STRATEGIC CASE STUDY NOVEMBER 2018 EXAM ANSWERS

Variant 5

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SECTION 1

Requirement 1 – mission statement

The mission statement sets out Novak's mission and offers a brief summary of the approach taken to achieving that mission. That information will clearly have value to potential investors in deciding whether or not to invest. A clear statement will enable shareholders to establish what industry the company is in and to get a quick understanding of the business model. Following the mission statement will ensure that Novak is living up to shareholder expectations and understanding, with no risk that they will feel it necessary to divest in order to maintain the balance of their portfolios. If necessary, Novak can justify a strategic decision on the grounds that its actions are consist with its mission statement, which should reassure the shareholders that the company has a clear direction.

The mission statement cannot drive strategy because it is, at most, a statement of intent that was realistic and sensible at the time it was written. Novak's mission may evolve in line with changes to the industry and it is to be expected that it will be updated as and when necessary. The mission statement cannot always drive strategic management because it does not cover every area in which strategic decisions must be made, such as financing strategy. The mission statement is likely to reflect certain basic elements of the business, such as the market that it serves. It is unlikely that the board will ever have to refer to it directly.

Novak's shareholders will have no reason to complain if the company invests in the development of treatments for orphan diseases because that is consistent with the broad terms of the mission statement. Novak's mission statement says that it will innovate and the development of new products may offer insights and knowledge that can be applied in unexpected areas. A treatment intended to cure a rare disease may turn out to offer benefits in treating more common ailments. The strategy of developing cures for one or more orphan diseases could offer commercial benefits. Setting the research staff the challenge of finding a cure may motivate them and attract leading research scientists into the company. The launch of effective treatments for serious diseases may prove newsworthy and so create positive publicity for Novak. This exposure could lead to more doctors prescribing Novak's existing pharmaceuticals.

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The mission statement and statement of corporate values do not necessarily compel Novak to make a strategic investment in curing these diseases. There could, for example, be some ambiguity in the mission statement itself. It may not help “society” greatly if Novak develops a cure from which very few people will benefit. As a broad statement of principle, the mission statement is fine, but the board must still make difficult decisions that will leave it open to challenge. The mission statement and the statement of corporate values must also be interpreted in the context of Novak being a quoted company that has a responsibility to its shareholders. This raises questions about the extent to which the need to make a profit should be addressed. For example, “driven by the needs of consumers” could be read in different ways. The potential consumers who suffer from orphan diseases may have significant needs as individuals, but the overall benefit may be limited by the small numbers who will benefit.

Requirement 2 – CSR reporting

Stakeholder inclusiveness requires the identification of the stakeholders and an explanation of the manner in which their interests have been addressed. Novak’s report offers examples of its interactions with healthcare professionals and also with the patients from developing countries who have received Kartiam free of charge. Novak makes no explicit mention of the extent to which stakeholder needs drive the company’s activities. For example, is the training provided to healthcare professionals intended to fill gaps in their knowledge or is it simply an approach to promoting Novak’s products? The subsidy of treatments offered to developing countries and the gifting of medication for common diseases such as malaria is admirable, but there is no indication as to whether the victims of orphan diseases are regarded as stakeholders and whether Novak intends to do anything to assist them.

Sustainability context requires an indication of the overall performance with regard to sustainability. Essentially, it asks what does Novak mean by sustainability? The need for clarity is illustrated by the question of tackling disease. There is nothing to state how Novak goes about setting priorities for its development and manufacturing activities. For example, would Novak be prepared to direct resources to the development of a treatment for a debilitating orphan disease if that would prevent the development of a new treatment that offered greater sales potential? The question of side effects in the development and sale of pharmaceutical products is a crucial aspect of sustainability and the management of patient welfare, but there is no indication of how Novak balances the risks and benefits associated with taking its products.

Materiality implies that users’ information needs are being met. In the context of CSR, this would imply that users are informed about the aspects of sustainability that interests them. Users who wish to understand the extent to which Novak aims to develop cures for diseases will be disappointed because there is little or nothing in this statement to advise them. The report offers an unhelpful statistic concerning the number of patents filed and a brief statement about the potential advantages of new technologies. The question of materiality in relation to orphan diseases really depends on the extent to which users are interested in Novak’s performance. If stakeholders have not requested further disclosure then it might be inferred that they have little wish to know and so there is no material omission.

