ADVANCED LEVEL EXAMINATION

TUESDAY 3 NOVEMBER 2015

(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	

QUESTION 1

Riller plc is a UK-based building company which constructs residential properties (ie houses and apartments). It is listed on the London Stock Exchange.

In common with many other companies that build residential properties, Riller performed poorly from 2008 until 2012, because of downward pressure on property prices and on sales volumes during the recession. However, Riller has now returned to profit, following an upturn in property prices since 2012.

The chief executive of Riller, Gary Griffiths, asked to meet with Laura Lewis, who is a partner in Hayes & Scott LLP (HS), a firm of ICAEW Chartered Accountants. You work for HS as a senior in the advisory department. Riller is a client of HS, but not an audit client.

The meeting

Gary opened the meeting. “Riller has been increasingly profitable over the past two years. Factors that have helped us return to profit include a reorganisation in 2012 and also, more recently, the general improvement in the residential property market. In order to continue this growth in profit, however, the board has decided that the company needs to make a strategic acquisition.

“I have prepared some information about the UK residential property building industry and market background, including an extract from the annual report of Mega plc, one of the UK market leaders (**Exhibit 1**). I have also provided some background information on Riller (**Exhibit 2**). The finance director, Julie Morton, who is an ICAEW Chartered Accountant, has provided some financial and operating data (**Exhibit 3**).

“The Riller board has identified a possible target company, Minnen plc, and I have drafted confidential briefing notes relating to its acquisition (**Exhibit 4**). We would welcome HS’s evaluation of this potential acquisition.

“Financing the acquisition is a key factor. There are two alternative forms of consideration for purchasing Minnen:

(a) make an offer of a share-for-share exchange; or
(b) issue bonds to finance a cash acquisition.

“Julie has provided some information about the financing of the acquisition (**Exhibit 5**).

“In addition, if we decide to acquire Minnen, we will need HS to carry out due diligence procedures.

“I appreciate that information is limited at the moment, but I have provided terms of reference for an engagement between Riller and HS where I set out more precisely what is required from your firm (**Exhibit 6**).”

Engagement partner’s briefing

Laura asks to see you after the meeting. She outlines what occurred during the meeting with Gary and gives you the following instructions:

"I would like you to provide for me a draft response to the requests made by Gary, the Riller chief executive (Exhibit 6).

"In addition, after the meeting, I received a phone call from Julie Morton (**Exhibit 7**) about an ethical concern. I would like you to prepare notes setting out the ethical issues arising for all relevant parties. Your notes should include the actions that HS and Julie should now take."

Requirement

Respond to the briefing from the engagement partner, Laura, by drafting the required reply to Gary (Exhibit 6) and preparing notes on the ethical issues (Exhibit 7).

Total: 60 marks

Exhibit 1: UK residential property building industry and market background – prepared by Gary Griffiths

The residential property market comprises two sectors: the new-build sector and the secondary market sector. The new-build sector is concerned with the construction and sale by building companies of new houses and apartments. The secondary market sector is concerned with the sale by individuals of their homes in private transactions with individual purchasers. Individuals buying a house or apartment normally obtain a loan to finance the purchase.

The prices of residential properties can fluctuate widely. In particular, there can be periods of rapid increases, sometimes as high as 20% in one year in some regions of the UK. However, prices can also fall, as occurred in the recession from around 2008 to 2012. Many residential property building companies failed in this period and most suffered losses.

As property prices started to increase after 2012, most residential property building companies that survived the recession showed significant increases in profits. Residential property price increases have occurred throughout the UK. However, while the increases have been significant in London and the surrounding areas (where property prices have always been significantly higher than the rest of the UK), there have been smaller price increases in other regions.

The factors influencing residential property prices are varied but include: the level of personal incomes, loan interest rates, availability of credit to house buyers, consumer confidence, employment levels and available supply of properties.

Extract from industry magazine: House Builders Herald – 27 October 2015

The UK's largest residential property building companies will see profits increase significantly in 2015. Research shows that the UK's 10 largest companies in the industry own enough land to build around half a million homes. In total, they made pre-tax profits of more than £2,000 million in 2014 – a 35% increase on 2013.

