STRATEGIC CASE STUDY MAY 2018 EXAM ANSWERS

Variant 2

The May 2018 exam can be viewed at

https://connect.cimaglobal.com/resources/may-2018-strategic-case-study-variant-2-questions

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SECTION 1

Requirement 1 – managing relationships

The two main stakeholders are the content providers and the subscribers. These could both be classed as high power and high interest in terms of the Mendelow matrix.

The first priority is to reassure the content providers that their intellectual property is safe. In the first instance, we need to brief Ronsteel Productions on the initial findings from our investigation, for example, how many subscribers were involved and how many files had they downloaded? We need to demonstrate to Ronsteel Productions that we acted decisively as soon as they alerted us to the fact that their content had been copied and uploaded. We should also pass on details of the subscribers who were responsible in case the production company wishes to pursue its own action against them.

We also need to reassure the other production companies. They may be concerned that Ronsteel Productions discovered only its own files because it would have no particular interest in checking the internet for other companies' content. We need to brief the other providers on the information that could enable them to check whether they have been compromised, such as the addresses of the sites on which the pirated material was discovered. We also need to reassure all production companies that we will suspend the download service until they give us their permission to reinstate it. In practical terms, piracy is an ongoing problem that affects all media providers and so the production companies may not be unduly concerned about this discovery.

We must also take steps to brief subscribers because this service was introduced in response to subscriber demand. The fact that 11 million subscribers have downloaded the app indicates that the service was widely anticipated and that its immediate suspension will be a disappointment. In the first instance, we should post an explanation for the problems on Couchweb's website and also email every subscriber to clarify the problem. We should do this immediately, before subscribers are possibly misled by distorted press reports. For example, they may feel that the security of their devices has been compromised by downloading the app.

Couchweb will also have to ensure that its shareholders do not panic. This story may attract a great deal of attention in the press and there may be concerns that the capital markets overstate the scale of the problem. Couchweb needs to issue a clear message that the only aspect of its service that has been affected is the download service and that all other services are operating as before. The shareholders also need to appreciate that Couchweb's systems are robust and that the damage caused by this piracy is relatively minor.

Requirement 2 – Enterprise Risk Management (ERM)

It could be argued that it is disappointing that Couchweb has not implemented ERM already because ERM is essentially a process that ensures that risk management is considered in the context of business strategy. ERM would ensure that Couchweb had a proportionate and realistic approach to the identification and management of risks, avoiding risks that exceeded the company's risk appetite. Risks would be addressed in a top down manner, with staff at all levels being aware of the risks associated with their areas of responsibility. There would be systems and procedures in place to manage those risks and staff would be motivated to adhere to these.

ERM would have given Couchweb's risk management a formal direction, which should have both reduced the likelihood of a problem and offered a defence in the event that a problem arose in the future. For example, Couchweb is heavily dependent upon IT for both the delivery of its service and for the processing of subscribers' payments. An ERM system would ensure that the Board took an active interest in IT security and continuity of service and made sure that the necessary resources were available to staff to deal with risks. Staff would be aware of the systems and procedures and there would be regular compliance tests to ensure that these functioned properly.

It could, however, be argued that Couchweb's exposure to risk would not have been reduced by the adoption of ERM. Taking the piracy case as an example, the company was well aware of the threat and had put an encryption system in place to address that. ERM would not necessarily have affected the safeguards put in place by Couchweb because the risk had been formally evaluated in this case and had been addressed by what appeared to have been a realistic response. As with any risk management process, Couchweb was left with a residual risk that it chose to accept and so it was unfortunate that the piracy occurred. The only way to prevent it from occurring would have been to have continued to restrict access to streaming only.

There may be a risk that ERM could create a false sense of comfort if it is approached in a mechanical, box-ticking way. Couchweb clearly understood the risks associated with this new venture and had taken the necessary steps to prevent them. The introduction of ERM may formalise risk management, which is potentially beneficial, but it could also prove a distraction from the ongoing business of identifying and managing the risks themselves. Couchweb's business model requires the company to focus a great deal of attention on specific risks such as those relating to IT systems and that focus may be weakened slightly by a wider process.

