ADVANCED LEVEL EXAMINATION

TUESDAY 22 JULY 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 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.

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 | | | | |

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QUESTION 1

Funnel Cruises plc (FC) is a listed company which operates cruise ships globally. The cruise line industry involves the operation of passenger ships for holiday voyages from 2 days up to longer cruises of over 30 days.

You are a recently qualified ICAEW Chartered Accountant working in the business advisory and assurance department of a large, international firm of ICAEW Chartered Accountants, Reez LLP (Reez). FC is a client, but not an audit client, of Reez.

Gary Gregory is the acting treasurer of FC. The previous treasurer retired in February 2014, having reached normal retirement age. Gary called Reez last week to arrange a meeting with your manager, Helen Long. You accompany Helen to the meeting.

The meeting

Gary opened the meeting. "The FC board believes that the company is generally progressing well in its long-term plans to become one of the leading operators in the global cruise line industry. However, the management accounts for the year ended 30 June 2014 have just been finalised and there has been a fall in operating profit compared with the previous year. We will be carrying out an internal analysis, but we would also like some external, independent scrutiny by Reez of FC's performance.

"I have provided some background details for you about the cruise line industry and FC's operations (**Exhibits 1 and 2**).

"I have also provided you with financial and operating information for FC (**Exhibit 3**).

"In addition, there are some further issues where the FC board requires the help of Reez. I will provide an overview of these issues now, but I will also send a 'terms of engagement' document following the meeting with a summary of what will be required of Reez.

<u>Foreign currency risk management</u>

"FC generates revenue in many currencies and it also incurs costs in different currencies. The board believes that, since the retirement of the previous treasurer, it has not had an adequate understanding of FC's foreign currency risks.

"The board is concerned about the cash impact of foreign exchange risk, recognising that most customers pay FC, on average, four months before their cruise takes place.

"The board would also like to understand the foreign currency issues relating to interdivisional trading, including settlement procedures for outstanding balances between divisions.

"A further issue relates to foreign currency risks arising from payments for new ships that are currently being constructed for FC. These are long-term projects involving significant expenditure in euro.

"I have provided some brief thoughts of my own on these issues (**Exhibit 4**), but the FC board has also requested the advice of Reez.

Potential acquisition

"FC is considering making a bid for the entire ordinary share capital of Coastal Hotels Inc (Coastal). The board is aware that FC is very dependent on the cruise market and is therefore exposed to industry specific risks, particularly oil price volatility and overcapacity. The board believes that some related diversification is appropriate, whilst remaining within the wider leisure industry. Coastal fits into this model as it has hotels in a number of the US ports that our cruise ships visit. I have provided you with some initial, limited information (**Exhibit 5**).

"A particular issue is that Coastal is making losses, so I am not sure whether the normal methods of valuation using earnings or cash flow would be appropriate. It would be easy just to use the net asset value, but the board would also like to explore other methods of determining an appropriate valuation for Coastal and it would welcome the opinion of Reez.

"If we are not relying on earnings to determine the valuation, I am not sure whether detailed due diligence is necessary. If we do perform due diligence, the board is split about whether we should ask Reez to do this work or whether we should perform due diligence using our own staff, who are the industry experts, as the board is interested in more than just financial due diligence.

"If FC eventually acquires Coastal's shares for a consideration of less than the fair value of its net assets, please explain how this difference would be dealt with in the FC group financial statements, particularly as Coastal is a US company so the transaction would be in US$.

Food poisoning incident

"On 4 July 2014, there was an unfortunate occurrence of food poisoning on one of FC's ships, which affected most of the passengers and crew. The causes are still unclear and we are currently investigating.

"The board is very concerned about reputational damage. As a result of this incident, it estimates that FC's total customer bookings and total revenues will fall by 10% in the year ending 30 June 2015 compared to the preceding year. Litigation costs are estimated at £10 million and are likely to be paid in December 2015.

