



**ADVANCED LEVEL EXAMINATION**

**NOVEMBER 2015**

**Mock Exam 2**

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# **STRATEGIC BUSINESS MANAGEMENT**

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## **ANSWERS**

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## 1 Power Products plc

### Marking guide

| Requirement   | Marks     | Skills  |
|---|-----------|---|
| (1) Assessment of current performance and future prospects without the new investment | 13        | Using limited information to assess financial performance and prospects   |
| (2) Investment appraisal  | 18        | Critical review of an investment appraisal, based on limited information<br><br>Identifying areas of concern which reduce the level confidence which can be placed on the estimated figures |
| (3) Financial reporting implications of foreign investment                            | 9         | Application of accounting standard and awareness of implications of foreign exchange movements  |
| (4) Exchange risk and hedging issues  | 14        | Understanding of FX exposures and hedging instruments<br><br>Ability to construct a long-term hedge against FX risk   |
| (5) Ethical issues  | 6         | Awareness of ethical issues: advocacy threat; bribery   |
| <b>Total marks</b>  | <b>60</b> |   |

#### (1) Financial performance of PP

Over the period 20X3 – 20X5, PP has achieved modest growth in revenue but a slight fall in profit margins, with the result that the expected profit after tax in 20X5 is lower than the profit after tax in 20X3. This performance is worse than the company had led investors to expect.

Growth in annual revenue in the period 20X3 to 20X5 is expected to average 3.6%. This is not strong growth, but at least shows that revenue is increasing. However costs have been increasing as a percentage of revenue and profit margins have been falling. The gross profit margin was 62.4% in 20X3 but is expected to be just 59.9% in 20X5. If the gross margin had been 62.4% in 20X5, gross profit would have been nearly £9 million higher.

Operating profit has also fallen as a percentage of sales revenue, from 15.8% in 20X3 to 14.7% in 20X5. If the operating margin had been 15.8% in 20X5, operating profit would have been nearly £4 million higher.

Financial performance has been made even worse by the increase in finance costs. We do not know why the company's debt capital increased by £100 million between 20X3 and 20X5. For a company whose equity is currently valued at only £216 million, this is a large increase in debt and should be a matter of some concern.

From an investor's perspective, PP has only limited attraction as an equity investment. With the increase in debt capital, financial risk has increased but annual earnings have fallen slightly, in spite of the company's indications to the contrary. The fall in the share price by nearly 23% from its level earlier in the year is perhaps understandable.

Investors may regard PP as an equity investment for earning a high dividend yield, to compensate them for the lack of earnings and dividend growth. Expected dividends in 20X5 are £16.2 million. On the basis of the current share price, the expected dividend yield for 20X5 is 7.5% (16.2/216). However the high dividend payment ratio may help to explain the company's poor prospects for earnings growth without the new investment in the Canadian project.

Further analysis may be required, but it would appear that in the forecast for 20X6 – 20X8, the growth in revenue and profits may be attributable almost entirely to the planned Canadian venture. If so, this reinforces the view that the existing UK business operations do not have significant growth potential. This must be a matter of serious concern.

In summary, the company's performance over the past three years indicates slow revenue growth and falling profit margins. This appears to have disappointed investors, and the share price has fallen. The share price may need to be sustained by a high dividend pay-out policy, and from a strategic perspective PP may be a potential takeover target, lacking clear strategic direction. Without new investment, the company does not appear to have prospects for growth.

**(2) The proposal to invest in the Canadian project**

- (a) The NPV has been calculated in Canadian dollars, indicating that the DCF analysis by the management accountants has been based on Canadian dollar cash flows. As a result, the effect of any change over time in the exchange rate between the Canadian dollar and sterling has been ignored.

From the perspective of a UK company, the project should be evaluated in £ sterling, taking into consideration expectations of changes in the exchange rate over time and the amount of remittances of profits from the Canadian operation to the UK in sterling.

- (b) I have made an initial assessment of the possible NPV of the investment. This shows a positive NPV of about £7 million. The current market value of the company's equity is £216 million; this indicates that even if the NPV estimate is correct, this investment of £100 million will only increase the value of equity by about 3% (7m/216m).
- (c) My calculations and assumptions are set out in the attachment to these notes.
- (d) However, I have concerns about the assumptions that have been used, and these should raise doubts about the reliability of the estimated NPV. My first concern is with the cost of capital that has been used for discounting.

The PV calculations have used the company's current weighted average cost of capital, 8%.

