

CGMA MAY 2018 EXAM ANSWERS

Variant 3

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SECTION 1

Requirement 1 – Stakeholder management implications

We have identified a number of key stakeholder with both a high interest and high power who will be affected by this arrangement.

Our shareholders will be affected by the fact that we have diluted their interest in Couchweb by giving Koldor Productions a 5% stake. We need to communicate our confidence so that the shareholders realise that we intend to attract significant numbers of new subscribers and so their wealth should increase overall. We could start by briefing the analysts on our predictions for this new Southerian programming, backing up our expectations with evidence and analysis that supports our forecasts. The very fact that the share price has increased is worth commenting on because it implies that the capital markets believe that we have made a good deal.

Koldor Productions is a key stakeholder, both as a supplier and as a shareholder. As a supplier, there is little that Koldor Productions can do to affect the revenues that will be generated by their existing back catalogue. That is really a matter for Couchweb's marketing skills. The key will be in terms of the production of fresh content to add to this existing programming. We need to ensure that we engage with Koldor Productions, offering suggestions and making sure that these subscriptions are not cancelled. Feedback from Couchweb could be valuable to Koldor Productions in terms of maintaining its viewer satisfaction in its home market for terrestrial broadcasting in Southeria. We also need to maintain Koldor Productions' loyalty as a shareholder because the sale of a 5% stake by a major supplier that is close to Couchweb's management would be viewed as a very distressing sign by the stock market.

Couchweb's other suppliers will also be interested in the potential impact that this development may have on their relationship with the company. Couchweb relies heavily on a small number of major production studios and they may feel that they should also negotiate a shareholding in return for their continuing support. The production companies may also be concerned that the content acquired from Koldor Productions will restrict the capacity to carry their material. There will also be concerns that many Southerian speaking subscribers are bilingual and may watch Southerian-language content in place of their local content. Couchweb will have to ensure that it

keeps its existing suppliers well informed of its intentions and makes sure that their concerns are understood and addressed.

Subscribers could be annoyed that their websites are carrying large quantities of Southerian programming. There are likely to be expatriate subscribers in many countries who will resent the fact that Couchweb is catering for Southerian speakers, but not for them. Couchweb should make it clear that it is considering the possibility of offering a wider range of foreign-language programming to meet the needs of other expatriates. Subscribers may also find it annoying that they have to scroll through Southerian content that does not interest them. Couchweb will have to ensure that it modifies the interface and the algorithms for recommending further viewing so that viewers are not confused by lists of programmes that they will not understand.

Requirement 2 – share price behaviour

Koldor Productions' purchase of 2% of Couchweb would have pushed up our share price quite significantly. The capital markets are constantly looking for 'news' that would enable it to anticipate share price movements. The weak form of the efficient markets hypothesis suggests that share prices reflect the information available from past trading on the stock market. The fact that Couchweb shares were being bought aggressively would have implied that a market participant had some favourable news about the company and that would have encouraged speculators to buy, pushing prices up further, even though the facts were still to be announced.

The same logic would suggest that Couchweb's share price would fall dramatically when the shares were sold. The fact that the sale came so quickly after the purchase could imply that Couchweb has suffered a setback and the resulting fall could take the share price below its level before Kondor Productions first purchased. That decrease should correct itself, hopefully fairly quickly, because there is no reason for large transactions that would influence market prices to continue. Short-term speculative pressures can make share prices fluctuate, but shares will always be valued correctly in an efficient market.

This event may undermine the shareholders' confidence and could depress share prices because of that. The fluctuation adds to the historical volatility of the share price, which is essentially the same as saying that the shares are a riskier investment and that could depress their value. The fact that the Stock Exchange is investigating could also depress the shares because Couchweb may be viewed as having weak governance. The fact that it could enter into a partnership with a supplier that is prepared to manipulate share prices suggests that Couchweb's board may be either incompetent or dishonest.

