CIMA

STRATEGIC CASE STUDY FEBRUARY 2020 EXAM ANSWERS

Variant 1

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SECTION 1

Requirement 1 – reputational risk

The reputational risk here is potentially significant. There could be a loss of revenue if consumers start to feel guilty about the damage that their favourite coffee is causing to the environment. S/D should have been ready to deal with this type of criticism by having an argument ready to present to consumers. For example, encouraging consumers to pay greater attention to returning their used coffee pods might help to alleviate any guilt that they feel about the product. It might also be possible to focus on the "guilty pleasure" aspect by reminding consumers that they enjoy drinking S/D coffee and would have to revert to other types.

S/D's pods are a relatively easy target for environmental campaigners because they use significantly more in terms of resources to manufacture and distribute than conventional means of making coffee. A bag of coffee beans or a jar of instant coffee will make many drinks, while leaving a much smaller environmental footprint than a batch of pods. Coffee pods require additional material and processing once the ground coffee has been obtained and so they are inherently more harmful than the traditional means by which coffee is sold for home use. The coffee pods will add significantly to the weight and bulk of, say, a week's supply of coffee, requiring more delivery vehicles.

The fact that S/D has acknowledged the possible reputational impact in its risk report demonstrates, at least, that the potential risk has been recognised. The real concern is that the recognition has not resulted in an effective change that would pre-empt the bad publicity associated with these pods. By reporting the risk and highlighting the concern, S/D may have encouraged the campaigners to start the petition, if only because S/D has drawn attention to it and so created an easy target. The stated mitigation appears to offer only a very limited and reluctant response to the problem, which probably adds to the risk that S/D is taking.

Planetgard's decision to confront S/D in this way is not particularly surprising, but the risk would have been difficult to manage. Even if S/D could achieve 100% success in recalling used pods, they would require resources to collect and transport. S/D would find it almost impossible to argue a case for its sustainability, even if the recovery of materials could be improved. S/D is competing with instant coffee manufacturers whose products are sold in glass jars that can be placed in the recycling bin. The only real defence against the reputational issue is to hope that criticisms of coffee pods does not capture the public's imagination and environmentalists move on to deal with a different category of products.

Requirement 2 – strategy

As a starting point, S/D should aim to identify the stakeholders whom it will have to deal with in order to address this criticism.

S/D should consider how best to deal with the environmentalists, who have high interest in sustainability issues but who have relatively little power of their own. They could, however, harness the power of other stakeholders such as the government. There is little point in negotiating directly with the environmentalists themselves because they are unlikely to withdraw their complaints about S/D, under any circumstances. Indeed, any direct engagement with Planetgard or any of the other lobbyists could simply generate additional adverse publicity. S/D should, however, aim to engage directly with these organisations through the media. S/D should aim to offer its own perspective of any point raised by Planetgard in order to ensure that the public (who are also potential customers) recognise that S/D is not necessarily as guilty as suggested of harming the environment.

S/D should engage directly with the government. The government has a great deal of power, because it could have relatively little interest in imposing such an onerous change in the law. If the environmentalists succeed then the prices of consumer goods will rise because manufacturers will have to allow for the cost of recycling. Such a move could make the law unpopular with voters. There may be ways in which S/D could make sufficient changes to enable the government to argue that the proposed change in the law is unnecessary. The government could then claim to have taken steps to reduce the problem, enabling it to avoid losing the votes of consumers whose spending power will otherwise be impaired.

S/D should aim to work with other manufacturers, with a view to arguing that it would be necessary for them to relocate in the event that the proposed law was passed. Other manufacturers will have a high interest and, if they work together, should have some power to resist the proposed law. The law would clearly not apply to S/D alone; many other manufacturers would be left in a position where their costs would increase. If large numbers threatened to move away from Middland then the government might withdraw from the proposal to protect jobs. At the very least, S/D should be able to count on support from the companies that manufacture S/D-compatible coffee machines, who would lose this line of revenue. Care should be taken to ensure that the tone of any lobbying is managed carefully to avoid creating the impression that the government is being bullied. The focus should be on protecting the livelihoods of employees and the investment of shareholders.

