1 Brady

Brady Co is a clothing manufacturer, based in a European country. It was founded nearly 50 years ago, and has established a favourable reputation as a high-quality manufacturer of men's and ladies' clothes. For the last financial year, Brady's revenue was almost £75 million, and its net profit before tax was £1.2 million.

Brady manufactures clothing for a number of European and international clothing retailers, including a number of well known high street retailers. It manufactures clothing in the medium to higher price ranges, and its customers require top quality designs and finishing to maintain their brand reputation. The majority of Brady's clothing is manufactured under its customers' own labels; for example, clothing manufacture for Skyblue is labelled with Skyblue's brands. (Skyblue is Brady's largest customer, and last year accounted for just over £16 million of its revenue.)

Over the last 20 years, Brady has seen many of its former European competitors suffer losses and cease trading. In addition, as the clothing industry has become more price sensitive, some companies have moved part or all of their manufacturing to foreign countries to achieve a cheaper operating base.

Brady has managed to remain profitable, but has seen its margins on many product lines reduced greatly, and it has been unable to retain some customers who have chosen to import clothing produced in Asia and sold at much lower prices.

Due to their size, the high street retailers wield considerable buying power, and so have been able to dictate terms of business and prices to the clothing manufacturers. However, in recent years, the established high street retailers have themselves come under increased price pressure following the growth of new retailers and new brands, who have procured their goods mainly from non-European sources.

As a result, the remaining clothing manufacturers based in Europe are having to look very hard at their strategic plans in order to maintain their businesses in the future.

Human resources

In the clothing manufacturing business, one of the most crucial aspects to achieve customer satisfaction is quality. Brady has been very fortunate in having a skilled, dedicated workforce who have always adapted to new machinery and procedures, and have been instrumental in suggesting ways in which quality could be improved. These changes have sometimes involved a very minor change in the design of a garment, and the designers now work much more closely with the operational staff to ensure that the garments can be assembled as quickly and efficiently as possible.

Technology

Brady's management team also recognises the importance of technology to the business. Five years ago, the company invested in new IT solutions which enabled its customers to track all orders from the garment cutting process right through to completion of the manufacturing process and then on to the delivery of the garments to customers' premises.

The IT solutions also enabled Brady to monitor its production processes including machine usage, wastage at various stages of production and speed of production through the various stages. This has enabled Brady's management to reduce areas that did not add value to the finished garment. The use of TQM throughout the business has also increased Brady's efficiency and enabled it to eliminate some other areas which did not add value to the finished garments.

Although margins remain low, these IT solutions have been vital in helping Brady to operate profitably, and thereby remain in business.

Changes in the supply chain

Many of Brady's customers have needed to speed up the process of supplying clothes to their shops, in order to meet market demands and to remain competitive. Brady has worked closely with its customers in order to achieve shorter lead times from design to delivery of finished products.

Five years ago, Brady also introduced a new design centre, centralised at its Head Office. The design centre uses computer aided design techniques, which have helped Brady's customers to sample the finished appearance of new designs prior to any clothes being manufactured. This seems to have helped Brady win new business and to retain its current customers. It has also contributed to Brady's ability to speed up the process from design to finished article. In addition, Brady has benefited from

working more closely with its customers and this has resulted in further orders, which Brady's customers would otherwise have procured from overseas sources.

Growing competition from China

Over the last two decades, a number of European companies have spent millions of Euros establishing manufacturing bases in low cost countries outside Europe. These companies have invested in the low cost countries with the aim of cutting costs by taking advantage of low overheads and lower labour rates, whilst still maintaining quality levels.

However, these operations are now facing intense competition from clothing manufactured in China. Clothing manufactured in China is recognised as being of a higher quality than many garments manufactured in Europe, although it is produced at a substantially lower cost.

Until recently, Brady's market has not been significantly affected by imported goods, because it is focused on medium to higher priced clothing, rather than cheaper ranges of clothes. However, many of Brady's customers are now looking to reduce their costs either by buying more imported clothes or by negotiating substantial price cuts from their existing suppliers.

Joint venture

At the latest board meeting, Brady's directors discussed the possibility of the company moving some of its own manufacturing processes to China. This could enable Brady to operate more profitably and should increase its ability to retain its existing customer base. In addition, the directors felt that such a move should allow Brady to compete more effectively in order to win new business.

At the meeting, the Managing Director also explained that Brady has been approached by a Chinese clothes manufacturing company called LIN. LIN has proposed a joint venture with Brady, although the respective shares of the venture partners have not yet been decided.

LIN proposes that Brady should concentrate on doing what it does best, which is designing and distributing to the European market. Brady should continue to work with its current customers to agree designs, which could then be electronically transferred to a factory in China to be manufactured. Brady would continue to supply its existing customers, but with clothes manufactured in China by LIN. This proposal would necessitate the closure of all of Brady's European factories.

The proposed joint venture would require the construction of a large purpose built factory with manufacturing capacity of over 20 million garments per year. However, Brady's Marketing and Operations Directors are both concerned about whether the proposed joint venture will work well for the company in the longer term.

Investment in IT

Later in the meeting, the IT director stressed the continuing importance of investing in IT in order to win new business. He presented a proposal to enhance Brady's existing IT systems to provide a secure extranet system which would be totally interactive, allowing existing, as well as new customers to browse through all of the available designs that Brady is offering to manufacture. The proposed system would allow customers to order online.

The system would also allow customers to personalise their orders, as they would be able to choose the colours, the materials and the designs they wanted. The IT director is confident that this additional functionality will allow Brady to secure a lot of new business as well as safeguarding existing customers. He is also confident that a price premium could be charged for clothes that are 'custom made' to individual requirements, therefore enhancing the margins that could be earned.

Three potential medium-sized customers, who did not previously buy clothing from Brady have expressed an interest in the 'custom made' production facility. Initial discussions with the customers suggested that the level of business from each of them would generate a contribution to profit of about £114,000 per year. Fixed costs directly associated with the new 'custom made' facility are estimated to be £200,000 per year.

However, the Operations Director is concerned about the whole logic behind the proposal, and argued that it is trying to shift Brady from having mass production systems into small scale batch production.

Requirements

1.1 Discuss the scope and nature of the changes which are likely to be required by Brady if it decides to adopt the proposal to:

(a) Relocate its own manufacturing operations to China
(b) Enter into a joint venture for manufacturing in China
(c) Develop a new interactive ordering system **(12 marks)**

1.2 Taking account of both financial and strategic considerations, evaluate the benefits to Brady of the IT director's proposal. **(8 marks)**

1.3 Analyse the potential advantages and disadvantages to Brady of the proposal for the joint venture in China. **(10 marks)**

Note: Your answer to question 1.3 should focus specifically on the advantages and disadvantages of joint ventures as a method of expansion, not the advantages and disadvantages of international expansion in general, or expansion into China.

Total: 30 marks

2 Guestway Hotels

Guestway Hotels ('Guestway') owns a number of hotels across a European country. All of the hotels are wholly owned by the company, but the manager of each hotel has a large amount of autonomy for the day to day running of their own hotel, and for ensuring it is well maintained.

The hotel managers also have the authority to adjust room prices in their hotels. One of Guestway's key performance measures is room occupancy rates, and the managers can increase or decrease room prices in response to the numbers of unoccupied rooms available and expected demand at different times of the year.

Guestway's hotel managers are entitled to an annual bonus payment. The level of their bonus is determined by the average room occupancy rates in their hotel over the year, as well as the net profit margin (%) achieved by their hotel for the year.

Five years ago, Guestway was bought by a group of investors. A key part of the investors' strategic plan for the company is to increase its market share within its current country, with a view to subsequently expanding into neighbouring countries.

Guestway's business model has always been to offer high quality accommodation and service for its customers, who include business travellers as well as leisure travellers. There are no plans to change this strategy, despite the change of ownership.

Recently, Guestway's senior management team have become increasingly concerned about the performance of one of its hotels (in Sawton).

A new manager was appointed two years ago, and the Sawton hotel's occupancy rates soon began to increase following his appointment. The hotel's net margin also increased slightly.

However there have been an increasing number of negative comments about the Sawton hotel posted on online hotel customer review sites. Three key themes have emerged from these comments:

- Although rooms have become cheaper at the Sawton hotel, the standard of service has fallen significantly.
- The rooms need cleaning and re-decorating; and the fixtures and fittings need replacing (for example, the beds need new mattresses).
- Business travellers who have stayed at a number of different Guestway hotels say the ambience of the Sawton hotel is completely different to the others in the group. It now feels more like a budget hotel than a high quality hotel.

Guestway's Operations Director has arranged an urgent meeting with the manager of the Sawton hotel to discuss its performance.

In preparation for the meeting, Guestway's management accountant has prepared a summary of the key performance indicators for the Sawton hotel; comparing the performance for 20X4 (last year) to 20X1 (under the previous manager). The Sawton hotel has 150 guest bedrooms, and is open for 365 days per year.

KPI	Comment	20X4	20X1
Average room occupancy rates	Number of rooms let/Total number of rooms in hotel	94%	78%
Average daily room rates	Daily revenue from rooms let/Number of rooms let	£65	£90
Service cost per room	Total daily room servicing costs/Number of rooms let	£6	£8.50
Promotion & marketing costs	Promotion & marketing costs as a % of total revenue	5%	7.5%
Net profit margin	EBIT/Revenue	9.8%	9.7%
Return on investment	EBIT/Total assets	11.2%	11.0%

Note: You should assume that all of the hotel's revenue is earned from selling accommodation to guests.

Requirements

2.1 With reference to the Sawton hotel's performance, discuss the potential for conflict between Guestway's long-term objectives and the short-term performance of individual hotels. **(15 marks)**

2.2 Evaluate the extent to which Guestway's key performance indicators are consistent with its corporate strategy. **(8 marks)**

Total: 23 marks

3 Qualserve

Qualserve is a small management consultancy practice, based in a major city in a European country. Like many similar practices, Qualserve is a partnership.

Over the last five years, Qualserve has grown significantly. Last year (20X9), Qualserve earned a fee income of £3.2 million, and a profit after tax of £0.7 million; compared to £1.8 million and £0.45 million in 20X5.

Qualserve now employs a total of 14 consultants (including the partners) and 11 support staff. The support staff mainly work in administration, finance, research and marketing roles. Qualserve's financial statements for 20X9 showed net assets of £1.2 million (20X5: £1.0 million).

Qualserve's business

Qualserve has a variety of clients across financial services, manufacturing, construction, retail and logistics industries. Most of Qualserve's clients can still be regarded as Small and Medium Enterprises (SMEs), but a few of them have now grown to become large and successful organisations. Indeed, Qualserve now has three clients in the 'top ten' of the country, when companies in that industry sector are ranked by turnover.

In all the projects it undertakes, Qualserve ensures that the staff of the client organisation are fully involved in the consultancy process. Client staff are normally included as members of the project team, thereby ensuring that the project has greater acceptance from the client organisation. As a result of this approach, Qualserve has established a favourable positive reputation for successful projects, which in turn has led to some client referrals as well as securing repeat business from existing clients.

Staff retention

Until two years ago, Qualserve's staff turnover was very low, and it had never 'lost' a key employee. The partnership was, and still is, viewed as a caring and loyal employer, at least matching the market rate in terms of salaries and benefits. The partners were confident that staff loyalty would continue, since Qualserve was still growing and provided interesting and challenging projects as well as opportunities for career progression.

The partners were shocked when, two years ago, two consultants resigned to join rival consultancy firms. Last year, another consultant left, this time to join a client organisation as its director of finance. So far this year, one consultant resigned to set up his own business, and another chose not to return to the partnership at the end of a secondment to a client. Although Qualserve has recruited suitably qualified replacements for the staff who have left, the cumulative effect of all these losses is that about a third of all Qualserve's consultants have now been with the practice for less than three years.

Knowledge management

Geoff Halls is the partner at Qualserve responsible for administration, marketing and IT. He believes that Qualserve could be able to offer knowledge management consultancy services to its clients in the future. However, in the first instance he is keen to run a 'pilot scheme' within Qualserve to improve the way knowledge is managed within the practice. He is concerned that communication and knowledge sharing between staff is nowhere near as effective as it could be.

Project resourcing

When Qualserve begins a new consultancy project, the designated project manager 'recruits' the consultancy team from those consultants who are not engaged in another project. Staff are allocated to projects on a 'first come, first served' basis, so it is common for project managers to find that some of the consultants with the greatest experience in the required specialist areas are already engaged on another project and are therefore unavailable.

Freeway Consultants Ltd

One of the partners at Qualserve is a friend of the managing director of Freeway Consultants Ltd ('Freeway').

Freeway was formed ten years ago by Ted Bell, a former university lecturer in business and IT, and the company specialises in the provision of information systems and knowledge management solutions to SME clients.

As Qualserve and Freeway are currently not direct rivals, they decided to exchange information for the purposes of benchmarking. Ted Bell has since provided the following information about Freeway to the partners at Qualserve.

Freeway Consultants – key information

Total employees 8 (including 6 consultants)

	(20X9 – £m)	(20X5 – £m)
Total fee income	1.5	1.1
Profit after tax	0.4	0.2
Net assets (closing balance)	0.6	0.5

One of the consultants who left Qualserve two years ago, Helen Adams, joined Freeway as a senior manager. Feedback from Ms Adams is that she prefers Freeway's approach to serving client needs. Because Freeway is so small, the whole organisation can be dedicated to each and every client project. Ms Adams also values Freeway's emphasis on continuing professional development (CPD), which is not something that Qualserve feels to be important. Since its formation, no staff have left Freeway.

Freeway has also received two awards for outstanding customer service levels from the National Institute of Professional Services.

Requirements

Write a report for the partners at Qualserve which:

3.1 Includes a benchmarking analysis comparing the performance of Qualserve with that of Freeway, and uses the Balanced Scorecard as a framework for the analysis.

Note: There are up to 8 marks available for calculations in this requirement. **(20 marks)**

3.2 Advises the partners of Qualserve how they might best protect its strategic position, using Porter's 'five forces' model as a structure for your advice. **(8 marks)**

Total: 28 marks

4 Maltis Supermarkets

Maltis Supermarkets ('Maltis') is a large European multinational retail business. It operates four different types of store: supermarkets, hypermarkets, discount stores and convenience stores.

In the Maltis group, the characteristics of four different types of store can be described as follows:

Supermarkets are self-service stores which sell a wide variety of food, beverages and household consumables, such as washing and cleaning materials. Supermarkets also stock a variety of small household goods (such as cooking utensils).

Hypermarkets stock the same type of products as supermarkets but in addition also sell a wide range of electrical goods (eg, washing machines, refrigerators) and furniture. Many of the hypermarkets also offer a range of services including beauty treatments, hairdressing and optician services. The hypermarkets tend to be located on out of town sites.

Maltis sells the food and beverage products in its supermarkets and hypermarkets at a higher price than many of its competitors because it believes that its customers are prepared to pay higher prices for higher quality products.

