ADVANCED LEVEL EXAMINATION

NOVEMBER 2015

Mock Exam 1

STRATEGIC BUSINESS MANAGEMENT

ANSWERS

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1 **Davrina plc**

Marking guide

Requirement	Marks	Skills
(1) Analysis of current financial performance and position, and future prospects	14	Identification of a range of factors indicating that the company may no longer be growing
(2) Explanation of advantages and disadvantages of strategy for growth by acquisition	19	Assessment of strategic implications Financial reporting treatment of intangibles acquired Assessment of financial implications and cost of capital implications
(3) Valuation and offer price for Ethernaze	8	Assessment of strategic value Assessment of different approaches to valuation and reaching a conclusion
(4) Explanation of the benefits of CRM and recommend how to finance the proposed system	11	Assessment of value of CRM for Davrina Evaluation of lease or buy decision
(5) Treatment of IT development costs	8	Advice on financial reporting implications of IT system development, including implications of lease or buy decision
Total marks	60	

(1) **Financial performance and position of Davrina: is there a risk of loss of growth?**

Before expressing any reservations about the financial situation and prospects of Davrina, it should be stated that the company enjoyed 33% growth in sales revenue in 20X4 and its net profit margin was about 3% of sales. The company does not face an imminent financial crisis.

Having made this comment, there are clearly matters that should concern Davrina's board.

(a) Sales revenue growth. Although sales revenue increased by 33% in 20X4, this rate of growth is substantially lower than the 48% growth enjoyed in 20X3. The UK in particular experienced very strong sales revenue growth. The USA and the EU regions enjoyed sales growth of 45% or more, but in the USA the strong growth comes after a relatively disappointing performance in 20X3 and the rate of growth has fallen in the EU. A greater concern is the fall in the rate of sales growth in the Rest of the World, down from 52% in 20X3 to just 13% in 20X4.

The evidence of a slow-down in sales is not yet convincing, but this is an aspect of performance that Davrina's management need to keep under close review.

(b) The average number of units in one basket of sale in 20X4 was 2.5 and the average price per unit was £22, giving an average order value of £55. In 20X3, the average number of units per basket was 2.36 and the average price per unit was £23.91 (reflecting the 6% increase in units per basket and 8% fall in price per unit sold). There is no information about the percentage or volume of returns. However the fall in average price may be an indication of a price war in the online market; if so, this may affect future prospects for sales revenue, with companies having to sell more units at lower prices in order to increase revenue.

(c) Costs in 20X4 as a percentage of sales were higher than in 20X3 and as a result profit margins were lower. Operating profit as a percentage of sales fell from 11.1% to just 4.8%. The ratio of distribution costs and payroll costs to sales has increased in 20X4, reducing operating profit by 2.6% of sales: these aspects of costs should be monitored closely, and should not be allowed to increase unnecessarily. The company also appears to have increased its marketing spending, which may be another sign of increasing competition in the

market. However given the increase in sales revenue in 20X4, the increase in marketing spending may have been very effective. The board of Davrina should ask management to explain the increases in costs, if they have not done so already.

(d) Depreciation and amortisation charges in 20X4 amounted to 13.7% of the value of net non-current assets at the end of the year. We do not have details of depreciation and amortisation rates, but it might be appropriate to review the policy on amortisation of intangible assets, to ensure that these are being written off over a suitable length of time.

(e) It might also be appropriate to check with Davrina's management the level of spending on IT. IT costs in 20X4 were just 1.3% of sales revenue (although a large proportion of payroll costs as well as amortisation charges may also relate to IT). This appears to be a low level of spending for an online sales company. It may be possible to compare these costs with similar costs of other online selling companies that publish their annual accounts.

(f) The segmental statements indicate that in 20X4 some regions performed more profitably than others. Gross profit minus distribution expenses, as a percentage of sales revenue, was 39.1% and 38.6% in the UK and the EU respectively, but only 32.5% in the USA and 30.4% in the Rest of the World. We do not have any previous year figures for analysis of trends, but it would appear that financial performance is not consistent between the geographical regions.

(g) There is limited information about the cash flows of the company. It might be expected that a company making profit after tax of £14.2 million in 20X4 and £27.2 million in 20X3 should enjoy strong liquidity. This is not the case with Davrina. At the end of 20X4 its cash holdings were only £2,700,000 and it had non-current liabilities of £60 million – most or all of which appears to be medium-term debt. It seems likely that the company either distributes a large proportion of its profits as dividends, or that it invests large amounts in non-current assets.

(h) The board has a progressive dividend policy and in 20X4 dividend payments were £1.30 per share. On 8 million shares, this means total dividend payments of £10.4 million. Profit after tax for the year was £14.2 million, indicating that the company is reinvesting only a fairly small proportion of its earnings in the business. A low rate of reinvestment is likely to restrict opportunities for future growth in the business.

(i) EPS in 20X4 was £1.775 (£14.2 million/8 million). The P/E ratio has fallen to 28, indicating a share price of £49.70 per share. Dividend yield is therefore 2.6%. This would probably be considered reasonable in a growing company, but investors may expect a higher yield if the company goes 'ex growth'.