S/D should attempt to address the root cause of the criticism. Ideally, it should encourage consumers to return their pods for recycling because doing so would reduce the wastage of scarce resources. The consumers probably have very little real interest in this issue because they are unlikely to collect and return their used pods unless there is an incentive for them to do so. S/D might consider giving a discount to customers who return their used pods or make a donation to charity for every pod returned. It may also be possible for S/D to seek a different approach, such as reengineering the pods so that they can be recycled more easily or even just so that they contain less material.

SECTION 2

Requirement 1 – ethical arguments

The principle of integrity requires S/D to be straightforward, honest and truthful. The claim that S/D is motivated by a desire to protect the environment appears to breach that principle in several ways. The plant itself will require used pods to be collected and brought to the plant from around the world. That will create an environmental problem in itself. The recycling will then cause significant harm to the environment, through the evaporation of solvents and the need to get rid of contaminated coffee grounds, which will either involve emissions through burning or problems associated with dumping the grounds in landfill, from which the solvents may further evaporate or leech into the ground. At best, the argument that S/D is attempting to protect the environment is dishonest because the company is, at best, only reducing the harm caused by the manufacture and use of these pods.

It could be argued that this plant will involve a breach of professional competence and due care because S/D is merely obeying the letter of the law as it currently stands, but it seems likely that it will be in breach of the spirit of the law. S/D is not protecting the environment if it is polluting the atmosphere by burning chemical waste in order to recycle materials, some of which are of little real value even after they have been recovered. The underlying spirit of the law is to avoid consuming scarce resources unless absolutely necessary and to avoid harmful emissions. This plant does not conform to society's needs and interests. S/D cannot claim to be acting out of a desire to protect the environment if the acquisition of this plant is merely an attempt to do the bare minimum required to avoid breaking the law.

S/D's Board would also be in breach of the principle of professional behaviour by risking the company's reputation, which could prove detrimental to the shareholders' interests if the facts become widely known. The proposed manner in which the plant will operate will cause significant damage to the environment, which can only prove damaging to the company's reputation. The Board will compound this threat by claiming that it is acting to protect the environment because its actions will be clearly inconsistent with its claims. If the customers are motivated to return their pods out of a concern for the environment, in addition to the discount against future purchases, then they may resist any future alternative approaches that the company takes to manage the recycling.

Requirement 2 – financing

The most immediate issue is the impact that the funding decision will have on S/D's statement of financial position. At present, the company's gearing ratio is 942/(942+2,167) = 30%. Borrowing will increase that ratio to 1,342/(1,342+2,167) = 38%, which is a significant increase. If S/D issues equity in order to fund the investment then it will reduce its gearing to 942/(942+2,567) = 27%. In terms of the raw accounting ratios, debt will have a significant impact on gearing and will make the company appear significantly riskier.

The recent funding strategy applied by S/D should also be considered. The company increased its debt during the most recent financial year. Last year's statement of financial position shows a gearing ratio of 735/(735+2,095) = 26%. That increase may have been used to fund the significant acquisition of PPE. Further borrowing could create the impression that the Board is taking a somewhat reckless approach to expansion, with increasing borrowing leading to additional risk. The shareholders might find it more reassuring for any further expansion to be funded with equity rather than debt.

The need to avoid any further increase in gearing is compounded by the nature of the asset that is being funded. S/D is entering a period of uncertainty because of the possibility of the introduction of onerous new laws that could disrupt operating cash flows. The plant itself is potentially incapable of addressing the concerns arising from the legislation and so there may be a need to modify it or even scrap it. In the event of any such disruption, the increased gearing will amplify the impact of the additional costs.

The plant will be located overseas, which could have implications for the terms of any borrowing arrangements. Lenders based in Middland may be unwilling to accept the plant itself as collateral for any loan because it would be potentially difficult to exercise any claim against it. Local lenders may be reluctant to accept the plant in any case because it may be difficult to sell due to the pollution associated with the solvents and metals that have been processed there. It may be difficult to secure the loan against other assets because existing debts amount to 857/1,233 = 70% of S/D's PPE and so those assets may already have been pledged and would be subject to debt covenants.

