ADVANCED LEVEL EXAMINATION

NOVEMBER 2015

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 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 **Davrina plc**

You have recently joined Duggan Walls LLP, a firm of ICAEW Chartered Accountants, and you are working in the department dealing with advisory and assurance work. You have been asked to attend a meeting that has been arranged between your manager Charles Kent and Emma Fry, the chief executive officer of an important client, Davrina plc.

Davrina is an AIM-listed company that has enjoyed spectacular growth in the past few years in online retailing. It sells cosmetics and leisure goods, mainly in the UK, targeting a market of customers who are mainly in their early to mid-20s.

The meeting

Emma begins the meeting with the following comments.

'We like to think that we are a very successful company that has enjoyed strong growth for several years. Until now, our growth has been entirely through organic expansion. We have historically enjoyed a strong competitive advantage in our online sales software, but this is getting outdated now and some of our competitors have more flexible systems.

'Recently, however the board has become concerned about a fall in our profitability. When the results for the year ended 31 December 20X4 were announced, Davrina's share price fell by one-third and it is now trading at a multiple of 28 times annual earnings. Two years ago it was trading at a multiple of 75 times annual earnings.

'I have some financial information about the company to give you (**Exhibit 1**).

<u>Growth strategy</u>

'The board of directors believes that in order to maintain or increase the P/E multiple for the share price, the company needs to expand rapidly. We have discussed the possibility of achieving the desired rate of growth through a combination of organic growth of the existing business and acquisitions of other newly-established online retail businesses.

'We are not sure about how to grow the business, or even in which parts of the market we should look to grow. Our sales manager Tom Barnes has prepared a brief summary for you of online retailing in the UK (**Exhibit 2**).

'If we do decide on a policy of growth through acquisition, we are going to need extra financing, and this is likely to be mostly debt. You may be interested in an email I received recently from the company treasurer, Dave Jackson (**Exhibit 3**).

<u>Potential acquisition in the supply chain</u>

'Ethernaze Ltd is a supplier to Davrina of leisurewear products for resale. The Ethernaze business was established by two sisters who each own 50 per cent of the equity. They have now informed me that they do not want to carry on in business any longer and have been unable to find a buyer who will pay an "honest price" for their company. They therefore plan to take the company into voluntary liquidation.

'In response to a request from me, they have provided details of the company's assets and liabilities at the end of December 20X4. They are unwilling, at this stage, to provide details of profits or losses, but I suspect that the company is operating at a loss or, at best, a very small profit. I shall give you the limited information that I have so far: it is a brief note from Sonia Lee, one of the two sisters (**Exhibit 4**).

'I think that the board of Davrina may wish to consider the possibility of acquiring Ethernaze, provided we offer a fair price. This will enable us to maintain the supply of products that have been popular with our online customers. With better organisation, it should be possible to operate the company at a profit and restore its financial position within a fairly short time.

'The Davrina board needs to make a quick decision before Ethernaze takes the liquidation option.

<u>Online sales system</u>

'The success of our business depends on online sales and payments through our website, and increasingly on the development of marketing initiatives that are properly targeted at customers, based upon their buying history. I think that we may need to invest heavily in a system upgrade that supports all of these activities, given that they will contribute to our avowed aim of organic growth. Our head of IT recently attended a presentation by a software supplier and is very enthusiastic about the potential benefits of a system upgrade, as am I, but there are still some questions to be answered. As you might expect, I am worried about the effect that all of this investment might have on our reported profits. I can't see the board agreeing to anything that will have a significant impact on earnings, when we are trying to restore profitability.

'We had a breach of system security a short while ago, so at the very least some improvement in our system will be necessary.

'I will give you a copy of a memo I sent recently to our head of IT that sets out some of my thinking about this (**Exhibit 5**). I will also send you the details of a possible investment in customer relationship management software (CRM) that our IT and marketing teams are very enthusiastic about (**Exhibit 6**).'

