CGMA MAY 2017 EXAM ANSWERS

Variant 4

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SECTION 1

Part 1

Copying new product

The commercial logic is that we can develop a new product line without incurring all of the costs that would otherwise have to be borne. For example, if we develop our own range by making subtle improvements to Qwench's products then we will be spared the process of researching customer reactions to significantly different flavours. We have also spared ourselves the costs of convincing potential retailers and other vendors that consumers will buy such drinks. Our advertising and marketing will be more effective because consumers are already aware of the concept of flower-flavoured drinks.

There is a downside to this approach to commercial development. Firstly, by the time that we have launched, consumers will be familiar with Qwench's range and they may be resistant to trying ours if it seems too similar. Our advertising will not have to sell the concept of these drinks, but we may struggle to say much that differentiates them from ours. Retailers may feel that stocking our range alongside Qwench's will only displace other proven and popular products. Qwench will have considered the possibility of direct competition and may have a response ready, such as cutting prices in the short term in order to force us to sell at a loss.

From a strategic point of view, we are developing a new line of products that will open up a new market to Fizz. Traditional soft drinks appeal to a wide range of age groups, but there may be a number of consumers who will be attracted to a more sophisticated product or one that is not associated with children and teenagers. We also need to be conscious of the threat from Qwench, particularly in the on-trade because restaurants would be a very natural outlet for an adult soft drink. Qwench may use this new range to approach the on-trade customers, who might then switch from Fizz to Qwench for their other soft drinks, or even be forced to grant Qwench an exclusive contract for all soft drinks.

The development and launch of a new product range will be a major financial risk for any manufacturer. There may be a significant investment in new manufacturing technology, as well as developing the necessary supply chain for materials. The initial interest in these new drinks will have to be evaluated more formally than by following Qwench because the initial interest in the product may prove short-lived. Fizz will doubly upset its shareholders if the company fails to develop its own, unique product range and then wastes money by launching a copy of someone else's product just as consumer demand tails off.

Part 2

Ethical risks

The ethical arguments might be approached using the CIMA Code of Ethics as a starting point.

The most immediate issue is that Fizz must comply with the principle of professional behaviour, which requires compliance with relevant laws and regulations. The laws relating to copying products can be complicated, even if the basic idea of patenting the idea of mixing floral extracts with water cannot be patented. There could be significant legal costs if Qwench uses the courts to block Fizz's development of a competing range of drinks. Apart from the potential costs and penalties in the event that Fizz loses, the associated publicity will also create the impression that Fizz has no ideas of its own for interesting new products.

There could be issues associated with professional competence and due care because our product will not be identical to Qwench's. We do not necessarily know what health issues might arise from the use of the specific extracts that we are likely to use in our own range of drinks. Qwench may have developed or modified processes to render these ingredients safe and we may not detect all of those changes during our reverse engineering of the drinks. Even if we produce exact copies of Qwench's drinks, we are responsible for the safety of our own products. If we do not allow sufficient time for testing before we launch then we may be responsible for harming consumers.

The principle of integrity could also be in question. One interpretation of our launch is that we will be profiting from research and development undertaken by Qwench without any acknowledgement or payment for their effort. Fizz could be accused of passing off work undertaken by a competitor as its own and of selling the resulting product under false pretences. Consumers may be misled into believing that Fizz's drinks are different from Qwench's and so they may feel that they have been tricked into buying this product. Qwench developed a new product in good faith and has launched it in the expectation of developing a realistic return from its investment, but Fizz is interfering with its ability to enjoy the benefits of this work.

The principle of objectivity may negate some of these arguments. Arguably, Fizz's primary objective is to maximise shareholder wealth. Anything that it can do without breaking the law or causing other stakeholders significant harm is a legitimate action. There are many products that could be said to be copies. For example, Fizz already produces Fizz Cola, despite the fact that it did not invent cola and despite the fact that the drink probably tastes only a little different from competing colas. All businesses are faced with limitations that arise from market forces. If Qwench's new drink range becomes popular and profitable then it is likely to face a number of attempts to develop competing products.

