CGMA NOVEMBER 2017 EXAM ANSWERS

Variant 5

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SECTION 1

Part 1

Is the advert ethical?

The first argument is that this is an advertisement that is clearly designed to create a particular impression. Readers know that the purpose of an advert is to persuade them to buy something and so they should expect the facts to be presented in a favourable manner. The principle of integrity requires us to be straightforward and honest, but we are allowed some latitude in evoking the spirit of our product. For example, it is unlikely that any of our customers plan to drive a motor cycle across the Kalahari Desert. Steelcast's watches are sold through a retail network and sales staff are trained to explain the products and so customers will have the opportunity to have the issues explained to them at the point of purchase.

The principle of objectivity requires us to avoid dishonesty in our advertising. One argument is that it is an objective fact that Steelcast watches have been certified by an independent body as being chronometers. Interested customers can then investigate what that standard actually means in terms of accuracy. There is no formal standard for the accuracy of quartz watches and so it could be argued that the statement "as accurate as quartz" is just another way of stating that Steelcast watches are very accurate, which is true.

In terms of professional competence and due care, the crucial issue is that Steelcast has taken sufficient care to ensure the accuracy of each watch. This is critical in the context of a watch that is being sold to an adventurer because of the role that accurate timekeeping can have in the context of navigation. If the watches are being sold on the basis of their suitability for an extreme sporting lifestyle, then Steelcast must be able to guarantee that the watches meet those needs. The manufacturing process places huge emphasis on the precision of fabricating each watch and so Steelcast is probably not in breach.

There may be a breach of the principle of professional behaviour because Steelcast may be open to accusations that it is misleading by omission. It is clear that Steelcast watches are really only as accurate as quartz watches if they are checked and adjusted in a particular way. Some potential buyers will not mind this, but others may find it inconvenient to do so, particularly if they are involved in adventuring and do not have ready access to independent time checks. The controversy surrounding this advert could discredit Steelcast's reputation.

Part 2

Resignation

The stronger arguments are probably against resignation.

It is not uncommon for companies to actively create controversy with their advertising. Doing so stimulates public debate which can create a great deal of valuable publicity. Taking this advert as an example, the public discussion will give Steelcast the opportunity to stress just how accurate and reliable its watches are. Clearly, if that was part of the company's intention, it would be unfair to expect a board member to resign.

Another argument against resignation is that it is debatable whether the Board should accept responsibility for the wording of every advertisement published by the company. There will clearly be marketing teams who design adverts and they will be experts in all relevant codes of conduct and legislation, in addition to their marketing abilities. Perhaps the Board should have reviewed the adverts before they were published, but it would be justified in delegating the responsibility for advertising to its staff. Having said that, the Board will always bear the ultimate responsibility for every decision, even if it chose not to review the advert in advance.

A resignation would send a very clear message to customers that Steelcast takes any allegations of misleading advertising very seriously. If consumer confidence is damaged then the resignation of, say, the Marketing Director, would reinforce the message that Steelcast makes and sells a high quality product that is as reliable as stated. Any future advertising will be taken more seriously because the penalty for distorting the truth has already been established. This will also mean that more junior managers will take greater care when developing advertising campaigns because they realise that the Board will be more vigilant, if only to safeguard their jobs.

The resignation will also send a message to Steelcast's shareholders that the Board is prepared to take responsibility for the company's actions. A director has paid a heavy price for the damage done to the company's reputation and that should mean that greater care will be taken in the future. This suggests that the Board is acting with integrity and that the remaining directors will act as good stewards of the resources that they have been entrusted with. That argument could be flawed though, because the shareholders may start to wonder about the continuity of leadership if there is a possibility that Board members may resign over matters of principle.

SECTION 2

Part 1

Share for share exchange

We need to structure the exchange in such a way that it gives us a realistic chance of obtaining the Hantime shares that we need in order to make our plan work, without overpaying and so diluting the wealth of Steelcast's existing shareholders. As a starting point, the theoretical value of the combined companies would be H$6,980m + 4,724m = H$11,704. On that basis, a fair price would leave Steelcast's original shareholders with H$6,980 / 11,704 = 60% of the total shares and Hantime's former shareholders with 40%. In theory, Steelcast could increase the number of its own shares in issue by 67% and exchange those for 100% of Hantime's and that would give the resulting proportion.

That theoretical argument ignores the fact that there will be synergistic gains from this takeover. The capital markets will realise that Steelcast wishes to take advantage of those synergies. Hantime's share price will increase immediately we announce our intention to take the company over in the hope that Steelcast will pay more for those synergies. We need to budget for that "greenmail" element to the takeover. In an efficient market, the increase in Hantime's market capitalisation will equal the market's perception of how much we will be prepared to pay for the synergy between the companies.

In structuring the bid, we have to allow for the fact that the combined company will increase the risks for Steelcast's shareholders. Hantime has a higher beta coefficient and higher gearing. That will increase the beta and total gearing of Steelcast, which may discourage some shareholders and lead to some short term disruption in the share price because of those concerns. If Steelcast's share price declines slightly because of these transactions then it will be more difficult to get Hantime's shareholders to agree to the takeover.

