ADVANCED LEVEL

TUESDAY 2 NOVEMBER 2021

3.5 HOURS

STRATEGIC BUSINESS MANAGEMENT

This exam consists of **two** questions (100 marks).

Marks breakdown

Question 1	55 marks
Question 2	45 marks

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.

The link to the ICAEW bookshelf can be found in each question above the word processing area.

Important Information:

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Question 1

Assume the date is 1 November 2021

Demm plc is listed on the London Stock Exchange and has international operations. It manufactures packaging products used to protect goods during distribution.

You are an ICAEW Chartered Accountant and you have recently joined Demm as an assistant manager in the strategy department. Your line manager, Barry Stiles, has asked you to meet him.

Barry opened the meeting. “Demm has been subject to significant change. I know that you are new to the role, so I have provided you with some industry and company background (**Exhibits 1A** and **1B**). Forecast summary financial information for the year ending 31 December 2021 has been provided by the finance director (**Exhibit 2**).

“Demm has recently appointed a new CEO who has asked me to look at a number of issues and to report back to the board. I would like your help.

“In the past, Demm produced both paper packaging and plastic packaging, but it sold its plastic packaging division on 1 January 2021 for £100 million. The Demm board is now seeking to use these funds to invest in its paper packaging activities.

“The Demm board is considering an investment in new production machinery for the majority of its paper mills. The new machinery will be controlled by artificial intelligence (AI) to improve the efficiency of paper packaging production. The board is still to decide on this potential investment, as it is concerned about risks and it is unsure of the best timing for the investment. I have provided details about the potential investment in new machinery controlled by AI (**Exhibit 3A**). Since preparing the details in Exhibit 3A, I have received information about a potential new entrant to the packaging industry in 2022 (**Exhibit 3B**). The directors held an informal meeting to explore ideas on these matters, as a result of which they raised a range of issues which we will need to consider (**Exhibit 3C**).

“Another potential opportunity has arisen. Demm has been offered a choice between two mutually exclusive sales contracts with major distribution companies. I have provided details on the two sales contracts (**Exhibit 4**).

“The board is also reviewing Demm’s environmental strategy. I have provided details (**Exhibit 5**). The board believes that significant efforts have been made in recent years to reduce Demm’s environmental impact, but the directors recognise that more needs to be done.

“I would like you to draft a report for the Demm board. I have set out instructions in a separate document (**Exhibit 6**) explaining what I would like you to do.”

Requirement

Respond to the instructions from your line manager, Barry Stiles (Exhibit 6).

Total: 55 marks

Exhibit 1A: Industry background – provided by Barry Stiles

Packaging, typically made from paper or plastic, is used to protect goods during distribution. Paper packaging (made from paper and cardboard) dominates the market. Paper packaging is produced at factories that are known as 'paper mills'.

The UK paper packaging market is volatile, with periods of rapid growth and sharp decline in recent years.

Historically, plastic packaging has been a competitive substitute for paper packaging. However, growing concerns over plastic's environmental impact have reduced demand in recent years.

The paper packaging market also faces environmental impact concerns. The main raw material used is pulp, produced either from virgin sources (ie, from trees cut down in forests) or from recycled paper packaging.

Legislation and regulation impact the industry. Packaging manufacturers are required to recover and recycle increasing proportions of paper packaging. This includes wastage from their own production processes and recovery of used paper packaging from customers. Also, some food products cannot legally be distributed in recycled paper packaging where it is in direct contact with the food.

Following years of global decline in the paper packaging industry, the trend for internet shopping has increased demand for packaging. This is because deliveries of single items to consumers require more packaging per item than large deliveries of multiple items to retailers.

Exhibit 1B: Company background – provided by Barry Stiles

Customers and markets

Since 1 January 2021, Demm has produced and sold only paper packaging. Demm's major customers include food companies, manufacturers of fast-moving consumer goods (FMCG) and online retailers. Larger customers have global operations.

The geographical distribution of paper packaging deliveries to Demm's customers, by volume and value, is:

Europe	45%
US	35%
Asia	20%

Sales to US customers are invoiced in US$. All other sales are invoiced in £.

