potential employers. A golden parachute gives them some security when they act in the shareholders' best interests instead of their own. For example, they might leave a currency exposure unhedged because they believe that the shareholders are aware of the risk and can structure their portfolio so that they are protected through diversification.