CIMA

STRATEGIC CASE STUDY FEBRUARY 2020 EXAM ANSWERS

Variant 2

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SECTION 1

Requirement 1 – managing relationships

S/D will have to accept responsibility for the management of these relationships because the manufacturers and retailers do not depend upon S/D to the same extent that S/D depends upon them. The manufacturers rely on S/D only for the right to use its brand name in their promotion of coffee machines and the retailers do not rely directly on S/D for any purpose. If S/D does not take some initiative then the retailers may take the decision to discontinue the sale of S/D-compatible machines without consultation, which could prompt the manufacturers to cease production. S/D should factor the relative importance of the relationships into the approaches that it makes to these parties.

S/D could start by thinking about what it has to offer the manufacturers and retailers, in the hope that it might strengthen its bargaining power. Ideally, S/D would offer the prospect of an increase in sales of pods, which could stimulate demand for machines and so benefit both manufacturers and retailers. The fact that sales are direct and online means that S/D has a good relationship with its customers and can offer evidence to back up its claims that demand will continue and even expand. S/D might unveil any plans to actively promote its pods and discuss timing of any such initiative so that the manufacturers and retailers could make the best possible use of it.

S/D should start by attempting to seek the cooperation of the manufacturers in dealing with the retailers. Doing so will ensure that they are offering a more coherent response to the threat of closure. It might be possible to work with the manufacturers to develop new features that would enable them to relaunch their coffee makers and so attract more sales. S/D might contribute to the desirability of these new features through promotion or even by adding some varieties of pods that have been blended to make use of them. The retailers would be more likely to continue to stock S/D-compatible machines if there was the possibility of a strong demand from consumers.

As an alternative to collaborating with all three of the manufacturers, S/D could consider supporting just one and helping it to negotiate with the retailers. Arguably, S/D only needs one manufacturer, so there is no particular need to retain all three in order to maintain the supply of machines. The advantage of that is that the sale of just one brand of S/D compatible machines would be compatible with the “keep things simple” approach. The danger is that any manufacturer who refuses this offer to

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collaborate with S/D will then expect S/D to approach its competitors and could therefore be encouraged to cease manufacturing prematurely.

In the event that the retailers are not open to persuasion, S/D could offer the manufacturers the ability to sell machines through SD's website. Given the benefits of retaining a ready supply of machines, it might not even be necessary to make any charge or seek a full margin from sales. Customers who use S/D pods will be on the site in any case and so the manufacturers will have direct access to the market. S/D could provide the links to the machines and the manufacturers could fulfil the orders directly.

Requirement 2 – risk report

The purpose of the risk report is to enable the shareholders to understand the risks that their funds are exposed to because of their investment in S/D. That implies that the report should always provide a full account of all significant risks even if that might provide third parties with useful information. In this case, the risk itself is obvious, so its exclusion from the risk report could create the impression that the directors have evaluated the risk and decided that it does not matter.

Excluding such a significant and obvious risk from the report is more likely to leave the shareholders with the impression that the Board is unaware of the threat. That could easily undermine the shareholders' confidence in the directors. It could also undermine confidence in the credibility of other information that is published by the company, such as the financial statements.

Excluding the report for the reason stated could be counterproductive. The manufacturers will clearly be aware that S/D is dependent upon a steady supply of machines. Attempts to play down that dependence might be interpreted as weakness and could actually encourage the manufacturers to press S/D for some advantage. It would probably be more effective for S/D to acknowledge the risk and offer a clear statement in mitigation.

As a general principle, directors are not permitted to withhold information that is required by regulations just because the disclosure would compromise or embarrass the company. It is debatable whether suppressing the disclosure would be effective in any case because the markets are generally efficient and are capable of making use of all available information. If a known risk is excluded from the risk report then the market will simply infer the missing facts, which could have the effect of increasing the harm done to the market capitalisation.

SECTION 2

Requirement 1 – evaluation of strategic option

The SAF model offers a useful starting point.

The suitability of this option depends on its strategic fit. S/D is in the business of making and selling coffee pods, which may not appear to be a suitable basis for investing in a factory making electrical goods. The factory could be viewed as an extension of the existing business model. S/D creates wealth through the manufacture and sale of pods. Adding the machines that enable consumers to make coffee from those pods would be a logical extension of the existing strategy. There is clear synergy between the pods and the machines, if only because they are sold to exactly the same customer base.

