

**CGMA STRATEGIC CASE STUDY FEBRUARY 2019 EXAM**  
**ANSWERS**

**Variant 5**

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**SECTION 1**

**Risks of product recall**

A recall of the Primus, our latest mainstream wrist-based fitness and activity tracker, could create a reputational risk for us. The Primus has only been on the market since 2017 and has been the flagship for our VitaPulse technology. This could severely affect the achievement of our forecasts for sales of this product, which is a key element of our product growth projections.

It may also result in a lack of trust of the remaining products in our portfolio. We have recently launched the Chorus for children and this recall could have repercussions on the level of trust and integrity of all our products and may have a knock-on effect on the sales we have predicted for the Chorus.

We have built our reputation on our strong focus on health and fitness. Our customers rely on their accuracy and therefore, if this comes into question, it will completely undermine our whole ethos.

This in turn, leads to the risk of loss of shareholder confidence in our products and in our long-term strategic direction. A product recall may result in a short term drop in market confidence in our products and systems and this may cause shareholders to sell their shares. This in turn, would reduce the value of the business. If we are to undertake a product recall, we must have a strategy in place to communicate and reassure shareholders immediately of our positive actions to rectify the problems we have found.

A product recall will have a significant cost. This may put further business investment at risk, and may detract staff from product development activities, whilst investigation of this issue is undertaken. This is likely to mean that resources, both financial and staff, will be diverted away from product research and development. In addition, customers may take legal action against us and this will divert our attention and also take up significant time and financial resources. We may find ourselves subject to legal claims from opportunistic customers who may say that they have suffered anxiety or stress from seeing the results of the tracker. Even if the impact is not so severe as legal action, customers may seek compensation for the inconvenience of having to return their trackers.

However, these risks must be weighed against the risks of doing nothing. Obviously, doing nothing will initially cost nothing in the short term but, in the longer term, could cost us significantly if the technology is indeed found to be defective and we then may face serious and hugely expensive legal challenges. The reputational risk may indeed be far more severe if we choose to do nothing as, if found to be defective, this would go completely against our business ethos by willingly ignoring a serious defective health management issue with our product. The subsequent damage to our reputation could be irretrievable. At least with a product recall, we would be able to manage the risks more effectively as we would be in control of the process.

I would suggest that this issue is investigated more thoroughly with some urgency before a final decision is made.

### **Role and Responsibilities of Directors**

As a board of directors, you have a fiduciary duty to shareholders to act in their best interests. You also have a responsibility to exercise care and skill in the decisions we make on behalf of the company and the shareholders and not protect our own reputations. Shareholders' interests should come first.

It could be argued that the Board has already failed in its duty by allowing the Primus trackers to be sold with the new technology prior to the results of the tests being checked. Shareholders will no doubt want to know why the tests were not carried out prior to the product launch. Directors have a duty to act with care and skill. Therefore, the Board needs to ensure that the full consequences of the failure of the technology, as well as the recall/do nothing decision outlined above, are fully considered.

However, you must also consider your responsibilities as directors to Vita's other stakeholders. In this case we also have a duty of care and responsibility to other stakeholders; notably, our customers and their health and welfare.

Although as directors, you have a duty to promote the best interests of the shareholders and promote the success of the company, by taking a decision to carry out a product recall this may result in significant cost and reputational risk to Vita. However, this is likely to be only a short-term effect and, as directors, you must be taking the longer-term perspective and be considering the long-term implications of such a decision on the reputation and indeed the overall survival of the business.

It would be inappropriate of you, as directors, to make a short-term decision to protect short term reputation that, in the long term, could jeopardise the overall survival of the business.

The directors' primary duty is to maximise shareholder wealth, but you also have a duty to evaluate and maximise the impact on our operations and the community in which we operate. You must protect our customers from any health risks.

Fundamentally, it is your duty to ensure that this issue is not merely ignored, whether you think it insignificant or not. Directors should use their professional judgement. For instance, Guy, as Chief Technology Officer, has offered his professional opinion with regards to the fact that the tests show that the technology has fallen outside of the strict tolerance range. However, this does not necessarily mean that he is right in his opinion that the products need to be recalled and that it should be his decision alone. The Board as a whole need to make a judgement on the action to take.

However, if you feel that as a board you do not have the necessary experience or knowledge to make this decision, then you must seek the advice of other experts to provide Vita with the necessary objective advice.

If there is a reasonable degree of risk that you feel could compromise the integrity of our products, then you have a duty of care to Vita's customers and users to prioritise their needs over and above the needs of the shareholders.

If an independent investigation, together with your own external expertise, identifies a potential risk to users, then you have a duty to assess the potential risk.