"The board would like Reez to calculate and explain the impact of the incident, including the effect of the decrease in bookings and revenue on the expected operating profit for the year ending 30 June 2015. I would also like Reez to recommend any actions that FC should take to reduce the extent of the impact."

Manager's instructions

Following the meeting, Helen called you into her office. "The FC board would like Reez to prepare a report addressing the issues explained by Gary in our meeting. Gary has now provided more detail of what is required in a 'terms of engagement' document **(Exhibit 6)**. Please draft a response to this document."

Requirement

Respond to the instructions from Helen, your manager, based on the 'terms of engagement' document (Exhibit 6). **(60 marks)**

Exhibit 1 – Background details, the global cruise line industry: prepared by Gary Gregory

The cruise line industry is dominated by multinational companies. The industry is defined as including ocean and sea cruises, but excluding river and lake cruises.

Industry data

In the year ended 30 June 2014, the global cruise line industry generated revenues of £19.2 billion.

The cruise line industry has grown in recent years despite the economic downturn. Global passenger numbers and sales revenue each increased by 3.5% in the year ended 30 June 2014.

The global fleet of all cruise line operators has 250 ships, with a total passenger capacity per night at sea of 410,000.

Competition

There is severe competition between cruise line operators with passenger capacity growing through the introduction of new, larger ships.

The largest of the new ships are over 225,000 tonnes, each with a capacity of about 5,400 passengers. By increasing capacity per ship, cruise lines are able to reduce cost per passenger, and encourage increased spending on-board by offering a greater range of amenities and activities.

The high capital cost of entering the market is a significant barrier to entry for new competitors.

Revenue generation

Passenger tickets make up about 75% of total industry revenues. Customers pay for tickets, on average, four months before departure. The other 25% of revenues are from other ‘paid for’ on-board activities (eg drinks, shopping, spa and beauty treatments) and on-shore excursions. Meals are included in the passenger ticket price, but other ‘paid for’ activities have become an important source of additional revenue in recent years for most operators.

Exhibit 2 – Background details, FC's operations: prepared by Gary Gregory

Introduction

FC is incorporated in the UK, but it has a dual listing on the London Stock Exchange and the New York Stock Exchange. Shareholders are mainly international institutions. FC reports under IFRS and has a 30 June accounting year end.

Organisational structure

FC is organised into three geographical divisions: UK, US and France. Each division is autonomous and owns and operates a number of ships.

Branding

The company offers mid-market cruises under the single FC brand name.

The fleet of ships

FC has a fleet of 24 ships of different sizes, ranging from 60,000 tonnes (with a passenger capacity of 1,000) up to 130,000 tonnes (with a passenger capacity of 3,600). All ships are owned by FC. There are no leases.

New ships

Two identical new ships are in the process of being built for FC and are scheduled for delivery from an Italian dockyard: *The Spirit of the Sea* in January 2015; and *The Ocean Odyssey* in March 2016. Each ship will be 130,000 tonnes, carry 3,600 passengers and each will cost €540 million. The contracts are fixed price in euro and overall it will take 3 years to build each ship. Progress payments are made by FC while each ship is being built, and a final payment of €270 million is to be made on delivery of each ship.

The treasury department

FC uses a centralised treasury department to co-ordinate the activities of the three divisions. The £ is used as the base currency and is also the functional currency of FC for financial reporting purposes. All divisions inform the central treasury department of their transactions with each other. Central treasury then informs each division of the outstanding amounts payable or receivable to settle the balances arising from interdivisional transactions.

Exhibit 3 – Financial and operating information: prepared by FC management accountant

Management accounts - Statement of profit or loss for years ended 30 June

	2014 £m	2013 £m
Revenue:		
Passenger tickets	2,925	3,040
'Paid for' on-board activities and excursions	920	909
Total revenue	3,845	3,949
Operating costs:		
Fuel	425	378
Staff costs	435	431
Food	240	241
'Paid for' on-board activities and excursions	250	222
Depreciation	381	380
Other ship operating costs (**Note 1**)	1,239	1,398
Selling and administration	430	429
Operating profit	**445**	**470**
Gain on fuel derivatives	25	-
Gain on foreign currency derivatives	45	-
Earnings before interest and taxes	**515**	**470**

Note 1
'Other ship operating costs' are largely fixed and include: port costs, maintenance, repairs, consumables, freight and logistics.