Operations and raw materials

Demm operates from ten paper mills in Europe and two paper mills in the US. All paper mills produce approximately equal amounts of output. Each paper mill has multiple production lines and uses a variety of machinery.

Demm uses virgin and recycled pulp in its production. Currently this is in a ratio of 40:60, respectively. The proportion of recycled pulp used has increased in recent years.

Virgin pulp is supplied by third party forestry companies. Demm works with these suppliers to encourage sustainable replanting of forests.

Demm operates a recycling unit at each paper mill. This produces recycled pulp by reprocessing the wastepaper from Demm's production and used paper packaging recovered from its customers.

All the recycled pulp used in Demm's paper packaging comes from Demm's own recycling units.

Demm sells surplus recycled pulp to other companies.

Exhibit 2: Forecast summary financial information – provided by Demm's finance director

Forecast summary statement of profit or loss for year ending 31 December 2021

	£m
Revenue	4,361
Operating expenses	(4,304)
Operating profit	57
Finance costs	(8)
Profit before tax	49

Forecast summary statement of financial position at 31 December 2021

	£m
Non-current assets	
Property, plant and equipment	935
Current assets	
Cash	112
Other current assets	372
Total assets	1,419
Equity	
Ordinary share capital – £1 shares	50
Retained earnings	532
Other reserves	246
Total equity	828
Non-current liabilities	
Loans	214
Other	239
Current liabilities	138
Total equity and liabilities	1,419

Exhibit 3A: New machinery controlled by artificial intelligence – provided by Barry Stiles

The Demm board is considering a project for an investment in new artificial intelligence controlled production machinery (AI machinery) at seven of its paper mills. It has set up a project team to gather data and evaluate the potential investment.

The AI machinery will enable Demm to produce more efficient packaging, which can be tailored to fit customers' products. This will help Demm use less raw materials.

The AI machinery will be operated separately from Demm's existing production lines. It will use machine learning which is expected, over time, to enhance production efficiency and improve Demm's competitive position in the industry. Demm's AI machinery is expected to have a five-year useful life. However, once acquired, it would have a negligible disposal value because of its specialist nature.

As the packaging market is volatile, the project team has made three estimates of the size of the packaging market over the life-cycle of the AI machinery: optimistic; most likely; and pessimistic. For each market size, the project team estimated the total present value (PV) of net operating cash inflows for Demm over a five-year planning horizon. This is calculated as the total estimated discounted net operating cash inflows from the project, before deducting the initial cost of all AI machinery. The estimates are as follows:

Packaging market size	**Probability**	**Total PV of net operating cash inflows £m**
Optimistic	0.3	180
Most likely	0.5	120
Pessimistic	0.2	90

Net operating cash inflows are expected to occur evenly over the five-year planning horizon.

A discount rate of 8% per annum has been used to determine the PV of cash inflows. The market risk-free interest rate can be assumed to be 2% per annum.

There is some uncertainty over the initial investment cost of the AI machinery. The standard software supplied by the manufacturer of the AI machinery would need to be reprogrammed and there remain some technical issues to resolve. As a result, the project team has estimated that there is a 40% probability that the initial investment cost of the AI machinery will be £75 million; and a 60% probability that it will be £95 million. The final investment cost will only be known for certain shortly after the AI machinery is brought into use, as final adaptations may be needed.

The probabilities for the PV of net operating cash inflows are independent of the probabilities for the initial investment cost.

If the investment goes ahead, it is currently planned to take place on 1 January 2022 and the AI machinery would be brought into use on that date.

However, the Demm board is unsure of the best timing and initial investment could therefore be delayed a year, until 1 January 2023. At that date, the investment costs, probabilities and the PV of net operating cash inflows would be the same as at 1 January 2022.

Exhibit 3B: Potential new entrant to the packaging industry – provided by Barry Stiles

After the project team prepared the data in Exhibit 3A, Demm received information that an international paper company, Hagg Inc, is considering entering the paper packaging market.

