

CGMA MAY 2017 EXAM ANSWERS

Variant 5

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SECTION 1

Part 1

Approach government

Our approach should reflect the fact that the government is likely to come under pressure to legislate because of the recent bad publicity associated with energy drinks. It is highly unlikely that we will be able to prevent restrictions, but we may be able to find a compromise position that enables us to sell this product, albeit with some changes. The most immediate priority is to establish a low-key dialogue because any public statements that we make are likely to force the government into a robust response, otherwise it will appear weak and ineffective. If we agree to work with government then the legislation will not be as difficult to enact because we will not delay and interfere in matters, perhaps by resorting to the courts.

It would be worth making a joint approach with the other manufacturers who sell energy drinks in Nortland. A joint approach would make it easier for the government because they would only have to deal with one industry view. It would also reduce the risk that manufacturers might become divided if the legislators deliberately offered proposals that affected each manufacturer differently. For example, Qwench's energy drink contains more caffeine than Fizz's and so Qwench's product will have to change more if a limit is placed on the concentration of caffeine.

The simplest response would be for the industry to develop a code of conduct for energy drinks. That would avoid difficult problems of definition and enforcement that would complicate drafting effective legislation. It is also likely to offer a faster response to the problems that energy drinks appear to be causing. If the manufacturers agree to change the drinks themselves or the manner in which they are sold then the government can claim the credit for having brought about this initiative. If a realistic set of guidelines can be developed, such as printing warnings on cans and recommending a limited intake, then the industry will have more freedom to continue without the restrictions that a formal change in the law would introduce.

We might remind the government that there are other political dimensions to this threat. For example, Fizz has a factory in Nortland and jobs might be lost if Funn is banned or legislation makes it necessary to cease production. With the right presentation, public opinion might be pushed in a particular direction so that the government is criticised for interfering with a product that consumers enjoy. Given that soft drinks are likely to be advertised, newspaper and television news agencies may take the view that they would not wish the sale of any consumer product to be curtailed.

Part 2

Briefing shareholders

The shareholders will be keen to see the impact on Fizz of any changes introduced by the government. This is a significant product for Fizz and any ban or restriction could restrict future profits and cash flows. Fizz should be as transparent as possible in order to minimise the concerns that might be fuelled by uncertainties and rumours. Hopefully, Fizz can offer a realistic assessment of the most likely outcome and the overall impact, if any, on future sales.

Fizz should also explain the action that it plans to take, on the understanding that the major shareholders agree to maintain confidence. This is essentially a matter of stewardship because Fizz's Board is faced with a challenge that must be addressed effectively in order to maintain the shareholders' wealth. If the Board cannot demonstrate that it is working to resolve matters in Fizz's favour, the shareholders may start pushing for change. There is also the possibility that some of the shareholders could take their own action in support of Fizz, but that ought to be coordinated so that it doesn't interfere with Fizz.

Given that this is a confidential briefing for major shareholders, Fizz might also reveal its plans for any contingencies in the event of an extreme response such as an outright ban. Fizz should consider the scenario that it is no longer possible to sell Funn in its present form and should be putting plans in place. For example, might it be possible to promote existing CSDs more effectively to sell drinks like Froot and Fizz Cola to the customer group who previously bought Funn? Alternatively, would it be possible to develop an alternative drink that could recapture the market that will be lost in the event that Funn is banned?

The shareholders will also be keen to understand whether energy drinks are actually harmful. Many shareholders wish to earn their dividends in a manner that is socially responsible. They may be unhappy about using what is effectively a loophole in the law to sell a product that is being presented as harmful. Press reports are not necessarily accurate and impartial when it comes to selling stories as newsworthy and so the shareholders will undoubtedly welcome a balanced view of the matter. In this case, for example, it is clear that the accident was due to a lorry driver acting irresponsibly. The driver could just as easily have consumed an excess of strong coffee in order to stay awake while driving illegally.

SECTION 2

Part 1

Energy drinks and ethics

The CIMA Code of Ethics might give us a starting point for a discussion of this matter.