There is a further argument that this investment would be suitable because it would protect the revenue stream from the manufacture and sale of coffee pods. S/D's ownership of the factory would ensure that consumers could obtain compatible machines going into the future. This would eliminate a potential source of risk in S/D's business model.

The acceptability of this model would depend on the shareholders' response to S/D's investment. It may prove difficult to convince the shareholders that this would be a sound investment because of S/D's lack of experience in this market. The fact that an experienced manufacturer of electrical goods is selling the factory would further undermine the credibility of the proposal. The danger is that the shareholders may not fully understand the business logic associated with this proposal.

In this case, the Board may have to tolerate a slight decrease in S/D's share price if the market does not fully support the proposal. The changing market for these machines may mean that they cannot be manufactured and sold at a profit and so S/D will have to take over their manufacture, even if that involves little or no profit. It is unlikely that the shareholders will have such a negative reaction that this will cause a significant drop in the share price or prompt calls to replace the Board.

The feasibility of this project is quite strong. S/D already has a distribution channel through its website. S/D can use a courier company to collect and deliver machines from the factory, which should not require more than a minimal alteration to support such logistics. If necessary, the whole of the fulfilment system could be outsourced to a third party, with factory output being collected in bulk and taken to a purpose-built fulfilment centre operated by a courier company.

There could be concerns about S/D's lack of expertise with regard to the manufacture of electrical goods, but those could be addressed by hiring staff to close that gap. Presumably, the factory staff will be available for hire by S/D and they can continue to make the same machines as before. The new product lines to be added from Orpalast and Zendiclam should not require significant retaining for the staff.

Requirement 2 – valuation

Homewyre's factory is essentially an unquoted business and so should be valued as such. As always, the final valuation will be determined by negotiation and will reflect the fact that this process is a zero-sum game, with one side wishing the highest possible selling price and the other side seeking the lowest. The fact that Homewyre plans to close down the factory suggests that S/D might press for an earnings-based valuation, which would probably place a low value on the business. Homewyre might respond by pressing for an asset-based valuation, which would be a realistic valuation basis for both parties because S/D effectively wishes to acquire assets and that is essentially what Homewyre is selling.

The valuation basis for the assets included in the factory will also require some consideration. S/D might press for a low value, based on the possibility that the assets may have to be scrapped if the sale cannot be agreed. Homewyre may counter that the factory is worth a great deal more than scrap value to S/D because it is acquiring a complete and functional factory that will save the time and cost associated with establishing a factory from scratch. To an extent, the bargaining position will depend on the alternatives open to Homewyre because there may be other potential buyers, who could wish to acquire the factory to develop it for some other purpose and so may be prepared to pay more than the value of the existing assets. The fact that S/D will be

in a position to offer the factory staff jobs could work in the other direction because it will save Homewyre the bad publicity associated with making staff redundant.

The valuation of the rights to use brand names is a rather different matter. The three companies will have to consider the impact that these rights could have on their sales in other areas. For example, the manufacturers are risking the possibility that S/D's quality management will be poor and so their reputations could be damaged by the sale of defective coffee machines that carry their names. They could also be concerned that S/D could eat into sales of other products that they make, including machines that are compatible with other pod systems or even generic coffee makers that do not rely on pods. Overall, the manufacturers will have reason to seek a fairly high charge for the brand rights in order to compensate for the risks and costs. They will also seek fairly substantial reassurances that the quality standard will be high.

S/D is in a slightly stronger position with regard to the negotiation because it is debatable whether it really needs the manufacturers' brand names. S/D could simply pay for the design of its own range of coffee machines that could be sold under its own brand name. It would clearly be preferable for the existing manufacturers to let S/D use their names, but S/D could use its existing relationship with consumers to sell machines if agreement cannot be reached. S/D also has the fact that it is in negotiation with three manufacturers as a bargaining point because it would be possible to make machines under a familiar brand name if a deal can be reached with only one or two of the manufacturers. That would weaken the positions of the individual manufacturers.