SECTION 2

Requirement 1 – usefulness of Kentdata

Couchweb has two main needs from Kentdata. The first would be to enable it to commission or purchase programmes that are as attractive as possible to viewers. The fact that a significant number of subscribers disagree or strongly disagree with the suggestion that they find all of their favourite programmes on Couchweb is a concern because that could lead to cancelled subscriptions. The ratings attached to programme content is encouraging because there were plenty of four and five-star ratings, although that ignores the fact that subscribers are rating programmes that they chose to watch and so perhaps there should have been an even more positive response. The system also requires the active participation of subscribers, which means that the largest response of all is for “did not score”.

Couchweb also has a large catalogue of content that subscribers can access, which is clearly one of the reasons for them keeping their subscriptions. The danger is that the catalogue may be so large that it is difficult for subscribers to find the programmes that are of greatest interest to them. There is a very mixed reaction to the statement that subscribers find the recommendations for further research to be helpful, which suggests that subscribers may not be guided to the content that they would actually enjoy. Offering unhelpful recommendations will also risk irritating subscribers, which could be a factor in deciding to cancel subscriptions.

Kentdata could help with the first main need by helping Couchweb to identify new programmes and programme ideas that will be attractive to subscribers. Analysing comment on social media and gathering other data from industry sources might help Couchdata to create its own content that will both attract viewers and cost less than buying from production companies. That will also ensure that Couchweb is keeping abreast of trends and changes in viewing habits, bearing in mind the lead time associated with creating new content. Couchweb may also be better equipped to identify movies that will interest subscribers at an early stage, before they have been shown in cinemas. There may be less competition from other broadcasters at that stage.

Kentdata will also help Couchweb to analyse data from subscribers’ use of the website. Users have to log in in order to gain access and so Couchweb has the means to track their viewing habits in some detail. Ideally, Kentdata will be able to break down the catalogue into detailed genres. Doing so will make it easier to offer recommendations based on programmes that the subscriber has both watched and enjoyed. It may be possible to draw upon other sources, such as the wording of reviews and comments in social media to break content down between different categories. For example, a crime movie could have fantasy elements such as action sequences and car chases or it could be about police procedures. Some viewers might prefer the former and other the latter and so recommendations can be fine-tuned.

Requirement 2 – setting a price

Kentdata cannot really be valued in terms of traditional valuation models. The company owns very little in the form of assets, other than the intellectual property in the founder’s expertise and the software. Income-based models will also mean very little to Couchweb because it does not intend to operate Kentdata as an independent profit-making entity. Past profits and profit growth could, however, set the starting point for negotiations with the founder because he is unlikely to sell his business for less than it is worth to him as a source of future profits. So Couchweb should start by analysing historical financial statements and estimating the company's value to Martin Kent, its owner.

The next step is for Couchweb to estimate the value of the contribution that Kentdata might make to Couchweb's future profitability. That value will, undoubtedly, be extremely difficult to estimate, but we could start by asking for examples of the work done for film studios and production companies. We might make a range of estimates of the potential impact that this analysis could have on Couchweb's profitability and estimate that value as an upper limit for bargaining purposes. We can carry out a sensitivity analysis by inputting a range of estimates in order to reduce the risk of overpaying because of unrealistic expectations.

We need to be clear about what we are actually buying and ensure that we build that into the negotiations. Kentdata appears to comprise Martin Kent's expertise and the software that he has developed. It may be that the software will be of little value without Mr Kent's ability to interpret the output and keep the model up to date. We have to ensure that any acquisition takes account of his interests and ensures that he plans to remain with Kentdata for the foreseeable future**.**

The starting point would be to approach Martin Kent with an offer that includes both a realistic price for the company and an attractive compensation package for his continuing services into the future. We need to be flexible in our negotiation because we could risk alerting him to the company's value to our competitors. If he believes that another media company would pay more, then we could lose Kendata and find ourselves competing against a rival that is benefitting from his insights. At the same time, we should also be careful not to overvalue Kentdata because there are likely to be similar businesses that could offer a very similar benefit.