However if the investment goes ahead and is financed by debt capital, there will be a change in the company's cost of capital. The WACC may fall because of the higher gearing, but the cost of equity will rise. Neither the current WACC nor the WACC with additional financing would be an appropriate cost of capital, because neither would reflect the return that should be required from the new investment.

There may also be some difference in the business risk with the Canadian investment. If so, the cost of capital will be affected by the change in business risk as well as the higher financial risk.

I recommend that there should be a review of the cost of capital that is used to evaluate the proposed investment, or that a different method of evaluation should be used. Using a WACC of 8% as the discount rate is inappropriate.

- (e) There are other questionable assumptions in the cash flow estimates.

I do not know the rates of taxation in Canada. The rate that has been used in the DCF analysis, 12%, seems very low, and its accuracy should be investigated. If the effective rate of tax is higher than 12%, this will reduce the after-tax cash flows from the investment, and will reduce the NPV. This is a particular concern given that the NPV is only marginally positive. Since it is assumed that cash flows from the investment will be remitted to the UK, it would seem more appropriate to apply a UK rate of taxation to the profits. However, applying a tax rate of 20%, for example, would give a negative NPV.

The exchange rates for converting dollar cash flows into sterling cash flows have been based on PPP theory, estimates of the general rates of inflation in the UK and Canada, and the different rate of inflation in project revenues. These are estimates that could be substantially incorrect. Inflation is difficult to predict over the long term, and the fact that the cash flows assume zero inflation from year 5 onwards underlines the uncertainty in the estimates. If inflation is lower in Canada than in the UK, we might expect the Canadian dollar to appreciate in value against sterling, and this would increase the project NPV.

**Conclusion**

I must conclude that there is considerable uncertainty about the estimated NPV for this investment, and a review of the assumptions and estimates is desirable, especially given the low NPV. Your recommendation to the board (or operational management) should be for the project to be re-assessed.

On the basis of the information available, I would predict that if the company announces the Canadian project and its estimated returns, PP may disappoint its shareholders again.

Attachment: NPV calculation

It is assumed that the exchange rate each year will change in accordance with purchasing power parity theory, so that the exchange rate for the first four years will increase by a factor (1.04/1.02) to reflect the differing rates of inflation in Canada and the UK. Since it is assumed that there will be no inflation from the fifth year onwards, the exchange rate will not change from the end of Year 4 onwards.

It is assumed that all net cash flows will be remitted to the UK in the year that they arise.

| Year | Revenue<br>C\$m | Operating<br>cost<br>C\$m | Net cash<br>flow<br>C\$m | Tax @<br>12%<br>C\$m | Net cash<br>flow after<br>tax C\$m | Exchange<br>rate | Net cash<br>flow<br>£m |
|------|-----------------|---------------------------|--------------------------|----------------------|------------------------------------|------------------|------------------------|
| 1    | 51.500          | 20.800                    | 30.700                   | 3.684                | 27.016                             | 1.835            | 14.72                  |
| 2    | 53.045          | 21.632                    | 31.413                   | 3.770                | 27.643                             | 1.871            | 14.77                  |
| 3    | 54.636          | 22.497                    | 32.139                   | 3.857                | 28.282                             | 1.908            | 14.82                  |
| 4    | 56.275          | 23.397                    | 32.878                   | 3.945                | 28.933                             | 1.945            | 14.88                  |
| 5    | 56.275          | 23.397                    | 32.878                   | 3.945                | 28.933                             | 1.945            | 14.88                  |
| 6    | 56.275          | 23.397                    | 32.878                   | 3.945                | 28.933                             | 1.945            | 14.88                  |
| 7    | 56.275          | 23.397                    | 32.878                   | 3.945                | 28.933                             | 1.945            | 14.88                  |

Capital allowances

| Year | Written down balance<br>C\$m       | Allowance<br>(20%)<br>C\$m | Tax relief<br>(12%)<br>C\$m | Tax relief<br>£m |
|------|------------------------------------|----------------------------|-----------------------------|------------------|
| 1    | 180.00<br>(36.00)<br><u>144.00</u> | 36.00                      | 4.320                       | 2.35             |
| 2    | (28.80)<br><u>115.20</u>           | 28.80                      | 3.456                       | 1.85             |
| 3    | (23.04)<br><u>92.16</u>            | 23.04                      | 2.765                       | 1.45             |
| 4    | (18.43)<br><u>73.73</u>            | 18.43                      | 2.212                       | 1.14             |
| 5    | (14.75)<br><u>58.98</u>            | 14.75                      | 1.770                       | 0.91             |
| 6    | (11.80)<br><u>47.18</u>            | 11.80                      | 1.416                       | 0.73             |
| 7    | 80.00                              | (32.82)                    | (3.938)                     | (2.02)           |