Manager's instructions

Following the meeting, Charles Kent tells you that Emma Fry has sent him a letter setting out the requirements of the Davrina board (**Exhibit 7**). He would like you to draft a reply to each of the requests that are set out in this letter.

Requirement

Prepare the draft reply that Charles Kent has asked for.

Assume it is now July 20X5.

(60 marks)

Exhibit 1: Financial information prepared by Davrina's management accountant

Extracts from the statements of profit or loss of Davrina plc for the years ended 31 December:

	20X4	*20X3*
	£'000	£'000
Revenue	461,300	346,000
Cost of sales	(232,500)	(166,100)
Gross profit	228,800	179,900
Distribution expenses	(69,100)	(46,900)
Payroll and staff costs	(45,400)	(29,900)
Warehousing costs	(25,600)	(19,100)
Marketing costs	(25,800)	(12,600)
Production costs	(2,500)	(2,300)
IT costs	(6,200)	(4,900)
Depreciation and amortisation	(7,800)	(6,300)
Other operating costs	(24,100)	(19,600)
Operating profit	22,300	38,300
Finance costs	(4,600)	(4,400)
Profit before tax	17,700	33,900
Taxation	(3,500)	(6,700)
Profit after tax	14,200	27,200

Extracts from segmental statements for the year ending 31 December 20X4:

	UK	*USA*	*EU*	*Rest of world*	*Total*
	£'000	£'000	£'000	£'000	£'000
Revenue	110,500	47,400	107,400	196,000	461,300
Cost of sales	(53,600)	(22,000)	(52,100)	(104,800)	(232,500)
Gross profit	56,900	25,400	55,300	91,200	228,800
Distribution expenses	(13,700)	(10,000)	(13,800)	(31,600)	(69,100)
	43,200	15,400	41,500	59,600	159,700
Other operating expenses					(137,400)
Operating profit					22,300

Summarised statement of financial position as at 31 December 20X4:

	£'000
Non-current assets	
Intangible assets	28,100
Property, plant and equipment	29,000
	57,100
Current assets	
Inventory	90,000
Receivables	15,200
Cash	2,700
	107,900
Total assets	165,000
Equity	
Shares (8 million shares of 25 pence each)	2,000
Reserves	56,800
	58,800
Non-current liabilities	60,000
Current liabilities	46,200
Total equity and liabilities	165,000

Additional notes

(1) Customers often buy two or more product items in one sale, and a 'basket of sale' is used as a term to mean the entire content of a customer order. The average number of units in one basket of sale in 20X4 was 2.5 units, an increase of 6% on 20X3, and the average sales price per unit was £22, a fall of 8% compared with 20X3.

(2) About 40% of the company's tangible non-current assets are computer equipment.

(3) The company's intangible assets consist mainly of capitalised software that is not regarded as being an integral part of the hardware that it runs on, and web site development costs. These assets are amortised over four to five years.

(4) Borrowings consist of medium-term bank loans, on which the average annual interest rate is currently 6%.

(5) The board has a policy of paying a 'progressive dividend', with growth in dividends per share each year. In 20X4 dividend payments were £1.30 per share.

Analysis of sales growth as a percentage of previous year's revenue

In the year to 31 December	*20X4*	*20X3*
UK	64%	48%
USA	45%	25%
EU	48%	55%
Rest of world	13%	52%
Total	33%	48%

Exhibit 2: Note on the online retail market in the UK

Prepared by Tom Barnes, Sales Manager of Davrina plc

The online retail market in the UK continues to grow, although the rate of growth is currently not as rapid as in the past. In the past 12 months, as the economy has recovered, total retail sales in the UK have grown by about 4 per cent and online retail sales by 9 per cent.

The market is dominated by a small number of large retailers, notably Amazon, which continues to expand into different parts of the online market. The biggest sectors of the market are for digital products such as music, films and e-books, and for fashion clothing, but the market for online grocery shopping is increasing.

Games are a popular download, especially to smartphones and tablet computers. However the games applications business is not online retailing, and many games users expect to get their apps for free.

