

STRATEGIC CASE STUDY NOVEMBER 2018 EXAM ANSWERS

Variant 2

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SECTION 1

Requirement 1 – challenge

Novak has a wide range of stakeholders whose interests are in constant conflict. As a quoted company, it must generate profits in order to compensate shareholders for investing and risking their wealth. At the same time, customers may feel that if Novak makes profits then potentially life-saving pharmaceuticals become more difficult for patients to afford. The primary objective of any company is to maximise shareholder wealth and so Novak will always be open to accusations that its business model is exploitative. The fact that Novak is one of the largest and most successful pharmaceutical companies will undoubtedly be viewed as further evidence that the company is exploiting its customers.

Pharmaceutical companies will often appear to be profiteering because of the need to recover heavy research and development costs. The nature of the process means that every successful product has to bear the research costs incurred on several unsuccessful studies too. The fact that these are sunk costs that are not directly related to the continuing manufacture and sales of current products makes it difficult for customers to understand why they should be asked to pay for them. In any case, the fact that Novak appears to be making a profit from the discounted sale of Ubitran whilst the company is undoubtedly failing to cover total costs creates a gap in credibility.

It costs commentators such as this journalist nothing to impose a duty to support worthy causes upon pharmaceutical companies. It is easy to overlook the fact that charities exist to offer support and that any individual or organisation can support charities. Pharmaceutical companies have no particular duty to make charitable donations. Making such gifts would essentially be at the cost of their shareholders, who may object to making gifts in this way.

Some pharmaceutical products are intended largely for patients in developing countries, which may add to the sense that such patients are being exploited. For example, anti-parasitic drugs are likely to be for use in rural areas with tropical climates, many of which are not particularly wealthy. It is easy to portray selling such products to their target markets as a cynical act. In the absence of a market it would,

however, be far too expensive to develop such drugs and take them through the testing process.

Requirement 2 – corporate social responsibility report

The additional disclosures will create more scope for presenting Novak's contribution to society in the best possible light. Extending the disclosure will enable us to go into greater depth and highlight more examples of socially responsible behaviour so that our stakeholders are better informed as to our values and our contribution. The very fact that we wish to offer this additional transparency will reinforce the message that we are a socially-responsible entity. If management did not care about these responsibilities, then it would have little interest in extending its report. The fact that this information is part of the annual report means that it will have a greater impact in terms of credibility and exposure than a less formal publication of the same information.

Reassuring stakeholders will, hopefully, offset some of the negative publicity attracted by the industry, such as the news report that we have been asked to comment on. Increasing our disclosures on a voluntary basis will help us to manage the whole discourse about the role that pharmaceutical companies play. Volunteering additional information will reduce the threat of regulators or other bodies imposing more stringent disclosure requirements that might harm our image. We can also allow for the creation of a balance between the reporting of externalities and downsides, which might be best offset by upsides and positives.

The disadvantage of expanding our disclosures is that our critics will invariably find ways to use any information that we disclose against us. For example, our decision to gift tablets that were close to their use by dates was made to look greedy and self-serving. Nothing can alter the fact that our industry exists to make profit and in doing so we have to charge for medication. On a wider note, we also have to manage risks, including the risk that some of our products may inflict serious side effects.

It will be difficult to reverse any policy of providing additional voluntary disclosures. It may be that our circumstances change in future years and we might wish to suspend some of the additional disclosures that we have been making, but doing so will draw attention to those gaps in disclosure. We may find ourselves having to publish negative information in the future because we cannot afford to withhold those disclosures. There could be more flexible alternatives to making positive disclosures that would not have this ratcheting effect for future annual reports.