Discount stores sell a variety of electrical appliances and electronic equipment. Although Maltis's discount stores sell branded products, they pursue a high-volume, low priced strategy, which means that customers can often buy electrical appliances more cheaply in the discount stores than in Maltis's own hypermarkets.

As well as offering lower prices than the hypermarkets, the discount stores also offer a greater range of electrical goods for customers to choose from. The discount stores specialise in the goods which they sell; something which the supermarkets and hypermarkets cannot do because of the range of different goods they offer.

Convenience stores are small stores in urban or residential areas which sell a relatively narrow range of goods which are purchased regularly by customers, such as groceries, confectionery, toiletries, and alcoholic and soft drinks. The range of products the convenience stores can offer is limited by the space available. Customers are willing to pay premium prices due to the convenience of the store, and the convenience stores charge higher prices for the same brands and products compared to Maltis's supermarkets.

Mission statement

The Management Commentary in Maltis's latest financial statements identifies that the Group intends to employ different generic competitive strategies depending on the market segments in which its stores are trading.

The Board has also produced the following mission statement for the Group:

> 'Maltis practises sustainable investment within an ethical culture and strives to achieve customer satisfaction by giving a courteous and efficient service, selling high quality goods at a reasonable price, sourcing goods from local suppliers where possible, and causing the least damage possible to the natural environment. We aim to satisfy our customers wherever we trade. By this, we aim to satisfy our shareholders by achieving consistent growth in our share price whilst also enhancing our reputation for being an environmentally responsible company.'

Corporate Social Responsibility (CSR)

Maltis has addressed its CSR obligation by establishing environmental targets for greenhouse gas emissions, and careful monitoring of its supply chain.

Supplies are sourced from the country in which a store is located as much as possible, but a number of products still have to be transported across long distances. Approximately 30% of the physical quantity of goods sold across the group are sourced from within the same country in which they are sold. These are usually perishable items such as fruit and vegetables. The remaining 70% of goods are sourced

from large international manufacturers and distributors, and tend to be large items such as electrical equipment.

Maltis aspires to become carbon neutral over the long term. The Board aims to reduce its carbon emissions by investing in state of the art technology in its new store developments, and by carrying out modifications to existing stores.

Sustainable trading

The Group Procurement Director has recently returned from a conference at which the key themes included social responsibility in the supply chain, and triple bottom line reporting.

Following his discussions at the conference with senior officials from other leading grocery retailers, the Director is concerned that the number of fair trade products which Maltis stocks is significantly lower than that for its competitors. He feels the same is also true of the number of organic food products stocked, and believes Maltis should take action to increase the number of fair trade and organic food products it stocks.

The Operations Director expressed the caution that fair trade and organic food products both tend to be more expensive than 'traditional' alternatives. He argued that, in the context of ongoing economic difficulties across Europe, it is important that Maltis maintains a competitive price point as well as a socially responsible image. He pointed out that whenever Maltis carries out customer surveys the factor which customers consistently rank most important is achieving 'Value for money' even though its prices are higher than many of its competitors. The surveys also indicate that Maltis's customers value shopping solutions which make their lives easier and more pleasurable, again that their decisions about where to shop are not based solely on price.

However, the Marketing Director highlighted that sales of Fair Trade coffee had increased by 5% overall across Europe in the past year, while sales of non-Fair Trade coffee have declined slightly. Recent surveys have indicated that European customers are choosing to buy Fair Trade produce because they feel it is a way they can help demonstrate 'a social conscience' and improve the living conditions for people living and working in what they perceive to be poorer parts of the world.

Therefore, the Marketing Director suggested that if Maltis promotes sales of Fair Trade it could demonstrate it is responding to customers' demand as well as being socially responsible. In this context, he suggested that Maltis could use its commitment to Fair Trade produce as an illustration of the way it is helping to promote sustainable development.

Recent publicity

In recent weeks there have been a number of negative comments on a consumer website arising from customers who have bought electrical products in Maltis's hypermarkets only to find they could have bought exactly the same goods in Maltis's own discount stores for a lower price. The general sentiment of the comments has been that consumers should avoid buying electrical products at Maltis's hypermarkets because their prices are not competitive.

The Marketing Director has expressed concern the impact this could have on the hypermarkets' reputation and sales; and as a result has proposed that the price of the electrical goods be reduced in the hypermarket to match those in the discount stores.

However, the Managing Director of the Hypermarkets division has argued against this idea. He believes that Maltis already sells its consumer durables at competitive prices in the hypermarkets, and that the majority of customers will be prepared to pay more for shopping in the hypermarket due to the range of the other food and household goods they can buy there, and the quality of those goods. In addition, he pointed out that Maltis deliberately charges a higher price for its food and beverages in its hypermarkets than many of its competitors do because its customers are prepared to pay higher prices for better quality goods.

The Managing Director continued that customers value solutions that make their lives easier and Maltis's hypermarkets provide this value by allowing them to buy a very wide range of products in one place.

The Corporate Affairs Director also reminded the other Directors that they had written in the Management Commentary of the Group's latest Financial Statements, that 'We intend to employ different generic competitive strategies depending on the market segment in which our stores trade.'

But, in a bitter exchange, the Marketing Director retorted: 'Our mission statement also says that 'We aim to satisfy our customers wherever we trade' but the comments on the website would seem to suggest that some of our customers are far from satisfied!'

Requirements

4.1 Analyse the generic strategies which Maltis has used for its stores, and evaluate the extent to which those strategies can help it achieve sustainable competitive advantage. **(15 marks)**

4.2 Discuss the extent to which the proposals to increase the number of Fair Trade and organic products that Maltis stocks will help it fulfil its mission statement. **(10 marks)**

4.3 Analyse the potential impact that the proposal to increase the number of Fair Trade products could have on Maltis' value chain. **(5 marks)**

Total: 30 marks

5 Bryant & Watson Advertising

Bryant & Watson Advertising (BWA) is an advertising agency based in a wealthy European country, Ostland. BWA operates out of three regional offices (Central, South and North) with its head office functions based in the South office. The business offers a wide range of advertising services, although they can be summarised into three types of service:

- Strategic: Advising on an overall advertising campaign (for example, the mix of advertising channels to be used in the campaign and its overall themes);
- Buying: Advising and buying advertising space (on television, radio, websites and in newspapers and magazines); and
- Creative: Designing and producing specific adverts for the customers' use.

BWA is one of the three largest and most successful agencies in Ostland. It has many years' experience and has won numerous awards for the advertising campaigns it has delivered.

Competition within the advertising market in Ostland is fierce, as advertising spending by businesses has suffered recently during the nationwide economic downturn. Most new business is won in tender competitions between different advertising agencies.

Ostland is a large country and economic conditions vary noticeably between different regions. There is also considerable diversity of markets and fashions across its regions. As a result, BWA's regional offices have developed with a considerable amount of decision-making autonomy. This autonomy also reflects the temperament of the key creative employees of the firm who have a strong attachment to their campaign ideas and take great personal pride in their success.

The individualism of the key employees also comes from the way that BWA has grown. The business has been built through acquisition of small, local businesses in each of the three regions. Each of these acquisitions has been consolidated into the appropriate regional office.

You are the Group accountant at BWA, and the Financial Controller has asked you to help her prepare this month's Board papers by analysing the current financial position of the three regional offices. Extracts from the most recent management accounts are shown in Appendix 1. The basic supporting calculations have already been accurately completed by one of the assistant accountants and the results are in Appendix 2, but the Financial Controller stressed that the Board papers need to provide an analysis of the results, rather than just repeating the figures from the accounts.

The Financial Controller also explained that the Board have expressed concern about how appropriate it is to use net income as the key performance measure for each of the regional offices. They have asked the Finance Department to suggest other measures, and to indicate why these measures might be appropriate.

The Board has suggested that it might be appropriate to use different key measures for each office, rather than using the same measures across all three offices. The Financial Controller has also indicated that controllability and responsibility accounting are important issues to consider, because they were discussed at the last Board meeting.

Additionally, the Financial Controller has passed on to you a request from the Board to comment on the company's remuneration policy at the regional offices, and the suitability of the performance measures being used to determine salaries and bonuses. To help you in this, the Financial Controller provided you with a note (see Appendix 3) describing the current remuneration policies by job type at BWA.

Requirements

Prepare the relevant extracts for a report to the board of BWA which:

5.1 Assesses the recent performance of the three regional offices by interpreting the data given in Appendices 1 and 2. **(10 marks)**

5.2 Evaluates the choice of net income as the performance measure for the regional offices and suggests other measures and why they are appropriate for each office. **(10 marks)**

5.3 Uses the information provided to evaluate BWA's remuneration policy, suggesting changes as appropriate. **(10 marks)**

Total: 30 marks

Appendix 1 – BWA financial data

The figures are drawn from the regional offices' management accounts for the year to 31 December 20X3.

	Central £m	South £m	North £m
Revenue	166	575	467
Cost of sales	50	162	159
Staff costs	58	213	145
Other costs	30	95	67
Operating profit	28	105	96
Allocated head office costs	7	34	16
Net income	21	71	80
Net cash flow in year	26	95	51
Current assets	24	90	131
Current liabilities	11	39	34
Capital expenditure	3	11	26
Capital employed	43	133	123

Notes

1 The data for each office is for the regional office only. It excludes any costs of the head office function based there other than the allocated costs listed.

2 Notional cost of capital at BWA is 9%.

3 Current assets contains only accounts receivable for each office.

Appendix 2 – Basic calculations

(These can be assumed to be calculated correctly.)

		Change on year		Margins		
		Dec-X3	Dec-X2	Dec-X3	Dec-X2	Dec-X1
Revenue						
	Central	–1.8%	–1.2%			
	South	1.0%	1.0%			
	North	9.0%	8.2%			
Cost of sales						
	Central			30.1%	30.2%	30.4%
	South			28.2%	29.1%	30.1%
	North			34.0%	31.8%	30.1%
Staff costs						
	Central			35.0%	35.0%	35.2%
	South			37.0%	37.0%	36.9%
	North			31.1%	31.1%	31.1%
Operating profit						
	Central	–7.0%	0.0%	16.9%	18.0%	17.7%
	South	8.1%	8.6%	18.3%	17.1%	16.0%
	North	5.6%	4.7%	20.4%	21.1%	21.7%
Net Income						
	Central	–4.9%	–4.6%	12.7%	13.5%	13.9%
	South	12.1%	13.7%	12.3%	11.2%	9.8%

	Change on year		Margins		
	Dec-X3	Dec-X2	Dec-X3	Dec-X2	Dec-X1
North	6.7%	5.6%	16.9%	17.3%	17.9%

Notes

1 Other costs and allocated head office costs are fixed.
2 Margins are calculated as a percentage of revenue.

		Dec-X3	Dec-X2	Dec-X1
Current ratio				
	Central	2.2	2.3	2.1
	South	2.3	2.3	2.4
	North	3.8	2.9	2.4
Receivable days				
	Central	53	56	55
	South	57	58	59
	North	93	69	54
ROCE	(based on operating profit)			
	Central	65%	86%	115%
	South	79%	90%	103%
	North	85%	105%	139%
	(based on net income)			
	Central	49%	64%	90%
	South	53%	58%	63%
	North	71%	87%	115%
Residual income (£m's)	(based on operating profit)			
	Central	24.1	26.6	28.2
	South	93.0	88.1	82.8
	North	93.9	91.3	89.4
	(based on net income)			
	Central	17.1	18.7	20.4
	South	59.0	54.1	48.8
	North	76.0	73.3	71.4

Appendix 3

Note on remuneration prepared by the Financial Controller:

There are broadly five grades of staff at each regional office. The following is an outline of their remuneration packages. (The head office staff are treated separately and are not part of this exercise.)

Senior management

All staff at this level are paid a basic fixed salary, which reflects industry norms over the last few years, plus a bonus dependent on the net income of their office.

Creative staff

Creative staff all have individual packages which reflect the market rates in order to recruit them at the time that they were recruited. Some staff receive a fixed salary only while some receive a package which includes a fixed element plus a bonus based on their office's revenues.

Buying staff

Buyers of advertising space are paid a fixed salary plus a bonus based on the prices for advertising space that they negotiate compared to the budgeted cost of space. The budget is set by the finance team at head office based on previous years' experience and their forecast for supply and demand in the year in question.

Account management staff

Account management staff handle relationships with existing clients and also develop business with new clients. They are paid a fixed market-based salary.

Administration staff

These staff are paid the market rate for their jobs as a fixed salary based on hours worked.

6 Tony Rossi

Tony Rossi was born in Italy, but has worked as a chef in the UK for many years.

In 20X1 he received a major inheritance, and in July 20X2 Tony used his inheritance money to buy a small warehouse located in Southern Italy and to lease land and machinery for the warehouse. He then began trading, by importing Italian food ingredients to the UK.

On 1 July 20X3, he leased land and built a distribution warehouse in the North West of England, using money borrowed from the bank.

Initially, Tony traded as Rossi Trading. However, sales grew significantly, and Rossi Trading was incorporated, as Italian Food Ingredients Ltd (IFI), on 1 July 20X5.

Recent issues

Last week Tony rang Bill Adams, a partner in Baxter & Badger LLP (BB), the firm of ICAEW Chartered Accountants and business advisers for whom you work. Tony sounded anxious when he opened the conversation.

'Bill, it's good to speak to you. I need your help. I just can't cope with the growth in my business. It's expanded too quickly for me to manage and control. Now I have a potential contract from a national supermarket chain, BetterBuys, which could increase sales further.

In addition, as all my ingredients are purchased from Italian suppliers, I am concerned about currency rate movements although I have benefited from the relative strength of sterling against the euro this year. In the year ended 30 June 20X6, I estimate that, on average, the £ was valued 5% higher than the euro, compared with the previous year ended 30 June 20X5. However, I am concerned that, in the future, currency rates might move against me.

I will send you some background notes for my business (**Exhibit 1**) and some financial and operating data (**Exhibit 2**).

I need your advice on two specific issues:

(1) Revenue is growing, but I seem to be making less profit each year. I would like you to prepare notes for me, analysing the available data and other information to explain why this is the case.

(2) I would also like your advice on whether to accept the contract from BetterBuys supermarket (**Exhibit 3**). I am concerned about the risks and wider strategic issues, as well as financial returns.'

Requirement

Prepare working notes to assist Bill Adams in replying to Tony Rossi. **Total: 28 marks**

Exhibit 1 – Business background – notes prepared by Tony Rossi

Given my knowledge of Italian food, culture and language, together with my experience of the UK restaurant market, I perceived there to be a gap in the market which I could satisfy by selling high quality, genuine Italian food to restaurants in the UK.

With my inheritance, I purchased a small warehouse in Southern Italy and entered into operating leases for land and machinery. This facility enabled me to purchase and package genuine Italian food ingredients (including pasta, sausages, cured meats and cheeses). A courier delivers these from Italy to my distribution warehouse in the North West of England three times a week. From there, the ingredients are delivered to restaurants within 100 kilometres of the distribution warehouse. IFI's marketing slogan is 'from Italy to restaurant table in 48 hours'.