(j) The current state of Davrina's IT system is not a financial issue, except that the current IT system does not have the capabilities of some of Davrina's rivals and further spending of at least £5 million will be needed to upgrade the IT system next year. This may have a beneficial effect on sales volume, but spending on upgrading the IT system will entail further borrowing, either through a bank loan or leasing, the servicing of which will put further pressure on cash flows.

(k) Investors would seem to be concerned about the future prospects of Davrina. The share price fell by one-third on the announcement of its 20X4 results and shares are trading on a much lower multiple of earnings than two years ago. The share price is still trading on a high P/E multiple, suggesting that investors are still expecting growth, but it is probable that expectations of future growth are not as high as they used to be. This investor sentiment may apply specifically to Davrina, or may apply more generally to high-growth IT companies. Companies are most unlikely to sustain very high P/E multiples for an extended length of time, and a 'market correction' could occur in the not-too-distant future.

In summary, the financial prospects of Davrina may be less strong than they appeared two years ago, and there are aspects of financial performance that management should seek to improve – sales growth, cost control and liquidity or cash flow management seem to be the most critical areas for review and improvement.

(2) **Strategy of growth through acquisitions**

Introduction

It is highly probable that in order to maintain a high P/E ratio for the share price, the company must offer investors prospects of strong earnings growth in the future. If the business no longer has the capability of growing organically at the same rate as in the past, achieving growth through acquisitions may be a viable alternative strategy.

We do not have much detail about the proposed strategy for growth. Unless target companies are in much the same sort of business as Davrina, an acquisitions strategy is likely to change the business profile and business model of the company. The board of Davrina should be able to express a clear strategic objective for the growing company, in order to maintain investor confidence and support. An indiscriminate acquisitions 'spree' is likely to have a detrimental effect.

Advantages and disadvantages of an acquisition-led growth strategy

The main attraction of a strategy of growth through acquisitions is that it is usually possible to achieve a much faster rate of growth in revenues and profit than with a strategy of organic growth. If the Davrina board is hoping to move from the AIM market to a listing on the main London market, the further growth in the business that may be necessary as a pre-condition for a full listing can probably be achieved most easily through acquisition-led growth.

However there are a considerable number of disadvantages to an acquisition strategy, especially in technology markets.

(a) The purchase cost of IT businesses is often high, and based on expectations of future growth and profitability, without a track record of historical revenues and profits. We are told that Davrina would be looking to acquire newly-established online retailing businesses, where the business risk is presumably high.

(b) Organic growth can be achieved with a single IT system and web site. With each new acquisition, Davrina would be acquiring a different web site and a different IT system. It would then face the choice of maintaining a number of different IT systems, one for each separate business, or trying to integrate all the businesses into the same IT system – a task that may be time-consuming, difficult and costly. Acquisitions may be made in the expectation of cost-savings through synergy, such as sharing the same IT platform, but synergy may be very difficult to achieve in practice, and this will affect profits, EPS and, presumably, the share price.

(c) Growth by moving into new product areas can be risky. (This applies to organic growth too, but the risk with organic growth is less because the time frame would be longer.) Davrina would need to select suitable niche markets, and hope that bigger competitors will not expand into the same market sector. Entry costs into a new market niche for established online retailers may be fairly low, so risks of new competitors after making an acquisition could be high.

(d) If Davrina intends to move all acquired businesses on to the same IT platform, it may be asked why it should not establish its own new businesses rather than acquire other companies and integrate systems.

Some business risks facing Davrina will be the same no matter whether it tries to grow through acquisitions or organically. Competition is likely to be a major threat, and IT companies must always be prepared to update their systems whenever significant new technological developments occur. With online retailing of physical products, there is likely to be a threat to profitability from customer demands for lower prices as the online market grows, and rising costs of distributions and returns.

In summary, an acquisition-led growth strategy is a high risk strategy, and the decision of Davrina's board may depend on the risk appetite of the board and the views/expectations of major shareholders.

Financial reporting implications

Acquisitions of IT companies typically result in payment of a purchase price that is well in excess of the fair value of the net tangible assets acquired. On acquisition, there may be recognition of some intangible assets, such as software, databases, internet domains or customer lists – these would be recognised at fair value. The remaining balance of the purchase price would be accounted for, on consolidation, as purchased goodwill.

With IAS 38 *Intangible Assets*, there is a presumption that it is possible to establish the fair value of any intangible assets being acquired (and therefore the cost of those assets) reliably. Any such assets must also be identifiable and under the control of the acquirer, and there must be a probability of future economic benefits from the assets.

Intangible assets, when recognised, should be amortised on a systematic basis over their expected useful lives (unless the expected life is indefinite, which is unlikely in the case of acquiring an IT company).

Purchased goodwill is not amortised but must be subject to annual impairment reviews. Any impairments in value are written off to profit or loss. When an IT company has large amounts of goodwill in its reported financial statements, the risk of impairment can be high.

A strategy of growth through acquisition in the IT market will therefore affect reported performance through the additional profitability that the acquired entities bring to the group. However, there could also be additional costs on consolidation due to the amortisation of intangibles and impairment of goodwill. The overall effect on reported group profits will depend on the underlying profitability of the acquired business.

In addition, there is also likely to be a substantial increase in intangible assets in the consolidated statement of financial position.

