

CGMA FEBRUARY 2018 EXAM ANSWERS

Variant 3

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SECTION 1

Benefits of being a listed company

A stock market listing is likely to raise the profile of Royals in Hylandia. We currently may be relatively well known in our own industry, but a stock market listing would make us highly visible and raise our profile across business sectors.

With an enhanced profile, we may achieve greater standing and credibility with suppliers and importantly, with providers of finance. We have had a strong relationship with our current bank up to this point, but a stock market listing may allow us to seek alternative credit elsewhere. As a listed company, we are more likely to be viewed favourably and granted extended credit facilities with key lenders.

A stock market listing should assist us in raising capital for our future growth strategies through the issue of shares and expansion outside of Hylandia, which is one of our corporate aims. The reputation that comes from being listed may help to attract investment abroad.

Once we are listed, the market should provide us with a far more accurate valuation of the business which has not really been possible up to this point. This is beneficial to Marco and Frederik. It will be easier to trade shares in the future, should Marco or Frederik want to sell any of their shareholding and avenues such as rights issues also become available. Shares become more marketable and will be able to trade their shares more effectively.

There are benefits to the staff and managers of Royals. Improvements to Royals reputation as a result of being listed means that the business is more likely to succeed in the long term and therefore it may result in improved pay and better career prospects.

Problems of being listed

A listing may be costly and will take up a significant amount of time for the Board. We must ensure that during this time we do not lose focus on other key issues in the

business and that we maintain our focus on continuing to grow the business. A listing may detract from this in the short term.

Although Marco has experience in his previous business of involvement in a stock market listing, we may require external expertise to assist in the process. This may be costly.

Making shares available to the wider market will inevitably lead to loss of control of Royals for Marco and Frederik. This may be difficult for them to accept as they have such a close association with this business. It is likely that GEM will sell their currently held shares and also new shares will need to be offered to the public in order to generate sufficient interest in the shares. Therefore, the level of ownership for Marco and Frederik will be diluted. Although they will still likely wish to retain a significant shareholding, this is unlikely to be enough to hold a controlling interest in the business that they started.

The reporting requirements will now be more onerous as a listed company. We will have to file our annual accounts with the Hylandia company authority and our accounting records must be submitted in accordance with International Accounting Standards. We will be expected to follow strict listing rules, including those of Corporate Governance requirements, which are likely to be extremely detailed and onerous for the Board.

Implications of listing on the operations and structure of the Board

Operations:

Firstly we would need to comply with the Hylandia Corporate Governance Code. This would need to be stated in our annual report to our investors. The Board operations would not necessarily differ significantly from now, in terms of general activities, responsibilities and board meetings. However, more formal procedures for reporting board meetings would be required and the activities of the Board would come under more scrutiny from outside investors.

The Board would need to adhere to strict Corporate Governance guidelines, based around key principles such as Effectiveness, Accountability and Relations with shareholders. We would need to hold an annual general meeting so that shareholders have a forum to communicate with our directors. There will need to be formal procedures in place for the appointment of directors and for the re-election of directors at regular intervals. This will need to be reported in our annual report to investors. It will be important to establish transparent and clear arrangements for corporate reporting and principles for internal control. A range of committees will need to be established to demonstrate accountability in key areas. For example, an audit committee and a remunerations committee will need to be established and the reports and outcomes from these committees would need to be reported to investors within our published annual results.

Royals Board will also need to develop and maintain an appropriate relationship with external auditors. A more formalised and detailed relationship with external auditors will now need to be exercised.

Structure:

Royals Board will need to demonstrate clear divisions of responsibility. This should not be an issue for us, as we currently have clear lines of responsibility and a separate

Chairman and Chief Executive Officer and other Board positions with clear areas of responsibility. One issue may be the role of Frederik as the Chief Operating Officer, which currently has a very wide remit, including property management. The scope of this directorship may need to be reconsidered and an additional director added to the Board. The current responsibilities of these roles will likely need to be widened to take on the extra responsibilities required of these positions in a listed business.

A significant change required to the current Royals Board will be the need for more NED's. Following a listing, the Board will need to consist of half independent NED's, excluding the Chair. Currently we only employ two NED's. Any new NED's will need to be independent and contain a mix of skills and experience from inside and outside the health and fitness industry. The role of the NED's is to scrutinise the performance of management and ensure the integrity of the financial information and controls and that our risk management systems are robust.

As stated earlier, we will need to set up a number of key committees including a remuneration, nominations and audit committees. Key NEDS's will be required to chair these committees and have regular and reported meetings on key activities which will need to be reported back to the Chair and to investors.