IFI invested heavily in marketing expenditure to get the business established, and has kept a strong marketing team to maintain growth. I give every new customer my 'five-year promise': that selling prices will not increase for five years from their first order with my business. This has been really successful in attracting new customers and I hope it will enhance future performance.

IFI's policy is to sell at the same price to every customer. This has attracted small customers because they know that larger customers are not getting a better deal. This is my 'low prices, but no discounts' policy.

This business model has proved very successful but, in some senses, too successful. Demand has increased significantly and this has meant that some foods have had to be stored for 24 hours or more as IFI's operating capability cannot cope with some peaks in volumes demanded. Demand has also

spread beyond the original 100-kilometre radius from the distribution warehouse to about 150 kilometres, which has meant further delays in distribution.'

Exhibit 2 – Financial and operating data

Income statements for years ended 30 June

	Rossi Trading			IFI
				Draft
	20X3	20X4	20X5	20X6
	£'000	£'000	£'000	£'000
Revenue	4,200	5,600	7,600	10,000
Cost of sales (Note 1)	(2,650)	(3,800)	(5,600)	(7,600)
Marketing	(420)	(490)	(540)	(650)
Distribution	(500)	(580)	(670)	(870)
Administration	(50)	(60)	(90)	(200)
Interest	–	(140)	(200)	(220)
Profit before tax	580	530	500	460

Statement of financial position extracts at 30 June

	Rossi Trading			IFI
				Draft
	20X3	20X4	20X5	20X6
	£'000	£'000	£'000	£'000
PPE (Note 2)	3,800	5,500	5,200	4,900
Cash	10	50	80	2,100
Other current assets	210	520	1,140	1,750
Loan	–	(2,000)	(2,500)	(2,500)
Lease liability	–	–	–	(2,000)
Current liabilities	(250)	(300)	(380)	(430)
Net assets	3,770	3,770	3,540	3,820

Operating data for years ended 30 June

	Rossi Trading			IFI
	20X3	20X4	20X5	20X6
Number of suppliers	10	20	40	80
Number of customers	200	300	450	650
Number of products	20	35	60	90
Drawings or dividends	£400,000	£530,000	£730,000	£200,000

Notes

1 Cost of sales includes all depreciation on property, plant and equipment (PPE). All other cost of sales relates to production wages in Italy and purchases of ingredents from Italian suppliers.

2 The Italian warehouse was acquired for the euro equivalent of £4 million on 1 July 20X2. The UK distribution warehouse was acquired for £2 million on 1 July 20X3. All PPE is depreciated on a straight-line basis over 20 years with a zero residual value.

(3) The normal annual depreciation has been charged on the UK distribution warehouse for the year ended 30 June 20X6.

(4) All land and machinery is held under operating leases.

Exhibit 3 – Supermarket contract

An offer has recently been received from a national supermarket chain, BetterBuys, to purchase all its Italian sausages from IFI. The sausages would be packaged under the BetterBuys brand name. Volumes would be a minimum of 700,000 kilos per year for 2 years from 1 January 20X7 at an average price of £3 per kilo. This price is significantly lower than prices charged by IFI to restaurants for the same ingredients.

The estimated cost to IFI of purchasing and packaging the sausages per kilo would be:

Purchase and packaging in Italy (translated from euros):

	£
In 20X7	2.40
In 20X8	2.50
UK distribution (in £s in 20X7 and 20X8)	0.20

As a result of the BetterBuys contract, it is estimated that additional fixed costs of £200,000 would be incurred in 20X7, and £215,000 in 20X8.

7 Taywell

Taywell operates an estate agency business in England, arranging the sale of houses and other residential properties, as well as managing rental properties on behalf of private landlords.

Taywell has been in business for over 25 years, and has 12 offices located across the south of the country. It specialises in marketing and selling high value, exclusive residential properties.

In the last five years, the company has seen the number of its property sales steadily declining. Property sales across the industry as a whole have fallen over this period, although the majority of estate agents have seen the number of their property sales increasing over the last year.

Taywell's directors believe that the decline in its sales over the last five years has been due to the underlying economic climate in the country, with the downturn in the economy leading to a slowing down in residential property sales. The directors are confident that the decline in sales does not reflect any underlying problems within Taywell itself.

Taywell uses a standard software package which is widely used across the estate agency industry to manage enquiries from buyers, to arrange property viewings and for general marketing purposes. It also uses the software package to automatically match enquiries from buyers against the available properties in its database of properties. However, Taywell does not have a customer database to record customer information.

The company has a website on which it advertises all of its properties across the south of England. The website allows customers to view the basic property details, such as internal photographs and floor layout. In order to obtain more detailed information on each property, customers must contact one of Taywell's offices in order to be sent a printed version of the property details.

While some customers visit their local office in person, or telephone one of the agents, many use email to contact an office to request property details. The email system is also the main form of internal communication between Taywell's employees and is often used to transfer files from one office to another. The estate agency software package is not linked to the website. Therefore, if any changes are made to the information held on the estate agency software, this change has to be duplicated on the website. In the past this has led to customers viewing incorrect information on the website, because it had not been fully updated.

Until now, the level of investment in information technology at Taywell has been minimal, and the directors have not considered information technology to be a critical aspect of the business. The directors have never considered developing an e-business strategy because they believe that the main strategic priority is enhancing Taywell's reputation for high quality, face to face customer service. The Managing Director stated at the most recent board meeting that 'It is vital we retain our focus upon keeping our customers happy. Developing our website to sell our properties is merely a distraction from what we do, and from what our customers want.'

However, the Marketing Director is concerned that Taywell is not keeping up to date with technological developments and that the company should use its information systems more strategically. The Marketing Director has researched a large number of websites, including those of other estate agents and those of companies across a range of retail and service business. He has identified a range of Web 2.0 technologies which Taywell could use to improve its own website. The Marketing Director has also highlighted to the other directors a new technology development which enables potential home buyers to receive property details whilst viewing a property, by using location-based applications on their mobile phones or hand-held devices (such as iPads).

The Marketing Director is currently preparing a report for the other Directors, summarising the findings of his research, and outlining his belief Taywell could benefit significantly from developing an e-business

strategy. The Marketing Director has discussed his findings with you, and has asked you to help him to prepare his report.

Requirements

7.1 Briefly analyse the current and future strategic importance of information systems at Taywell, and explain why any decisions about the company's investment in information systems should be a strategic decision. **(9 marks)**

7.2 Analyse the benefits and problems of developing an e-business strategy for Taywell. **(8 marks)**

7.3 Recommend, with reasons, two different applications of Web 2.0 technology that Taywell could adopt. **(8 marks)**

Total: 25 marks

8 Martigate

Martigate is a quoted company. Its board comprises an equal number of both executive and non-executive directors. The company has a remuneration committee, comprised entirely of non-executive directors.

A major institutional investor in Martigate has written to the chair of the remuneration committee to raise some concerns about the manner in which the performance of Martigate's executive directors is controlled and rewarded.

At present, each of the executive directors receives a fairly substantial fixed annual salary combined with options granted under an executive share option scheme. The executive share option scheme (ESOS) is designed in order to align the directors' interests with those of the shareholders.

The remuneration committee reviews each director's performance during the financial year and grants a number of share options in accordance with performance.

The options are issued 'at the money' (that is, the exercise price is the same as the market price) so that the directors have an incentive to increase the share price. The options can only be exercised on a specified date that falls three years after their issue. If a director leaves the company then any outstanding options will lapse without compensation.

The institutional investor has expressed concern about the ESOS arrangement because of the underlying financial implications of the scheme. Martigate first introduced ESOSs in order to motivate the executive directors to act in the shareholders' interests and the following points were highlighted in support of the scheme:

- If the directors work towards maximising Martigate's share price, then the options will provide higher returns if they are in the money when they come due for exercise.
- Martigate's directors are much less likely to reject investment opportunities with positive net present values if they hold options.
- The directors are normally more risk averse than the shareholders when it comes to project appraisal, but holding options makes risk-taking more appealing.

However, the institutional investor is concerned that the options may have encouraged dysfunctional behaviour by the directors, although the investor has pointed out that it is difficult to be certain about this because of the limited information which is available to the shareholders.

The institutional investor has suggested that the executive directors should be rewarded with a simpler scheme, such as an annual profit-related bonus. At present, it is unclear whether the reward system in place provides the executive directors with meaningful feedback on their performance. As a shareholder, the investor wishes to see a clearer link between the directors' performance and their remuneration.

Requirements

8.1 Explain why the introduction of ESOSs could motivate Martigate's executive directors to accept positive net present value (NPV) projects. **(6 marks)**

8.2 Explain how an ESOS scheme could affect the actions taken by the directors (other than project appraisal decisions). **(6 marks)**

8.3 Evaluate the advantages and disadvantages of rewarding executive directors by paying a bonus based on a simple and transparent measure such as profit. **(8 marks)**

Total: 20 marks

9 Fonezone

Fonezone Ltd ('Fonezone') is the leading retailer of mobile telephones in its country. The company has over 100 branches, with at least 1 branch in every major town and city. Some branches are located within easy walking distance of one another.

Fonezone has a highly aggressive management team. The management team views sales growth as the key to the company's continuing success, and believes that increasing Fonezone's share of the retail market will enable it to negotiate large discounts from manufacturers and network providers. The management team also believes that Fonezone's growth will create economies of scale in the advertising and promotion of the company and its services.

Three years ago the directors abandoned traditional budgeting and target setting. They decided that budgets did not necessarily give branch staff a sufficient incentive to maximise sales, because staff tended to work towards achieving but not surpassing sales targets. Subsequently, the directors introduced a new management control system with the following features:

- Shop sales are recorded using electronic point of sales (EPoS) cash registers that are linked to head office. Every sale indicates the branch and the member of staff responsible for the sale. These transactions are recorded in real time during the course of the day.
- A terminal in every shop lists a running total of that shop's sales for the day, analysed between each member of sales staff. The terminal also indicates the shop's ranking for the day relative to all of Fonezone's other shops.
- Every shop manager must be at work at least an hour before the shop opens. During that hour the manager receives a telephone call from the regional sales manager to discuss the previous day's sales and likely sales during the day ahead.
- Each shop manager is permitted considerable freedom to introduce special offers and promotions, subject to achieving an acceptable margin on each sale made.
- At the end of every week the manager and staff of the five shops with the highest sales are given a substantial bonus. The manager and staff at the five shops with the poorest sales are given one week's notice to improve or they face being moved to other shops or even being dismissed.
- Sales have grown rapidly since this system was introduced, although the rate of growth has been declining recently.

The Human Resources Director has been investigating staff turnover rates and levels of staff absenteeism. She has discovered that many of Fonezone's branch managers and sales staff have been with the company for several years. They seem to thrive in the competitive environment and the company pays staff with good sales records a substantial salary compared with other retailers. However, Fonezone also suffers a high staff turnover every year and some members of staff are frequently absent for health reasons, with their doctors certifying them as ill due to stress-related conditions.

One of Fonezone's non-executive directors, who has recently joined the Board, is concerned that the company's management control systems are unethical. The director is an ICAEW member, and has provided the board with extracts from ICAEW's *Code of Ethics* to substantiate the basis of his concerns.

Requirements

9.1 Discuss the operational risks that could arise as a result of the new management control system. Your discussion should include the potential risks associated with this new system. **(12 marks)**

9.2 Advise Fonezone's directors on the ethical implications of their approach to personnel management. **(8 marks)**

Total: 20 marks

10 Stored for You plc

Stored for You plc is a warehousing and distribution company that has been in existence for 50 years. Its original aim was to provide additional storage facilities to companies that did not want to invest in huge warehouses but required space for partially completed orders to be stored. Once the orders were complete, the companies would then package and ship them to their final destinations.

During the last 20 years, Stored for You has offered the additional service of packaging the goods for their customers. The company prides itself on being at the top end of the market for service and now attracts not only manufacturing companies, but also multinational companies with employees being sent abroad on secondment. Stored for You provides a full storage and packing service for employees' furniture and personal effects.

Whilst Stored for You's customers tend to be from the top end of the market, they are increasingly looking for value for money, particularly in the current challenging economic climate. Other competitors have been steadily coming into the market, some of which are targeting Stored for You's market segment.

In a bid to offer more competitive pricing, but at the same time maintain the high quality of service, Stored for You is considering changing to an activity based costing approach to charging overheads to particular customers. The directors believe that this technique will lead to more accurate allocation of overheads which will in turn allow them to improve their pricing structure.

Annual costs

The following information is available about Stored for You's annual costs:

	£'000
Packaging materials	4,875
Indirect labour – basic	875
– overtime	75
Annual rental of premises	1,250
Administration	150

Work centres

Indirect labour and overheads can be attributed to three different work centres – inspection, storage and packaging – in the following proportions:

	Inspection	**Storage**	**Packaging**
Indirect labour – basic	0.20	0.15	0.65
– overtime	0.65	0.10	0.25
Premises	0.15	0.70	0.15
Administration	0.45	0.05	0.50

Packaging materials are 100% attributed to the packaging work centre.

Fragility

Observation and experience have shown that the fragility of goods affects inspection time for each customer. Storage space is not affected by fragility but depends – quite logically – on the dimensions of the goods being stored. Packaging is affected by the complexity and fragility of the goods being wrapped.

The exact impact of fragility on inspection and packaging costs has not been calculated.

Cost drivers

The cost drivers for each of the costs have been established as follows:

Cost	Cost driver
Inspection	Number of items to be inspected
Storage	Number of cubic metres
Packaging	Number of packages

Volume of work during the year

During the last year, Stored for You handled the following volume of work:

Number of items inspected	160,000
Number of packages	100,000
Total storage space available was	250,000 cubic metres

Technology Talks plc

Technology Talks plc is a major customer of Stored for You and during the last year had 50,000 cubic metres of goods inspected, stored and packaged. This amounted to 20,000 items packaged into 10,000 packages.

Requirements

10.1 Using activity based costing, calculate the amount to be charged to Technology Talks for the last year. **(7 marks)**

10.2 Explain how activity based costing may be used in a service industry to improve decision-making and profitability. **(10 marks)**

10.3 Discuss the main factors that Stored for You should consider when setting prices for its customers. **(8 marks)**

Total: 25 marks

11 ACE Ltd

ACE Ltd is a UK based trading company. It has several branches worldwide: England (head office), Ireland, Germany, Canada, Malaysia, Nigeria and Australia.

ACE currently does not hedge although the new financial controller is keen to do so in order to address the risks facing the business. He has constructed the following illustration to show how currency hedging actually works.

Transaction: cash receipt due in three months' time (in December) of US $326,000

London Market $/£ exchange rates

Spot	1.2635 – 1.2685
Three months forward	0.35 – 0.30 cents premium

Annual three month interest rates

	Borrowing	Lending
Sterling	6.5%	4.2%
Dollars	6%	3%

Philadelphia Stock Exchange

December Sterling options. Standard size of contracts £31,250.