Operating data for years ended 30 June

	2014	2013
Number of passengers in year	2,460,000	2,390,000
Occupancy (% of capacity utilised)	90%	92%
Total passenger capacity of fleet per night (at 30 June)	62,000	59,000
Number of staff	22,500	22,500
Number of ships in fleet at 30 June	24	23
Carrying amount of fleet at 30 June (£ million)	5,190	4,940
Fair value of fleet at 30 June (£ million)	7,000	6,500
Fuel consumption (000's tonnes)	839	849

Exhibit 4 overleaf

Exhibit 4 – Foreign currency risks: prepared by Gary Gregory

Operating cash flows

The central treasury department manages foreign currency risks with third parties for the company as a whole.

FC receives cash inflows from customers in a variety of currencies and makes payments for costs in many currencies. In the past, FC has only occasionally hedged its exposure to fluctuations in foreign currency exchange rates on operating cash flows. I would like to recommend to the board that FC should start to use foreign currency derivative financial instruments (futures and options) to hedge currency risks on operating cash flows in a more systematic way.

Interdivisional balances

FC's ships travel around the world and each of the three FC divisions frequently performs maintenance and refuelling of the ships belonging to the other divisions. These services are paid for in local currencies. For example, if the US division pays for costs in US$ on behalf of the UK division then this amount will be owed in US$ by the UK division to the US division.

Similarly, customers in one country, for example the UK, may wish to book a cruise on a US ship. In this case, the UK division would take payment in £ sterling for the booking from the customer, but would then owe this amount in £ sterling, as an interdivisional balance, to the US division which operates the cruise. This results in significant outstanding interdivisional balances in multiple currencies.

The FC board wishes to introduce multilateral netting off of interdivisional balances, but the previous treasurer was dealing with this, so we would appreciate the guidance of Reez. The interdivisional balances at 30 June 2014 are:

	Payables division		
	UK	**France**	**US**
Receivables division			
UK (£)	-	£2.4m	-
France (euro)	-	-	€1.8m
US (US$)	US$6.4m	US$3.6m	-

The treasury department has determined that net settlements will be made in £ sterling and has set the following exchange rates for interdivisional settlements at 30 June 2014:

	France	**US**
£1 =	€1.2	US$1.6

New shipbuilding currency risks

Our shipbuilding contracts are typically denominated in euro, as most ships are built in Italy. FC's decisions regarding whether, and how, to hedge foreign currency commitments for new shipbuilding are made on a case-by-case basis, taking into consideration the amount and duration of the exposure, market volatility, currency exchange rate correlation, economic trends, the overall expected net cash flows by currency and other offsetting risks.

In July 2013, the previous FC treasurer entered into foreign currency, zero-cost collars with FC's bank to hedge the final payment for building *The Ocean Odyssey*. These collars mature in March 2016 at: a ceiling rate of £0.85 to €1, amounting to £229.5 million; and a floor rate of £0.77 to €1, amounting to £207.9 million. If the spot rate is between these two rates on the date of maturity, then FC would neither owe any amounts, nor receive any payments under these collars.

I do not really understand the implications of these commitments for risk management. Please explain how the use of these collars affects our foreign currency risks.

Exhibit 5 overleaf

Exhibit 5 – Potential acquisition of Coastal Hotels Inc: prepared by Gary Gregory

Coastal owns 10 hotels on the US coast. They have not performed well. The financial statements of Coastal show losses and the hotel carrying amounts have suffered an impairment charge in two of the past four years.