If Hagg enters the packaging market, it is estimated that Demm will lose market share and the PV of net operating cash inflows from the new AI machinery (Exhibit 3A) will decrease by 35% for each estimate of packaging market size. Initial investment costs and the associated probabilities would be unaffected. The probabilities of packaging market size will also be unaffected by Hagg's entry to the market.

I understand that the Hagg board will make a final decision on whether to enter the packaging market during 2022. Current estimates show a 25% probability of Hagg entering the market that year. However, if Hagg does not enter the packaging market in 2022, it is very unlikely to do so at a later date.

Exhibit 3C: Issues to consider, identified at an informal meeting of directors – prepared by company secretary

The directors had an informal meeting to consider the matters identified in both Exhibit 3A and Exhibit 3B, and raised the following financial and non-financial issues to be considered:

- Whether to invest in the AI machinery.
- How the possibility of Hagg's market entry could affect the desirability of Demm's potential new investment in AI machinery.
- The risk of generating a negative NPV and how to mitigate this risk.
- The most appropriate timing of the investment if the board decides to acquire the AI machinery.
- The financial reporting treatment of the AI machinery if Hagg decides to enter the market after Demm has invested in AI machinery on 1 January 2022.
- How the AI machinery investment would contribute to Demm's wider strategy and policies.

This was an informal session, and the issues are not set out in any particular order.

Exhibit 4: Potential new sales contracts for Demm – provided by Barry Stiles

The Demm marketing team is in contract negotiations with two potential new customers: Zambesi Inc and Nile plc. Both potential customers are companies with global operations. Zambesi is US-based and Nile operates from the UK.

Zambesi and Nile compete with each other in some markets, Demm therefore needs to choose between the two mutually exclusive contracts.

Both Zambesi and Nile have made it clear that they want a close partnership with Demm as their preferred supplier, including shared and integrated information technology.

Some initial capital investment will be needed by Demm to fulfil either contract, as the type of packaging will be bespoke to either Zambesi or Nile. This is because the packaging needs to fit their main products precisely in order to reduce paper wastage.

The marketing team has provided the following additional information and estimates for the two contracts:

<u>Contract 1 – Zambesi</u>

Zambesi manufactures FMCG and is a growing company. It sells mainly to global retailers, with 50% of its revenue from US customers. Increasingly, Zambesi also makes internet sales directly to consumers as B2C sales.

Zambesi requires all its paper packaging from Demm to be made from recycled pulp.

This would be a three-year contract, which is potentially renewable.

The mean estimated total PV of cash inflows over the three-year contract period is £3 million (calculated as the estimated discounted net operating cash flows from the contract, before deducting the initial investment).

There is a 50% probability that the PV of cash inflows will be between £2.5 million and £3.5 million. The standard deviation (SD) of the PV of cash inflow estimates is £0.75 million.

The initial investment, at the beginning of the three-year period is reasonably certain at £2.5 million.

Because of technology changes, new investment of £2.5 million would be needed every three years if the contract is renewed.

<u>Contract 2 – Nile</u>

Nile manufactures a wide range of goods including foods and FMCG. It sells globally, but 50% of its sales are in Europe. Nile's revenue has been slowly decreasing in recent years.

Nile's contract requirements mean that approximately 50% of its packaging will be made from recycled pulp and 50% from virgin pulp. This is partly due to requirements relating to the packaging of food products.

This would be a four-year contract, which is potentially renewable.

The mean estimated total PV of cash inflows is £4 million over the four-year contract period. There is a 50% probability that the PV of cash inflows will be between £3 million and £5 million. The standard deviation of PV estimates is £1.5 million.

The initial investment is reasonably certain at £3.4 million.

As a result of technology changes, further new investment of £3.4 million would be needed every four years if the contract is renewed.

Both sales contracts

The total PV of cash inflow estimates approximates to a normal distribution for both contracts. The same discount rate of 8% per annum has been used to determine the PV of cash inflows for both contracts.

Either contract would commence on 1 January 2022.

Exhibit 5: Environmental strategy – provided by Barry Stiles

Reducing environmental impact is a core aim of Demm's business model. Where possible, recycled pulp is used for production, but 23% of Demm's packaging is sold to customers in food distribution, where regulations do not permit the use of recycled paper packaging.

