MARK PLAN AND EXAMINER'S COMMENTARY – TI SBM July 2014

This report includes:
- a summary of the scenario and requirements for each question
- the technical and skills marks available for each part of the requirement
- a description of how skills should be demonstrated
- detailed points for a full answer
- examiner's commentary on candidates' performance

The information set out below was that used to mark the questions. Markers were encouraged to use discretion and to award partial marks where a point was either not explained fully or made by implication.

Question 1 - Funnel Cruises plc

Scenario

The industry in the scenario is global cruise lines. The candidate is in the role of an ICAEW Chartered Accountant working in a business advisory capacity. The client is Funnel Cruises (FC), which is a major international cruise line company whose finance director has just retired.

FC has recently prepared its annual management accounts which showed a fall in operating profit. This has caused some concern for the board which is seeking greater analysis of the reasons for the poor performance. Financial and operating data is provided and candidates are required to analyse and explain the performance of FC for the year.

The board has three further issues:

First, the global cruise industry incurs costs and earns revenues in many currencies and the risk of foreign currency exposure is a concern. This includes: operating cash flows; interdivisional balances; and the costs of construction of new ships. Candidates are required to: assess whether the use of derivatives is appropriate to manage foreign currency risks on operating cash flows; calculate and explain the sterling settlements of interdivisional currency balances using multilateral netting off procedures; and explain how the use of zero cost collars can mitigate foreign currency risks with respect to progress payments under long term contracts for building new ships.

Second, the FC board has identified a potential acquisition of a company which operates a chain of hotels in the US. The valuation of this company is problematic as it is making losses. It is likely that the consideration may be less than the fair value of the net assets, creating a problem of negative goodwill in the financial statements. Candidates are required to: identify and evaluate suitable approaches to determine an acquisition price for Coastal, given that it is making losses; explain, with calculations, how negative goodwill would be treated in the FC group financial statements; and explain the benefits of carrying out due diligence for Coastal given it is loss making, explaining whether due diligence procedures would be best carried out by an independent assurance provider or by FC's own staff.

Third, a food poisoning incident on a ship shortly after the accounting year end has caused expected revenues to decline by 10% next year. The board is concerned about the impact on profit and reputation of this incident. Candidates are required to calculate and explain the impact of the food poisoning incident on FC's operating profit, recommending any operational actions that FC should consider.

Requirement	Marks	Skills assessed
Analyse and explain the performance of FC for the year	19	• Understand and assimilate the data provided • Carry out data analysis to identify meaningful causal relationships between different elements of the data • Provide adjustments to the financial data to isolate profit arising from the two primary operating activities • Provide a qualitative interpretation of the interrelationship between the two primary operating activities • Provide qualitative analysis of causal relationships impacting on performance • Use judgement to conclude on the primary reasons for the decline in performance.
Assess whether the use of derivatives is appropriate to manage foreign currency risks on operating cash flows; calculate and explain the sterling settlements of interdivisional currency balances using multilateral netting off procedures; and explain how the use of zero cost collars can mitigate foreign currency risks with respect to payments under contracts for building new ships.	16	• Identify the nature of the operating currency risks (cash in advance of service delivery) • Evaluate the impact on currency risk • Conclude derivatives have limited use and explain alternative means of achieving objectives.

Identify and evaluate suitable approaches to determine an acquisition price for Coastal given that it is making operating losses; explain, with calculations, how negative goodwill would be dealt with in the FC group financial statements; and explain the benefits of carrying out due diligence for Coastal and whether a professional assurance firm should carry out such procedures.	14	• Identify the nature of the valuation problem for a loss making company • Identify a range of scenarios for return to profit • Select appropriate means of providing a valuation • Determine negative goodwill • Set out treatment of negative goodwill • Explain the benefits of due diligence in the circumstances • Identify and explain the benefits of due diligence being carried out by a professional assurance firm.
Calculate and explain the impact of the food poisoning incident on FC's operating profit, recommending any operational actions that FC should consider.	11	• Analyse the impact on costs and profits of a 10% reduction in sales revenue and passenger numbers • Isolate fixed and variable costs • Make recommendations of appropriate actions.
Maximum marks	**60**	

Examiners' comments

Requirement 1 – Performance analysis

Many candidates performed well on this requirement, although there was significant variation in the quality of the answers.

In respect of the calculations, many candidates made insufficient use of the data. The better candidates tended to present a table of key pieces of data at the beginning of their answer. Weaker candidates tended to weave occasional pieces of data into their narrative. Weaker candidates tended to add little analysis to the data provided in the question, merely calculating percentage increases and decreases in individual costs and revenue.

The majority of candidates calculated gross profit and operating profit margin, but did not go further to look at ratios such as revenue generated per customer and growth in operating profit per quarter. Many candidates struggled with the fact that there was not a prior year to compare the figures to and failed to understand the significance of quarterly reporting. Better candidates covered a range of data on revenues, costs and profit using the operating data to provide analysis based on passenger numbers, occupancy, ships, fuel, and asset values. There was a significant amount of data provided in the question so part of the skill of analysis was to select the most relevant data to help explain performance.

The qualitative evaluation varied, but better candidates interpreted their quantitative analysis to demonstrated cause and effect relationships and build an explanation of underlying events. Weaker candidates merely noted whether their figures or ratios had gone up or down.

The approach of some candidates was merely to show and explain the changes in each type of cost. Whilst reasonable, it was not sufficient in identifying the wider operational and market issues. It also wasted time on explaining some trivial cost changes, rather than analysing data to explain the key business issues.

Many candidates mentioned the 'paid for on board' activities, although stripping out these costs and revenues from the overall data was less common. Few candidates made the comparison between the 'paid for on board' activities and the residual tickets sales and cruise operations, or noted the interdependencies.

Requirement 2 – Foreign exchange issues

(i) Use of derivatives

Many candidates described long lists of all the different derivatives possible, which was not particularly helpful in addressing the situation in the scenario. Specifically, the key issue in terms of operating cash flows was the fact that FC is being paid in advance by customers before the service is provided. As a result, the typical foreign exchange transaction risks about being paid at a later date was less relevant. There was insufficient focus on operating cash flows with many candidates widening the focus to non-operating cash flows which was not required in this element of the question. A critical and analytical approach to the specific issues of the client company was required in order to provide bespoke advice, rather than reproducing a general section from the learning materials on foreign currency transaction risk management.