## **SECTION 2**

### **How the public litigation could impact on financial performance for the forthcoming year**

This high-profile litigation case may affect the financial performance of Vita negatively in the forthcoming year. If the case is brought to court quickly and we can prove beyond doubt that our tracker had nothing to do with the death of the customer, then we may be able to avoid any great damage to performance. However, it appears unlikely that Vita will be able to deal with the claim quickly and quietly given the rumours already spreading on social media and the imminent press coverage of the issue. There are several reasons why performance could therefore be detrimentally affected:

#### **Costs to fight the case**

Whether or not the management team of Vita consider this to be a valid claim, there will still be costs incurred in fighting this case. There will be legal costs, which may or may not be recovered if they win the case, as well as administrative costs and expenses involved in managing how information relating to the issue is communicated to the public. There may even be an increase in insurance premiums in the future.

#### **Public relations costs**

The cost of reassuring the public that Vita products continue to be reliable, high quality fitness trackers could be significant. Even if Vita is proven to be completely blameless, the marketing department will need to reassure the public that products are trustworthy, counteracting consumers thinking 'there is no smoke without fire'. This may require campaigns in newspapers, on television and through social media. Social media is particularly important in scenarios such as this, as negative rumours can spread quickly, are hard to control and can inflict serious damage to reputation and hence performance.

#### **Reduction in revenue**

Possibly the most important potential impact on performance arises from the potential negative public relations noted above. There could be a notable reduction in sales if consumers believe negative rumours, and miss any positive messages that Vita send out into the marketplace. If in doubt, customers could switch their purchases to another tracker available in this saturated market, which could impact on Vita sales across the portfolio.

#### **Refunds**

Even if Vita products are completely blameless, the negative rumours could lead to product returns. Vita may face customers contacting it with fears that its products could harm them, demanding a refund. Vita will need to work out how to deal with these sorts of claims as although they want to offer good customer service, allowing fully

working products to be returned could be expensive and worsen the circulating rumours.

### **A contingent liability**

It appears unlikely, from the information given, that a provision will be required to cover the damages being claimed because the probability of a successful claim is less than 50%. However, Vita will need to disclose details of the case as a contingent liability. If the chances of a successful claim rose to more than 50% then a provision would be required provided the damages were capable of reliable estimation.

### **Share price**

The share price could fall based on the markets expectation that this claim, and associated rumours could affect financial performance in the forthcoming year.

### **Building an effective team to deal with the litigation and use of different skills**

To deal with this major case Vita will need to take the threat seriously utilising skills from across the business and buying in skills it does not have in-house.

Legal staff will be of key importance in this scenario. Although Vita may have some limited legal in-house expertise, it is unlikely to have the resources required to fight an aggressive public legal battle, particularly as it has not had to do so before. Therefore, external expertise will be required immediately.

Public relations and marketing staff will also be vitally important in this scenario. Even false rumours have the potential to damage an organisation's reputation and sales, so the marketing department will have to work hard to ensure the public is reassured and false rumours circulating, particularly those on social media, are quickly dealt with.

Finance staff will be needed to look at the potential costs likely to be associated with fighting this claim and to ensure they have made disclosures, budgeted and provided as appropriate according to the information available.

Research and development staff will be needed to ensure all claims about the accuracy and reliability of the product are dealt with. They may want to refer to recent test results to prove that there were no issues apparent in the product concerned.

The senior management team will need to guide, control and coordinate the various elements of the business dealing with this issue, to ensure that Vita approaches the problem in a unified, consistent and informed manner.

The team identified to deal with the claim will need to have the qualities of any good team to work well. There needs to be good leadership from directors and more senior members of the organisation. Staff may feel unsure of how to approach the relatively new issue and be un-nerved by its existence. A strong and confident leadership style will reassure staff that all is well, and the organisation is equipped to deal with scenarios such as this.

Good communication, both within the organisation and externally, is important. Staff will need to be informed that the claim is unfounded and that steps are being taken to prove this. Updates regarding the progress of the case will also be useful to prevent staff generating their own rumours and speculating about things they have seen in the press or on social media. The team is effectively dealing with a 'project' by being allocated to this work and, hence, good planning in terms of how often to meet, and who meets when and for what, is also needed to ensure the team works well together.

External communication is also important. Shareholders will need to be informed in a controlled and calm manner, to minimise the short-term impact on share price. Positive messages to shareholders and the public are key to consolidating the universal view that there is not a problem with Vita products.

Members of the team gathered to address the legal case will need to be able to deal with the additional responsibilities as well as their usual 'day job'. They will need to plan their time, communicate well, and deal with sensitive matters confidentially and with integrity.

## **SECTION 3**

### **Potential impact on share price**

The way in which Rogerson Investments decides to sell its shareholding in Vita could significantly impact share price, particularly if communication is not handled well.