SECTION 3

Requirement 1 – incompatible systems

S/D should have considered the possibility that the factory's systems would be incompatible with the rest of the S/D Group when it was conducting due diligence on the acquisition. The Board should have asked the IT staff to investigate the systems in place before a final price was agreed. Presumably, S/D would have been aware of the potential incompatibility and the Board decided to proceed with the purchase in any case.

While the due diligence should have considered S/D's systems, it is debatable how much access S/D would have been able to obtain prior to the acquisition. The manufacturer who owned the factory would have been reluctant to give access to check the files because that would have given S/D access to potentially sensitive information. The Board should have worked on the basis that it would have to budget for significant changes to the factory's systems and so the fact that this cost must be incurred cannot be viewed as negligence.

The fact that the systems were incompatible would be almost inevitable given that the factory is in a very different business to the rest of S/D. While it would have been ideal to have found a factory that used a more desirable system, waiting to find one would probably have involved a great deal of compromise in a more important area, such as the suitability of the manufacturing equipment. S/D was in urgent need of a means to protect the availability of machines for its customers.

The Board should have considered the need to adapt systems in evaluating the cash flows associated with this investment. An attempt should have been made to have this taken into account in negotiating the purchase price, although the seller could probably have resisted such attempts because S/D had to buy the factory in order to protect its

main business. Negligence would only have been an issue if S/D had been reckless with regard to the systems in its decision to proceed.

Requirement 2 – cyber risks

The structure of the files might not lend itself to the software that S/D uses. For example, the manner in which costs are classified might be more complicated than in the rest of S/D and so the recording of purchases might require a different program altogether. It may be possible to adapt the software, but that might lead to problems with the consolidation of the output in the form of management accounts.

A similar issue could arise for payroll, if there are differences in the nature of employment contracts that do not fit with S/D's software. For example, the structure of overtime payments or pension arrangements could be incompatible with the new software. Even if the software is compatible, these are potentially complicated areas that could lead to errors arising from the need to set up the software to adapt to those differences.

Even relatively straightforward adjustments could lead to errors. For example, it may be necessary to give suppliers or employees new reference numbers. It would almost certainly be possible to program the conversion from one reference system to another, but there could be errors in the conversion process. For example, two different suppliers could be issued with the same reference number, which could lead to one of them being paid for invoices submitted by the other.

The conversion of the system could be exploited by fraudulent staff, who might make changes to standing files in order to conceal theft. There will be a large number of new records being created and so it would not be difficult to add, say, a small number of fake staff records to the payroll. If that addition succeeded, the bogus staff salaries could be transferred electronically into bank accounts created by the fraudulent staff.

Requirement 3 – internal audit

S/D's Internal Audit Charter follows the usual practice of defining the duties of Internal Audit in terms of the Board's wishes, which could include the checking of the conversion of the system if the Board so wished. S/D's Board may wish to make the best possible use of the internal auditors' expertise in devising tests and gathering evidence and so they should have the necessary skills. Using Internal Audit in this way would avoid the risk of distracting other staff from their normal responsibilities and so would be less likely to cause delays or omissions elsewhere.

S/D's Board could announce that it plans to have an Internal Audit investigation carried out, which might encourage staff to do their work properly and might deter dishonesty. The Board can use the Internal Audit Department to set a tone from the top that will result in a sound control environment. The fact that S/D's Board plans to invest internal audit resources in this activity signals that the directors take this matter seriously.

Quoted companies normally use their internal audit work department to compliance test systems rather than conduct detailed tests of files and records. S/D has an annual internal audit plan that will be disrupted if internal audit staff are diverted to test the implementation of the new system. It might be argued that checking the conversion is really the responsibility if the IT staff and staff responsible for applications such as purchases or payroll, although Internal Audit staff will be more objective in conducting this review than the managers and staff who had a role in the initial implementation.

There is a risk that the independence of S/D's Internal Audit Department could be compromised by this assignment. If Internal Audit reviews the conversion and reports that it is satisfactory then the audit staff may prove reluctant to report on any problems that are subsequently detected at a later date. That lack of independence could also be manifested in a recklessness in testing in that area in future audits because the staff may take it for granted that nothing was overlooked.