The sale value of the business in Year 7 = C\$80m/1.945 = £41.13m

| Year | Investment<br>£m | Operating cash<br>flows after tax<br>£m | Capital<br>allowance tax<br>relief<br>£m | Total cash<br>flow<br>£m | Discount<br>factor at<br>8% | PV<br>£m     |
|------|------------------|---|--|--------------------------|-----------------------------|--------------|
| 0    | (100.00)         |   |  | (100.00)                 | 1.000                       | (100.00)     |
| 1    |                  | 14.72                                   | 2.35                                     | 17.07                    | 0.926                       | 15.81        |
| 2    |                  | 14.77                                   | 1.85                                     | 16.62                    | 0.857                       | 14.24        |
| 3    |                  | 14.82                                   | 1.45                                     | 16.27                    | 0.794                       | 12.92        |
| 4    |                  | 14.88                                   | 1.14                                     | 16.02                    | 0.735                       | 11.77        |
| 5    |                  | 14.88                                   | 0.91                                     | 15.79                    | 0.681                       | 10.75        |
| 6    |                  | 14.88                                   | 0.73                                     | 15.61                    | 0.630                       | 9.83         |
| 7    | 41.13            | 14.88                                   | (2.02)                                   | 53.99                    | 0.583                       | 31.48        |
| NPV  |                  |   |  |                          |                             | <u>+6.80</u> |

(3) **Canadian investment: financial reporting implications**

If PP decides to undertake the Canadian investment and establish a Canadian subsidiary, it will have to account on consolidation for the effect of changes in the dollar-sterling exchange rate. To comply with IAS 21 *The Effects of Changes in Foreign Exchange Rates* on consolidation, the assets and liabilities of the Canadian subsidiary should be translated into sterling at the closing rate

(the rate at the date of the statement of financial position) and income and expenses should be translated at the exchange rates at the dates of transactions (or in practice, at an average rate for the period).

As a result exchange differences will occur, due to movements in the exchange rate over time. These should be recognised in other comprehensive income, and not in profit or loss.

If the Canadian dollar strengthens in value against sterling, we should expect favourable exchange rate differences, which would be added to an equity reserve. On the other hand, a fall in the value of the dollar should be expected to result in adverse exchange rate differences and a reduction in the reserve.

The reason for reporting exchange rate differences in other comprehensive income is that cash flows are not affected by consolidation; therefore it is inappropriate to include the effect of the differences in profit or loss. (However, when there are actual cash flow transactions between the subsidiary and the UK parent, such as the payment of dividends, the transaction should be recorded at the rate of exchange at the date of the transaction.)

On disposal of the subsidiary, the cumulative amount of exchange differences should be recognised in profit or loss when the gain or loss on disposal is recognised. This is because the gain or loss on disposal should be recognised in full in profit or loss.

PP currently proposes to finance the Canadian investment with debt in sterling. The company might wish to consider borrowing in Canadian dollars rather than in sterling. If it were to do this, it would be able to apply the rules of hedge accounting, and gains or losses on translation of the subsidiary's net assets could be offset wholly or in part by losses or gains on the dollar loans, in other comprehensive income.

#### **(4) Exchange risks and hedging the exposures**

##### Hedging transaction exposures

During the course of the Canadian investment, there will be transactions between the Canadian operation and the UK-based operation. This may simply be remittances of dividends, but there may also be other transactions in goods and services. At a transactional level there will be exchange risk.

For dividend payments, for example, there will be an exposure to exchange risk between the time that a dividend payment is decided and the time that it is actually made. It should also be recognised that if the Canadian dollar strengthens against sterling over time, changes in the spot exchange rate will benefit PP. The risk for PP arises from a fall in the value of the Canadian dollar, with the result that remittances to the UK in sterling would fall in value.

A decision to hedge transaction exposures should depend on expectations about short-term movements in the exchange rate. When the exchange rate is expected to move favourably or if the period of the exposure is short, hedging may not be considered necessary, or even desirable.

The need for hedging transaction exposures is much greater when the exchange rate is volatile and the period of the exposure is quite long.

It is possible to hedge transactional risk exposures using forward exchange contracts, but the cover is only short term, between the time that a transaction is initiated and the time that it is settled. Forward exchange contracts cannot provide a hedge against long-term changes in an exchange rate.