(Premium quoted in cents per £1)

Exercise price $/£	Calls	Puts
1.25	2.77	0.81
1.26	2.17	1.06
1.27	1.61	1.50
1.28	1.16	2.05

Requirements

11.1 Suggest reasons why ACE may not need to undertake any hedging activities. **(4 marks)**

11.2 Discuss three forms of hedging that might be beneficial to ACE. You should give an advantage and disadvantage of each method and comment on whether this would be an appropriate method for ACE to adopt.

(You do not need to comment on hedge accounting per IAS 39 or IFRS 9.) **(6 marks)**

11.3 (a) Calculate the net sterling receipts that the company might expect for its transaction if it hedges its exchange risk on the forward foreign exchange market. **(2 marks)**

(b) Explain how the company can use the money market to hedge its exchange risk exposure on the receipt of $326,000 in 3 months' time and calculate the effective 3 month exchange rate it will achieve. **(4 marks)**

(c) The company decides to use traded options to hedge its exposure on its three month receipt. What will be its total net sterling receipts if it buys options at 1.27 but the actual exchange rate in 3 months' time turns out to be 1.30? **(4 marks)**

11.4 Explain how the financial controller might make use of interest rate hedges. **(5 marks)**

Total: 25 marks

12 Try-it plc

Try-it plc is a listed company which sells do-it-yourself products through large retail outlets throughout Ruritania. The company has been on the lookout for some time for investment opportunities and has finally found a small chain of DIY stores that it believes will fit in with the company's profile. Try-it plc may also consider taking over one of its own suppliers of hardware in order to reduce costs and provide a better price to its customers.

In order to appraise these expansion plans Try-it needs to establish the correct cost of capital to use.

The company is currently financed as follows:

	R£	Market value
Share capital – 1,000,000 shares of 50p nominal value	500,000	80p
Redeemable debt – 6% loan stock £100 nominal value	500,000	R£97 per £100 cum int
Irredeemable debt – 7% £100 nominal value	250,000	R£85 per £100 ex int

The redeemable debt is to be redeemed in four years' time at a premium of R£2 per R£100 nominal and interest is paid annually on 31 December. Corporation tax is 23%.

The risk free rate is 5% and the current market rate of return is 12%. The company is believed to have a β of 1.6. Current dividends, which have just been paid, are 10p per share with an expected annual growth rate of 5%.

Some discussion has arisen at a recent board meeting about financial reconstruction and refinancing. The board believes that the company should raise more debt finance both to replace its short-term loan and to take advantage of the investment opportunities. The board believes that bonds would be the best method of raising this debt. However the directors are concerned about the risks of taking out finance for a period of a number of years, and want to see risk measured using a method that takes into account the length of a bond's life.

You are the finance director's assistant and these items have been passed on for you to deal with.

Requirements

12.1 Calculate the WACC for the company using (a) CAPM and (b) the dividend valuation model. Explain why the cost of equity may differ between these two methods. **(10 marks)**

12.2 Write some briefing notes explaining the difference between financial reconstruction and refinancing and discuss whether the issuing of bonds by Try-it plc would be considered to be financial reconstruction or refinancing. **(6 marks)**

12.3 Explain the concept of duration and how sensitivity to interest rate risk is reflected in the duration calculation. **(5 marks)**

12.4 Explain the importance of pecking order theory in the context of the refinancing decision. **(4 marks)**

Note: Ignore any tax on the redemption premium. **Total: 25 marks**

13 PizzaClub plc

PizzaClub plc (PizzaClub) is a large international catering company that specialises in pizza delivery. Its outlets have small self-service pizza and pasta cafe facilities, but its main business is summed up in its slogan 'Pizzas delivered to your door, or for pick-up, FAST'. It boasts that it 'has outlets in all major cities worldwide as well as a large number of smaller outlets in most major towns'.

PizzaClub is constantly on the look out for potential acquisitions that will improve its network and at the moment is considering its UK operations. With this in mind it has targeted a small chain of pizza restaurants, Maria's Pizzas, that offers a takeaway and delivery service in an area where there are currently very few PizzaClub outlets.

PizzaClub has approached the owners of Maria's who seem keen to realise their investment. PizzaClub would be able to finance this acquisition through currently available funds as this is a relatively small acquisition for the company.

Since Maria's is not a listed company PizzaClub is researching a realistic valuation for the company. Maria's has also employed a consultant to help ensure that the business is not undervalued.

PizzaClub: 31 December 20X8

Issued share capital (50p ordinary shares)	£2,645,000
Net assets	£7,250,000
EPS (pence)	21
Dividend per share (pence)	16
Debt: equity	1:1.25
Share price (pence)	216
Gross dividend yield for the sector	10%

Maria's: 31 December

	20X8	**20X7**
	£'000	**£'000**
Profit after tax	140	120
Dividends	(50)	(50)
	90	70
Statement of financial position		
Non-current assets	450	415
Working capital	130	75
	580	490
Share capital (£1 ordinary shares)	50	50
Retained earnings	530	440
	580	490

The non-current assets of Maria's have been included at their carrying amount. A more realistic fair value for these assets would be £300,000 and this has been agreed by the owners of Maria's. Maria's current dividend growth is zero.

The β of the equities in the sector is around 0.7, the return on the market index is 11.2% and the risk free rate is 4.6%.

Requirements

13.1 Calculate the total equity valuation and value per share of Maria's using three different valuation methods. Comment on each of the methods used and indicate whether the share price obtained is realistic. **(11 marks)**

13.2 Using your solution from requirement 13.1, discuss whether it will be possible to arrive at a share price that will be acceptable to all parties. **(8 marks)**

13.3 Discuss the additional factors that would need to be considered by the parties if PizzaClub's offer were to be in PizzaClub shares rather than cash only and for a majority holding of, say, 70% of Maria's share capital. **(6 marks)**

Total: 25 marks

14 Rocky Road Institute

Rocky Road Institute (RRI) is an established provider of professional education in the English speaking country of Tarant. The privately owned institute competes effectively with publicly owned universities and colleges, although its competitors – being on a much larger scale – offer a wider range of courses. Whilst RRI is a profit-making organisation, it enjoys educational trust status and thus exemption from taxation in Tarant. The currency in Tarant is the Tarant £ (T£).

Whilst RRI is performing strongly in the professional education market, its new Principal is keen to pursue an aggressive expansion strategy with the long-term aim of offering a more extensive suite of courses. As a starting point, breaking into international markets is being considered, although this has met with some resistance from current staff who have voiced their preference for domestic expansion first. There are only sufficient financial and non-financial resources for one expansion project.

The following investment opportunities have been identified.

Plan A – New campus in an Asia-Pacific country (Apac)

RRI attracts many students from Apac hence the identification of a potential permanent investment in a new campus in that country. Apac is a developing country whose government is very keen to attract investment from overseas, although it would require some involvement in the project. For example, course content would have to be approved by the government before the course could be offered.

There is currently an ideal site available for long-term lease, with an option to take over ownership in 20 years' time. The contract allows 'get out' clauses at five-yearly intervals, at which points either party may terminate the agreement. However if RRI terminated the contract there would be no refund of the lease payment.

Teaching responsibilities would be split between local tutors and tutors from Tarant who will be seconded to Apac on two year contracts (with the option to extend for another year).

Whilst opening a new international campus would enhance RRI's profile and reputation, the main disadvantage of this project is exposure to foreign currency risk. Apac students would not want to pay fees in Tarant £ but would be prepared to pay in US dollars as this currency is widely used in Apac. RRI could also pay all expenses arising in Apac – with the exception of capital expenditure – in US dollars.

Plan B – New campus in Tarant

The current campus has insufficient space for the planned increase in courses offered therefore a new campus will be needed. Whilst there is no space for expanding the current campus, there is a suitable site a few miles away that would allow for the construction of additional facilities. At the moment, RRI is negotiating with the current owner of the site and is seeking planning permission from the local council. A grant would be available for the development of the site, although the extent of this grant (or the outcome of the planning application) will not be known for six months.

The main benefit to RRI from developing this site will be its proximity to a major business park and it is hoping to exploit the potential part-time student market there. Initial research has shown that fee income would be considerably enhanced as a result, and this increase is reflected in the figures below. As the location is very lucrative, there has been considerable interest from other parties who are also keen to develop the site. To demonstrate its interest, RRI has agreed to pay a non-refundable deposit of T£125,000, pending the outcome of the investment appraisal. This is enough to reserve the site for six months, after which the seller requires a firm decision.

The main disadvantage from this project would be the travelling time and cost for the existing staff.

Financial analysis for both plans

Fees

	Year 1	Year 2	Year 3
Plan A (US$'000)	11,625	13,375	16,125
Plan B (T£'000)	4,375	5,625	6,750

Capital expenditure

	Plan A Apac$'000	Plan B T£'000
Freehold cost of land		15,000
Fixtures and equipment	10,000	2,500
Purchase of lease	50,000	
Construction costs	25,000	7,500

Freehold land is not depreciated. Buildings, fixtures and equipment in Plan B will be depreciated over 25 years. The total capital costs in Plan A will be written off over the period of the lease.

Other information

(a) Fees and costs in Plan B are expected to increase by 3% per annum indefinitely from Year 4 onwards. This equates to the rate of inflation in Tarant.

(b) Current spot rates are T£1 = Apac $7 and T£1 = US$1.75. The T£ is expected to strengthen against the US$ by approximately 0.8% per annum until Year 3.

(c) There is no official interest rate and no published inflation rate in Apac. For convenience therefore RRI is assuming that Plan A fees (in T£ terms) will remain constant in nominal terms until Year 20.

(d) Annual cash operating costs are expected to be 55% of annual fees for both plans.

(e) RRI has spent T£25,000 on a survey of the available land a few miles from its current site. The institute has also spent T£50,000 on consultants' fees for the proposed international investment.

(f) RRI has estimated that it will lose T£625,000 per annum in fee income from existing courses if it sets up a campus in Apac.

(g) If a new campus is developed in Tarant (Plan B) it is estimated that the time and money spent on tutors travelling between campuses will be 1.5% of fee income each year.

(h) RRI estimates that a cost of capital of 14% is appropriate for the investment in Tarant (Plan B) whilst the increased risk of Plan A warrants a cost of capital of 18%.

(i) Assume all cash flows occur at the year end and that all capital outlays occur at the start of Year 1 of the project.

(j) The Apac $50m for the purchase of the lease in Plan A is a one-off, up-front payment to cover the duration of the lease.

Requirements

14.1 Evaluate both plans using the net present value (NPV) approach and on the basis of your results recommend which plan RRI should choose. **(16 marks)**

14.2 Suggest other factors that RRI should consider prior to making a final decision. **(8 marks)**

Total: 24 marks

15 BST Motors Co

BST Motors Co (BST) is a long-established listed company. Its main business is the retailing of new and used motor cars and the provision of after-sales service. It has sales outlets in most of the major towns and cities in the country. It also owns a substantial amount of land and property that it has acquired over the years, much of which it rents or leases on medium to long-term agreements. Approximately 80% of its net current asset value is land and buildings.

The company has grown organically for the last few years but is now considering expanding by acquisition.

SM owns a number of car showrooms in wealthy, semi-rural locations. All of these showrooms operate the franchise of a well-known major motor manufacturer. SM is a long-established private company with the majority of shares owned by the founding family, many of whom still work for the company. The

major shareholders are now considering selling the business if a suitable price can be agreed. The managing director of SM, who is a major shareholder, has approached BST to see if they would be interested in buying SM. He has implied that holders of up to 50% of SM's shares might be willing to accept BST shares as part of the deal.

The forecast earnings of BST for the next financial year are £35 million. According to the managing director of SM, his company's earnings are expected to be £4 million for the next financial year.

Financial statistics and other information on BST and SM are shown below:

	BST	SM
Shares in issue (millions)	25	1.5
Earnings per share (pence)	112.5	153
Dividend per share (pence)	50.6	100
Share price (pence)	1237	N/A
Net asset value attributable to equity (£m)	350	45
Debt ratio (outstanding debt as percentage of total market value of company)	20	0
Forecast growth rate percentage (constant, annualised)	4	5
Cost of equity	9%	N/A

SM does not calculate a cost of equity, but the industry average for similar companies is 10%.

Requirements

Assume you are a financial manager working with BST. Advise the BST board on the following issues in connection with a possible bid for SM.

15.1 Methods of valuation that might be appropriate and a range of valuations for SM within which BST should be prepared to negotiate. **(9 marks)**

15.2 The financial factors relating to both companies that might affect the bid. **(9 marks)**

15.3 Explain the practical considerations in the valuation of shares and businesses. **(7 marks)**

Total: 25 marks

16 Holt plc

Holt plc sells its products in two distinct and separate markets – known within Holt as 'North' and 'South'.

Sales for the forthcoming year are expected to amount to £1.2 million, spread evenly throughout the year, and to be split 40% North and 60% South. All sales are on credit and the variable cost of Holt's products is 80% of sales price. It is expected that North's customers will take an average 72 days credit whereas South's will take an average of 50 days; no bad debts are expected.

A change in the level of advertising would both increase total invoiced sales for the year by 20% and change the mix of sales to 60% North and 40% South. This increase in sales would be achieved without alteration to inventory levels or payables. However, such a change would increase the period of credit taken and cause bad debts to occur. Consideration is therefore being given to the introduction of a 3% cash discount for payment within 30 days with net terms for payment in 50 days. The expected pattern of receipts, both with and without the introduction of cash discounts, for the new level of sales is:

	% of sales taking exact number of days credit			
	No cash discounts		Cash discounts	
Exact number of days credit taken	**North**	**South**	**North**	**South**
	%	%	%	%
30	10	8	60	30
60	20	10	–	8
90	68	80	39	60
Bad debts	2	2	1	2

However, for both North and South only 2/3 of those paying in 30 days will in fact take the cash discount.

Short term finance is readily available at a cost of 11% per annum.

Assume a 360 day year.

Requirements

16.1 Ignoring the introduction of cash discounts, determine:

(a) The effect of the introduction of the advertising campaign on Holt's receivables position net of bad debts.

(b) The maximum amount it would be worth paying for the advertising campaign, based on the contribution from the increase in sales and the total costs associated with the increase in receivables. **(10 marks)**

16.2 Assuming the advertising campaign is undertaken and the new sales levels are achieved, for North and South separately, determine the net annual benefit or cost from the application of the cash discount terms by:

(a) Calculating the reduction in receivables that will occur when the cash discounts are introduced.

(b) Calculating the savings associated with the discounts.

(c) Calculating the cost of the discounts.

(d) Calculating the net benefit or cost from the application of the discounts. **(8 marks)**

16.3 Outline and explain the importance of the main factors to be considered in determining the method of financing the working capital requirements of a growing, but seasonal, firm.

Specify three potentially suitable types of short- or medium-term finance which may assist in the financing of working capital requirements and outline the merits, disadvantages and risk of each. **(7 marks)**

Total: 25 marks

17 Nestlehoff Restaurants

'It's Nigel here. I need your advice. Can we meet tomorrow at your office to discuss some issues that have arisen?'

