STRATEGIC CASE STUDY NOVEMBER 2018 EXAM ANSWERS

Variant 4

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SECTION 1

Requirement 1 – BCG matrix

There are many strategic models that involve classifying aspects of a business into a 2x2 matrix. These often offer valuable insights into the company's position and the direction that it should follow. The BCG matrix is essentially a useful starting point in the discussion of a company's product portfolio, which may assist in dealing with companies such as Novak that have significant numbers of products. The fact that this report is so negative almost certainly suggests that the consultants have made an error in applying their model to Novak. It is debatable whether it would be possible to develop a product that could offer a high share of a market that was growing rapidly. "Stars" generally require high levels of on-going investment and that would undoubtedly be true in the event that Novak created, say, a new type of product that did offer both high market share and high growth.

The traditional view of "dogs" is that they offer a low market share of a low growth market. As such, they should be considered for divestment. Such a view would be very short-sighted because the manufacturing costs of these products are generally low in relation to their selling prices. Novak may be unable to maintain a strong market share because these products are essentially generic, although there may be a slight advantage in the case of drugs that have recently gone off-patent because of the trademark issues that enable Novak to distinguish its product in terms of name. Given that these products can be sold at a healthy contribution for as long as there is a demand, there seems little point in withdrawing them.

The traditional view of "cash cows" is that they offer a high share of a market that has limited growth prospects. It is probably untrue to argue that the market for a drug is limited by the incidence of the disease for which it is indicated because there could be other social pressures that can create new markets. For example, there can be political and social pressure to make expensive products available to patients suffering from serious illness that have no effective alternative. The problem is that the advice is either to hold or divest such products, which is precisely what Novak is already doing. Pharmaceutical companies generally sell their patented products at a premium, but sometimes sell their patents. Advising Novak to do what the industry does already as a matter of routine may well justify the claim that the report was a waste of time and money.

Novak would undoubtedly benefit from developing patented products that offered the potential for high market growth, but such aspirations may prove impractical. It would be difficult to identify a potential product that offered scope for sustained growth because there are treatments already available for most curable diseases. Novak might attempt to develop a new range of pharmaceuticals that would be commercially attractive, such as a safe and effective drug that guaranteed weight loss or the reversal of aging. The problem is that developing such a product seems such an obvious strategy that it would exist already if it was possible. Given the high probability that the development of any new product will fail, this would be a risky venture.

Requirement 2 – stakeholders

Firstly, the pursuit of financial objectives and the maximisation of shareholder wealth is in no way inconsistent with the mission statement. Given the limited timespan of patent protection, the only way in which Novak can create profits is by the ongoing development and distribution of innovative new products that are genuine improvements over existing, and so cheaper, off-patent drugs. Offering the shareholders a realistic return for the risks that they are taking creates a sustainable business that can continue to fund research and development. It may seem cynical to refer to society in the mission statement if the intention is to maximise shareholder wealth, but the ability to earn profits is a prerequisite of funding the development of new drugs.

Managing other stakeholders may be difficult because they may be difficult to identify and engage with. For example, customers usually feature on lists of key stakeholders, but it is not always clear who Novak's customers are. Drugs have to be approved by health authorities, prescribed by doctors and consumed by patients. A product that would satisfy a clear and significant patient need would not necessarily be granted approval by health boards or prescribed by doctors. Each of these potential "customers" has different needs and interests and their importance may change throughout the development of a drug.

Employees are key stakeholders, but the only aspect of product development that is universally applicable to the entire workforce is that the creation of new and successful products will protect their job security. Production staff will have no other direct interest in product development unless it somehow creates a need for them to learn new skills in product formulation. Research staff will clearly have a far more active interest in product development because their careers may be enhanced because of their involvement in the development of a new product. That will have several implications for Novak, including the possibility that research staff will overstate the likelihood of success of a project because they wish to develop their CVs.

