

CGMA FEBRUARY 2017 EXAM ANSWERS

Variant 5

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SECTION 1

Part 1

The biggest risk is that Evestar will struggle to sell advertising on its new channel and that the expanded company will fail. At present, Evestar owns the rights to a few highly successful programmes, which may owe much of their success to the fact that they are shown by the major national broadcasters. Advertisers know that IndTV is popular with viewers and they know that it will replace Teeland Variety with another programme on Saturday nights. Evestar will be competing in an area of the industry that they know nothing about.

Even if Evestar is able to retain its viewers for a few key slots in the week, we have the threat that we may be unable to offer attractive programming over a whole week's broadcasting. Viewers may enjoy the programmes that we have been making up until now, but they may not wish to watch much more reality television over the course of a week. There is a risk that we will leave viewers bored with our brand of television and that we will impair viewing figures in the longer term. If we are forced to buy programmes for broadcast then we will lose the synergies associated with making and broadcasting our own programmes.

The most obvious benefit is that we can retain the advertising revenues earned by our own programmes, rather than allowing broadcasters to take some of the added value. In theory, this vertical integration should make us more profitable because we can make our own programmes for very little and we can then use them to generate advertising revenues. We can work closely with advertisers to offer opportunities for discounts and other forms of incentive to make commitments to advertising on our new channel. The fact that we are broadcasting familiar programmes that are already popular with viewers should help.

We may also have greater scope to work with new programme ideas that could be viewed as risky propositions by the mainstream broadcasters. The reality television genre offers considerable scope and Evestar will be able to put new ideas into production in order to gauge viewer response. The downside of putting a new idea into a midweek slot is not that high if we have control over the programme and can even abandon production if it is not well received. The upside of being able to try new ideas in a low-risk manner should enable us to develop new ideas that we can either use to retain viewers or sell to other broadcasters.

Part 2

Paying by cash would give us a little more flexibility because we could either sell new shares through a rights issue or we could borrow the cost. This flexibility may not be particularly valuable because we have a high gearing ratio already and so borrowing may be difficult to negotiate. Having said that, Evestar is making substantial taxable profits and so the tax savings on further borrowing would offer tax relief as well as a lower gross cost compared to equity. Debt is generally cheaper than equity.

A cash offer could be more attractive to the seller. Presumably, we are not planning to buy a major company such as IndTV and the smaller digital channels are generally fairly recent start-ups. Their present owners may be keen to liquidate their investment and could be willing to accept less in cash than they would demand for shares. Evestar is a quoted company, but it could be difficult for the target company's shareholders to predict what they will get from selling their shares immediately after the takeover.

A share exchange avoids the need for any outflow of cash. Evestar will not have to promote and pay more for a major public issue and so professional fees should be minimised. The company is essentially introducing new equity investors, who are effectively giving their equity in the target company in return for their new stake in Evestar. This would be an opportunity to expand through acquisition at the lowest possible cost.

The biggest risk is that Evestar's existing equity shareholders will suffer because of the dilution of their equity. The shares that are issued will spread the existing returns more thinly. There may be a considerable gain if the merger proves successful and the expected synergies are realised. Unfortunately, the downside risk would be that Evestar finds itself having to dispose of its investment in the target company's assets. A cash purchase would leave Evestar owning a block of shares that could be sold to dispose of the target in a neat and precise manner.

SECTION 2

Part 1

We need to ensure that the targets reflect the situation that Evestar finds itself in. We are creating a new channel that may not prove effective when it comes to attracting viewers. We will be stirring up competition for ourselves with mainstream broadcasters, who will react to any attempts by us to take their viewers. The advertisers do not necessarily want or need another channel to dilute their advertising spend. Our Head of Advertising will be demotivated if we do not allow for such challenges.

We must ensure that the Head of Advertising has some sort of stretching target, though, otherwise we cannot expect to see much progress. We should start by going back to the assumptions in the business plan associated with the decision to acquire a broadcast channel. Those assumptions should cover the question of revenue generation and we should ensure that we still regard them as achievable. We must develop a strategy for selling advertising, which is just as important as that for making programmes, and base any production targets on that.

We should conduct market research and study scenarios to gather as much information as we can about likely viewing figures. These projections should then equip the Head of Advertising to talk to potential advertisers in an informed and constructive manner. We need to set targets on the basis that we are competing with the existing mainstream broadcasters and that we expect to win a realistic market share even if we have to offer discounts in the initial stages of this new venture. The Head of Advertising should be consulted in setting the basic target.

The Head of Advertising could also be given more specific targets for activity levels, such as the number of meetings held with advertisers. Amongst other matters, these meetings should be used as an opportunity to seek feedback and proposals from advertisers in order to evaluate potential demand. This feedback could then be converted into further targets, such as converting promising leads into contracts from clients. The Head of Advertising should be set a very specific target in terms of the discounts that should be offered when comparing our rates with those for comparable viewing figures offered by other channels.

