CGMA
Chartered Global Management Accountant™

Powered by AICPA | CIMA

CGMA NOVEMBER 2015 EXAM ANSWERS

Variant 1

These answers have been provided by CIMA for information purposes only. The answers created are indicative of a response that could be given by a good candidate. They are not to be considered exhaustive, and other appropriate relevant responses would receive credit.

CIMA will not accept challenges to these answers on the basis of academic judgement.

SECTION 1

From: Finance Manager
To: Sarah Johns, Marketing Director
Re: USD movement

Hi Sarah,

Marcus has forwarded your email for me to respond.

Why are we affected by USD exchange rates?

This is essentially economic risk, which can be difficult to understand and almost impossible to measure. There are a number of complicated variables at work here.

The timber price is set by supply and demand in the global market. The USD's strength can affect both supply and demand. The fact that the product is a commodity means that we are tied to the market selling price. There is very little that we can do to differentiate ourselves.

Many of our competitors are located in other countries, including the US. They have the advantage that they receive the same USD selling price, which is now lower when converted to M$. US producers and producers from countries whose currency move in sympathy to the USD can effectively undercut us in our domestic market when the USD is weak. Suppliers who were previously unable to export to Marland can now afford to do so at a profit. Shipping costs to Marland could also be lower because other commodities are priced in USD. For example, fuel oil will be cheaper, which might offset the lower freight charges that we enjoy in our own domestic sales.

We suffer the reverse of that problem when we export. We have to charge more USD in order to obtain the same revenue in terms of M$. This makes it more expensive to export to the US and to countries whose currencies move in sympathy to the USD. The only good news is that we might also benefit from lower shipping costs when we export our goods.

We have a further problem because a weaker USD can have implications for the state of the US economy and, by extension, much of the global economy. A weak USD can make it necessary for interest rates to increase and for other economic measures that could limit demand for timber. Higher interest rates could inhibit the housing market, which would reduce demand for timber for building. Other consumer goods could be less attractive, reducing

© The Chartered Institute of Management Accountants 2015 – no reproduction without prior consent

demand for packaging, which is often made out of wood pulp. This would be a further reason for customers requiring us to reduce our prices.

Why didn't we hedge this risk?

It would have been extremely difficult to hedge this risk.

There are two approaches to hedging currency risk. The most effective method of dealing with economic exposure is to employ natural hedging. Ideally, we would structure our business so that any costs or revenues that were exposed to the USD were offset, so that any currency movement would affect each equally with little, or no, net effect.

Natural hedging is difficult in this case as most of our operating expenses are fixed in terms of M$ because of the nature of our business. For example, our wages costs and most of our other forestry management costs are priced in M$. Depreciation of plant and equipment will also be fixed in M$, which creates a dilemma because depreciation and amortisation are accounting expenses that affect reported profit, but they have no impact of their own. We might be tempted to hedge future reported profit rather than future earnings, which would further complicate our competitive position.

The fact that the forests are located in Marland means that there is only a very narrow scope for fixing any costs in terms of USD. We might, for example, insist on replacing all plant and equipment with items imported from the US so that we could offset the economic cost of replacing those items against our revenues, all in USD.

The only (slim) possibility might be to find a US customer who was keen to be invoiced in M$. That might be viable in the case of a customer who used our timber in the manufacture of goods that are exported to Marland. Such an arrangement would provide both parties with a degree of natural hedging at very little net cost to either.

The alternative to natural hedging is active hedging through the use of derivatives and other instruments. That is costly both in terms of transaction costs and management time and effort.

Active hedging tends to be better suited to hedging a major event, such as a single receipt or payment in a foreign currency at some future date. In that case, the cost of the hedging instrument is a worthwhile expense because it eliminates the potential volatility on that major transaction.

Active hedging can be used on smaller and more regular transactions, such as routine exposures to the USD rate, but the problem is that the price of the derivative will always reflect risks and expectations. In other words, the counterparty writing options, forwards and futures contracts will charge more for them whenever there is a realistic likelihood of the instrument being exercised. Ultimately, that would mean that the cost to Wodd of hedging these movements would probably be very close to the costs associated with bearing the risk.

Section 2

Impact on share price

If capital markets are efficient then it could be argued that there is actually very little that can be done to protect the share price. In an efficient market, the share price will accurately reflect everything that is known about Wodd's future.

The Chief Executive's comment suggests that the share price has not fallen since the USD weakened, which could be interpreted in more than one way. One possibility is that the markets were able to anticipate the weakening of the USD and its impact on Wodd's future cash flows. In that case, the price already reflects the impact of the decline of the USD and nothing further can be done.

A second possibility is that market participants are unaware of the implications of the decline for this company. In that case, any additional information will probably alert the market to the problem and the share price will decline. It is unlikely that the market is mistaken, although efficient markets are not necessarily infallible. It may take the realisation that Wodd's results were disappointing after a prolonged decline in the USD to alert the markets to that relationship.

We might protect the share price by releasing information relating to the impact of the USD rate on Wodd. The markets might be depressed both because of the fundamental implications of the loss of competitive advantage and also because of the speculative implications of the uncertainty surrounding those concerns. Informing the market can do little about the fundamental analysis of the company's prospects, but it can reduce the speculative uncertainties, which are likely to push prices down rather than up.

There is a possibility that the markets will not accept any information released by the company and so prices will be unaffected. The markets may believe that Wodd's Board has an incentive to boost the share price and so any positive information that is released out of self-interest may be incomplete or otherwise misleading.