Society at large will be a stakeholder, although that will be a complicated matter to tease out. The logistics of making, distributing and storing pharmaceuticals may have a hefty carbon footprint. For example, Novak serves the world from 12 factories. The need to store, manage and use drugs before their expiry date can lead to a great deal of wasted energy. Pharmaceutical products cure disease, which is a worthy social objective, but access to drugs may depend on personal wealth and location. The development of an expensive new drug would be pointless unless there was an expectation that it would be sold. Promoting that sale could leave health boards short of funds for existing treatments that may be less visible, but could be more worthy.

SECTION 2

Requirement 1 – Blenalix

The CIMA Code of Ethics provides us with a useful starting point.

The concept of integrity requires us to be straightforward and honest in our dealings. In this case, we propose to give our test subjects a drug that has caused fainting and extreme nausea. The alternative would be to abandon development of this drug. The additional tests on volunteer subjects could be conducted with integrity. Nothing that we have discovered so far suggests that the drug can cause direct and permanent harm. The volunteers should be given full disclosure of the possible side effects and Novak's test team should take precautions, such as keeping them for observation until the risk of fainting has passed.

The concept of objectivity requires us to set aside conflict of interest in the application of professional judgement. As a company, Novak has a duty to maximise shareholder wealth. While we should not pursue that to the point of risking the safety of our other stakeholders, we should not reject an opportunity to generate revenue without good reason. Presumably, our volunteers are willing to accept a degree of discomfort and even some risk for the sake of a fee. We have no reason to suspend development of a potential new product that could benefit our shareholders, simply because we are unduly concerned about the welfare of our volunteers.

The concept of professional competence and due care requires that there be an ongoing commitment to professional knowledge and skills. In this case, the additional testing that we will conduct will help us to better understand the behaviour of this drug as well as the broader question of how we can manage side effects. We ought to take this opportunity to learn as much as we can about mitigating the side effects associated with Blenalix. The knowledge that we develop from this project may well help Novak to develop effective responses to side effects in other cases where the indicated disease is far more serious.

The concept of professional behaviour requires us to comply with laws and regulation and to avoid causing discredit. This is an area where we will have to take care. The key is to ensure, first of all, that we do not breach any health and safety legislation. Presumably, we can do that by evaluating the risk and by keeping the volunteers under medical supervision. We need to ensure that our behaviour demonstrates our commitment to safeguarding volunteer health. For example, by acting promptly in the event that a volunteer complains of being unwell. We also need to take care to document any safety briefing and ensure that volunteers have no reason to complain that they were misled prior to becoming involved.

Requirement 2 – Darlafen

Thomas is proposing that we break the law in the countries in which we plan to release the product. Essentially, we would have to lie and state that mandatory tests have been carried out on animals when, in fact, they have not. As a corporate citizen, Novak does not have the right to disregard the law of the countries in which it does business. Similarly, the directors do not have the right to set aside the law simply because they happen to disagree with it. There is no reason to believe that this particular law is unjust.

If we proceed with the sale of the suggested basis then we risk the possibility that our behaviour will be uncovered. In that case then we may face legal penalties in one or more of the countries in which we do business. The courts may be severe in such a case because we have breached the law in such a blatant manner and developing countries are frequently unhappy about having their sovereignty undermined by multinational companies. There is no real defense for our behaviour, other than that we disagree with the law, which is hardly an argument that will satisfy the courts. The fact that we cannot offer a meaningful defense will lead to additional adverse publicity associated with this case because we will seem disrespectful and arrogant.

Thomas' suggestion is that we should lie about having completed all mandatory safety checks before selling our pharmaceutical product. Our justification for doing so is to save money. The danger is that our stakeholders will be concerned that we have neglected safety procedures on other products and so we may lose credibility and business. We may find that many health boards switch to alternative suppliers for certain drugs, simply to allay patient fears that Novak products have not been adequately tested.