Nigel Nestlehoff, a celebrity chef and chief executive of Nestlehoff Restaurants Ltd (NR), was making a telephone call to Jason James, a partner in Phillips & Potter LLP (PP), a firm of ICAEW Chartered Accountants. You work as a senior in the PP business advisory and assurance section. NR is a client of PP, but not an audit client. Jason agreed to the meeting and asked you to join him.

The meeting

Nigel opened the meeting. 'I have provided notes on the company's background (**Exhibit 1**).

'I own six restaurants and have a further eight franchised under the NR brand name. I need to analyse and compare the performance of owned and franchised restaurants in order to help me plan NR's future expansion. I have provided you with some financial and operating data (**Exhibit 2**).

'In order to expand, I need to raise new finance. Harmonds Bank has suggested two alternative financing arrangements: a sale and leaseback or a bank loan (**Exhibit 3**). I need your advice and I would also like to understand the impact of the sale and leaseback on NR's financial statements.

'Additionally, I believe that some franchisees are understating revenue to avoid paying the full franchise fees. I would like PP to outline the controls that could be implemented to give assurance that the revenue of franchisees is fully stated. I have provided details (**Exhibit 4**).'

Instructions

Immediately after the meeting, Jason emailed you the following instructions:

(1) Analyse and compare the performance of: (a) owned restaurants; and (b) franchised restaurants, over the three-year period 20X2 to 20X4.

(2) In respect of future financing for expansion (Exhibit 3):

- Compare the proposed sale and leaseback arrangement with a bank loan, based on the information provided. I do not need detailed calculations at this stage.
- Explain, including calculations, the future financial reporting treatment of the sale and leaseback proposal offered by Harmonds Bank.

(3) Explain the controls that should be established to prevent and detect material understatement of revenues by franchisees who may be trying to avoid paying part of the 15% franchise fee (Exhibit 4).

I do not want you to consider tax at this stage.

Requirement

Respond to the instructions from the engagement partner, Jason.

Note: Assume it is now July 20X5.

Total: 25 marks

Exhibit 1: Background notes – prepared by Nigel Nestlehoff

Company history

On 1 January 20X2, NR purchased and set up 6 restaurants at a cost of £500,000 each. On the same date, NR also set up and franchised a further 2 restaurants.

Purchasing the six restaurants used up all my initial funding and, in retrospect, I think this was a mistake. All of the restaurants I have opened since have been franchised. All the owned and franchised restaurants are approximately the same size.

When the company was first launched, I visited all the restaurants regularly but, as the business has grown, more of my time has been spent on managerial duties, which has meant less contact time with customers and franchisees.

I estimate that the average occupancy of all the restaurants is currently about 55% of capacity, although this varies significantly between days of the week.

All restaurants are located in the UK.

The franchise arrangements

The cost of setting up franchised restaurants is shared equally between NR and the franchisee. The average total cost of setting up a restaurant, including purchasing the premises, is £500,000.

From the beginning of 20X3, NR financed its share of the cost of purchasing and setting up the restaurant premises for franchised restaurants by bank borrowing. Franchises are all set up in January of each year.

NR charges each franchisee a fixed annual franchise fee of £20,000 and a further variable annual franchise fee of 15% of the franchisee's total annual revenue. In return, the franchisee is allowed to operate using the NR brand name and to benefit from advertising and operational support.

The franchisee benefits from a brand name which has high levels of recognition throughout the UK. Franchisees are required to abide by the terms of the franchise arrangement so that NR can protect its reputation.

Franchisees can charge any prices they wish to customers above an agreed minimum price, but must use the NR standard menu.

The franchise arrangement requires franchisees to make their premises and accounting records available to inspection by NR staff.

Exhibit 2: Financial and operating data – prepared by NR accountant

Management accounts - Operating data for years ended 31 December

Owned restaurants

	20X2	20X3	20X4
Total number of owned restaurants	6	6	6
	£	£	£
Revenue	1,500,000	1,470,000	1,410,000
Operating profit	240,000	190,000	90,000

Franchised restaurants

Total number of franchised restaurants	2	5	8

Revenue for NR:	£	£	£
Fixed fees received	40,000	100,000	160,000
15% variable fees	54,000	142,500	240,000
Costs to NR of running franchises	(80,000)	(200,000)	(320,000)
Operating profit from franchises	14,000	42,500	80,000

Management accounts - summary statement of financial position at 31 December 20X4

	Notes	Total
		£'000
Non-current assets	1	7,300
Current assets		1,900
Total assets		9,200
Equity		4,500
Non-current liabilities		
Bank loan – Harmonds Bank	2	4,200
Current liabilities		500
Total equity and liabilities		9,200

Notes

1 Non-current assets comprise: owned restaurants; NR's share of the cost of setting up franchised restaurants; a head office; and restaurant fittings and equipment.

2 The bank loan is from Harmonds Bank, redeemable in five years' time (20Y0), and charged at an annual rate of interest of 10%.

Exhibit 3: Financing arrangements

The bank has proposed two alternative financing arrangements.

Sale and leaseback

The six owned restaurant properties would be subject to a 10-year sale and leaseback agreement, under a single contract with Harmonds Bank, with effect from 31 December 20X5.

At 31 December 20X5, the total fair value of all 6 restaurant properties is estimated to be £3.6 million, and their carrying amount is £2.8 million. The 6 restaurant properties originally cost a total of £3 million.

The restaurant properties will have a remaining useful life of 36 years at 31 December 20X5, and are being depreciated in total at £75,000 per annum.

Under the terms of the sale and leaseback agreement, on 1 January 20X6 Harmonds Bank would pay NR a total cash sum of £4 million for the 6 restaurant properties.

Lease rentals payable by NR to Harmonds Bank would be £565,000 per annum for 10 years, payable annually in arrears. Market rentals for similar properties are about £450,000 per annum.

Harmonds Bank would take over the properties at the end of the lease period, at which time they are expected to have a fair value of about £2.5 million.

The implicit annual interest rate of the sale and leaseback arrangement is 12%.

Loan

As an alternative to a sale and leaseback arrangement, Harmonds Bank would make a 10-year, 10% fixed rate loan of £4 million to NR. The loan would be drawn down on 31 December 20X5. Interest is payable annually in arrears. The loan would be secured with a fixed charge over the owned restaurants and a floating charge over all other NR assets.

Exhibit 4: Controls over income from franchisees - prepared by Nigel Nestlehoff

I am concerned that franchisees have the incentive to understate the revenues declared to NR in order to reduce the total amount of the 15% variable element of the franchise fee that they pay to NR.

NR does not have the control mechanisms to prevent or detect the potential understatement of revenue by franchisees with any degree of certainty. The only formal system we have is that franchisees report monthly sales, with supporting analysis of daily sales.

We visit franchisees' premises occasionally, but we have no formal programme of procedures to detect unrecorded sales.

Other than these occasional visits, we have few controls over the recording of sales by franchisees.

18 Silver Spoon Serving plc

Note: Assume that the current date is 7 November 20X5.

Silver Spoon Serving plc ('SSS') is a listed company which manufactures silver cutlery and other tableware made from silver. You work for the auditors of SSS, but you are currently on secondment to the corporate finance department of SSS. The company has a 31 December accounting year end.

The chief executive, Tiger Irons, asked you into his office and came straight to the point:

'Our finance director is ill at the moment and there are two significant transactions that we are looking at entering into. I therefore need your help in analysing the issues associated with these transactions.

Silver contract

'An international group of hotels, Handals, which is based in Germany, is proposing to make a significant purchase from us of new silver cutlery and tableware for a fixed price, denominated in euros, of €15 million. The goods would contain the Handals logo, which would be cut into every item. Part of this order is for the hotels' own use and partly for them to sell to their customers from in hotel shops.

'Delivery would not be until 30 November 20X6 but the contract needs to be signed before the end of November 20X5. Cash settlement from Handals would be at the end of January 20X7. I expect that products sold under the Handals contract would take about three months to manufacture, so I would not expect to start work on this order until late August 20X6. Given our other commitments, we will be working at full capacity in this three-month period. We would probably purchase, and pay for, the silver for manufacturing the order at the end of July 20X6. Silver commodity markets are settled in US$.

'Frankly I am worried. Silver prices are volatile and we have several different currencies involved here. I am attaching a schedule of contract estimates (see **Exhibit 1**) and they show we can make a profit at today's prices and exchange rates, but who knows what will happen by the time we need to deliver the goods.

'What I would like you to do is prepare a memorandum for me setting out all the key risks of the contract and also assess the financial reporting issues arising from the contract for each of the years affected. Assume, for this purpose, that there is no hedging or other attempt to manage the risk.

'I would then like you to explain key potential hedging strategies which could reduce, or eliminate, risks and identify the financial reporting issues arising from these hedging strategies for all years affected by the contract.

Sale and leaseback arrangement

'A small factory which we own is almost certainly going to be sold under a sale and leaseback agreement to a property development company. We are happy to do this because our plan is to move this production to different premises in late 20X8 or early 20X9. At this point, the building will be demolished. The current market value of these premises is approximately £2 million and they are shown at £1.7 million in our accounts at the moment.

'The property developer has offered us two options (details are in **Exhibit 2**) and we need to make a decision fairly quickly, so I would like you to summarise the effect on the financial statements of each option over three years and suggest which of the two options is better for us in financial terms. Both options allow us to occupy the premises for the next three years but on different terms.

'We have already obtained an estimate of a market rate for renting these premises which is £175,000 per year.'

Exhibit 1 – Contract estimates

	Amount	Today's exchange rate
Contract price	€15m	€/£ 1.12
Cost of silver	$14.4m	$/£ 1.25
Other variable costs	£1m	

The budgeted profit is £0.87 million.

Notes:

1 The mid-market spot price of silver is currently US$7.2 per troy ounce. The contract requires 2 million troy ounces.

2 The 9-month futures quote on silver per troy ounce is:

Spot (US$)	7.199	– 7.201
9 months	0.11	– 0.13 cents discount

3 SSS's functional currency is the £.

Exhibit 2 – Sale and leaseback details

Option A

Purchase price: £1,925,000
Annual rental payments in arrears: £150,000
Option for us to vacate early after the first 12 months by giving 6 months' notice.

Option B

Purchase price: £2,150,000
Annual rental payments in arrears: £245,000
No option to vacate early.

Instructions

Immediately after your meeting, Tiger emailed you to confirm the action points arising from your discussion with him.

I would like you to prepare a memorandum which does the following:

(1) Analyses the key risks arising from the Handals contract, and assesses the financial reporting issues arising from the contract for each of the years affected (assuming we do not implement any hedging strategies)

(2) Explains potential hedging strategies which could reduce, or eliminate the risks arising from the Handals contract, and identify the financial reporting issues arising from those hedging strategies

(3) Summarise the effect on the financial statements of the two sale and leaseback options we have been offered by the property developer, and advise which option is better for us in financial terms.

Requirement

Prepare the memorandum requested by the chief executive.

Total: 35 marks

19 Mugswamp plc

You are a senior in the firm of ICAEW Chartered Accountants that audits Mugswamp plc, a company with an AIM listing, which currently processes waste paper to produce recycled paper. The majority of the ordinary shares are held by the Mugswamp family, with Harold Mugswamp, the chairman, owning 40% of the ordinary share capital. It has no subsidiaries or associated companies. The forthcoming year end is 30 November 20X2.

You receive the following email from the audit manager.

To: Charlie Peters
From: Claire Cooling
Date: 15 October 20X2
Subject: Mugswamp plc – Financial strategy

Mugswamp plc has been conducting a major strategic review. As a result a number of finance issues have been identified. The FD of Mugswamp, William Walters has had little experience of these and has asked for our assistance. I would like you to prepare some briefing notes addressing the issues I have set out below.

(1) **Diversification**

The strategic review has identified an opportunity to diversify into the recycling of plastics. The proposed diversification will give rise to significant synergies in the acquisition of material as the same collection points will be used as for paper. There are, however, few production and marketing synergies, so a significant new investment of £54 million will be needed, including a new plastics reprocessing plant at a cost of £40 million. The company does not have sufficient debt capacity to finance this development and it has been made clear by the chairman that there is unlikely to be any new equity capital available, either from him or from the other shareholders. The chairman has also made it clear that he does not want the operating profits of the new project being severely damaged by high financing costs. He hopes to sell his shares in the company and retire next year, and he needs to disclose significant profit growth in the financial statements to achieve a good price. The FD has been looking at a number of arrangements. I have attached a summary of the details which he has given me (**Exhibit 1**).

Information required

Please could you set out the financial reporting implications of each of these proposed financing methods including, where the information permits, the impact on reported profits for the year to 30 November 20X3.

In addition, please highlight any financial risks that arise for Mugswamp from these financing methods and which may form the basis of a more detailed assurance assignment at a later date.

(2) **Foreign exchange**

Waste paper collected by Mugswamp is sent to China for sorting. A shipment is sent every three months for which Mugswamp is charged a fixed amount. Mugswamp is invoiced by the Chinese company in US dollars on receipt of the shipment. They are required to pay three months later when the sorting is complete and the recyclable waste is returned to them. The latest shipment will be invoiced at $485,000 on 31 October 20X2 and is due to be paid on 31 January 20X3. The functional currency of the Chinese company is the US dollar. The directors are concerned that the dollar exchange rate may fluctuate over the next few months and are considering entering into a forward contract to buy dollars on 31 January 20X3 in order to hedge any movements in the spot rate. The forward would be negotiated at a premium of 9.00 cents with no transaction costs.

Information required

William Walters has asked for an explanation as to whether hedge accounting can be used for this transaction. You should also explain how this type of hedge would be accounted for. For the purposes of your explanation you should assume the following:

Date	Spot rate	Forward rate for buying dollars at 31 January 20X3
31 October 20X2	$1.25:£1	Premium of 6.00c
30 November 20X2	$1.20:£1	Premium of 5.00c
31 January 20X3	$1.14:£1	As spot

(3) **Re-financing existing debt capital**

The company is also looking to re-finance some of its existing debt capital, given that existing loan notes are due to be repaid in four months' time. The bank has offered Mugswamp £12 million, so they are not concerned that the finance will not be available. However, the bank has offered alternatives as to how the interest rate will operate. Option 1 is a fixed rate of 8.5% over the term of 5 years, and Option 2 is a floating rate note (LIBOR + 2% amounting to a variable rate of, currently, 9.5%). William is concerned by the widely held view that interest rates are going to fall, and that whilst the fixed rate looks attractive in relation to the variable rate, it may not do so for long.

Mugswamp have used interest rate swap arrangements before and, if they were to take out the fixed rate agreement from the bank, it might be possible to swap to a variable rate loan subsequently (subject to a 0.5% per annum charge by the bank for its arrangement of the swap). Initial inquiries suggest that Mugswamp might receive 8.9% fixed from the counterparty if it pays an agreed variable rate.

Information required

What should be the maximum level variable rate that Mugswamp should accept as its contribution to the swap? Also if interest rates fall, is there any advantage in waiting to raise funds by this new debt issue?

Requirement

Produce the briefing notes requested by your manager. Assume that the time value of money can be ignored in any calculation of the value of a forward contract.

