### STRATEGIC CASE STUDY PROTOTYPE ANSWERS

**Variant 2**

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**TASK 1**

**Requirement 1 – fixing ingredient prices**

The most immediate advantage is that we would know the cost of ingredients into the future, up to the period that is covered by these instruments. Ingredients are a significant component of our total cost price. We will be able to price our products, knowing that we will not suffer any unforeseen losses due to an increase in sugar reliance on digital model prices. That will also ensure that our cash flows are easier to manage because we will not be forced to deal with unexpected payables.

The fact that our competitors fixed their prices meant that we were at a potential disadvantage if prices rose, as they did recently. Our competitors can leave their selling prices unchanged without incurring any reduction in profits. Their shareholders may appreciate the resulting decrease in volatility and so their shares may be regarded as less risky. Their boards may also seem more astute because they are not leaving themselves exposed to commodity fluctuations.

Fixing prices protects us against price rises, but also means that we cannot take advantage of price falls. If sugar prices had fallen then we could either have undercut our competitors or left our selling prices unchanged and had a larger profit.

Paradoxically, we cannot be certain whether our competitors will fix their prices in the future and so we could find ourselves fixing and suffering a loss of market share if prices fall. It is also debatable whether fixing in advance will affect our total costs in the long term. Sellers will not fix their prices without some thought about how the market is likely to move.

**Requirement 2 – scenario planning**

A formal system of scenario planning would involve Fizz’s management and board making constant predictions about the future so that potential disruptions can be at least planned for. The most relevant starting point would be to keep Fizz’s PEST analysis up to date, with particular attention being paid to changes that might be foreseen. The prediction should extend out to a realistic horizon, allowing for likely disruptions such as a general election and a change of government. The implications of those changes for Fizz’s business future should then be considered.
The Board might establish a planning committee of senior managers to conduct the scenario planning process. It might be useful to hold a brainstorming session, with some input from a facilitator, to identify areas in which scenarios might be considered. Once a list has been compiled and described in sufficient detail to ensure that each item is clear and actionable, the next step would be to rank them in order of priority. The scenarios that reflect the most likely threats or opportunities should be tackled first, with working parties established to develop suitable responses for each scenario.

The scenario planning process should possibly extend beyond the development of planning documents. The Board should consider whether any of those plans should be underpinned by resources. For example, scenarios relating to the loss of IT systems might be underpinned by the identification of suppliers who could be used to replace any damaged or corrupted hardware or software. If necessary, those contacts might be paid a retainer so that they will be prepared to support Fizz in the event of an IT disaster. For some systems, the Board could go so far as to invest in additional capabilities, such as the creation of a backup system that could be used if the primary system fails.

One possible scenario might be a curtailment of the sale of high-calorie drinks, possibly arising from legislation or from consumer tastes. Fizz could plan for that possibility in terms of the production implications, if any, of changing the proportions of tradition versus sugar-free drinks. It might be possible to plan ahead by consulting with lobbying firms and putting one on a retainer in case Fizz ever has to defend the safety of its products. It would also be useful to have the basis for a marketing plan ready for a shift to alternative products.

Another scenario might be a disruption in the on-trade market, perhaps with mergers between some major players. That could leave Fizz competing to serve a smaller number of customers, each of whom is larger. Fizz might address that possibility by ensuring that it serves as many of the existing on-trade customers as possible, even if some are slightly uneconomic, so that it is likely to be serving both parties to any merger. Fizz should also gather as much information as it can about the business sectors that its customers occupy so that it is aware of any major changes that could have an impact on its customer base.
**Task 2**

**Requirement 1 – acquisition decision**

We should consider the suitability of this investment. It could be argued that we are heavily dependent on our ability to secure and manage supplies of commodities, particularly sugar. It could be argued that the acquisition of Benton Farm Management will give Fizz greater control over its supply chain. The ability to engage with farmers and to better understand their perceptions of the sugar market would be helpful in terms of making decisions about hedging and ordering in advance. Fizz buys other farmed commodities, such as fruit juices, and so this investment could support a host of products.