(ii) Multilateral netting off

This was generally a well attempted requirement. However, for a simple calculation, it was surprising how many candidates could not determine the correct answer and convert to £s as the base currency of the company.

For most candidates the discussion was reasonable in appreciating the purpose, nature and benefits of multilateral netting off.

(iii) Zero cost collars

Most candidates understood collars and were able to calculate the upper and lower limits of the collar. Some got confused in explaining the benefits of a collar even though they were able to calculate the numbers correctly. Generally, most candidates had few problems explaining how collars could mitigate foreign exchange risks in the context of progress payments on a long term contract for building a ship.

Requirement 3 – Acquisition of Coastal

(i) Acquisition price

Students were generally able to identify that Coastal was loss making and therefore typical valuation methods are not suitable, although a few did go through a generic list of valuation techniques. Most mentioned that net assets was a good starting point for discussions, although weaker candidates tended not to go much beyond making this point. Some candidates did talk about a cash flow model or EBITDA to estimate a valuation for a loss-making company.

(ii) Negative goodwill

Only a minority of candidates considered the need to allow for the losses in the period until the date that the acquisition takes place. Even fewer were able to actually calculate the loss correctly and get the correct negative goodwill figure of £2m.

Most calculated it to be £5m, but did manage to identify that it was negative goodwill. Having arrived at a negative goodwill figure (correct or incorrect) too few candidates understood the correct treatment of negative goodwill and there was an array of answers, mostly incorrect.

(iii) Due diligence

This requirement was well answered and many punctuated their answers with headings of all the different due diligence processes they could undertake. They were also able to attempt a reasoned response on who should carry out the due diligence. Many identified the key issue of independence.

Requirement 4 – Food poisoning incident

Many candidates were able to attain a good number of marks on the calculation section. This was particularly where candidates split out the impact on a line-by-line basis. Most candidates who did so made a reasonable attempt to identify which costs were variable, and would therefore decrease with the reduced passenger volume, and which costs were fixed.

Weaker candidates calculated the impact using a broad 10% decrease and therefore lost marks (ie assuming all costs are variable). Almost all candidates included the litigation costs.

Not many were able to discuss the impact in any detail, although some did spot that a 10% fall in revenues resulted in a much greater decrease in profits.

Most candidates were able to produce a reasonable discussion on the actions that should be taken by the company to reduce the impact on profit.

Solution

To 30 June	2014 £m	2013 £m
Fuel cost per tonne (£s)	506	445
Profit on 'paid for' on board activities (£m)	670	687
Loss on Passenger tickets (£m)	(225)	(217)
Total operating profit (£m)	445	470
Revenue per ship (£m)	160.2	171.7
Profit per ship (£m)	18.5	20.4
Revenue per passenger (£s)	1,563	1,652
Profit per passenger (£s)	180.9	196.7
Revenue per passenger per night (£s) (W1)	188.79	199.32
Revenue per staff member (£s)	170,889	175,511
Profit per staff member (£s)	19,778	20,889
Cost per tonne fuel (£s)	507	445
ROCE	3.4%	3.8%
Operating profit margin	11.6%	11.9%

(W1) Passenger numbers analysis

	2014	2013	Increase
Number of passengers per night	55,800 (90% x 62,000)	54,280 (92% x 59,000)	2.8%
Passengers nights per year (365 days)	20,367,000	19,812,200	

Overall performance – adjusting the data

In comparing the data for the years to 30 June 2014 and 30 June 2013, it is necessary to distinguish underlying trading operations from other activities such as hedging using derivatives.

Whilst relevant to current performance, gains on fuel and currency derivatives are unlikely to be repeated systematically and arise from random currency movements in an efficient market. They are therefore are not part of underlying operating performance.

Thus while EBIT has increased in 2014 from 2013 the operating profit has fallen.

Two operating streams

Total revenue has declined by 2.6% in 2014 compared to 2013. There are however two separate operating streams.

The 'paid for activities on board' can be analysed as follows:

	2014 £'m	**2013 £'m**	**% change**
Revenue	920	909	1.2%
Costs	(250)	(222)	12.6%
Profit	670	687	(2.5)%
Operating margin	72.8%	75.6%	

Paid for activities on board have declined slightly in term of profitability, but remain an extremely high margin activity.

Stripping out the 'paid for activities on board' from the total revenues and costs enables the residual core activity of running cruises through passenger tickets to be evaluated:

	2014 £'m	**2013 £'m**	**% change**
Revenue	2,925	3,040	(3.8)%
Costs	(3,150)	(3,257)	(3.3)%
Loss	(225)	(217)	(3.7)%

The core activity of running cruises would therefore appear to be making losses. Moreover, the losses have increased by 3.7% in 2014 compared to 2013.

However, such a clear distinction between the two operating streams is likely to be invalid as they are so highly interdependent. If the management accounting system had allocated more overheads to 'paid for activities on board' then the result could have been very different.

It therefore remains necessary for the core business of attracting passengers to cruises to succeed. This is fundamental to an appraisal of the performance of the business as a whole.

Revenue

The decline in passenger ticket revenues of 3.8% should be compared with the increase in passenger numbers in order to compare price and volume effects on revenue. Passengers have actually risen by 2.9% which could imply that there has been a significant adverse price effect. This could be reflected in the fall in revenue per passenger from £1,652 to £1,563 (down 5.4%). The revenue per passenger night has also decreased by 2.8%

Revenue per ship has fallen by 6.7% and revenue per employee by 2.6%.

In seeking causal factors to explain the fall in revenue, there are indications that price has been reduced in an attempt to increase passenger numbers. Marginal costs are low from taking an extra passenger so it is important to attract as many passengers as possible per cruise to improve utilisation which has fallen from 92% in 2013 to 90% in 2014. In addition to the ticket price for any incremental passengers, there is the opportunity to sell other paid for activities on board.

If there is overcapacity in the industry as more large ships are launched then there is increasing pressure on cruise operators to lower ticket prices to maximise utilisation.

One additional explanation is that price per passenger booking may have fallen due to the average length of a cruise being lower in 2014 than it was in 2013. In these circumstances the lower revenue per passenger would reflect lower prices for shorter cruises rather than discounting. Further information is needed to evaluate this proposition.