Decisions about hedging specific transactions, for example dividend payments, can be made on an individual basis, using the information available at the time.

##### Hedging the exposure to the Canadian dollar investment

A more serious concern may be the exposure of the company to the long-term investment in Canadian dollars. If the Canadian dollar depreciates in value over time, the sterling value of the company's investment will fall. If there is a risk of a significant fall in the value of the dollar over time, a hedging arrangement may be considered desirable. (If the dollar is expected to appreciate in value or if the Canadian dollar-sterling exchange rate is expected to remain fairly stable, hedging measures might be considered unnecessary.)

A suitable hedge might be to borrow in Canadian dollars rather than in sterling. Dividends in dollars from the subsidiary could be used to pay interest and repay capital on the loan. It might be possible to arrange Canadian dollar funding so that the payments on the loan match the expected cash flows from the dividends.

If borrowing in Canadian dollars is not possible, the company might consider switching its sterling interest payment obligations into Canadian dollar obligations using a currency swap.

A currency swap could provide a useful hedge against exchange risk over the full seven-year term of the investment, although the cash flow requirements would have to be considered. A swap could be arranged with a bank in which PP makes regular payments of 'interest' on C\$180 million to the bank and the bank in return makes regular payments of 'interest' to PP on £100 million. The swap 'interest' rates would be determined by the bank. At the end of the seven-year swap term, PP would make a payment of C\$180 million to the bank and the bank would pay £100 million to PP.

During the seven-year term of the swap, PP would therefore pay interest on its £100 million loan and also swap 'interest' on C\$180 million. It would receive swap 'interest' on £100 million, which it could use to pay most or all of the interest on the real loan of £100 million. Its net liability would be entirely or mostly in Canadian dollars, and this swap interest could be paid from the cash flows generated by the Canadian investment, without the need for any currency exchange.

At the end of the swap term the payment of C\$180 million to the swap bank could be made partly from the proceeds from selling the investment for C\$80 million. PP would need to have accumulated sufficient dollars over the seven years to make up the difference of C\$100 million. Alternatively different cash flow arrangements might be negotiable with the swap bank. At the maturity of the swap, the £100 million received from the swap bank would be used to make a 'bullet' repayment of the maturing £100 million loan.

In conclusion, if the investment in Canada goes ahead and is financed with debt capital, and if there are concerns about the future movement in the exchange rate, a hedging measure would seem prudent. If Canadian dollar borrowing is not possible for PP, a currency swap could provide an alternative method of hedging against the exchange risk for the full seven-year duration of the investment.

**(5) The chairman's proposal to ask the auditors for assistance**

The chairman should be informed that his proposal to ask the external auditors for their support by attending meetings with investors is totally inappropriate.

By attending meetings with investors, the auditors would appear to be lending their support to the arguments and estimates of PP's management, and encouraging investors to support the Canadian investment.

This would be an advocacy threat to the independence and objectivity of the auditors, and would be a request to the auditors to breach their code of professional ethics.

(I need not add that as there are doubts about the reliability of the NPV estimates, the auditors are unlikely to agree anyway with the opinions of our operational management team.)

However, perhaps of even greater concern is the suggestion that if the auditors help promote the Canadian project as requested then their re-appointment as auditors would be guaranteed 'for the foreseeable future'.

This appears to be a fairly unsubtle bribe, which may raise concerns over the ethical integrity of the Chairman. If he is prepared to try to use a bribe in this situation, what other situations might he also be prepared to use bribes to influence business performance or a business decision? If the Chairman has offered bribes to other organisations, this is not only unethical, but it is also illegal.

Ironically, the incentive being offered here cannot be guaranteed anyway. The re-appointment of the auditors will be decided annually by PP's shareholders at the AGM, and if the shareholders vote in favour of a change of auditor (for whatever reason) the Chairman will be powerless to guarantee the auditors remain in office as he has suggested.