SECTION 2

Part 1

Strategic relationship with charity

The first step would be to identify areas where we might find common ground with the charity. War on Hunger is effectively arguing that farmers in developing countries ought to be left to grow indigenous crops that can be eaten locally. We have a different agenda because we need the factors to grow cash crops that we can make into drinks. We might be able to reconcile those positions if we can address the charity's specific concerns associated with growing cash crops. These are basically the increased risk of crop failures and the consumption of clean water in the growth and processing of crops for export. We might be able to develop a trading model that would enable us to buy cash crops without exposing the farmers to risks and without exhausting local water supplies.

The first thing that we should consider is whether it would be realistic for us to trade with local farmers in a manner that War on Hunger could support. It has a clear message at present, that traditional subsistence crops are suited to the local soil and weather. The charity will risk diluting its argument if it collaborate with us. We would have to convince it that we can do business in a manner that would benefit the farmers and other stakeholders who are affected by its activities. For example, if Fizz funded the development of clean and sustainable water supplies so that there was a net increase in the water available even after intensive farming took over then the charity might be more open to support us.

We will have to be open about the fact that Fizz will benefit from working closely with War on Hunger because transparency will be crucial to ensuring the viability of this relationship. We will have to reassure our shareholders that our support of farmers is in their overall financial interests and War on Hunger will have to reassure its donors and other stakeholders that the relationship is in the farmers' interests. We need to be able to count on War on Hunger's public support because it may assist us in dealing with host governments and even with the farmers themselves. We will have to develop a model whereby there is clear benefit to the farmers, even if crops fail or market prices fall.

War on Hunger should be asked to identify the potential downsides to the farmers of any agreement to grow flowers instead of their present crops. We can then discuss ways in which Fizz can eliminate those. We need to take care to avoid creating scope for dysfunctional behaviour because there could be a risk that farmers will deliberately neglect their crops if we have guaranteed their return in advance. We also need to establish potential time horizons and exit strategies, so that we do not become tied into an ongoing relationship in the event that we find alternative sources for our ingredients or if demand falls. War on Hunger should be asked to indicate what would be a reasonable period of notice in terms of replanting the fields and bringing in alternative crops if we decide to withdraw.

Part 2

Sustainability reporting

Our starting point is to establish the sourcing of our ingredients and determine the extent to which they are imported from the Third World. That may prove difficult in some cases because some commodities are grown widely and may be sourced from a mixture of First World and Third World sources. We need to be clear about the sourcing and should not deny responsibility on the basis that we buy from suppliers who make the ultimate sourcing decision. At the very least, we should establish how we select suppliers and how we ensure that they are sourcing commodities in a responsible and sustainable manner.

We also need to identify the stakeholders whose needs we will address. For example, the news story about Qwench establishes that diverting clean water affects the local community as a whole, and not just the farmers who supply the produce. We need to establish the basis on which stakeholder interests will be identified and reported. For example, local norms may differ from those in force in Nortland and we need to apply the criteria that our shareholders and consumers would regard as realistic in their own experience. We should not disregard needs on the basis that local laws in host countries do not respect rights in the absence of, say, legal rights.

Fizz needs to be clear as to how sustainability will be defined and determined. For example, rather than simply disclosing the quantity of water consumed in the growth of Fizz's ingredients, it would be desirable to state the extent to which that consumption affects the overall welfare of local communities. It may be difficult to quantify that in terms of water consumption, so Fizz could work with charities and aid agencies to estimate the proportion of the local population that does not have access to clean water. That would, at least, establish the extent to which there could be a direct cost associated with the diversion of water to farming cash crops.

Fizz should determine its materiality threshold in terms of the interests and expectations of the interest groups who wish to understand Fizz's performance. That may mean, for example, that Fizz should report on a location by location basis rather than talking in general terms about its overall performance. Arguably, an adverse impact on one community cannot be compensated by a limited or positive impact on another. Fizz should be clear about the manner in which it determines materiality for the sake of its reporting.

