ADVANCED LEVEL EXAMINATION

TUESDAY 7 NOVEMBER 2017

(3½ HOURS)

STRATEGIC BUSINESS MANAGEMENT

This paper consists of **TWO** questions (100 marks).

1. Ensure your candidate details are on the front of your answer booklet. You will be given time to sign, date and print your name on the answer booklet, and to enter your candidate number on this question paper. You may not write anything else until the exam starts.

2. Answer each question in black ball point pen only.

3. Answers to each question must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.

4. The examiner will take account of the way in which material is presented.

5. When the assessment is declared closed, you must stop writing immediately. If you continue to write (even completing your candidate details on a continuation booklet), it will be classed as misconduct.

The questions in this paper have been prepared on the assumption that candidates do not have a detailed knowledge of the types of organisations to which they relate. No additional credit will be given to candidates displaying such knowledge.

IMPORTANT Question papers contain confidential information and must NOT be removed from the Examination Hall. **DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK**	You MUST enter your candidate number in this box ☐☐☐☐

QUESTION 1

You are an ICAEW Chartered Accountant working for a venture capital firm, Investment Capital Funding (ICF).

ICF specialises in providing finance, in the form of equity and debt capital, for management buy-outs (MBOs). Typically, ICF will aim to hold its investments for three to five years, before selling to make a significant gain. It is currently considering a potential investment in a company called Gemstone Jewellery Ltd (GJ) which owns and operates a chain of retail jewellery shops.

Potential investment in GJ

GJ's entire ordinary share capital is owned by Ultima plc, which is the parent of a large and diverse group of companies.

The board of GJ (the MBO team) entered into preliminary negotiations with Ultima to acquire the entire ordinary share capital of GJ. The MBO team approached ICF and Farmley Bank for advice and finance. Farmley Bank is a large commercial bank.

You report to Alison Brewer, who is the ICF manager responsible for the GJ engagement, and she called you to a meeting.

Meeting

Alison opened the meeting: "I held preliminary meetings with the MBO team and I have provided some background information on GJ, based on these discussions (**Exhibit 1**).

"I have also provided you with the proposed structure for the MBO deal, which is planned to take place on 1 January 2018 (**Exhibit 2**).

"The MBO team prepared some extracts from its business plan, outlining its future strategies for GJ (**Exhibit 3**). It has also prepared forecast financial and operating data (**Exhibit 4**).

"Based on my conversations during the preliminary meetings with the MBO team, it appears that potential ethical issues have arisen with respect to the deal. I have set out some details (**Exhibit 5**).

"There are some potential risks for ICF if we invest in the MBO. We will therefore need financial, commercial and operational due diligence to provide assurance in respect of these risks. However, based on the information currently available, I think that the proposed deal is worth examining more closely."

Instructions from Alison Brewer

"I would like you to draft a report in which you should:

(1) Prepare forecasts of the value of the GJ equity at:
(a) 31 December 2017; and
(b) 31 December 2020
Provide supporting explanations. Use discounted free cash flows and apply the working assumptions in Exhibit 4. Assume that the MBO takes place.

(2) Identify and explain the key potential benefits and risks of the MBO for each of the following stakeholders:
- ICF
- The MBO team
- Farmley Bank.

(3) Set out the key financial, commercial and operational due diligence procedures that should be carried out by the due diligence team acting for ICF.

(4) Explain the financial reporting implications for GJ, if any, arising from each of the strategies identified in Exhibit 3.

(5) Explain the potential ethical issues arising from the matters identified in Exhibit 5. Set out the actions that should be taken by GJ's chief executive (Kevin), its finance director (Geoff) and by ICF in response to these issues."

Requirement

Respond to the instructions from Alison Brewer.

Total: 58 marks

Exhibit 1: GJ company background – prepared by Alison Brewer

GJ operates a chain of 20 shops, selling jewellery in the mid-market to up-market range. GJ owns the freehold of all of these shops, which are similar in size and value.

GJ manufactures, in its own workshop, about 10% of the jewellery that it sells. This enables GJ to make high-quality items according to customers' individual specifications. These items have a higher price than the other jewellery that GJ sells, but they are less profitable per item. However, they enhance the company's reputation.

The remaining 90% of the jewellery that GJ sells is purchased from wholesalers and other jewellery manufacturers.