From an ethical point of view, the share price will eventually incorporate all of the effects of the USD movement once the facts are known and released. The market environment will eventually impact on the reported profit according to the audited financial statements. The danger is that, in the meantime, Wodd's competitive edge will be hampered by the release of information that could benefit the company's competitors. This loss will be borne by the shareholders.

The basic ethical dilemma is that the directors will benefit from Wodd maintaining its share price through the release of information. In the long term, the shareholders' wealth will revert to its equilibrium position as the share price is corrected through the publication of credible financial reports.

Briefing analysts

From a logical point of view, it is really the investment analysts who make the capital markets efficient. The whole point of market efficiency is that the collective opinion of the market participants leads to an unbiased processing of information so that the price is always 'correct'.

Not all market participants are equally responsible for this process. Information can only be interpreted by those who have taken the trouble to obtain it and those who have the means to make sense of it. Investment analysts take the trouble to study all potentially price-sensitive information in the hope that they might obtain a short-term advantage. This possibility motivates them to be thorough in gathering and reading information. In the same way, there would be little point in conducting this research if the analysts could not make sense of the

information and so they will develop the necessary skills and understanding of the industries and the companies in which they are interested.

This means that briefing key analysts will give them the means to incorporate any additional information that the Board releases into the company's share price. Doing so could encourage the shareholders to offer their continued support to the Board if it leads to the share price strengthening.

The two ethical dilemmas are the extent to which we should bias any briefings and the implications of briefing only a limited number of participants.

If the Board invites the analysts to a briefing then it is for them to set the agenda and to decide what will be released. In the short term, releasing only positive information could lead to the share price being inflated. Technically, that would not be dishonest, but it would lead to the possibility that an investor who bought while the price reflected only good news could suffer a loss when the less attractive information was released.

Many market participants are keen to speculate by buying and selling mispriced shares. If we brief a select group of analysts then they will possess information that could enable them to buy shares while they are the only ones in possession of good news. Again, that would be unfair because the analysts could profit from the ignorance of their counterparty to any transaction.

Quite apart from anything else, these briefings could leave the analysts open to accusations of the criminal offence of insider trading. Anyone who trades while in possession of knowledge derived from the company is acting both unethically and illegally. Technically, the analyst would have to publish the information, with our permission, before trading again in our shares or ask us to publish that information.

Section 3

Respect privacy?

Effectively, this is an ethical dilemma arising from a conflict between my duty as an employee to Wodd and my sense of respecting a colleague's privacy.

As an employee, I do have a duty to inform my superiors of any matters that might affect the company's progress. That duty is limited to knowledge that I have obtained in legitimate ways. I cannot, for example, be expected to spy on my boss or to eavesdrop on a personal conversation. Arguably, I should have stepped out of my office or made my presence known to Marcus so that he could have terminated his call.

Conversely, I have no specific duty of confidence to Marcus as a person. His career plans were not divulged to me in any professional capacity and I only obtained the information because he was careless in discussing them over the telephone.

If I agree to respect Marcus' privacy then that assurance would be sufficient to create a duty not to pass on the information.

Shareholder safeguards?

One of the biggest issues in governance is the fact that the shareholders can and should diversify their portfolios so that certain risks are cancelled. Directors cannot diversify in the same way because they only have a single career and a single primary source of revenue.

If the shareholders are aware that Wodd is exposed to a weak USD then they can counter that by investing in companies that benefit from the weakness in that currency. There is no particular cost associated with such a strategy, apart from the cost of designing a suitably diversified portfolio. The return offered by equity investments assumes that the shareholders will diversify away all unsystematic risks, so all rational shareholders should have diversified portfolios and none should be exposed to, say, movements on a particular currency.

Our personal capital as shareholders is tied up with the reputation of the companies that we manage. We are generally expected to accept rewards that are linked to the company's financial performance. Very few board members will have sufficient personal resources to diversify any of the risks attached to this personal capital.

Accept severance?

It could be argued that directors' contracts provide for such a payment and so it is perfectly legitimate for them to accept the rewards to which they are entitled. If the shareholders object to the payment then they should not have made it available when they set the directors' contracts in the first place.

The shareholders possibly chose to make this payment available in order to be competitive when recruiting the Board. Many companies offer 'golden parachute' terms in their directors' contracts and so Wodd would be uncompetitive in attracting the best Board members if it chose not to do so.

Directors' remuneration is also structured to benefit the shareholders by directing the Board's motivation. The fact that the directors cannot diversify unsystematic risks means that they may be more risk averse than the shareholders would like. If the directors are protected from downside risks then they may be more open to taking realistic risks.

The only argument against accepting such a payoff is the bad publicity that tends to be attracted in the press. Such payments are often misrepresented as implying greed by the directors and incompetence on the part of the shareholders for agreeing to them.

Predicting movements in exchange rates

There are two sides to this issue. Exchange rates are set through a complex set of economic and political variables. The economic fundamentals that can drive movements are open to intervention by the governments, who can manage the effects by adjusting interest rates and other variables. Many of the factors that drive exchange rate movements are collated as government statistics that are generally confidential until they are published on a specific date. Speculators often attempt to predict those factors, but there is no way to be certain of doing so accurately.

There are predictions implicit in market prices. For example, some derivatives will become more expensive when the market is expected to become more volatile. The expected direction of changes can also be determined by looking at premiums and discounts on the forwards and futures markets. These predictions are generally regarded as unbiased because the currency markets are regarded as very efficient. As a basis for planning, they do not provide companies such as Wodd with helpful information. By the time an expected decline in the USD is clear to us, it is also clear to our customers and competitors. We cannot make effective use of that information in order to protect ourselves.