

# **STRATEGIC CASE STUDY MAY 2015 EXAM ANSWERS**

## **Variant 5**

THE MAY 2015 EXAM CAN BE VIEWED AT

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### **Section 1**

#### **Finance Manager's report on reserves figures**

The purpose of this report is to recommend a course of action for dealing with recent revelations concerning the oil reserves.

#### **Stakeholders**

Most of our shareholders will suffer a loss of value through a fall in their share price. They may actually prefer that we did not make a public announcement because it may take some time for the problem with the reserves to become apparent and they could have sold their shares in the meantime at an inflated price.

Two major shareholders, Andrew Jones and Fouce, will technically be unable to sell any shares before an announcement is made because their relationship with Slide will put them in possession of inside information. Both parties may feel that their personal integrity will be underpinned by insisting on a public announcement.

The governments of the countries where the wells are located will be affected. The announcement will create political and economic problems because they will be losing the cash flows from royalties, taxes, etc. There may also be unemployment due to the production being suspended.

Slide's lenders may be concerned because our future cash flows are likely to be diminished through the flow of oil being suspended. We will also lose the possibility of selling the wells unless we factor the risk that they will remain unproductive into the selling price.

From an ethical point of view, we could draw some inspiration from the CIMA Code of Ethics.

The principle of integrity requires that we are straightforward and honest. Our current public stance is that we have valuable reserves that may have no value. We cannot leave that misleading state of affairs to continue unchecked if we are to claim to have acted with integrity. Deciding to leave a misleading announcement in place is every bit as dishonest as making a misleading announcement to begin with.

Objectivity has a number of issues associated with it, including a refusal to permit conflict of interest to affect behaviour. We cannot justify withholding an important announcement just because it will harm the company or the careers of the senior management team.

Professional behaviour suggests that we should comply with law and regulations. The stock exchange requires full disclosures of price-sensitive matters such as this reduction in our reserve figure. We would be breaking the rules. Furthermore, when it is discovered that we have done so, Slide's reputation will be affected in future dealings. We will also be bringing our professional bodies' reputations into disrepute.

### **Impact on share price**

The share price is essentially a net present value of future net cash flows. The stock market is constantly gathering information on all quoted companies and taking that into account in the evaluation of future dividend payments. Clearly, our ability to produce oil from these wells is part of the set of information that will be incorporated into our share price.

The efficient markets hypothesis indicates that all relevant information is incorporated into the share price at all times. If we provide the markets with new information to the effect that future revenues will decline then the share price will fall.

The size of the fall depends in part on what the market's expectations were to begin with. That is partly associated with how the markets expected us to use these wells, whether they would be sold at their market price or retained for production. These losses will be estimated through the whole process of supply and demand for shares, there need not be an explicit calculation of the cost to Slide of the lost revenues.

The losses will be mitigated by the fact that the stock market is likely to be cautious with respect to relying on soft forecasts such as oil revenues. Analysts will often take the view that directors will be optimistic when predicting certain future events and so many disclosures will be discounted to prevent losses when the truth becomes apparent. In other words, Slide's share price was probably determined on the basis that some of our reserves were irrecoverable and so the reduction in price is unlikely to be as significant as it might be.

Market efficiency means that the stock market was looking at every variable that might affect Slide's valuation, including factors such as changes in the market price of oil. Investment analysts already knew that shale oil was displacing some traditional sources of oil. They also knew that falling oil prices would render some wells uneconomic from a production point of view and that Slide had a reputation for focussing on borderline wells. In other words, the analysis would have taken much of the information behind our forthcoming announcement into account when setting the share price and so the fall in price may not be as drastic as feared.

In addition to these fundamental factors, the share price may be affected by short-term speculative forces. Technical analysts will look at the movements in Slide's price as an opportunity to profit from leading movements by short selling in order to close their positions when the price falls to an even lower point. That may accentuate any fall in the short-term because the markets will have no way of distinguishing short sellers from investors who hold useful information about problems affecting Slide.

## **Section 2**

### **Finance Manager's report on the Board's proposals**

#### **Big Data**

Paradoxically, I suspect that Big Data is being used already by the markets as a whole, without it necessarily being called as such. Oil is a major worldwide commodity and so the people who trade in the various markets will be drawing upon every source of financial, economic and technical information to predict the market price. The commodities markets mean that there are significant resources being invested in maintaining a link between spot prices and the forecast prices implied by futures and options. These market will already be evaluating any indicators that could provide an insight, such as different industrial statistics that might indicate future movements in the demand for oil. Regardless of the title, this equates to the concept of Big Data.

Slide could only benefit from applying Big Data if it had some unique insight that other market members could not match and that is unlikely. A major producer might have sufficient influence to drive the price of oil, but Slide is not in that category and so it is likely to be fruitless to even try.

Much of the information that is gathered by the market would be too expensive for Slide to buy and so we could not compete in offering superior forecasts. Slide can, however, obtain the benefits because market forces will tend to inform all of this forecasting and predicting and so the prices offered on the spot and futures markets are likely to be the best forecasts that are available. It would be possible for Slide to create a small team of economists to identify the implicit forecasts that are available from market prices and that is likely to prove at least as effective as any independent forecasting facility.