Total: 40 marks

Exhibit 1

Memorandum

Prepared by: William Walters (FD)
Subject: Financing options
Date: 15 October 20X2

The most likely means of raising the finance required is from our assets, together with some borrowing. The following are some arrangements I have discussed, but they have not been finalised.

(1) **Debt factoring**

We have total trade receivables of about £10 million. Of this about £4 million are not due for at least two months and, more usually, up to about four months, and these could be sold to a debt factor. The terms we have been offered at the moment are that cash, equal to 80% of the gross receivables sold, would be made available immediately on completion of the agreement (about 1 December 20X2) and would be non-returnable. A credit protection premium of 2% of gross receivables sold would be payable, together with interest of 1.25% per month on the amounts advanced, net of any cash received from the receivables by the factor. After three months all remaining amounts would be paid by the factor to Mugswamp plc and any further responsibility would belong to the factor.

(2) **Sale and leaseback**

Our existing plant for reprocessing paper products is our major non-current asset. The plant was purchased on 1 December 20W8 for £25 million. It had an estimated useful economic life at that time of 20 years, with a zero residual value. We depreciate straight line and have not revalued. It would be sold, as part of the sale and leaseback arrangement, for its fair value of £35 million on 1 December 20X2. The annual lease rentals have not yet been finally determined, but would be at the market rate. The leaseback period is 15 years. I particularly like this idea because we will make a profit on the sale as well as raising new finance.

(3) **New loan**

We already have some bank loans but there is probably scope for another £15 million of new borrowing at most. The problem is that commercial interest charges in the UK on this amount would damage our profits. I have however found a loan from a Swiss bank that would raise £15 million at today's exchange rates, and would be available from 1 December 20X2 repayable in 6 years from that date. It would be denominated in Swiss francs (CHF) and carry a zero annual interest rate, but with a redemption premium of 50%. The company does not have any dealings in Switzerland, but the loan would at least save any interest charges to profit or loss in the short term.

20 Yolland plc

'We might have started out as a family run company but now, as a listed company in a highly competitive business environment, our approach to governance is no longer appropriate. After these recent results, this company needs turning around, and that requires some difficult decisions.'

The board meeting

Yvette Yolland is the finance director of Yolland plc, which manufactures domestic appliances that use rechargeable batteries. She was speaking at a board meeting following the release of disappointing financial results for the year to 30 September 20X8. Margins across the industry have been reduced in recent years as increased penetration of low-cost imports has triggered intense price competition.

Nevertheless, Yolland's financial results are more disappointing than those reported by the majority of its domestic competitors. Yvette continued:

'The current policy that the board consists mainly of family members who take all the key decisions just cannot be sustained. We have had some good middle managers who could have come onto the board, but they have all left because they were not given the right incentives. We need to provide the incentives to motivate these key people to stay with us for the long term. Cash is short, but we need to do

something. Also, for our general workforce, our pension scheme is one of the poorest in the industry. We need to do something to create a culture of long-term loyalty.

In addition, we have to rationalise and cut costs if we are to stay competitive. I have not analysed the data yet, but I do not believe that toothbrush production is viable any longer.'

The board meeting ended in disagreement as to the best course of action, but Yvette was asked to prepare proposals with supporting data for the next board meeting. Concerns expressed by the board included the impact of the proposals on reported pre-tax profit and cash flow. However, it was recognised that, overall, the main consideration was to make the correct commercial and strategic decisions.

Your meeting with the FD

You are a newly appointed assistant to Yvette and she called you into her office the day after the board meeting. She explained what had occurred at the meeting and then continued:

'I need your help to prepare a case for the proposals that I have been asked to present to the next board meeting. I know you are new to the company, so I have provided you with some background details (**Exhibit 1**).

The **first proposal** relates to the strategic and financial viability of toothbrush production. I have prepared some data for you (**Exhibit 2**).

I would like you to draft a report assessing the viability of toothbrush production and explaining the factors that should be considered in deciding whether to cease manufacturing toothbrushes.

In connection with this, I would like to change our accounting information system so that it routinely collects information in the way we have done in Exhibit 2, but I am concerned about the impact on reported profit.

Please explain how we would measure inventories for financial reporting purposes if we allocated overheads in this way and also calculate the carrying amount of one item of finished inventory for each of our three types of product based on this data.

The **second proposal**, to take the company forward, is to make each of the three products (or two if we decide to cease toothbrush manufacture) into separate autonomous divisions, each under the control of a senior manager, who is not currently on the board. The directors would then be free to deal with policy and strategy matters rather than the day to day operations.

I believe that restructuring the company on a divisional basis would be much more appropriate than the current basis, but the current board members are comfortable with the current system and appear very reluctant to change.

I appreciate that there can be disadvantages as well as advantages from changing to a divisionalised structure, but please could you assess the main implications of restructuring the business on such a basis.

As well as looking at the differences between the structures themselves, please can you also discuss the importance of the change management process in relation to introducing the new structure?

The new divisional managers and their managerial teams will need incentives. In order to do this, I propose that the company should issue share options to these managers. I have provided some details (**Exhibit 3**).

In additional to my proposal to issue share options, I also propose to improve the pension scheme for all employees to encourage long-term loyalty. I have two alternative suggestions (**Exhibit 4**) and I would like you to explain the financial implications of each of these.

Finally, I would like you to set out the overall effects of the share option scheme and the revisions to the pension scheme on the motivation and performance of Yolland's managers and employees. Also, assess the potential costs involved in these schemes.'

Instructions:

Immediately after your meeting, Yvette emailed you to confirm the action points arising from your discussion with her.

I would like you to draft a report which does the following:

(1) Assesses the viability of toothbrush production and explains the factors that should be considered in deciding whether to cease manufacturing toothbrushes.

(2) Illustrates how we would measure inventories for financial reporting purposes if we allocated overheads using activity-based costing as suggested in Exhibit 2; and calculates the carrying amount of one item of finished inventory for each of our three types of product based on the data provided in Exhibit 2.

(3) Assesses the main implications of restructuring the business to a divisionalised structure, and discusses the importance of the change management process which would be required to introduce the new structure.

(4) Explains the effects which the suggestions for the share option scheme (Exhibit 3) will have on managers' motivation and performance, and the potential costs of the scheme.

(5) Summarises the effects which the suggested revisions to the pension scheme (Exhibit 4) will have on the motivation of Yolland's managers and employees. Please also assess the financial statement implications of both suggestions.

Requirement

Respond to the finance director's instructions. **Total: 45 marks**

Exhibit 1 – Company background

Yolland is a small listed company which manufactures domestic appliances which operate using rechargeable batteries. It has three products: toothbrushes, shavers and lighting. The appliances are all manufactured at the same factory using different production lines. The company has grown quickly, but its accounting information systems have not changed in line with the company's commercial growth.

The management accounting records have never been able to distinguish clearly the profitability of each of the three products. As a consequence, the company is managed functionally with each board member of the Yolland family being responsible for an activity (eg, finance, marketing, production, purchasing, human resources) for all three products.

Exhibit 2 – Cost and operations data

The following data on the activities of the three products have been collected as part of a special review exercise. The data are for the year ended 30 September 20X8.

	Shavers	**Lighting**	**Toothbrushes**
Output (units)	500,000	300,000	200,000
Selling price per unit (£)	£25	£50	£20
Cost per unit:			
Material	£10	£10	£5
Labour	£5	£5	£5
Activities per annum:			
Number of set-ups	20	20	20
Number of orders	100	50	50

Total overhead costs	**£**
Set-up costs	2,160,000
Ordering costs	2,400,000
Volume related overheads	4,000,000
Fixed factory costs (allocated on the basis of units of output)	4,500,000
Fixed administration costs (allocated on the basis of labour costs)	1,500,000
Total	14,560,000

Exhibit 3 – Share option scheme

To tie managers into the company, share options would be given to existing managers after three years of continued employment from 31 March 20X9, on which date the scheme would commence. If these employees were to leave before 31 March 20Y2, they would receive no share options.

I therefore propose that on 31 March 20X9 each of the 100 managers is given 1,200 share options in Yolland which can be exercised on 31 March 20Y2 if the employee is still in employment with the company. Each option gives the holder the right to subscribe for one new ordinary share in Yolland on 31 March 20Y2 at an exercise price of £8.

The problem is that many managers may stay for three years to receive the share options and then leave. My idea is therefore to issue the same amount of share options, under the same conditions, on 31 March every year. So, whenever managers leave, they would be giving up a large value in options that would not yet have vested.

My working assumptions are:

- The fair value of one option will be £3 at 31 March 20X9, and the value of one Yolland share at that date will be £8.
- Share prices in future will increase by £1 per year. (Please also assume that the fair value of the option will also increase by the same amount.) However, the exercise price of the share options will remain constant at £8 throughout the period.
- Assume 10 managers, who have been in long-term employment, will leave during each full year, but they will be replaced by an equivalent number of new managers.
- Managers joining after 31 March in any year would not qualify for the scheme until the following year.

Exhibit 4 – Pension proposals

Yolland has a defined benefit scheme. The company recognises gains and losses on remeasurement of the defined benefit asset or liability (actuarial gains and losses) in accordance with IAS 19 *Employee Benefits.*

Suggestion 1

Employees will have the same pension rights as previously, but they will no longer be required to make contributions themselves. Yolland will therefore increase its annual contribution to the defined benefit scheme for existing employees by the amount that the employees used to contribute themselves.

Suggestion 2

The conditions of the pension scheme will be changed to increase the pension benefits accrued from each year of service by employees. This will take retrospective effect from the date that each employee joined the company. The employees' own contributions will be maintained at their present level in future.

21 Kramp plc

Note: You should assume it is currently mid-20X4.

You work as a senior in Cable Trinder, a large firm of ICAEW Chartered Accountants. The firm acts as business advisers and auditors to Kramp plc (Kramp).

Kramp plc is a listed, UK-based pharmaceuticals company whose shares are traded on the London Stock Exchange. It is a medium-sized company for the pharmaceuticals business, specialising in the development of drugs for the treatment of muscular disorders. In this particular area of medicine, Kramp is one of the world's leading pharmaceutical companies.

You have been asked to attend a meeting with Barbara Haslam, the engagement partner.

The meeting

Barbara begins the meeting. 'You have probably heard in the financial news that Kramp has received a takeover bid from the Japanese pharmaceuticals firm, Sunami. The Kramp board intends to advise shareholders to reject the bid, but it has given them a few problems to deal with. It has asked for our advice and opinions prior to a board meeting that has been called for next Wednesday, in five days' time.

'They would like us to address a number of issues.

<u>Profitability</u>

'One of the main reasons for rejecting the offer from Sunami is that the Kramp board members believe that the offer seriously undervalues the company. They believe that although Kramp has not performed as well as hoped in the past few years, there is a strong pipeline of drugs under development and profits will grow substantially in the future. On the basis of its future profits, Kramp should be worth far more than Sunami have offered.

'I have been given some notes on the historical and future profitability of Kramp. These were supplied to me by Kramp's finance director yesterday (**Exhibit 1**).

Risk management

'The board has a programme for restoring profitability, but this will take six or seven years to have its full effect. The chairman, CEO and chief financial officer intend to make a presentation to shareholders and analysts, to set out their strategy for the future as an independent company. They expect to be questioned extensively about strategic risks and have asked us to provide some input to their thinking on risk management. Pierre Laclos, the CEO of Kramp, has sent me a memo about this, with a copy of an email he received from his Chief Operating Officer (**Exhibit 2**).

'I understand that the chairman of the Kramp audit committee has criticised the risk management system in the company, and the board is looking for advice on how it should respond. I have a concern that the company is exposed to significant risks in its supply chain and that it has not addressed these sufficiently in the past.

The offer from Sunami to acquire Kramp

'The Kramp board is aware that if it rejects the offer from Sunami, it must be able to give good reasons for doing so. They know that the main issue is price, but they think that there are other reasons why stakeholders may support the board in opposing the bid.'

I can give you some details about the offer (**Exhibit 3**).

Potential acquisition

'The Kramp board has already started to consider strategies for discouraging unwelcome takeover bids in the future. The CEO has drafted a paper on the acquisition of a smaller pharmaceuticals company, but before it is considered formally by the board, he would like us to give our views on a valuation. I can give you a copy of the draft paper (**Exhibit 4**).'

End of meeting

At the end of the meeting Barbara Haslam says that she would like you to prepare notes for her on several matters that she has set out in a briefing note to you (**Exhibit 5**).

Requirement

Prepare the notes that have been requested by Barbara Haslam.

Total: 40 marks

Exhibit 1 – Notes from the finance director of Kramp on the company's financial position

In the past few years, Kramp has suffered a fall in revenue and profitability. This has been due mainly to a successful drug coming out of patent.

There is already a pipeline of new drugs under development, which should enable the company to return to profit growth in four years' time. The board plans to increase investment in research and development to achieve a continuing flow of new products over the next 10 to 15 years. By 20X9, the company intends to be the acknowledged scientific leader in its particular area of medicinal drugs.

In the short term, however, our financial performance has been disappointing. At the end of 20X3 we reported a fall in annual revenue and a fall in profits, as follows.

Year to 31 December	**20X3**	**20X2**
	£m	**£m**
Revenue	1,607	1,719
Cost of sales	(290)	(306)
Gross profit	1,317	1,413
Research and development	(304)	(292)
Sales and administration costs	(920)	(838)
Operating profit	93	283

Some members of the board of Kramp are blaming the fall in profits on a weak dollar. Most of Kramp's costs are incurred in euros and sterling, but most of its revenues are in US dollars. However I am not convinced by their arguments that our exposures to exchange risk are significant.

Cash flows from operating activities during 20X3 were £288 million (positive).

The pipeline of new drugs is showing some signs of improvement. Sales of a fairly new drug Arbolin were £400 million in 20X3, up 67% on the previous year, and an even more recent product, Brabalin achieved sales of £180 million, up over 200% on the previous year. Sales of established drugs to emerging countries also rose by about 10% in the year.

The company has 140 million shares in issue, and their current market price is £13.75, having fallen from a high of £18 towards the end of 20X1.

Exhibit 2 – Risk management

Memo from Pierre Laclos, CEO of Kramp plc to Barbara Haslam

Dear Barbara

I am wondering whether you can help me out. I have to make a presentation to a group of investors and analysts about the main risks facing our company and the measures that are under review to manage our risks. Quite simply, I don't have any time at the moment to put my ideas together and I don't want to ask my Chief Operating Officer to help me – he gets too technical for the audience I shall be addressing.

So can you put together some brief notes for me about risk management and how it should affect Kramp. I am attaching a memo sent to me by my COO which may give you a decent idea of the sort of information that I need.

Regards

Pierre

Email from the Chief Operating Officer of Kramp to the CEO, copied to Cable Trinder

The management of the company recognise that there are some business risks that could threaten the planned restoration of profit growth. They have identified the main risks as:

- Product pipeline risks
- Commercialisation of new products risks
- Supply chain and delivery risks
- Legal, regulatory and compliance risks

These risks are expressed in very general terms and I do not suppose that many individuals in our audience of investors and analysts will have much idea of what these risks actually mean.