Operating profit and costs

Operating profit has decreased by 5.3% from £470m to £445m. This is significantly greater than the fall in revenue of 2.6%.

Many of the costs will be fixed. Staff numbers for example are constant.

Where the costs are variable the cost drivers are likely to be:

- The number of passenger bookings (up by 2.9%)
- The distance travelled on voyages (an indicator is that fuel consumption is down by 1.2%)
- The number of ships (increase from 23 to 24)
- The number of voyages or stop-overs at ports (no data available)

Whilst the indicators are mixed regarding the level of activity, the key changes in costs are:

1. Fuel

Fuel costs have increased by 12.4% despite the number of tonnes of fuel used falling by 1.2%. This is reflected by the increase in the price of fuel per tonne from £445 to £507, an increase of 13.9%.

However the absolute increase in fuel costs of £47m has been offset by derivatives hedging on fuel, resulting in gains of £25m and leaving a net increase of £22m.

2. Employee costs

The number of employees is constant at 22,500 and payroll costs have increased by 0.9%. This does not therefore seem a major contributory factor in explaining the change in profit, despite the fact that payroll is a major cost.

3. Other ship operating costs

These costs had a major favourable effect on operating profit as they decreased by 11.4% and they are one of the largest operating costs. Further investigation is needed; as if other costs continue on an upward trend then it seems unlikely that other ship operating costs can continue to decrease at the current rate to compensate. The significance of these costs is indicated in that, if they have stayed at their 2014 level, then operating profits would have fallen by around one third to £286m.

4. Food

Food costs have remained constant despite the increase in the number of passengers. This might be because lower quality food has been purchased, smaller portion sizes have been given or improved discounts have been obtained from suppliers.

5. Depreciation and ships

It is slightly surprising that depreciation has not risen, as a new ship has been brought into use.

This might be because it was brought into use near the year end or it might be that older ships are now fully depreciated.

ROCE has fallen from 3.8% to 3.4%. Lower operating profits are a factor but also if the new ship was brought into use late in the year is will be included in the year end asset base but has not been able to contribute to profit.

2. Foreign currency transactions

(a) Use of foreign currency derivatives

FC is unusual in receiving cash at least 4-months in advance of providing the services it delivers. Also, some cash is likely to be received as a deposit to secure the booking when the contract is made. Whilst there may be some FOREX movement between the contract date and the date of receipt of the residual cash, few costs will be incurred in this period as it will still be at least 4-months before the cruise commences. In the short term, therefore, for each sale there is therefore limited transaction risk which would be common to normal international trading. In the case of FC, monies received can be converted on receipt to the currency in which costs will be incurred (subject to netting) using money markets as a means of hedging.

For longer time horizons, there is economic foreign currency risk exposure. Economic risk is the risk that exchange rate movements might reduce FC's international competitiveness. It is the risk that the present value of the future cash flows might be adversely affected by exchange rate movements. Derivatives are normally relatively short term instruments and are likely to be ineffective in mitigating such long term risks.

Exchange rate fluctuations of the euro, U.S. dollar and other currencies against £ sterling will affect FC's reported financial results since the reporting currency for its consolidated financial statements is the £. Any strengthening of the £ against these foreign currencies has the financial statement effect of decreasing the £ values reported for cruise revenues and expenses. Any weakening of the £ has the opposite effect.

The use of derivative financial instruments can offset cash flows risks, but may not be the most suitable means to do so in the case of FC.

By utilizing derivatives such as forwards and options and other financial instruments (such as foreign currency swaps, foreign currency debt obligations and foreign currency cash balances) exchange risk can be managed by locking into agreed exchange rates and avoiding future fluctuations. However, this is largely unnecessary for FC's revenues (as cash is received in advance) and therefore using derivatives is probably not desirable.

(b) Interdivisional sterling settlements

Multilateral netting off occurs when each of the three divisions of FC interact with the central treasury department to net off their transactions. The arrangement should be co-ordinated by the central treasury (or alternatively by FC's bankers). The process involves establishing a 'base' currency to record all intra-group transactions.

This procedure has the advantage for FC of reducing the number of transactions and thus transaction costs, including foreign exchange purchase costs and money transmission costs. There will also be less loss of interest through having money in transit. However, it requires strict control procedures from the central treasury. In addition, there may be some countries which FC deals with which have severe restrictions on, or even prohibition of, netting because it is seen as a means of tax avoidance. There may also be other legal and tax issues to consider.

In terms of the data provided, multilateral netting off would take place as follows.

Convert to £:

Receivables division	**UK** (£)	**France** (euro)	**US** (US$)	**Total receipts £**	**Total payments £**	**Net receipt/ (payment) £**
UK (£)		£2.4m		£2.4m	£(4.0)m	£(1.6)m
France (euro)			£1.5m	£1.5m	£(4.65)m	£(3.15)m
US (US$)	£4.0m	£2.25m		£6.25m	£(1.5)m	£4.75m

All transactions are handled in £. Therefore:

The UK division should pay £1.6m to the US division.

The France division should pay £3.15m to the US division.

(c) New ship building

Using a collar arrangement, FC has bought a foreign exchange rate cap and at the same time sold a foreign exchange rate floor, which locks the exchange rate between these two limits.

If the euro appreciates significantly against the £, then the risk, without hedging, would have been significant as the cost of the ship would increase materially in £ sterling terms. Conversely, if the £ appreciates against the euro then the cost of the ship in £ sterling would be reduced.

The collar would accept the risk of currency movements within the ceiling to floor range of £0.85 = €1 and £0.77 = €1. Outside these limits, the upside and downside potential of currency fluctuations is removed by the collar.

Given that the final payment for the ship is €270 million then the maximum that can be paid is £229.5 million at the ceiling rate of £0.85 to €1. The minimum that can be paid is £207.9 million at the floor rate of £0.77 to €1.

The collars however only cover the final payment for one ship and end in 2015. There remains foreign currency risk exposure for the final payment in respect of the second ship. The progress payments for both ships also remain unhedged.

3. Potential Acquisition of Coastal

(a) Valuation methodology

The normal models used to determine valuation based on future earnings or cash flows cannot be readily applied to a business making losses as, on the face of it, this would give a negative value.

The most obvious alternative would be to use the fair value of the assets as a means of valuation. This would give a fair value of $30 million.

