CGMA

CGMA NOVEMBER 2017 EXAM ANSWERS

Variant 2

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SECTION 1

Part 1

Low consequence

The most serious outcome would be if these forgeries could devalue or undermine the Steelcast brand. Steelcast watches are luxury products and that status is largely due to the exclusivity associated with wearing a Steelcast watch. If the forgeries make the watches appear to be commonplace then they will lose much of their appeal and so potential customers may switch to a different brand. Part of the appeal of Steelcast watches is that they are robust and can be worn in an active setting. It would be difficult to make a fake watch that could mimic that build quality.

Having said that, the very fact that the watches are regarded as being sufficiently desirable to forge suggests that the watches are aspirational and potential customers will know that their watch will be real. Anyone wearing a genuine Steelcast watch is likely to look relatively prosperous in terms of clothing, car and lifestyle. Such customers will not have to worry about their watches being mistaken for forgeries. Those who wish to wear a fake Steelcast watch will effectively be in a completely different market and so the forgeries should have little real impact on demand. It is almost certain that all luxury watch brands are subject to forgery and so it would almost be a concern if Steelcast was not being forged because it would imply that the company's products were undesirable.

The realistic forgeries do create something of a threat because they may discourage potential customers from spending thousands of H$ for something that is fake. The risk is a matter of some concern if we leave it unchecked, but it could be mitigated through careful management. The key is to ensure that customers are aware of the network of official retailers who sell genuine Steelcast watches. The status of these retailers could be checked through the Steelcast website. One consequence of that is that it would actually support the network of authorised dealers and might encourage potential customers to buy new watches rather than risk buying fake watches on the pre-owned market.

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If the fashion for wearing fake Steelcast watches is a social comment on the brand itself or the wider market for luxury products then that could threaten revenues. It is unlikely that such a trend would persist because people would quickly tire of it, but it could take some time for sales of Steelcast watches to recover. Steelcast's board cannot view that threat as low consequence, although it should aim to mitigate it by creating a brand image that focusses on virtues such as success and achievement and can be linked to the watch's practical appeal. The impact of this risk is largely outside Steelcast's control, but care should be taken to distance the company from anything that could be linked to excess or vanity.

Part 2

Complacency in product portfolio

It could be argued at a simplistic level that Steelcast's product range enjoys a high share of a low growth market niche. That would render products such as Brawn 'Cash Cows' in terms of the Boston Consulting Group matrix. Such products are at the maturity stage of their product lifecycle. The conventional approach to the management of a cash cow is to harvest the revenue stream from the product, perhaps using the resulting revenue stream to finance the development of new products.

It could be argued that the nature of Steelcast's market makes such a view somewhat naïve. Steelcast makes products that are prized because they have a classic style that is functional and aspirational. As such it is deemed highly desirable to its target market. Steelcast does invest in maintaining the product with incremental changes to the design and construction as new techniques and materials are developed, so the retention of the same basic design is deliberate rather than complacent. The crucial question is whether market share might decline, in which case Steelcast would need to be ready with new products.

It could be argued that the approach associated with models such as the BCG matrix and similar is inappropriate to Steelcast's strategic business model. The company focusses on a market segment that prizes luxury and is prepared to pay for it. That market segment is, necessarily, limited in size by economic variables that Steelcast cannot control. Steelcast's business model could actually benefit from the commitment to creating and preserving a range of classic styles. Young people can aspire to owning a Steelcast Brawn and those who succeed in their ambitions can actually put that ambition into effect later in life when they are fortunate enough to be able to own one.

It could be argued that we have been complacent with regard to opening up wider markets through diversification. We could, for example, have created a less prestigious watch brand that could have been sold more widely in a lower price bracket under a different name. Or we could have defined Steelcast as an aspirational brand of luxury goods that need not have been restricted to making and selling watches. In either case, we could have used the ongoing revenues from selling luxury watches to fund the development of the product and the associated need for working capital.

SECTION 2

Part 1

Addressing forgery

The first factor that might influence the government's approach is the extent to which Steelcast's relocation will affect Wayland's economy. Steelcast will employ 300 people at its factory, which is unlikely to provide a significant boost to the national economy. There may be a further impact because Steelcast's subsidiary will have to pay tax and it will also be buying materials and services from local suppliers. The bigger the economic impact, the more influence that Steelcast will have, if only because it can threaten to relocate again and withdraw its support for the Wayland economy.

Wayland's government might view Steelcast's relocation as a potential encouragement to other companies to follow. In that case, there would be additional pressure upon the government to support Steelcast with regard to intellectual property, otherwise Steelcast might move again and harm Wayland's reputation. The more visible Steelcast can make its initial move, the more influence it will have over the government. Steelcast should make it clear from the outset that the move is partly motivated by the wish to see action taken against the companies responsible for the forgery.

The economic power of the forgers may also be an issue. In some countries, the manufacture of forged goods is a major industry in its own right any many jobs depend on it. If that is the case in Wayland, then the fact that Steelcast owns a small factory and employs 300 people will make little or no difference. The forgers may be a major source of tax revenue or they may use bribery to maintain good relations with the government.

The business culture in Wayland may have a part to play. Countries vary in terms of the extent to which they protect and respect copyright and intellectual property. Legal systems can vary in terms of the extent to which courts will enforce property rights and have the ability to enforce judgements. It may prove difficult for Steelcast to obtain effective support from Wayland's legal system even if it takes up residence. The perpetrators of the forgery may be respected and powerful entities and it may prove difficult for Steelcast to take effective action against them.

