ADVANCED LEVEL EXAMINATION

JULY 2016

Mock Exam 1

(3½ hours)

STRATEGIC BUSINESS MANAGEMENT

This paper consists of **TWO** questions (100 marks).

1. Ensure your candidate details are on the front of your answer booklet. You will be given time to sign, date and print your name on the answer booklet, and to enter your candidate number on this question paper. You may not write anything else until the exam starts.
2. Answer each question in black ball point pen only.
3. Answers to each written test question must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.
4. The examiner will take account of the way in which answers are presented.
5. When the assessment is declared closed, you must stop writing immediately. If you continue to write (even completing your candidate details on a continuation booklet), it will be classed as misconduct.

The questions in this paper have been prepared on the assumption that candidates do not have a detailed knowledge of the types of organisations to which they relate. No additional credit will be given to candidates displaying such knowledge.

IMPORTANT

Question papers contain confidential information and must NOT be removed from the examination hall.

DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK

You MUST enter your candidate number in this box.

1 Biaggi Ltd

The clothes designer, Valentino Biaggi, was born in Italy and began his career there, but has subsequently worked in England for the last ten years.

His company, Biaggi Ltd, has developed a favourable reputation for the quality of its clothes, and has enjoyed rapid growth in recent years.

However, Valentino is concerned that the company's apparent success is not being reflected in its financial performance. He has asked to meet with Heidi Clark who is a partner in Bard & Franck LLP (BF), a firm of ICAEW Chartered Accountants.

You work for BF as a senior in the advisory department. Biaggi Ltd is a client of BF, but not an audit client.

The meeting

Valentino opened the meeting. 'Thanks for agreeing to see me. I need your help with various matters.

Although you may already be familiar with my company, I have prepared some background notes about the company, and I will send you these (**Exhibit 1**) as well as some financial and operating data (**Exhibit 2**).

You will see that the company has been growing, but although this should be good news, I am concerned that the company is actually expanding too quickly for me to manage and control. In addition, I have now been approached by a national retail chain, Sartore, with a proposal which could increase sales further (**Exhibit 6**).

In addition to the general concerns I have about the performance of the business, I am also concerned about currency rate movements. In the year ended 30 June 2015, Biaggi Ltd benefitted from the fact that the value of £ sterling appreciated against the euro, but this last year (ended 30 June 2016), I estimate that, on average, the £ was valued 5% lower against the euro compared with the prior year (ended 30 June 2015). I am worried that, in the future, exchange rates might continue to move against me, and would welcome BF's advice on ways to reduce the impact of these adverse currency movements. As a specific example, I attach details of a large payment that we are due to make to our Italian employees at the end of October (**Exhibit 5**).

Finally, I would like to talk about the supply side of our business model. Historically, Biaggi has employed skilled workers to manufacture all our clothes in-house. However, as the business has expanded, we have had to use a network of external suppliers in order to produce the volume and range of clothes required. As we continue to grow, I expect we will need to use an increasing number of suppliers, but I would like to know what the issues associated with this might be.'

Engagement partner's briefing

Heidi asked to see you after the meeting. She outlines the conversation she had with Valentino during the meeting, and gives you the following instructions:

'I would like you to provide for me a draft response to the requests made by Valentino Biaggi **(Exhibit 7)**'.

Requirement

Respond to the instructions from Heidi, by drafting the reply required to Valentino (**Exhibit 7**).

Assume it is now July 2016.

Total: 55 marks

Exhibit 1 – Business background – notes prepared by Valentino Biaggi

Valentino Biaggi has been designing high quality, fashionable clothes for over 25 years, working for the family business. For the majority of this time, the business has been a partnership, based in Italy, whose clothes were sold by boutique retailers throughout Italy. However, Valentino noticed that his clothes were becoming increasingly popular in the UK, and so ten years ago, with the support of his family, he decided to terminate his contracts with the Italian shops, and establish his own retail operations in the UK.

To support the change in strategy, Biaggi Ltd was incorporated on 1 July 2006.