For example what exactly do we mean by 'product pipeline risks' and 'supply chain and delivery risks', and how might they affect the company, its operations and its profitability?

We also need to give investors and analysts an idea of the measures we are taking to manage these risks and ensure that the company stays on track to achieve its long term strategic objectives.

Your presentation needs to put across the message that we are managing our risks successfully, and that the company has an exciting future that investors should be willing to support.

Exhibit 3 – The offer from Sunami to acquire Kramp

Sunami is a listed pharmaceuticals company and much larger than Kramp. Its offer is to buy 100% of the ordinary shares of Kramp, paying in a combination of cash and shares in Sunami. At the current Sunami share price the indicative offer is worth £20.40 per Kramp share. Sunami insist that a takeover of Kramp should be an agreed and negotiated deal; it does not want to become involved in a hostile bid.

The board of Kramp are concerned about the welfare of their 5,200 employees. They suspect that if the takeover goes ahead, Sunami could make up to 50% of the existing Kramp work force redundant.

Exhibit 4 – BVC

The board of directors believes that in order to reduce the risk of further hostile takeover bids, it will have to make acquisitions of its own. Although the hostile bid from Sunami has not yet been successfully defeated, the board is looking at the possibility of acquiring 100% of the equity of another pharmaceuticals company, BVC, and has entered into discussions with its owner-directors. BVC is an all-equity company.

The owner-directors have provided the following outline figures for BVC as a starting point for discussions:

Year to 30 June	**20X4 Actual £m**	**20X5 Forecast £m**
Revenue	450	477
EBITDA	59	63
Profit after tax	26	28
Dividends	20	22
Carrying amount of net assets at 30 June	289	295

Over the previous five years the company has achieved steady growth in revenue (averaging 5% per year), earnings (also averaging 5% per year) and dividends (averaging 8% per year). Given the product pipeline of BVC, it is expected that the rates of growth in revenue and earnings should be sustainable for at least five more years.

Kramp uses a weighted average cost of capital of 10% for most investment appraisals. However, if the company is acquired, Kramp would finance the acquisition by obtaining a 5-year loan of £650 million at an expected annual interest cost of 7%. The loan principal would be repaid in a single payment (a bullet repayment) at the end of the loan term. Any additional amount payable to acquire BVC would be paid for out of the company's existing cash resources.

The finance director of Kramp has estimated that the asset beta (ungeared beta) for the pharmaceuticals industry is 1.2, the risk-free cost of capital is 5% and the average market return is 11%. The rate of tax on corporate profits is 20%.

I would appreciate your views about a range of possible valuations for this company.

Exhibit 5 – Briefing note from Barbara Haslam

Please prepare notes for me on the following matters. I intend to use them as a basis for a report I shall be preparing for the client, so please set out your notes in a formal and clear presentation.

(1) The board of Kramp has asked me to provide an analysis of the major strategic risks facing the company, giving particular attention to risks that the company may be exposed to in its supply chain. Can you please also give brief suggestions about how each of these risks might be managed?

(2) The board also wants us to provide an assessment of the offer from Sunami, bearing in mind the current financial position of Kramp and the future plans of the board.

(3) Before the CEO presents his paper on the acquisition of BVC, he would like us to give our views on a valuation, including calculations.

(4) There is one last point. Some of the directors of Kramp are unhappy about rejecting a bid from Sunami without referring it to the shareholders. The chairman has asked me how he might respond to their concerns.

22 Homez Ltd

Homez Ltd (Homez) owns a chain of 213 stores located just outside major towns and cities. All the stores are located in the UK, mainly in the south of England and the Midlands. The stores sell two types of product: car accessories (maintenance products and car equipment) and bicycle products (a wide range of bicycles and cycling accessories).

Recent performance

Homez has been successful in increasing its profitability and operating efficiency from each store.

Its stores range from 400 square metres to 900 square metres and they are situated in key sites in order to maintain the brand reputation. Recent performance of Homez for the years ended 30 June has been:

	20X8 Draft £m	**20X7 £m**	**20X6 £m**
Revenue			
Car products	179	170	164
Cycle products	193	170	151
Total	372	340	315
Operating profit			
Car products	21.5	20.0	19.7
Cycle products	15.4	14.0	12.1
Total	36.9	34.0	31.8

There has been strong growth in the cycle market, due to environmental and health factors, and this has resulted in increasing demand and improved sales. Homez has accommodated this trend by transferring floor space from car products to cycle products. This policy has, however, begun to affect car product sales. As a consequence, the Homez board wishes to expand the number of outlets within the UK, but it

has had problems in identifying suitable sites. This has been due to the lack of appropriate locations because of the unwillingness of local government to give planning permission for large, new out-of-town commercial property developments.

Given the difficulties in purchasing new sites, a board strategy document (produced in 20X7) identified, as a key objective of Homez, the expansion of the business through acquisition. As a consequence, the Homez board has spent some time trying to identify smaller chains of car accessory or bicycle retailers which it might acquire. In June 20X8, Floom Ltd (Floom), a chain of bicycle and bicycle accessory stores, was identified as a possible acquisition.

Potential acquisition of Floom

Floom operates from 70 stores in the UK, mainly in the north of England and the Midlands, with an average floor space of 200 square metres. These stores are all located in town or city centres.

Floom's shares are currently held as follows:

	Ordinary shares
Intercycles Ltd (Intercycles)	70%
Retro Properties Ltd (RP)	30%

The Floom board of directors made an initial approach to the board of Homez, suggesting that it might wish to make an offer. At a meeting with the Homez board, Paul Hooton, the finance director of Floom, explained the situation.

'We understand that Homez is wishing to make an acquisition in one of its two core areas of car accessories or bicycles. The major shareholder of Floom is Intercycles Ltd (Intercycles) and it has indicated that it wishes to withdraw from the UK cycle retail market and is seeking a buyer for its shares in Floom. The other shareholder, Retro Properties Ltd (RP), is concerned about the relationship with a new major shareholder and may also be willing to accept an offer for its shares.

As you can see from the statements of profit or loss and other comprehensive income (**Exhibit 1**), Floom is an expanding company with annual growth in profits of around 17% over the past two years. We would clearly require this strong growth factor to be built into any valuation.

The Floom board of directors is willing to make some limited, non-public, information available to Homez to enable an initial bid to be made.'

Request from the financial accountant

You are an assistant to the financial accountant of Homez, Andy Webster.

Floom has provided financial statement data (**Exhibit 1**) and some other information (**Exhibit 2**). Andy has also provided some additional notes to guide you, based on a recent meeting with the Floom board, together with some working assumptions (**Exhibit 3**).

Andy has asked you to prepare sections of a draft report which address each of the following:

(a) Explain the key strategic, operational and financial issues arising from the acquisition of Floom, from the perspective of Homez.

(b) I appreciate that the information is incomplete at the moment so you will have to make some assumptions. Nevertheless, I would like you to determine estimated valuations on which we can base a bid to acquire the entire ordinary share capital of Floom. One valuation should use the net asset method. Also, derive another valuation, using one other appropriate valuation method (for which I suggest you adopt a working assumption of 10% as the annual discount rate). Explain and justify the two methods of valuation that you have employed.

(c) I would also like you to determine the extent to which the above valuation would change if we were to acquire only the 70% shareholding in Floom currently held by Intercycles.

(d) Explain any significant concerns you have with the financial reporting and other information provided by Floom that you would like our auditors to look at during the due diligence process – I don't want a long list of all the usual items, just focus on the key issues that specifically arise from the information currently available in this case.

(e) Briefly evaluate the historical operating performance of Floom using the available data.

Requirement

Prepare the sections of the draft report requested by the financial accountant, Andy Webster.

Total: 42 marks

Exhibit 1 – Financial information provided by Floom

Statements of profit or loss and other comprehensive income for the years ended 30 June

	Notes	20X8 Draft £'000	20X7 £'000	20X6 £'000
Revenue		36,300	33,000	30,000
Cost of sales		(18,800)	(16,800)	(15,000)
Gross profit		17,500	16,200	15,000
Operating expenses	1	(12,000)	(11,500)	(11,000)
Profit from operations		5,500	4,700	4,000
Finance costs	2	(700)	(600)	(500)
Profit before tax		4,800	4,100	3,500
Tax (effective tax rate of 30%)		(1,440)	(1,230)	(1,050)
Profit for the year		3,360	2,870	2,450

Statements of financial position at 30 June

	Notes	20X8 Draft £'000	20X7 £'000	20X6 £'000
Non-current assets				
Property, plant and equipment	3	39,000	36,000	34,000
Current assets	4	10,000	5,000	3,000
Total assets		49,000	41,000	37,000
Capital and reserves				
Issued capital		1,000	1,000	1,000
Retained earnings		11,230	7,870	5,000
Equity		12,230	8,870	6,000
Non-current liabilities				
Loans	2	35,000	30,000	25,000
Provision		–	–	4,000
Current liabilities		1,770	2,130	2,000
Total equity and liabilities		49,000	41,000	37,000

Notes:

1 Operating expenses include operating lease rentals. There are no properties held under finance leases. Some of the operating lease rentals arise from a sale and leaseback agreement. On 30 June 20X5, 25 stores were the subject of a sale and leaseback agreement, with RP being the lessor. Under this agreement RP made an initial payment to Floom of £1.7 million per store and this resulted in below-market lease rentals of £40,000 per store, per year. Only these operating lease rentals paid are charged through profit or loss for the year in respect of the sale and leaseback agreement. This sale and leaseback agreement is for 10 years, with all rights reverting to the lessor at the end of the lease. The cash generated from the sale and leaseback has been used to fund expansion.

There were also a total of 20 further new properties acquired under operating leases by Floom being 10 stores on each of 1 July 20X6 and 1 July 20X7. RP was also the lessor for all of these stores. However, these stores had fair market lease rentals of £80,000 per store per year. These lease rentals are recognised in operating expenses.

These leases are also for 10 years with all rights reverting to the lessor at the end of the lease.

2 A refinancing agreement took place on 1 July 20X5 when a 4-year bond, with a nominal value of £25 million, was issued at par. The interest rate on the bond was 2% per annum which has been charged to profit or loss for the year. The bond also has a redemption premium of 37.1%. Two further bonds with the same terms, but each with a nominal value of £5 million, were issued on 1 July 20X6 and 1 July 20X7 respectively.

3 Property, plant and equipment includes 25 stores which are owned freehold by Floom.

All non-current assets are stated at historical cost less depreciation, as follows:

	Owned properties	Fixtures and fittings	Total

Cost	£'000	£'000	£'000
At 1/7/20X7	50,000	20,000	70,000
Additions	–	5,000	5,000
At 30/6/20X8	50,000	25,000	75,000
Accumulated depreciation			
At 1/7/20X7	24,000	10,000	34,000
Charge for the year	1,000	1,000	2,000
At 30/6/20X8	25,000	11,000	36,000
Carrying amount			
At 30/6/20X8	25,000	14,000	39,000

The fair value of the owned properties at 30 June 20X8 is £50 million and this has been unchanged for some years.

Floom stores at 30 June

	20X8	20X7	20X6
Number of owned stores	25	25	25
Number of stores held under operating leases	45	35	25
Total stores	70	60	50

Stores are in prime sites and this is a key to success. All the stores, freehold and leasehold are of a similar size and nature.

4 Current assets consist almost entirely of inventories. At 30 June 20X8, £9 million of the inventories were cycles supplied by Intercycles, of which cycles amounting to £8 million had developed faults with the frame due to a production problem at the factory.

Exhibit 2 – Other information

The Floom business

Floom was established by Intercycles twenty years ago as part of a strategy of vertical integration. Intercycles is a manufacturer of bicycles and bicycle parts. The store managers of Floom are allowed to purchase from other bicycle suppliers, but at least 50% of their purchases of inventories must be from Intercycles. Most store managers restrict their purchases to this 50% minimum.

On 1 July 20X6 Intercycles sold 30% of their existing shares to RP.

Financial reporting

All property, plant and equipment are depreciated to a zero residual value over its estimated useful life as follows.

- Owned buildings – 50 years straight-line on cost
- Fixtures and fittings – 5% to 10% reducing balance

Exhibit 3 – Additional notes and working assumptions

Make a working assumption that cost of sales is all a variable cost and that other operating expenses are all fixed costs.

The vendors are anxious to make a quick sale. For simplicity, therefore, assume in the valuation calculations that the sale actually took place on 1 July 20X8.

Assume sales volumes would increase by 10% per annum and sales prices by 5% per annum for 2 years from 1 July 20X8 and then both will be constant indefinitely.

In order to generate additional demand, an extra £2 million of marketing costs will be incurred each year.

Some of the stores are in poor condition. Capital expenditure (capex) will therefore need to be £3 million per year to achieve the increased sales levels being forecast. However, no new outlets will be opened, so the capex requirement will not be as large as in the past few years.

Surplus assets can be sold for £1.5 million during the first year of trading if the acquisition takes place.

23 Harper Ltd

It is the middle of July 20X8.

Harper Ltd has been manufacturing and supplying garden hose equipment for over twenty years. It was acquired by French plc at the end of September 20X7, as part of French plc's expansion strategy. The

Chief Executive of French plc felt that there was scope to generate improvements within Harper's business and to that end introduced a strategy of making high quality products and delivering superior customer service. The Chief Executive feels that by implementing a Total Quality Management programme, this should be achievable without a commensurate increase in price.

There were some initial difficulties, but by mid-20X8, Harper's results are starting to look promising compared to the budget.

You are John James, and work for the firm Lowe Brow, which undertakes assurance engagements for companies in the French Group. Your manager is Claire Davids and you have just received the following memo from her.

MEMO

To: John James
From: Claire Davids
Subject: Harper Ltd – dividend and bonus

I have received an email from Shane Williams, Chief Executive of Harper Ltd, **Exhibit 1**, and I would like you to consider the potential problems with the bonus scheme and dividend payment using the further information that I have attached.

The email highlights concerns that Shane has about dividend payments, in view of their large size. He wants information and guidance from us, initially, about potential weaknesses in controls over bonus payments.

(1) Please therefore can you draft a memo detailing the risks in the procedures for calculating bonuses, and the internal controls that are needed to make sure that the correct amount of bonuses are paid. In addition, can you let me know what risks there may be if a system of paying some bonuses on the basis of 'Cost of Quality' is introduced.

(2) Second, please can you draft a report to be sent to the directors of Harper Ltd from me discussing the topics of concern about dividends and bonuses, namely:

   (a) The payment of the dividend required by French plc, and
   (b) The ways in which bonus payments can be determined.

You should consider the financial method used by Harper, return on total assets (ROTA), and the return on investment measure proposed by French. You should also discuss the 'Cost of Quality' measure and the best way to reconcile these various measures.

Regards

Claire

Requirement

You are required to respond to the requests of Claire Davids concerning the dividend payment referred to in **Exhibit 1** and the bonuses referred to in **Exhibit 2**. (You are not required to prepare an executive summary or introduction to the report.)