The principle of professional behaviour suggests that we should comply with the law and should avoid actions that negatively impact our reputation. That suggests that we should obey the spirit of the law as well as the letter. Fizz is in breach of the spirit of the law because we are marketing Funn as a “dietary supplement”, but effectively promoting it as a soft drink. If we tried to sell Funn as a soft drink we would be banned from doing so because the law would prevent its sale due to the very high concentration of caffeine. The fact that we are exploiting a loophole in the law to sell what is essentially an unsafe product is a clear violation of this principle.

There is a lack of integrity in our positioning of this product as an energy drink. The word “energy” has positive connotations linked to vitality and action, which may be one of the reasons that it is popular with young adults. That energy boost is derived from the combination of a very high level of sugar with an excess of caffeine. If consumers were sold the drink as “high calorie” or “extra sugar” then they would probably be less inclined to buy it. Calling Funn an energy drink may also help to prevent consumers from being concerned by the physical reaction to drinking it. Instead of being concerned that the physical and mental excitement obtained from drinking it is a sign that it is causing harm, consumers are being encouraged to seek that response.

We could be in breach of the principle of objectivity because of the manner in which we disclose our ingredients. Most consumers are aware of the effects of caffeine, but we do not state how much caffeine is in a can of Funn, so we are choosing not to inform them of the dosage, which is not as high as that of some competing products but is nevertheless high. We also supplement the caffeine with guarana, which is not quite the same but it has a similar and complementary effect. Our packaging complies with all relevant legislation, but it fails to enable consumers to make an informed decision as to their intake of powerful stimulants.

Finally, our advertising message may well put us in breach of the principle of professional competence and due care. For example, our billboard advertisement may well have been humorous, but the underlying message was that drinking Funn to excess makes it possible to keep going without rest. The product is aimed at young consumers, whom we know to be at risk because of lifestyle issues such as being recently qualified to drive. We have promoted Funn on the basis that it is not necessary to rest properly if fatigue is offset by an energy drink.

Part 2

Hong’s performance

We need to distinguish the impact of Hong’s testimony on Fizz’s reputation from his competence as CEO. It should be borne in mind that Hong was being questioned by a defence lawyer who had prepared a series of questions that were intended to reduce the driver’s culpability. The lawyer’s strategy was supported by the rules of courtroom procedure, whereby Hong was obliged to answer all questions and to answer them truthfully. The lawyer undoubtedly knew the answers that Hong would have to give to each and every factual question that he asked, such as the concentration of caffeine and guarana and would have challenged Hong if he had offered a misleading response.

Hong might have avoided some of the questions by claiming ignorance of the facts, as he did when he refused to answer the question about the effects of 1,000mg of caffeine. Had he done so, the lawyer would undoubtedly have called a witness who would have had the answers, either a manager from Fizz or an independent expert witness. The only effect would have been to increase the perception that our CEO is unaware of the effects of the products that we are selling. Similarly, the lawyer's question concerning the billboard could not have been answered differently without seeming evasive. The words that we use speak for themselves.

The one issue that we might have with Hong's behaviour is that he lost his temper when asked about the dangers created by the sale of Funn. His remarks were damaging because Funn is not "only" a soft drink, it is also a Fizz product and one that should matter to us. He also used the word "overdose", which created the impression that Funn is a drug. Hong displayed significant loss of judgement over the reply that he gave, despite the fact that he knew in advance that the defence lawyer would have fully intended to provoke him.

The one argument in favour of having Hong resign is that the company is in danger of suffering serious reputational damage, both because of the publicity attached to our product and also because of his ill-considered remarks. If Hong is persuaded to resign then we will be sending a message to the capital markets that there have been errors of judgement in the past and that the source of those errors has been removed. In a sense, it does not matter whether that message is true or fair because the key is to reassure and manage perceptions. Hong's bad tempered remark at the end of his testimony echoes similar cases where CEOs have left after making misjudged statements.