Business model

The high quality of Biaggi Ltd's clothes, as well as the style of their designs, is crucial to the success of the business. Therefore, despite the expansion of the sales market, Biaggi continues to make all its clothes in Italy, and continues to employ many of the skilled tailors who have helped to build its brand name.

In recent years, Biaggi has begun to outsource the manufacturing of some products to a network of carefully selected, skilled artisans, with whom Valentino has developed good working relationships.

Biaggi Ltd does not compete primarily on price. The prices the company charge reflect the quality of the design, workmanship and materials used, and Biaggi believes it charges a fair price for its clothes on that basis. Market research has shown that, for Biaggi's customers, the design and quality of the clothes are the most important factors in their purchasing decision.

In the clothing industry as a whole, the proportion of purchases made online has been increasing over the last ten years. Although Biaggi has an e-commerce website, its revenues are still dominated by sales in store, because customers prefer to see – and to try on – the clothes before buying them. Biaggi Ltd currently only sells its clothes through its own stores, or through its website. It does not sell them through any third party retailers (for example, department stores).

Marketing

Biaggi Ltd initially invested heavily in marketing expenditure to establish the business in the UK and has kept a strong marketing team to maintain growth. The company's marketing message is based around supplying 'a touch of Italian glamour in England'.

Supply and logistics

The company currently owns two warehouses: one in Italy and one in England. Finished clothes, from the in-house tailors and the external suppliers, are held in the Italian warehouse.

Clothes are then transported, by lorry, from the Italian warehouse to a distribution warehouse in central England once a week. From there, the clothes are delivered to Biaggi's shops. The company currently has ten shops, which it rents under operating leases.

Exhibit 2 – Financial and operating data

INCOME STATEMENTS FOR YEARS ENDED 30 JUNE

	Actual			*Draft*
	2013	*2014*	*2015*	*2016*
	£'000	£'000	£'000	£'000
Revenue	19,658	23,964	26,990	30,337
Cost of sales (note 1)	(12,156)	(15,496)	(17,768)	(20,800)
Retail costs (note 2)	(2,724)	(3,040)	(3,144)	(3,348)
Distribution (notes 3,5,6)	(1,904)	(2,088)	(2,316)	(2,436)
Other operating expenses (note 4)	(576)	(680)	(981)	(1,050)
Interest	-	(140)	(200)	(200)
Profit before tax	2,298	2,520	2,581	2,503

STATEMENT OF FINANCIAL POSITION EXTRACTS AT 30 JUNE

	Actual			*Draft*
	2013	*2014*	*2015*	*2016*
	£'000	£'000	£'000	£'000
PPE (note 5)	3,800	5,500	5,200	4,900
Cash	40	150	290	2,380
Other current assets	820	2,040	3,840	6,760
Loan	-	(2,000)	(2,500)	(2,500)
Lease liability	-	-	-	(2,000)
Current liabilities	(960)	(1,040)	(1,600)	(1,750)
Net assets	3,700	4,650	5,230	7,790

OPERATING DATA FOR YEARS ENDED 30 JUNE

	Actual			*Draft*
	2013	*2014*	*2015*	*2016*
Product range (number of products)	104	120	152	180
Number of sales transactions	192,400	257,280	332,400	389,350
Product returns (items)	1,640	2,050	2,770	3,208

Notes.

1 Cost of sales includes only the cost of manufacturing the clothes or procuring the clothes sold in the period. It includes all depreciation on property, plant and equipment at the manufacturing centre in Italy. It does not include distribution costs, or any employee costs for the UK stores.

2 Retail costs relate to the UK store operations, and include employee costs, rental costs and utility costs.

3 Distribution costs comprise the logistics and distribution costs, including warehouse operating costs, and fuel and transport costs.

4 Other operating expenses includes sales and marketing costs.

5 The Italian warehouse was acquired for the euro equivalent of £4 million on 1 July 2012. The UK distribution warehouse was acquired for £2 million on 1 July 2013. All PPE is depreciated on a straight-line basis over 20 years with a zero residual value.

6 The normal annual depreciation has been charged on the UK distribution warehouse for the year ended 30 June 2016, despite the sale and leaseback agreement (**Exhibit 3**).