Total: 45 marks

Exhibit 1

Email to Claire Davids from Shane Williams

Claire

Further to our recent discussion, I attach a copy of a recent memo to me from my Group Chief Executive. I need to respond to his concerns about bonuses and the need to make sure that we don't pay more than our managers are properly entitled to. Bonus payments in Harper are large, and as you know, I am concerned about risks of weaknesses in control over these payments.

I would also like you to let me have a report on the bonus payments and the dividend payment, for my next board meeting.

Please find Exhibits 2–7, which contain relevant information.

Regards

Shane

Attachment to email

French plc

Fourth Floor Suite, Centre City Tower
The Queensway, Sheffield

Memorandum

From: Sir Alfred Evans,Chief Executive, French plc
To: Shane Williams, Chief Executive, Harper Ltd
Subject: Dividend and Bonuses
Date: 13 July 20X8

(1) In accordance with board policy, we have decided for all group companies the level of dividend required to be paid to the parent company. The targeted level of return on group investment in Harper Ltd will require an interim cash dividend for the year to 30 September 20X8 of £2 million which should be paid in the first week of August 20X8.

I would remind you that it continues to be group policy that individual companies are responsible for their own funding.

(2) I am becoming increasingly concerned at the continued high level of the bonuses based on ROTA, particularly while profits are falling, and I would be interested in your ideas as to a possible review.

I look forward to hearing of your agreement to this by 27 July please.

Exhibit 2

An extract from a report by the finance director of Harper Ltd

Performance evaluation

French plc evaluates the performance of its subsidiaries using both financial and non-financial indicators. The key financial measure is the accounting figure 'earnings attributable to the parent company'. Back at head office senior management relate this figure to French's investment in the subsidiary before comparing the 'return on investment' of one subsidiary with another.

Harper will have to change its own system of performance measurement to suit the parent company. Its key indicator has always been Return on Total Assets (ROTA), defined as profit before tax divided by the carrying amount of non-current assets plus current assets. ROTA has also been the key financial statistic used to measure the performance of the three product group managers.

There are three senior managers each responsible for one of the three product groups. These managers are evaluated on the profitability of their particular product group, and receive bonuses based upon the product group's ROTA. The bonuses, which start at 40% of basic salary, are triggered by achieving a target ROTA of 18%.

French plc has based its TQM package on the premise that quality and reliability (Q and R) are the responsibility of all managers. Hence:

(a) Managers' performance on Q and R is a key criterion in performance evaluation.
(b) Managers' commitment to Q and R will not be measured – only the results.

French plc wants Harper Ltd to adopt the 'Cost of Quality' (COQ) measure to assess managers' performance in TQM, so that COQ becomes a criterion for deciding bonuses. COQ represents expenditures that arise because poor quality has occurred or to prevent poor quality from arising in the future. The COQ measure is designed to highlight the cost of poor quality, 'the cost of doing things wrong'.

I have reclassified expenditures to derive a total COQ. As you can see, this is a large slice of profit. I am concerned that unless we can implement COQ into the performance measures for product group managers and their bonus calculation then TQM will just be a pretext for letting overheads get out of control.

We need to consider how managers' performance in this area is to be measured and how these measures will be linked to their bonuses.

COQ – % of net sales billed

	20X6/X7 %	20X7/X8 (to date) %
Prevention costs	1.7	1.8
Appraisal costs	2.7	2.9

Internal failure costs	5.5	5.7
External failure costs	2.1	1.8
	12.0	12.2

Exhibit 3

Harper Ltd

Management accounts
Statement of profit or loss summary
9 months to 30 June 20X8

	Actual £'000	%	Budget £'000	%
Revenue	16,920	100	18,110	100
Cost of sales				
Materials	(3,785)	22	(4,068)	22
Labour	(1,602)	9	(1,724)	10
Production overheads	(7,759)	46	(6,875)	38
Total	13,146	78	12,667	70
Gross profit	3,774	22	5,443	30
Marketing, selling, general and admin costs	(1,400)	8	(1,200)	7
Trading profit	2,374	14	4,243	23
Interest	(320)	2	(360)	2
Profit on sale of non-current assets	200	1	–	0
Profit before taxation	2,254	13	3,883	21
Income tax expense	(902)	5	(1,281)	7
Profit after taxation	1,352	8	2,602	14

Exhibit 4

Harper Ltd

Statement of financial position extract (actual) as at 30 June 20X8

	Notes	£'000	£'000
Property, plant and equipment			14,859
Current assets			
Inventory		4,002	
Receivables	1	2,520	
Bank and cash		45	
		6,567	
Payables	2	(4,167)	
			2,400
Non-current liabilities		(2,500)	
Provisions		(100)	
			(2,600)
			14,659

Notes

1 **Analysis of receivables**

	£'000
Trade receivables	2,308
Other receivables	50
Prepayments	162
	2,520

2 **Analysis of payables**

	£'000
Trade payables	1,535
Income taxes	2,611
Other taxes	21
	4,167

Exhibit 5

Central Bank plc

Central Bank plc
29 High Street
Millford
LL0 0YD
KENT

The Directors
Harper Limited
Units 5 and 6
Avenue Industrial Estate
Dover
Kent

Ref: wp/25/mrs

Date: 3 Feb 20X8

Dear Sirs

Following our meeting yesterday to discuss your borrowing position we can confirm that the bank is willing to make available an overdraft facility of £250,000 on the terms set out in the agreement of 1 June 20X5. This facility will be reviewed again at the end of September 20X8.

In relation to your term loan which currently stands at £2,500,000 we can confirm that the bank would be willing to consider a request for additional credit when this is due to be repaid in 20X9. We would however remind you that this would have to be based on a fresh analysis by the bank at the time the request is made. Currently we have set a maximum long-term borrowing limit for the company of £2.75 million; clearly this may have to be reconsidered in the light of the circumstances when an application is made.

Yours faithfully

R Jones

Corporate Business Manager

Exhibit 6

The Financial Paper
September 20X7
French plc raises £32 million to fund Harper purchase

French plc the industrial conglomerate is paying £30 million for Harper Limited, the Kent based manufacturer of garden hose equipment.

The price of the deal was revealed yesterday in a rights issue document to shareholders.

Preliminary agreement on the purchase was reached last month with HLC plc who wished to sell their wholly owned subsidiary as part of a strategic move to eliminate peripheral activities.

French will raise approximately £32 million net from the rights issue which already has support of more than 60% of its shareholders.

Under the terms of the issue holders of French ordinary shares will be offered new shares at 98p on a 1 for 2 basis.

The rights issue which is conditional upon shareholders' approval has been underwritten by Credit Danke, the merchant bankers.

French recently announced improved pre-tax profits for the year to 30 June 20X7 of £33.5 million (£30 million) on revenue of £330 million (£312 million). French has net assets of £123 million on its last statement of financial position and only £4.5 million of long-term borrowings. This should enable earnings to be boosted in the current year.

French's shares gained 11p on the announcement, ending the day at £1.29.

Exhibit 7

Harper Ltd

Statement of profit or loss for the year ended 30 September 20X7

	20X7 £'000	20X6 £'000
Revenue	24,516	28,879
Cost of sales	(17,039)	(18,771)
Gross profit	7,477	10,108
Distribution costs	(408)	(420)
Administration expenses	(1,472)	(1,601)
Operating profit	5,597	8,087
Net bank interest	(361)	(321)
Profit on ordinary activities before taxation	5,236	7,766
Income tax expense	(1,694)	(2,816)
Profit after tax	3,542	4,950

Harper Ltd

Statement of financial position at 30 September 20X7

	Notes	20X7 £'000	20X7 £'000	20X6 £'000	20X6 £'000
Property, plant and equipment	1		13,229		13,268
Current assets					
Inventory		3,290		2,953	
Receivables		3,715		4,079	
Cash at bank and in hand		99		3	
			7,104		7,035
Total assets			20,333		20,303
Equity and liabilities					
Share capital			4,696		4,696
Share premium account			3,494		3,494
Revaluation surplus			4,774		4,774
Retained earnings			343		301
Equity			13,307		13,265
Non-current liabilities			2,500		2,500
Provisions			99		98
Current liabilities			4,427		4,440
Total equity and liabilities			20,333		20,303

Note 1

Property, plant and equipment

	Land and buildings £'000	Machinery, equipment and fixtures £'000	Total £'000
At cost or valuation			
At 1 October 20X6	5,736	11,916	17,652
Additions	1	2,158	2,159
Disposals	–	(408)	(408)
At 30 September 20X7	5,737	13,666	19,403
At cost	16	13,666	13,682
At valuation 20W9	2,485	–	2,485
At valuation 20X3	1,622	–	1,622
At directors' valuation 20X5	1,614	–	1,614
At 30 September 20X7	5,737	13,666	19,403
Depreciation			
At 1 October 20X6	43	4,341	4,384
Charge for the year	11	2,105	2,116
Disposals	–	(326)	(326)
At 30 September 20X7	54	6,120	6,174
Carrying amount			

	Land and buildings £'000	Machinery, equipment and fixtures £'000	Total £'000
At 30 September 20X7	5,683	7,546	13,229
At 30 September 20X6	5,693	7,575	13,268

Dividends

The dividend payment for the year ended 30 September 20X7 was £3.5 million and that for the year ended 30 September 20X6 was £4 million.

24 British Flint plc

Background

British Flint plc (British Flint) grew out of Monkridge Minerals Ltd, a company set up almost 100 years ago to extract and process minerals in the UK. The business has expanded and diversified over the years and now also encompasses specialised chemical engineering and foundry work.

Three generations of Monkridges ran the business until flotation approximately 40 years ago, when a Chairman and a CEO were recruited from outside the firm. Several members of the Monkridge family still hold senior positions in the business, but family ownership interest is now confined to the Monkridge family trust. This owns 8% of British Flint's issued share capital and has the right to appoint a director to the board. The trust has also provided substantial loan capital to the company and holds £6.5 million nominal value of its debentures. Only 14% of the trust's capital has been invested in securities other than those of British Flint.

British Flint has experienced several years of slow or negative revenue growth and declining profits. The board consider this to be the result of the emergence of substitute products and increased competition from lower-cost foreign producers. Reduced operating cash inflows have meant that, while debenture interest payments have been made when due, the company has been unable to maintain its dividend at the levels of previous years and the share price has fallen significantly as a result.

Despite its current difficulties, the board and its advisers consider that the company has a sound future, but only if it is able to bring to market its own new range of products and implement a series of cost-reduction measures identified by the production, HR and finance directors. These developments will require significant initial investment, amounting to a minimum of £49 million. If funds cannot be secured, the directors believe British Flint will decline rapidly, with insolvency likely within three years. They are therefore proposing that the company should undergo a scheme of capital reconstruction.

The general nature of the company's plans for improvement was discussed in the directors' most recent annual report. They include extensive investment in a new minerals extraction site in South America; a programme of staff restructuring in the UK and the rest of Europe that will involve significant redundancies; and the construction of new plant for the production of carbon fibre-reinforced alloy castings.

The new castings operation represents a major departure for British Flint, which has little experience in this kind of advanced technology.

The scheme of reconstruction

British Flint has 80 million ordinary shares of £1 nominal value in issue, together with debentures originally issued at their par value of £100 million. These debentures are secured on the company's assets, have a coupon of 7% and are redeemable at par on 30 September 20X9.

At the last board meeting, the Finance Director presented his outline proposals for a scheme of reconstruction, which was accepted by the board, subject to taking further professional advice.

The immediate aim of the reconstruction is to raise capital to fund the company's turnaround. A longer-term aim is to lower the level of financial gearing in order to reduce the extent of the company's financial risk. This is to be achieved by converting the 7% debentures at par into ordinary share capital and raising new capital by a new issue of secured debentures with a nominal value of £60 million, a coupon of 6.5% and a life of 7 years. The Finance Director has proposed that the effective date of this reconstruction should be 30 September 20X4.

Discussion with client

It is now 1 March 20X4.

You are employed by the firm of ICAEW Chartered Accountants that advises the Monkridge family trust. At a recent meeting with you, Mr Monkridge – a member of the family – explained the British Flint reconstruction plan as explained to him by the Monkridge trust's nominee director. This information has not been publicly released and is regarded as commercially confidential.

Mr Monkridge feels the scheme is complex and confesses that he does not really understand its implications. He is very concerned about the effect the plan is likely to have on British Flint's finance costs and on the Monkridge trust's income and the value of its assets. He asked for a detailed analysis of the scheme's implications, both for the company and for the trust, and in the longer term as well as the short term.

In conversation about the company's prospects, Mr Monkridge also expressed concern about the reinforced alloy castings project. He said that the production director had acknowledged that it was very risky and, while unlikely to fail completely, might easily fail to achieve its potential returns.

A further matter of concern for Mr Monkridge is the implications that the reconstruction scheme and future investment plans of British Flint may have for corporate governance of the company. He does not feel that the current board should be allowed to lead the company in the future and that substantial changes will be desirable.

You agree with Mr Monkridge that you will carry out an analysis of the proposed reconstruction and investment plans of British Flint, and prepare an informal report for him that covers the following matters.

- The effect the scheme is likely to have both on British Flint's cost of capital and its cash position.

  (Assume the following equation in finding the cost of capital:

  Cost of debt capital = (1 – T)(Risk free rate + Credit spread))
- The effect the scheme is likely to have on British Flint's share price.
- The probable impact of the scheme on the Monkridge family trust.
- Whether the risk involved in the alloy castings project is likely to affect British Flint's beta value.
- The prospects for success of the reconstruction scheme, in both the short term and longer term, and advice on the implications of the scheme for the company's debenture holders.
- Corporate governance arrangements in British Flint and any ethical issues associated with the reconstruction scheme, if this goes ahead.

Requirement

Draft the report for Mr Monkridge.

Total: 45 marks

Exhibit 1

Market data relating to the securities of British Flint plc

Equity

Current market price	27.45p
P/E	6.4
Equity beta value	1.46

7% debentures

Current market price	£86.0528
Standard & Poor's rating	BB

Other information

Corporation tax rate	20%

Risk free rate of return %

1 year	2 years	3 years	4 years	5 years	6 years	7 years
4.24	4.47	4.71	4.95	5.20	5.52	5.89

Current risk market portfolio rate of return 9.72%

Credit spreads for BB rated bonds – basis points

1 year	2 years	3 years	4 years	5 years	6 years	7 years
320	375	434	494	555	617	689

Exhibit 2

Extract from the financial statements of the Monkridge family trust for the year ended 31 March 20X3

	£'000
Securities held	
6.4m £1 nominal shares in British Flint plc – market price valuation	2,240
British Flint plc 7% debentures – market price valuation	5,876

Exhibit 3

British Flint plc – financial statement extracts years ended 30 September

	20X1	**20X2**	**20X3**
	£'000	**£'000**	**£'000**
Revenue	65,724	64,219	63,287
Cost of sales	32,759	33,469	31,250
Gross profit	32,965	30,750	32,037
Expenses	21,450	21,450	21,479
EBIT	11,515	9,300	10,558
Tax	1,205	998	127
Net assets	57,900	54,720	53,450
Dividend per share (pence)	3.7	2.9	1.5