ADVANCED LEVEL EXAMINATION

TUESDAY 4 NOVEMBER 2014

(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.
2. Answer each question in black ballpoint 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.

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.

DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK

You MUST enter your candidate number in this box

QUESTION 1

Firebrand Forklift Trucks Ltd (FFT) is a manufacturer of diesel-powered forklift trucks with a factory located in Wales. It was established in 2009 and exports globally.

Recent years have not been good for FFT. In 2009, the company borrowed to expand, but revenue has decreased since 2012. Over the last year, FFT has struggled to meet debt interest payments and a long-term bank loan of £100 million from Kittminster Bank becomes repayable in December 2014. There is also an overdraft with Kittminster Bank. FFT cannot obtain the necessary funding to redeem this loan or repay the overdraft.

The chairman of FFT, Murray Moore, asked to meet with Rose Ready, who is a partner in Davies & Hyland LLP (DH), a firm of ICAEW Chartered Accountants. You work for DH as a senior in the advisory department.

The meeting

Murray opened the meeting. “Rose, we are in a state of real crisis. FFT needs your firm’s help urgently.

“Despite taking all reasonable measures, including factoring of receivables, we are unable to obtain the funding to redeem the loan or repay the overdraft. As a result, Kittminster Bank is considering whether or not to put FFT into administration. Meanwhile, Kittminster Bank has given the FFT board the opportunity to put together a recovery plan in the form of a financial reconstruction and I would like your firm’s help with this plan.

“Given that FFT is a new client for DH, I have provided you with some information about the forklift truck industry and the market background (**Exhibit 1**). I have also provided the FFT company background (**Exhibit 2**), including some financial and operating data (**Exhibit 3**).

“The FFT board has drafted a proposed financial reconstruction scheme (**Exhibit 4**). We would welcome DH’s evaluation of this scheme, including whether it is likely to be acceptable to all stakeholders.

“If we are allowed by Kittminster Bank to continue to trade, one new proposal to boost revenue is to offer customers the opportunity to lease our forklift trucks, rather than buying them outright. I need DH to evaluate this proposal (**Exhibit 5**) as I want to show it to the bank as a positive move forward, if it permits us to continue trading.

“As if we did not have enough problems, last week we received an email from a journalist accusing us, in effect, of unethical trading (**Exhibit 6**). We need your expertise and independent support in this matter, so I would be grateful if you could advise us how we should reply. I also need DH to support our response and to argue that FFT has acted ethically, as we always inform our customers, before and after the sale, about the safe use of our vehicles.

“I have attached terms of reference for an engagement between FFT and DH, where I set out more precisely what I require from your firm (**Exhibit 7**).”

Instructions

After the meeting, Rose asks to see you. She outlines what occurred during the meeting with Murray and gives you the following instructions:

“I would like you to provide a draft response to the requests from Murray, the FFT chairman, (Exhibit 7) for my consideration.

“In addition, I am concerned about the implications for our firm of giving advice and support to FFT on its response to the journalist (Exhibit 6). Please provide a briefing note for me explaining any ethical issues arising for our firm from giving advice and support to FFT in this matter.”

Requirement

Respond to the instructions from the engagement partner, Rose Ready.

Total: 60 marks

Exhibit 1: Forklift truck industry and market background – prepared by Murray Moore

Forklift trucks are powered industrial vehicles used for lifting and moving materials over short distances. They are essential vehicles in warehouses and distribution centres for the movement of goods.

Forklift trucks differ according to how they are powered. The most popular type of power unit is electric, driven by rechargeable batteries. Larger forklift trucks are normally powered by diesel engines. Diesel engine trucks should not be used in an enclosed space because of the health risk from harmful emissions. Many countries have laws against the indoor use of diesel-powered forklift trucks, but there remain a number of countries where it is not prohibited by law.

Forklift trucks also vary significantly in size, which is a key factor in terms of load-bearing ability and price.

The industry is dominated by a number of large international companies. In 2013, the top 20 global manufacturers generated revenues of about £19,000 million from the sale of approximately 950,000 forklift trucks. Annual revenue growth has been around 2% for these companies.

More generally in the industry, the cost of a new forklift truck can vary from £9,000 to around £90,000, depending mainly on the means by which it is powered and the load capacity of the truck. When buying a forklift truck, customers need to consider not just the initial cost, but also the ongoing costs of usage.

Competition in the forklift truck industry is intense and is influenced by a range of factors including brand loyalty, customer service, price, availability, performance, quality, features and the cost of ownership over the life of the forklift truck.

