ADVANCED LEVEL EXAMINATION

JULY 2016

Mock Exam 2

(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 material is 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.

You MUST enter your candidate number in this box.

DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK

1 Selworthy plc

Selworthy plc is a listed company which operates in the chemical industry manufacturing paints.

You are Claire Gull, a newly-appointed assistant accountant reporting to the Selworthy finance director, Roger Richards, who is an ICAEW Chartered Accountant.

Roger has asked you to come into his office for a meeting to discuss some work he needs you to do for him.

The meeting

Roger explained: 'I have a meeting next week with our new chief executive, Wesley Wilson. He has made it clear that he wants to change our strategy and expand the business. I realise that you are new to Selworthy, so I have provided you with a brief summary of the company's background (**Exhibit 1**).

Wesley has prepared some notes which summarise his review of the strategic issues and operational matters which have come to his attention during the first 60 days since his appointment (**Exhibit 2**). He has asked me to provide an initial response to his review at next week's board meeting.

Wesley is also keen to make an acquisition. He has identified two possible targets, but we are in a position to acquire only one of them, so we would need to make a choice and it is quite urgent. I have prepared a paper giving details of the two target companies based on preliminary due diligence and draft forecast financial statements for the year ending 31 December 20X1 (**Exhibit 3**).

As you will see from my paper (**Exhibit 3**), Wesley is keen for us to use debt rather than equity to finance the acquisition. Last week, Wesley and I were at a dinner with our relationship manager from the bank, and Wesley mentioned that we might need to take out a new loan shortly. Although the relationship manager seemed amenable to the idea in principle, he reminded Wesley that the bank would require an assurance report from our auditors on Selworthy's three year forecast to support the loan application, as well as covenants limiting gearing and so on.

After the dinner Wesley told me he was rather surprised by this, because he didn't see how our auditors could provide any assurance over forecast figures, because they were only used to auditing historic financial information. He asked for a brief note to be included with the papers for the next board meeting, explaining how the auditor's work in this context would differ from that at the year end audit.

Finally, last week I also attended a conference on the state of the paint manufacturing industry, and I took notes on the keynote speech (**Exhibit 4**). I suspect that some of the issues in my notes could have relevance for our growth strategy and any decision to acquire one of the two companies. I haven't discussed these issues with my colleagues yet, but before I do I should like you to carry out a preliminary assessment of them.

I appreciate there is quite a lot for you to consider here, so I will send you an email which sets out more precisely what I would like you to do (**Exhibit 5**).'

Requirement

Respond to the instructions (**Exhibit 5**) of the finance director, Roger Richards.

Where appropriate, assume a tax rate of 23%.

Assume the date 'now' is November 20X1.

Total: 60 marks

Exhibit 1 – Company background

Selworthy is a relatively small producer of paints in the context of the global industry. It makes all its sales in the UK, where it has a 7% market share. It has one factory in the South of England and a distribution warehouse in central England.

Selworthy's average cost of producing one litre of paint is £2; it produces approximately 15 million litres per year. The average cost per litre at this level of output is made up as follows:

	£
Materials	0.40
Factory labour	0.80
Distribution	0.10
Fixed production overheads	0.20
Fixed administrative expenses	0.50

The average selling price of one litre of paint is £2.10, with its sales being both to small and large retailers and wholesalers. This price reflects a very competitive market with tight margins.

Exhibit 2 – CEO's notes – Review of the business

I have spoken to many people, inside and outside of the company, during the 60 days since my appointment. There are many good aspects of our business, but there are also some things I would like to change. I have set out a summary of my initial thoughts below.

Objectives

Growth has been too slow in the past. My target for Selworthy is to provide shareholders with 15% per annum sustainable growth in profit before tax. There are no other specific objectives as I believe that, if we meet this target growth rate, all reasonable requirements of other stakeholders can be satisfied.

Business strategy

We operate in a mature industry which has shown no growth in revenues in the past few years. It is unreasonable to suggest that our target profit growth can be met from increased UK market share or from margin increases. I therefore propose three elements to the strategy for growth:

(i) Commence exporting to expand sales into new geographical markets.