7 All shops and shop equipment are held under operating leases. Similarly, all machinery in the manufacturing centre and warehouses is held under operating leases.

Exhibit 3 – Sale and leaseback

On 1 July 2015, in order to raise finance for its continuing growth in the UK, including an expansion of its distribution facilities, Biaggi entered into a sale and leaseback agreement on its existing distribution warehouse in England.

The terms of the sale and leaseback agreement were that Biaggi sold the warehouse to a financial institution for £2 million, which is equivalent to the present value of the minimum lease payments. Biaggi then leased it back under an 18-year lease.

The lease includes a clause transferring title back to Biaggi at a zero price at the end of the lease agreement. The annual rental is £243,860 payable in arrears with the first payment being made on 1 July 2016.

At the time of the transaction, the accounts assistant was unsure how to deal with this transaction, so they recognised the cash receipt of £2 million and a lease liability of the same amount.

Unfortunately, our plans to expand the UK distribution facilities have been delayed, but we need to invest the cash in the distribution network soon, as this is currently at full capacity.

Exhibit 4 – Financing proposals

Although Biaggi's clothes are all hand-finished, parts of the manufacturing process have been automated in order to increase the volume of clothes which can be produced. However, in order to support the continued expansion of the business, further investment in larger and more sophisticated equipment is now required.

Finance will be needed for this investment, and an Italian bank, Gienna, has offered two alternative proposals:

Proposal 1

A five-year loan of €3.5 million at an 8% fixed annual rate of interest. Interest is payable annually in arrears. The principal is repayable at the end of the five-year period.

Proposal 2

A five-year loan of €3.5 million, repayable annually in arrears, in equal annual instalments of €876,534.

Exhibit 5

Bonus payment

As the business has expanded, Biaggi's human resources department has grown, and along with developing our general policies and procedures on HR-related matters, the department has carried out a review of all employee contracts. One issue that the review highlighted is that many of our staff in Italy are entitled to an additional monetary payment, in the form of a loyalty bonus, to recognise their contribution to Biaggi's growth in recent years. This payment is due to be made in three months' time, at the end of October, and will total €2m across all eligible employees.

Given the size of this payment, I am concerned that the euro exchange rate may fluctuate further over the next few months. In particular, because of the uncertainty about the rates, I do not know how much sterling we will need to cover this €2m payment. All I do know is that if the euro continues to strengthen against the £ as it did during the year ended 30 June 2016, then the cost of such payments will increase. This sum of €2m is the largest single cash payment that Biaggi has ever had to make, but I expect that, as the business grows, the frequency with which we have to make large payments in euros will increase. I know in principle that it is possible to hedge against adverse currency movements, but our expertise in this area is limited and I am increasingly inclined to use the prevailing spot rate for the sake of simplicity.

My accounts clerk has done some initial investigating in the financial press and extracted the following details, which I confess are of little help to me in deciding which hedging strategy to adopt. Maybe you can make sense of them?

Current euro spot rate	£1 = €1.32 - €1.33
Euro three month forward rate	£1 = €1.29 - €1.30

Interest rates

	Borrowing	*Deposit*
£ sterling	4.25	3.75
€ euro	3.50	3.00

Details for €10,000 options contracts at exercise price of £1 = €1.33:

	Calls			*Puts*	
August	*September*	*October*	*August*	*September*	*October*
1.25	1.80	2.00	0.68	1.15	1.45

Exhibit 6 – Retail contract

Biaggi has recently been approached by a national UK retail chain, Sartore, to supply it with a range of cotton shirts. The shirts would be packaged under the Sartore brand name.

Volumes would be a minimum of 300,000 shirts per year for two years from 1 January 2017 at a price of £15 per shirt. This price is significantly lower than Biaggi charges for its shirts. However, this reflects the fact that the designs for Sartore's shirts will be more standardised than Biaggi's own shirts.

The estimated costs to Biaggi Ltd of producing the shirts (per shirt) would be:

Manufacturing (translated from euros)

In 2017	£12.50
In 2018	£12.75
Logistics and distribution (both years)	£0.40

If Biaggi accepted the contract, it is estimated that additional fixed costs of £500,000 would be incurred in 2017, and £520,000 in 2018.

