Chartered Institute of Management Accountants CIMA

STRATEGIC CASE STUDY PRACTICE EXAM ANSWERS

The Practice Exam can be viewed at
http://www.pearsonvue.com/cima/practiceexams/

These answers have been provided by CIMA for information purposes only. The answers created are indicative of a response that could be given by a good candidate. They are not to be considered exhaustive, and other appropriate relevant responses would receive credit.

CIMA will not accept challenges to these answers on the basis of academic judgement.

Section 1

(a) Stakeholder analysis

Briefing for presentation to Cast Board

High power low Interest - Potential shareholders
High power high interest - Arnold, other existing shareholders
Low power low interest - Customers
Low power high interest - Suppliers, Employees

I have identified above six key stakeholders and have plotted their interest using a Mendelow matrix. Ironically, Cast's mission statement (see pre-seen) focuses on the company's customers and yet they are viewed as having little interest and lacking in power.

Our principal concern is Arnold. He owns a significant block of shares that gives him a degree of influence simply through his voting power. That ownership stake inevitably gives him an interest in Cast's direction, but he has the further interest arising from his family ties to the company. A quotation is unlikely to have any direct benefit for Arnold, if only because his annual dividend is sufficient to make him a very wealthy person.

The other shareholders have a different set of interests. None owns a sufficiently large block of shares to exert any significant power through votes. They have little to lose, therefore, in terms of dilution of voting rights in the event of a placement. Their primary interest in a quotation is that their stake in Cast will be far more readily realisable. They may, for example, decide to diversify their holdings by selling shares in Cast and using the proceeds to invest in other industries.

Potential shareholders are unlikely to have a significant interest in the newly quoted company because they can already invest in a range of online retailers. The only reason that Cast may be of any particular interest would be if the shares were introduced at a significant discount to their intrinsic value. Hopefully, Cast's management team will ensure that the shares are sold at an appropriate price and so there is unlikely to be a great deal of interest in subscribing. The markets will have to be willing to buy, though, or the placement will fail. The initial market price will be set by supply and demand by the market.

Cast's suppliers will have a moderate interest and relatively little power. If Cast is quoted then the group will possibly find it easier to raise funds for expansion and so suppliers may have an even more powerful customer to deal with. If Cast expands then suppliers will lose further bargaining power in dealing with the company. The business is not, however, particularly capital intensive and there is probably very little need for additional equity to fund expansion, so suppliers are unlikely to be greatly affected.

Cast's employees will have little power over anything that the company does because they are unskilled and can easily be replaced. These changes are also very unlikely to interest the employees. The company does not treat its staff particularly well. The pressures arising from a quote to report strong earnings will not lead to the company reducing staff benefits because they could not be much poorer. Also, the company is unlikely to introduce a share-based incentive scheme, so the employees will not have any direct interest in the share price.

Customers are generally regarded as stakeholders, but Cast's customers will not be particularly affected by this development. Cast's customers buy because of price and convenience. A stock market quote is unlikely to change the manner in which Cast conducts business with its customers. To sum up, Arnold is the most important stakeholder in this matter. The board will have to consider his interests very carefully in order to ensure the success of the quotation.

(b) Strategy for dealing with Arnold

From: Adviser
To: Judith
Subject: Arnold

Hi Judith,
I have been thinking ahead to the difficult problem of dealing with Arnold in the event that the proposal to pursue a stock market quotation goes ahead.

Our basic dilemma is that most of the shareholders are keen to seek a quotation, which means that Arnold could be unable to prevent this from going ahead even if he resists. His resistance could, however, prove both costly and disruptive. The market may be reluctant to pay a great deal for Cast's shares if Arnold threatens to, say, sell a large block of shares as a sign of his displeasure.

Any attempt to defeat Arnold is likely to harm Cast, even if it results in Arnold's influence reducing. We need to work towards persuading him to work with us willingly.

The first approach that we might pursue would be to persuade Arnold that pursuing a quotation is consistent with the company's underlying values. The business has grown successfully from humble origins as a small family business, but most large corporations started in the same way.

We should try to persuade him that a quotation is part of the natural process of development for a successful business. We should point out that Cast is a very different entity to the one that was created by its founders and that the changes in Cast's business model might be mirrored by changes in its governance and ownership.

Arnold's interest in the company's origins are due to his family connection to the founder. We could recognise that by offering him a non-executive directorship. Giving him a seat on the board would enable him to ensure that the company's values are maintained and pursued. His influence could be underpinned by having him chair at least one of the board committees. If Arnold had a place on the nominations committee then it would not be a particularly onerous responsibility, but he would be able to influence the appointment of board members and so he could affect Cast's ongoing management style.