Many established retailers, with bricks-and-mortar retail outlets, have developed a multi-channel retailing strategy, and have web sites for making online purchases.

For companies such as Davrina, which sell physical products online, distribution and returns are a problem. There are problems with delivering sales orders when the customer is not at home, and the costs of returns can be high. Some online retailers expect customers to pay the postage cost of returns. Multi-channel retailers can offer a 'bricks-and-click' service, where customers can buy online and collect the item within 24 hours at a local store, where they can examine the item or try it on before they take it away.

Dealing with returns can be very expensive. The problem is that with some products, customers may not be entirely certain what they are buying until the item is delivered to them. Online clothing retailers probably have the biggest problem, due to uncertainty about clothing sizes. Quite a large percentage of items that are sent to customers following an online purchase are returned, and this creates administrative costs as well as wasted postage costs.

Successful online retailers must have a well-designed web site – even major retailing groups will struggle if their web site is poorly-designed. We also need to advertise effectively on a small marketing budget: Davrina uses small ads in search engines such as Google but we are also trying to encourage the use of social networks for spreading views about our products. We have also built a database of customers, and we email them with special offers.

It is difficult to predict the future of online retailing. Our view, however, is that the market has room for substantial further growth, and in time it will become normal to buy most products online. We also think that there will be opportunities for niche retailers, in spite of the presence of larger online competitors. The market for digital products is global, but for many physical products markets will remain mostly national – because of the costs of distribution.

Davrina has benefited in recent years from a high share price. Many quoted online retail companies still command high P/E ratios, but my view is that valuations will decline over time as expectations of future growth and profitability in the market are reduced and become a bit more realistic.

Exhibit 3: Email from the Davrina treasurer, Dave Jackson, to Emma Fry: additional financing

Emma

I have been looking into financing methods, as you requested.

We have been given indications by a syndicate of banks that the company should be able to raise up to £100 million in loans at an annual interest rate of about 6% to finance acquisitions, with tax relief at 20% on the interest costs.

I would be attracted to debt capital as a source of funding. With the volatility in our share price, we cannot be certain about the cost of our equity. We estimate that our cost of equity is about 15%, which is much higher than the cost of debt.

However if we do go for debt financing, I would recommend that we look for fixed interest payments and medium-term borrowing. I can see interest rates increasing by a few percentage points over the next two or three years.

Exhibit 4: Ethernaze

Note from Sonia Lee to Emma Fry:

Dear Emma

Here is a summary of the assets and current liabilities of Ethernaze as of the end of December 20X4.

Assets:	£'000
Cash	21.5
PPE	1.0
Inventory	125.3
Receivables	30.0
Current liabilities (mainly a bank loan maturing in September 20X5)	176.9

In 20X4, our sales to Davrina totalled £340,000. Our gross profit margin on sales is about 50%. We make some sales to other customers but these are not significant: we supply almost exclusively to Davrina.

We would be interested in an offer from Davrina to buy the business, but let me know soon. We have already almost made up our minds to put the company into liquidation.

Exhibit 5: Memo written by Emma Fry to Davrina's head of IT systems

Not so long ago, our online sales system was among the most innovative and successful online retailing software systems in the world but the system (hardware and software) has not been updated for three or four years. In that time, our competitors have developed their own online transaction capabilities and in many areas of customer service they now outperform us.

As you know, the company also suffered a blow to its reputation two months ago with the report in the media that a hacker into our system stole the identities of a half a million customers and the payment card details of over a hundred thousand. A number of shareholders are apparently still angry at the system failure and are demanding changes to the composition of the audit committee and the board.

Following your review of suitable new systems that are available on the market, you have told me that Davrina will have to spend at least £5 million purchasing software and hardware next year to at least 'catch up' with our competitors in terms of online capability, and to provide an enhanced level of data security. That's £1 million more than the current value of our IT system in our accounts.

We are going to have to announce improvements to the IT system to address these concerns, but the cost worries me.