There could be governance implications in that Novak's senior management team has demonstrated that it is prepared to be dishonest in order to further its interests. That could make it more difficult to trust Novak's board, which could have an effect on the share price. The fact that the decision was not actually taken at board level may make it appear that the board is not in control of its senior managers. The fact that the cost of the testing is likely to be far less than the cost of rectifying this issue will also make the board appear reckless.

SECTION 3

Requirement 1 – share price

In a strong-form efficient market, the share price will reflect all information, whether it is public knowledge or not. The fact that the meeting was announced on Tuesday meant that the analysts were aware that something important was about to be announced, which would have led to them attempting to predict what that announcement was likely to be. It was a reasonable assumption that Novak would release good news because quoted companies frequently attempt to play down bad news without drawing attention to it. It is perfectly possible that the increased share price was due to the market inferring that good news would be released on Tuesday and that the price would rise, in which case it would be logical for the price to rise in advance of the announcement.

The pattern of price movements shows an increase before the announcement followed by a smaller dip afterwards. If the markets had been leaked the whole story then the price might not have required correction after the news was released officially. It would appear that the market had anticipated good news but was then slightly disappointed when the news was a little less positive than had been hoped. If the actual news turned out to be disappointing, then the whole story cannot have been known in advance.

In the semi-strong form of efficiency, the share price will reflect all publicly-available information. Once that information is made available then it will be quickly and accurately incorporated into the share price. The precise timing of the publication will have no effect on the extent to which it affects the share price, as long as the market has the information. The additional publicity associated with a formal analysts' meeting would not actually affect the share price. Any analysts who did not receive the information would be prompted to find out why Novak's share price was moving or risk being left behind.

The fluctuations in the share price because of the uncertainty prior to the announcement should have no impact on the long-term share price. The fluctuation could imply greater volatility and so increased risk, but any such overreaction would quickly be rectified. The markets will realise that Novak's share price had been affected by short-term speculation and that the root cause of that had little to do with the company's cash flows. The share price will quickly settle on a more realistic equilibrium price that is based on future expectations rather than past observations.

Requirement 2 – internal audit

The most significant difficulty associated with investigating the leak is that it could have originated from outside the company. The regulatory agencies were aware of the announcement and that it could have value to market participants. If the leak originated from within Novak then the perpetrator may not have been foolish enough to use company email or a company phone to pass on the news. In that case, the only way to determine whether there had been a leak would be to ask everybody who could have been in possession of the news and whether they admit to passing it on.

The challenges associated with investigating insider trading would depend on the manner in which the insider exploited the news. A crude insider trading scheme would involve purchasing shares immediately before the announcement and selling them immediately after. Internal Audit could then generate a list of suspects by examining the share register. It would be more difficult to investigate if the perpetrator purchased shares before the announcement with the intention of keeping them and enjoying a higher return from having made a bargain purchase. There could be further challenges, such as the possibility that the insider might have used an accomplice to buy and sell the shares and so the dealings might not be linked back to anyone who could readily be traced by Internal Audit. Internal Audit may not have a comprehensive list of everybody inside Novak who had this inside knowledge. There could always be the risk that the news was passed on in conversation or that a colleague saw a document.

The Internal Audit Department generally focusses on compliance work rather than this type of investigation. It could be a distraction from the ongoing work of the department to use it in this way. This could also undermine the relationship between internal auditors and management. The investigation is essentially aimed at establishing whether a criminal act has been committed. Presumably, if it has, then Novak will have to take severe disciplinary action and possibly even report the guilty party to the authorities. Any bad feeling arising from the investigation may make it difficult for the Internal Audit Department to offer a constructive service in the future, even if it does not discover any insider trading.

It could be argued that the Internal Audit Department has the necessary skills to provide the board with the reassurance that it is seeking. Commissioning a thorough internal audit investigation would effectively just postpone more routine audit work and so there would be no overall loss of assurance. The board would have confidence in the department's expertise and its ability to maintain confidentiality. The risk of alienating managers could be managed and minimised by taking a positive and helpful attitude and conducting the investigation in an open and transparent manner.