Jeff Knight of the House Builders Association, whose members account for 75% of new residential properties built in the UK, said: "Profits in the industry fell very steeply in 2008 and the following few years, with most companies making losses and many companies failing. Those companies surviving the crisis have reorganised, with profits now returning to pre-recession levels."

Extract from Mega plc's annual report for the year ended 30 September 2015

Mega continues to be one of the UK's leading residential property building companies.

During the current financial year, Mega's total sales volumes grew by 24% to 3,785 residential properties. In the same period, the average selling price of our properties increased by 15%.

The substantial increase in the number of properties sold, combined with property price inflation in excess of build cost inflation, improved our gross margin from 20.7% to 22.8%.

Exhibit 2: Riller company background – prepared by Gary Griffiths

Riller was established over 50 years ago. It grew by developing a good reputation for building residential properties and obtained a listing on the London Stock Exchange in 2001. The properties built by Riller are positioned above mid-market in terms of size and quality. It has focused its building activity in large towns and cities in the north of England.

The company has survived by adopting a prudent policy of acquiring a significant landbank (land on which houses can be built in future) and, unlike many companies that failed in the recession, its financial gearing is relatively low.

In common with many companies in the industry, Riller's profit has increased significantly in the past two years as a result of rising property prices and increased sales volumes. Industry profit growth is expected to continue for three more years at about 10% per annum, before stabilising to zero growth.

In the UK residential property building industry, Riller is in the top 25 largest companies, but it is outside the top 10 companies which dominate the industry.

Riller has a large central depot from which it operates in the north of England. It does not have a depot in the south of England, as it seldom has building projects in that area.

Riller's houses and apartments have proved popular because of its good reputation for quality building, and also as a result of careful selection of the location of the land it acquires.

Riller purchases land a long time before it needs to build on the land and it therefore has a substantial landbank in inventories. A key reason for the recent increase in profit has been that land was acquired at low cost during the recession. Increases in the value of land over the past three years have made recent land purchases significantly more expensive than was previously the case.

Inventories are the company's major asset and comprise primarily the landbank, but also building materials, work-in-progress on partially completed houses and unsold completed houses.

Revenue is recognised on legal completion of the sale of each house.

Riller's share capital is owned 27% by Financial First (a private equity company) and the remaining shares by a number of financial institutions.

Riller does not currently have any subsidiaries.

Exhibit 3: Riller financial and operating data – prepared by Julie Morton

Riller: Summary statements of profit or loss for the years ended 30 September:

	2015	2014
	£'000	£'000
Revenue	285,300	232,500
Cost of sales	(218,900)	(189,400)
Gross profit	66,400	43,100
Distribution and administration costs	(28,500)	(21,200)
Operating profit	37,900	21,900
Net finance costs	(10,200)	(9,300)
Profit before tax	27,700	12,600
Income tax expense	(6,100)	(2,700)
Profit for the year	21,600	9,900

Riller: Summary statement of financial position at 30 September 2015**:**

	£'000
Non-current assets	
Property, plant and equipment	3,700
Current assets	
Inventories	566,300
Trade and other receivables	4,700
Cash	29,600
Total assets	**604,300**
Equity	
£1 ordinary shares	32,000
Share premium	108,500
Retained earnings	66,300
Non-current liabilities	
Loans	260,000
Current liabilities	
Trade and other payables	137,500
Total equity and liabilities	**604,300**

Exhibit 4: Potential acquisition of Minnen plc – confidential briefing notes prepared by Gary Griffiths

Negotiations

Preliminary negotiations have taken place with the Minnen board about the possibility of Riller acquiring 100% of the ordinary share capital of Minnen on 30 September 2016.

The Minnen board believes that an appropriate bid price would be £4 per share and it would be willing to recommend that the shareholders accept an offer from Riller at this price. This would give a total proposed consideration of £80 million.

Minnen company background

Minnen is an AIM-listed company which builds residential properties mainly in the south of England, including London. Minnen has its main depot in the south east of England. Minnen is not in the top 25 largest UK housebuilding companies, but it has an excellent reputation for quality.

The directors of Minnen own 20% of its ordinary shares, with financial institutions holding the remaining shares.

