

CGMA NOVEMBER 2015 EXAM ANSWERS

Variant 4

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Section 1

Impact on share price

In theory, the share price should change in response to the net present value of the project. In practice, the share price will depend on the market's perceptions of the proposal, which may differ from that of the Board. As a Board, we need to be clear about the information that we will release because the shareholders cannot evaluate the proposal without some facts, but we cannot risk passing on information that would be useful to our competitors. We also need to be careful not to make unduly optimistic claims for the proposal, otherwise we will risk losing our credibility if the market is disappointed.

The proposal would give us a degree of diversification, although that would have little impact on the shareholders who can easily diversify their portfolios to include power generation or almost any other business activity. We need to be careful to show that we are aware of the pitfalls of a forestry company going into the power generation business. The market could be concerned that the investment will fail because we lack the necessary expertise, or power generation could sound like a distraction from the key business of growing and felling timber.

In an efficient market, the market will make full use of all available information. The market will be aware that we own a forest of poor quality timber that is not expected to generate much return as it stands. The market might take it for granted that this asset will continue to have little value and so the share price might increase when we announce that we are putting it to good use. Alternatively, the market's evaluation could have been a little deeper and the possibility that some alternative use might be found could have been considered. In that case, the market need not be aware of the specific proposal to use the forest for a power plant, simply that more profitable uses were available. If the market had anticipated such a move then the share price would already have incorporated the anticipated cash flows and the announcement itself would lead to only a minor adjustment for the specific news of the nature of the project and its timing.

Clearly, we cannot interview the market. We can, however, study analysts' reports on the company in order to see whether they refer to the forest and the alternative uses that it might have. We can also meet with analysts who specialise in forestry to ask whether they understand the possibilities that are open to us. The greater the market's understanding, the less pronounced any change in price will be. That will require great care, because announcing

a project with a potential NPV that is less than expected could actually lead to a decrease in the share price.

Long term risks

Electricity is very much a commodity and the price can rise and fall depending on market forces. Once we establish this power station, our future revenues will be out of our control.

There are derivatives that we can use to sell electricity forward. In the short term, that will permit us to fix our prices for up to, say, a year in advance. There could still be a significant price change arising from a major shift in the market, but we cannot manage that risk. A major increase in supply, perhaps from the expansion of another sector in the industry, could see prices falling significantly and in the long term.

We have a major advantage in this case because we already own the fuel that we will be burning in the station. The opportunity cost of burning it in the generator is very small because it is low grade and so it would have very little market value if we sold it on the open market as timber. There are, however, costs associated with harvesting and transporting the biomass and that is likely to be quite a labour-intensive business, so the costs are fixed.

It might be possible to organise the power station so that the staff can be redeployed if it becomes necessary to suspend generating activities in the short to medium term. The gathering and processing of the biomass itself is not particularly skilled work and employees who are engaged for that purpose could just as easily be deployed on other types of forestry work, provided their contracts of employment made that permissible. That would leave only the core team of technical staff underemployed in the event of a suspension in activities.

The danger to Wodd is that governments and consumers are becoming increasingly concerned about carbon emissions. Burning biomass will undoubtedly release greenhouse gases into the atmosphere. Arguments such as the absorption of CO₂ by growing trees are quite difficult to communicate to consumers, who will find it difficult to justify burning biomass against alternatives such as wind and solar power.

There could be scope for education playing a part in justifying biomass electricity. Sustainability should feature prominently in web pages and other media. Wodd might work with the power companies to develop a publicity campaign for the use of biomass. The argument might focus on simpler and far more visual arguments, such as the short and simple footprint of transporting biomass from the forest to a nearby power station, in contrast to shipping coal, oil and gas from the point of extraction to the power stations that burn those fuels.

Wodd also has to beware of government action against carbon emissions. Even if biomass is relatively sustainable in comparison to traditional fuels, the existing generating companies have more influence than the emerging biomass industry. Wodd should consider employing lobbyists to manage the relationship with government.

Section 2

Press release

Forestry companies own large areas of land that are, indeed, left to flourish as areas of natural beauty. We have a duty to our shareholders to make some commercial use of that land, otherwise we cannot justify its retention. If the land was sold for some purpose other than forestry then it might be developed in some other manner that would be more objectionable than the limited plans that Wodd has for North Forest.

Wodd respects the interests of local residents and we aim to develop this site in a sympathetic and responsible manner. In doing so, we will create long-term jobs that will stimulate the local economy and provide the basis for a balanced community. The alternative is an ageing community that may find that facilities such as health care and other services are withdrawn as younger people are forced to move away to find work and to raise families.

The visual impact of a biomass power station need not be as significant as claimed. The development will be taking place in a forest and the surrounding trees will limit the impact. We can work with architects and engineers to limit the intrusion as far as possible. The forest is a commercial asset and it has to be used for something. In the absence of a biomass power station, we might come under pressure to erect a wind farm, which would cover a much larger area and will have to dominate the landscape in order to ensure that the turbines are exposed to the wind. It would be in everybody's interests for local residents to work with Wodd on achieving a compromise that best suits all parties.

Wodd agrees that the planet needs trees and forests. This is one reason for wishing to build our biomass power station. The land is not particularly suited to traditional commercial forestry. If we do not find an alternative use for ourselves then we may have to sell to a developer who will clear the trees and switch to a more overtly industrial use. Even agricultural use would require the trees to be cleared to create, say, sheep grazing.

Wodd is an experienced and responsible forestry company. We know how to harvest trees without threatening the viability of the forest itself. It would not be in our interests to construct a power station and then to consume all of the available fuel by excessive harvesting.

