CGMA MAY 2017 EXAM ANSWERS

Variant 2

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

SECTION 1

Part 1

Ethics of product placement

We might use some of the concepts from the CIMA Code of Ethics to determine whether this proposal is unethical.

Promoting our drink in this way could be viewed as a breach of the concept of integrity, because we are supposed to be straightforward, honest and truthful in our business relationships. Audience members will not realise that the prominent placement of Froot is an active attempt by Fizz to market a product to them while they are watching. Inserting the drink into a much larger movie is effectively creating the same impressions as an advert, but it is arguably unfair to consumers who may not realise that they are being subject to this influence. Many consumers will believe that Froot is being used because it is a popular soft drink and will not realise that it is a paid promotion.

There could be an issue of due care because we are putting Froot in the hands of a leading actor in a starring role. This film may be popular with younger viewers, who are being presented with a very positive impression of a high-calorie drink. The character is a role model, who is working alongside a well-known and popular comedian. The audience will see the hero and his sidekick drinking Froot frequently in the course of the film and that could encourage impressionable viewers to drink too much of this product.

There could also be a breach of professional behaviour because the question of product placement may be viewed as somewhat unethical and so the Board may be risking Fizz's reputation. Fizz may be viewed as having attempted to mislead the audience into believing that its product was selected for the film on the basis of merit or popularity. That could have the effect of creating a backlash if there are complaints, particularly if they are aired in the press or on social media. It might be more ethical for Fizz to commission an overt television and newspaper advert featuring Billy Boxx and tied to the film.

All of these arguments are potentially valid, but there is a counter argument that the placement is basically ethical. Firstly, the film itself is clearly a work of fiction and viewers will watch it on the understanding that it is not real. If they can differentiate the other actions of the hero (e.g. car chases and fight scenes) from reality then they can choose not to drink Froot constantly. The film's audience will be protected to some extent by the age restrictions that are generally applied to movie audiences and so younger viewers should not be watching the film without supervision. Finally, product placement is a well-known phenomenon that should not confuse many audience members. Most will be aware that manufacturers frequently pay to have their products showcased.

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Part 2

Shareholder response

The cost of this placement is almost 7% of 2016's pre-tax profit. It is a material amount. This is a high-risk investment because Froot is already a popular drink in Nortland and it is unclear whether its placement in this film will boost sales in other countries. Indeed, there is a risk that the film itself will prove unpopular and so very few potential consumers may even see it. In the best possible case, export sales will develop gradually, long after the cost has been incurred.

The most effective way to reassure the shareholders would be for Fizz to issue a press release to announce that it had secured this prominent placement arrangement. That would enable the deal to be publicised, hopefully on the basis that Fizz had made an astute investment. It will also show that Fizz is growing to the stage where it can justify making such a substantial investment in a Hollywood movie. That will enable the shareholders to be ready for the expense appearing in the financial statements for the year ended 31 December 2017 and to have decided that this is a justifiable expense.

The financial statements will show the investment as an expense because this cost cannot be capitalised under IAS 38, but the notes to the financial statements should reflect the reasons for the write-off, if only to remind the shareholders that there is a long-term strategy in play here. We can back that up with a discussion in the Chairman's report that expresses confidence in the merits of this investment. It could even be worth inserting a page in the financial statements that discusses this project and shows some stills from the film.

Finally, it would be worth briefing major shareholders on a face-to-face basis. That would give them the opportunity to ask questions and express any misgivings. If we do this in advance then we will be expressing confidence that this is such an excellent proposal that we are confident the shareholders will back it. If the major shareholders are informed then there shouldn't be any significant concern when the financial statements are published with a one-off expense that diminishes the profit for the year.

SECTION 2

Part 1

Currency risk

The translation risks will arise from any monetary balances arising from transactions in foreign currency that will remain unsettled at the year end. In this case, the most likely balances will be trade receivables denominated in a foreign currency. If a sale is made to a foreign customer, the balance due will be translated to N$ at the prevailing rate at the date of the transaction. If the balance remains unsettled at the year end, then it will be restated at the closing rate and any difference will be recorded as a currency gain or loss.

Translation gains and losses are likely to be very limited because the total working capital investment in this venture is only N$30m, and much of that will be in the form of physical assets such as inventory. Also, export sales are often settled very promptly as part of the process of managing credit risks. The likely exposure will be reduced if some sales are effectively made on a cash basis because the customer has to pay for the goods before they are released from the dockside. We also need to consider the volatility of any exchange rates because the lower the volatility the less scope there is for an exchange gain or loss.

Economic risks are likely to arise largely because changing rates will affect the cost of Froot in the export markets. If the N$ strengthens then it will cost more for the importer to buy a consignment of Froot and that will push up the retail price. The local soft drinks will then have a more competitive retail price and that could push Fizz out of the market. Of course, there could also be some upside risk in that any weakening of the N$ will reduce the retail price in target countries.

The economic risk as described is largely related to the price elasticity of demand. In this case, Froot is a new drink, so it is well-differentiated from competing products on the market. It is also tied into a recent Hollywood movie. These factors may make it possible to charge a premium, at least in the early stages of its introduction to the market. Furthermore, Fizz may be willing to treat the overseas launch of Froot as a long-term venture and be prepared to operate at a loss initially. In that case, the loss may not be affected to a material extent by currency movements and so the risk may be small.