Implications of acquisition strategy for financing costs

In addition to the possibility of a change (increase) in the strategic risk profile of the company, there will also be some increase in the cost of equity – and the returns expected by shareholders – if Davrina increases its financial gearing – and financial risk.

- The current value of Davrina's equity = Earnings × 28 = £14.2 million × 28 = £397.6 million. The treasurer has indicated that the cost of equity is around 15%.
- The current value of Davrina's debt capital is about £60 million at book value. This has an after-tax cost of 4.8% (6% less tax relief). If the company undertakes an expansion programme financed by £100 million of new debt, total debt will increase to about £160 million.

We can estimate how the new borrowing might affect the cost of equity in Davrina, using the assumptions and formulae suggested by Modigliani and Miller.

On the basis of assumptions used in the workings below, I estimate that there will be some increase in the cost of Davrina's equity although only from 15% to about 16.6% and (according to MM theory) there will be some fall in the weighted average cost of capital.

In summary, the board of Davrina needs to be confident that an acquisitions strategy will generate growth in earnings. Making acquisitions for relatively small growth will disappoint shareholders and affect the share price.

The treasurer, Dave Jackson, has indicated that it might be preferable for the company to seek fixed-rate debt to finance its growth. It may be difficult for Davrina to borrow for the medium or long term at a fixed rate. Bank lending is more likely to be at a variable rate over the medium term. However if the company borrows at a variable rate, it should be able to swap its net liabilities into a fixed rate with an interest rate swap.

WORKINGS

Since:

$$k_{eg} = k_{eu} + (k_{eu} - k_d)\frac{V_d}{V_e}(1-t)$$

$0.15 = k_{eu} + (k_{eu} - 0.06)\ 60.0/397.6\ (1 - 0.20)$

$0.15 + 0.00724 = 1.12072\ k_{eu}$

$k_{eu} = 0.14$

If we assume that the market value of debt capital increases to £160 million and the market value of equity is unchanged:

$k_{eg} = 0.14 + (0.14 - 0.06)(160/397.6)(1 - 0.20)$

$k_{eg} = 0.1658$

(3) **Valuation for Ethernaze**

Ethernaze is a supplier of products that Davrina sells through its web sites. It is not a major supplier to Davrina. Total purchases from Ethernaze in 20X4 were £340,000, and the total cost of sales of Davrina in 20X4 was £232.5 million.

Davrina's management are unlikely to have much expertise in the management of a manufacturing company such as Ethernaze, although its operating costs do include some production costs.

From a strategic perspective, there seems little or no benefit to be obtained from making the acquisition, except as a way of securing a relatively small source of future supply of goods.

If the board decides that it would like to submit an offer for Ethernaze, a valuation is difficult because of the poor financial condition of the company. At the end of December 20X4, the company's assets totalled £177,800 at book value and its current liabilities, including a maturing bank loan, were just £176,900. The book value of equity was therefore just £900.

The company's liquidity position seems unsustainable. It is difficult to see how Ethernaze's debts – in particular, its bank loan – can be repaid in the next few months out of operating cash flows. At best, the company's assets would need to be liquidated to raise cash to pay the liabilities. This is what the owners of Ethernaze probably have in mind.

As a consequence an assets-based valuation of Ethernaze is not appropriate, because the realisable value of the company's assets after repaying the company's debts may be close to (or perhaps less than) zero.

A valuation based on comparisons with similar companies would also be difficult, given the low or non-existent profits of the company and the difficulty of finding a comparable listed company to use as a benchmark for the valuation.

It therefore seems inevitable that any valuation of Ethernaze should be based on a DCF analysis of the additional cash flows that Davrina might expect to gain from the acquisition. Ethernaze seems to be making little or no profit, and may even be operating at a loss. It may be achieving gross profit of about £170,000 per year (50% of sales of £340,000 to Davrina), but it also has other operating costs. These may well include salaries for the current owner-directors, which means that there may be only a small cash surplus from operations each year.

Without more information it is not possible to suggest an offer price for Ethernaze shares. The owners want an 'honest price', but the company needs an injection of new finance to avoid insolvency. Acquiring Ethernaze would have little or no strategic benefit for Davrina and it is surprising that the directors are even considering an offer. At best, any offer should be small; however our firm should not recommend any purchase price that it cannot, in its professional opinion, justify to the client.

(4) **CRM and the lease or buy decision**

Customer relationship management (CRM) involves the use of database technology and IT systems to help an organisation develop long-term and mutually valuable relationships with its customers.

A typical CRM system will involve a more comprehensive database than the one currently operated by Davrina and which can be accessed wherever the customer interacts with the company - through website transactions, contact with sales teams, queries to call centres and other order processing functions. All participants in Davrina's customer-facing processes – sales, customer service, marketing – can co-ordinate their efforts so that the customer receives a consistent and suitable service, such as targeted marketing campaigns rather than the current 'broad brush' approach.

CRM software and its associated hardware will provide the data to help Davrina to provide the products that its customers want, provide better customer service, help the marketing team to cross-sell and up-sell products, attract new customers and better understand who its customers are. These benefits will come from CRM software's ability to:

- Track a customer's account history to help to personalise the products and services that each one receives
- Measure marketing campaigns, analysing customer 'clicks' and subsequent sales
- 'Mine' data to identify purchasing trends in each market
- Aggregate transaction information to provide KPIs for the business
- Help with forecasting by using sales history to generate sales projections

From the analysis of Davrina's financial situation given above it seems that the company has benefited from increased marketing spending, with increased sales revenue in 20X4. Investment in a CRM system could be expected to continue this trend as management seeks to improve sales growth.