GJ no longer fits into the strategic plans of Ultima. For the past year, the Ultima board has been seeking to sell GJ's entire ordinary share capital, but it has not been successful.

In September 2017, the GJ board became aware that Ultima was having difficulty in finding a buyer for GJ. As a result, they entered into negotiations with the Ultima board to assess the feasibility of an MBO.

The Ultima board and the GJ board have now reached agreement in principle on the terms for an MBO. However, the GJ board has limited personal finance available, so it is seeking financial backing from Farmley Bank and from ICF.

Brief biographies of the GJ board (the MBO team) are as follows:

- Kevin Parsons (chief executive)
  He has a wide range of experience in senior roles in retailing and leads the MBO team. He has been GJ's chief executive for 7 years, after joining from a rival company.

- Geoff Boyne (finance director)
  He is an ICAEW Chartered Accountant. He has been central to the discussions with Ultima and negotiated the provisional financial terms of the MBO. He has worked in different Ultima subsidiaries for 30 years, but has worked for GJ for only the past two years.

- Sally Bothan (operations director)
  She has worked in the role of operations director for 10 years and is responsible for jewellery manufacture in GJ's workshop. She has experience in this type of role, having previously worked for a number of jewellery manufacturing companies.

- Gail Gao (marketing director)
  Gail has worked part-time for GJ for the past 5 years. She is also responsible for the Ultima group marketing strategy, which is centralised. She intends to work full-time for GJ after the MBO.

Exhibit 2: Proposed MBO deal structure – prepared by Alison Brewer

The proposed consideration for the acquisition of GJ, payable to Ultima, will total £40 million.

It would be made up as follows:

Source of finance	**Amount**	**Comment**
Management team equity	£1 million	Management will own 10% of the ordinary share capital in GJ.
Venture capital equity (ICF)	£9 million	ICF will own 90% of the ordinary share capital in GJ.
Bank senior debt (Farmley Bank)	£18 million	This debt will carry an annual interest rate of 6% and is repayable on 1 January 2021. This debt will rank equally with the £1.5 million existing loan from GJ's bank, Roatt Bank plc.
Venture capital – subordinated debt (ICF)	£10 million	This debt will rank below the Farmley Bank and Roatt Bank debt. It will carry an annual interest rate of 9% and is repayable on 1 January 2021.
Deferred consideration	£2 million	This additional amount needs to be paid to Ultima by GJ shareholders on 31 December 2018.
Total consideration	**£40 million**	Total payable to Ultima.

Notes:

- On 1 January 2018, the four members of the MBO team would each pay £250,000 to buy shares in GJ.
- Any debt owing to Farmley Bank or to ICF which has not been repaid from free cash flows by 1 January 2021 would need to be refinanced with new debt on that date.
- ICF aims to make an average annual return of at least 35% over the life of its investment in MBOs.

Exhibit 3: Extract from business plan – prepared by MBO team

The MBO team has a three-year plan from 1 January 2018 to increase the value of the GJ shares, obtain an AIM listing and then exit their investment through selling their shares on AIM on 31 December 2020.

Business strategy

The MBO team believes that GJ's manufacturing workshop is not making enough profit to justify its continued existence. It intends to sell the workshop on 1 January 2018 for £3 million and use the entire proceeds to refurbish and upgrade all 20 shops. The MBO team believes that after the refurbishment, customers will perceive GJ as more up-market. As a result, selling prices could be increased by 5% each year from 2018 until 2020.

The workshop has been fully depreciated in the financial statements for some years.

Following the sale of the workshop, GJ would no longer be able to satisfy requests to make jewellery to individual customer specifications. In order to replace this type of jewellery, GJ will buy equivalent high-quality jewellery from other jewellery manufacturers.

Strategies to generate cash

A key aspect of the financial strategy over the next three years will be to generate increased cash flows to repay debt at 31 December 2020.

The key strategies to generate cash are:

<u>Sale and leaseback of retail outlets</u>

It is proposed that, on 1 January 2018, five of the 20 shops will be sold and leased back. The following details, at 1 January 2018, relate to the five shops in total:

Carrying amount	£3.2 million
Fair value	£4.3 million
Proceeds	£5.5 million

The lease period will be eight years and the total annual rental for the five shops will be £550,000, payable on 31 December each year, commencing 31 December 2018. The rental is above the normal market rental for this type of property. The lessor will retain the properties at the end of this lease period.