2 **Western Wheels Ltd**

**Marking guide**

| Requirement   | Marks     | Skills   |
|---|-----------|--|
| (1) Evaluate the performance of WW for the year ended 30 September 20X5. Indicate further information needed to make a more complete assessment of performance                                      | 10        | Identify key data concerning performance<br>Analyse data to identify trends in revenue, contribution and profit, and determine underlying causal factors<br>Interpret data and explain performance<br>Justify additional information needs |
| (2) Critically appraise the forecasts made by WW's board. Evaluate the key underlying assumptions and discuss the adequacy of the supporting explanations   | 7         | Analyse data to identify areas of over optimism<br>Question the assumptions underlying WW's forecasts  |
| (3) Explain the implications of post-acquisition trading on asset values in IM group financial statements   | 5         | Identify that actual performance suggests the possible impairment of assets and the need for an impairment review<br>Explain the impact of the impairment review on the group financial statements   |
| (4) Evaluate the benefits of asking a firm of independent accountants to review WW's forecasts, and assess the extent to which they will be able to report on the forecasts                         | 7         | Evaluate how much benefit IM would gain from the independent report<br>Explain the level of assurance which the independent accountants could provide  |
| (5) Explain whether the IM group control framework is likely to have affected the performance of WW<br><br>Comment on whether the alternative approach is likely to improve WW's future performance | 6         | Identify appropriate control issues for WW<br>Identify linkages between control and performance<br>Evaluate whether proposed changes to the performance management structure could help to improve WW's future performance                 |
| (6) Evaluate the likely impact of the bonus scheme on the motivation of the WW board members<br><br>Identify the impact of the bonus scheme on the financial statements of WW                       | 5         | Identify potential issues of motivation and creative accounting arising from the bonus scheme<br>Explain the appropriate financial reporting treatment of the bonus scheme   |
| <b>Total marks</b>  | <b>40</b> |  |

### Data analysis for (a) and (b)

| Years to 30 September         | 20X4        | 20X5        | 20X6        | 20X7        |
|-------------------------------|-------------|-------------|-------------|-------------|
| Price home £                  | 100         | 100         | 110         | 120         |
| Price export £                | 100         | 100         | 100         | 100         |
| Materials per unit £          | 20          | 19          | 18          | 17          |
| Direct labour per unit £      | 30          | 30          | 30          | 30          |
| Units sold                    |             |             |             |             |
| Home                          | 352,000     | 315,000     | 346,500     | 381,100     |
| Export                        | 132,000     | 119,000     | 142,800     | 171,400     |
| Total                         | 484,000     | 434,000     | 489,300     | 552,500     |
| ROCE % [Y/E capital]          | 1.94        | 0.04        | 28.30       | 34.57       |
| Contribution margin %         | 50.0        | 51.0        | 55.2        | 58.7        |
| Operating profit margin %     | 0.68        | 0.014       | 12.60       | 19.49       |
| Sales revenue growth          |             |             |             |             |
| Home %                        |             | (10.5)      | 21.0        | 20.0        |
| Export %                      |             | (9.8)       | 20.0        | 20.0        |
| Total %                       |             | (10.3)      | 20.7        | 20.0        |
| Contribution growth %         |             | (8.5)       | 30.6        | 27.7        |
| Operating profit growth %     |             | (98.2)      | 109,950     | 85.6        |
| Sales volume growth:          |             |             |             |             |
| Home %                        |             | (10.5)      | 10.0        | 10.0        |
| Export %                      |             | (9.8)       | 20.0        | 20.0        |
| Total sales %                 |             | (10.3)      | 12.7        | 12.9        |
| % of sales revenue from       |             |             |             |             |
| UK Market                     | 72.7        | 72.6        | 72.7        | 72.7        |
| Exports                       | 27.3        | 27.4        | 27.3        | 27.3        |
| % change Production overhead  |             | (10.3)      | 12.7        | 12.9        |
| % change Labour costs         |             | (10.3)      | 12.7        | 12.9        |
| Industry data:                |             |             |             |             |
| UK sales (no. of wheels)      | 6,000,000   | 6,120,000   | 6,242,400   | 6,367,248   |
| Global sales (66m x 4 wheels) | 264,000,000 | 264,000,000 | 264,000,000 | 264,000,000 |
| Market share                  |             |             |             |             |
| UK %                          | 5.9         | 5.1         | 5.6         | 6.0         |
| Global %                      | 0.18        | 0.16        | 0.19        | 0.21        |

## (1) Performance of WW in year ended 30 September 20X5

### Revenues

Sales volumes declined by 10.3% in 20X5 compared to 20X4. This decrease was reflected broadly equally in both the UK market (down 10.5%) and the export market (down 9.8%).

The decrease in sales volumes occurred despite no change in sterling equivalent prices, which remained at £100 per wheel. Exchange rate movements may however have caused a price increase denominated in local currencies for export markets. This is suggested in the WW board report but no clear causal link is identified to specific geographical markets or specific currencies in the WW notes.

Given constant prices, sales revenues declined by the same % as sales volumes.