Outline data for Coastal is as follows:	**US$m**
Carrying amount of net assets at 31 December 2013	32
Fair value of net assets at 31 December 2013	30
Forecast loss after tax for year ending 31 December 2014	4
Loss after tax for year ended 31 December 2013	2

Coastal generated revenue of US$20 million in the year ended 31 December 2013 and forecasts revenue of US$19 million for the year ending 31 December 2014.

Notes:

- The Coastal accounting year end is 31 December
- An acquisition date of 30 September 2014 seems most likely if the deal goes ahead
- An acquisition price of US$25 million for Coastal's entire ordinary share capital has been suggested by the Coastal board, but this amount has not been agreed
- Coastal reports in accordance with IFRS
- Assume an exchange rate of £1 = US$1.6

Exhibit 6 – Terms of engagement: prepared by Gary Gregory

The FC board requests that Reez prepares a report comprising the following:

(1) Using Exhibit 3 and the other information provided, analyse and explain the performance of FC for the year ended 30 June 2014.

(2) With respect to FC's foreign currency transactions (Exhibit 4):
- Evaluate whether derivative financial instruments would be the most appropriate method for the centralised treasury department to manage FC's foreign currency risks in respect of its operating cash flows.
- Calculate the £ sterling settlements of interdivisional currency balances at 30 June 2014 using multilateral netting off procedures. Explain how these procedures may be of benefit to FC.
- Explain how the use of zero cost collars can mitigate foreign currency risks with respect to payments under contracts for building new ships.

(3) So far as the information permits, with respect to FC's potential acquisition of Coastal (Exhibit 5):
- Identify and evaluate suitable methods to determine an acquisition price for Coastal's entire ordinary share capital given that the company is making losses.
- Explain, with calculations, how the difference between the consideration and the fair value of Coastal's net assets would be recognised and measured in the FC group financial statements for the year ending 30 June 2015. For this purpose assume an acquisition price of US$25 million. State any assumptions.
- Explain the benefits of carrying out due diligence for Coastal. Assess whether it would be preferable if this were to be completed by FC staff, or an independent assurance provider, such as Reez.

(4) Calculate and explain the expected impact of the food poisoning incident on FC's operating profit for the year ending 30 June 2015. Recommend any operational actions that FC should consider in order to reduce the extent of the impact on profit.

Assume that, in the absence of the food poisoning incident, the statement of profit or loss for the year ending 30 June 2015 would have been the same as for the year ended 30 June 2014.

QUESTION 2

Landex plc is a large-scale manufacturer of high-quality watches. The company's manufacturing facility is based in the UK, but it exports throughout the world.

You are Stella Savoy, an ICAEW Chartered Accountant who has just joined Landex. You have been asked to attend a meeting with the head of procurement, Kieran Black.

The meeting

Kieran opened the meeting. "Thanks for coming to see me, Stella. I realise that you are new to Landex, so I have provided some background notes about the company (**Exhibit 1**).

"The problem is that the directors are not happy. You would think they would be, given the increases in sales that have been achieved in recent years, but they are not. They are concerned that the recent growth achieved is not sustainable due to issues with our supply chain.

"The board believes, in particular, that we need to review the procurement arrangements for watch casings. The casings provide the outer shell to hold the watch mechanism and so are critical to our final product. The casings are currently supplied by a local company, Gootle Ltd. However, Gootle no longer has the capacity to supply all our needs efficiently and the situation will worsen unless it invests in new equipment and a new factory.

"Prior to making such an investment, the Gootle board is seeking assurances from the Landex board that Gootle will continue to be the sole supplier of watch casings for Landex over the next few years.

"Opinion was divided on this issue at a recent Landex board meeting. As a result, three directors have produced briefing papers, each proposing different strategies for Landex's future procurement policy for watch casings over the next four years. I have provided you with these briefing papers (**Exhibit 2**) so that you can evaluate each of these three strategies. To help you, I have provided some forecasts of demand and some working assumptions (**Exhibit 3**).