The feasibility of the venture is complicated by the fact that the service provided by Benton Farm Management really requires independence. Farmers may be reluctant to seek advice in the future if there is a possibility that they will be encouraged to grow sugar beet for the consultant’s parent company. The farmers might not see any great advantage in signing contracts with Fizz given that most commodities can be sold forward and so they may be suspicious of any contract that does not match the terms available from the market. It may be possible to overcome these problems if the consultants have a prior relationship with the farms and are trusted to give sound advice. They could declare their interest in buying particular crops and demonstrate why the contract being offered is win-win.

The acceptability of the proposal really depends on the cost of the investment. Fizz can afford to be reasonably generous because it will benefit from all of the revenues that the consultancy earns, in addition to any costs that are averted through developing relationships with farm businesses. Fizz will have to consider whether there are any risks associated with this investment. For example, does the founder have an ongoing role in the business and will it create problems if the founder leaves?

**Requirement 2 – valuation**

We might start by valuing the company’s assets. That generally undervalues companies, but we still need to know roughly how much the asset are worth just in case they exceed the value associated with future cash flows. The seller will not accept less than the asset valuation. The farm management software may have a significant value if it is superior to that of competing systems and it was developed internally, so the founder may have an exaggerated belief in its value. Paradoxically, the value of the software may be more easily determined by reviewing the profitability of the company, because its value is tied to the company’s ability to sell services. Benton Farm Management may also own property, such as office premises, which should be relatively easy to value on the basis of market prices for similar properties.

A more realistic approach would be to value the company on the basis of its earnings. One approach would be to identify a quoted company in the same line of business and determine its price/earnings ratio. Multiplying Benton Farm Management’s earnings per share by the P/E ratio would give a defensible share price that reflected stock market views on the company’s value. The biggest challenge would be to find a suitable quoted comparative because Benton Farm Management has a very specific business model and there may not be a quoted company that focuses on this very narrow area. In that case, Fizz might look at typical P/E ratios for companies that offer consulting and at companies in the agriculture industry in the hope that their p/e ratios fall within a reasonably narrow range.
Fizz might modify the p/e basis to reflect the additional profits that Benton Farm Management will bring to the group. Ultimately, the price of a company will be determined by negotiation and so there is no “correct” valuation. The target’s founder might attempt to press Fizz into paying more than the market valuation of earnings. Fizz should consider that possibility and should have an upper limit that reflects the total value to the group of a successful acquisition. Fizz should be prepared to negotiate in case the founder argues that the selling price should reflect these projected earnings. In that case, the founder is likely to overstate that value.

**Requirement 3 – exchange of shares**

The most immediate benefit is that the share exchange will conserve cash within the Fizz Group. Issuing shares would effectively pass the cost on to the shareholders, through a dilution in their ownership. That dilution would be offset by the (hopefully) positive NPV of the acquisition. Fizz is quoted company, which suggests that the shares are widely held and so the existing shareholders will not suffer any meaningful loss of control. This assumes that Benton is small enough to be absorbed by Fizz without issuing sufficient shares to change shareholder perceptions of risk and return to a material extent.

Giving Benton’s founder a significant minority holding, even a few percent of the company, could introduce short term volatility into Fizz’s share price. If the founder decides sell the Fizz shares in order to realise cash from the sale than the share price will fall. In an efficient market, the disposal of shares is often interpreted as a signal than a market participant has some “bad news” and so others may sell for speculative reasons. The share price would recover in time, but it could put Fizz’s Board under some pressure and could lead to concerns about the wisdom of the acquisition.

Fizz has a low gearing ratio and so could afford to borrow in order to raise funds to acquire Benton. The ratio is presently 31.4/ (272.8+31.4) = 10%, which is not a significant level. It is unlikely that Fizz will pay enough to have a meaningful impact on gearing. That would permit a simpler message to be presented to the shareholders because the Board could simply enter into a loan agreement and announce the takeover once it is completed. That would probably place less emphasis on the acquisition and so the shareholders would be less inclined to react unfavourably.