To reduce environmental impact, Demm operates a circular production model, where it can make, deliver, collect and recycle paper packaging products, all within 20 days.

A key reason for Demm deciding to stop producing plastic packaging on 1 January 2021 was to improve its environmental impact and enhance public and stakeholder perceptions of its activities.

Plastic is widely viewed as more environmentally harmful than paper. Nevertheless, there are also public concerns about environmental impact for all companies operating in the paper industry, including paper packaging. A key aspect of these concerns relates to the non-sustainable destruction of forests to make virgin pulp.

Although there is more to be achieved, the board believes that Demm is making significant efforts to improve its environmental impact. However, Demm has possibly not communicated its progress to shareholders and other stakeholders as well as it should have done.

The CEO has suggested that Demm would benefit from having an environmental audit provided by an external assurance firm. She al so suggested that a small number of environmental key performance indicators should be developed that can measure Demm's progress on reducing environmental impact and which are capable of being audited.

Exhibit 6: Instructions from Barry Stiles

I would like you to prepare a report for the board addressing the following matters.

1.

(a) Explain and evaluate the benefits and risks of investing in the new AI machinery (Exhibit 3A). Provide a reasoned recommendation that takes account of relevant financial and non-financial issues. Show supporting calculations, including the probability of generating a negative expected NPV.

Ignore the possibility of a new market entrant (Exhibit 3B).

(b) Explain how your evaluation in 1.(a) would change when Demm becomes aware of the possibility of Hagg as a new market entrant (Exhibit 3B). Provide reasoned advice to the directors about the decision they should now take regarding the investment in the new AI machinery. Show revised calculations.

(c) Assume that Demm invests in the new AI machinery on 1 January 2022, at a cost of £95 million and Hagg enters the market in December 2022.

Explain the financial reporting treatment of the AI machinery in Demm's financial statements for the year ending 31 December 2022. Show supporting calculations. State any assumptions.

2. Provide reasoned advice to the Demm board regarding which of the two mutually exclusive sales contracts should be accepted (Exhibit 4). Consider financial and non-financial factors. Show supporting calculations which evaluate returns and risks.

3. In respect of Demm's environmental activities:
   (a) explain the benefits of the proposed environmental audit engagement for Demm;
   (b) identify and justify KPIs for Demm to measure its environmental impact; and
   (c) set out assurance procedures that would reliably evidence these KPIs.

Question 2

Assume the date is 1 November 2021

Rudder plc is a listed construction company.

You are Amy Arnside, a senior working for Harris & Harland LLP (HH), a firm of ICAEW Chartered Accountants. Rudder is a new client of HH, but it is not an audit client.

You receive the following email from Elley Chan, a manager at HH.

To:	Amy Arnside
From:	Elley Chan
Date:	1 November 2021
Subject:	Rudder plc

"HH has been engaged to provide advice to Rudder. I am the engagement manager and you have been assigned to my team.

"Last week, I met the Rudder board and they provided background notes on Rudder, together with forecast financial information (**Exhibit 1**).

"The Rudder finance director, Henry Khan, explained that Rudder has an opportunity to purchase a prime piece of land for development at a price below its market value. Details are given in extracts from the Rudder board minutes (**Exhibit 2**). The Rudder board is now considering how the land purchase might be financed and would like advice on this matter from HH. Henry has provided a briefing paper which sets out the available methods of borrowing for Rudder to finance the land purchase (**Exhibit 3**).

"Janet Johansen, Rudder's CEO, raised a further matter which related to the dividend for the year ending 31 December 2021. Some of Rudder's directors believe that the dividend for 2021 should be cancelled to provide part of the finance for the land purchase. Other directors want to maintain the dividend at the same level as last year. Janet has provided briefing notes about this matter (**Exhibit 4**).

"A potential ethical issue has been highlighted to me in confidence by Janet. I have provided you with notes regarding this matter (**Exhibit 5**).

"I have set out instructions in a separate document (**Exhibit 6**) explaining what I would like you to do."

Requirement

Respond to the instructions from the engagement manager, Elley Chan (Exhibit 6).