The decline in UK sales was against a background of a growing UK market for cars and therefore for car wheels. This meant that UK market share fell from 5.9% in 20X4 to only 5.1% in 20X5.

The commentary from the WW board provides a limited explanation of the fall and a degree of professional scepticism is appropriate to the explanation they offer. They point to “difficult trading conditions” but the UK market was growing. If there were new entrants to compete against for market share, there was no indication of this in the WW board notes.

### Costs

The WW board notes indicate that cost reductions were made, for example by reducing staff. Given the lower output achieved, one would expect total costs to be lower. Indications of cost cutting and efficiencies may be given by looking at costs per unit. This shows no change in direct labour costs per unit despite WW management’s assertion.

There has been a reduction in material costs per unit from £20 to £19 which has had a favourable effect in constraining the reduction in profit. However, it may have affected the quality of the output resulting in the fall in sales volumes. More information would be needed in respect of customer complaints to substantiate this view.

The production overhead has fallen by 10.3% which has had a favourable effect on profit. However, one would expect most of the production overhead to be fixed costs, yet it has moved in line with payroll costs. This requires investigation as to whether the production overhead is being recovered on a labour cost or labour hour basis, or whether this is the actual total cost.

There has been a significant increase in development costs. It is not clear whether this is an increased cash spend that has not qualified for capitalisation in accordance with IAS 38 *Intangible Assets*; or whether this includes an impairment of capitalised costs or whether it includes amortisation of capitalised costs. The WW board notes point to design improvements from development activity, but more information is needed regarding the significance of these changes and the likely impact on sales.

Other fixed costs have decreased, but may require further consideration in assessing the division’s performance as these may not be under the control of the WW board.

Omitted costs should be considered. For example, given the loss making situation, it is slightly surprising that there are no impairments. More information is required that impairments have been appropriately considered.

Consideration also needs to be given as to whether all relevant provisions have been made, particularly as losses are being incurred.

### Profit

The consequent effect of revenue and cost movements has been to reduce operating profit from £330,000 to near break-even level at only £6,000. After interest is deducted there is a loss before tax in 20X5 of £134,000.

Given that costs are not split between the UK market and Export markets it is not possible to identify profits for each revenue stream. Given the arbitrary allocations that would be required this would probably not be a useful exercise. Nevertheless, there is a clear pattern of poor performance in both the years ended 30 September 20X4 and 20X5, with a decline in performance in the latter year.

### ROCE

There has been no movement in capital employed other than the retained earnings but the overall ROCE has fallen significantly as a result of the reduction in operating profit.

## (2) Appraisal of Forecasts

If the forecasts are to be believed, they represent a major turnaround in the fortunes of the WW business in 20X6 and 20X7 compared to the figures for 20X5 reviewed above. A degree of professional scepticism might be appropriate to these forecasts given the lack of explanation of clear causal factors in the WW board explanatory notes which should have explained the underlying reasons for the expected improvement.

### Revenues

The prices charged in the UK are forecast to increase by 10% in 20X6 and 9.1% in 20X7. Prices in export markets are constant. Unless the product mix has changed (eg a new large contract) this seems a significant price increase for what was described as a "difficult market" for 20X5 in the WW board notes.

Notwithstanding the price increases, sales volumes in the UK are forecast to increase by 10% in each of 20X6 and 20X7. This is against a background of UK market volume growth of only 2% per annum. This would see WW more than recover its 20X4 UK market share of 5.9% by 20X7 when it would reach 6.0%, despite a price rise of 20% over the 2 year period to 30 September 20X7.

The WW market report provides little explanation for this sales volume increase other than pointing to design improvements arising from development activities. This would require substantiation by market research or specific evidence of large new contracts agreed with motor manufacturers arising from the improvements.

There are no development costs expensed in 20X6 or 20X7. This may be because they are being capitalised in accordance with IAS 38 *Intangible Assets*, following the success of the development project but this requires attestation.

Export markets also show volume growth of 20% in both 20X6 and 20X7 but in this case there is no price increase. These are very challenging targets but at least they are not forecast to be achieved alongside price increases, as with the UK market.

It should be noted that WW is moving from uniform pricing in 20X5 to price discrimination in 20X6 between UK prices and export prices. There is no indication as to why this policy has been introduced and care needs to be exercised that there is no leakage between domestic and export markets. This may not be feasible under the contractual terms agreed with customers and any best price assurances given.

Overall, sales revenues are forecast to increase substantially, largely due to UK sales which continue to dominate overall sales at around 73% of total revenue. There is a distinct lack of evidence to support this optimism.