SECTION 2

Steps required to undertake stock market listing

If we undertake a listing, we will be offering shares for the first time on the Hylandia stock market. Our initial step is to seek the guidance of key experts. The best place to start is by appointing an advisory company which are specialists in this area, such as an issuing house, which is likely to be one of Hylandia's largest investment banks. Together with our venture capital investors, GEM, we will therefore firstly need to employ the services of an investment bank to take the lead role in the listing. Following the appointment, it will assist us in the appointment of specialists such as lawyers and stockbrokers and advise on specific Hylandia stock market requirements. It will also advise us on arrangements for underwriting and publishing the offer.

Our next step is to decide on whether we offer a fixed price for our shares or make a tender offer. With a tender offer, subscribers tender for shares at or above a fixed price. Once all offers have been received we then set a strike price and allocate shares to bidders who offered the strike price or above. The investment bank will need to advise us on an appropriate strike price to ensure we raise the required amount of finance from the share issue.

Therefore, prior to this, we will need clear communication and agreement with GEM on a price which is acceptable to it for the sale of its shares.

Next, we will need to present the offer in the form of a prospectus to potential shareholders, and this will normally be detailed in the Hylandia national newspapers. It may be useful to us to communicate with institutional investors to get an indication of the likely take up of the shares and to gauge an acceptable price for Royals shares.

Importance of effective communication during the listing process

We will need effective communication to a range of stakeholders to ensure that the listing is a success and that our reputation is maintained. Firstly, we will need communication with GEM. We need its support and participation throughout the process, as we will both want to benefit from the successful sale of the shares. It is important that we are in agreement on the price of the shares and therefore open and

honest discussions between us must be achieved to ensure both parties achieve their goals and expectations from the listing.

Effective communication with potential investors about our business and its future prospects will ensure that there are sufficient potential buyers to take up all of the shares on offer. This will most effectively be achieved through the prospectus.

We should also look for effective communication with the institutional investors prior to listing in order to set an appropriate and realistic initial offer price for the shares. These institutional investors need to be convinced of our credibility and reputation. Marco needs to be active and visible during the period to send a clear message of the future prospects of the business.

Communication to our staff will also need to be considered. There will inevitably be concerns about the future of the business and staff need to be reassured of their positions and the future of the business. It is possible that some of our staff will want to become investors in the company. This is actually a good way of getting further buy-in to the organisation from staff as they will have a vested interest then in helping to ensure the success of the business.

Impact on risk reporting

Risk reporting will form an important part of our annual report to shareholders. Although we currently present a description of our risks within the Chairs Statement, this will no longer be sufficient and we need to present risks in a more formalised way within a separate section of our annual report to investors. Risk reporting will now need to include:

An annual systematic review of forecast risks which is, in fact, largely the extent of our current risk reporting approach, which merely presents an overview of the risks faced by the business.

In addition to this, we will need to present a review of our risk strategy and the expected responses to any significant risks identified. A formal review of our risk strategy is not something that we currently undertake. This must be addressed, as a clear risk strategy will be a key expectation of investors who will need reassurance of our proposed strategic responses to risks of the business.

We will also need to undertake a process of monitoring and feedback on the action Royals has taken to address its risks. It will be necessary for us to implement a system which will monitor any material change to our business circumstances to provide an early warning of significant risk impacts to our business.

The monitoring of risks should form part of our internal audit activities and be an integral part of monitoring and information gathering within the business. Clearly a more structured and formalised approach to risk management and reporting is going to be required following a listing and will be a key expectation of investors.

Requirement for New Performance Measures for Stakeholders

Our current KPIs, including revenue, operating profit margin, number of gyms and gym membership will remain relevant key business performance measures and will be focused upon after listing. These will continue to be key determinants of our success and will be of high importance to our key stakeholders such as our new shareholders as they are key measures of our continued success and growth.

However, new KPIs need to be considered to satisfy stakeholders. Investor performance indicators such as annual return to investors, earnings per share,

dividend growth and debt to equity ratios will be of importance, specifically to investors concerned about returns on their investment and upon the long-term viability of the business and risks to financial stability of the business. Clearly, our performance will now be open to a much higher level of scrutiny, so including a wide range of performance measures, including those referred to above, will be very important.

This may be an appropriate time for Royals to consider widening performance measurement to include not only key financial indicators but also a wider range of non-financial performance measures, which would be more useful in measuring the achievement of our critical success factors and also for driving our strategic direction. For example, customer satisfaction measures would assist in monitoring our ability to not only grow membership levels but, importantly, to maintain current membership. Measures such as number of staff training days would assist in evaluating our effectiveness in delivery of our core services to customers and driving strategy towards membership growth. Staff turnover measurement would help us to evaluate our internal staff management processes. Investors will expect a wider range of both financial and non-financial and quantitative and qualitative measures upon which to base a more detailed assessment of Royals overall performance.