#### **Real time**

I think that these reserve figures will not change on a day to day basis and so any such disclosures would imply a spurious accuracy and immediacy. Oil prices change too frequently to enable us to be certain which of our reserves will actually come on-stream and each case will require a great deal of thought. For example, speculative forces could depress the price of oil temporarily, which would have no great impact on the viability of some marginal wells.

A real-time disclosure could create the impression of greater accuracy than is really the case. We need to keep the productivity of wells under review and their extraction costs, but we will not do that in real time in any case. We also need to take a view on whether market conditions suggest that a particular field is viable, but that is a matter for detailed discussion on the basis of a significant economic forecast.

The real time report is likely to be viewed as a gimmick and so it will add nothing to our credibility and could even undermine it. If we linked the reserves to the daily spot price of oil then we could have a simple graphic, but it would imply that our management of these reserves was simplistic and ill-informed.

#### **Geologists – rewarding forecasts**

There is clear merit in evaluating the performance of any member of staff and linking rewards to performance. This proposal could focus the attention of geologists on the accurate prediction of outcomes.

There are, however, too many drawbacks.

Firstly, the geologists could become reluctant to express a view until they are certain of the outcome. We might be unable to obtain a clear understanding of the viability of projects without a realistic “best guess” from the geologists and they may become evasive for fear of protecting their bonuses.

The geologists may also become entrenched for the sake of their bonuses. They could have an incentive to distort their evaluation of marginal wells so that they come online and so protect that aspect of their bonuses.

The timescales will also be complicated. It could take years to bring an oil well into production. That could have the unanticipated effect of encouraging geologists to stay with the company in order to preserve their accumulated bonuses, but it will break much of the linkage between the work and the reward.

### **Geologists – punishing failures**

It is unlikely that many professional staff would agree to work under such terms. These predictions are inherently prone to uncertainty and so a prediction made in good faith could lead to disciplinary action. Slide would probably lose staff to other oil companies who have more enlightened employment practices.

There is a lack of symmetry to this proposal because there is no upside risk for a geologist, only the threat of disciplinary action for an alleged error. It is to be hoped that any professional in this field will make large numbers of predictions, most of which are correct and some of which may appear to have been ill-judged. Thus, a typical geologist could be expected to fall under the threat of disciplinary action at some time under this proposal.

How will Slide deal with cases where a well is sold to a third party? It may be that Slide will be unable to test many of the geologists’ predictions because the buyer will conduct due diligence before buying the well and will have no reason to come back to Slide if the reserves turn out to have been inflated.

## **Section 3**

### **Finance Manager's report on shale oil proposal**

#### **Risks**

The biggest risk is that we are entering an established industry where the other players have better knowledge and more experience. This is a new type of oil exploration and our existing technical experts are not necessarily capable of finding reserves and bringing them to production. That is particularly true if we stick to the basic model that we have applied of working to identify and exploit marginal fields that would be overlooked by competitors.

It seems rather reckless to enter this market simply to test our capability. We would need to be reasonably certain that we could obtain the necessary expertise in order to compete for exploration rights.

There is a danger that the availability of significant deposits in the USA will motivate the US government to find as much shale oil as possible. The US regards oil security as an important strategic issue and so it would be willing to find and exploit as many deposits as it required for its own purposes. That could have an impact on the oil price, which could make it uneconomic for us to explore for shale oil.

#### **Key factors**

The first factor is whether we believe that there is any strategic advantage in mining specifically for shale oil. Oil is a commodity and consumers care little for whether it came from conventional drilling or from fracking. If we feel exposed to changes in the industry then we should adapt, otherwise we should stick to what we are already good at.

The availability of suitable exploration rights is an important factor. It may be that the market for these rights has yet to settle down and so rights may be mispriced. It may be that there are opportunities to buy sites that are good risks and so we could exploit the novelty of this market to effect. Clearly, the converse may be just as true.

There could be environmental factors that should be taken into account. Fracking is potentially contentious because of fears that the technology is harmful. Slide could lose its reputation for social responsibility.

#### **Selection of countries**

We might consider revisiting the geology of the countries in which we already have interests and so have an infrastructure in place. We may have a better understanding of the prospects of finding shale oil in those locations. Following previous entrants to the USA and other established fields may simply mean that we have to pay top prices for the right to explore.

The nature of the equipment that is required is also an issue. We may find that locating and constructing the necessary equipment will render some promising sites uneconomic because we would have to import too much machinery. The need for experienced operators is also a factor.

The willingness of governments to permit this form of exploration and extraction is also a key factor. If a particular country is already oil rich and is unwilling to permit fracking then we may find that it is pointless seeking permission and we will simply waste time. The proximity of potential fracking sites to centres of population may have a part to play in this factor.

## **Technical staff**

The fact that this is a new form of exploration may mean that there are relatively few experts who can offer an established track record. The fact that an applicant was involved in a successful project may mean that he or she was lucky in finding oil or that he or she was a small part of an expert team.

Experts may be in short supply and they may be attracted to the employers who are already major players in this industry. They may feel that there are superior opportunities for job security and promotion.

If much of the industry is located in the USA then Slide may be asking staff to work in less comfortable postings in the quest for shale oil in other countries. Experts may be unwilling to relocate.

Potential employees may feel that they will be a very small part of Slide's operations, with seniority being accorded to the geologists in the conventional oil industry. The threat of a "them and us" environment may deter staff from joining Slide in case they are side lined or passed over for promotion.