If Arnold could also be persuaded to accept some dilution of his influence then that would defuse the concerns that the markets might have concerning his intentions. It might be possible to persuade him to sell some of his shares as part of the placement on the stock exchange. Cast could persuade him to put the proceeds to some good use, such as the establishment of a charitable foundation, which Cast might also support as part of its ongoing development as a quoted company.

Section 2

(a) Valuation models

Cast should avoid asset-based valuation models. Most entities that operate as going concerns are worth more than the sum of their asset values. It would be a little defeatist to value Cast as a collection of assets, particularly as the company is not particularly resource intensive. The company owns significant intellectual property in the form of intangibles such as brand recognition and customer databases. Those assets are extremely valuable, but they are impossible to value in a manner that lends itself to inclusion in the financial statements. This means that Cast's share price is likely to be undervalued. The fact that Cast's assets include a significant cash balance is also something that ought to be played down, rather than highlighted by a valuation model. It may be appropriate for an unquoted company to remain highly liquid so that its board can move quickly in order to pursue opportunities, but a quoted company cannot afford to tie up assets in such an unproductive manner.

Earnings-based valuations have greater potential because Cast is a profitable company that will generate returns for its shareholders. The company has not been operating in its present form for very long, but we could use that to our advantage by arguing that the historical earnings per share figure will grow. We could suggest some realistic forecasts for next year's EPS as a further discussion point.

Unfortunately, any valuation exercise is likely to create a tension between the interests of buyers and sellers and buyers will be naturally suspicious of any arguments that historical performance measures be replaced with more optimistic alternatives. This method also requires the identification of a suitable quoted company whose price/earnings ratio can be applied to the EPS. There are several companies that operate in a similar manner to Cast. Ideally, we should offer a range of P/E ratios and argue that Cast should be compared with the most successful of these businesses.

Dividend-based valuations are probably unsuitable in this case. Firstly, the company has been a family business since its creation. The dividends paid to date could reflect the interests of the family members rather than the company's ability to service dividends. The relationship between the company and its shareholders has been relatively close and so there has been very little need for the company to worry about signalling. For example, the company could afford to pay a healthy dividend in a good year without being unduly concerned that the shareholders will panic if the payment is not sustained in future years. In other words, the company's dividend history probably says little or nothing about the company's ability to service future dividends as a quoted company that is answerable to the shareholders. The dividend growth model essentially determines the net present value of future dividends on the basis of past observations of dividend payments and growth rates.

The fact that the company has created a substantial cash balance implies that the payment of dividends has not been a priority in the past and that attitude will almost certainly change once the company is quoted.

Cash-based models make perfect theoretical sense. The problem is that the cash flows and the associated discount rates do not lend themselves to defensible forecasts. Apart from the asset-based models, the approaches discussed above could be viewed as surrogates for the estimation and valuation of future cash flows. The fact that Cash has a relatively short history in its present form could be used to advantage in this case. The company's free cash flows since the revision to the basic business model can be determined. These will be more likely to lend themselves to realistic and defensible forecasts than the dividend models. The forecasts will not be any more contentious than those that are likely to appear in a prospectus or other offer document. The cost of capital could be based on the cost of equity for other retailers in a similar market.

The historical movements in share prices for both Greatline and Fashionstore provide something of a caveat in our analysis of these models (see pre-seen). We regard both as potential comparators and yet their share prices have tended to move in a fairly independent fashion. Greatline's price has crept up steadily while Fashionstore's has been somewhat volatile. Some of the models that we might apply would have produced very different results depending on whether we had selected Greatline or Fashionstore as our reference point.

(b) Governance issues

The first complication is the question of where the directors' allegiance lies. The directors clearly have a duty to the company and the present shareholders. There could be an argument that the directors' duty to the shareholders is a corporate responsibility to the shareholders as a whole rather than a particular group. In other words, it may not be appropriate for the directors to aim to maximise the share price in order to privilege the interests of the present shareholders over those of the incoming shareholders.

From an agency point of view, the directors may be motivated to develop a strong relationship with the incoming shareholders, because they will have a greater say in the directors' future. On that basis, the directors may be tempted to push the placement price down because that is likely to lead to the share price rising after the issue, which will reduce the risk of the disappointment associated with a subsequent fall in the share price.