This manipulation of Couchweb's share price makes it almost impossible to tell whether the stock market is supportive of our deal with Koldor Production. The initial purchase was undoubtedly motivated by the expectation of a price rise when the agreement was announced, but the market could still have been processing the implications of the large purchase when the deal was announced. The investment analysts may feel that Koldor Productions' behaviour signals that it is not as confident in the success of the Southerian venture as we are. In that event, the analysts may not make a strong buy recommendation even though Couchweb believes that it will generate significant new profits.

SECTION 2

Requirement 1 – political risks

The fact that the government restricts access to the internet suggests that it is authoritarian and that it might respond aggressively to any concerns raised by Couchweb's activities. The main political risk is that the Southerian government could withdraw access to Couchweb's website within the country. That could create problems because Couchweb will already have taken subscriptions and will be unable to provide the service that subscribers have paid for. Fortunately, there is little need to provide a great deal in the form of infrastructure within the country and so there should be little need to put either staff or assets at risk by locating them in the country.

There could be a political risk in terms of Couchweb's apparent support of the Southerian regime. Couchweb could be viewed as cooperating with the government's censorship and that could lead to protests. There could be a risk of calls for subscribers to boycott Couchweb until it ceases its service in Southeria. The fact that Couchweb will be offering access to a selection of 'acceptable' English-language material could be presented as further evidence of support for the Southerian Government's stance. It is relatively easy for activists and protesters to draw attention to their concerns about such matters through the internet and Couchweb's subscribers are clearly internet users.

Jorge has considerable experience of dealing with the Southerian government and knows what types of programming will be likely to cause offence. He has already broadcast the material that will be offered through Couchweb as its 'back-catalogue' and can remove anything that did create problems in the past. Jorge's staff will be able to check the content of any English-language material that Couchweb will offer in addition to the Southerian programming in order to check its suitability. The Southerian government will be unwilling to act against Jorge unless it is absolutely necessary because he is the only source of acceptable television material in the country.

Jorge's involvement with Couchweb could actually heighten the political risks elsewhere in the world. He is clearly a trusted member of the establishment in Southeria and his partnership with Couchweb could further undermine the company's credibility if there is any controversy over its Southerian service. The fact that Jorge's company owns a sizeable percentage of Couchweb's equity creates further potential for controversy. The allegations of insider trading further undermine Jorge's credibility as a business partner and could taint Couchweb's reputation. There could be a backlash in terms of the popularity of the Southerian programming amongst the expatriate community that was the original target audience.

Requirement 2 – product portfolio

Couchweb's present product portfolio comprises the streaming of generic content that is produced by the major media production companies for global audiences. Those production companies routinely create dubbed or subtitled versions that are accessible to audiences who speak different languages. The global nature of TV programming and movie distribution makes it perfectly feasible for Couchweb to offer this content. Couchweb relies on attracting a large subscriber base so that it can keep subscriptions low and still afford to offer licensing fees that are attractive to the production companies.

Jorge's proposal suggests that Couchweb should offer a more focused product that will be of interest only to those living in a particular country. The market for this content will be restricted to Southerian nationals. There is no real scope for growth because

Couchweb is already serving the expatriate market. There is no guarantee that the ability to stream previously broadcast content will be of interest to potential subscribers. The set-up costs will, however, be small because Couchweb has already created the website for expatriates and so it will be a simple matter to make that accessible to subscribers in Southeria.

This proposal could be viewed as a form of diversification. The feedback from expatriates who already have access to this material is generally positive. New subscribers give high ratings to the questions posed in the survey. In particular, they make less use of non-Southerian programming than established subscribers and are satisfied with the service. Apart from language, this programme content is attractive for cultural reasons and so it offers a change from material devised for a global audience. Couchweb could use this venture to investigate the possibility that potential subscribers will be attracted by the availability of locally-sourced content.

The potential for diversification could also apply to the development and commissioning of new programme content. Couchweb's monitoring of subscribers' viewing habits might enable it to identify locally produced content that is extremely popular with home audiences. Some of those programme concepts could be adapted for a more global audience, such as the recent phenomenon of Scandinavian detective thrillers being remade for a global audience. Clearly, if Couchweb could gather data that could be used to develop such ideas then it would be able to enhance its existing main product.