Part 2

Scrip dividend

The suspension of the dividend could prove a problem for shareholder confidence. The dividend would have been a known and certain cash flow, whereas the investment in an overseas expansion is uncertain. The fact that the directors cannot afford to pay the dividend because of this project could make it seem like a rather reckless use of the shareholders' money. Last year's dividend was only $N66.0 – (255.2 – 220.0) = N$30.8, so the proposed suspension of dividend seems like a cancellation of more or less the whole dividend for the year.

The shareholders may be concerned that the scrip dividend does not suit their tax positions. Generally, dividends are more attractive to shareholders who prefer to pay income tax than earn capital gains. Companies often attract a body of shareholders whose tax circumstances are well aligned with the company's dividend policy. Any disruption could lead to a number of shareholders selling Fizz shares in order to be certain that their tax needs are met.

In one sense, the scrip dividend makes very little difference to the shareholders. It essentially increases the number of shares in issue and dilutes the value of each share. The dividend will tie up distributable reserves and convert them into non-distributable share capital which could, in theory, limit the scope for future dividends. In reality, this will have almost no impact on the shareholders because reserves are currently N$255.2m and so

tying up N$30m will have almost no real effect. There is also the fact that if the dividend had been paid that would have reduced distributable reserves by the same amount.

The prospect of selling the scrip shares would create the risk that the shareholders' interests could be diluted. The selling price might not allow fully for the prospect of the overseas expansion and so the shareholders may regret selling a portion of their equity at this time. They may have been forced to do so in any case in order to generate cash flow in the light of the suspension of the dividend, but the terms of the scrip dividend could put the suggestion in some shareholders' minds to the effect that the scrip shares should be sold.

SECTION 3

Part 1

Valuing target company

Our first consideration is establishing how much the company is worth to Fizz. That value is essentially the savings that it will create in terms of establishing the necessary infrastructure in the US. If we buy Deliver then we will acquire a team of employees who understand the issues associated with selling and delivering soft drinks in that part of the US. Those new employees will have contacts that would take years for us to develop if we established a new company from scratch. There will also be an asset base that comprises used assets in good repair and working order that will be cheaper than acquiring the equivalent assets new.

We also need to establish the minimum price that Deliver's present owners will accept. The fact that the company is for sale suggests that they are not generating sufficient profit to make it worth keeping the business. We should consider looking at the earnings and use a basis such as the price/earnings multiple to establish a realistic price. Logically, we should compare that with the assets basis, excluding the workforce, and the dividends basis and should set the highest result as the starting point for negotiations. The fact that the present owners are planning to sell suggests that we should consider asking for their valuation first, in order to avoid starting with too high a bid and overpaying as a result.

Part 2

Divestment strategy

Ideally, we would wish to sell our investment in Deliver in the event that our venture is unsuccessful. Maximising the potential selling price involves keeping Deliver in a form that could be sold as a viable going concern. The easiest way to do that would be to continue to sell the existing range of products. While that could be viewed as assisting competitors, it will be easier for Deliver to deal with customers if it can offer a full range of soft drinks alongside Froot. It could also assist us to sell Fizz Carbonated alongside Froot.

We need to ensure that we maintain a healthy level of investment in Deliver as a business. That will include maintaining assets to a high degree and training staff. We also need to develop a widespread customer base, which is consistent with our initial mission in any case. In an ideal world, we may be able to persuade the buyer to continue to import Froot and make sales even if we withdraw from the US.

Part 3

Retain sales force

The most immediate challenge is that we will have to integrate Deliver's business model with that of Fizz. We are essentially keen to sell as much Froot as possible, possibly in place of existing products that the sales force is used to promoting. It may be difficult to motivate the sales team to promote Froot heavily because they may lose sales figures and commissions if their customers are unwilling to buy Froot in significant quantities. If customers struggle to sell the initial consignments of Froot then the sales team may become even more disheartened.

We also have the problem of developing a suitable marketing and promotional campaign. Techniques that work well in Nortland may fail in the US. If we do not support Froot effectively then the sales team will be demotivated. Froot may also be heavily associated with Pronto Foods, which could have an impact on making sales to other on-trade and off-trade customers.

Part 4

KPIs

The starting point would be to establish how Deliver is going to maintain contact with Pronto. One important indicator would be the seniority of the contact between Deliver and Pronto. Deliver should assign a senior sales manager to act as the account executive for this customer and it would be desirable to see a reciprocal arrangement where Pronto had an equally senior person as its contact. Fizz should be kept informed of the level and the nature of the contact, such as the number of meetings, phone calls and emails. We should also be looking for a realistic measure of any problems and the speed and efficiency with which we have dealt with them.

Fizz should also be looking for other evidence of proactive attempts to sell Froot through Pronto restaurants. For example, the prominence of Froot on the drinks menu. Ideally, Froot should be at the top of the list. Or sales promotions, such as deals involving price reductions if Froot is ordered in place of another drink. We would also be looking to see the nature and extent of any graphics or other references to Froot in Pronto restaurants and the length of time that those posters or other works are to be kept in place.