Minnen: Extracts from statements of profit or loss for years ended 30 September:

	2015	**2014**
	£'000	**£'000**
Revenue	133,400	130,800
Gross profit	16,100	15,500
Operating profit	8,100	7,750
Profit before tax	7,000	6,700
Profit for the year	5,600	5,300

Minnen: Summary statement of financial position at 30 September 2015:

	£'000
Non-current assets	
Property, plant and equipment	2,200
Current assets	
Inventories	184,800
Trade and other receivables	2,300
Cash	1,300
Total assets	**190,600**
Equity	
£1 ordinary shares	20,000
Retained earnings	22,000
Non-current liabilities	
Loan (redeemable in 2020)	87,000
Current liabilities	61,600
Total equity and liabilities	**190,600**

Note:

- Inventories are measured at the lower of cost and net realisable value.
- The fair value of Minnen's net assets, excluding internally-generated intangibles, is £58 million.

Comparison of operating data – Riller and Minnen

	Riller		Minnen
	2015	**2014**	**2015**
Number of houses sold in year ended 30 September	765	820	242
Number of 'plots' of land held in landbank at 30 September	5,550	4,600	1,600

Synergies from the acquisition

The commercial and operating synergies, after tax, for the enlarged group which could arise from the acquisition, are:

- Overhead efficiency savings of £200,000 per annum.
- Material and subcontractor procurement gains from scale economies amounting to £100,000 per annum.
- Other cost savings amounting to £50,000 per annum.

Working assumptions

- The acquisition would take place on 30 September 2016.
- In the absence of an acquisition, Minnen's profit after tax will increase by 10% per annum over the three years from 30 September 2015, before stabilising to zero growth thereafter.
- An annual discount rate of 10% is to be used to evaluate the acquisition.
- Operating cash flows arise at the end of the year to which they relate.
- One 'plot' of land is used to build one residential property.

Share prices

Current quoted share prices on the London Stock Exchange are:

Riller	£7.20
Minnen	£3.20

These prices have remained around the same level since 30 September 2015.

Post-acquisition integration

It has not yet been decided whether Riller would retain the Minnen brand name after acquisition or rebrand all its operations under the Riller brand.

Financial reporting concerns of the Riller board

The Riller board has a number of concerns about the impact of an acquisition of Minnen on the Riller group financial statements.

The Riller board's specific concerns about the acquisition are:

- The impact of the acquisition on the group statement of financial position, including the treatment of the Minnen brand name.
- The financial reporting implications of each of the two methods of financing the acquisition (Exhibit 5).

Exhibit 5: Financing the acquisition of Minnen plc – prepared by Julie Morton

As a working assumption, the bid value for Minnen is unlikely to be affected by the method of financing the acquisition.

The acquisition can be implemented by two alternative methods of financing: a share-for-share exchange; or cash raised from the issue of a 10-year bond.

The amount under either method would be equal to the full amount of the consideration paid for 100% of the share capital of Minnen.

(a) <u>Share-for-share exchange</u>

Acquire 100% of the ordinary shares of Minnen through a share-for-share exchange using newly-issued Riller ordinary shares.

The Riller board has specific concerns about the impact of the share-for-share exchange on Riller's share price and about any other implications for its existing shareholders.

(b) <u>10-year bonds</u>

Issue 10-year bonds at a fixed annual rate of interest of 5%. The funds raised will be used to make a cash acquisition of 100% of the ordinary shares of Minnen.

The Riller board is confident that market interest rates and expectations will remain stable until 30 September 2016. However, the Riller board has specific concerns about how subsequent changes in market interest rates will affect the fair value of the bonds and about the implications of this for Riller.

Exhibit 6: Terms of reference – prepared by Gary Griffiths

The Riller board would like HS to prepare a report addressing the issues set out below.

(1) With respect to the potential acquisition of Minnen:

- analyse and compare the performance and position of Minnen and Riller;
- explain the factors that should be considered in deciding whether it would be beneficial to acquire Minnen;
- determine and justify a price per share that should be offered for the acquisition of Minnen, taking into account the proposal of £4 per share by the Minnen board. Use a variety of models; and
- explain the financial reporting implications for the consolidated financial statements of Riller, addressing the specific concerns raised by the Riller board (Exhibit 4).

(2) With respect to the two alternative methods of financing the acquisition (Exhibit 5):

- evaluate the factors that should be considered in deciding which method of financing should be used. Address the specific concerns of the Riller board (Exhibit 5), but do not restrict yourself to these; and
- provide a reasoned recommendation regarding the method of finance that should be used.