**Task 3**

**Requirement 1 – internal controls**

Ideally, there would be some segregation of duties that would make it difficult for consultants to overstate the premium. At present, the consultant seems to input the variables into the system and then makes an offer based on the results. The fraud would be far more difficult if another member of staff gathered the basic data for input into the system. The system would then identify the recommended crops and the consultant could negotiate the contract with the farmer. The consultants could have the ability to read farmer’s files but not to input or change variables, so that the premium could not be falsified by entering, say, a misleading test result relating to soil conditions.

The consultants should have limits to the level of premium that they can offer without first seeking authorisation. If the consultants wish to offer a higher premium then they should be required to seek authorisation from a more senior colleague and to justify
the payment. That would limit the amount by which any premium could be overstated, which would make the fraud less attractive to both the farmer and the consultant.

Consultants should be required to submit all soil samples for retention and possible retesting in the event of a query. Benton should develop a clear and logical process for arriving at any recommendations concerning crops. It should be possible for a manager to check the consultants’ recommendations by reviewing the work done and considering the logic that has been applied.

Consultants could be asked to work in teams with each team focussing on a particular region or type of farm. Team members would work together in dealing with each farm. That would lead to the farmers developing a working relationship with more than one consultant, which would mean that the team members would have to collude if they wished to repeat this fraud. This arrangement would offer further practical advantages, such as giving the consultants a better overview of the farms in their regions.

Benton Farm Management might review all cases where consultants are recommending beet contracts with farmers. There should be an upper limit per tonne on the premium that should be negotiated with farmers, in order to ensure that consultants do not offer excessive amounts. Any premium that exceeds a given amount should trigger a review by a manager before it is finalised.

A manager should conduct a number of follow-up visits to a random selection of farms that are in receipt of a premium in order to check that the consultant’s recommendation is justified. Disciplinary action should be taken against the original consultants if the follow-up investigation reveals a different result to that originally submitted. The results of any such action should be made public so that all staff are deterred from misstating the results of their surveys.

**Requirement 2 – internal audit**

Audit resources should be directed at areas of high risk and so the facts of this case should be reviewed. The internal audit department could investigate the possibility that this matter is worth investigating by identifying the numbers of contracts that involved Fizz paying a premium to motivate a farmer to grow sugar beet. If there are very few such contracts or if the premiums are relatively small then the investigation would be unlikely to yield a meaningful result. If the dismissed consultant was the main source of such contracts then there is even less point because he has already left the company.

This would be a difficult fraud to investigate because it involves collusion between consultants and farmers. Any investigation that requires a response from the farmers could lead to a loss of business if farmers react badly to any implication that they have been dishonest. There may not be any files or documents that would enable the internal auditor to check that the data that has been input into the system has been done so correctly. It may be helpful to seek the advice of Maureen Sakes before proceeding with any investigation.

There could be an argument that an internal audit investigation would ensure that the remaining consultants are deterred from manipulating future premiums. It would reflect the Board’s attitude towards staff fraud and would deter any future abuse of this loophole. It would also be useful for the Board to know whether it has many farmers who could be unwilling to stop growing crops for Fizz if their premiums are no longer being overstated. In that case, the audit team should make a point of interviewing as many consultants as possible in order to warn them that they are subject to review.

It should be borne in mind that the internal audit department will have a full programme of work and that an ad hoc fraud investigation could be a distraction. Internal audit is generally about checking and encouraging compliance and so there could be more
significant issues that are overlooked if audit staff are redirected. The decision to interrupt the programme should be taken account of the work that will be delayed or possibly left undone and the risks associated with those areas. The Board should also be aware of the impact and should decide on the depth of the fraud investigation, allowing for the resources that are to be redirected.