SECTION 3

Two performance measures evaluated

Regional Managers should only be measured against factors that are within their control. Our Marketing department is responsible for new membership, customer retention and other marketing activities, through activities undertaken on our website, customer email addresses and social media accounts. Brodie's comments are justified for the current measure of 'number of new customers per gym'. This is not controllable by Regional Managers. New customers will be attracted by a range of factors, including marketing, word of mouth recommendations and their own personal motivations. Arguably, Regional Managers will have a greater influence on customer retention, as if the Regional Managers motivate their gym staff to work to their optimum abilities and provide the correct training etc., then this should have an influence on the customers wanting to remain Royals customers. However, it could also be argued that customer retention is based on many factors which are not controlled by the Regional Managers such as pricing, location and quality of facilities. Brodie has some influence on these by making sure that his inspections of the gyms and training of staff are effective, so that new members will want to join. However, overall this measure will not be within his control. Therefore Brodie has a valid case for concern.

Similarly, residual income is likely to be a measure which is difficult to understand by the Regional Managers and like membership numbers, is unlikely to be wholly controllable by the Regional Managers. Residual income per region is likely to be based on many factors outside of the control of the Regional Managers, particularly the asset base used by the gyms in each region. Residual Income should be used to assess the performance of Investment Centre Managers who have control over their asset base, but in our case, investment decisions are not made by the Regional Managers.

Designing performance measures to drive strategy

The Regional Managers all clearly feel overworked and we have not provided any pay increases despite increasing responsibility for Regional Managers as Royals has grown. This, coupled with performance measures they do not agree with is causing demotivation and we must address this.

Therefore, if as an organisation, we intend to continue to use a performance measurement system, these measures must be re-considered in terms of how they can be used to improve and motivate performance and to drive our strategy of being the leading gym business in Hylandia. Therefore, our starting point is to ensure that our performance measures are designed to focus staff and management attention on this objective. We must also design performance measures which drive us towards achieving our critical success factors. So this would include measures on customer acquisition and retention rates and measures of customer satisfaction.

Also, to ensure the successful implementation of such measures we must seek the advice of the Regional Managers themselves as to what would be appropriate and achievable. Involvement in setting performance measures is much more likely to encourage buy-in.

Also, by setting targets and performance measures that are controllable and clearly directly related to the work they undertake, they are able to see how their own improvement in performance could assist in improving the outcome of the measure.

Improvement to future communications

The work needed to get the business listed has kept Frederik busy and has seemingly had an impact on the morale of the Regional Managers. However, we should now be back to normal operations and Frederik must try to make himself available to meet with the Regional Managers, or another senior manager must take on the role.

There should be a regular monthly/weekly meeting between the Regional Manager's to provide them with a forum to discuss issues that have occurred in their regions and to identify issues that collectively need to be raised with senior management. A weekly meeting may be difficult but at least once a month, one day must be set aside when all four Regional Managers meet at Head Office. Frederik, or another delegated senior manager, should attend this meeting and can then ensure that Regional Managers are regularly updated with corporate developments and necessary communications that need to be given to the gym staff. In this way, we can be assured that all four Regional Managers are receiving the same communication and that consistency of communication is achieved for all gym staff as well.

The Regional Managers are our only form of regular communication with gym staff. These are our front-line staff and if Regional Managers are feeling unhappy this will inevitably have a knock-on effect on the morale of our gym staff. If gym staff are unhappy then this may lead to loss of customers, particularly if staff leave and customers leave with them. Therefore, keeping Regional Managers well informed and feeling part of the wider team is important to ensure morale throughout the business is maintained. These four members of staff potentially have a huge influence on the majority of Royals overall head count.

Improvements to morale

Obviously, the points raised above in regard to improved communication strategies will be a key starting point to improve the morale of the Regional Managers. However, I believe there are several other actions we could take to improve morale and motivation.

Part of managing change, particularly such a fundamental change as a public listing, is helping staff to perform well after the change process and to support them during these changes. One method to help Regional Managers could be some form of mentoring. This would involve a member of the senior management team offering advice and support and general guidance on the change process and to act as a role model for Regional Managers. We could also consider running team building events and exercises for the Regional Managers. Regular updates on skills and Continual Professional Development (CPD) should also be offered.

One aspect to consider is the level of pay offered to our Regional Managers. Currently they are paid a moderate basic salary but better pay, commensurate with responsibilities, should be considered. For example, as the number of gyms in their area of responsibility increases, then the level of pay could rise too. Alternatively, a bonus system could be considered, based upon the controllable performance measures highlighted above, such as staff retention rates and customer satisfaction survey results. Currently, pay is not rising with levels of responsibility and this most certainly will have a demotivating effect on Regional Managers. We could also consider having a Regional Manager representative as part of regular senior management team meetings (possibly on a rotational basis) or have a senior regional manager to whom all the others report. This sense of belonging as a senior manager within the business may be a motivational factor for Regional Managers.