However establishing this value would be a key factor in due diligence (see below). Fluctuations in fair value between the date of valuation and the date of acquisition would also need to be considered.

However, both the earnings model and the net asset valuation need some further consideration.

Regarding the net assets model, the method of determining fair value needs consideration. The hotels are worth only what a potential purchaser is willing to pay. There is unlikely to be an active market and the potential sale price may be subject to significant variation according to market conditions and the needs of any potential purchaser. Further consideration is therefore required of the fair values.

In addition, there may be value attributable to unrecognised assets. This is likely to be limited given the loss making position and the nature of the hotel business, but there may be intangible assets that could demand a price. This might include the use of the brand name if Coastal is withdrawing from the market.

Regarding the earnings model, the straightforward acceptance of financial reporting losses as a measure of contribution to the business may be inappropriate.

A key question is: why is the Coastal business loss making? The following should be considered:

- While the current Coastal management is making losses, this may reflect the performance of the management, rather than the potential of the hotels. An alternative management may yield more potential and generate profit which would increase the value to FC. Most obviously, if FC used the hotels for their cruise passengers (where the hotel is located at a port used by FC) prior to, or after, cruises, this may generate a significant new source of income and therefore return Coastal to profit.

- Alternative explanations for the losses could be:
    - the current adverse phase of the economic cycle
    - lack of funds and other resources for investment by the current owners
    - start-up phase of development

- The measure of profit is likely to be imperfect and will include non cash items such as depreciation. Once these are backed out, then the free cash flows generated may be positive which could indicate a valuation greater than the fair value of the assets. Cash flow models may therefore be used where free cash flow is positive. Also, a rough initial estimate could be a multiple of EBITDA.

- It may be that Coastal is making operating profits, but loan interest creates a loss after tax. In this case, it may be that for operational purposes Coastal is profitable and a different financing structure under FC ownership may generate profits.

Overall, the price to sell is likely to be determined by negotiations which are constrained by:

- The maximum amount a purchaser is willing to pay (which may include an alternative use to the hotel buildings and alternative acquisitions); and
- The minimum amount that Coastal shareholders will accept for the sale.

(b) Financial Reporting

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between independent and knowledgeable market participants at the measurement date.

The fair value of the Coastal assets will need to be determined in accordance with IFRS 13. The three levels of inputs used to measure fair value are as follows:

- Level 1 measurements are based on unadjusted quoted prices in active markets for identical assets or liabilities that we have the ability to access. Valuation of these items does not entail a significant amount of judgment.
- Level 2 measurements are based on quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active or market data other than quoted prices that are observable for the assets or liabilities.
- Level 3 measurements are based on unobservable data that are supported by little or no market activity and are significant to the fair value of the assets or liabilities.

The fair value on acquisition for Coastal will therefore probably use Level 3 measurements unless there are very similar hotels in similar locations.

If the acquisition price is below this value, then there is negative goodwill. IFRS 3 requires that FC should:

- reassess the identification and measurement of Coastal's identifiable assets, liabilities and contingent liabilities and the measurement of the cost of the business combination; and
- Recognise immediately in profit or loss any excess (ie negative goodwill) remaining after that reassessment.

In the case of FC acquiring Coastal on 30 September 2014 then the negative goodwill would be:

	US $'m
Fair value of net assets at 31 December 2013	30
Less	
Forecast loss for period to 30 September 2014	
($4m x 9/12)	(3)
Fair value of assets at 30 September 2014	27
Consideration	(25)
Negative goodwill (Bargain purchase)	2

On consolidation, negative goodwill is measured at $2m/1.6 £1.25m

The £1.25m gain is recognized in profit or loss on the date of acquisition (30 September 2014) (IFRS3 para 34)

Dr	Negative goodwill	£1.25m	
Cr	Profit or loss		£1.25m

NB It is assumed that there are no further fair value changes between 31 December 2013 and 30 September 2014 other than those relating to retained earnings.

(c) Due diligence

The acquisition would be material to FC and assurance over a number of aspects of the business can mitigate some risks of the acquisition, even though the purchase price is not primarily dependent on Coastal's future earnings.

Due diligence is a means of attesting that information, normally on behalf of a prospective bidder. It can take place at different stages in the negotiations, although the timing is likely to affect the nature of the due diligence process.

Due diligence will attempt to achieve the following objectives.

- Confirm the accuracy of the information and assumptions on which the bid is based.
- Provide the bidder with an independent assessment and review of the target business.
- Identify and quantify areas of commercial and financial risk.
- Give assurance to providers of finance.
- Place the bidder in a better position for determining the value of the target company.

There are several different forms of due diligence which generate different types of benefits. Some of these can be carried out by independent assurance providers (such as Reez) others require specialist skills, while others can be carried out by FC's own staff.

Financial due diligence

Financial due diligence is a review of the target company's financial position, financial risk and projections. The primary role in this case would be to attest the fair value of the hotels and make projections of future cash flows based on current commitments and contractual obligations. The benefit to FC would be to have a credible valuation based on the assets of

Coastal. If this acquisition takes place, but the business then fails, this also provides the value to be attained by FC as an exit strategy.

The financial due diligence may support the bargain purchase review required by IFRS 3 (see above).

Property valuer's will be needed for part of this process rather than Reez staff or FC staff.

Commercial due diligence

Commercial due diligence work complements that of financial due diligence by considering the target company's markets and external economic environment. Information may come from the target company and its business contacts. Alternatively, it may come from external information sources.

Such information is useful for advanced planning of an appropriate post-acquisition strategy.

Reez staff would provide some expertise and objectivity in carrying out this task but FC may also have competent staff in this respect but without any specialist experience in the hotel industry.

Operational due diligence

Operational due diligence considers the operational risks and possible improvements which can be made in a target company. In particular it will:

- Validate vendor assumed operational improvements in projections
- Identify operational upsides that may increase the value of the deal to return Coastal to profit

Again, Reez staff would provide some expertise and objectivity in carrying out this task but FC may also have competent staff in this respect, but probably without any specialist experience in the hotel industry.

Information technology due diligence

IT due diligence assesses the suitability and risks arising from IT factors in the target company. This may be a factor in improving the level of hotel bookings.

Specialist IT staff would be best placed to carry out this work.

Legal due diligence

Legal issues arising on an acquisition are likely to be relevant to the following.