The cash surplus creates a complicated stewardship dilemma for the shareholders. It was clearly acceptable to the original shareholders, but the market would expect the cash to be returned to the shareholders or invested. Either of those actions could occur before or after the placement. A decision has to be made and announced to avoid uncertainty, which could depress the issue price. If the directors invest the cash in the business then it may take some time for the return on that investment to be recognised. If the cash is invested in the business then it may take some time for a return to be recognised and so the directors may be tempted to disburse the cash. On the other hand, disbursing the cash will create the impression that the directors have no clear idea concerning the future growth of the company because they have elected not to expand the business.

The directors will have to ensure they are competent to manage this process. The issue is a complicated area that may be new to the directors because their recent experience is in the management of a private company (see pre-seen). Most have, however, worked for other businesses and some may have had some exposure to quoted companies. Furthermore, in the short term they can pay for professional advice from consultants, or they may even bring an additional executive director with a quoted company background on to the board.

It could be argued that Cast's board will require change in the event of a quotation, even if that change is only to increase the complement of non-executive directors (see pre-seen). Arthur Brown may well continue as non-executive chairman, given his experience in banking. But the company would almost certainly have to appoint additional non-executives to support him.

Section 3

(a) Ethical implications

The basic problem arising from an ethical analysis of Cast's employment practices is that the employees' interests are in conflict with the shareholders. Resolving the dilemma can be assisted by expressing the dilemma in terms of positive and negative duties.

The directors have a negative duty to the shareholders to avoid spending more than necessary on running the company. Enhancing the employees' working conditions is a positive duty. It is generally accepted that negative duties are more compelling than positive duties. For example, the directors will definitely be responsible for an ethical breach of their duty to the shareholders if they overpay the employees. It is debatable whether the directors are responsible for the legal and economic conditions that make it possible to pay a low wage for working under quite difficult conditions.

There could be further dimensions to an ethical argument.

The refusal to recognise trade unions may be regarded as undemocratic. The employees are being denied the opportunity to be represented by a union that can consult and speak for the workforce. In many countries, trade unions are regarded as an important safeguard against exploitation of staff by greedy or uncaring employers. It appears that Cast's board is keen to force the employees to accept the terms and conditions laid down by the company and is unwilling to negotiate. Such behaviour will only work when the employees have no alternative but to accept such treatment. It could be argued that this is, in itself, evidence of abuse by Cast's board.

The pace of work is again a matter of balancing the shareholders' interests against the employees'. Slowing down the pace of work would require the employment of more staff and so the cost of labour would increase. The ethical question that has to be resolved is the extent to which the employees' complaints about stress and tiredness indicate excessive workload or simply tight deadlines. If the pace of work is abusive and sustained only because the employees have nowhere else to work then the company is being exploitative.

The payment of overtime rates is really a matter for market forces. If the employees were aware that this would be the arrangement when they signed their contracts then the company is within its rights.

It seems unfair to dismiss staff without attempting to rectify matters. It may be possible to assist staff by offering training or reassignment to a less demanding job. Dismissal does condemn staff to being left on the local jobs market and appears to be motivated by a desire to intimidate the remaining staff.

It is noticeable that the allegations against Cast are at odds with the statements made in the company's CSR report (see pre-seen). By claiming that the company offers employees "good jobs and genuine career prospects" it is committing itself to doing so even if it might be argued that an employer's duties are far more limited than that.

(b) Implications for the issue price

It is unlikely that Arnold's shareholding will have a major impact on the issue price. The market will wish to know whether he intends to take an active role in the management of the company. He has not really done so in the past and we should indicate that he is unlikely to do so in the future.

He stands to lose a great deal if his behaviour impacts the share price and so the markets may not be unduly concerned that he has the power to undermine confidence by selling blocks of shares.

Arnold has had a life-long commitment to the company and we would expect that to continue. He would attract a great deal of bad personal publicity if he was seen to interfere with the smooth running of the company. He would be viewed as irresponsible.

There are ethical investors who might be a little unwilling to invest in a company that has a poor record in employee relations. They would probably not regard the claims made against Cast as sufficiently serious to warrant refusing to investing in the company. Cast is not abusing workers to any serious degree. It is not, for example, causing severe injury or employing child labour. Cast should ensure that it maintains acceptable working conditions for its staff so that the company can bear scrutiny. If Cast loses the support of these investors then it will be difficult to redeem matters.

Cast should take care to communicate and publicise its treatment of the workforce. The markets might be slightly nervous that bad publicity could cost the company sales and profits. There could also be concerns that the company will be forced to incur higher labour costs and that will also reduce profits. Cast could deal with those concerns by devising a strategy for addressing the complaints and making it clear that the strategy had been incorporated into the forecasts in the prospectus. The communication process will also help to ensure that the company does not run into problems with, say, appointing staff.