Exhibit 6: Notes from head of IT about proposed system upgrade

Technology and the internet is continually evolving, and will continue to shape the way that we manage our customers. In particular, the proliferation of smartphone usage in our target age group has changed the way that customers compare offers, talk to each other (especially via social media) and make purchase decisions. Competitors such as Amazon continue to expand into the online market and we need to keep up. Developing our website capability is a key part of this, enabling our customers to buy what (and how) they want - but I have talked to our marketing department and there is a firm belief that we need to get much better at communicating with our customers. This work has been started with the development of our database, but its functionality is rudimentary and is limited to stored contact details which are used to send customers details of special offers, regardless of their suitability to the recipient.

We have already discussed a system upgrade that will bring us more up to date in terms of capability and data security, costing £5m. The same supplier can provide us with a system whose functionality goes beyond these basic requirements and includes an integrated customer relationship management (CRM) system.

The cost of such a system would be as follows:

- New website and CRM software £5.5m
- Server hardware £500,000

It is predicted that such a system would deliver increased sales revenue of £1.5m per year.

I have spoken with the finance department about the feasibility of this, and it appears that there are two routes available to us:

- Davrina could purchase the system outright, using bank loan facilities. If the system is purchased, Davrina would be able to claim an annual tax depreciation allowance of 20% of the reducing balance.
- Davrina could lease the system under an agreement which would entail payment of £1,250,000 at the end of each year for the next five years.

Payments of annual maintenance, training and technical support fees for the software and hardware would be around 1.5% of the original total price, regardless of the finance option chosen.

Exhibit 7: Draft terms of engagement set out in a letter from Emma Fry

The board of Davrina requires Duggan Walls LLP to prepare a report covering the following matters.

(1) Explain and evaluate the financial performance and position of Davrina and assess the risk that its business operations may cease to achieve further growth.

(2) Set out and explain the advantages and disadvantages for Davrina plc of pursuing a strategy of growth through acquisitions in the UK online retailing market. Please include any comments you may have on financing options for an acquisition-led growth strategy, and on the financial reporting implications of such a strategy.

(3) Suggest, and justify, a valuation and offer price for the small supplier company, Ethernaze Ltd, bearing in mind that its owners are considering putting the company into voluntary liquidation.

(4) Briefly explain the benefits to Davrina of investing in customer relationship management (CRM) and show what the preferred financing method should be if we decide to go ahead with the enhanced project.

(5) Explain the implications for reported profits of undertaking the project to enhance the company's IT systems with associated CRM capability, depending on whether Davrina purchases the system or chooses to lease it.

Total: 60 marks

2 **Textiles with Care plc**

Textiles with Care plc (TC) is a listed company which manufactures clothes and household textile products in a number of factories throughout Europe, although most costs and revenues arise in the UK. TC also owns a chain of retail shops which sell the clothes made in TC's own factories, alongside those of other clothing manufacturers.

A new chief executive officer (CEO) of TC, Steve Gavinson, was appointed in July 20X5. After spending some time reviewing the business, Steve came to the preliminary conclusion that a reorganisation is needed. This would involve the closure of some business units.

Before making any final decisions, Steve decided to take external advice from Smith & West LLP (SW), a firm of ICAEW Chartered Accountants. You are a senior working for SW. You and the engagement manager, Kirsty Hall, meet with Steve.

The meeting

Steve opened the meeting: 'I want to reorganise TC and close down some of the underperforming business units. I am concerned, however, about the impact on the financial statements if I decide to close these units. I have provided you with some details (**Exhibit 1**).

'TC needs to raise finance to support the reorganisation and to expand the business. I would appreciate your advice regarding which of the alternative methods of finance we should select and I have provided details (**Exhibit 2**).

'Whichever of the alternative methods of finance is used, the finance provider will require profit forecasts to support the request for finance. It will also require an assurance report relating to these forecasts and I would like SW to provide this. I need to understand this process, so please explain the key assurance procedures that would be performed.