SECTION 3

Part 1

Dividend

The shareholders may regard the substantial dividend as an expression of confidence by the new CEO and so they may be encouraged by the gesture. The Board is collectively responsible for Fizz's viability and so we will all face severe sanctions if the company struggles because of a reckless pay-out. The problem is that this payment is clearly not sustainable because it exceeds the profit after tax for 2016. The shareholders may feel that this dividend is an advance against the eventual collapse and break-up of Fizz.

The shareholders may believe that Helen Chalmers is simply trying to make a grand gesture in order to live up to her reputation for decisive action. She has only just been appointed and is only just getting to know the company and so she is hardly in a position to make such a payment with any real confidence. She is also a turnaround specialist, which means that she will plan to work for Fizz until it has staged a recovery before moving on to her next challenge. In other words, she only needs to create the impression of growth and recovery in the short to medium term and the shareholders may be less than impressed if she is doing so by paying a lavish dividend.

Part 2

Debt covenant

The most straightforward response would be to enter into negotiation with the existing lenders in the hope that they can be persuaded to relax the covenant. It seems unlikely that they would do so because at present the gearing ratio is only $31.4/(272.8 + 31.4) = 10\%$. The dividend and further debt would change that to $(31.4 + 120.0)/((272.8 - 80.0) + (31.4 + 120.0)) = 44\%$. In other words, the existing lenders will be heavily exposed in the event that Fizz should fail. The Board could present a detailed business plan with a cash flow forecast that shows that Fizz can afford to service the higher gearing level. Even that may be unlikely to succeed because there is no real upside to the lenders. Fizz is entering into an expansion that will benefit the shareholders, having been funded using the lenders' investment.

One possibility would be rather extreme, but Fizz could possibly refinance the existing borrowings. If the existing lenders cannot be persuaded to relax their conditions, we could increase the fresh debt to N\$140.0m and use the additional N\$20m to settle the loans that are presently outstanding. The new loans would be negotiated on the understanding of that total debt level and so it would be acceptable to all parties. The only drawbacks may be that the existing lenders will be able to charge penalties for early repayment and also the new loans may attract a higher rate of interest because of the much higher gearing ratio.

Part 3

Communication with shareholders

Helen should take the time to speak with major shareholders before she takes any major decisions. Doing so will have two major effects. Firstly, she will have a better understanding of the shareholders' concerns. She is joining the company at a difficult time. The CEO has been replaced in the midst of a controversy and there are doubts about the product portfolio. The shareholders may have bigger priorities than the receipt of an unaffordable dividend. The fact that Fizz has a sizeable contingent of shareholders from the founding family means that they may attempt to communicate with her in other ways if she does not take the time to listen to them. It would be embarrassing for Fizz if the shareholders feel the need to brief the press on their concerns in the hope of changing Helen's direction.

The second way in which communication might address those concerns would be by leaving the shareholders better informed of Helen's logic. She has experience of successfully turning round companies in difficult circumstances and so she may be capable of making a quick and accurate evaluation of Fizz's position. If she takes the time to talk to the major shareholders and explains her strategy to them then they will be more likely to support her by retaining their shares in the face of the heightened uncertainty. It is the actions of the major shareholders who dictate the share price because the capital markets will pay far more attention to their actions if only because their confidence may be informed by better knowledge of the company's position.

Part 4

Michael Clann

The first problem is that Michael is presently a senior manager at Fizz and may have worked his way up through the ranks. While that is not necessarily a bad thing, it does mean that his experience may be limited; indeed Fizz may be the only company he has ever worked for. There is also the risk that he has risen up through production and may have a slightly biased view of the company's priorities because of that. These concerns are a problem, because his prior relationship and membership of the founding family means that his loyalty is not in doubt.

There would be serious governance issues associated with Michael's appointment. Having a father and son serve side by side as Chairman and CEO would undermine the benefits of having separation of those key roles. It would be difficult to persuade stakeholders that Walter was providing adequate oversight of Michael's actions as CEO. There may also be some resistance from the other board members because of the fact that Michael has previously served in a subordinate role and has suddenly been promoted to CEO. There may be resentment and demotivation because Michael has stepped over the other board members in order to obtain the top job.