Before making anything public, Steelcast should investigate the distribution of shareholdings in Hantime. It will be easier to negotiate a share exchange if the shares are held largely by institutional shareholders who hold relatively large blocks of shares. Steelcast could offer a deal that grants the existing shareholders a realistic premium over the present market price in return for a commitment at this early stage. It might help to make any such deal conditional on Steelcast obtaining an 80% share of Hantime, so that there was a disincentive to breach confidence.

Part 2

Currency risk

The first issue is that we will be subject to translation risks because of our investment in a foreign subsidiary. Hantime will be a foreign operation and the retranslation of assets and liabilities and goodwill on acquisition will result in currency gains and losses. These gains and losses will go to other comprehensive income, but they will still have an impact on total equity. It can be argued that translation risk is not really a genuine problem because it simply restates the numbers in the consolidated financial statements without actually impacting on the future cash flows, but it has been suggested that shareholders can be concerned about exchange risks in practice.

Transaction risks will arise because Steelcast will have to make payments to Hantime. Those payables may change the cost of settling those balances in terms of H$ in Steelcast's financial statements, which may have an impact on the motivation of managers. There could also be tax implications arising from those currency gains and losses. The consolidated statements for the Steelcast group will not show those gains and losses because Steelcast's payables are Hantime's receivables and so the changes will offset one another.

The biggest issue could be economic risk. Changes to the E$ could affect the cost of quartz movements and that could have an impact on Steelcast's costs in selling its range of quartz watches. The Steelcast group will also be affected by the implications of any movements in the E$ for Hantime's products. A strengthening of the E$ will make it more difficult for Hantime to export its products, while also increasing the cost to Steelcast of buying its quartz movements. The fact that Hantime is in the middle market may mean that potential customers are less prosperous and more conscious of pricing in comparison to Steelcast's customers. That could make this risk more serious.

Paradoxically, the economic risk created by this arrangement could lead to a degree of diversification for Steelcast. At present, the company is heavily exposed to the strength of the H$ because all of its costs are denominated in that currency and it exports watches around the world. Provided the H$ and E$ are affected by different factors and move independently, having a reliance on two currencies could reduce the overall risk. Some of Steelcast's costs will now be based on the E$ instead of all being in H$.

SECTION 3

Part 1

Synergies

The most significant synergy was the ability to market a Steelcast watch powered by a Hantime quartz movement. This raises the challenge of making a quartz watch that will be accepted by customers. Steelcast's present product range is popular because of the emotional appeal of the hand-built movements as well as the practical benefits of having a watch that is not dependent on battery power. Customers may resent paying the same price for a watch that looks the same on the outside but it powered by a mass-produced electronic movement. There may be problems if the Steelcast range starts to lose its appeal because the company may be moving away from its traditional values.

There could be engineering problems associated with making a quartz movement compatible with a Steelcast watch. Steelcast promotes its watches as robust and sells them as suitable for an active lifestyle. It may be difficult to build the same degree of robustness into an electronic watch movement, which could lead to accusations that Steelcast has compromised its quality. Steelcast's engineers do not necessarily understand the problems associated with modifying the design and construction of Hantime's movements to meet their needs.

Part 2

Correct information

The most effective way to minimise rumours is to be as transparent as possible. Ideally, Steelcast should have a formal communication strategy that is aimed at briefing analysts so that they are aware of the progress towards the launch of the new product range. It is common for quoted companies to hold regular analyst briefings in order to ensure that the capital markets have clear and accurate information. Steelcast might also use opportunities such as trade fairs and similar public events to showcase prototypes so that the press is aware of what the new watches are likely to be like.

Steelcast should also take great care to minimise leaks from inside the group. Staff at both Steelcast and its Hantime subsidiary should be warned that everything related to product development is confidential. It should be made clear that anyone who leaks information will be punished severely. New staff should be vetted carefully, with references taken up and other checks made as to their characters and employment histories.

Part 3

Integrating IS

It may be that the two companies will operate largely independently of one another and that a lack of integration will cause relatively few problems in terms of operations. There could be difficulties in terms of Hantime scheduling production and making deliveries to meet Steelcast's needs. That problem could be addressed by finding an alternative approach to placing orders and so the impact may not be that serious.

Maintaining the group's IS will be complicated if there are two independent systems in operation. That could mean that maintenance costs and the risks of disruption are doubled. The lack of integration will mean that Steelcast's Board may not be able to request the same level of reporting from Hantime as they take for granted from

Steelcast. Requests may be more difficult and more complicated to fulfil. The preparation of consolidated management accounts and financial statements may be complicated by different IS.

Part 4

Strategy

The first question would be to examine the systems in place in each entity with a view to deciding whether one is superior to the other. It makes sense to change only one system if that would be possible, so that costs and disruption are minimised.

The next step would be to work with management teams to determine what they need. Even if we will standardise on one or other of the existing systems, it may be worth considering whether that system could be enhanced in a cost-effective manner.

Any local issues need to be taken into account. For example, local regulations might have implications for the accounting system and so those differences will have to be taken into account. We need to ensure that all specific needs are fully understood by both sides because such differences may not be obvious in any ongoing discussions.

There should be a steering committee appointed from the key functional areas in both Hantime and Steelcast. Hantime's representatives should be assured that the intention is not simply to export Steelcast's system to their company.