SECTION 2

Requirement 1 – economic currency risk

The most immediate question is whether it would have cost more to buy Kartiam than the competing products from Drank and Werstra. Ideally, we need to establish how much the pharmaceuticals that were purchased cost the Dolrovia Health Service in its own currency. This might be difficult to establish unless it has been announced or if our contacts in the industry happen to have that information. In the event that our price would have been greater then we need to consider whether that was because of the strength of our currency. We could do that by establishing whether our prices would have been competitive if our currency had been at its equilibrium price. We might also have been affected by economic risk if the competitors were able to set lower prices because their currencies were weak, so we need to estimate the effects of their pricing as well.

The nature of this transaction suggests that price may not be the only factor in our exclusion from this order. For example, is there any reason to believe that the Dolrovia Health Service might regard Novak's product as being comparable to those of Drank and Werstra? If they view the competing products as superior treatments for this serious disease then we might not have been considered even if our price had been lower and so we would not have been affected by currency risk. We should review the results of any contact that our marketing department has had with the Dolrovia Health Service to establish whether we have had any opportunity to evaluate their interest in Kartiam. If we have been unsuccessful in penetrating that market in the past then we have not been the victims of economic risk.

The urgency of delivery might also be a factor. The Dolrovia Health Service is faced with an epidemic and it requires supplies urgently. Kartiam is difficult to make and it may be that we could not have met their needs quickly enough. Again, that would indicate that we had not been affected by economic risk. The fact that the order was split between two suppliers would suggest that we might have missed the opportunity because time was of the essence and not because our competitors were more competitive on price. We should investigate the response times offered by Drank and Werstra in order to establish whether we could have fulfilled an order within the required timescale.

Finally, we should establish whether we might have lost this potential order because our competitors have developed a better working relationship with the Dolrovia Health Service. We should have our marketing department ask whether the buyers are aware of our products and whether they have any reason to prefer dealing with competitors. It may be that Drank and Werstra have simply been more effective at maintaining a strong working relationship with the customer and that led to them turning to those companies when they were faced with an urgent requirement. It may be that price, and so currency risk, had little to do with the lost order and that we should simply invest more in maintaining a better relationship with key customers.

Requirement 2 – Big Data analytics

The advantage of Big Data analytics is that it is a technique that offers the ability to make better use of otherwise independent data sources in order to identify patterns that yield more useful observations. For example, relating factors such as reports from local and national health services, weather, travel data, and so on could yield patterns that might give valuable insights. In the Dolrovia case, travel patterns might have indicated locations where outbreaks of malaria could be transmitted to Second City

and weather information might have yielded expectations about mosquito populations in those locations. Knowing how diseases move about the world will also help the pharmaceutical industry to manage inventories in readiness for the ongoing development of epidemics.

Big Data might be an effective means of predicting outbreaks, giving the pharmaceutical industry the ability to predict outbreaks in advance, which would enable us to schedule production and delivery to meet customer needs. Working with health boards in this way would add value to our services and would enable us to manage production and distribution more effectively. There would be less need to stockpile products as a precautionary measure if we could be sure of predicting problems in time. Reducing holding costs and wastage would enable health boards to spend more on treatments when outbreaks arose.

Cooperation between the pharmaceutical companies would be crucial to ensure that certain key variables are available to the model. For example, many diseases have symptoms such as headaches and tiredness that can be confused with the common cold. Increased demand for painkillers and cold remedies could be an important warning sign of an impending outbreak. Sharing data will also provide confirmation to the industry as a whole when health boards start to place orders for more specific remedies, confirming that early indications are resulting in a confirmed outbreak. Each company has its own area of expertise and so each can contribute different interests and data to the model for analysis. Much of the value of this exercise would be lost if the companies were operating independently.

An industry-wide model would reduce the risk of concerns that companies were exploiting patient health for the sake of profit. If, say, only Novak could predict malaria outbreaks then it might be viewed as cynical to use that information to compete with other companies rather than working to deal with the problem, making additional sales in the process. It could also be difficult for health boards to justify working with individual companies because that could raise ethical dilemmas in the event that an outbreak is predicted. Committing to purchase remedies from that one supplier could be viewed as unacceptable, given that there may be more cost-effective products available.