Part 2

The biggest implication for the company as a whole is that Denny attracts a great deal of publicity, which may help to sell television programmes. Newspaper editors can use his personality and prominence to sell a story that might otherwise be regarded as unremarkable. This can generate significant publicity that might boost viewing figures. It could also have the effect of making a negative story seem all the more personal, which could discourage people from watching the shows.

Denny's combined roles creates a particular dynamic on the Teeland Variety show because part of the attraction is the potential for disagreement between the three judges. Knowing that Denny is CEO and Chairman and so could, at least in theory, terminate the contracts of the other two judges, is a source of tension that could make viewing more compelling, especially when arguments break out. Denny is effectively unaccountable to any higher authority within Evestar for anything that he says and that could make for more dramatic television. The danger is that Denny could be seen as a bully and undue criticism of contestants could make viewers uncomfortable.

There may be a danger that Denny is spreading himself too thin with his various commitments. Acting as lead judge on Teeland Variety will take up a lot of time while production is under way. The roles of CEO and Chairman are essentially strategic in nature and so they may not require his full attention all of the time. The danger is that the public will

become bored with stories about Denny and so he could start to create negative connotations about the programmes that he is involved with.

The broad governance concerns associated with the combination of the CEO and Chairman roles are possibly heightened by Denny's role as a judge. The publicity and the exposure that his television appearances create may make him even more determined to make the fullest possible use of the freedom created by being both CEO and Chairman. If Denny starts to see himself as a key element of the most important product created by Evestar then he may develop a very dangerous sense of entitlement. That lack of self-reflection and the significant scope for abuse of position could lead to worries about a governance scandal.

SECTION 3

Part 1

The valuation exercise is complicated by the fact that the value to Evestar may be significantly different to the value to the existing owners. We need to establish both valuations because it will compromise our ability to reach an agreement if we do not allow for both parties' different interests.

The existing owners may view the company as a going concern and might wish to value it using a model based on dividends or profits. We will probably be more inclined to value the company as a single asset, namely the value of the broadcasting licence, which is effectively the only reason we are buying the company.

A profit-based model would take Teeland Fishing's most recent financial statements and would multiply the earnings attributable to the shareholders by a quoted broadcaster's price/earnings ratio. This would be a defensible starting point for valuation, although it would be distorted by the fact that a quoted company could enjoy economies of scale and so the P/E ratio might overstate value.

We might value the licence according to market forces because they could change hands from time to time. Looking at past selling prices would help us to estimate the market value. We might also get an approximation by looking at the prices paid for licences when digital television was launched. The government undoubtedly had a basis for the asking price per licence.

Part 2

Evestar is not really looking to exploit any real operating synergies with Teeland Fishing. All that we really need is that we acquire the right to broadcast our choice of programmes. We would need to investigate any restrictions that might have been imposed by the regulator who approved the sale of the licence to Teeland Fishing in the first instance. It is unlikely that there will be a problem, but we need to do that before the acquisition so that we can take care to ensure that the terms can be changed if need be. We may or may not broadcast Teeland Fishing's existing programmes during the working day, but we could just as easily fill those hours with almost any low-budget programming.

The technical staff who operate the broadcasting side of things will, presumably, stay with Evestar after the merger. It would be inconvenient to have to replace them, but there is no reason for us to threaten any redundancies or reductions and so should be able to convince them to stay on easily enough. We will be negotiating advertising contracts as a separate activity and we probably would not wish to extend Teeland Fishing's existing contracts because their rates are low. We are not particularly looking to retain the company's viewers.

Part 3

The control environment is largely driven by the attitudes of senior management towards internal control. There are good reasons to have a sound control environment, but that would not prevent individual management teams from differing in their approach. The control systems of a broadcaster will differ from those of a programme maker and that would affect approaches to controls. The fact that Evestar has employees out on location, with large numbers of fairly significant costs being incurred, would make it more appropriate to have a stricter control environment.

Teeland Fishing is a much smaller entity, which may mean that controls (and so the control environment) can be less formal and more dependent upon the close interest of directors in the operations and administration. A quoted company, such as Evestar, will be expected to

have formal systems in place to monitor staff at all levels and these must comply with applicable governance regulations. The fact that Teeland Fishing is also a retirement project for the directors could suggest that they are more concerned with promoting fishing than with controlling the entity. Conversely, they may be motivated by the fact that it is their money that is at stake.

Part 4

The starting point would be to look at the factors that might indicate a strong control environment. For example, does Teeland Fishing have an internal audit department of its own? If it does, then Evestar's internal auditors should meet with their counterparts and ask for their opinions. In the absence of an internal auditor, our audit team should meet with Teeland Fishing's directors on an individual basis and should ask about processes and procedures. The fact that the directors are all experienced business people means that they should be able to explain how the systems operate and their attitudes should come through.

There are other sources of information that can be tapped. Even a small entity should have regular management meetings and our internal auditor should review the paperwork prepared in advance and also the minutes. A good control environment implies the ability to manage the entity effectively. It would be desirable to see that the Board has regular budgetary reports and that variances are studied and investigated. This might be backed up by conversations with key people such as the management accountant and the cashier to establish just how effective they believe the management team to be.