

CGMA NOVEMBER 2015 EXAM ANSWERS

Variant 5

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Section 1

Are we behaving ethically?

This is a difficult question. It could be argued that we are acting in accordance with the law, but that we are in breach of social norms.

If we use CIMA's Code of Ethics as a starting point then we appear to be acting in accordance with most of the fundamental principles, but only at a very superficial level. For example, integrity requires us to be straightforward and honest. We could argue that we behave with integrity because we simply take a client's instructions to buy and then manage forestry land. We could argue that, in a democracy, it is perfectly acceptable for the government to create incentives using tax reliefs. In this case, the incentive is to protect forestry land by giving owners a tax incentive to keep the land as it is.

Unfortunately, we are open to accusations that we are abusing this tax incentive to win business. The logic behind the tax relief is not necessarily intended to encourage wealthy individuals with no interest in forestry to take temporary possession of such land. If political pressure or some other factors lead to the withdrawal of the tax incentive then these forestry owners may quickly divest themselves and the market value of forestry land may plummet. Our industry has effectively encouraged a trade that could one day lead to the redevelopment of forestry land because the tax incentives to protect it have been rendered unpopular. If the land is sold cheaply enough then it may be attractive to buy it for building or some other purpose.

Our payment of a commission could undermine objectivity. Tax accountants may feel that it is advantageous to refer their clients to us in order to reduce their tax bill and their advice to use forestry rather than some other tax planning approach may be motivated by our commission rather than the client's needs. If we really are a popular choice for advisers then our commissions may be more attractive than our competitors', which may lead to us having an unfair and unethical advantage.

There is no reason to suggest that professional competence is an issue with respect to our management of the forestry, but it is clear that our staff are not applying due diligence to establish whether this is a suitable investment for our clients. We are, potentially, tying clients' wealth up in a very illiquid asset that may create tax circumstances that would be difficult to unwind. Should an investor require cash for any reason, it may be difficult to realise an investment in forestry without incurring significant transaction costs and delays.

Confidentiality does not really apply to us.

Professional behaviour suggests that we should not engage in activities that would seem to be controversial. We have assisted a number of wealthy individuals to exploit what amounts to a tax loophole. Public opinion tends to regard such tax loopholes as divisive because they are rarely open to anyone who is not already quite wealthy. We are effectively drawing the forestry industry into disrepute and risking a tightening up of the rules in the future as a result of criticism that we are stimulating.

Response to article

Wodd welcomes the opportunity to respond to this article.

It would not be appropriate for us to comment on the allegations concerning Mr Crauder, or anyone else, with respect to tax. Tax law is complicated and the rules are a matter for government. Investing in forestry is, potentially, a very long term and high risk venture. Tax law protects the owners of forestry from the burden of tax liabilities that could make it difficult to manage the land and growing timber responsibly. Forestry owners are stewards of an important natural resource.

[comment: We need to distance ourselves from the specific controversy over Barry Crauder's tax liability. We also need to emphasise that we are acting within the law.]

We acknowledge that an investment in forestry requires considerable wealth. Responsible forestry management requires limited harvesting and land must be replanted to permit regrowth. It is simply not cost-effective to invest in forestry on a small scale, but that does not justify the argument that investment in forestry is an elitist activity.

[comment: This line of argument should create a sense that the article itself is a little mean-spirited. We need to present our investors as responsible stewards.]

We do pay a commission for successful referrals. It is common practice to do so in many industries. The companies which refer clients to us must conduct significant due diligence to establish a suitable investment strategy. We believe that many of the recommendations that we receive are due to the fact that we are a leading company in this industry. If we did not meet the expectations of our clients or their professional advisers then the referrals would cease.

[comment: We need to stress that there is nothing underhand about us paying a commission. We also need to argue that we only receive recommendations because of our expertise and the quality of our service.]

Section 2

A typical investigation

Some of the assurances provided by the certification will be more straightforward to test than others.

The starting point for a typical investigation will be to meet with the managers responsible for the management of the forestry in order to discuss their approach. If the subject of the investigation is behaving responsibly then the managers will be able to explain how they ensure that their plans lead to a sustainable forest.

During this meeting, we should aim to ask a range of open-ended questions, with a view to seeing whether there is a consistent story. For example, there would be no point in asking 'do you ever use chemical pesticides?' because that would clearly prompt a 'no' response. Asking more probing questions about the types of infestation that the managers have to deal with and the approach that they take to managing them will give them the opportunity to demonstrate good faith. It will be far more difficult to tell lies in a consistent manner if the questioning is open-ended and any anomalies are noted and followed up.

Site visits will allow for at least some of the claims made by the managers to be checked. For example, in an area that has been harvested there should be signs of saplings at the relevant stage of growth. There could be other forms of evidence, such as invoices from the purchase of saplings from a commercial grower or the existence of a nursery that is used to grow saplings on site.

The work done during the site visit could be linked to risks and also any concerns followed up. For example, if there is clear evidence of soil erosion and barren ground then there should be a concern that too many trees are being harvested. An explanation should be sought and a further series of visits conducted if the explanation is unsatisfactory.