'I expect you to maintain absolute confidentiality in this assignment, as the reorganisation announcement may increase the TC share price. As part of my remuneration package, I am due to receive a fixed value of shares in TC. I want to receive these shares at a lower price before announcing the reorganisation which will increase the share price.

'Despite the need to reorganise some parts of TC, the textiles units are performing well, and the company has been looking at potential ways of increasing supply for its bed linen and kitchen linen products. We are considering a deal with a new supplier in Asia (**Exhibit 3**), but would appreciate your advice about the issues for TC to consider before we make any decisions about this.

'I have prepared supporting notes, in which I have set out what I require of SW (**Exhibit 4**).'

Instructions

After the meeting with Steve, you accompany Kirsty back to the office where she explains what you will be required to do on this engagement: 'I would like you to draft a response to the list of tasks that Steve has asked SW to carry out (**Exhibit 4**).

'Also, please draft a briefing note for me that sets out any ethical issues for SW and explains any actions that the firm should take.'

Requirement

Respond to the instructions of the engagement manager, Kirsty Hall.

Assume it is now November 20X5.

(40 marks)

Exhibit 1: Underperforming business units – prepared by Steve Gavinson

(1) **The Chester factory**

The Chester factory makes children's clothes and is treated as a profit centre. It has performed poorly and I am convinced it should be closed. For me, the question is when, not if, this closure should happen.

It is my intention to prepare a formal plan and announce the closure, both publicly and to individual employees, before the 31 December 20X5 year end; then everyone understands their position. If we recognise losses in 20X5 as a result of the proposed closure, I do not mind too much, as they will be seen by shareholders as part of the previous CEO's tenure or part of the turnaround. The closure is planned to take place in March 20X6; however, I do not want closure costs recognised in 20X6, thereby affecting my first full year's profit as CEO.

If the Chester factory were to stay open, I estimate it would make an after-tax profit of only £200,000 per year for the foreseeable future. If we sold off the assets now, a recent valuation has indicated that we would obtain £8 million, after settling all liabilities, but before any closure costs.

Request for financial reporting advice

The following closure costs have been identified. Assuming that the announcement is made before 31 December 20X5, please determine the amount of the provision we can make in the financial statements for the year ended on that date.

	£'000
Statutory redundancy costs	220
Discretionary redundancy costs	340
Retraining of staff redeployed to other sites	200
Legal costs of solicitors for redundancies	22
Impairment of assets to be sold off	64
Expected profit on sale of patent rights	(150)
Penalty to exit a contract with a supplier as a result of the closure	88
Operating losses between date of announcement and date of closure	29
	813

(2) **Kidz Kitz Ltd**

The Kidz Kitz (KK) business unit is a separate subsidiary that operates a store selling children's clothing. The trade and assets of KK, including the brand name, were acquired from a rival company five years ago. KK is treated as a profit centre by TC and its cash flows are independent of the remainder of the group.

The lease on the building, which is being occupied by the store, expires on 31 December 20X9 and the lessor will take possession of the building on that date. I have therefore decided that KK will cease to trade no later than 31 December 20X9. There will be no surplus assets as the lease will have expired, and closure costs will be approximately equal to the cash generated from the sale of other assets.

However, consideration is being given to immediate closure of KK if a suitable buyer can be found for the assets and a fair price agreed.

The carrying amounts of the assets attributable to KK are expected to be as follows at 31 December 20X5:

	£'000
Property, plant and equipment	1,600
Purchased goodwill	300
Brand name	460
Trade receivables	20
Inventories	380
	2,760

The finance director has prepared the following budgeted cash flows for KK for each of the four years to 31 December 20X9:

	20X6	*20X7*	*20X8*	*20X9*
	£'000	£'000	£'000	£'000
Cash receipts from sales	5,200	6,400	6,600	6,300
Cash payments for inventories	(3,680)	(3,760)	(3,840)	(3,580)
Salary payments	(620)	(620)	(620)	(620)
Overhead payments	(900)	(900)	(900)	(900)
Interest payments on loan	(30)	(30)	(30)	(30)
Tax payments	–	(224)	(248)	(240)

It is estimated that the trade and assets of KK, including intangibles, could be sold as a single business for £2.2 million at 31 December 20X5, net of selling costs (which include the lease termination costs). If sold separately at 31 December 20X5, the property, plant and equipment would realise £1.2 million and the brand name could be sold for £220,000.