SECTION 3

Requirement 1 – internal audit role

In most organisations, internal audit's primary role is to ensure that systems are operating correctly. It is an important aspect of corporate governance because internal audit provides the Board with evidence that it takes internal control seriously. Diverting internal audit to ad hoc investigations such as this will reduce scope for conducting routine compliance audits and that might impair the control environment. If traditional internal audit is given less prominence then the auditor's authority could be undermined, even if that is not the Board's intention. It will also undermine the internal audit department's independence if the auditor starts to get involved in control processes such as checking for piracy.

Despite that, the internal audit staff are skilled in designing tests and gathering evidence from investigations. Their training and experience will make them well qualified to conduct this investigation. The Board will be confident in the findings of any investigation carried out by internal audit, which will make them more confident in any negotiations with production companies. Checking for piracy need not become a permanent part of the auditor's role because Couchweb could create a new department dedicated to that task if the need arises. The internal audit department is also a resource that exists to serve the Board's interests. It is not unusual for planned investigations to be postponed or deferred in order to release staff for urgent assignments.

Requirement 2 – internal audit checks

Internal auditors usually start by looking at risks and allocating resources in accordance with identified risks. One starting point would be to use Kentdata's software to identify "high risk" subscriber accounts. This analysis could be conducted in response to the findings of the initial investigation, with the database being checked for duplicate IP addresses and accounts that have a rapid turnover of downloads. Kentdata's software could also be used to identify accounts whose viewing patterns seem erratic, such as downloading a mixture of content that would not normally be chosen by the same person. Internal audit could also look at accounts where the activity is occurring largely during the normal working day, rather than in the evening or weekends.

The internal auditor could also search for 'high risk' content online, using internet search engines. Pirates aim to sell downloads through their own sites and so the pirated content has to be made visible to potential buyers. Internal audit could search for copies of all new content posted to the Couchweb site, much of which will be exclusive to Couchweb. If it finds a match then the auditor could buy a copy of the suspect file and check to see whether it originated at Couchweb.

Requirement 3 – dividend

The dividend payment will signal confidence in the company's ability to afford the dividend. If the directors pay a larger divided than Couchweb can afford then they could lose their jobs and may be banned from holding directorships with other companies. The fact that they are prepared to make such a commitment ought to reassure the shareholders that the Board is reasonably confident in its evaluation of future cash flows.

The shareholders may take the view that a substantial dividend has the effect of returning some of their equity, thereby reducing the potential loss in the event that Couchweb gets into serious difficulty because of piracy. That would not enhance confidence in the company itself, but it could be viewed as a sign that the directors have the shareholders' interests at heart.

The dividend is, however, open to alternative perspectives. The fact that the three founders are on Couchweb's Board means that they will participate in the additional dividend and so the payment could be viewed as self-interested. It could even be viewed as an attempt to increase the founders' personal savings in advance of any major problems with the company.

The dividend will have to be very large before it is likely to demonstrate any really meaningful confidence in Couchweb's future. It could also appear that the Board has no use for the cash to develop and expand Couchweb, which could undermine confidence.

Requirement 4 - announcement

The first priority is to ensure that the shareholders realise that Couchweb's dividend is to increase for this year only and that dividends will revert to usual levels. It is important to stress this, certainly by referring to it in the chairman's statement in the annual report and by briefing analysts.

The payment will have to be announced well in advance in case any shareholders are inconvenienced for tax purposes. A larger than expected dividend could be unpopular with shareholders who are taken into a higher tax band, so advance notice will enable shareholders to rearrange their portfolios.

The source of the funds will have to be addressed. There is little point in attempting to boost confidence if Couchweb's Board is paying out cash that the shareholders feel the company cannot afford. Ideally, the dividend can be presented as an opportunity to return excess cash to the shareholders.

The Board should indicate the extent of any exceptional costs associated with the need to compensate the production companies. If Couchweb is expected to be liable for these costs then the shareholders may be concerned that an extravagant dividend is likely to strain cash flows.