The lease or buy decision

The cost of capital that should be applied to the cash flows for the financing decision for the new system is the after-tax cost of borrowing: 6% × 80% = 4.8%; say 5%.

To purchase the system outright has an NPV of £783,600:

Purchase

Year	*Item*	*Cash flow* £'000	*Discount factor* 5%	*PV* £'000
0	System total cost	(6,000)	1.000	(6,000.0)
1 – 5	Software maintenance and support	(90)	4.329	(389.6)
1 – 5	Increased sales revenue	1,500	4.329	6,493.5
	Tax savings, from allowances			
2	20% × £1,200,000	240.0	0.907	217.7
3	20% × £960,000	192.0	0.864	165.9
4	20% × £768,000	153.6	0.823	126.4
5	20% × £614,400	122.9	0.784	96.4
6	20% × £491,520	98.3	0.746	73.3
			NPV of purchase	783.6

This should be considered in relation to Davrina's overall borrowing position. The company has been given indications that it should be able to raise up to £100 million in bank loans, aimed mainly at potential acquisitions. Borrowing £6 million, although a relatively small proportion of this total, could affect other acquisition decisions. The loan could be used in other business functions, or applied to other investments that could help to grow Davrina's business. The board will need to decide whether or not the IT upgrade and CRM investment is a preferred area for investment that will help to further its growth objectives.

Leasing

The features of the lease indicate that it should be treated as a finance lease in accordance with the terms of IAS 17 *Leases*. In this case the lease term is for the major part of the economic life of the asset, and it is apparent even before discounting that the present value of the minimum lease payments will amount to substantially all of the fair value (£6m) of the leased asset.

To lease the system has an NPV of £1,727,900:

Year		*Payments*	*Sales revenue*	*Savings in tax (20%)*	*Discount factor*	*PV*
		£'000	£'000	£'000	5%	£'000
1 – 5	Lease payments	(1,250)			4.329	(5,411.3)
1 – 5	Maintenance & support	(90)			4.329	(389.6)
1 – 5	Sales revenue		1,500		4.329	6,493.5
2	20% × (270,563 + 1,082,250)			270.6	0.907	245.4
3	20% × (221,591 + 1,082,250)			260.8	0.864	225.3
4	20% × (170,170 + 1,082,250)			250.5	0.823	206.2
5	20% × (116,179 + 1,082,250)			239.7	0.784	187.9
6	20% × (60,248 + 1,082,250)			228.5	0.746	170.5
					NPV of leasing	1,727.9

Tax benefits will arise from interest and amortisation expense (see the table in section (5) below for workings).

From this analysis it is preferable to lease the system, as it has a higher NPV. Another benefit to consider in regard to leasing is that it is possible that the system being considered is one which will have been significantly improved in five years' time, due to continual and rapid advances in technology. Davrina's management might conclude that it prefers to lease the system to be able to take advantage of upgrades in the future and not be stuck with an obsolete technology and faced again with being behind its competitors and their systems.

(5) **IT systems upgrade and effect on financial reporting**

Decision to buy

The financial reporting implications of incurring expenditure on website development (and other software development) are covered by IAS 38 *Intangible Assets* and also IAS 36 *Impairment of Assets*.

Davrina is considering expenditure on IT development. This will inevitably affect profitability, although the improvements to the systems are also expected to increase revenues and improve gross profit.

IAS 38 sets out the rules for the recognition of an intangible asset. For example the asset must be identifiable, it must be expected to provide economic benefits to the entity and the costs of development must be measurable reliably. If they meet the criteria for recognition as an intangible asset, development costs must be capitalised and amortised over their expected useful life – in this case, a fairly short period of 5 years, which is considered a suitable period for IT assets given the speed of innovation in the industry.

Amortisation costs will therefore be large at £5.5m/5 years = £1.1m per year. We do not have detailed information on the exact composition of the £5.5m website and software costs, so we are assuming here that the total amount can be recognised as an intangible asset. It could be that some of these costs would be more appropriately written off to profit in the first year, for example if there are any preliminary consultancy costs included in that figure.

The server hardware would be treated as a tangible asset under the provisions of IAS 16 *Property, Plant and Equipment* – recorded at cost (£500k) with £500k/5 years = £100k charged to profit or loss each year.

The annual amortisation cost and any preliminary costs that are identified within the £5.5m will therefore have a direct effect on the reported pre-tax profits of Davrina, as will the maintenance, training and technical support fees of 1.5% × £6m = £90,000 each year.

Decision to lease

If Davrina decides to lease the system, the appropriate accounting treatment is dealt with by IAS 17. Davrina as a finance lessee is in a broadly similar position as if it had purchased the new system outright, in that it is receiving substantially all the risks and rewards of ownership. The lease contract confers a right to use the system. This right meets the *Conceptual Framework*'s definition of an asset, and the liability of Davrina to make lease payments meets the *Conceptual Framework*'s definition of a liability.