(ii) Make acquisitions financed by increased borrowing.

(iii) Adopt more aggressive choices of accounting policies and estimates, within permitted financial reporting standards, in order to increase reported earnings over time.

These are not alternatives. I intend that we should follow all three elements of the strategy simultaneously.

(i) **Exporting**

Due to the high transport costs of paint, Selworthy does not currently export. We need to explore again opportunities in export markets.

As a test of what can be achieved in the short term, an opportunity has arisen for a one-year contract to sell one million, one-litre tins of paint to a wholesaler in Germany, Bremen Inc. Delivery would take place regularly throughout the year ending 31 December 20X2. The agreed selling price would be €2.40 per litre, payable three months after the end of the month in which the paint is delivered to Bremen.

I am keen to commence a strategy of exporting, but this contract could be unprofitable. I am also concerned about all the risks, just one of which is not getting paid by Bremen – we need to protect ourselves as a bad debt on this contract would severely damage us financially.

(ii) **Financial strategy for acquisitions**

Despite increases in borrowing this year, I believe our gearing is too low. I think we need to finance new acquisitions by borrowing. Over the next few years we should aim at least to double our borrowing. Acquisitions financed through debt will be a key factor in meeting our target growth figure.

(iii) **Accounting policies and estimates**

I am not an expert in this area, but I am keen that we use financial reporting choices to enhance growth in earnings after 20X1 wherever possible. I am not worried if the 20X1 earnings figure is low, as I can blame the previous CEO for this year's poor performance. Please address the following matters:

(a) We are undergoing a reorganisation at the moment. We plan to close our own delivery function on 1 January 20X2 and outsource it from that date. There will be residual administration tasks relating to closure, so redundancies will take place around April 20X2. I would like to make the maximum possible provisions to reduce profits in 20X1. If these provisions turn out to be excessive, then we can release them in later years. Let's be prudent.

(b) The delivery warehouse which we plan to close is held under a non-cancellable operating lease with a remaining term of five years and rentals of £200,000 per annum payable annually in arrears. Unfortunately, for the remaining lease term, we can only sub-let it for £150,000 per annum, also payable annually in arrears.

(c) Selworthy owns a plot of land in France which the previous CEO intended to develop, but this was not implemented. We paid €1.8m for it some years ago when the exchange rate was £1= €1.5. Commercial property market conditions in France are not good at the moment. It seems that the land now has a value of only about €1.5m, although we have not started advertising it yet. Given that we will make a loss on the disposal of this property of €300,000, I intend to make the sale in 20X1 to reduce profit in that year.

Working assumption – exchange rate

Our working assumption for all planning is that the current exchange rate is £1 = € 1.2 and it will remain at this level until 31 December 20X2.

Delivery function – staff issues

My understanding is that the plan to outsource the delivery function has been agreed by the Board, on the basis of a cost benefit analysis presented to them by the finance director (Roger). In particular, this analysis highlighted that the new arrangement means that Selworthy's delivery costs will become a purely variable cost, whereas its current staff and warehousing costs are both effectively fixed costs.

However, I am aware that there is considerable opposition to the plan from the delivery staff. Many of the 15 staff employed in the function have worked for Selworthy for a number of years, and fear their prospects for finding a replacement job are not good, due to high levels of unemployment in their region of the country. All of the delivery staff are also union members. I have received a letter from the union representative alleging that the decision to outsource the function victimises his members – because the delivery function is the only function within Selworthy which has a unionised workforce. The union representative has claimed that the closure is 'wholly unethical and unjustified'.

Exhibit 3 – Two target acquisitions

Target 1 – Colour Chem Ltd

Colour Chem Ltd (CC) is a private company which produces solvents and other chemicals for sale to paint industry manufacturers throughout Europe, but with 50% of sales being in the UK. About 20% of its total sales are to Selworthy.

Most of CC's property, plant and equipment is held under operating leases of 8 to 15 years. About 60% of CC's cost of sales comprises fixed costs with the remainder being variable costs. All administrative expenses are fixed. Distribution costs are all variable.