Total: 45 marks

Exhibit 1: Company background and forecast financial information – provided by the Rudder board

Operations and markets

Rudder specialises in constructing buildings on industrial sites and large retail sites. Nearly all of its operations are in the UK.

Typically, Rudder will have six to eight large projects at UK sites under active construction at the same time. Each project can take from two to four years to complete.

In addition to active projects, Rudder owns four separate pieces of land held as a landbank. These are areas of land that have been purchased and are being held for varying periods (normally up to two years) before construction work on them commences.

The year ending 31 December 2021 is proving difficult for Rudder. In February 2021, Rudder won a major new contract for a site in York, in the North of England, but market conditions are difficult and worsened in the second half of 2021. As a result, Rudder's profits and share price have fallen during 2021 and future cash flows are uncertain.

Although operating profits are expected to remain at 2021 levels over the next two years, the Rudder directors believe that the company is well placed to recover and experience strong growth in the long term.

Expected shareholdings at 31 December 2021

Shareholder group	Comment	Shares in millions
Pension funds	No single pension fund owns more than 3 million Rudder shares.	46
Insurance companies	Four insurance companies own Rudder shares. Each holding is over 3 million shares.	15
Private equity	Two private equity investors. Each own 14 million shares.	28
Individuals	Approximately 12,000 private individuals hold shares in Rudder.	10
Directors	Five directors own shares in Rudder. Their holdings range from 160,000 shares held by the marketing director to 305,000 shares held by the CEO.	1
Total share capital (£1 ordinary shares)		**100**

Forecast financial information – prepared by Henry Khan, the finance director

Extracts from forecast statement of profit or loss for year ending 31 December 2021

	£m
Revenue	1,476
Operating profit	46
Finance costs (including £11.2m interest on borrowings)	(14)
Profit before tax	32
Taxation	(9)
Profit after tax	23

Extracts from forecast statement of financial position at 31 December 2021

	£m
Non-current assets	
Property, plant and equipment	305
Current assets	
Inventories (including landbank £243m)	587
Cash	8
Other current assets	172
Total assets	1,072
Equity	
Ordinary share capital – £1 shares	100
Retained earnings	247
Other reserves	150
Total equity	497
Non-current liabilities	
Borrowings (Note)	351
Other	71
Current liabilities	153
Total equity and liabilities	1,072

Note:

Borrowings comprise:

	Nominal amount £m	Carrying amount £m	Redemption date
3.5% Bank loan	190	190	June 2024
2.8% Bonds	165	161	May 2029
Total	**355**	**351**	

The principal amounts of the borrowings are repayable in full on the redemption date.

The borrowings are recognised at amortised cost in Rudder's financial statements.

No dividend for 2021 has been recognised in the above extracts.

The current Rudder price per share was £10.03 on 1 November 2021 and it is forecast that this price will be approximately the same on 31 December 2021.

Exhibit 2: Purchase of land − extracts from Rudder board minutes for meeting held on 15th October 2021

The board discussed the purchase of a prime piece of land ('the land') which is suitable for building a retail site or industrial site.

Operations director, Wendy West:

Wendy stated that Rudder is able to purchase the land for £120 million if it can act quickly and complete the deal in January 2022. She believes that the land is worth significantly more than £120 million and that the landowner is keen to sell quickly. However, Wendy stated that Rudder will not be able to start construction on the land until the end of 2024 and the land will be held in the landbank until that time.

Finance director, Henry Khan:

Henry stated that Rudder is not able to raise new equity finance at such short notice and, even if it were, equity markets are not currently favourable for a new share issue. To raise the £120 million to purchase the land, Rudder will therefore need to borrow. Henry provided briefing notes outlining the available methods of borrowing to finance the land purchase (**Exhibit 3**). However, Henry stated that it would not be possible to raise the £120 million using just one of these methods.

CEO, Janet Johansen

Janet stated that the amount of borrowing required to finance the land purchase could be reduced by cancelling the 2021 dividend. Janet agreed to provide briefing notes to consider a dividend cancellation (**Exhibit 4**).

Board resolution

Board members all agreed to purchase the land. A decision still needs to be made by the Board on the best methods of financing.