Wodd respects the right of all citizens to pursue their legal and democratic rights. Anyone who wishes to lodge a formal objection to our plans is free to do so. We cannot, however, condone the incitement to direct action against our activities. Firstly, because we will not undertake any construction work until we have obtained full permission to do so, by which time the democratic process will have been completed. Secondly, North Forest is an active working forest in a remote area. Protestors who enter the forest illegally will be putting their safety at risk as well as endangering our employees and those of our contractors. Finally, we do have a duty to our shareholders and employees to proceed with any permitted development so that we can secure their futures.

Safeguards

Banks are often regarded as legitimate targets for protest because they enable development work. We might agree to keep the identity of the bank providing this loan confidential in order to avoid encouraging protestors. Most banks do fund projects that could prove controversial and so this is unlikely to be a major concern.

The bank's bigger concern is that we will incur significant additional costs because of the protests. We may struggle to keep up with our cash flows if we have to finance delays. We need to have a contingency plan in place to ensure that the impact of any protest is limited to, perhaps, a token media event that will cause little real disruption. We should, for example, have researched our legal remedies in the event of any trespass to the site so that we are

clear about our ability to remove protestors. We should have our lawyers draft the necessary applications for court injunctions or other legal remedies so that we can react quickly and effectively. We should liaise with the local police service so that we are able to reassure the bank that any legal remedy can be enforced.

The construction company will have very similar concerns. It will not wish to get caught up in delays and bad publicity.

The first issue is the safety and security of the construction company's workers and their equipment. We may need to insure against any injury or damage caused by protest so that we can indemnify the company.

Our contract with the builder will also have to clarify the implications of any delays due to the protest for the application of penalty clauses.

We may be able to reduce the danger to employees by having multiple routes to and from the site. If construction workers and delivery drivers can be directed to a number of possible routes then it will be more difficult for protestors to target or delay them.

We can engage a private security company to be in attendance to protect the site and to remove any protestors. This is important because the construction company will also be concerned about the legal and moral implications of injuring a protestor who gets in the path of heavy equipment or a falling tree.

There should also be a secure location for equipment that is parked up overnight. Even a non-violent protest could involve disabling equipment by tainting fuel tanks or removing components.

Section 3

Spending on wildlife protection

One important argument is that our primary duty is to maximise shareholder wealth. If we regard wildlife protection as a discretionary activity then we will be spending money needlessly and harming the shareholders.

There is a large body of 'ethical' investors who consider factors such as environmental responsibility when selecting investments. It may be that employing wildlife experts makes Wodd more attractive to such investors and so ensures that there is the widest possible demand for shares.

Wildlife protection could make commercial sense. If we are aware of the different species inhabiting our property then we can be forewarned of any problems that might arise. For example, we may be able to work with the authorities to relocate rare species in a safe and humane way if we are aware of their presence before the official survey.

Wildlife protection also reduces the risk of reputational issues arising from the accidental destruction of a natural habitat. If we take responsibility for protecting wildlife then we will be able to address some of the potential concerns that are frequently directed at the forestry industry.

Implications of a change

Every organisation has a control environment that can be best defined as the attitude of the Board towards internal control. If senior management takes internal control seriously then more junior staff will regard it as important they do so too. There is no point in creating control procedures if they do not operate in practice and enforcement is really a matter for the Board to determine.

We have a member of the Board asking a junior member of staff to lie in a formal report. The implication here is that the associated control procedure does not matter in this case and so the Finance Director does not care if the control is circumvented. The danger is that it will start to become difficult for Wodd's staff to understand when controls matter and when they do not and so other control procedures may fail.

Asking a colleague to lie shows a lack of integrity on the part of the Finance Director. The message that is being communicated, at least by implication, is that integrity should not be permitted to interfere with self-interest.

Motivating wildlife officers

The problem faced by the wildlife officers is that their actions will tend to be viewed as constraining Wodd's commercial activities. A forestry manager will not be pleased that a planned operation has to be postponed because of a discovery by the wildlife officers. This will be complicated by the nature of wildlife that might be observed. For example, some creatures are migratory and so their presence may be temporary and it may be unclear whether they will suffer any real harm if their habitat is damaged. Other creatures may be difficult to identify or distinguish from more common species. It may be difficult for the officers to state conclusively that a particular creature is present.

Perhaps motivation is partly down to recruitment of suitable employees. Employing applicants with training and qualifications in a discipline associated with ecology or animal welfare will ensure that they are self-motivated. Employing such individuals should mean that they have the conviction to report any sighting that they realise will make them unpopular.

Wodd can also encourage the wildlife officers by tracking counts that measure biodiversity and other relevant factors that indicate that they are doing their jobs properly.

Aggressive directors

As CEO you have to strike a balance between pursuing the company's interests and harming stakeholders' interests. In general, it is almost certain that any individual who reaches the Board of a quoted company will be ambitious and goal-centred.

Openness and transparency in decision-making is one strategy for mitigating the aggressive pursuit of profit. If the Board members are encouraged to discuss the implications of certain courses of action then they may be more inclined to disregard possibilities that would be deemed unacceptable. For example, health and safety issues can involve quite a delicate balance between managing costs and ensuring safety. Perhaps an open discussion of the need for a particular piece of safety equipment will make it easier to establish whether it would be morally acceptable to avoid the cost of acquiring it.

Paying attention to stakeholder feedback and asking the Board to comment on concerns will help.

The Remuneration Committee should aim to take a balanced view of performance, looking at non-financial issues as well as financial. If directors are rewarded for profits only then they are bound to be more aggressive than if they have a range of objectives beyond profit.