"There are some further issues I would like you to consider:

"If, as suggested by the production director, we were to set up our own manufacturing facility in Moldovia (Exhibit 2, Proposal 3), we would need to decide how to finance this investment and I have identified two alternatives (**Exhibit 4**). I would like you to advise us on the more appropriate form of finance and to set out the financial reporting treatment for both alternatives.

"Gootle was set up 10 years ago when Landex outsourced its production of watch casings to Gootle. Many of the Landex staff were made redundant as a result of the outsourcing, but transferred their employment to Gootle. They received lower redundancy payments as a consequence of obtaining alternative employment. The Landex chairman, at that time, promised that Landex would always use Gootle as its sole supplier of watch casings. I would like you to set out the ethical position for Landex if we were now to cease using Gootle as a supplier.

"Also, the finance director of Landex, Catherine Jurys, has declared a conflict of interest, in that her brother is on the board of one of the suppliers she is proposing, Rotblat (Exhibit 2, Proposal 2). The board has expressed concern about any ethical issues that may arise from this relationship and whether any disclosures would be required in the financial statements. I would like you to draft some notes for the board addressing these issues. However, I advise you to be very careful with anything you may wish to say on this matter, as the finance director is very keen that her proposal should be implemented.

"Thank you again for coming along to see me. I will provide you with notes of our meeting that set out more precisely what I require you to do (**Exhibit 5**)."

Requirement

Respond to the instructions (Exhibit 5) from Kieran Black, the head of procurement.

(40 marks)

Exhibit 1 – Landex business background: prepared by Kieran Black

Landex is a listed company generating revenues of over £300 million per annum with sales in over 80 countries. The company has a single manufacturing site in the UK and most of its suppliers are also UK companies.

Landex manufactures high quality watches which retail from £1,000 upwards. The brand has widespread global recognition and is a symbol of quality and style. The watches have a traditional mechanism (rather than the quartz movement found in most watches) and are made by skilled employees, largely being assembled by hand.

The watch casings are the most significant bought-in component and are made from high quality glass, along with steel, silver or gold.

Demand, in volume terms, has increased by over 10% per annum in recent years. This has generated significant profit, but the increase in output has brought with it problems of maintaining quality. There have also been difficulties ensuring that the external procurement of components and raw materials is timely, efficient, flexible and within the production capacity of suppliers.

Landex has a 31 December accounting year end.

Exhibit 2 – Directors' briefing papers: three proposed procurement strategies

Proposal 1: Retain Gootle as the sole supplier of watch casings – prepared by operations director, Nancy Ritz

Gootle has supplied us with watch casings for many years and it has been reliable, provided generally good quality products and at a fair price. They also supply on a just-in-time basis so we can hold minimal inventories of watch casings.

Admittedly, Gootle has struggled to keep pace with the rate of expansion achieved by Landex in recent years, but we need to help them solve this issue, not just walk away at the first sign of a problem.

In my view, Landex should build a partnership supply relationship with Gootle, underpinned by a four-year supply contract and monitored by a service level agreement. This will give them the confidence to invest in new equipment and a new factory to expand their capacity and meet our needs in the medium term.

In initial negotiations, the Gootle board has stated that it can supply the watch casings at an average price of £100 each throughout the next four years.

Proposal 2: Have multiple global suppliers of watch casings – prepared by finance director, Catherine Jurys

The problem with Landex is that it is an international company on the demand side, but a very local company on the supply side. We have been too loyal to Gootle as our sole supplier of watch casings. We need to open up the supply contract for watch casings to global competition and have multiple suppliers. These suppliers can then compete on price, quality and service.

Initial investigations have revealed three potential suppliers: Mumbai Casings (India); Rotblat (China); and SH Watches (Vietnam). We can use all of these suppliers to meet our needs.

Contracts would be denominated in local currencies and transport costs would also be incurred in local currencies. Using expected exchange rates at 31 December 2015, the watch casings could be supplied, on average, for the equivalent of £90 per casing, plus transport costs of £3 each.

Contracts would be renewable annually, so suppliers could be changed, prices renegotiated and competition reinforced on a regular basis. It is expected that, due to competition, the prices in terms of local currencies will not change over the period 2015 to 2018, although this is by no means certain.