Some of the other issues will require the subjects of the certification activities to express their own views on how they should be evaluated. For example, the entity has to decide how best to observe and respect the rights and issues of local communities. There cannot be a single set of measures for that type of quality because different forests will have different types of communities living in and around them. For example, a green belt forest in a semi-urban region may demonstrate engagement by offering leisure facilities to locals and tourists. Residents in rural areas may have different interests altogether, such as depending on care in cultivation by the forestry in order to avoid contamination of drinking water. In any event, that may require that we gather evidence of perceptions by means of surveys or other activities.

Motivating and evaluating

The first problem may be associated with the background and career path of the investigators. If we train forestry workers they may be keen to move back into the mainstream management of forestry, but at a more senior position. That may be difficult if we have too many investigators to make such a transition to supervision or management a realistic possibility. If we use internal auditors then they have a less obvious career path, perhaps apart from leaving Wodd and moving into some other type of assurance or accreditation service.

In either case, it would be helpful for Wodd to provide relevant and interesting training for all staff involved in certification. It might even be possible to sponsor study for membership of relevant professional bodies or academic qualifications.

There is a basic problem with evaluating any assurance activity because the work of the investigators may never be open to further investigation. Any errors that they make may never be uncovered and that could create some temptation to cut corners and take risks. The way to prevent that is to have a system of thorough reviews of working papers before certification

is granted. The reviewers should insist that their queries are cleared to their satisfaction before passing the file. Reviewers should be experts in this area so that their queries and opinions are respected by the investigators. Ideally, that will encourage them through a desire to impress the reviewers.

Given the need for a thorough investigation, it may be risky to set time budgets. However, there does have to be some basis for managing investigators' time and ensuring that their work is completed quickly as well as to a high standard. The key to minimising the risk of dysfunctional behaviour is to encourage investigators to offer explanation for any adverse variances. If a site visit takes longer than budgeted because of concerns about the initial findings then the investigators should be commended for stating that they extended their visit in response to those concerns. The outcomes of such additional work can be investigated to enable us to establish whether the additional time was, indeed, necessary.

Section 3

Effects on Wodd

The most immediate effect will be that we will be unlikely to obtain any further clients for forestry management.

In the short term, we might actually generate fresh fees from those individuals who have invested through us in the past. They may decide to sell their forestry land because of the loss of the tax shield and we will be well placed to find interested buyers.

We might even be able to buy some additional land for ourselves at a reasonable price. It would be unethical to buy our own clients' land at depressed prices, but there are other companies whose clients would be selling.

The bigger question is whether we might suffer a loss because of declining fair values of forestry land. That is an economic question that really depends on the extent to which these wealthy individuals might have inflated land prices. If sales of land represent a large proportion of the land that is under forestry then we could see a loss. However, the land will always have a significant intrinsic value because of the need for timber.

Briefing analysts

Analysts do not set share prices on a minute by minute basis. When news is released, market makers may adjust the prices of the shares that are affected and those adjustments may be corrected by subsequent trading. Negative news that is not fully understood could lead to an excessive downward adjustment.

There can be speculative forces at work that can affect the share price in the short term. Speculators may attempt to force our shares down further by selling short in the hope that they can unsettle the market and close out their positions if the price falls further.

Briefing the analysts could have a number of effects. Firstly, the business press may approach the analysts in the hope of a helpful quote. If the analysts in our industry make reassuring comments then the market may be reassured.

Secondly, the analysts may anticipate the price fall and could brief their bigger clients to buy forestry companies. That will help share prices to recover quickly.

Dividend

Dividends are often viewed as a costly signal by the stock market. In other words, they trust the signal because there is a cost to the directors if the message turns out to be false. In this case, the additional dividend is a sign that the directors expect profitability to carry on more or less as before. If that turns out to be unduly optimistic then Wodd may run into financial difficulties, which could damage the Board's careers.

In the immediate aftermath of the tax announcement, it is unlikely that the market will pay a great deal of attention to Wodd's dividend announcement. After all, the Board could be sincere in its belief that nothing will change, but they could still be mistaken. It is also unlikely that Wodd will prosper significantly because of these changes, so any dividend increase is likely to be too modest to impact the share price to any great extent.

Options

Options give the directors a clear incentive to ensure that the share price exceeds the strike price at maturity, otherwise the option will lapse worthless. The shareholders are encouraged by the fact that they can see the directors having an incentive to maximise their wealth.

Options also give the directors an incentive to take realistic risks because additional volatility in the share price will make their options more valuable. That deals with the agency-based concern that the directors may be too risk averse because they are protective of their careers.

The biggest problem created by options is that they only have value if they are in the money at expiry. That can create an incentive to manipulate the share price. Misleading the market in the short term can create significant benefits for the directors because even a small profit on a large number of options that are due to expire could be a significant value. For example, announcing a dividend that the company cannot afford might raise share prices in order to enable the directors to exercise their options. The directors can then argue that any subsequent problems were unforeseen effects of a valid business decision.