### Costs

Material costs per unit are forecast to continue to fall by £1 per annum over the period 20X4 to 20X7. Significant doubt should exist about whether this can be achieved without impacting on quality and therefore sales volumes. The fact that there has been a fault in the wheels requiring a recall and a provision underlines the question marks over quality.

The production overhead is forecast to increase by over 12% in each of 20X6 and 20X7. This is less than the 20% sales volume growth, but this is to be expected given that fixed costs are likely to form a large element of production element. Indeed, it may be surprising that production overhead is forecast to rise so much, given the likely fixed cost content. Moreover, production overhead is forecast to continue to move in line with direct payroll costs, which is surprising given the fixed and variable cost elements expected for these two cost headings. The underlying assumptions require investigation.

It is surprising that no provisions are required for either 20X6 or 20X7. While the recall issue causing the original provision may have been resolved by 20X6 it would be unusual for no provisions to be required. Consideration should also be given as to whether there should be any impairments in respect of the recall.

## Profit

Overall significant increases are forecast in both absolute terms and percentage terms for contribution, operating profit and profit before tax. The assumptions and causal factors on which these forecasts are based are inadequately explained in the covering notes and significant scepticism should exist as to whether they can be achieved.

The forecasts appear to rely on assumptions based on the simultaneous achievement of potentially conflicting factors including significant sales volume rises being achieved, despite large price increases, reductions in raw material costs per unit and lower selling costs per unit.

Without further explanation and evidence the forecasts lack credibility.

### (3) Financial reporting implications of asset values post-acquisition

IM acquired WW for £24 million, when the fair value of WW's net assets was £18.6 million, indicating a payment for goodwill of £5.4 million. This amount will have been capitalised as an intangible asset in the Group statement of financial position.

As the WW brand has continued to be used after the acquisition, the fair value of the brand acquired (£550,000) should have been capitalised separately in the Group statement of financial position. It is not clear whether the brand is being amortised, but even if it is, WW's recent performance suggests the carrying value should also be reviewed for impairment.

The shortfall in WW's actual performance post-acquisition, compared to the figures forecast at the time of acquisition, indicates that an impairment review of the asset value of goodwill will also be required, to ensure that its carrying value reflects its value in use, in accordance with IAS 36 *Impairment of Assets*.

WW's actual profit before tax in 20X4 (£190k) was 91% below the forecast figure (£2,160k); and WW's performance declined further in 20X5, leading to a pre-tax loss of £134k compared to a forecast profit of £2,960k.

IAS 36 requires that the value in use calculated for the Group financial statements should be based on the future cash flows IM expects to derive from WW, with those cash flow projections being based on reasonable and supportable assumptions. Although we are currently looking at profit figures rather than cash flows, it seems inevitable that the profit shortfall will have had a significant negative impact on WW's cash flows. Moreover, given the apparently lack of credibility in WW's forecasts, IM would be advised to produce its own forecasts as the basis of the impairment review, to ensure that the figures used are reasonable and supportable.

IAS 36 requires that any impairment loss required as a result of the review should be recognised as a loss in Group profit or loss for the year. However, the standard also specifically requires that goodwill must be subject to an annual impairment review. Therefore, by 30 September 20X6 the initial goodwill figure of £5.4 million may have already been substantially impaired, thereby also reducing the potential charge to profit or loss in 20X6.

### (4) External assurance reports

In order for IM to make rational decisions about WW, it needs to have credible and reliable information about WW's performance. However, there are concerns that the forecasts prepared by WW are neither credible nor reliable. If a firm of accountants carried out a review of the forecast, they would be able to provide independent assurance about the level of confidence IM can have in the forecast.

If the accountants accept an assurance engagement to review the forecasts, the guidelines for such an engagement are provided by ISAE 3400 *The Examination of Prospective Financial Information*.

The forecast prepared by WW's management should be based on certain specified assumptions. In part, these may be based on historical information about the company, but they will also be based on future expectations about WW's competitive environment.

In an assurance engagement, the accountants will need to satisfy themselves about the reliability of any historical information that has been used as a basis for the forecasts. They will also need to consider the reasonableness of the assumptions used to prepare the forecast, and then check that the forecast has been accurately prepared on the basis of those assumptions. The aim of their engagement will be to obtain sufficient evidence to decide whether or not this is the case; and provided they are able to obtain this evidence then they will be able to issue a report at the end of their engagement.