Proposal 3: Set up Landex's own manufacturing facility in Moldovia – prepared by production director, Sue Harben

If we set up our own manufacturing facility solely for watch casings, we can exercise more control over production volumes, quality and costs. By setting up in a developing economy, like Moldovia, we can gain significant financial benefits from lower costs. Also, we will convert variable costs into fixed costs, which will be a major benefit if demand continues to grow.

The currency of Moldovia is the Moldovian dollar (M$).

I estimate that, on 1 January 2015, we would incur initial set-up costs of M$40 million to build the factory. Variable costs per watch casing are expected to be M$40 and annual fixed costs are estimated to be M$25 million. We can exit after four years, if we need to, and sell the factory for M$20 million, net of all disengagement costs.

Exhibit 3 – Demand forecasts and working assumptions: prepared by Kieran Black

Demand forecast

It is expected that global sales volumes for Landex watches over the next four years will be as follows:

	Number of Watches
2015	200,000
2016	220,000
2017	235,000
2018	245,000

Each watch requires one casing.

Working assumptions

The following working assumptions should be applied for all three proposals for the procurement of watch casings (Exhibit 2).

- All three proposals would commence on 1 January 2015 and run for an expected period of four years.
- Calculations are to be made over the four-year planning horizon (ie up to the end of 2018).
- Landex evaluates projects using an annual discount rate of 10% for present value calculations.
- At 1 January 2015, the exchange rate with Moldovia is M$2 = £1. However, the M$ will appreciate by 5% per annum against the £ thereafter.
- The basket of currencies used for Proposal 2 (the currencies of India, China and Vietnam) will depreciate at 2% per annum against the £ from 1 January 2016.
- Operating cash flows will arise at year ends.
- Landex's functional currency is £ sterling.

Do not worry about tax for now. We can deal with this later.

Exhibits 4 and 5 overleaf

Exhibit 4 – Financing the Moldovian factory: prepared by Landex's treasury department

There are two alternatives for financing the initial cost of M$40 million for setting up a Moldovian factory (Exhibit 2, Proposal 3):

<u>Alternative A</u> – issue a zero coupon, M$40 million bond at par in Moldovia, on 1 January 2015, redeemable at a 17% premium on 31 December 2018.

<u>Alternative B</u> – issue a £20 million, 5% bond at par, in the UK, on 1 January 2015. The financial institution handling the placing would charge 2% of the par value of the bond as a fee, which is payable when the bond is issued. The bond is to be redeemed at par on 31 December 2018. Nominal interest is to be paid annually in arrears on 31 December.

Exhibit 5 – Extracts from notes of the meeting between Kieran Black and Stella Savoy: prepared by Kieran Black

Please prepare a report to the board addressing the following issues:

(1) Evaluate and compare the three procurement proposals put forward by the directors in their briefing papers (Exhibit 2). Include supporting calculations up to the end of 2018, and also explain the wider operational and strategic implications of the three proposals. Use the working assumptions and demand forecasts provided (Exhibit 3).

Also explain, without further calculations, the benefits and risks of each proposal if they operate for longer than four years.

(2) Assume that Landex decides to set up a manufacturing facility in Moldovia. With regard to the two alternatives for financing the Moldovian factory (Exhibit 4):

- Provide reasoned advice as to which of the two bonds should be issued. Include in your analysis supporting calculations of the bonds' annual effective rates of interest to Landex based on £ sterling cash flows.
- Set out the financial reporting treatment of both bonds in the financial statements of Landex for each year that they would be outstanding. Provide supporting calculations.

(3) In respect of the proposed procurement strategies explain:

- the ethical implications for Landex of ceasing to use Gootle as a supplier.
- the ethical implications, for Landex and its finance director, arising from her brother's position on the Rotblat board.

(4) Set out any corporate governance and financial reporting issues that may arise for Landex if Rotblat were to become one of its suppliers.