The finance lease should therefore initially be recorded as an asset and corresponding liability in Davrina's statement of financial position at the lower of the fair value of the asset and the present value of the minimum lease payments – in this case, £5,411,250 (see lease working earlier).

Finance lease payments should be apportioned between the interest element and the remaining capital balance.

The amortisation policy for assets held under finance leases should be consistent with that for owned assets – in this case, amortisation of the asset will occur over 5 years which is a suitable length of time for IT assets.

The maintenance, training and technical support fees of £90,000 each year will also be chargeable to profit.

The table below summarises the financial effects of the finance lease each year, showing the annual interest payment and the figure for amortisation.

Year	*Opening balance*	*Interest 5%*	*Principal*	*Lease payment*	*Closing liability*	*Amortisation*	*Book value*
	£	£	£	£	£	£	£
0	–	–	–	–	5,411,250	–	5,411,250
1	5,411,250	270,563	979,437	1,250,000	4,431,813	1,082,250	4,329,000
2	4,431,813	221,591	1,028,409	1,250,000	3,403,404	1,082,250	3,246,750
3	3,403,404	170,170	1,079,830	1,250,000	2,323,574	1,082,250	2,164,500
4	2,323,574	116,179	1,133,821	1,250,000	1,189,753	1,082,250	1,082,250
5	1,189,753	60,247	1,189,753	1,250,000	0	1,082,250	–

We do not know whether the development of an upgraded web site will affect the valuation of the existing web site in the company's statement of financial position. It seems possible that the upgrade to the system may reduce the fair value of the existing web site asset. If so, any impairment must be charged to profit or loss.

In summary, a big investment in website and software development will have a significant impact on reported profits, whichever financing method is used. Davrina's board must hope that the improvements will generate the anticipated increases in revenues and gross profit to offset the costs.

2 **Textiles with Care plc**

Marking guide

Requirement	Marks	Skills
(1) Evaluate the factors that should be considered in making the closure or disposal decision Determine and explain the appropriate financial reporting treatment as requested	13	For Chester Factory: Identify factors relevant to the closure decision Calculate the effect of continuing and the effect of closure Identify factors determining whether each cost of closure could be recognised as a provision For Kidz Kitz: Calculate the NPV of closure, identifying relevant cash flows and appropriate discount rate Identify non-financial factors relevant to the closure decision Identify cash flows relevant to value in use in accordance with IAS 36 *Impairment of Assets*
(2) Determine the cost of finance for the two financing alternatives Recommend the most appropriate alternative Explain financial reporting treatment for each	6	Determine the annual cost of finance for the two financing instruments Identify factors relevant to financing decision, and use judgement to make a reasoned recommendation Explain the correct FR treatment of financial liabilities and the interest expense
(3) Explain the nature of the key assurance procedures to be performed in respect of the forecasts	10	Outline and explain the assurance procedures relevant to forecast information (in accordance with ISAE 3400) Explain that limited assurance is the only opinion that can be provided on forecast information, and audit procedures should be consistent with this
(4) Discuss the issues TC should consider before deciding whether or not to agree a deal with a new supplier in Asia	5	Discuss the factors determining whether to manufacture in-house or to use an external supplier Discuss the factors relating to using a supplier in Asia rather than one in Europe
(5) Set out ethical issues for SW and explain the actions the firm should take	6	Set out ethical principles (including confidentiality and conflict of interest), and identify key issues (eg timing of CEO's decisions) Explain appropriate action
Total marks	40	

(1) **Underperforming Business Units**

Chester factory

Closure decision

If the Chester factory were to stay open, it would generate an annual return of 2.5% pa (200/8,000). While the risk may be different to the KK business unit (see below) the after tax WACC in that case is 6% pa which is far above the 2.5% pa return generated by the Chester factory.

An alternative way of looking at the valuation issue would be to discount £200,000 at 6% in perpetuity. This gives £3.333m (£200,000/0.06) which is far below the £8m that it could be sold for immediately.

Although there are some closure costs associated with immediate closure (see below) these are small compared to the £8m cash that would be generated on disposal.

Other factors to consider are:

- Although expected to earn only £200,000 per annum, efficiency improvements could increase this to a level where it would be better to retain it in the group. A basic calculation using the 6% figure (which may not be appropriate for this business unit) is £480,000 profit pa (6% × £8m). This would therefore require a very significant increase in profitability.
- The Chester factory may be interdependent with other TC divisions and the disposal of this business unit may lead to loss of profits elsewhere in the group. For example, retail units may depend on the Chester factory for their inventory and the transfer prices may be below market values.

Unless the above issues have a major impact, there is a clear rationale for disposing of the Chester factory.

Financial Reporting

Costs to be provided	£'000
1. Statutory redundancy costs	220
2. Discretionary redundancy costs	340
3. Retraining of staff who would be redeployed to other sites	–
4. Legal costs of solicitors handling redundancies	22
5. Impairment of assets to be sold off	–
6. Expected profit on sale of patent rights	–
7. Penalty to exit a contract with a supplier as a result of closure	88
8. Operating losses to be incurred between the date of the announcement and the date of closure	–
Total provision	**670**

Notes.