Cost reductions

The MBO team planned the following annual reductions in operating costs, compared with the year ending 31 December 2017. They expect these annual cost savings to be sustained indefinitely after 2018.

Cost type	**Cost saving for 2018**	**Explanation**
Staff costs	£600,000	Staff numbers at each shop will be reduced by one employee. There will also be the loss of some headquarters administrative staff. This lower level of staff will be maintained in future years. Redundancy costs are expected to be insignificant as staff turnover is high. No inflation increases in wages and salaries are expected.
Purchases of jewellery	£1,400,000	The quality of gemstones and precious metals is to be reduced in order to decrease purchase costs. The quality will be held at this lower level for future years.
Central service payments to Ultima	£1,000,000	Removal of head office central service payments currently being made to Ultima for marketing, human resources and other administrative services which have been supplied centrally.
Total	**£3,000,000**	

Improved inventory management

Inventory management will be improved immediately following the MBO. As a result, the value of inventory held in shops will be 25% lower than at 31 December 2017 and will then be held at this lower level for the foreseeable future.

Exhibit 4: Forecast financial and operating data – prepared by GJ board

Extracts from forecast statement of profit or loss for the year ending 31 December 2017

	£'000
Revenue	60,000
Operating costs (excluding depreciation)	(53,580)
Depreciation	(500)
Operating profit	**5,920**

Tax is based on accounting profit and is charged at 20%.

Extracts from forecast statement of financial position at 31 December 2017

	£'000
Property, plant and equipment	12,800
Inventories	1,800
Trade receivables	400
Assets	**15,000**
Non-current liabilities	
5% Roatt Bank plc loan (repayable 2025)	1,500
Current liabilities	4,800
Ordinary shares (£1)	1,000
Retained earnings	7,700
Liabilities and equity	**15,000**

Working assumptions for the MBO

- The MBO will take place on 1 January 2018.
- All of the actions in Exhibit 3 will be implemented as planned.
- No changes in working capital other than those in Exhibit 3 will be required.
- Revenue will increase by 5% in the year ending 31 December 2018 compared with the year ending 31 December 2017. Revenue will continue to increase at 5% per annum up to and including the year ending 31 December 2020. It will then remain at the 2020 level indefinitely. The revenue increases are due to selling price increases.
- The appropriate risk adjusted discount rate is 10% per annum.
- No dividends will be paid.
- Capital expenditure will be maintained at £50,000 per annum for the foreseeable future. This is in addition to the initial £3 million refurbishment of the 20 shops (Exhibit 3).

- Depreciation for each owned shop will remain at the same level as for the year ending 31 December 2017. However, from 1 January 2018, there will be additional annual depreciation of £300,000 on the refurbishment cost.

- The tax rate is based on accounting profit and will remain at 20%.

- Surplus free cash flows generated over the three-year period to 1 January 2021 will be used to reduce the Farmley Bank debt and ICF debt on that date.

If an MBO does not take place, annual revenue and operating costs will remain at the same levels as for the year ending 31 December 2017 for an indefinite period.

Exhibit 5: Potential ethical issues – prepared by Alison Brewer

Geoff Boyne, the GJ finance director, informed the other three GJ directors that, after the MBO takes place, he wishes to work only part-time as GJ's finance director. Geoff expressed a strong wish to remain as part of the MBO team and, like the other three directors, is willing to contribute £250,000 to acquire shares in GJ. Geoff has not informed the other directors of any other roles he will be taking up.

Yesterday, Kevin Parsons, the GJ chief executive, was having informal discussions with the Ultima CEO. Kevin was told that Geoff is in the process of arranging a new contract with Ultima, to work as a part-time consultant for Ultima from March 2018. This will utilise all the remainder of his working time not spent at GJ.

The Ultima CEO told Kevin that Geoff intended to announce his new contract with Ultima to the other three GJ directors, but only after the MBO deal is signed. He said this was because Geoff did not want it to influence the MBO negotiations.

QUESTION 2

Hayfield plc manufactures high-quality heavy equipment for the construction industry, including mechanical diggers, bulldozers, excavators and cranes. Its only factory is based in the UK.