A working assumption is that all sales volumes will grow at 10% per annum over the next three years from 1 January 20X2 but, thereafter, zero growth is expected for the foreseeable future. Prices, variable costs per unit and total fixed costs are assumed to remain constant in pound sterling terms in the foreseeable future, reflecting competition in the market. There will be no synergistic cost savings or surplus assets as a consequence of the acquisition.

Target 2 – Puma Paints Ltd

Puma Paints Ltd (PP) is a manufacturer of quality paints, which is currently owned by a large chemicals company. While in the same industry as Selworthy, its paints sell for about twice the price of Selworthy's paints. Sales are to upmarket retailers throughout Europe. The market is stagnant so no increases in sales volumes or prices are expected in the foreseeable future.

Material costs make up 50% of the cost of sales, and 70% of the cost of sales consist of variable costs.

Cost savings of about £100,000 per annum will arise from the acquisition of PP, mainly in administrative and distribution costs. Surplus assets can be sold off immediately for their carrying amount of £500,000.

With either target company, the acquisition would take place on 1 January 20X2.

Draft forecast statements of profit or loss for the year ending 31 December 20X1

	Selworthy	*CC*	*PP*
	£'000	£'000	£'000
Revenue	31,500	10,000	9,800
Cost of sales	(21,000)	(8,000)	(5,000)
Administrative expenses	(7,500)	(1,000)	(1,500)
Distribution costs	(1,500)	(1,000)	(800)
Operating profit	1,500	0	2,500
Finance costs	(1,000)	–	(500)
Profit before tax	500	0	2,000
Tax (23%)	(115)	–	(460)
Profit after tax	385	0	1,540

Draft forecast statements of financial position at 31 December 20X1

	Selworthy	*CC*	*PP*
	£'000	£'000	£'000
Non-current assets			
Property, plant and equipment	65,000	5,000	20,000
Current assets			
Inventories	3,500	3,000	1,500
Receivables	4,000	2,000	2,000
Cash and cash equivalents	1,000	2,000	–
Total assets	73,500	12,000	23,500
Equity and liabilities			
Issued capital – £1 ordinary shares	20,000	5,000	6,000
Share premium	15,000	4,000	4,000
Retained earnings	15,500	2,500	5,000
Equity	50,500	11,500	15,000
Non-current liabilities			
Long-term loan	20,000	–	7,500
Current liabilities			
Trade payables	3,000	500	1,000
Total equity and liabilities	73,500	12,000	23,500

The carrying amounts of assets approximately reflect their fair values.

Note. The current share price for Selworthy equity is 15 pence per share.

Exhibit 4 – Notes on the state of the paint manufacturing industry

Paints produced by the industry consist mainly of household paints (40% of total sales revenue), product finishes for cars and furniture etc (25%), industrial coatings (20%) and other products such as varnish removers and paint thinners. Profitability depends on technological expertise and efficient production. Small manufacturers are able to compete with larger groups because of the large range of paints and coatings used for many different applications. The industry continues to innovate. Recent developments have been improved water-resistant and corrosion-resistant paints, and a niche market is developing in ecologically-friendly ‘green’ paints.

There is strong brand dominance in some parts of the market, notably in household paints. However there is strong competition throughout the industry, which means that prices have remained fairly stable for the past five years, and are expected to remain stable in the future – in spite of a forecast rise of 5% per year in raw material costs. Profit margins in general are small.

Growth in sales in the industry as a whole has been slow for the past five years, and is expected to remain at about 1% in the foreseeable future. Faster growth is not expected until there is a significant increase in economic activity.