1. Legal obligation. The legal obligation creates the requirement for a provision in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
2. Constructive obligation. The constructive obligation creates the requirement for a provision in accordance with IAS 37.
3. Retraining of staff who would be redeployed to other sites. No provision can be made as retraining costs are associated with the ongoing activities of the entity so cannot be included in a restructuring provision, IAS 37 para 81(a).
4. Legal costs of solicitors handling redundancies. These costs are necessarily entailed in the reconstruction and are directly attributable expenditure, IAS 37 para 80. As a result they are provided for.
5. Impairment of assets to be sold off. The write-down would be credited to the asset (IFRS 5 *Non-Current Assets Held for Sale and Discontinued Operations*), rather than being a provision.
6. Expected profit on sale of patents. Gains on expected disposal of assets are not taken into account in measuring a provision, IAS 37 paras 51 and 83.

7. Penalty to exit a contract with a supplier as a result of closure. The penalty to exit means that the contract can be considered as onerous following the closure. These costs are therefore recognised as a provision as they are directly attributable to the restructuring.

8. Operating losses to be incurred between the date of the announcement and the date of closure. Provisions for future operating losses are not permitted as a provision as they do not meet the definition of a liability, IAS 37 para 63 (as there is no present obligation arising from past events).

Even though the conditions for recognising some costs as a provision are satisfied, it seems unlikely that the Chester factory would constitute a discontinued operation per IFRS 5, based on the information available. Whilst the closure will be announced before 31 December 20X5, there is no suggestion that the factory will be available for immediate sale or will be actively marketed by this date as required by IFRS 5 paras 7 and 8.

Kidz Kitz Ltd

WORKINGS (in £'000)

	20X6	*20X7*	*20X8*	*20X9*	*NPV*
Cash receipts from sales	5,200	6,400	6,600	6,300	
Cash paid to buy inventories	(3,680)	(3,760)	(3,840)	(3,580)	
Salary payments	(620)	(620)	(620)	(620)	
Overheads paid	(900)	(900)	(900)	(900)	
Restructuring	0	–	–	–	
Operating cash flows	0	1,120	1,240	1,200	
Interest payments on loan	–	–	–	–	
Cash flow before tax	0	1,120	1,240	1,200	
Tax payments @ 20%	0	224	248	240	
Cash flow after tax	0	896	992	960	
NPVs					
@ interest rate 7% (before tax flows) for impairment calculation	0.0	978.3	1,012.2	915.5	**2,906.0**
@ interest rate 6% (after tax flows) for closure decision	0.0	797.4	832.9	760.4	**2,390.7**

Closure decision

Discounting the after tax cash flows at the after-tax discount rate gives a positive net present value of £2.39m.

Keeping KK open and generating this NPV needs to be compared to the value generated by immediate disposal. If the trade and assets are sold as a single transaction this would generate £2.2m. This is lower than the NPV that could be achieved by keeping the store trading, which would suggest that the store be kept open.

Factors to consider other than the above numbers are:

- Any taxes payable on the disposal. This would depend on their tax written down value.
- Other opportunities may present themselves over the next few years and keeping the business trading would maintain the real option to take advantage of these.
- Liquidity may be a factor in the group and the immediate generation of cash may provide much needed liquidity, particularly as KK only plans to break even in the coming year, so little cash would be generated from operations next year if it were to be kept open.

Overall, the advice would be to keep KK open, but the decision is not clear cut and could be reviewed on a periodic basis in case there is a change in any of the estimates.

Financial Reporting

The purpose of an impairment test is to ensure assets, and groups of inter-related assets (cash-generating units), are stated at no more than their recoverable amount, being the higher of: fair value less costs of disposal; and value in use (present value of net cash inflows relating to the asset). This is, in effect, the best return the entity could generate by either selling the asset or retaining it to generate cash flows in the business (See closure decision above).

IAS 36 *Impairment of Assets* requires an entity to discount at a rate that reflects the 'current market assessments of (a) the time value of money, and (b) the risks specific to the asset for which future cash flow estimates have not been adjusted'. It also requires the use of the before-tax interest rate (IAS 36 para 55) so, in this case, it is 7% rather than the 6% used previously for the closure decision. Similarly it requires tax and interest to be excluded from cash flows from the asset or cash generating unit (IAS 36, para 50). Any impairment losses would however generate a deferred tax adjustment.

Based on the above calculations the value in use is therefore £2,906,000.

Fair value is determined using the criteria in IFRS 13 *Fair Value Measurement*, and represents the market value of the assets at a point in time, normally the year end.

Recoverable amount

Higher of:

	£'000
Fair value less costs of disposal	2,200.0
Value in use	2,906.0

Therefore value in use of £2,906,000 is the recoverable amount.

As this exceeds the carrying amount of £2,760,000 there is no impairment.

(2) **Financing**

2.1 Assessment of financing alternatives

Alternative 1 – Euro denominated bank loan

The current annual rate of interest on the loan is 7%, but this may vary, up or down, over the life of the loan. Whilst in an efficient market it is not possible to predict with any accuracy how market interest rates will change over a five-year period, some indication in the short term is given by forward £/€ exchange rates. In the longer term, fixed rate bonds will give a broad indication of market expectations of future movements in short term interest rates.

Interest rate parity would suggest that if markets expect the £ to strengthen against the €, then sterling interest rates will be lower than € interest rates, or there would be inefficient arbitrage opportunities.