You are a junior manager working for Ball, Brown & Birkett LLP (BBB), a firm of ICAEW Chartered Accountants. Hayfield is a client of BBB, but not an audit client.

Anita Lipton, the chief executive of Hayfield, sent the following email to David Rook, a partner in BBB.

> David
>
> I am emailing you on behalf of the board. Our finance director is currently on sick leave. We do not have anybody else with sufficient experience to evaluate some important issues which the board needs to address urgently.
>
> I have attached some background information about the industry and the company (**Exhibit 1**). I am concerned about the following:
>
> <u>Operational performance</u>
>
> Profit for the year ended 30 September 2017 was significantly below the level we expected when we set the budget.
>
> The board understands some of the factors which may have caused the decline in profit. However, it is not clear why profit was so far below the budgeted level for the year ended 30 September 2017.
>
> I have attached extracts from our management information pack together with a request for advice (**Exhibit 2**).
>
> <u>Expansion plan</u>
>
> To increase future profit, the board wants to expand into new markets and set up a new factory producing tractors in South Africa.
>
> I have attached more information on this plan, together with a request for advice (**Exhibit 3**).

Instructions from David

David forwarded Anita's email to you, including the three attachments (Exhibits 1, 2 and 3).

He asked you to draft a response to Anita's requests for advice which are set out in Exhibit 2 and Exhibit 3.

Requirement

Respond to the instructions from David.

Total: 42 marks

Exhibit 1 – Industry and company background information

Industry background

The construction equipment industry is dominated by a few major international companies. Hayfield is much smaller than these companies, but it has a good reputation for producing high-quality, durable and technologically-advanced heavy equipment and for providing good customer service. Hayfield's equipment is priced above the industry average.

Company history and production

Hayfield was established in 1954 and obtained a listing on the London Stock Exchange in 1988.

It manufactures a range of heavy equipment for the construction industry. This includes: mechanical diggers, bulldozers, excavators and cranes. There are a number of different models of each product, varying in size, power and price.

Each model is produced to a standard specification, which Hayfield then adapts to an individual customer's needs. As a result, a separate price is determined for each order based on the model type and customer specifications. It normally takes an average of two months from order to delivery. Few finished goods inventories are held by Hayfield.

Each unit produced requires one engine. Engines are imported from the US and paid for in US$ ($). All other costs are incurred in £ sterling.

Sales

Over 50 different models are made and the sales mix has remained constant over time. Production and sales volumes are constant over the year.

About a quarter of Hayfield's sales are in the UK, denominated in £ sterling. The remainder of Hayfield's sales are in the Eurozone, denominated in euro (€). The product sales mix is similar in both markets, which have become increasingly competitive in recent years.

Management information and budgeting

Management information for the year ended 30 September 2017, (Exhibit 2) was recently made available. The budget for the year ended 30 September 2017 was based on forecasts originally made in July 2016 and was not updated.

Exhibit 2 – Extracts from management information pack for the year ended 30 September 2017

Financial data	Note	Actual £m	Budget £m
Revenue:			
UK sales		211.2	240.0
Eurozone sales		712.7	806.4
		923.9	1,046.4
Cost of sales:			
Variable production costs:			
Purchase of engines		(156.0)	(153.6)
Other variable production costs	(1)	(257.4)	(345.6)
Fixed production costs	(1)	(265.0)	(240.0)
Cost of sales		(678.4)	(739.2)
Gross profit		245.5	307.2
Distribution and administration costs		(170.0)	(175.0)
Operating profit		75.5	132.2
Other gains and losses:			
Loss made from foreign currency hedging	(2)	(10.8)	-

Operating data

	Actual	Budget
Number of units sold:		
UK	4,400	4,800
Eurozone	11,200	14,400
Average exchange rates for year ended 30 September 2017:		
US Dollars	£1 = $1.20	£1 = $1.50
Euro	£1 = €1.10	£1 = €1.25
Cost per engine	$12,000	$12,000

Notes

(1) New automated production technology, introduced on 1 January 2017, increased fixed production costs by £24 million per year from this date. However, it also reduced variable production costs by an average of £2,000 per unit from 1 January 2017. These changes were not included in the budget as they could not be estimated accurately when the budget was set.