Most major international manufacturers of forklift trucks offer the choice to customers of purchasing or leasing. Leases typically range from short-term hires of a few days to long-term leases of up to six years.

Exhibit 2: FFT company background – prepared by Murray Moore

In the global forklift truck industry, FFT is a large company, but it is outside the top 20 companies. It was established in 2009 as a spin-off from a large Japanese motor manufacturer, Jitsumi. FFT purchases all of its diesel engines from Jitsumi under a long-term contract, which has an exclusivity clause preventing FFT purchasing engines from other manufacturers. FFT is tied into this contract for a further five years and the FFT board believes that it is paying significantly more than the market rate for its diesel engines.

FFT has one factory, which is located in south Wales near the port of Milford Haven, from where it exports its forklift trucks and into which it imports Jitsumi engines and some other components.

FFT currently produces only diesel-powered forklift trucks. These are designed for use in large, outdoor distribution centres and storage facilities.

FFT trucks have proved popular and, as a result, FFT has had a problem in maintaining sufficient production capacity to meet demand. This has partly arisen from a lack of cash to expand its production facilities further after the initial investment in 2009. However, there is also a general feeling by the FFT board that production is not as efficient as it should be. It believes that output is below what could be achieved, even with the existing production facilities. As a consequence, there has been a growing backlog of unfulfilled orders, resulting in a long lead time for customer deliveries.

Exhibit 3: FFT financial and operating data – provided by Murray Moore

Statements of profit or loss for the years ending 31 December:

	Forecast 2014 £'000	Actual 2013 £'000	Actual 2012 £'000
Revenue	667,000	694,300	703,500
Cost of sales	(480,000)	(499,900)	(492,400)
Gross profit	187,000	194,400	211,100
Distribution and administration costs	(195,000)	(199,500)	(201,800)
Operating profit/(loss)	(8,000)	(5,100)	9,300
Finance costs	(5,000)	(5,000)	(5,000)
Profit/(loss) before tax	(13,000)	(10,100)	4,300
Income tax expense	-	-	(860)
Profit/(loss) for the year	(13,000)	(10,100)	3,440

Forecast statement of financial position at 31 December 2014:

	£'000
Non-current assets	
Property, plant and equipment	132,700
Current assets	
Inventories	23,300
Trade receivables	24,600
Total assets	**180,600**
Equity	
£1 ordinary shares	40,000
Retained earnings (deficit)	(7,300)
Current liabilities	
Bank loan 5% – Kittminster	100,000
Bank overdraft – Kittminster	35,300
Trade payables	12,600
Total equity and liabilities	**180,600**

Operating data:

	Forecast 2014	Actual 2013	Actual 2012
Operating cash flows (£'000)	2,100	14,600	27,800
Number of trucks sold	39,235	38,570	37,030
Backlog (ie. number of trucks ordered by customers, but not produced at each year end)	16,350	12,855	9,260

The forecasts for the year ending 31 December 2014 are reliable as they comprise actual data from the management accounts for the 10 months ended 31 October 2014, plus the final two months of forecast figures.

Exhibit 4: Proposed financial reconstruction scheme – prepared by Murray Moore

The terms of the proposed financial reconstruction are:

- FFT to issue to existing ordinary shareholders: 10 million, additional new £1 shares, for cash of £10 million.
- Kittminster Bank to accept a new arrangement: a new loan of £120 million, at 8% per annum, redeemable on 31 December 2019 at par, in exchange for cancelling its existing loan and overdraft. No cash would be paid or received on this exchange.
- FFT to make a payment of £2 million to suppliers in partial settlement of trade payables, in order to secure the existing supply chain for the future. Of this total, it is proposed that £1.9 million should be paid to Jitsumi. Payments would be made from operating cash flows.

The cash raised from the new share capital would all be invested in plant and machinery which will enable more efficient production and a gradual reduction in the backlog of orders. As a consequence, it is estimated, as a working assumption, that FFT will be able to generate operating profits of £14 million in the year ending 31 December 2015 and in each year thereafter for the foreseeable future.

If the financial reconstruction scheme is not accepted and FFT is placed into administration by Kittminster Bank, the most likely outcome is that FFT will be liquidated.

The proceeds generated from the sale of the assets in a liquidation at 31 December 2014 are estimated to be**:**

	£'000
Property, plant and equipment	83,300
Inventories	13,300
Trade receivables	19,500

Other factors:

- Liquidation costs would be about £3.2 million.
- Kittminster Bank holds a fixed charge, in respect of the loan, over all property, plant and equipment. In the loan agreement, there is also a floating charge over all FFT assets.
- All the overdraft is due to Kittminster Bank in respect of which it holds a floating charge over all FFT assets.
- Of the trade payables at 31 December 2014, £9 million is due to Jitsumi. The Jitsumi board has become aware of the financial problems that FFT is experiencing and is refusing to supply further diesel engines unless outstanding balances are paid immediately. FFT holds only a small number of engines as they are supplied on a just-in-time basis.