Exhibit 5 – Extract from email sent by Roger Richards

I don't need you to produce a full report, but please prepare extracts on the following issues for me to include in the board papers for the next board meeting:

(1) In relation to the issues highlighted in Wesley's 60-day review (**Exhibit 2**), please:

- Explain the risks of the Bremen contract, including how these might be mitigated and give reasoned advice, with calculations, on whether we should accept the contract.
- Evaluate the risks and benefits of borrowing to finance future acquisitions (focus on our company's financial position and the use of the debt finance specifically to make acquisitions, as it can be assumed that the board understands the general arguments about gearing).
- Summarise the financial reporting implications of the each of the three matters Wesley has raised in section (iii) of his review of the business ('Accounting policies and estimates'). Please also indicate whether these matters can legitimately be used to enhance reported earnings growth.
- Advise whether the plan to close Selworthy's delivery function is a breach of ICAEW's Code of Ethics.

(2) With respect to the two potential acquisitions (Colour Chem and Puma Paints; **Exhibit 3**), and so far as the information currently available permits:

- Determine a valuation for the entire share capital of each company that indicates the maximum amount we should ultimately be willing to pay for each potential acquisition. Selworthy uses a discount rate of 10% per annum for all purposes, so use this rate to discount future earnings.
- Recommend, with reasons and supporting analysis, which company would be the better strategic and operational fit with our business. I appreciate that the acquisition price will be a key issue in our final decision, but ignore this for the purpose of your analysis.
- State any additional factors that we should consider before deciding on a final price for the two targets and identify the key matters that we would require the auditors to address during detailed due diligence procedures.

For the purpose of requirements (1) and (2), please ignore my notes on the state of the paint manufacturing industry.

(3) Use my notes on the state of the paint manufacturing industry (**Exhibit 4**) to indicate how this could have implications for Selworthy's decision to acquire either of the two companies, and for Selworthy's growth strategy in general.

(4) As requested by Wesley, produce a brief explanation of the differences between the assurance engagement in relation to the new bank loan and routine audit work.

2 Projecta Contractors plc

Projecta Contractors plc (PC) is a UK listed company that specialises in undertaking major construction project work, mainly in the UK and the US.

You are Lindsay Pitt, an ICAEW Chartered Accountant who has just joined PC as the group accountant. You have been asked to attend a meeting with the Finance Director, Chris Fellows.

Assume it is 'now' November 20X5.

The meeting

Chris opened the meeting. 'Hello Lindsay, let me explain why I have asked you to come and see me. I am hoping that you can help me with a presentation I shall be making to the Board in a few days' time. I know that you are new to PC, so I have prepared brief background notes about the company's current situation, and summary financial statements for the past two years (**Exhibits 1 and 2**).

The Board recognises that, overall, we are in a difficult financial position, and things have been getting worse for the past two or three years. We have a good business, but in the short term there are several problems that need to be sorted out. We have a full order book and a reasonable amount of cash in the bank, so not everything is bad. Our share price has fallen this year, but only by about 5%, from £0.57 to £0.54. But there are problems, and the board has asked me to make a presentation of the company's position at our next meeting.

PC has a bank loan of £30m repayable in six months' time, so I have been looking into ways of renewing our debt financing. I have been surprised by the reaction from our relationship bank. Even though we have a borrowing facility of £25m to meet short-term working capital requirements, which we have not used yet, the bank seems to be reluctant to offer us a new loan. Also, our major shareholders aren't interested in a rights issue to provide more equity.

I had a meeting with some hedge fund managers (Montana) a week or so ago, and they have come up with a refinancing package for PC. In strict confidence, I am going to give you some of the details of their offer (**Exhibit 3**).

Our business has been adversely affected by poor economic conditions. Although we are beginning to see an economic recovery in the UK and the US, the construction industry is usually one of the last to feel the benefits of an upswing in the economic cycle. Already in this current financial year, we have had to revise our profit downwards due to four major contracts over-running. In my opinion our bids to win those contracts were far too low, meaning that the budgeted profit margins were too low to justify the work involved. We were too keen to win the work. I intend to make project tendering and management risks an element of my presentation to the Board. I have made some notes for you that you may find useful (**Exhibit 4**).