Exhibit 7

Prepare a report for Valentino Biaggi which addresses the following issues:

(1) On 1 July 2015, I entered into a sale and leaseback arrangement on my distribution warehouse in England (**Exhibit 3**), but my accounts staff do not know how to treat this transaction in the financial statements. Please set out the financial reporting treatment of this arrangement for the year ended 30 June 2016, including calculations correcting the existing entries, if appropriate. Please use journal entries so my accounts staff can follow the adjustments clearly.

[Please ignore the tax implications of the sale and leaseback transaction. I will discuss these separately with our tax advisors.]

(2) I need to raise further finance to expand the business in Italy and I have received two proposals from Gienna, a bank in Italy (**Exhibit 4**). I would like you to advise me on which proposal, if either, I should accept. I need you to determine the cost of debt in each case in annual percentage terms and explain the risks of each proposed finance method. (I am not interested in the financial reporting implications at this stage.)

(3) Revenue is growing, but profit does not seem to be increasing at anywhere near the same rate. I would like you to prepare notes for me, analysing the available data and other information to explain why this is the case.

(4) Identify and illustrate three potential hedging strategies which could reduce Biaggi's foreign exchange risks for its euro payments (**Exhibit 5**), highlighting the advantages and disadvantages that the company should be aware of with each.

(5) I would also like your advice on whether to accept the contract from Sartore (**Exhibit 6**). I am concerned about the risks and wider strategic implications, as well as financial returns.

(6) Finally, please can you highlight the potential problems Biaggi could face from using additional external suppliers to satisfy the growing demand for its clothes.

2 Chocaulait Cravings plc

Chocaulait Cravings plc (CC) is a listed company which manufactures and sells top quality confectionery. The company was formed over a hundred years ago, and has become a household name throughout Europe.

You are a recently qualified ICAEW Chartered Accountant working in the business advisory and assurance department of a large firm of ICAEW Chartered Accountants, Hathway LLP (Hathway). CC is a client, but not an audit client, of Hathway.

The finance director at CC has had to take long-term sick leave and Becky Smith, the Chief Operating Officer is covering his role on an emergency basis until an interim financial director can be recruited. Becky has asked for a meeting with Hathway. You attended the meeting with your manager, Richard Stratton.

Assume it is now July 20X5.

The meeting

Becky opened the meeting. 'The CC board believes that the company is performing well in relation to its strategic aim of becoming a multi-channel retailer. However, the management accounts for the year ended 30 June have just been prepared and they show a fall in operating profit compared with the previous year. Our group management accountant is satisfied that the figures have been compiled correctly, but I need to be able to explain the results at the next board meeting. The CEO is expecting a small increase in profit this year compared to last. I would like some independent, external analysis of CC's performance to help me with my explanations.

I have provided some background details for you about the company and its business operations (**Exhibit 1**).

I have also provided you with the relevant financial and operating information for CC (**Exhibit 2**).

In addition, there are some further issues which I know CC's board would like Hathway's advice about. I will provide an overview of these issues now, but following the meeting I will also send a "terms of engagement" document which will provide a summary of the work CC requires from Hathway.

Potential acquisition

CC is considering making a bid to acquire Arista Cafés (Arista). CC had been thinking about opening its own "CC Cafés" to offer a range of snacks, light meals and refreshments, as well as selling a selection of our chocolates and confectionery. However, the board feels that an acquisition will enable CC to grow more quickly, and believes that Arista's reputation for serving the highest quality coffees and teas fits well with CC’s own brand positioning.

Arista is a privately owned company, with approximately 100 cafés across the UK. It has established a loyal customer base and, as a result, Arista’s cafés typically have higher sales volumes than other similar cafés in their areas. Arista’s brand name – and its association with the highest standards of taste, quality and customer service – is considered to be a contributing factor in its success.

We have had some initial high-level discussions with Arista's board, and have also obtained some limited financial information about the company (**Exhibit 3**). Negotiations are still at a preliminary stage, but things are looking promising so far.