SECTION 3

Requirement 1 – share price

The most immediate threat to the share price is that potential customers may be unwilling to buy pharmaceuticals from Novak until the allegations have been resolved. It would be unwise to buy from a company that has been accused of bribing customers because that could lead to suspicions that the managers placing the orders had accepted bribes. This is likely to be a complicated case and it could be years before it is resolved through the criminal courts, leaving Novak in a very difficult position for the whole of that time. The fact that the company could be fined will also be an issue, given that it could be a significant fine that is intended to deter other companies from the same corrupt practices.

The markets may also have significant concerns about the governance implications of this story. It could suggest that Novak's board is dishonest. If the directors were complicit in bribing foreign customers then they could be guilty of other forms of dishonesty or manipulation. Such concerns could lead to a further decrease in the share price because of the increased perception of risk. The shareholders might also feel that the bribe suggests that Novak's management team lacks confidence in the company's product range. If the products offered good quality and value for money then there would be little or no need to resort to bribery in order to make sales.

Concerns about lost revenue would be best addressed by taking control of the news coverage of the case. The allegation is that Ms Simm has bribed officials in more than one country and so it may be difficult to deny the charge. Novak could take immediate action to distance itself from Ms Simm, perhaps by terminating her employment for gross misconduct, in order to demonstrate that it will not tolerate such behaviour. Novak could also pay for her legal costs in mounting a defence in the hope that an excellent legal team would be able to prepare her defence quickly and bring the earliest possible conclusion to this uncertainty.

Concerns about the governance implications might be best addressed by commissioning an independent investigation to look into the background to the case and the extent to which Novak's management might be implicated. If bribes have been paid then the cash must have come from somewhere within Novak and the payment must have been authorised. An external audit firm could be asked to conduct this investigation, with a requirement to make a full report of its findings to, say, Novak's Chairman. The terms of the investigation could be that the results of the report will be made available to the public at the Chairman's discretion.

Requirement 2 – internal audit

The first difficulty is that this is a criminal case that is subject to court proceedings. Key evidence may have been taken by the police and other authorities and so the internal audit department may be unable to access it. It may also be difficult to conduct any form of detailed investigation without appearing to be interfering with or impeding the criminal investigation. The recipients of any bribes will be unlikely to admit to accepting payments because they could face criminal proceedings and disciplinary action themselves.

The second difficulty is that Ms Simm may have used her position as a senior manager to conceal, or at least disguise, transactions. For example, much of the alleged bribery could have taken the form of lavish entertaining that might simply result in hotel and restaurant bills that could be explained as business entertaining or subsistence for sales staff. Even cash payments could be written off as expense payments to sales

staff who were travelling through developing countries where corporate credit cards were not always accepted. The internal audit department might be unable to distinguish fraudulent transactions from legitimate payments, even if it conducts a thorough investigation.

The first difficulty might be best overcome by delaying the commencement of the internal audit investigation until the police have completed their preliminary investigation. The police will undoubtedly obtain search warrants and will take whatever materials they require and conduct interviews with staff at an early stage of their investigation. The internal audit staff should then be relatively free to conduct their own parallel investigation using whatever material has been left to them by the police. The police will have less cause for concern if the internal audit team shares any findings with them, even though it is highly unlikely that the police will reciprocate.

The second difficulty might be overcome by focusing on a detailed analysis of the bookkeeping records of transactions that were authorised by Ms Simm and her team. The dates and amounts of transactions could be studied to establish whether there are any suspicious patterns, such as large hotel bills when only a small sales team should have been present. Other issues might include whether transactions on corporate credit cards indicate that any cash taken for subsistence purposes was actually used for some other purpose. The total spend in different countries should be analysed and compared in order to establish whether there are significant differences that might indicate that some of the spend was for abnormal transactions such as bribes.