

CGMA FEBRUARY 2017 EXAM ANSWERS

Variant 4

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SECTION 1

Part 1

It seems that this will be the first time that Evestar has sold a licence to another programme maker. The ability to sell shows to this new market is an important capability that Evestar will have to acquire. These companies must all be based overseas because Evestar will not wish to have another company targeting broadcasters in Teeland with a competing version. This will require the development of contacts and the ability to negotiate in target countries. There may be cultural problems, such as understanding the different legal issues in different countries.

The development will also require skills in the practical issues associated with making programmes overseas. Evestar is used to operating from a fixed site in Teeland, where it is relatively straightforward to monitor and manage production. There will be significant logistical challenges in terms of transport and operating from a relatively inaccessible site. Even The Cavern was produced in an old mine, which would be well served by the infrastructure that would have been put in place to support mining operations.

We may have to base staff in Paradis on a permanent basis because the submarine and the site will have to be maintained and secured. We will also have to brief foreign production companies who come to use our set and we may even have to provide technical staff to record the action. This will require us to develop the necessary skills and understanding to recruit and manage our staff in this foreign location. We may have to develop an understanding of the labour and health and safety legislation in Paradis.

We need to master the technical complexities associated with recording aboard a submarine. The nature of the location may make it very difficult to run audio and video cables between compartments and there may be problems with lighting and audio recording. The submarine will not have been built to facilitate filming and there may be significant challenges. For example, the production crew may have to deal with the fact that the submarine is split into a large number of very small compartments and that the audio recordings may be affected by having to run a diesel engine for the sake of generating electricity.

Part 2

This venture will leave Evestar exposed to the effects of currency movements. In particular, there will be transaction risks associated with currency movements between contracting with other programme makers and the settlement of their balances. Billing those companies in T\$ will eliminate that risk. The downside is that the buyers will then be exposed to any movement in the T\$ and that may make them reluctant to sign a contract. This is a common problem when trading internationally. Effectively, one party must accept the currency transaction risks and they may be reluctant to do so without compensation.

These risks could have an impact on the net present value of the project because expectations of future currency rates could drive sales revenues. A strengthening T\$ will generally make it either more expensive to buy from Evestar or less attractive for Evestar to make those sales. These economic risks can be a significant problem, partly because they are difficult to quantify. If Evestar is renting out a facility in which T\$70m has been invested then the rental rates will have to be substantial in order to make that investment economic and that will deter potential buyers.

Some of the running costs associated with this programme are unlikely to lend themselves to trading in terms of T\$. For example, air fares for the crew and contestants will be driven largely by oil prices and those are priced in USD. Thus, we will be forced to accept some currency risks regardless. It may be possible to hedge those costs by finding a US customer, so that we have both income and expenses affected by USD exchange rates.

The anchorage and any associated land that we plan to purchase may be affected by currency movements. This would be indirect because changes in the economy of Paradis could affect both the exchange rate and the value of property there. The submarine is less at risk because it can be relocated to a different place where the economic variables may prove to be more favourable. The loans to acquire these assets probably could be taken out from Teeland sources and priced in T\$.

SECTION 2

Part 1

Evestar is highly geared, with a ratio of $250/(250+174) = 59\%$. Finance charges are already 17% of operating profit. Presumably, gearing would increase to $320/(320+174) = 65\%$. The impact on gearing suggests that we should revisit the question of whether it would be truly impossible to raise equity for this project.

The existing bonds are secured by a floating charge against Evestar's assets. This leaves specific assets available to serve as security, but it would seem inconceivable that the existing bondholders have not protected themselves with a restrictive covenant that would limit our ability to borrow further and to pledge assets as security. It may prove difficult or even impossible to secure any additional loans against Evestar's property. We may have to renegotiate with the bondholders to be permitted to borrow at all.

The downgrade in Evestar's bonds will be sufficient to increase the cost of debt on the existing bonds. It will make any additional debt that Evestar requires even more expensive to finance. It seems like a rather reckless act to be approaching the markets to increase borrowings at a time when the company is being criticised for being too highly geared. This is particularly true when the debt is being used to finance a speculative venture.

The assets that we will be buying for this project are hardly ideal security with which to mortgage a loan. A decommissioned submarine will always have an intrinsic value as scrap metal, but that may be diminished by the fact that the asset has been transported to Paradis. Transportation costs will have to be factored into the valuation of the submarine. The anchorage is a piece of property, but it is located on a deserted tropical island, which may suggest that it is very much a niche asset that could be difficult for a borrower to realise if claimed as collateral.