Rogerson Investments holds 15% of the share capital and hence is a large enough holding to potentially unsettle the market if shares are sold in a manner which signals to the market that there is something to worry about at Vita.

If Rogerson Investments sell all the 15% share capital at once this will flood the market with Vita shares and potentially change the relationship between the supply and demand of shares so that supply exceeds demand. This would reduce the price of shares. If Rogerson Investments also communicates to the market that they now see Vita as a bad risk and if other investors look at this sale and the changing share price and panic, they may also sell their shares, worsening the problem and sending share price into a nose dive.

The only way Vita can manage this situation is to communicate well with the market and reassure existing investors that there is no reason to sell and that Vita's future is promising.

If Rogerson Investments sell its 15% holding over a six-month period, the process is far more controlled and less upsetting to the market. If the shares are sold in even increments of 2.5% each month the issue with supply and demand will be less pronounced and the risk of other investors following suit will fall. This approach would be better for the stability of Vita share price in the short-term but good communication will still be required to reassure the market that there is no adverse cause for the sale. Investors will be able to identify that the entire holding is being sold and will want to understand why.

### **Communication with the public**

Now that the case has been resolved, and Vita products have been proven to be blameless in the death of Stuart Howkins, Vita needs to dispel any remaining negative rumours and repair any short-term damage done to its reputation because of the case.

It is important that the public is made aware that Vita products were not faulty and did not cause the death concerned. This message needs to be conveyed through the press, website and social media as appropriate to reach their existing and potential customers.

Vita should provide clear information regarding the facts of the outcome and ensure that message is received broadly in the marketplace, perhaps via a press conference.

However, Vita still need to be careful with this communication.

Although Vita has won the case, a member of the public, and a customer of Vita, has still died and the circumstances remain very sad irrespective of whether anyone was to blame.

Therefore, Vita must be respectful in its message, just stating the facts to reassure customers rather than taking a tone which is victorious or in any way celebratory.

It is not uncommon for fitness tracker organisations to face litigation, so it is important that Vita gets used to dealing with issues of this nature when they arise and is equipped to reassure customers of the progress and outcomes of cases.

### **A dedicated risk manager**

Currently, we manage risk through our Audit committee, which reviews and updates our risks and mitigation plans as necessary. It is suggested, however, that this is insufficient, considering the dynamic nature of our industry and the nature of the risks we face. We were clearly not sufficiently prepared for litigation and we must be better prepared in the future.

Considering the technological risks that we face, and the potential for litigation, a dedicated risk manager is likely to be of significant value to Vita and will enable the Board to discharge the responsibility of risk management more effectively. It is clear that risk professionals are increasingly being called on to operate within modern governance functions to better anticipate emerging and operational risks. In addition, a risk manager should be a key business partner, influencing strategic decision-making across the organisation. A risk manager could work collaboratively with corporate business functions such as digital, HR and R&D to assess strategic and functional business partners.

Technology is a major driver in the expansion of risk manager influence. Data protection and potential legislation require close co-ordination between a risk manager and other professionals in the organisation, to comprehend and manage the risks posed by technology going forward. A dedicated risk manager would be monitoring and updating risks on a continual basis, rather than 'as necessary', which may have helped us to have been better prepared for this particular incident. Our current risk register shows that litigation likelihood has been assessed at level 2 which, when considering the industry we are in, and the previous high-profile cases of litigation against our competitors, should have been rated higher in terms of likelihood.

### **The role of Vita's Audit committee**

The points made above in relation to the appointment of a dedicated risk manager do not reduce the importance of the role and activities of our Audit committee.

Regulation requires that our Audit Committee should contain at least one member who has a certain level of financial literacy. However, no such requirement is in place as regards their required qualifications and experience in general risk management. This, in fact, makes the appointment of a risk manager even more important to our organisation if we consider (as suggested by Bob Flint) that we do not adequately monitor and manage our risks.

However, risk management is such a broad topic that it might be difficult to define the activities and requirements of the Audit committee, particularly in terms of its risk management activities. The role in terms of the audit responsibilities are largely well defined and set out in the Corporate Governance Code but not so for risk responsibilities.

Importantly, the audit responsibilities of the Audit committee are based on satisfying compliance and, therefore, are relatively straightforward. However, risk is not a compliance issue and therefore the management and monitoring of risk is far more complex and requires the committee members to have a deeper understanding of risk across and throughout the business. However, it is likely that few NED's, in reality, have the depth of organisational experience and understanding to truly understand the risks of the business.

It could be argued that insisting on a high degree of financial literacy for audit committee members in fact stifles their ability to evaluate wider business matters, as risk management is clearly an area where variety of experience is crucial.