- Valuation of the target company – eg hidden liabilities, uncertain rights, onerous contractual obligations.
- The acquisition process – eg establishing the terms of the takeover (the investment agreement); contingent arrangements; financial restructuring; rights, duties and obligations of the various parties.
- The new group – eg new articles of association, rights of finance providers, restructuring.

Reliance will need to be placed on lawyers for this process rather than Reez staff or FC staff.

Human resources due diligence

Protecting and developing the rights and interests of human resources may be key to a successful acquisition. There may also be associated legal obligations.

Tax due diligence

Information will need to be provided to allow the potential purchaser to form an assessment of the tax risks and benefits associated with the company to be acquired. Purchasers will wish to assess the robustness of tax assets, and gain comfort about the position re potential liabilities (including a possible latent gain on disposal due to the low base cost). The nature of the acquisition may also be influenced by tax considerations (eg share purchase or trade and assets purchase), which in turn may be influenced by the value of the assets.

Reez tax staff would be well placed to carry out this work with respect to UK tax, but US tax specialists may also be required.

4. Impact of the food poisoning incident on financial reporting profit

There is no impact on profit from the incident for the year ended 30 June 2014 as it occurred after the year end and in accordance with IAS10 it did not affect conditions existing at the end of the reporting period. It is therefore a non-adjusting event for the year ended 30 June 2014. As a consequence, the entire impact of the incident will be recognised in FC’s operating profit for the year ending 30 June 2015.

In respect of the year ending 30 June 2015, there are multiple commercial effects that arise from the incident:

- loss of contribution from a 10% decline in sales
- litigation costs from passengers and crew
- costs of locating and rectifying the cause of the incident
- loss of reputation in longer term
- costs of changing food suppliers

No provision is permissible for future loss of earnings (specifically excluded by IAS37). However the decline in sales of 10% would reflect the short term reputational loss.

Although the litigation costs are to be paid at the end of 2015, (ie during the financial year the year ending 30 June 2016), to the extent that it is established that such costs are probable at 30 June 2015, a provision should be made for £10m (or other appropriate amount determined at that date) in the financial statements for the year ending 30 June 2015 in accordance with IAS37. This will therefore reduce operating profit for the year.

Redrafting the statement of profit or loss on the working assumption that the year ending 30 June 2015 would have been similar to the year ended 30 June 2014 requires identification of variable costs and fixed costs to estimate appropriate adjustments. It is assumed that variable costs vary linearly with passenger numbers.

Analysis of performance

To 30 June	**2014 £m**	**% Change***	**Estimated 2015**
Revenue:			
Passenger tickets (note 1)	2,925		
'Paid for' on board activities and excursions	920		
Total revenue	3,845	(10)%	3,460
Operating costs:			
Fuel	425	FC	425
Payroll	435	FC	435
Food	240	(10)%	216
'Paid for' on board activities and excursions	250	(10)%	225
Depreciation	381	FC	381
Other ship operating costs (Note 1)	1,239	FC	1,239
Selling and administration (note 2)	430	FC	430
Provision for litigation			(10)
Operating profit	**445**		**99**

** Tutorial note:*
Alternative reasonable assumptions are possible.

(W1) Other ship operating costs

More information is needed about the costs included here but it has been assumed that these costs are not variable with passenger numbers.

(W2) Selling and administration

Selling costs are assumed to be the same although given the incident they may need to increase or if they are commission based they may decrease.

Administration costs are assumed to be fixed.

Explanation

While revenues have fallen by 10% the operating profit has fallen by 78%.

This is due to the high level of fixed costs creating high operating gearing. This in turn makes profits sensitive to changes in sales. The fall in utilisation means that ships are being operated with fewer passengers, but incurring the same fixed operating costs as in the year ended 30 June 2014 when there were more passengers.

The provision for litigation costs is an additional cost, but they are not a major factor in compared with the scale of difference in operating profit between 2014 and 2015.

Actions that could be taken

Assuming that the reputational damage will diminish over time as customers forget about the incident, then short term actions needed to reduce these temporary effects (eg in the year ending 30 June 2015) could include:

- Reducing the size of the fleet for a year by leasing a ship to a rival company for 12 months. This would reduce the size of the fleet by 4.2% to accommodate the 10% fall in passengers. The downside is that some of the passengers who would have sailed on the leased ship might transfer to rival companies rather than other FC ships
- A more extreme solution, if the ship cannot be leased, is to decommission a ship until demand recovers
- New capacity is becoming available with two new ships being built at a time of reduced demand. Consideration should be given to selling an existing ship or selling the rights to one of the ships under construction
- Reduce the number of voyages and/or days at sea to raise utilisation for the smaller passenger numbers
- Reduce price to restrict the passenger number reduction to below 10%. This would only be appropriate if demand is elastic
- Increase advertising and marketing expenditure to offset some of the expected loss in sales
- Rebrand at least some of the ships (eg a separate division brand) to reduce the effects of damage to the FC brand from the incident
- Set up a contingency plan to deal with similar outbreaks in future.

It may be, however, that there will be lasting reputational damage from the food incident, which may require a public relations exercise around excellent standards of hygiene from new food suppliers and cleaners. Perhaps also improve quality of food overall, although this may come only at further cost.

Question 2 solution – Landex

Scenario

The company in the scenario is a large scale manufacturer of high quality watches. The company, Landex, is based in the UK, but it exports throughout the world.

The key issue in the question is managing procurement and the supply chain. The company has a sole, local supplier of watch casings, Gootle, which has struggled to keep pace with the expansion of Landex. Gootle requires investment in new production facilities in order to be able to supply the increasing volumes needed by Landex, but it is reluctant to do so unless Landex provides the guarantee of a long term exclusive supply agreement.

The Landex board is split between three choices for the future supply of watch casings: stay with Gootle and offer a new contract; have multiple global suppliers; or set up its own factory in a developing nation. Candidates were required to evaluate and compare the three procurement proposals put forward with supporting calculations, over a four year horizon, and to explain the wider operational and strategic implications. Candidates were also required to consider the benefits and risks of each proposal if they operate beyond the assumed period of four years.

If the construction of its own factory goes ahead, then there are two different financing choices. Candidates are required to give advice on which of the two bonds would be preferable and set out the financial reporting treatment for both bonds.