FFT has a cost of equity of 10% per annum. The tax rate is 20%.

Exhibit 5: Lease or buy choice for customers – prepared by Murray Moore

FFT does not currently offer customers the choice to lease its forklift trucks. However, it is being proposed that, in order to boost revenue from one of our most popular types of forklift truck, the FZ101, we should introduce for customers the alternative of leasing from FFT.

We propose to offer the FZ101 to customers under a three-year lease agreement. The lease payment would be £1,200 per quarter, payable quarterly in arrears. At the end of the lease, after three years, FFT would sell the used FZ101 for about £4,000. The annual discount rate for this type of project is 8.24%.

The list price of a new FZ101 is £16,200 and the variable cost of manufacture is £12,300.

Under the lease agreement, FFT would not be responsible for repairs and maintenance.

Exhibit 6: Email to the FFT board – from the journalist, Barry Bankhurst

The following email has been received from a journalist working for 'The Record', a major national newspaper:

To: FFT Board
From: Barry Bankhurst, Journalist with 'The Record'
Date: 1 November 2014
Subject: Health and Safety concerns with FFT's exported forklift trucks.

We have been carrying out a piece of investigative journalism on the health and safety of exports by UK manufacturers.

It has come to our notice that some FFT diesel-powered forklift trucks exported to developing nations, are being used inside warehouses by a number of employers. As a result, we believe that the emissions from the diesel engines have caused health problems for some of the employees driving them.

Moreover, we have discovered that FFT's sales documentation has not given clear warnings in the relevant local languages about the indoor use of diesel-powered forklift trucks.

We intend to publish an article in 'The Record' next week disclosing these discoveries. Before we do so, the editorial board has asked me to give you the right to respond and to justify FFT's actions. Your response may also be published in the article.

As part of this newspaper's contribution to the public interest, we are also requesting that the FFT board makes a public undertaking that the company will, with immediate effect, cease selling diesel-powered forklift trucks to those companies that are carrying out this practice of indoor use.

Barry Bankhurst
Journalist
The Record

Exhibit 7: Terms of reference – prepared by Murray Moore

The FFT board would like DH to prepare a report which:

(1) Explains the decline in FFT's profit over the years ended 31 December 2012, 31 December 2013 and 31 December 2014. Recommend actions which may improve profitability in future.

(2) With respect to the financial reconstruction scheme (Exhibit 4):
- Evaluates the effects of the proposed scheme and compares these with the effects of liquidation, setting out the benefits and risks for the various stakeholders and providing supporting calculations.
- Shows and explains the financial reporting implications for the financial statements for the year ending 31 December 2014 if, at that date, negotiations are still ongoing between FFT and Kittminster Bank regarding a restructuring of the loan.

(3) With respect to the proposal to boost revenue (Exhibit 5):
- Evaluates, with supporting calculations, the benefits and risks to FFT of leasing, compared with selling, the FZ101 forklift truck to customers.
- Explains how a lease for an FZ101 forklift truck would be treated in the FFT financial statements.

(4) Advises the FFT board how it should respond to the email from the journalist. Please indicate any future actions that FFT should take with regard to this matter, now that the issue has been brought to its attention.

QUESTION 2

“I just don’t understand what has gone wrong.” Richard Avebury, the managing director of Washing Solutions Ltd (WS), was opening a meeting with Xenon, Young and Zhang LLP (XYZ), a firm of ICAEW Chartered Accountants.

WS is a private company which manufactures washing machines used for cleaning clothes and other textiles. It has two divisions: the Industrial Division and the Household Division.

You are a senior working for XYZ, which acts as business advisers to WS. The XYZ engagement manager, Hayley Hughes, attended the meeting with Richard.

The meeting

Richard continued the meeting after his opening remarks: “We appointed a new management accountant last year and he introduced a cost allocation system that has been a disaster. I had to dismiss him last month. The problem is that I do not trust the budget or the management accounts and unfortunately the finance director has been ill for some time, so I have little experienced internal financial expertise to call on.

“I have therefore sent you some background information about the company (**Exhibit 1**) but, in brief, WS manufactures two ranges of washing machine: large industrial machines and smaller machines for domestic households.

“On 1 October 2013, WS implemented a strategy of quality improvement for the industrial washing machines. This required additional labour hours and some overhead costs, but we thought these additional costs would be worthwhile as the changes would be appreciated by customers, who would then be willing to pay more for the machines.