Exhibit 3: Briefing paper on methods of borrowing to finance the purchase of land – prepared by Henry Khan, finance director

We need to raise £120 million to finance the land purchase.

More than one method of borrowing will be required, so we need to consider the most appropriate mix of borrowing from various lenders.

Rudder's existing debt has loan covenants, but none that would prevent £120 million of new borrowing.

All borrowing will commence on 1 January 2022.

The five available methods of borrowing that I have identified are as follows.

<u>Method 1: Loan – Alsopp Bank</u>

A loan, up to a maximum of £40 million, is available at a fixed interest rate of 4% per annum. The principal amount of the loan is repayable in full at the end of four years. This loan contains a covenant stating that if the interest cover ratio for Rudder falls below 3 in the annual financial statements, then the annual interest rate on the loan will increase by 50 basis points, to 4.5%, for the following financial year and for all remaining years of the loan.

<u>Method 2: Loan – Swiss Bank</u>

A Swiss franc (CHF) denominated loan is available, up to a maximum of CHF48 million. The loan has a fixed interest rate of 1.2% per annum. The principal amount of the loan is repayable in full at the end of four years. The forecast exchange rate, at 31 December 2021, is £1 = CHF1.2

<u>Method 3: Loan – Carstairs Bank</u>

A loan, up to a maximum of £60 million, is available at a variable interest rate. The principal amount of the loan is repayable in full at the end of four years. The annual interest rate would be:

- the annual yield on a recently issued 10-year government bond (ie, gilt)
- plus 300 basis points (ie, 3%).

At 1 January 2022, the 10-year gilt yield is expected to be 0.4% per annum.
The interest rate on the loan would be reset annually at 1 January.

<u>Method 4: Bank loan repayable by instalments</u>

A loan is available from a UK investment bank for a fixed amount of £40 million. Repayment is by four equal annual instalments of principal and interest of £11,019,000. The first instalment would be payable on 31 December 2022.

Method 5: Corporate bonds

Corporate bonds up to a maximum of £60 million, would be issued at par. The nominal interest, payable annually in arrears, would be 1% per annum. The bonds would be redeemable at a premium of 10% above par on 31 December 2025. Transaction costs would be 2% of the nominal amount issued, payable on the issue date.

General notes and key considerations

All five methods of borrowing have a fixed charge over the newly purchased land and a floating charge over all other assets.

There would be minimal transaction costs for any of the four bank loans (Methods 1 to 4).

I am concerned about all types of risk. In particular, I am concerned about the impact of any changes in market interest rates over the next four years.

I also need to understand the impact of each method of borrowing on Rudder's financial statements.

I will obtain tax advice later, so tax effects can be ignored for now.

Summary

Advice is required on each individual borrowing method. However, we also need advice to select the most appropriate mix of borrowing methods to raise the £120 million to finance the land purchase. Overall, I want to use only two or three of the five available borrowing methods.

Exhibit 4: Briefing notes to consider a dividend cancellation – prepared by Janet Johansen, CEO

In the past, the Rudder board has increased the dividend each year, in the belief that this is what most shareholders prefer.

Rudder's recent dividend history is as follows:

Year	Total dividend
2018	£37.64m
2019	£38.80m
2020	£40.00m

The number of shares in issue has not changed in the last four years.

At a board meeting in September 2021, the directors made a provisional decision to maintain the dividend at £40 million for 2021. However, the board is now reconsidering this decision. The 2021 dividend could be cancelled to help finance the purchase of the land, by reducing the new borrowing needed.

Following the October 2021 board meeting, I have consulted the directors and have received two strong views about whether to pay a dividend.

The operations director, Wendy West, is in favour of paying the £40 million dividend for 2021 as originally planned. She provided the following view in her email:

> "We have always paid a dividend and it is just not fair to take this away from shareholders. I think that the share price will fall dramatically if we announce a dividend cancellation. We can clearly afford to pay the dividend out of the retained earnings of £247 million. If we do not do so, shareholder groups will want to know why. The AGM will be an uncomfortable experience for the board if there is a cancellation of the 2021 dividend."