SECTION 3

Part 1

Making sense of share price movements

The fact that Fizz experienced a fall in share price could be due to shareholders believing that this is a bad decision for their company. Fizz may be overpaying for WAP, which would dilute the share price as a result of the new shares being issued in return for WAP's equity. Or the markets may believe that the ethical business model will impose costs on Fizz that will reduce overall cash flows. It may even be that the markets believe that Fizz should not be expanding in this direction by opening an office in West Africa.

The increase in WAP's share price could be due to speculative forces. The knowledge that Fizz needs to acquire 80% could make it worth buying shares in the hope that Fizz will pay a premium in order to buy them. That would not imply that the market has particularly positive views about WAP's prospects, merely that Fizz is expected to pay over the current market value in order to complete the transaction. The price rise could be due to the fact that Fizz has announced terms that are over generous. As one would expect, Fizz has offered more than the current market price and so the market will be incorporating that premium into the current share price. Shareholders in WAP will become Fizz shareholders, with Fizz expanded by this acquisition. It could be that the market expects this acquisition to be a success and that the combined entity will generate much better returns thanks to synergies.

Part 2

Negotiation

The key is to argue that WAP's Board is overstating the value of its company and that the shareholders will miss an opportunity if they reject the offer. It is very likely that WAP's Board will be replaced in the event that the bid succeeds and so its members may be keen to protect their jobs. Even if they are retained, they will go from being in charge of a quoted company to being middle managers who are accountable to a parent company. Fizz might argue that the shareholders should reject the advice they have received on the grounds that it is biased.

One way to minimise the cost of a hostile bid would be to enter into a dialogue with WAP's Board members in the hope that we can negotiate for their support. If we persuade the management team that we have a strong argument to support the basis for our offer then we will stand a better chance of them stepping aside quietly rather than risking damage to their reputations if they are seen to support a weak case because of self-interest. If necessary, we might also enter into negotiations with the Board members concerning their roles and positions after the bid succeeds. They may be prepared to support the bid if their jobs will be protected or, conversely, if we offer them excellent severance terms in the event of their departure.

Part 3

Internal controls

The first control is to ensure that we determine a realistic "satisfactory price", that will enable War on Hunger to endorse us and that will ensure that all stakeholders are treated fairly. Our starting point would be to seek the advice of War on Hunger's local staff and have them advise us on a realistic living wage for the farmer and dependents who work on each farm that we will use. We might have the charity establish a means of identifying the people who are dependent on each farm to avoid having the claim overstated, perhaps by creating a definitive register based on GPS readings for location and digital photographs of the farm staff and their family members. We will then order goods in advance, with the farmer guaranteed the higher of the charity's living wage and the market value of the crops produced.

We need to ensure that we are not creating scope for dysfunctional behaviour. We might have War on Hunger train a number of advisers to visit the farms at key points in the crop cycle for each commodity that we have ordered. Those advisers would ensure that the crops have been planted and are being cared for, otherwise it would be possible for the farmer to benefit by neglecting the crop. The advisers could offer advice and support and so their presence could also be educational and could enable the farmers to improve yields and make their activities more sustainable in the long run. The advisers could also maintain records of weather conditions and other factors that would give a rough idea of expected crop yields, so that we can check that farmers' crop levels seem realistic.

Part 4

Internal audit

The internal auditor could start by taking a sample from WAP's purchase orders and checking that each has been evaluated by War on Hunger's staff. The agreement should reflect the evaluation prepared by War on Hunger and should be supported by the farmer's signature, which should be compared to the specimen copy collected by War on Hunger staff. The terms of each selected order should be in accordance with the wording specified by the charity in order to ensure that the farmer receives the agreed reward. The auditor should also conduct a comparison between the number of farms in WAP's purchase ledger and the number visited and evaluated by War on Hunger to check that there is no disparity to indicate that WAP is ordering from farms that are not in this agreement.

The internal audit staff should take a sample of recently completed orders to ensure that the payments are being made in accordance with the agreements. The quantity and quality of commodities received should be checked to shipping and goods received records. The quantities should also be reviewed for reasonableness against any reports from advisers who visited the farm during that season. Market prices should be checked to historical records to ensure that the farmer receives the higher of the two possible payments.