“However, since we made the quality improvement changes, we have won only a few tenders, when we would normally have won three to four times as many. It has been a terrible year for the Industrial Division. All we did was try to recover, in the tender price, the additional costs we incurred from quality improvements. I have sent you more information so you can see the details of our performance in tendering (**Exhibit 2**).

“I have also sent you some data prepared by the management accountant who has now left the company (**Exhibit 3A**) and an analysis of actual overhead costs (**Exhibit 3B**) prepared by the production director. I would like XYZ to examine what has happened with our overhead cost allocations and their impact on pricing and on inventory valuation for external financial reporting purposes.

“Unexpectedly, I recently received an email from a rival firm, Hexam, which also makes industrial washing machines. Their chief executive said that he had heard about the problems WS has been experiencing with its Industrial Division and enquired whether we would be interested in selling the division to Hexam, at a reasonable price.

“We would not have been interested in selling the Industrial Division a few months ago but, given the problems we are now having, it might not be a bad idea to sell it. I am just wondering why Hexam is so interested in buying the division, just as it seems to be underperforming. I would like XYZ to evaluate whether selling the division would be the right thing to do. I have provided some more details on Hexam’s offer (**Exhibit 4**).

"I have set out more precisely what I require from XYZ in the terms of engagement document (**Exhibit 5**)."

Your instructions

Hayley updated you with what had happened at the meeting and provided you with the supporting documentation from Richard. She then outlined the following: "I would like you to draft briefing notes for me giving a response to the instructions in the 'terms of engagement' from WS (Exhibit 5). Please be clear and provide as much relevant information as you can, as I will not have time to come back to you with any questions prior to my next meeting with Richard."

Requirement

Respond to the instructions from Hayley, the engagement manager.

Total: 40 marks

Exhibit 1: Company background – prepared by Richard Avebury

WS is a private company that produces washing machines for cleaning clothes and other textiles. It operates from a single factory in the south of England. The company has two divisions: the Industrial Division and the Household Division. Each division has its own product range, although some manufacturing processes are common to both divisions and there is some shared production machinery.

The Industrial Division makes a range of large, industrial washing machines, for use in the public sector (typically in hospitals, schools, local authority premises, prisons and military establishments). Sales of industrial washing machines are achieved by winning government tenders. Normally, each tender is for between 10 and 40 machines. Tenders are not solely awarded on the basis of the lowest bid, but price is a key factor and there is a control procedure by government staff to make sure that manufacturers' profits on any contract are not deemed to be excessive, when assessed on a full cost plus basis.

The Household Division makes a range of washing machines for use in private households. Customers tend to be large retailers and prices are set by market forces in competition with rival companies. The WS machines are mid-market. They retail to consumers at an average price of £550, but typically, they are sold to retailers at an average price of £400. Prices may, however, fluctuate according to competitive conditions at different times of the year.

The manufacturing processes of both divisions are highly mechanised. The majority of manufacturing costs relate to the depreciation, maintenance and operation of the production machinery and the purchase of materials.

WS has an accounting year end of 30 September.

Exhibit 2: Tendering by the Industrial Division – provided by Richard Avebury

The Industrial Division tenders only for UK government contracts. It is an approved supplier for the government and, as a consequence, reasonable profits have been made over time on most of these contracts. Many years ago, private sector tenders were made (eg. to hotels, cruise lines and restaurants), but WS was less successful at winning tenders to supply industrial washing machines to private sector companies, so these were not continued.

The government uses a 'framework agreement' for the procurement of industrial washing machines. This is where the government knows that public sector bodies are likely to need a particular product, but is unsure about the exact type they will need, or when they will be needed. In this case, the government sets up a group of approved suppliers that it can use for a tender process when necessary. The approved suppliers are invited to tender, following which the tenders are evaluated and then the contract is awarded.

This framework agreement process has restricted competition for WS and thereby enabled it to win, in most years, about 30% of the contracts for which it has tendered. The number of approved suppliers in the framework agreement for industrial washing machines is currently four, including WS. However, a new supplier is periodically introduced by the government in order to replace an existing supplier which is leaving the approved list.

Hexam, a rival firm, has recently become one of the government's approved suppliers for industrial washing machines, replacing one of the other existing approved suppliers.

