

CGMA FEBRUARY 2017 EXAM ANSWERS

Variant 3

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SECTION 1

Part 1

The programme creates a sense of drama out of the possibility that unknown performers may become successful entertainers through exposure on national television. Viewers enjoy the programme because they indulge themselves in the fantasy that they can engage with the development of successful show business careers. It could be argued that a great deal of entertainment is about presenting a fiction that affects the emotions of its audience and that this show is no different in that respect from, say, a feature film. Realistically, anyone watching Teeland Variety closely will be aware that the programme makers could not properly audition and screen every one of the thousands of acts who attend, nor could the acts chosen reflect the very best to appear because some are undoubtedly terrible.

There could be arguments against this notion. Firstly, much of the dramatic tension in the initial rounds arise because the acts that perform on stage are often selected precisely because they are terrible. The performers themselves may be under the illusion that they are good at what they do and their self-esteem may be harmed by the fact that they are criticised on television by the judges. They may have been willing to risk such an outcome in return for the opportunity to win the show, but the fact that Denny has predetermined that only musical acts can proceed may make this rather cruel as an entertainment. This could be viewed as a breach of the principle of acting with professional competence and due care in handling contestants.

Denny would clearly be in breach of the principle of objectivity. The programme is essentially a competition and the contestants should be evaluated on their merits. They should not be dismissed on the grounds that their style of act does not lend itself to Denny making a profit from them through his other business interests. The implicit contract with the contestants and even with the viewing public is that the acts will be considered on their strengths.

Finally, the fact that viewers are being encouraged to pay T\$2.00 in order to vote suggests that the judges should not be manipulating viewers' behaviour. Consciously making negative comments about some acts will undoubtedly affect some viewers' preferences and they may then vote for the act that the judges persuaded them to favour rather than the one that they most enjoyed. This would be a breach of integrity because Evestar is profiting from these votes even though they are being manipulated. Viewers are effectively paying to be misled.

Part 2

Systematic risks are generally linked to the impact of broad economic matters on the entity. For example, changes in interest rates will affect most companies to some extent.

Unsystematic risks arise from factors that are unlikely to affect all companies because they are unique to the entity. For example, the dishonest behaviour of a director or senior employee would be an unsystematic risk. Arguably, that makes the statement that the risk can be diversified away very true.

The diversification argument only makes sense if the portfolio is properly diversified and it is difficult to ensure that this is the case. In this event, it is highly unlikely that there will be a corresponding category of investment to offset this risk because it is unlikely that there are businesses that are well managed when Evestar is not and vice versa. This form of reckless behaviour would have the effect of making the portfolio more volatile, which could only be bad for the investors unless there is an upside to this misbehaviour. There is no such thing as a perfect hedge in many cases, although a very large portfolio may well come close.

It would be quite illogical to make this argument to the shareholders. First of all, their investment in Evestar will lose value and so their portfolio will decline in value because of this event. The losses were avoidable and so Denny's misbehaviour has cost them money. The diversification effect arises from the hope that there will be corresponding gains that offset the losses on Evestar, but those gains will occur randomly and will not be driven by the fact that Evestar suffered a loss. Making this argument will demonstrate a misunderstanding of a key theory in finance and so it would discredit the Board.

Even if the argument was valid, it would be difficult to convince most investors that they could ignore wilful bad behaviour by their directors. Finance theory present human behaviour in terms of mathematical models and these ignore the emotions and attitudes that are associated with observing human behaviour. Many investors would see this act as unacceptable even if they benefitted from it. Furthermore, not all market participants fully understand portfolio theory and any misunderstanding would be sufficient to undermine confidence in this argument, even if it was true.

SECTION 2

Part 1

Big Data might enable How Music to understand the features that might link an act's popularity with the raw data on the phone vote, so that it might understand the votes cast better. For example, there could be factors that affect voting behaviour that have little to do with the acts themselves. The television audience could, for example, be influenced by the weather. The audience may be smaller when the weather is nice enough to encourage viewers to venture outdoors and it may also affect the viewing demographics. This knowledge might reduce the risk of signing an act because it gathered a large proportion of the available votes on a slow night.

Big Data could also help Denny to manage the editing of broadcast shows to maximise the exposure of any acts that he favours. For example, he could look at whether later acts are more likely to receive votes than those appearing earlier in the shows, or whether musical acts receive more votes when shown successively or sandwiched with other forms of entertainment such as comedy. That same information could be used to establish whether any insights into the potential popularity of an act could have been driven by factors such as, say, a poor act that had been shown immediately before. Big Data will enable Denny to establish the qualitative issues that underpin the more obvious quantitative issues such as the raw number of votes cast.

Big Data may help to filter out geographical factors, or at least measure their impact by using the location data implied by landline calls. Viewers may vote in greater numbers when the act comes from their part of the country. If that is the case then Denny can establish whether it is helpful to encourage How Music's acts to make a feature of their backgrounds. It may translate to increased sales in some areas, but reduced sales elsewhere, if they do. There may be a stronger market in some parts of the country and it may be worth actively recruiting performers whose regional accents and biographical details appeal to more committed music buyers.