The group has a subsidiary in the UK, Projecta Advisers Ltd, that specialises in providing project managers for large government building projects. The Board approved a plan earlier this year to find a buyer for this subsidiary, and we have now been approached by a major project management consultancy in the UK that would like to purchase Projecta Advisers. Although the deal has not yet been

finalised, negotiations are reaching an advanced stage, and the Board would like to understand the financial reporting implications of the sale. I have set out some key details for you (**Exhibit 5**).

I would like you to help me by preparing some notes for my presentation to the Board. As you are new to the company, I think you can cast a fresh eye over some of the problems, and I'm sure that your input will help my own thinking. I have prepared a list of the things I would like you to do, and I will send these to you in an email after this meeting (**Exhibit 6**).'

Requirement

Prepare the notes that Chris Fellows has asked for in his email (**Exhibit 6**).

Total: 40 marks

Exhibit 1 – Projecta Contractors plc

Projecta Contractors plc (PC) is a well-established construction firm specialising in major construction contracts for customers in both the government and private business sectors. Although it occasionally does work in Europe, most of its operations are in the UK and the US. Approximately 55% of its revenue each year comes from construction projects in the UK and about 40% comes from the US.

PC operates with a number of subsidiary companies. Each subsidiary in the UK and the US specialises in a particular type of construction project, such as building construction, road infrastructure and telecommunications network construction.

At the beginning of the global economic recession several years ago, PC attempted to avoid cutting back its operations. It started to bid for contracts where budgeted profit margins were low, in order to win the work. This approach was successful for a time, but in the previous and current financial years, about 10% of the work force has been made redundant.

PC's customers have also felt the effects of the difficult economic conditions. Even though PC's customers are governments and major companies, the company currently has impaired receivables of £3.4m, of which £2.2m are over 12 months old. There are also £18.5m of receivables which are 'past due', but not yet impaired.

The Board of Directors responded to investor concerns about the company's position by increasing the annual dividend to £6.9m in 20X3 and maintaining dividends at this level in 20X4. The dividend per share in each year was £0.075. The current share price is £0.54.

Exhibit 2 – Summary consolidated financial statements, Projecta Contractors

Extracts from the statements of profit or loss of Projecta Contractors for the years ended 31 December

	20X4	*20X3*
	£m	£m
Revenue	625.7	618.6
Cost of sales	(563.4)	(548.1)
Gross profit	62.3	70.5
Other operating expenses	(60.3)	(66.3)
Operating profit	2.0	4.2
Finance costs	(6.7)	(5.2)
	(4.7)	(1.0)
Loss on discontinued operation	(3.3)	(1.5)
Loss for the year	(8.0)	(2.5)

Within the costs in 20X4, employment costs were £224.5m.

Projecta Contractors: Summary statements of financial position as at 31 December

	20X4		*20X3*	
	£m	£m	£m	£m
Intangible assets		89.4		98.0
Property, plant and equipment		86.0		91.7
Trade receivables		32.5		38.7
		207.9		228.4
Inventory	9.6		12.3	
Due from construction contract clients	45.1		45.3	
Receivables	89.7		88.6	
Cash and cash equivalents	43.9		39.1	
	188.3		185.3	
Assets held for sale	16.5		–	
		204.8		185.3
Total assets		412.7		413.7
Equity: Ordinary share capital and reserves		78.9		93.8
Long-term liabilities				
Trade payables	13.0		11.4	
Provisions	6.4		8.0	
Borrowing	89.4		78.6	
Derivative financial instruments	3.9		8.8	
		112.7		106.8
Current liabilities				
Due to construction contract clients	25.7		27.3	
Trade payables	146.1		158.2	
Borrowing	33.7		27.6	
	205.5		213.1	
Liabilities held for sale	15.6		–	
		221.1		213.1
Total equity plus liabilities		412.7		413.7

Exhibit 3 – Refinancing options

Notes on the outcome of meetings on refinancing options:

(1) Castro Bank plc (relationship bank). The bank would be reluctant to lend a large sum to PC, but may be able to arrange a small five-year syndicated loan of £30m. For any loan, the interest rate would be not less than 8%.