A key risk is that the finance is being raised in euro so the sterling equivalent of the amount outstanding is subject to exchange rate risk. Thus, if the € were to strengthen against the £, then the amount repayable in sterling terms would increase. Over a five year period this movement could be substantial. Conversely, if the € weakens against the £ then TC would benefit on redemption.

Given that TC has activities in Europe, then if revenues in € exceed costs in € then this loan could be a natural hedge. If this is not the case, then £/€ exchange rate risk could be increased by this loan.

Compared to the WACC rate of 7% before tax this loan appears to be expensive at 7%. We would need to investigate why this is the case as the 7% WACC includes a cost of equity element.

In terms of liquidity, this would favour the preference shares as more cash is available for longer given the earlier redemption date with this loan.

In terms of credit risk, if TC defaults on the repayment of interest or capital then the bank could potentially wind up the company with a creditors' voluntary liquidation.

Interest charges are tax allowable hence the implicit interest rate on the loan after tax is:

[(AFi 5 yrs) × (€ 24m × 7%) × (1 – T)] + (€ 24m/(1 + i)^5) = €24m

By linear interpolation or iteration = **5.6%**

Alternative 2 – 9% preference shares

The annual cost of finance for the preference shares is:

$(1.045)^2$ = 9.2%

The gross nominal rate of dividend is higher for the preference shares at 9% than the bonds at 5.6% but in addition the preference dividend needs to be paid half yearly so the annual rate is the compound half year rate at 9.2%.

Also, however, preference dividends are not relieved for tax whereas interest on the bond is tax allowable. The after tax cost of the bond is therefore lower.

While the cost of finance for the bond is lower than for the preference shares there are other factors to consider.

- The preference shares are redeemable after seven years rather than five years with the bond, so there is greater liquidity with the preference shares and more time for the reconstruction to take effect.
- If there is a default on the preference share dividend it is cumulative and therefore merely deferred. There are no rights for the preference shareholders to wind up the company.
- The preference shares are denominated in sterling so there is no currency risk.

Recommendation

The loan is the lower cost form of finance. The gap in the cost of finance between the two instruments is significant and is widened by the fact that the loan interest is tax relievable. As the currency risk can be largely offset by hedging, the loan therefore appears to be the preferred choice.

2.2 Financial reporting for financing alternatives

As most of TC's costs and revenues arise in the UK, its functional currency is the £.

Alternative 1 – Euro-denominated bank loan

The loan would initially be recognised at £20 million.

However, the euro-denominated loan is a financial liability and therefore needs to be translated at each year end at the year-end exchange rate. Any exchange gains or losses are recognised in profit or loss.

Interest is variable in euro terms and so would change each year in accordance with the basis of the contract. In addition, however, even if the euro amount of interest did not change, then it would need to be translated at the actual rate when interest accrues. If exchange rates move evenly over the year and interest accrues evenly, then the average exchange rate for the year may be used as an approximation.

Alternative 2 – 9% preference shares

The preference shares are redeemable and therefore they have the characteristics in substance of a debt instrument, even though their legal form is equity.

As a result, the preference shares are treated as a liability and the preference dividends are treated as a finance cost.

(3) **Assurance**

Providing assurance in respect of forecasts is covered by ISAE 3400 *The Examination of Prospective Financial Information*.

Prospective financial information means financial information based on assumptions about events that may occur in the future and possible actions by an entity. This would relate to the forecasts of profits made by TC to support its application for finance.

In this respect, a forecast is defined as prospective financial information based on assumptions as to future events which management expects to take place and the actions management expects to take (best-estimate assumptions).

The areas where SW needs to perform procedures to obtain sufficient appropriate evidence are:

- SW needs to satisfy itself that TC management's best-estimate assumptions on which the prospective financial information is based are not unreasonable and, in the case of hypothetical assumptions, that such assumptions are consistent with the purpose of the information (ie to raise new finance in the form of a loan or preference shares). This will require ascertaining that TC sales volumes are realistic for the prices being charged in the markets being accessed (eg similar ventures by other companies, existing market prices and revenues generated by retail outlets selling textiles and related products). As TC operates in the fashion industry this will require evidence on seasonal cycles and trends in the industry. To be able to do this SW will need clear evidence (eg market research) collected by TC to support the forecasts provided. Given that TC is made up of a number of business units then separate projections (similar to those provided for KK) and assumptions would be needed for each significant business unit. They can then be aggregated.
- The prospective financial information is properly prepared on the basis of the assumptions i.e. that the financial information produced (ie TC's revenues, costs, cash flows) is consistent with the assumptions in amount and timing. As TC is divisionalised, this will need to be done for each division or profit centre separately (such as KK and the Chester factory if they are retained) and then all the divisions should be aggregated.
- The prospective financial information is properly presented and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions (disclose assumptions for example about timing, the level of sales, the impact of advertising, costs, the number of new divisions opened each year). For example, the budget provided for the KK division would need to be reviewed for consistency if this division were to continue in operation.
- The prospective financial information is prepared on a consistent basis with historical financial statements, using appropriate accounting principles (for TC profit forecasts).

