CGMA

CGMA NOVEMBER 2017 EXAM ANSWERS

Variant 4

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SECTION 1

Part 1

Economic and business variables

Interest rates could have an effect on demand for Steelcast watches. If the cost of borrowing increases then mortgage payments will rise, disposable incomes will fall and potential customers may decide to postpone the purchase of a luxury watch or even downgrade their purchase to a less expensive product. Higher interest rates could also make it more expensive to fund the purchase of such a costly product. The cost of debt would also make it more difficult for retailers to carry inventory and they may run their holdings down.

Exchange rates could have an impact in export demand. If the H$ strengthens then foreign retailers will be forced to increase their prices and demand will fall. This could be difficult for us to mitigate because labour costs will be a significant part of the cost of making a watch and so most of our costs will be in H$. The significant cost of a Steelcast watch means that retailers will have to pass on any price increases because even a small percentage increase could have a significant effect on the total cost of a watch.

There could be governance issues affecting business purchases. In some countries it is common practice to give expensive business gifts to celebrate the signature of a contract, Business cultures can change very quickly, with such practices being caught up in anti-corruption laws. Potential recipients may be forced to refuse such gifts, which could further limit demand from this market.

Business confidence in general could have an impact on demand. Potential buyers will be unlikely to buy an expensive watch if their jobs are at risk. Any decline in revenues or profits across the economy could be a significant deterrent to discretionary purchases. Even a significant fall in share prices could be sufficient to trigger anxieties. Even those fortunate enough to feel secure may feel that it would appear insensitive to be seen to wear an expensive watch.

Part 2

Use of advertising

It could be argued that Steelcast's behaviour lacks integrity because it is effectively paying to have this comedian silenced. That is hardly being straightforward and honest in business relationships because it will appear to be buying advertising space as usual. It could be argued that buying advertising under these circumstances is effectively bribery of Boris Media's senior management. There could be concerns that Steelcast is overpaying for its advertising in order to obtain this concession.

Steelcast will appear to lack objectivity if it withdraws its advertising from Boris Media. Steelcast will appear to be basing an important commercial decision on a desire for revenge against the company that is poking fun at its products. That will undermine the credibility of Steelcast's board as mature and competent managers. Arguably, the appearance of objectivity is more important in some ways than the fact because stakeholders such as shareholders will not necessarily believe that their board is behaving objectively.

Switching advertising may put Steelcast in breach of the principle of professional competence and due care because, it is to be hoped, the planned spend was already in the company's best interest. Diverting advertising away from Boris Media's publications either means that the company will be reducing its spend or spending the money in less effective ways. The shareholders' money should be spent to achieve the best possible effect. It should not necessarily require Steelcast to change its advertising approach to respond to whatever threat has been created by the television programme.

This proposal will risk reputational damage, which means that Steelcast will be in breach of the principle of professional behaviour. We are effectively considering bullying another business using our economic strength. The public will see us as a large company attempting to threaten a favourite television comedy because it makes fun of our product. Apart from the perception of the company, we will be threatening the perception of our watch because we will be reinforcing the point of the joke by responding in this way.

SECTION 2

Part 1

Cost of capital

This is effectively an investment in a speculative expansion of Steelcast itself. However, the risks are different from, say, an investment in additional manufacturing capacity because there is no obvious way to estimate the returns from the investment. We are committing H$70m in the hope that revenues will increase thanks to publicity from the sponsorship. It will be difficult to determine the overall risks associated with that investment.

One response to that concern would be to start with Steelcast's cost of equity. The argument is that the investment is essentially an expansion of the company's marketing and promotional activities. The overall risks are roughly in line with that of Steelcast itself and so the cost of equity is not a ridiculous place to start. The historical cost of equity includes the risks associated with the returns from Steelcast's existing sponsorship arrangements, such as the polo team. If we use CAPM to estimate the return on equity then we will be focusing on the systematic risks, which are the more relevant to the maximisation of shareholders' wealth.

The other problem is the fact that the investment is spread over a five year period, with an initial down payment followed by a five year annuity. We need to determine the cost of equity associated with those payments, which are virtually risk free. If we use a lower cost of capital to evaluate the payment then we risk rejecting the sponsorship deal altogether. If we use too high a cost then we may understate the value of the shareholders' money that is being committed when we sign the contract.

We might be able to justify using the same cost of capital for the outgoing and for the inflows on the basis that there may be some offsetting of risks associated with both. For example, if Monzer runs into financial difficulties and is unable to meet its commitment to Steelcast then we will almost certainly be able to suspend the remaining payments under the contract. On that basis, it may be acceptable to evaluate the net revenues using Steelcast's cost of equity. This is not a perfect solution, though, because there are commercial risks that could arise over the term of the contract. For example, Monzer could perform badly on the track and could lose much of its appeal from a sponsorship perspective.