There are also two ethical issues. First, that Gootle was formed when Landex first outsourced watch casing manufacture and it was promised the supply contract indefinitely by the then chairman of Landex. Alternative procurement strategies are in breach of this promise. One of the other procurement strategies was put forward by the finance director, who has a brother on the board of the potential supplier. Candidates are required to set out the ethical, corporate governance and financial reporting implications of these issues.

Requirement	Marks	Skills assessed
Evaluate and compare, with supporting calculations, the three procurement proposals, and explain the wider operational and strategic implications.	16	• Perform calculations for each of the three proposals, setting out the financial consequences over the required 4-year horizon • Explain the wider operational and strategic implications of the three proposals considering risks and benefits • Consider and compare the three proposals if they extend beyond the expected horizon of 4 years • Use judgement to conclude on the preferred proposal.

Provide reasoned advice on which of the two bonds would be preferable and set out the financial reporting treatment for both bonds.	11	• Calculate the implicit interest rates on the bonds • Evaluate the impact of currency risk and other qualitative factors • Conclude and explain the preferred option • Set out and explain the financial reporting consequences.
Set out the ethical, issues relating to: • ceasing to use Gootle as a supplier. • FD's brother and RPTs	7	• Identify the ethical issues and use ethical principles and language • Set out appropriate actions
Set out any corporate governance and financial reporting issues that may arise for Landex if Rotblat were to become one of its suppliers.	6	• Set out related party transaction disclosures • Set out the corporate governance issues related to the director's personal interest in the contract with one supplier
Maximum marks	**40**	

Examiners' comments

Requirement 1 – Evaluation of the three procurement proposals

The calculations of the proposals were generally correct for at least proposal 1 and for many candidates also for proposal 2. However, most could not get to the correct answer for proposal 3. Nearly all candidates set out the calculations in a structured year-by-year format.

Some candidates included revenue in their calculations for each of the proposals. This was unnecessary as the revenue streams were common to all the procurement options and would not affect the decision of which supplier to select. It was also misleading as the watch casings are only one type of cost.

Common errors for proposal 3 were in the foreign exchange rate and the discount rate and knowing when to apply them.

The descriptive analysis of operating and strategic issues was variable, but most candidates were able to write some reasonable points on the differences between the proposals. Many focussed on the risks of an extended supply chain for proposal 2 and on high fixed costs and exchange rate risk for proposal 3.

Most candidates at least attempted to discuss the implications of the proposals continuing after 4 years. Most came to a conclusion that supported their discussion.

Requirement 2 – Financing the Moldovian factory

This was poorly answered and candidates clearly found it difficult to determine effective annual interest rates. The first bond calculation, Alternative A, was nearly always attempted but only a small minority of candidates achieved the correct answer. The most common error was to determine the return in M$ at 4% pa. This failed to recognise what was highlighted in the question that the redemption of the loan in sterling terms needs to consider future exchange rate movements.

Alternative B was a sterling bond so there was no foreign currency effect. However adjustment was needed for the issue costs in determining the effective annual interest rate. Many candidates failed to do this, arriving at 5%, or failed to do it correctly. For many the answer was significantly different to 5% and candidates failed to apply a reasonableness test which would suggest that a 2% issue cost would not make the effective rate materially different from the coupon rate.

Even where calculations were incorrect, appropriate advice based on candidates' own figures was awarded full credit.

The financial reporting treatment was variable although most candidates at least realised that the loan was a monetary item and effective interest is to be recognised in profit or loss each year.

Requirement 3 – Ethics

Ethics was reasonably answered and most candidates were able to describe in a reasoned way the key ethical issues and apply these to the scenario.

Most candidates reasonably concluded that there were no ethical grounds which would require Landex to maintain the supply contract with Gootle. Weaker candidates tended to sit on the fence rather than provide clear advice.

Answers were more varied regarding the finance director and her brother. Many answers centred around the financial reporting obligations of related parties. Better answers explored the ethical principles of the actions that the finance director had already taken, before going on to explore possible ethical issues which could arise, or be perceived to arise, from the decision process on procurement.

Requirement 4 – Governance and financial reporting

The financial reporting issues centred around the issue of related parties although more candidates asserted that the brother was a related party, than justified this conclusion. The coverage of required disclosures was generally good.

Governance issues provided some reasonable suggestions but also some extreme suggestions on the role of the finance director if Gootle were to win the procurement contract.

Solution

Proposal 1						
31 December	**Price**		**Number of casings**	**Total £**	**DF 10%**	**PV £**
	£					
2015	100		200,000	20,000,000	0.9090909	18,181,818
2016	100		220,000	22,000,000	0.8264463	18,181,818
2017	100		235,000	23,500,000	0.7513148	17,655,898
2018	100		245,000	24,500,000	0.6830135	16,733,830
					NPV	**£70,753,364**
Proposal 2						
31 December	**Price**	**Exchange rate**	**Number of casings**	**Total**	**DF 10%**	**PV**
	£					
2015	93	1	200,000	18,600,000	0.9090909	16,909,091
2016	93	0.98	220,000	20,050,800	0.8264463	16,570,909
2017	93	0.9604	235,000	20,989,542	0.7513148	15,769,754
2018	93	0.941192	245,000	21,445,060	0.6830135	14,647,264
					NPV	**£63,897,018**
Proposal 3						
Variable cost £		40	40	40	40	
31 December	**2014**	**2015**	**2016**	**2017**	**2018**	
Number of casings		200,000	220,000	235,000	245,000	
Outlay	40,000,000					
Variable cost		8,000,000	8,800,000	9,400,000	9,800,000	
Fixed costs		25,000,000	25,000,000	25,000,000	25,000,000	
Proceeds on closure					(20,000,000)	
Total M$	40,000,000	33,000,0000	33,800,000	34,400,000	14,800,000	
Exchange rate	2	1.9047619	1.814058957	1.727675	1.64540495	
Total £	20,000,000	17,325,000	18,632,250	19,911,150	8,994,746	
DF	1	0.9090909	0.8264463	0.7513148	0.6830135	
PV	20,000,000	15,750,000	15,398,554	14,959,542	6,143,533	
					NPV	**£72,251,628**

1. Procurement strategy - casings

Evaluation and comparison of the three proposals

Quantitative financial analysis

Comparing the figures in the above tables, the choice with the lowest present value over the four-year horizon is Proposal 2 with multiple overseas suppliers. The next best is Proposal 1 which is Gootle and the highest present value is Proposal 3, which is in-house production in a new factory in Moldovia.