Completeness suggests that there ought to be sufficient information on which to assess the entity’s performance on the issues covered. This document is clearly deficient because none of the points raised are covered in a comprehensive manner. For example, there is no mention of the manner in which the policy of subsidising sales to developing countries works or how many people have benefitted from this policy. There is nothing to indicate the extent to which the development programme is succeeding, beyond unhelpful reports of the number of patents filed. There is nothing in this document to indicate whether Novak's senior management or its research and development staff have any explicit interest in developing cures on the basis of clinical need, as opposed to commercial opportunity.

SECTION 2

Requirement 1 – forecasting

The first aspect of forecasting demand for our cure is to determine roughly how many cases there are of Kronds Disease. This will establish an upper limit for demand, on the basis that we are unlikely to sell more courses of treatment than there are victims. We could start by surveying the medical literature. Hopefully, there will be published studies that offer reliable evidence as to the incidence of this illness. In the event that there are no such studies, we will have to conduct our own surveys, possibly by contacting a sample of doctors in general practice to ask how many of their patients suffer from the disease or by gathering information from sufferer support groups.

We also need to establish the cause of this disease. If it is genetic then new cases will arise as time passes and the symptoms appear. If the disease is caused by lifestyle issues or exposure to known risk factors then its incidence will, hopefully, be on the decline because the disease is avoidable and people will take greater precautions. The severity of the illness must also be considered. A course of treatment that costs C$10,000 may be justified in the case of a life-threatening or life-changing disease, but even those factors may mean little if the illness tends not to arise until late in life or is generally accompanied by other illnesses that mean the cure would offer little benefit to the patient. The question of cause and lifestyle are also relevant here because society may be more tolerant of an expensive drug to treat a disease that was unavoidable, but there may be resistance to its purchase for patients who have made unhealthy lifestyle choices.

Novak could use the Delphi method, by meeting with a sample of doctors to ask whether they would prescribe the cure, in the event that it is developed. This discussion would involve asking a number of hypothetical questions about the doctors' experience of treating this disease and the number of patients on their registers for whom they would be prepared to prescribe a C$10,000 course of treatment. Any doctors who would not automatically prescribe the cure to each and every patient with the disease should then be asked for the criteria that were applied in making their decision. It may then be possible to estimate the percentage of the known population of sufferers who would receive this treatment.

Novak should also study the likely response of regulators in approving this drug for public funding. There may be precedents involving otherwise incurable orphan illnesses for which an expensive cure was developed and Novak should study those in case there is useful information to be had. If the regulators have restricted the use of new cures in similar contexts then it is reasonable to expect that they will do so again in this case. Novak could then approach the decision makers in these organisations to seek their opinions as to whether the precedents would be applied to the cure under consideration.

Requirement 2 – reputational risks

There is a danger that we will appear greedy and self-serving. We could cure a life-threating illness and chose not to do so until it became profitable. Such an attitude could undermine our attempts to lobby on behalf of our cure because we will risk being accused of hypocrisy in our attitude to the value of human suffering. If the press uses this argument against us then it may discourage the regulators from approving our drug in case they appear to be encouraging our greed. The case may raise wider questions in society about the pricing of Novak's products because many pharmaceuticals are very expensive.

Novak might pre-empt those reputational risks by blaming the initial abandonment of the project on the governments, who are unwilling to fund the purchase of life-saving drugs. Care would have to be taken to avoid alienating key decision makers, but the public may be willing to accept that health care is underfunded. The focus of the story could then be about Novak's desire to continue with the project in the interest of assisting those suffering from Kronds Disease. Large companies like Novak can employ public relations professionals to help them present themselves in a positive way.

The risk may be mitigated by the fact that Novak sells pharmaceutical products and so consumers have very little alternative but to buy them. It is unlikely that Novak will lose many sales because of matters of principle, such as allegations that the company is greedy. Reputational issues are unlikely to cause a company any real harm unless questions of patient safety are raised. Otherwise very few patients will pay any attention to the identity of the manufacturers of their prescription drugs and most doctors will prescribe on the basis of the most effective treatment.