However, before we can go further with the negotiations and make a firm offer, CC's board has asked me to estimate a preliminary valuation of Arista's shares, as a basis on which to make a bid. I would like your help with this task.

The board is also unsure at this stage what our post-acquisition strategy will be for Arista if we proceed with the acquisition. One choice is to continue operating the Arista cafés under their own name, the other is to rebrand them as CC Cafés. I would like your advice about the financial reporting implications of both strategies in the consolidated financial statements for the CC Group if we go ahead and make the acquisition.'

Recent issue – supplier payments

'Recently there have been a number of press articles which have been critical of the way companies pay their suppliers. CC has developed a good reputation for dealing with its suppliers in an open and honest way, but one of the articles claimed CC's payment arrangements were unethical.

Last year, CC renegotiated its terms and conditions with its cocoa suppliers with the effect that invoices would be paid after 30 working days, whereas they were previously paid after 20 working days. However, the terms and conditions also included a clause that suppliers could still request payment after 20 working days, subject to a 3% "prompt payment" discount deducted from the gross value of the invoices submitted.

The article claimed that this arrangement is simply another example of a large company abusing its power in relation to its suppliers. The board is very concerned about the potential damage this coverage could have on CC's reputation, although the board also believe the article has not been entirely fair to CC, because the revised terms and conditions are only bringing CC's payment arrangements in line with those of its major competitors.

The board would like your advice about how to respond to the article.

Before this article was published, however, the board had already been considering the need to obtain some independent assurance over our social responsibility report. The report highlights CC's aims to carry out its business with as little damage to the environment as possible and to deal fairly with all its stakeholders. We are also keen to ensure that all of our suppliers adhere to high ethical and environmental standards, with regard to sources of materials (such as cocoa and sugar) and in the way they treat their employees.

However, although we are keen to ensure this, the amount of assurance work we have carried out on our suppliers has been very limited to date, and we would like your advice about the key areas where we should look to include in this work. More generally, some members of the board are sceptical about the need for assurance over our social responsibility report, so it would be useful if you could summarise why such assurance is necessary.'

Manager's instructions

Following the meeting, Richard called you into his office. He explained, 'CC's board would like Hathway to prepare a report addressing the issues explained by Becky in our meeting. Becky has sent me the terms of engagement document which she promised us (**Exhibit 4**) and I would like you to draft a response to this.'

Requirement

Respond to the instructions from Richard, your manager, based on the 'terms of engagement' document (**Exhibit 4**).

Total: 45 marks

Exhibit 1 – Background details

All of CC's products are manufactured in its factory in the UK. The products are sold through CC's own ('high street') stores, online, and through large retail stores and supermarkets. In addition, CC also supplies 'own brand' label confectionery to several supermarkets. These supermarkets sell CC's products as well as the 'own brand' confectionery that CC manufactures for them.

CC's product portfolio includes a variety of milk, white and plain chocolates, but it has also expanded into producing other forms of confectionery (cakes and sweets).

Although CC exports its products across the world, its largest markets are the UK and Western Europe.

Business structure

CC is organised into two divisions: retail sales and commercial trading.

The retail sales division is responsible for selling CC's products through its own stores and online.

The commercial trading division is responsible for procurement and manufacturing of CC's products, which it then either supplies internally to the retail sales division or sells externally to third party retail stores and supermarkets.

Distribution channels

In recent years CC, like many other retailers, has experienced a decline in high street sales which has led it to reduce the number of stores it operates. Nonetheless, CC believes that high street stores remain an important sales channel, and its strategy is to provide a wide range of high quality products from the stores which are in the best locations to attract customers.

At the same time, CC has looked to increase other sales outlets, in particular its website, in line with its strategic aim to become a multi-channel retailer.

The board is also keen to increase international sales further, particularly outside Europe, and they believe that internet shopping could help to achieve this.

Market conditions

Despite difficult conditions, the chocolate market in the UK and Europe has continued to grow in recent years, as customers have been buying chocolate products as an affordable alternative to higher priced gifts.

Sales remain seasonal, however, so CC is trying to encourage customers to buy its product throughout the year rather than at peak sales periods only (such as Christmas).