Part 2

Directors' defenses

The most obvious defense would be to argue that Steelcast's offer is too low. Makke is unquoted and so the valuation is highly subjective and it open to dispute. Regardless of how much Steelcast offers, Makke's board can argue that Tom is being underpaid for the company and that he would be better off if he kept it in its present form. Steelcast cannot afford to overpay for Makke because there will be significant costs associated with the closure in Hiland and the relocation to Wayland.

Makke's directors could also consider a poison pill defense to make the acquisition less attractive to Steelcast, which might make them reduce their offer and so discourage Tom from selling. For example, it might dismiss some of the skilled workers who would be required to complete the polishing and finishing of bracelets so that Steelcast will not have a ready-made workforce whenever they acquire the company. A variation of this approach would be to enter into a long-term contract to supply a customer with a significant quantity of goods. That would make it difficult for Makke to serve Steelcast's needs unless Steelcast paid to cancel the contract.

Makke's board might attempt to tarnish Steelcast's reputation by lobbying against the takeover. Making watch bracelets is skilled work, but it might be presented as far less skilled and more labour intensive than making watch movements. Steelcast could be presented as exporting unpleasant or unskilled work to Wayland. The board could appeal directly to the press or to government departments, which might have the effect of making Tom's position difficult if he sells the company simply to make money.

Makke's board might look for an alternative bidder who would be willing to leave them in control and to carry on as before. If Steelcast takes the company over then it will have little interest in maintaining the present board's autonomy because it will wish the company's factory to make watch bracelets to their schedule. There may be other potential buyers who could be approached with a view to competing with Steelcast. Makke is unlikely to be the only company that can meet Steelcast's needs and so almost any inconvenience that Makke's board can create could be sufficient to have Steelcast move on to a different target.

SECTION 3

Part 1

Risk committee

It could be argued that Steelcast's risk management procedures should already be adequate and so the creation of a board committee should do very little to enhance the quality of Steelcast's risk management. There is already a risk manager, who occupies a senior position and who reports to the board. This manager appears to have a satisfactory administrative process in place, with a risk register that is kept up to date. The board is clearly aware of the importance of risk management and has invested time and resources in keeping risk under control.

Having a risk committee will ensure that there is greater supervision at a strategic level. The risk manager will remain in post, but will now have a designated point of contact at board level in order to report on the ongoing management of risks. The risk committee will accept formal responsibility for the overall management of risk and so it is more likely to remain on the board's agenda for discussion. The detailed management of risk should not require improvement, but it may be possible to find ways in which risk can be managed a little more effectively.

Part 2

Shareholder confidence

It would be relatively unusual for a quoted company to choose not to have a risk committee and so the absence of a risk committee could undermine confidence to some extent. The announcement of the creation of a risk committee could offset that and also address any associated implications for governance in general arising from the lack of an important committee.

Even in the absence of a risk committee, the company has been publishing a risk report as part of the annual report and so it is clear that risks are carefully managed. That should indicate that the board is aware of risk, is collating information and reports and is working to alleviate serious problems.

The shareholders' perceptions of risk will also be conditioned by the nature of the industry and of past performance. The existence or otherwise of a committee will do little or nothing to counter serious concerns about risk.

Steelcast is long established as a company and it sells a mature range of products. While all businesses are subject to some risk, Steelcast is not in a particularly risky industry and so hopefully its shareholders will not be particularly concerned about the need for a risk committee.

Part 3

Systematic v unsystematic risk

Risk committees tend to focus on all risks without separating them according to systematic or unsystematic. One reason for this is that the directors have a duty to maximise shareholder wealth. This would suggest that only systematic risks matter because unsystematic risks can be diversified away. However, there can be no guarantee that every shareholder is properly diversified and so they may be exposed to total risk, including the risks that can be diversified.

It can be difficult to distinguish systematic risks from unsystematic because some risks can be difficult to classify. For example, an increase in interest rates is likely to harm the markets generally because many companies will be forced to pay more for debt. However, some companies will suffer specific losses, such as declining demand because consumers regard their products as discretionary. If mortgages become more expensive then consumers will spend less on other things.

The directors are personally exposed to all risks, not just systematic, because their marketability in the job market may be at risk. Being a director of a quoted company that fails because of an unsystematic risk may be justifiable in terms of finance theory, but other employers are unlikely to be forgiving.

The directors also have duties other than to maximise shareholder wealth, many of which coincide with managing unsystematic risks. For example, the directors are personally responsible for health and safety matters. The financial effects of an industrial accident may be diversifiable, but the company and its board may be open to prosecution and legal claims if insufficient attention has been paid to a risk factor.

Part 4

Share price

It is very unlikely that the risk committee's work will have a significant impact on the share price. One reason for that is that even efficient markets cannot incorporate information that is not made available into the share price. The risk committee may identify and mitigate a number of serious risks that the stock market knew nothing about. In that case, neither the risk nor the mitigation would impact on the share price.

As time passes, the risk committee's actions may have a beneficial effect on total risk and that might not all have been foreseen by the stock market. Even so, the markets will respond primarily to systematic risks and it may be difficult to observe any relationship between the disclosures in the risk report and any decrease in beta coefficients.

The risk committee's actions will not always involve a decrease in risk because it may not always be cost-effective to mitigate a risk. The share price will increase only if risks diminish, but if the board decides to accept a risk then the share price will probably remain unchanged.

Finally, it is generally difficult to link movements in the share price to any specific event or factor. The capital markets are constantly changing and addressing "news", but separating, say, disclosures in the risk report from disclosures in the financial statements that were published at the same time would be extremely difficult.