Finally, public perception of pharmaceutical companies may be that they do earn significant profits from the sale of products that patients need for the sake of their health. This case may simply confirm a belief that already existed across society and so the impact on Novak's reputation could well be minimal. Pharmaceutical companies already develop drugs on the basis of commercial potential, regardless of the fact that they offer limited benefits over existing treatments. They are already known to sell goods at significant mark-ups over their manufacturing costs.

SECTION 3

Requirement 1 – predicting rates

There is a clear logic to the International Fisher Effect, which states that all countries will have the same real interest rate, otherwise cash would flow from countries with lower real interest rates to others that had higher. If two countries have different interest rates then it is reasonable to assume that the country with the higher rate will see its currency decline in value relative to the country with the lower interest rate. The expected decline would be just enough to offset the differential in interest rates, so depositing funds in either currency would yield the same overall return after currency gains and losses were taken into account. Where there are derivative instruments that enable forward rates to be fixed in advance, the size and direction of any change implied by the premium or discount between the spot and forward rates should correspond exactly to the differential between the interest rates, otherwise it would create arbitrage opportunities.

The International Fisher Effect offers a logical basis for a forecast exchange rate, but it is by no means guaranteed to be accurate. Governments pay close attention to economic variables such as interest rates and the strength of national currencies and they may intervene with the equilibrium levels that would otherwise be set by market forces alone. There is no guarantee that interest rates and exchange rates will move together in real time and that could also have implications for the accuracy of the forecast rate in March 2019. Novak's board should, however, be reasonably confident that any forecast produced this way will be accurate in terms of the direction of any change and its order of magnitude.

Bringing the payment forward would clearly fix the cost of the coffee plants in terms of C$, but that would be an expensive response to this risk. Making such a large payment several months in advance will be expensive in terms of the interest that Novak will have to forego. If Novak attempts to reduce the payment to allow for interest then that will effectively be passing the currency risk over to the supplier, which is desirable to Novak but unlikely to be acceptable to the supplier. The only justification for such a rash action would be the volatility of the V$, which could create a significant downside risk that might justify the heavy cost of advance payment in full.

Making an early payment would be bad business in other ways. Firstly, it creates the risk that the supplier will default on the delivery of the plants. At present, we have to make a sizeable payment on the delivery of the plants. The plants have yet to be grown and there could be problems with their growth and harvest that could prevent the supplier from meeting this commitment. There will also be accounting issues because the payment will appear as a significant receivable in our financial statements. This will create a poor impression of our treasury management skills

Requirement 2 – hedge accounting

Hedge accounting does not "protect" the financial statements. It simply permits changes to the timing of the recognition of gains and losses on hedging instruments that would otherwise go to the statement of profit or loss in a period that did not coincide with the loss or gain on the hedged item. In other words, if Novak enters into a cash flow hedge in order to protect this payment, hedge accounting would avoid the potentially misleading pattern of recognising offsetting gains and losses in different accounting periods. There is, of course, no particular disadvantage to recognising movements in this manner because it should help the shareholders to understand our performance more easily. That said, we could just as easily hedge the risk in any manner that we choose without applying hedge accounting if we wished to simplify the accounting arrangements.

The size of this payable is so small in comparison to Novak's other current assets and liabilities that it is debatable whether there is any need to be concerned with hedge accounting. The Board is concerned that this will be an expensive research study and they are keen to avoid any additional expense arising from currency movements, which is understandable. However, the project will not be disclosed in such a way that it will be visible to the shareholders and so any movements will be included amongst other totals. The management time involved in creating and documenting the hedge in order to apply hedge accounting will not be justified.

Management should always focus on cash flows when managing and hedging risks. The accounting treatment of those future cash flows, including the risks of gains and losses, has no economic impact on the entity. The question of whether to hedge and the manner of hedging if it is decided to do so should be considered on the basis of the risks and the risk appetite. The accounting treatment of any hedging opportunity should not affect the decision as to whether or not to proceed with it. It would be far preferable to select the hedging strategy that best meets Novak's needs and then consider the application of hedge accounting once the strategy has been decided.

Hedge accounting is not the only way to enable the shareholders to understand the net risks associated with this transaction. In the absence of hedge accounting, we could simply explain the risks and the steps that we have taken in order to mitigate them. The danger in selecting a hedging strategy on the basis of its eligibility for hedge accounting is that we could be accused of dysfunctional behaviour. If the cost-effective strategy is simple and straightforward then it should be easy to explain to the shareholders.