There is, of course, a downside to funding this investment using equity. The investment itself appears to be a response to threatened regulation and so will not improve future cash flows. The upside of investing is the avoidance of penalties that have not been a concern until now. Buying the plant is likely to be perceived as a negative NPV investment and so the share price will decrease. Funding the investment using equity will exacerbate the decrease because of the additional dilution.

SECTION 3

Requirement 1 – internal controls

The most obvious control would have been to have separated the duties of making and recording sales from dealing with customer queries. This would have meant that any questions raised by customers would have been dealt with by a member of staff who would have had no incentive to have misled the customer. Ensuring that a manager or supervisor dealt with all queries would permit questions to be addressed by someone who was competent to deal with them and also to consider the concerns arising from the customer's request.

Credit notes should not be authorised or issued by anyone who is responsible for raising invoices or handling receipts from customers. The salesperson should have been required to request the raising of a credit note from a supervisor or manager in accounts receivable, who should have been quick to query the reason for the error in the pricing of the invoices. Seeking authorisation from the same person would also have highlighted the number of credit notes being issued.

The salesperson should not have had the authority to input selling prices in sales invoices. Aluminium is a commodity that has a fluctuating selling price. Selling prices should be determined at least daily by a sales manager. Invoices should be raised by a computerised routine that prices sales using unit prices that have been authorised and input by senior managers who are not responsible for handling receipts. The unit prices should be visible on the company website so that customers can check that they are being charged the latest authorised price.

The salesperson's fraud was only possible because he could effectively handle cash receipts in addition to creating invoices. The fraud was only possible because of the unwitting collusion between the customer and the salesperson. It would have been possible to reduce that threat by ensuring that all customers were issued with a clear set of S/D's terms of trade for these sales and that those terms included the contact details, including bank details. Proper paperwork in setting up the relationship with customers would have helped prevent this loss.

Requirement 2 – internal audit

The first thing would be for internal audit to establish the objectives of their investigation because that could affect the manner in which evidence is to be gathered and evaluated. The chief internal auditor should be briefed as to whether the intention is to prosecute the fraudulent salesperson, to offer customers who have suffered losses a refund or simply to understand the scale of the irregularities that have occurred. The audit team should be selected and given a time budget. Given the nature of the problem, S/D should ensure that the audit team comprises experienced staff who will not be under any real time pressure on this investigation.

The audit team should gather any and all "objective" material that they might use in order to identify and evaluate transactions. In particular, the audit team might ensure that it has a file of definitive prices for the sale of aluminium for the period covered by the investigation. That will enable the team to be certain as to whether the correct price has been charged for any given transaction that is under review. Ideally, the content of the file should be confirmed by a senior sales manager, or similar, in case the salesperson disputes an auditor's claim that a sale was mispriced.

The audit team should list all of the credit notes that have been raised during the period under review and classify those as to who raised them and why. Clearly, any notes raised by the salesperson will be particularly suspect, but he could have been collaborating with others within the company. The recipients of credit notes should be listed because they are all potential victims of the salesperson's fraud. The overall value of the different categories of credit note should be totalled because that will make it possible to establish a rough approximation to the fraud.

The audit team should examine a sample of sales invoices and check that the pricing is in accordance with the definitive prices. Such a check is required because there is no guarantee that the credit note adjustment was the only form that the fraudulent salesperson used. It may be possible to download all invoices raised during the period under consideration so that the pricing could be checked electronically. Any deviations should be noted and the overstatements of the prices could then be estimated arithmetically.

The audit team could check the saleperson's emails, telephone log and correspondence. Emails to customers already identified at risk should be studied with particular care. The salesperson should be suspended or transferred during the investigation so that any redirection of payments to his bank account will be highlighted by an apparent failure by the customers to pay any recent invoices. The customers should be contacted and asked to clarify which accounts they have been paying for purchases from S/D.