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CGMA MAY 2017 EXAM ANSWERS

Variant 3

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SECTION 1

Part 1

Fixing ingredient prices

The most immediate advantage is that we would know the cost of ingredients into the future, up to the period that is covered by these instruments. Ingredients are a significant component of our total cost price. We will be able to price our products, knowing that we will not suffer any unforeseen losses due to an increase in sugar prices. This will also ensure that our cash flows are easier to manage because we will not be forced to deal with unexpected payables.

The fact that our competitors fixed their prices meant that we were at a potential disadvantage if prices rose, as they did recently. Our competitors can leave their selling prices unchanged without incurring any reduction in profits. Their shareholders may appreciate the resulting decrease in volatility and so their shares may be regarded as less risky. Their boards may also seem more astute because they are not leaving themselves exposed to commodity fluctuations.

Fixing prices protects us against price rises, but also means that we cannot take advantage of price falls. If sugar prices had fallen then we could either have undercut our competitors or left our selling prices unchanged and had a larger profit. Paradoxically, we cannot be certain whether our competitors will fix their prices in the future and so we could find ourselves fixing and suffering a loss of market share if prices fall. We could be forced to sell at a loss in order to maintain our market position.

It is also debatable whether fixing in advance will affect our total costs in the long term. Sellers will not fix their prices without some thought about how the market is likely to move. If sellers' expectations of prices are largely accurate then we will end up paying the same overall as we would by buying on the open market. Furthermore, there are market forces that will cancel any fluctuations. If sugar prices rise then farmers will sow crops accordingly so that supply increases and the market price falls.

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Part 2

Scenario planning

A formal system of scenario planning would involve Fizz's management and board making constant predictions about the future so that potential disruptions can be at least planned for. The most relevant starting point would be to keep Fizz's PEST analysis up to date, with particular attention being paid to changes that might be foreseen. The prediction should extend out to a realistic horizon, allowing for likely disruptions such as a general election and a change of government. The implications of those changes for Fizz's business future should then be considered.

Ideally, these changes will lend themselves to a limited number of matters for consideration. For example, there may be several scenarios in which manufacturing costs increase. Fizz can then consider a range of likely possibilities, ranging from the least likely, through to the most likely. Each of these possibilities can then be planned for, so that Fizz has contingency plans in place for each scenario. It may also be worth considering whether there are resources that ought to be acquired in preparation for a key scenario's occurrence.

One possible scenario might be a curtailment of the sale of high-calorie drinks, possibly arising from legislation or from consumer tastes. Fizz could plan for that possibility in terms of the production implications, if any, of changing the proportions of traditional versus sugar-free drinks. It might be possible to plan ahead by consulting with lobbying firms and putting one on a retainer in case Fizz ever has to defend the safety of its products. It would also be useful to have the basis for a marketing plan ready for a shift to alternative products.

Another scenario might be a disruption in the on-trade market, perhaps with mergers between some major players. That could leave Fizz competing to serve a smaller number of customers, each of whom is larger. Fizz might address that possibility by ensuring that it serves as many of the existing on-trade customers as possible, even if some are slightly uneconomic, so that it is likely to be serving both parties to any merger. Fizz should also gather as much information as it can about the business sectors that its customers occupy so that it is aware of any major changes that could have an impact on its customer base.

SECTION 2

Part 1

IFRS disclosures

The first issue is that hedge accounting is effectively optional and so we cannot take it for granted that any competitors who do not reflect hedge accounting relationships in their financial statements are not hedging. We can, however, count on competitors who are subject to IAS 39 preparing any hedge accounting entries in accordance with IAS 39. Lucky Cola and Benson Beverages are both applying hedge accounting, which indicates that they regard the associated transactions as “highly probable”. This gives us some indication of these companies’ minimum expectations regarding highly probably future purchases.

Both Lucky Cola and Benson Beverages have seen significant increases in the absolute value of their cash flow hedge reserves relative to cost of sales. That implies either that they have only started hedging in earnest since the beginning of 2016 or that they hedged in 2015 but commodity prices did not move significantly after entering into the hedging arrangements in the latter part of 2015. There is a credit balance on the 2016 reserve, which indicates that commodity prices have moved adversely since the hedge was created. The debit balance at the end of 2015 may suggest that the two competitors were either unlucky or that they are willing to hedge even if prices are expected to move in the manufacturers’ favour.

The fact that the companies can apply hedge accounting may give us some insight into the sourcing of their ingredients. If our competitors disclose the instruments that they have purchased then they have to form an effective hedge against the commodities. Prices in different markets may not move in exactly the same manner and so the purchase of a future in one market and the intended purchase of a commodity in another may not be wholly effective. The implications of different currencies may also be an issue. Purchasing a commodities future for, say, HFCS in, say, the US would leave the manufacturer exposed to fluctuations between USD and N$, which would require a separate hedge to eliminate the risk entirely.

Unfortunately, the disclosures are only really updated on an annual basis with each new annual report. The information in the financial statements enables us to see that our competitors are hedging and that they believe that they are doing so effectively, but we cannot necessarily tell the gross value of the cash flows that are being hedged. We cannot, therefore, necessarily tell whether our competitors intend to expand production. Indeed, they could conceal such an expansion in their position by claiming that some of the financial instruments they hold are for speculative purposes and by assuming that some of their hedges are ineffective.