However the figures warrant some further analysis.

While no calculations have been performed beyond 2018 as instructed, there is a clear trend that costs per item are decreasing with Proposal 2 due to the depreciation in the exchange rate in the basket of currencies. If this were to continue then this option would become even more attractive in narrow financial terms over time.

To a lesser extent, the costs of Proposal 1 are also declining.

While Proposal 3 is the highest cost in PV terms over the four year period, it has the lowest variable cost per item of the three proposals. As a result, if demand continues to expand this is more likely to become the lowest cost option due to the high operating gearing.

The above analysis is however only a narrow financial analysis. As instructed, the operating and strategic implications of the three proposals also need to be considered.

Operating and strategic analysis

There are three choices:

(1) A single UK supplier (the existing supplier Gootle)
(2) Multiple suppliers (three internationally based suppliers)
(3) Bring production back in-house (with the Moldovian factory)

The current arrangement with Gootle can be described as one of strategic procurement. This is the development of a partnership between a company and a supplier of strategic value. The arrangement is usually long-term, single-source in nature and addresses not only the buying of parts, products, or services, but product design and supplier capacity.

This type of relationship can be beneficial for some organisations which may need to establish close links with companies in the supply chain to meet their own production needs or strategic objectives.

Some of the advantages to Landex from single sourcing with Gootle may include:

- Consistency (shape, size, quality, design) from a single supplier
- Easier to monitor quality
- Gootle is dependent on Landex, and is therefore more responsive to Landex's needs, if a large amount of its income is being earned from it
- More scale economies can be earned by Gootle to reduce costs if Landex's entire supply is sourced with it. This can then be passed on to Landex in reduced prices

- Communication, integration and synchronisation of the two companies systems are easier (eg integrated IT systems)
- Collaboration is easier and more mutually beneficial in developing new products because all the benefits come to one supplier
- Gootle has an existing and proven relationship with Landex and therefore there is less risk and greater awareness of its strategic capability.

However, there may also be some problems with Gootle as a single source supplier, some of which have already been experienced by Landex in recent years arsing from Gootle's inability to match Landex's rate of expansion:

- If there is an inability by Gootle to supply for Landex in full then this may disrupt Landex's production. This means Landex may need to hold inventories in future
- If there are variations in demand by Landex, a single supplier such as Gootle may not be able to satisfy these in the short term (which may be another reason for Landex to hold inventory)
- Gootle might exert upward pressure on prices if it knows Landex is tied into it for a number of years as the sole supplier and therefore has no alternative source of supply.

If Landex has multiple suppliers (as in Proposal 2) there are a number of benefits:

- Landex can drive down prices charged to it by encouraging competition between suppliers who know that Landex has a choice of alternative suppliers
- Switching sources of supply is possible by dropping a supplier altogether if it is delivering a poor quality product or service, or at least reducing the number of purchases
- Landex can benefit from innovation in future product development from many companies rather than just one

However, if Landex has multiple suppliers there may however be a number of problems:

- Each supplier has a smaller income from Landex than a single source supplier and so may lack commitment to development of watch case design
- Multiple communications become more difficult and more expensive for Landex (eg more difficult to integrate multiple IT systems)
- Reduced scale economies
- Suppliers are less likely to invest in bespoke equipment and produce a bespoke product for Landex as production volumes may be insufficient.
- All of the potential suppliers would be new and therefore this may create some initial uncertainty and front-end costs in establishing new relationships and communications systems

Along with the issue of single and multiple suppliers, there is the simultaneous decision of UK or international suppliers. Having suppliers that are geographically remote creates a series of problems:

- The lead times and uncertainty of delivery time are greater if the geographical distances are greater such as from India, China and Vietnam. This is made worse if the watch casings vary is size or style.
- Cross border supply chains may produce regulatory, language, cultural, exchange rate and tax problems.

- Exchange rate risk exists – if the overseas currencies appreciate, then operating costs in £ terms will increase. Conversely, if the M$ fails to depreciates in the final year of the planning horizon then the disposal proceeds will be worth less in £ sterling terms.

Setting up in-house production in Moldovia (Proposal 3) has some benefits:

- Control is exercised over product quality and delivery, as the supply chain is internalised within the company
- If demand increases, variable costs are low and profit will increase more rapidly than the other alternatives due to high operating gearing
- Price negotiation and renegotiation are avoided, as prices are internal transfer prices
- Landex can benefit from controlling innovation in future product development and it stands to gain the entire benefit from doing so, without sharing with external suppliers.

Setting up in-house production in Moldovia has some risks:
- There is high operating gearing from fixed costs so if planned expansion does not occur, then profit would be very sensitive to a shortfall in sales
- Management may be distracted from the normal day-to-day operations from setting up a production site in Moldovia and this may have an adverse effect on sales
- Landex may no longer have the core competences in watch casing production as it has not made them for 10 years, and even then only in the UK. As such, to invest in what is not a core activity or a core competence may be subject to high risks that need not be taken.

Advice

The current supplier, Gootle, has proved reliable and therefore reduces risk and gives assurance over quality. Landex may thus be best continuing with Gootle as sole supplier but, in negotiations on price and service, the possibility of multiple suppliers could be raised in order to obtain the best possible contract terms.

Any decision need not be permanent and any commitment to Gootle could be made conditional on service levels achieved over time and commitments on price.

<u>Four-year horizon</u>

Four years may be considered to be too short a planning horizon to recover the initial outlay for Proposal 3. A longer and more realistic planning horizon seems likely to favour this proposal strongly. The low variable cost per unit means that over a long time period increased output can benefit from higher contributions per unit for Proposal 3 compared with the two other proposals.

Other factors to consider are:
- The assumed annual exchange rate movements (5% appreciation of M$; and 2% depreciation of the basket of currencies) are unlikely to be sustained in the longer term with efficient currency markets unless there is a long term disparity in interest rates with £ sterling rates. The PV changes over the four year horizon are therefore unlikely to be sustained beyond 4 years
- Contracts may be renegotiated after four years under Proposals 1 and 2 which may mean either more favourable or less favourable pricing. Such negotiations would not apply to Proposal 3.