Part 2

The Marooned project stands out from existing activities because it requires a substantial investment in property and also plant and equipment and it will also be required to operate in a fairly autonomous manner, with overseas sales to third parties. It would make sense to establish a formal management structure for Marooned, giving the management team autonomy to manage their resources in the most effective way possible. Ideally, we would wish to motivate the team to go out and sell as many licences to use the Marooned programme concept as well as the set itself. We need to develop suitable performance measures to obtain a motivated performance.

The management team of Marooned will be expected to deliver a realistic rate of return on the T\$70m invested in the project. This could prove demotivating because they were unable to offer any input into the project itself. They may find themselves hampered by problems with the location or the host government and will still be expected to turn in a satisfactory performance. We cannot necessarily agree to the project being classified as a profit centre rather than an investment centre because we cannot permit managers to lose sight of the significant investment that has been made.

The fact that Marooned stands alone within the structure of Evestar makes performance measurement difficult because there are no comparable figures from other SBUs. This could lead to dysfunctional behaviour because the Marooned management team may simply aim to fill as many two week slots as possible in any given year regardless of the revenue generated. In the absence of specific targets, the management team could become stressed by concerns that their performance could always be improved. We would need to ensure that there were regular reports and reviews so that there can be clear communication as to the quality of the management team and its efforts.

One further complication is that the Marooned SBU is selling the means to create a product and not the product itself. The Marooned team may support a foreign programme maker in an effective manner, but the resulting programme must still be sold to a broadcaster and viewers encouraged to watch. There may be a lack of repeat business if foreign versions are not promoted well and viewers choose not to watch. We need to ensure that we either accept that, or we give the team the resources to support the distribution channels, perhaps by developing suitable advertising for the show.

SECTION 3

Part 1

The basic ethical issue here is that the programme makers were put under pressure to provoke one or more incidents that would be reported on social media or in the press and so improve viewing figures. The incident that was provoked amounted to a cruel bullying incident that harmed the mental health of two contestants, at least temporarily. This seems like a clear breach of the principle of professional competence and due care. The Board was aware that it was creating an inflammatory situation for contestants who had already been put in a stressful environment and it ignored their health and safety needs.

This could also be viewed as a lack of integrity. The Board was effectively changing the profile of the competition in order to create more attractive television. The change of intensity in the pressures imposed on the contestants was bound to have unpredictable results, which demonstrates a reckless lack of consideration of the contestants. The contestants could have had no way to tell that such extreme penalties would have been introduced in these circumstances.

Part 2

The first control would have been to have had very clear guidelines in place as to the manner in which the competition would be permitted to unfold. There should have been input from an accredited psychologist as to an acceptable level of penalty for the failure to complete this task correctly. The contestants are being placed under undue levels of stress and discomfort as it is, without withdrawing basic comforts such as showers. All decisions relating to the programme should have been left to the programme makers and the Board should not have interfered.

The contestants should have very clear instructions as to what constitutes unacceptable behaviour in the contest. The whole point of the show is to create drama and conflict, but that cannot be at such a cost to contestants that they feel endangered. The whole submarine is wired for audio and video and there should have been a means to tell the contestants that they could not douse the bedding in cold water. There should be a zero tolerance of bullying, with perpetrators being ejected from the competition.

Part 3

The entity will probably have the greatest value as a going concern, but it has a very brief and undistinguished history and so cash or profit-based models will be difficult to apply. We might create or update a business plan for Marooned and use that as the starting point in our negotiations with potential buyers. The difficulty will be that the show has proven controversial in Teeland, but that may not be a particular issue in other countries where social norms pay less heed to health and safety. It may be possible to negotiate the sale on the basis of anticipated revenues and profits according to the plan.

The alternative would be to present the Marooned set as two assets: the submarine and the anchorage. They may have some value in a different context, such as an unusual holiday home for a very wealthy individual or as a tourist attraction for the government of Paradis. We could investigate buying the land surrounding the anchorage in order to develop a facility such as a marina or some other form of resort. It may then be possible to use the submarine in some other way, possibly sinking it as a reef to attract marine life for tourists wishing to scuba dive.

Part 4

We might argue that the investment in this venture is a sunk cost and that we should be prepared to abandon the venture while realising as much of our investment as we can. The shareholders are likely to view this as a careless waste of their money. It is very common for disputes or arguments arising from governance issues to be viewed in an emotional manner. There may also be concerns of a recurrence if there is no action arising from this incident.

There could also be a share price reaction, but the size and direction will depend on the shareholders' perceptions. If the markets viewed this as a loss making proposition then the abandonment of the project may lead to an increase in the share price because the losses will have been avoided. Conversely, if the Board had convinced the markets that this would be a commercially sound venture then the share price would almost certainly fall because of the revision of expectations. Share price movements would leave emotion out of the equation, although they may factor in the effects of possibilities such as the changes to future operations as a result of this incident.