Assume that operating cash flows occur on the last day of each year and that a tax rate of 20% will apply for the foreseeable future.

Annual discount rates based on a risk-adjusted weighted average cost of capital for KK are as follows:

Before-tax discount rate	7%
After-tax discount rate	6%

Request for financial reporting advice

No impairment losses have previously been recognised in respect of KK, but a competitor entered the market recently which means that impairment testing is required at 31 December 20X5 for KK.

Advice is therefore needed to determine the amount of any impairment and the carrying amount of KK's assets at 31 December 20X5 in the TC consolidated financial statements. Please show the allocation of any impairment losses to each type of asset.

Exhibit 2: New financing – prepared by Steve Gavinson

To support the reorganisation plan and to increase capacity, TC needs to raise new finance of £20 million on 1 January 20X6.

The TC board has decided that issuing ordinary shares is not appropriate at this time because it believes that the share price is significantly undervalued in financial markets, which have not fully recognised TC's growth potential following a reorganisation.

We have identified two alternatives:

Financing alternative 1 – Euro-denominated bank loan

Enter into a five-year loan of €24 million on 1 January 20X6 at a variable annual rate of interest, which is currently 7% and which tracks the European Central Bank interest rate. Interest is payable annually in arrears. The principal is repayable after five years (that is, on 31 December 20Y0). There would be no issue costs payable by TC. We expect the exchange rate to be £1 = €1.2 on 1 January 20X6.

Financing alternative 2 – Redeemable 9% cumulative preference shares

Issue £20 million of 9% cumulative preference shares at par on 1 January 20X6. The shares will be redeemed at par after seven years (that is, on 31 December 20Y2). Dividends are payable half-yearly in equal amounts (ie interim and final dividends would each be £900,000).

Exhibit 3: New supplier – prepared by Steve Gavinson

TC's existing factories across Europe provide good quality products and have proved reliable in delivering orders on time.

However, they are now operating close to capacity and are struggling to keep pace with increased demand in recent years.

In addition, although our factories are performing well in terms of quality and service, it looks like there are a number of suppliers in Asia who could supply textile products for us more cheaply. However, some of the senior management team have raised concerns about using Asian suppliers, arguing that TC has no experience of operating outside Europe, and most of its revenue is achieved in the UK.

Exhibit 4: Memo from Kirsty Hall – tasks required

Please can you carry out the following tasks which have been requested by Steve Gavinson.

- With respect to the two underperforming business units (**Exhibit 1**):
  - Evaluate, including calculations, the factors that should be considered in making a closure or disposal decision; and
  - Determine and explain the appropriate financial reporting treatment in the financial statements for the year ending 31 December 20X5 for each of my two 'requests for financial reporting advice' notes in Exhibit 1.

  Please ignore the tax implications of the decision whether to sell Kidz Kitz or to allow it to continue trading beyond 31 December 20X5. These are being considered separately by our tax advisers.
- Determine the cost of finance in annual percentage terms for each of the two financing alternatives (**Exhibit 2**) and recommend the most appropriate alternative by comparing the risks and benefits. Also, so far as the information permits, explain the financial reporting treatment for each financing alternative.
- Explain the nature of the key assurance procedures that you would perform with respect to the forecasts being made.
- Briefly discuss the issues TC should consider in order to decide whether or not to agree a deal with a new supplier in Asia.

Please could you also draft a briefing note for me that sets out any ethical issues for SW and explains any actions that the firm should take.

Total: 40 marks

ICAEW
Metropolitan House
321 Avebury Boulevard
Milton Keynes
MK9 2FZ
www.icaew.com

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