2. Methods of financing initial investment in Moldovian factory

Financial assessment

Alternative 1- M$40 million, zero coupon bond

The annual cost of debt is M$ terms is $[(117/100)^{1/4} -1]$ = 4% per annum

However, the functional currency of Landex is the £ and the M$ is forecast to appreciate against the £ over the 4-year term of the bond from its current level of M$2 = £1. As a result, the exchange rate on 31 December 2018, when the bond is due to be redeemed, is expected to be £1= M$1.645405 (ie M$2/1.05^4)

As a consequence, in £ sterling terms, the bond generates £20m when issued and requires £28.4428m (ie M$40m x 1.17/1.645405) to redeem it.

The annual cost of debt to Landex in £ sterling terms is therefore $[(28.4428/20)^{1/4} -1]$ = **9.203%** per annum.

Alternative 2 – £20 million, 5% bond

The coupon rate on the bond is 5% giving annual interest payments of £1m in arrears. However, the cost of debt needs to consider the 2% fee for the investment bank. Under this alternative, the effective rate of interest on the bond (i) is:

$$(£20m \times 0.98) = £1m/(1+i) + £1m/(1+i)^2 + £1m/(1+i)^3 + £21/(1+i)^4$$

Solving for i (by iteration, estimation or linear interpolation) the effective rate of interest on the bond is **5.57%** per annum.

Thus, in sterling terms the UK bond has a lower cost of debt by some margin.

Advice

Not only is the 5% sterling bond lower cost, but it is also lower risk. There is a risk with the zero coupon bond that the M$ may appreciate even more than the 5% pa expected.

Also the M$ bond adds to the operating foreign exchange risk rather than hedging it, as it adds even more costs in M$.

The clear advice is therefore to issue the 5% sterling bond.

Financial Reporting

Alternative 1 - M$40 million, zero coupon bonds

This bond is a monetary item thus the liability, including accrued interest, is translated at the year end exchange rate each year in accordance with IAS 21. Any exchange rate movement is recognised in profit or loss.

The effective interest on the bond is recognised through profit or loss each year, even though it is not paid.

Year	Opening balance M$m	Interest M$ 4%	Closing balance M$m	M$ Exchange rate	Closing balance (SOFP) £m	Movement (profit/loss) £m
2015	40	1.6	41.6	1.904762	21.84	1.840
2016	41.6	1.664	43.264	1.814059	23.849	2.009
2017	43.264	1.73056	44.99456	1.727675	26.043	2.194
2018	44.99456	1.7997824	46.794342	1.645405	28.439	2.396
REDEMPTION 17%			46.8			
ROUNDING			0.0056576			

The movement goes to profit or loss comprising both the loan interest and the retranslation of the liability as a monetary item.

Alternative 2 - £20 million, 5% bond

Year	Opening balance £M	Interest 5.57%	Cash paid £m	Closing balance £m
2015	19.6	1.09172	1	19.69172
2016	19.69172	1.096829	1	19.78855
2017	19.78855	1.102222	1	19.89077
2018	19.89077	1.107916	21	0

Rounding -0.00131

The interest is charged to profit or loss in accordance with IAS 32
The closing balance at the end of each year is shown as a liability in the SOFP

3. Ethics

Ceasing to use Gootle

An ethical principle in this case is one of honesty in assessing whether there was an intention by the chairman, 10 years ago, to honour his statement or to mislead to gain short term advantage of reduced redundancy costs.

A key factor is the passage of time and the capacity of the chairman to bind the board's actions 10 years later. On this basis, there does not seem any strong ethical obligation to maintain Gootle as a supplier.

However Landex could consider whether there is any ethical obligation to employees to make additional payments now.

Indeed, to maintain Gootle as a supplier, if they were not the best choice on commercial grounds would be an ethical breach by the Landex board towards its shareholders to whom the board owes their primary duty.

Use of Rotblat as a supplier

The ethical principle in this case is a conflict of interest by the finance director both in being influential in determining who obtains the contract and, if the contract is awarded to Rotblat, in obtaining more favourable terms than would be available on an arm's length basis to other suppliers.

The ethical safeguards would be transparency so the board is aware of the relationship (the FD seems to have done this in 'declaring an interest'). Also, the role of the FD in the decision as to who should be awarded the supply contract should be minimised. The fact that two other directors are putting forward alternative proposals appears to be some safeguard, showing that there is active debate within the board.

There may be a suggestion of an intimidation threat if non board members, such as myself, make arguments contrary to the proposals of the FD. This needs to be safeguarded against by openness and transparency and, if the FD is an ICAEW Chartered Accountant, he is bound by their ethical code.

4. Corporate governance and financial reporting

<u>Corporate Governance</u>

The board of directors is a key stakeholder and is fundamental to corporate governance. In this case a key member of the board, the finance director, has potential influence over two key decisions:

- Whether to have Rotblat as a supplier
- If Rotblat becomes a supplier, the terms on which the contract is made and manner in which the service monitored

A key corporate governance issue is that the finance director, as a key member of the board, can potentially influence these decisions in which she has a personal interest. There is therefore a risk that contracts may be undertaken or continued that are not in the best interests of the company.

One safeguard would be for the finance director to be excluded from decisions in respect of the supply contracts for watch casings. If this is not possible or reasonable then she should be excluded from voting on such matters.

Financial Reporting

Consideration needs to be given as to whether a contract with Rotblat would be a related party transaction in accordance with IAS 24.

The finance director, Catherine Jurys, as a member of the board is part of key management personnel and is therefore a related party.

IAS 24, para 9, also deems close family members of key management personnel to be related parties if they may be expected to influence, or be influenced by, them in their dealings with the company. Whilst a brother is not one of the examples given of close family members in IAS 24, the general test of influence applies.

It is a question of fact whether Catherine Jurys' brother is likely to influence her, or be influenced by her, in respect of the Rotblat supply contract. A safe underlying initial assumption, in the absence of evidence to the contrary, is that there is such an influence. The fact that Catherine is strongly support of the Rotblat proposition, rather than being neutral, is indicative of such influence.

If it is ultimately deemed appropriate that it is a related party contract, then the nature of the contract should be disclosed in accordance with IAS24, para19. In addition, the amount of the transactions, outstanding balances, commitments, guarantees and bad debts should be disclosed.