Part 2

Hedging department

The first thing that we need to do is to discuss Fizz’s expected hedging strategy with Hong. The skills that will be required if we intend to hedge each and every prospective purchase will be very different to those that will be required if the futures are to be used more selectively. If we plan to hedge all purchases of HFSC then the primary skills will be administrative. The team will have to work closely with the buying department to ensure that there is a future in place to protect each major buy and to ensure that we remain up to date with the hedging instruments.

If, as Hong’s question suggests, we are looking for a more active trading strategy then we need to consider the consequences carefully. We need to distinguish a trading strategy from a trading objective. If the trading strategy is to reduce the volatility of commodity ingredient

costs to an acceptable level then that would be the starting point for the team's decisions. The skills that would be required would be the ability to observe and understand the market forces that affect spot and future markets. The team would then use those skills to selectively trade in specific positions that would have the trading objective of eliminating risk from specific future purchases.

If the trading strategy is to eliminate all risk within the horizon imposed by the availability of instruments then it would be ideal if there were no unhedged purchases. If they occur then we will have to investigate the reason, because it may have been necessary to buy more than intended when the new department was arranging the hedge. If the team is expected to be more selective in its hedging then we need to be careful not to encourage dysfunctional behaviour. It might become desirable to hedge every anticipated purchase, simply in order to avoid being held responsible for any losses.

The danger with tracking hedging gains and losses is that the team members might start to see opportunities to advance themselves through actively trading on the markets. Their roles as traders and their knowledge of manufacturers' needs might impart the belief that they are capable of predicting market movements. That could leave Fizz exposed to much greater risks if the traders start to take large positions that effectively gamble on their ability to outsmart the commodities markets. This could lead to the rogue trader phenomenon, whereby the team starts to make ever larger positions in order to conceal any losses that arise.

SECTION 3

Part 1

Diversifiable risk

The shareholders may take the view that they can diversify just as easily for themselves. Fizz is exposed to increases in sugar prices, so the shareholders might benefit from investing in one or more other companies that benefit from price rises. Given that investors should diversify in any case and should hold a range of shares, there is nothing to prevent them from building a portfolio that diversifies this specific risk. There is a general principle in finance theory that the market will not pay for something that shareholders can accomplish for themselves and so the diversification may not add any value.

There could be an exception with respect to the members of the Clann family, who appear to retain a substantial proportion of the equity. They may not have sufficient wealth to enable them to properly diversify all of the risks associated with investing in Fizz and so they might appreciate it if Fizz hedged for them. The only problem would be that if there are any costs associated with hedging then the net cash flows will be reduced and Fizz's market capitalisation will decrease by the net present value of the costs. The costs may not amount to much more than the cost of tying up cash in margin payments, so the impact may not be particularly severe.

Part 2

Shareholder wealth

Shareholder wealth is related to the market capitalisation, which is linked to market's expectations of future cash flows. The market cannot be aware of every decision made by management. One way to strengthen the link between decisions and share price would be to be open and transparent. If the shareholders are kept informed of both good news and bad then they will be able to incorporate that into setting an appropriate market price. Even then, the release of too much information will also inform competitors, who would then be able to use that knowledge to work against Fizz.

As a rule of thumb, if the directors invest only in positive net present value projects then the market will become aware of the successes, even if they take a little time to yield success. If they then announce new investments, the share price might respond favourably just because the directors have a reputation for selecting and implementing good projects. It will also be good for shareholder wealth if the directors can manage the company efficiently to ensure that it is profitable because in the long term that will yield net cash inflows. Again, there are advantages to delivering steady and consistent performance and being accountable and transparent because that will build confidence on the part of the shareholders.

Part 3

Internal controls

The first control is a detailed set of conditions for trading that the traders must follow. Those conditions must be consistent with the Board's strategy for hedging. We might, for example, state that we will use hedging to fix prices for budgeted purchases up to twelve months in advance. The forwards team would then have a clear set of criteria that can be used to trigger a trade and only such trades should be executed. The buying department should be responsible for ensuring that the budget is kept up to date on a rolling basis and that the latest version is passed to the traders.

Given the likely size and importance of these positions, we should not permit them to be entered into on the authority of a junior manager. The documentation for a trade should be completed by a member of the trading team and passed to the team supervisor for review. The team supervisor should check the details, particularly that the quantities match the budget. The trade should be reviewed by a senior manager or even by the finance director in order to establish that it is reasonable before it is placed.

Part 4

Internal audit

The auditor should start by deciding whether to sample the positions that have been entered into or whether it might be just as simple to investigate all that have been completed since the previous audit. The auditor should check that the documentation supporting each selected transaction has been properly signed and authorised. The details should also tie up to any supporting documentation such as the budget. The auditor should also check that the positions are being maintained properly, with all margins in place and cash flows correctly accounted for.

The futures should also be tested in total by comparing the overall size of the position at any given time with the projected purchases. Ideally, there will be a broker's account or similar starting point that the auditor will be able to use to get an overview of the positions that are outstanding and Fizz's margins on each. That overall position should reconcile to the budgeted purchases. If the auditor conducts that reconciliation on a snap inspection basis from time to time it will deter the traders from leaving any uncovered positions open.