(3) Identify and explain the key risks to Riller relating to the acquisition of Minnen which will need to be assessed during the due diligence process. Set out the due diligence procedures that HS could undertake to address these risks. I do not need a long list of the standard due diligence procedures, just those relevant to the key risks.

Exhibit 7: Note of telephone conversation with Julie Morton – prepared by Laura Lewis

The finance director of Riller, Julie Morton, called me confidentially today to raise an ethical concern.

Julie said that some of the Minnen directors have informally indicated that they might be prepared to recommend a lower bid price to Minnen shareholders. This would depend on Riller guaranteeing that they would retain their positions as directors after the acquisition, with their remuneration packages remaining at their current levels.

Julie explained that Gary is keen to minimise the cost of the acquisition and would therefore like to consider this suggestion, but she has concerns and would like some advice from HS.

QUESTION 2

Kinn plc is a listed engineering company operating through three divisions: Mechanical, Electrical and Civil.

Kinn has performed poorly in recent years and, following a review of the business, it intends to restructure. The board is therefore seeking advice from Giplin and Linthwatt LLP (GL), a firm of ICAEW Chartered Accountants. You are a senior working in the business advisory department of GL.

Aisha Ashton, a partner in GL, has received an email from the Kinn finance director, Roger Reed, which she has forwarded to you.

To: Aisha Ashton
From: Roger Reed
Date: 3 November 2015
Subject: Sale of Electrical Division

Dear Aisha,

The Kinn board needs GL's help.

As you have not previously worked on an engagement for Kinn, I have provided some background notes about the company (**Exhibit 1**).

Some segments of our business have not been performing well. In particular, we entered the electrical engineering market a few years ago, opening an Electrical Division in a newly-built factory in Germany, but it has not been a success. Following a review, we decided to sell the Electrical Division and withdraw from the electrical engineering market completely. I have provided you with some details (**Exhibit 2**).

The sale of the Electrical Division will generate net cash proceeds of £25 million for Kinn and we therefore have the short-term problem of how we invest this money to earn a pre-determined rate of interest. I have set out some details (**Exhibit 3**).

The board is still deciding how to use the net cash proceeds in the longer term and it would value GL's advice on this matter. I have set out the alternatives that we would like you to consider (**Exhibit 4**).

The Kinn board would like GL to prepare a report addressing the issues explained above. I have provided more details of what is required in a 'terms of engagement' document **(Exhibit 5)**.

Partner's instructions

Aisha calls you into her office. "I would like you to draft the report requested in Roger's 'terms of engagement' document (Exhibit 5)."

Requirement

Respond to the instructions from Aisha.

Total: 40 marks

Exhibit 1: Company background notes – prepared by Roger Reed

Products and divisions

Kinn plc is an engineering company. It has three divisions: Mechanical, Electrical and Civil. The divisions are autonomous, but they are not separate subsidiaries.

Division	**Products**	**Location**
Mechanical	Industrial machinery	UK
Electrical	Generators	Germany
Civil	Roads, railways, bridges	Italy

The Electrical Division was set up six years ago to diversify into electrical engineering products, but it has struggled to compete, despite significant investment. The decision to set up this division is now regarded by Kinn's management as a mistake.

The Mechanical Division and the Civil Division have performed reasonably well, but both of the divisional heads believe that these two divisions have suffered from under-investment, with most of the company's available funds being provided to the Electrical Division, in an attempt to help it to become established.

Performance

The performance of Kinn has been below expectations. This has been largely due to the Electrical Division. At first, it was believed that the poor performance of the Electrical Division was temporary and attributable to the division being in the start-up phase. However, whilst achieving profit, it has continued to perform below expectations.

Pressure from shareholders about poor share price performance resulted in the recent appointment of a new chief executive to implement a different approach. Following the review of the business, the Kinn board now has the aim of developing a strategy to increase the share price.

Based on currently available data, the forecast performance for the year ending 31 December 2015 is:

	Mechanical £'000	**Electrical £'000**	**Civil £'000**	**Total £'000**
Revenue	16,600	4,500	22,900	44,000
Operating profit	4,250	620	4,600	9,470
Profit before tax	3,100	110	3,300	6,510
Net assets at carrying amount	34,000	26,400	46,400	106,800
Total assets at carrying amount	57,000	36,600	72,400	166,000

Head office costs are allocated between the divisions using a range of metrics and these allocated costs are included in the above data.