In this scenario, a key part of the accountants' work is likely to involve establishing whether the factors which give rise to the expected improvement in performance appear reasonable or not.

However, a major problem with any financial forecast is that, even if there are valid and verifiable reasons for the assumptions that have been made, predicting the future is a subjective exercise. Similarly, the assumptions in a forecast are, by their nature, speculative, so actual performance will differ from the forecast.

As such, the accountants will not be in a position to express an opinion on whether the results in the forecast will be achieved. Instead, they will only be able to provide limited assurance.

If the accountants believe that the assumptions provide a reasonable basis for the forecast, and that the forecast has been properly prepared, they will issue a statement of negative assurance – that there is nothing to suggest the forecast is inappropriate. This will be accompanied by a caveat that, nonetheless, the results in the forecast may still not be achieved.

If the accountants believe the assumptions do not provide a reasonable basis for the forecast, they will issue an adverse opinion.

In this case, however, it appears that Rachel has already identified that the forecasts are not credible, and has her own (qualified) staff available to review WW's performance. As such, it is not clear what additional benefit IM would gain from asking the independent accountants to carry out an independent review of the forecast.

If anything, as the engagement is for the benefit of IM's management, a consultancy engagement might be more appropriate. In this type of engagement, the accountancy firm would assess the degree of reliability in the forecast, and perhaps provide an alternative forecast based on different assumptions. Again though, this may be something which IM could do internally, rather than needing to use an external firm.

#### **(5) IM Group Control Framework**

The IM board operates a highly centralised system for controlling its subsidiaries with limited devolvement of decision making to subsidiary board level.

Each subsidiary is, therefore, responsible to the main board for its performance, despite having limitations on its control over that performance.

The internal governance arrangement is therefore one of centralised control on a divisionalised basis, with WW being one such division.

In terms of financial autonomy, the WW board is not able to borrow from external institutions. The only source of funding is from IM which imposes an annual interest charge of 7% over which WW appears to have no control. Similarly, the IM board retains control over investment decisions, so WW could not be regarded as an investment centre.

In terms of other operating decisions, the WW board appears to have limited control over pricing and the purchase and sale of assets. There are therefore questions over whether WW could even be regarded as a profit centre.

If WW is to be monitored on the basis of ROCE then it seems reasonable that the WW board has some discretion over the capital base and the ability to borrow to buy assets to form part of the capital employed. But no group, however devolved, is likely to give up parent company board control over capital/borrowing decisions entirely.

The suggested alternative control framework gives more autonomy to WW management to take local decisions, while maintaining accountability to the parent company board for overall performance.

This would restore the situation to a similar governance structure that existed when WW was part of the TT group. This would enable localised decision making and probably more rapid decision making.

In this context, the main IM board would need to set clear objectives and monitor achievement of these objectives, but the WW board would control the means by which these are to be achieved.

By enabling local decision making by the WW board, it would be more feasible to incentivise managers to improve performance as their actions can now impact on performance (see below).

**(6) Bonus scheme**

(i) Impact on motivation

This scheme is directly linked to the performance of WW rather than the group and hence it is more within the control of the WW board.

The major disadvantage is that it is an accounting-based measure rather than a market-based measure and may therefore give rise to incentives for creative accounting by the directors in order to achieve their bonus.

The major advantage is that it has a truth-inducing element in that if the directors have made forecasts that they know not to be credible (see above) the scheme would be unattractive as they would lose 15% of salary (£24,000 per year on average) and not meet the conditions to be awarded the bonus. On the other hand, if they believe in the forecasts, they would be in favour of the scheme as they would gain £80,000 each in 20X6 and £100,000 each in 20X7, while only losing £24,000 each in basic salary.

(ii) Financial reporting impact

This is a short term bonus payment in accordance with IAS 19 *Employee Benefits*. It would be recognised on an accruals basis as it would be known at the year-end whether the forecasts had been met.

In the year ending 30 September 20X6, the following amount would be recognised if the forecasts had been achieved:

|                            | £'000 | £'000 |
|----------------------------|-------|-------|
| DR Payroll expenses        | 640   |       |
| CR Liability (£80,000 x 8) |       | 640   |

In the year ending 30 September 20X7, the following amount would be recognised if the forecasts had been achieved:

|                             | £'000 | £'000 |
|-----------------------------|-------|-------|
| DR Payroll expenses         | 800   |       |
| CR Liability (£100,000 x 8) |       | 800   |

The liabilities would be cleared when payment was made on 31 December each year.

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ISBN 978-1-78363-109-4  
  
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