<u>Tendering data for WS – Industrial Division washing machines</u>

Years ended 30 September:

	2013	**2014**
Number of tenders made	900	800
Number of successful tenders	270	80
Number of washing machines tendered for	25,200	20,000
Number of washing machines sold under successful tenders	8,100	1,760
Value of tenders made (£'000)	£30,240	£28,000
Value of successful tenders (£'000)	£9,720	£2,288

Exhibit 3A: Budgeted and actual data – prepared by WS management accountant

Years ended 30 September:	2013		2014	
	Industrial	**Household**	**Industrial**	**Household**
Budgeted profit per unit				
	£	**£**	**£**	**£**
Average selling price per unit: (Note 1)	1,200	400	1,300	400
Average cost per unit:				
Materials (Note 2)	(468)	(124)	(460)	(124)
Direct labour costs (at £8 per hour) (Note 2)	(32)	(16)	(40)	(16)
Overhead allocation (at £100 per labour hour) (Note 3)	(400)	(200)	(500)	(200)
Budgeted profit per unit	300	60	300	60

Note 1: The actual selling price per unit was equal to the budgeted selling price per unit

Note 2: The actual direct labour cost per unit and actual materials cost per unit were equal to their budgeted costs per unit

Note 3: The budgeted overhead allocation rates were based on budgeted overhead costs and budgeted labour hours.

	2013		2014	
	Industrial	**Household**	**Industrial**	**Household**
Actual data				
Units produced and sold	8,100	12,000	1,760	12,000
Budget data				
Labour hours	32,000	24,000	40,000	24,000
Budgeted units produced and sold	8,000	12,000	8,000	12,000

Total overheads for the years ended 30 September were as follows:

	2013	**2014**
	£	**£**
Actual overheads (£'000)	5,650	4,850
Budgeted overheads (£'000)	5,600	6,400

<u>Commentary by management accountant</u>

The additional quality improvement changes, implemented on 1 October 2013, were estimated to require one extra labour hour per industrial machine. WS factored this into the budget, along with the associated overhead allocation, to determine the tender prices for the year ended 30 September 2014. However, although the government claims to believe in quality improvement, it is clearly not willing to pay for it in terms of higher prices. We clearly got our budgeting badly wrong.

Exhibit 3B: Analysis of actual overhead costs – prepared by WS production director

In October 2014, a review of actual overhead costs incurred found them to be a mixture of fixed costs and variable costs. For both the years ended 30 September 2013 and 30 September 2014, the actual variable overhead incurred is estimated at £16 per labour hour plus £1,000 per production run set-up, with all other overheads incurred being fixed costs.

Actual production run set-ups were:

	2013		2014	
	Industrial	**Household**	**Industrial**	**Household**
Number of production run set-ups	500	1,000	100	1,000

Exhibit 4: Potential acquisition by Hexam – prepared by Richard Avebury

Hexam Ltd is a private company which manufactures a range of industrial cleaning equipment, including industrial washing machines. It does not make household washing machines.

Hexam has grown rapidly in recent years and is seeking to expand further through organic growth and acquisitions. I understand that it has the objective of obtaining an AIM listing in 2018.

Last month, Hexam became one of the approved suppliers for government contracts for the procurement of washing machines. It also sells industrial washing machines in the private sector to hotels, cruise lines and restaurants.

The current share capital of Hexam is held: 30% by the founding Hexam family; and 70% by private equity firms.

Hexam does not have sufficient cash resources to acquire the Industrial Division of WS, but it has offered to transfer some of its shares to WS as full consideration for the trade and assets of the Industrial Division. The Hexam shares would be newly issued and, after the deal, WS would hold 20% of the total ordinary share capital of Hexam.

Exhibit 5: Terms of engagement – prepared by Richard Avebury

The WS board would like XYZ to prepare a report which addresses the following:

(1) Analyse and explain, using the data in Exhibit 2, the decline in the Industrial Division's tendering success during the year ended 30 September 2014, compared with the year ended 30 September 2013.

(2) Using Exhibit 3A and 3B, so far as the information permits, explain with supporting calculations why the actual profit differs from the budgeted profit for each of the two divisions, and for the company as a whole, for the year ended 30 September 2014.

(3) Analyse and explain:
- the effect that the overhead cost allocations had on pricing in the Industrial Division in the year ended 30 September 2014; and
- the problems which arise in using the overhead cost allocations for valuing inventories for financial reporting purposes in the WS financial statements.

(4) With regard to the offer from Hexam to acquire the Industrial Division explain:
- the strategic, operating and financial factors that the WS board needs to consider before deciding whether to sell the Industrial Division to Hexam; and
- the risks arising, and the due diligence procedures that should be carried out by WS on Hexam, in respect of using shares as the consideration. I do not need all the normal due diligence procedures, only those relating to the extra risks arising from a consideration comprising shares, rather than cash.