Exhibit 2: Sale of Electrical Division – provided by Roger Reed

The Kinn board decided a few months ago that the Electrical Division should be sold. It has been successful in finding a buyer, a German engineering company, Reingold GmbH.

The details of the sale negotiations are being finalised, but a cash price has been agreed with Reingold. The date of sale is expected to be 31 March 2016. On this date, Kinn will receive net cash proceeds of £25 million from the sale of the assets of its Electrical Division, after settlement of its liabilities.

The board has two main concerns:

(1) The impact on the future financial performance of Kinn for the year ending 31 December 2016 arising from the disposal of the Electrical Division, including the effect on key ratios.

(2) The financial reporting implications arising from the sale agreement for the Electrical Division in the financial statements for the year ending 31 December 2015.

Working assumption

If there is no investment or restructuring, the performance of all three divisions in the year ending 31 December 2016 will be the same as that forecast for the year ending 31 December 2015.

Exhibit 3: Short-term deposit of net cash proceeds of £25 million – prepared by Roger Reed

The £25 million net cash proceeds from the sale of the Electrical Division is expected to be received on 31 March 2016. At that date, the funds will be placed on short-term, fixed-interest deposit with Kinn's bank for three months until 30 June 2016, when there will be a long-term use for these funds (Exhibit 4).

The board has expressed concern that short-term deposit interest rates might fall in the three months to 31 March 2016, so it wants to lock into interest rates at 31 December 2015.

The board is considering using LIFFE 3-month sterling interest rate futures (contract size £500,000) to remove interest rate risk between 31 December 2015 and 31 March 2016.

The board expects at 31 December 2015 that:

- the short-term, fixed-interest deposit rate will be 3.75% per annum; and
- the March 2016, 3-month sterling interest rate futures contract will be trading at 96.00.

Exhibit 4: Long-term use of net cash proceeds of £25 million – prepared by Roger Reed

There is disagreement on the board as to how the net cash proceeds from the sale of the Electrical Division should be used for long-term investment on 30 June 2016.

Two alternatives were suggested. The board is keen to understand the likely impact on the risk of the company and on its share price for each of these alternatives.

<u>Alternative 1</u>

Purchase new production equipment for the Mechanical Division in order to improve its productivity and quality.

It is estimated that the new investment will generate a 9% annual return indefinitely.

The cost of new production equipment on 30 June 2016 for the Mechanical Division would be £45 million. To finance this amount, Kinn would use the net cash proceeds of £25 million from the sale of the Electrical Division and also borrow a further £20 million, repayable on 30 June 2022.

Kinn's current credit rating is BBB. Its bank has indicated that it would be willing to provide the £20 million debt finance at either a fixed rate of 6% per annum or a floating rate of 12-month LIBOR + 3%. The 12-month LIBOR is currently 3.75%.

The board is unsure which of these types of debt it should use.

<u>Alternative 2</u>

Use the whole of the £25 million net cash proceeds from the sale of the Electrical Division to reduce some of the existing borrowing.

Exhibit 5: Terms of engagement – prepared by Roger Reed

The Kinn board would like GL to prepare a report in which you:

(1) (a) Analyse the forecast financial performance of Kinn for the year ending 31 December 2015.

Calculate and explain the impact on the company's future performance for the year ending 31 December 2016 arising from the sale of the Electrical Division. Apply the working assumption in Exhibit 2.

(b) Set out and explain the financial reporting implications arising from the sale agreement for the Electrical Division in the financial statements for the year ending 31 December 2015.

Ignore tax and deferred tax for now.

(2) Explain how the proposed interest rate futures could manage interest rate risk arising from the short-term deposit of the £25 million (Exhibit 3).

Illustrate your explanation with calculations showing how the contract will work if interest rates fall by 1% (to 2.75%) between 1 January 2016 and 31 March 2016.

State any assumptions.

(3) Explain the likely effects on the risk of the company, and on Kinn's share price, of each alternative long-term use of the net cash proceeds (Exhibit 4). Set out any assumptions you make.

Advise whether Kinn should use the fixed or variable rate loan, from its bank, if the board were to decide on Alternative 1.