In his email, the finance director, Henry Khan, took a different view:

> "We have already agreed to purchase the land, so we need to raise £120 million, but we should not borrow more than this. Given the recent financial performance and the uncertain market conditions, Rudder needs to preserve its cash rather than pay a dividend.
>
> "We need to take into account financial risk and the interests of all stakeholders."

Summary

The opinion of the board is divided between cancelling the 2021 dividend or maintaining it at the 2020 level of £40 million. There is no support from any director for paying a reduced dividend or an increased dividend, so these choices are not to be considered.

The board needs to take professional advice from HH.

Exhibit 5: Potential ethical issue – prepared by Janet Johansen, CEO [CONFIDENTIAL]

Last week, I received the following anonymous voicemail from someone who said he was a financial analyst working for an investment bank:

> "I want to warn you about your marketing director, Matt Tarkle. We met at a conference on 9 August 2021. In an informal conversation he suggested to me that Rudder was performing well and that it was about to release some good news to the financial markets, which could increase its share price.
>
> "I followed Matt's advice and recommended that some of my major clients buy Rudder shares, only to find a few weeks later that bad news was released by Rudder and its share price fell. My clients were unhappy and I am at risk of losing my bonus, or even my job!"

As our advisors, I would like HH's opinion on this matter.

I am concerned about Matt's wider conduct in this matter. I have also looked into Matt's buying and selling of his own shares in Rudder. Whilst it might be appropriate for Matt to buy and sell his Rudder shares, I am concerned about the ethics of this behaviour.

I do not want to say any more at this stage, as I have not yet discussed this matter with Matt or the other directors. However, I have prepared the schedule below showing Matt's trading in Rudder shares over the past year and some key events for Rudder.

I will ask our lawyers to look into the legal and regulatory aspects of Matt's trading, so you do not need to decide whether Matt's actions are legal. However, I would be interested in your advice on the actions that I should take, depending on whether Matt is deemed to have acted legally or illegally.

I would also like HH to consider the ethical aspects of Matt's behaviour and his professional conduct as a director.

Event	Date	Share price at end of day's trading	Share price movement on the day of the event
Rudder wins major new building contract in York. The board agreed that this would be kept confidential until publicly announced (see below).	12 February 2021	£12.48	£0.10 up
Matt buys 27,000 shares in Rudder.	16 February 2021	£12.67	£0.20 up
Rudder publicly announces winning new contract in York.	19 February 2021	£14.33	£1.40 up

Matt's conversation with anonymous financial analyst.	9 August 2021	£13.03	£0.01 up
Matt sells 32,000 shares in Rudder.	16 August 2021	£13.32	£0.30 down
Rudder publicly announces a profit warning for 2021 financial year.	6 September 2021	£10.11	£2.60 down

On 31 December 2020, the Rudder share price was £12.50.

Exhibit 6: Instructions - prepared by Elley Chan, HH engagement manager

1. Advise the board on how Rudder should raise £120 million to finance the purchase of the new land (Exhibit 2) by selecting a mix of borrowing from the five available methods (Exhibit 3). In so doing:

   (a) Evaluate each method of borrowing by:
   - calculating the annual effective interest rate (where possible) and explaining the cost of borrowing;
   - assessing the risks; and
   - setting out and explaining the financial reporting treatment in Rudder's financial statements for the year ending 31 December 2022.

   (b) Recommend and justify the most appropriate mix of borrowing methods to raise the £120 million. Select a mix of two or three of the five available methods of borrowing.

<u>Notes</u>

- Ignore the possible cancellation of Rudder's dividend for the year ending 31 December 2021 (Exhibit 4).
- Ignore tax.
- Use all relevant available information.

2. Provide reasoned advice for the Rudder board on whether the 2021 dividend should be cancelled (Exhibit 4). In so doing, evaluate the comments of the operations director and the finance director. Use all relevant available information.

3. Set out any ethical issues for Rudder and Matt Tarkle, the marketing director, arising from the matters described by the CEO (Exhibit 5). Recommend the actions that the CEO should take, depending on whether Matt is deemed to have acted legally or illegally.