SECTION 3

Requirement 1 – non-executive’s duties

The defining characteristic of a non-executive’s duties is that they should not involve acting in a decision-making role within the company, so that they retain their independence. All directors share a joint responsibility for the management of the company and for the strategic decisions made by the Board. It is inappropriate for Chet to attempt to restrict or exclude Jade from the discussion concerning the relationship between Couchweb and Koldor Productions. As a non-executive, Jade has a duty to review and evaluate the merits of decisions being taken by the rest of Couchweb’s Board.

It would appear that Jade has done nothing more than conduct some very basic due diligence on Jorge, who will be a key stakeholder. She has downloaded some press reports that should have been obtained as a matter of routine and should have been brought to the Board’s attention. It should not have been left to Jade to collate this material, but it is well within her duty to do so. It is unrealistic to argue that this relationship with Jorge is merely an ‘operational matter’ and he should respect Jade’s concerns. Even if her input to the meeting was inappropriate, Chet’s response should have been to accept that the matters that she raised required some discussion. He should not have criticised her.

Requirement 2 – ethics of continuing

Jade should act with integrity, which means that she will be straightforward and honest and will not associate herself with misleading behaviour. So far, Jade has behaved correctly by raising her concerns with the Board. If they address those concerns satisfactorily then she will be free to continue in her role. If they refuse to deal with the problem, then the only manner in which Jade can express her concerns will be to resign and so distance herself from this corrupt behaviour. Certainly, remaining on the Board would be interpreted as satisfaction with Couchweb’s management.

The principle of professional behaviour would also require Jade to protect her reputation and the reputation of the role of the non-executive director. Non-executives are appointed because they have the necessary experience and background to reassure the shareholders of the quality of the oversight that they can offer. If Jade remains in post and there is a subsequent scandal because of Jorge’s past then her reputation may be damaged. Apart from the loss of career prospects, she will also undermine confidence in governance generally.

Requirement 3 – shareholder wealth

Shareholder wealth is essentially determined by future cash flows, discounted at the cost of equity. The cost of equity is determined by the beta coefficient, which focuses on systematic risks. The shareholders’ wealth may not actually be significantly affected in the long term because the risks that Jade has identified are really of a nature that can be diversified away. If Jade resigns then she will undoubtedly be replaced with someone else who is similarly experienced and qualified.

In the short term, Jade’s departure is likely to be perceived as bad news by the markets and so the share price will decrease, temporarily reducing shareholder wealth. Couchweb is a major quoted company and so her appointment is prestigious and will undoubtedly be well paid. The fact that she is prepared to resign from such a post will be interpreted as a sign that there are concerns about the company and so

speculators may sell shares immediately in the expectation of further disclosures about the background. As time passes, Couchweb will undoubtedly be able to reassure the markets.

Requirement 4 – Koldor’s shares

The fact that Koldor Productions is a shareholder does not alter Couchweb’s responsibilities toward them. The duty to maximise shareholder wealth applies to the maximisation of the wealth of the shareholders as a body and not as a collection of individuals. Certainly the commercial relationship between Couchweb and Koldor Productions should not be affected by the shareholding. It would be wrong, for example, to pay more for Koldor Productions’ content because doing so would increase its wealth. There could be a conflict of interest arising from Koldor Productions’ position as both a shareholder and a supplier and Couchweb needs to be careful not to allow its shareholders’ interests to be affected because of that.

There could be problems in managing this relationship as a result of this shareholding. For example, Couchweb may provide Koldor Productions with viewing figures or subscriber rates that are disappointing. That could put Koldor Productions in a position to sell shares before the news is released to the public. Koldor Productions could also use its position as a shareholder to threaten Couchweb’s Board. A 5% stake is insufficient to give any real influence, but it is a sizeable block of shares that could be offered to a potential bidder who was considering a takeover attempt against Couchweb.