Exhibit 2 – Financial and operating information – prepared by CC management accountant

Summary management accounts – Statement of profit or loss for years ended 30 June

	20X5 £'000	*20X4* £'000
Revenue		
Retail	144,063	149,270
Commercial trading	109,780	103,730
	253,843	253,000
Cost of sales		
Retail	(73,472)	(75,008)
Commercial trading	(57,744)	(54,355)
Gross profit	**122,627**	**123,637**
Operating costs	(89,850)	(88,653)
Operating profit	**32,777**	**34,984**
Finance costs	(5,050)	(5,125)
Profit before tax	**27,727**	**29,859**

Note.

Finance costs relate substantially to interest payable on overdrafts, loans and leases. Exchange differences on foreign currency payments were £45,000 in 20X4 and £8,000 in 20X5.

Selected operating data for years ended 30 June – prepared by CC management accountant

		20X5	*20X4*
Channel mix within retail business			
Own stores (%)		91.7	93.4
On line sales (%)		8.3	6.6
Number of own stores	*Note 1*	278	305
Retail chains and supermarket groups supplied		15	12
Average discounts given (%)		3.0	2.5
Salary costs (£'000)		60,050	59,520
Average monthly numbers of people employed			
Retail division		2,175	2,320
Commercial trading division		1,300	1,175
Head office		105	105
		3,580	3,600

Note 1.

The high street closures took place on 1 July 20X4. No new CC high street stores were opened during 20X4 – 20X5.

The average annual revenue of the stores which closed was £410,500 for the year ended 30 June 20X4.

CC incurred one-off redundancy payments and store closure costs of £1.1m in relation to the store closure programme. These costs are shown within operating costs. There had been no equivalent store closures in the year ended 30 June 20X4.

Exhibit 3 – Potential acquisition of Arista Cafés – prepared by Becky Smith

Arista Cafés is a family run business, with a number of well-established cafés throughout the UK.

The family appear amenable to the idea of a takeover, but as the business is performing well they are not under any pressure to sell it. Although we have not had any formal discussions with Arista about a sale price yet, we believe that they will be looking for a price in the region of £50m.

Summary financial data is as follows:

Income statement extract for the year ended 31 March 20X5

	£'000
Revenue	68,320
Operating costs	63,650
Profit for the year	4,670
Dividends proposed	3,100

Statement of financial position for Arista Cafés as at 31 March 20X5

Assets	£'000
Non-current assets	25,500
Inventories	5,650
Total assets	31,150
Equity and liabilities	
Share capital (£0.50 shares)	5,000
Retained earnings	21,915
Current liabilities	4,235
Total equity and liabilities	31,150

Working assumptions

Some preliminary investigations by CC have revealed the following:

- Arista owns the freehold for many of the shop units where its cafés are situated. These are shown at cost (£21.3m) in the statement of financial position, but as a rough estimate they could be worth closer to 1.5 times that value on the open market.
- Arista's revenue and profits for the year ended 31 March 20X5 appear broadly consistent with the previous years (for which accounts have been seen).

Other information:

Listed coffee shops in the UK have an average P/E ratio of 24.

A suitable cost of equity to appraise this acquisition is 15%.

Exhibit 4 – Terms of engagement – prepared by Becky Smith

The CC board requests that Hathway prepares a report which addresses the following issues:

(a) Using Exhibit 2 and the other information provided, analyse and explain the performance of CC for the year ended 30 June 20X5. Highlight any additional information that could help to explain CC's performance further.

(b) As far as the information permits, identify possible valuations of Arista, using: assets basis; P/E basis; and dividends basis. Highlight the advantages and drawbacks of the methods of valuation, and any concerns you have about the valuation.

(c) Explain the financial reporting implications of the valuation of Arista, and of any subsequent decision to rebrand the Arista Cafés as CC Cafés.

(d) Advise the board how it should respond to the press articles about CC's payment arrangements to its suppliers.

(e) Explain the main objectives of an assurance engagement addressing CC's supply chain. Also, highlight the main reasons why the social responsibility report should be subject to external assurance.

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