It is clear that, as prospective financial information is subjective information, it is impossible to give the same level of assurance regarding forecasts for TC as would be applicable to historic financial information for its historic performance. In particular it covers at least a five-year horizon for the loan and seven years for the preference shares.

In this instance, the procedures carried out should gather sufficient appropriate evidence consistent with providing limited assurance in the form of a negatively expressed opinion.

ISAE 3400 suggests that SW should express an opinion including:

- A statement of negatively expressed assurance as to whether the assumptions provide a reasonable basis for the prospective financial information.
- An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and the relevant reporting framework.
- Appropriate caveats as to the achievability of the forecasts (eg where there is a new venture following the CEO's reorganisation there may be little internal precedent on which to substantiate assumptions).

(4) **Possible new supplier**

The textiles business units seem to be performing well, in contrast to some of TC's clothing business units. As such, it would appear sensible for TC to increase its supply capacity in order to meet the increasing demand.

Historically, TC appears to have manufactured all its products in its own factories. Therefore, before deciding which supplier to use or where they should be located, TC should consider whether it wants to change this policy of in-house manufacturing and start using external suppliers. The alternative would be either to expand some of its existing factories, or to build a new factory of its own.

Agreeing a deal with an external supplier is likely to provide TC with extra supply more quickly than if it expands its own production capacity, and will not involve any capital expenditure. Similarly, the costs of the additional supply will be variable costs. This could be significant if demand falls again in future, because it means TC would not be lumbered with the additional fixed costs associated with the greater factory space, nor left with excess capacity.

However, using its own factories provides TC with greater control over its supply chain than if it uses external suppliers – particularly in relation to the quality of its products. Product quality, and reliability of delivery, appear to be important factors in TC's current success, and TC needs to be confident that using external suppliers will not have an adverse effect on performance in these respects.

In addition, TC has no experience of managing external suppliers. This again could present control issues (in relation to managing the supplier's performance), but there could also be practical operational issues, for example in relation to how orders are communicated to the supplier.

Although price is also an important factor in the sourcing decision, TC should not select a supplier simply because they charge the lowest prices. Although such a decision might seem profitable in the short-term, it may prove not to be if quality issues subsequently affect sales and TC's brand reputation in the longer term. Similarly, if any social responsibility issues emerge at a supplier, this could also damage TC's reputation by association. As such, TC would be advised to carry out supplier assurance work before signing any deals with external suppliers, wherever they are located.

If TC does decide to start using external suppliers, it then has to decide whether an Asian supplier is preferable to a European one. It seems likely that the Asian suppliers will be cheaper than the European ones, but here again TC should also consider a range of non-price factors.

The geographical distance between TC and the suppliers means that there are likely to be longer lead times, and also could lead to greater uncertainty over delivery times. Dealing with suppliers in a foreign country could also produce regulatory, language and cultural problems. If TC pays for the goods in the supplier's local currency, it could also be exposed to exchange rate risk.

(5) **Ethics**

It is an ethical principle that, as ICAEW Chartered Accountants, we should maintain confidentiality. The ethical issue of concern is not therefore confidentiality as such, but the reasons why the CEO wishes to maintain confidentiality, including the possibility of making a personal gain. Additionally, external confidentiality to the public is different from internal confidentiality to other directors, which is essentially a question of corporate governance.

The timing of the announcement of the reconstruction is a matter for the TC board. If the CEO were buying or selling shares then there is a risk of illegal behaviour based on insider trading, but as it is part of a remuneration package this does not appear to be the case. Indeed, there is no evidence that the CEO can control the timing of the issuing of shares to him.

The ethical issue is, however, that the CEO is altering the timing of decisions which may affect TC shareholders and other stakeholders in order to make personal gains.

Similarly, issues arise with the CEO bringing forward the closure decision so profits of the current year are affected by the provision, rather than future years on which Steve's performance will be judged.

Again, companies are entitled to vary the timing of transactions to gain commercial advantage, but the ethical issue in this case is one of the conflict of interest of the CEO, where the delay is made for personal, rather than corporate, benefit.

The ethical principles arising are:

Ethical principle	Explanation
Integrity: Straightforward and honest in business and professional relationships.	Steve may be promoting his own interests above those of the company and other stakeholders.
Objectivity: Not allowing bias, conflict of interest or influence of others to override professional or business judgement.	There is a self-interest threat to Steve in the suggestion that there may be some personal gain from timing transactions in accordance with Steve's best interests. This can create conflict of personal interest with the fiduciary duty of directors. For SW, the question in whether the duty of confidentiality should be overridden by the requirement for transparency. In the first instance, those charged with governance could be made aware of the facts and our concerns. This may be the audit committee if there is one or the company chairman if not.
Legal issue or breach	Legal advice could be taken by SW to ascertain whether there is any breach of laws or regulations by the CEO. If this is the case, then there may be a duty or right to disclose the behaviour of the CEO if those charged with governance refuse to do so.

Actions

The SW engagement partner should discuss the issues with Steve including: his motivations; confidentiality; and governance. If there are grounds to suspect that Steve is promoting his self-interest beyond the corporate interest then the issues should be discussed with those charged with governance or with the chairman.

Based on legal advice if Steve’s behaviour is deemed to be illegal then there may be a duty to disclose the relevant facts, which would override the principle of confidentiality.

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