Part 2

Factors that will determine success

The most obvious issue is the publicity enjoyed by Monzer. Much of that will be outside Steelcast's control because publicity will be determined largely by racing success. Steelcast could aim to do as much as possible to promote the Monzer brand in association with Steelcast, perhaps by developing an advert using a picture of the Monzer car. It might also be possible to work with other sponsors so that the timing of different campaigns using Monzer as the basis could be spread out to prevent over-exposure while keeping Monzer in the public view.

The whole point of the agreement is to ensure that the Steelcast logo is photographed and seen. Steelcast should employ someone to monitor the number of times that Steelcast's image appears in press photographs and on television. These should be collated and reviewed by our marketing department to ensure that we are obtaining reasonable publicity from our sponsorship. We can also work with Monzer to see whether there is any way in which we might encourage our press contacts to pay more attention to the team.

We should pay attention to the details of our contract with Monzer, such as the size and position of our logos. We should have a representative at every race to ensure that the logos are fixed in the correct places and are of the agreed size. We need to check in case the cars have been modified and the modification covers the signage or makes the driver less visible. We also need to ensure that if a Monzer driver wins that our logo is left visible while any trophy is being presented at the conclusion of the race. For example, the driver should not wear a waterproof on top of the race suit that carried the Steelcast logo.

Finally, we need to ensure that Monzer does not lose Kim Harris because he appears to attract a great deal of attention from the media. Perhaps the sponsorship contract should have a clause that gives Steelcast the option to withdraw if Harris stops driving for Monzer. We might also offer Harris a separate sponsorship or bonus arrangement to motivate him to continue to drive to the best of his ability for Monzer. Our lawyers should check the terms of Harris' contract as a Monzer driver to ensure that we can be as confident as possible that he will not depart for a different team in the near future.

SECTION 3

Part 1

Challenges

The first challenge is that this is not a typical internal audit investigation. Generally, internal auditors focus on compliance and do not undertake unstructured reviews such as this. In the absence of a procedure to test, the auditor may struggle to design and conduct suitable tests.

Steelcast's Chairman should brief the head of internal audit directly and should indicate the parameters of the investigation. The Chairman should make it clear how much evidence and how great an assurance is required.

The second challenge is that the internal audit department is being asked to investigate the CEO, which raises serious questions of independence. The audit team may be concerned that this assignment will have an impact on their careers.

The Chairman should clearly set out the scope of this investigation and should identify specific questions that are to be answered, This should be copied to the CEO so that there can be no doubt that the audit team is acting under the express authority of the Chairman and that it would be inappropriate for the CEO to take offence at the investigation.

Part 2

Investigation

The first aspect of the investigation would be to determine how many of the races that Alain had attended since the sponsorship deal was signed. That should be a simple matter of asking Alain himself because it is unlikely that he would lie.

Assuming that Alain admitted to using the sponsorship facilities, the next issue would be to investigate whether there was a legitimate business reason for his attendance. If, for example, Alain was using the races to network with important business contacts then that would be a valid reason for his attendance as CEO of Steelcast.

If Alain was attending in order to network then the internal audit department should request copies of meeting notes that Alain has prepared for Steelcast's management team. It would be even better if Alain could point to formal agreements or contracts that were signed as a result of the meetings.

The internal audit department should check the costs associated with Alain's attendance at the races. These should not exceed the company's limits. In the event that he did not undertake any business then he should have met the costs himself.

Part 3

Share price

The shareholders may be concerned that their money has been spent on the pursuit of Alain's interest in motor racing. The share price could fall if the shareholders believe that the anticipated benefits from sponsorship might not be forthcoming.

That concern is complicated by the fact that Alain's interest does not necessarily conflict with the anticipated benefits. Steelcast will still enjoy the benefits of the publicity, regardless of the possibility that the CEO has been abusing the right to access the VIP areas.

Concerns might arise from the fact that the CEO could become caught up in a corruption scandal. In the worst possible case, Alain will have to resign and that may lead to an interruption in the company's strategic leadership.

While the possibility of Alain's departure may unsettle the markets, there could be an argument that his behaviour was unwise, but not necessarily sufficiently bad to require his resignation. There could also be an argument that the CEO is responsible for strategic leadership and that the existing strategies can be managed by the remainder of the board without interruption until such time as a replacement can be found.

Part 4

Releasing report

The publication of the report is unlikely to enhance or protect the share price. If the fact that the report will be published is announced in advance then the concerns about Alain will remain newsworthy until such time as the report is published. It is likely to extend the period of uncertainty and keep the allegations in the shareholders' minds.

The proposal to publish the report would also confirm that the Board regards these allegations as sufficiently serious to subject their CEO to a formal investigation. It may have been possible for the news story to have been managed in such a way that the Board regarded these concerns as having very little substance.

Clearly, if the results of the report are negative then that will make Alain's position more difficult and so the share price will be under greater pressure. The report would be confirming the worst possible case with regard to the CEO's behaviour and would eliminate the possibility that he has behaved fairly.

Above all releasing the report would clearly demonstrate that we are a company that takes a proactive approach to corporate governance and can be relied upon to act responsibly and ethically.