(2) At meetings with major shareholders, all showed a reluctance to support a rights issue of equity. Most of them pointed to the company's current dividend policy as their reason for holding on to their shares.

(3) Montana Hedge Fund indicated that it would be willing to organise a financing package of £35m for PC. This would consist of three elements:

- £19.6m of new equity in the form of 40 million ordinary shares.
- £5.4m of 8% redeemable preference shares, redeemable after five years.
- £10m in 7.5% unsecured bonds, repayable after 10 years.

Exhibit 4 – Construction projects: tendering and project management

The process of tendering for major construction projects is expensive. In 20X4 PC incurred costs of £5m in tendering for new projects. Bidders are not reimbursed by customers; therefore the cost of unsuccessful bids must be recouped in the price charged for bids that prove successful.

PC estimates that between 1 in 3 and 1 in 4 bids are successful, but a few years ago, at the beginning of the economic downturn, PC was achieving a success rate of over 1 in 2.

The bids for new contracts are decided by a senior management committee, supported by the finance department. Most contracts provide for an increase in the price payable to cover inflation in materials costs, as measured by an appropriate construction cost index. There is no inflationary allowance in the price for increases in other costs – such as labour costs and other project operating costs.

Most projects last for a number of years, and payments are received throughout the course of the work.

At the end of each financial year, the project manager for each project estimates the remaining costs to completion. If the estimate of the remaining costs exceeds the amount of further revenue due from the project, a loss is recognised immediately. In the past two years, however, unexpected losses have occurred due to projects taking longer to complete than anticipated.

The finance director of PC, Chris Fellows, is dissatisfied about project reviews, cost control and forecasts of costs to complete and contract value forecasting. In his opinion, controls are not strong enough, meaning the company is suffering from unexpected losses. In June 20X5 PC gave a profit warning to the stock market due to unexpected cost overruns on two projects that were over a year late in completion.

Exhibit 5 – proposed sale of Projecta Advisers

We entered the project management market almost five years ago, establishing Projecta Advisers ('PA') in the UK. This company provides professional project management services to local and national government clients using a pool of experienced project managers that it has built up since it was established. The company has built a good reputation for helping its clients to deliver large building projects on time, on budget and in accordance with quality standards. This might be through the provision of integrated multi-skilled teams, or the appointment of a single project manager. It has been successful, but shareholders have long been worried about what some have seen as an unwelcome diversification into consultancy and away from our core expertise in contract tendering and construction. Given the difficult conditions that the Projecta group is experiencing,

a decision was taken to sell PA and we have found a buyer, BuildForce, which is a specialist consultancy firm based in the UK.

The details of the sale negotiations are still being finalised, but they are at an advanced stage and a cash price has been agreed. The date of the sale is expected to be 1 April 20X6 and on this date, Projecta Contractors will receive net cash proceeds of £13.5 million for the sale of the net assets of PA. An extract of forecast figures for Projecta Advisers for the year to 31 December 20X5 is given below.

	£'000
Revenue	10,700
Operating profit	730
Net profit	540
Intangible assets	3,239
Tangible assets	1,279
	4,518
Receivables	21,388
Cash	5,184
Payables	(15,990)
	10,582
Net assets	15,100

Exhibit 6 – Tasks

The tasks that Chris Fellows has asked you to carry out were included in the following email you received from him.

Lindsay

Do not worry about presenting your notes to me formally. Just make them clear and comprehensible please. I should like you to do the following for me.

(a) Use the information that I have given you to indicate why Projecta Contractors may be in financial difficulty. What are the symptoms and causes of the company's problems as far as you can judge, and to what extent should they be disclosed in the company's annual report and accounts?

(b) Explain the merits and disadvantages of the two refinancing options available to PC: a syndicated bank loan or the package proposed by Montana Hedge Fund. Also explain the probable reasons for the refusal of shareholders to support a rights issue.

(c) Assess the apparent problems faced by the company in its procedures for bidding for contracts and in subsequent project management and control.

(d) Explain the financial reporting implications of the sale of Projecta Advisers to BuildForce in the financial statements for the year ended 31 December 20X5.

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