Big Data can also look for patterns across weeks. The voters are identified by their phone numbers and so it would be possible to establish the frequency of voting by individuals and whether there is any useful information to be had from separating the data from repeat voters from that of less active participants. There may also be some useful demographic information implied by the type of phone used to vote. For example, mobile phones may be more likely to be used by younger people and may imply access to social media during the broadcast.

Part 2

The first thing to establish is how the data from the phone company is organised. There is scope for independence because the phone company has no particular interest in manipulating the figures relating to any given act. The data is, however, likely to take the form of a database of votes with the accompanying details. Thus, the first priority for internal audit is to establish how the votes are transmitted to Evestar and who has access to them. Secondly, it is important to understand how the database is analysed.

The internal auditor will then check that the system has operated correctly with regard to the transmission of data files. The best way to do that would be to request duplicate copies of the files from the telephone company so that we can verify the files in Evestar's archives against them. This could take the form of basic comparison of factors such as the file size and the time and date when it was last saved or it may involve a more extensive electronic comparison on a record by record basis. The comparison should confirm that none of the data has been excluded or deleted in order to manipulate the overall result.

The analysis must also be checked. The best way to accomplish this would be to analyse the results of the duplicate file obtained from the phone company. The auditor can write a database routine that counts the votes for each act and outputs this in a format that should be comparable with the version created by the production team. Any discrepancy should be queried and the reasons investigated, particularly if the difference involved the overstatement of votes for any acts subsequently signed by How Music. The internal auditor could also review the logic in the database routines used by the production staff to count the votes.

The votes could also be analysed for any other signs of manipulation. For example, some viewers may vote more than once, but a pattern of significant numbers of votes cast by duplicate numbers could suggest cheating. It is clearly possible that any such repeat votes could be cast by How Music or an associate with a view to creating positive publicity. This is particularly important in the case of the final show, which ought to be regarded as high risk because of the news value of winning the show.

SECTION 3

Part 1

The principal concern associated with combining the roles of CEO and Chairman is that there will be too much power and too little accountability. One defence that Evestar can offer is that Denny is a very high-profile individual who attracts a great deal of media attention. Furthermore, Evestar's operations attract considerable interest. The decisions made by Denny are likely to be noticed and commented on. It could be argued that there is little real need to appoint another board member to review Denny's decisions and management style because the general public and popular press will highlight any abuses.

A second defence for Denny's dual appointment is his unique ability to lead Evestar. Firstly, he founded the company and has been its driving force since its creation. Thanks to his leadership, Evestar has prospered. Denny's personal reputation is at stake because it would reflect very badly on him in the event that Evestar should fail. Denny's background in the music industry is also a major advantage because his reputation in the music industry will help to attract musical acts for shows such as Teeland Variety. It could be argued that more traditional business people would stifle Evestar's creativity in the event that Denny was replaced.

Part 2

The basic problem with Denny resigning from one post could be that he will continue as before, albeit with a different job title. It will be very difficult for the replacement for whichever post he vacates to become established as a true authority figure. In that case, any changes will be artificial and it will be unfair to the shareholders because it will create a false sense of oversight that does not actually exist. It could also be difficult to recruit a credible person for the vacant role because potential candidates will fear that their careers may be damaged.

Denny cannot really vacate the role of CEO and continue as Chairman because he has had such a hands-on role with Evestar in its artistic development. The danger is that he will be inclined to meddle in strategy and so undermine the replacement CEO. It might be even worse if he continues as CEO because the new chairman may find it very difficult to manage Denny. Also, the other directors are used to deferring to him and so they may not accept his replacement's leadership in the event of a dispute.

Part 3

Denny's knowledge of the music industry will undoubtedly have helped him in developing and promoting the musical elements of the programmes made by Evestar. Starmaker and Choirwars are both essentially about broadcasting musical acts that viewers will enjoy. Denny knows how to identify acts that will prove popular and knows which styles of music go down well. Signing and promoting acts identified through Evestar's programmes benefits the programmes as well as How Music.

Knowing that Denny is an influential member of the music industry creates opportunities to make the programmes more appealing to viewers. Watching an unknown performer face a music executive of Denny's stature will help create tension when programmes are broadcast. The acts themselves will be under greater pressure and so there will be more scope for conflict during the programme. The fact that Denny is an important and successful person could actually create a sense of jealousy and dislike that could actually encourage viewers to watch, just to see him bullying contestants.

Part 4

The efficient markets hypothesis implies that share prices contain all relevant information. It may be that the rumours add little to what the market knew already, which is that Denny need not necessarily stay on the Board of Evestar indefinitely and that he may leave at any time. In that case, the share price would only respond to information that actually narrowed down the likely timing of any departure. It may be that the markets are kept well informed because Denny's intentions may be queried frequently and so the rumours may be nothing new.

The lack of a reaction to any credible rumours that Denny might leave would be bad news for Denny because it would suggest that the markets do not care if he vacates office. This would mean that the markets do not believe that he contributes anything of great value, although that would be the stock market's opinion and not the actual reality. The fact that the share price did not increase at least means that Denny is not perceived as holding the company back. It may take some time for the markets to evaluate the impact of Denny's departure and so there may not be a single, discernible reaction.