(2) Hayfield's treasury department hedges some of its foreign currency risks using forward currency contracts in respect of a proportion of:

- expected receipts of € from customers over the forthcoming 18 months on a rolling basis
- future payments for engines made in $ over the forthcoming 6 months on a rolling basis

The treasury department hedges only a proportion of its foreign currency receipts and payments, as the objective is to mitigate some of the foreign currency risk, rather than attempt to remove all of it. The budget for the year ended 30 September 2017 did not try to predict either favourable or adverse currency movements.

The loss on foreign currency hedging of £10.8 million is the balance on a foreign currency suspense account. This has been used to record all changes in the fair values of forward foreign currency contracts that occurred during the year ended 30 September 2017. All forward contracts held at 30 September 2017 have been adjusted to fair value at that date.

Request for advice

I would like BBB to do the following:

(a) Prepare:

- a statement which reconciles actual operating profit and budgeted operating profit for the year ended 30 September 2017, showing clearly the financial impact of changes in each of the following reconciling factors:
    - Automation
    - Sales volume
    - Price
    - Foreign exchange
    - Fixed costs (excluding effects from automation)
    - Distribution and administration costs.

- notes for the board which explain each of the reconciling factors and a conclusion explaining why the overall actual operating profit was less than budget operating profit.

(b) Explain, as far as the available information permits:

- why a loss was made on foreign currency hedging contracts.

- how the loss of £10.8 million made from foreign currency hedging should be recognised, measured and presented in Hayfield's published financial statements for the year ended 30 September 2017.

Exhibit 3 – Expansion plan

The Hayfield board wants to set up a new production facility in South Africa to build tractors for the agricultural industry. Hayfield does not currently build tractors or other agricultural machinery in its UK factory, but the production of tractors is similar to the production of construction equipment.

The tractors will be basic models with fewer features and less technology than existing construction equipment made in the UK. It is expected that the labour and other production costs will be lower in South Africa than in the UK. Tractor engines would be sourced locally in South Africa.

As a result of lower production costs, the Hayfield board expects to be able to sell tractors built in South Africa at a low average price, equivalent to about £25,000. The target market is large farming businesses in Africa, South Asia and South America.

The board believes that this expansion would compensate for the decline in sales in the UK and Eurozone markets.

Two alternative strategies have been identified for the expansion plan:

(1) Enter into a joint venture with a South African company.
(2) Set up a new subsidiary which would operate independently in South Africa.

(1) <u>A joint venture</u>

Under this proposal, Hayfield will enter into a joint venture with a South African company.

Initial negotiations have taken place with Cape Trucks and Buses (CTB), a well-established company which builds trucks and buses in South Africa and sells them throughout Africa. CTB does not manufacture products for the agricultural industry.

While the details are still to be finalised, the following have been identified as key elements of a potential joint venture agreement:

- CTB will provide the land, factory building and production labour. CTB's existing supply chain will be used.
- Hayfield will buy the plant and equipment at a cost of about £38 million. It will also provide marketing and operations management expertise.
- Profits will be shared equally between CTB and Hayfield.
- Rights to individual assets will be retained by the venturer which purchased them.
- It is not intended to set up a separate joint venture company. Instead, the arrangement will be based on a contractual agreement which will determine the rights and obligations of CTB and Hayfield. The initial contract will be for five years, but may be extended.
- Key decisions can be taken only with the consent of both parties.

The Hayfield board is concerned that, if the joint venture goes ahead, there will be risks relating to business trust arising from dealing with a new and unknown business partner. These include concerns about determining the profit to be shared between the venturers and compliance with the terms of the joint venture agreement.

(2) <u>A new subsidiary</u>

Under this proposal, Hayfield will set up a new subsidiary, AgriMech South Africa Ltd (AMSA). AMSA will acquire, and operate autonomously, a factory in South Africa. The share capital of AMSA will be small, so Hayfield will make a £ sterling-denominated loan of £55 million to AMSA to finance the purchase of a factory and production facilities.

Request for advice

(a) Compare and evaluate the two alternative strategies for expanding into South Africa, indicating the potential benefits and risks of each. Recommend and justify the preferred strategy. Ignore financial reporting considerations for this purpose.

(b) Explain the appropriate financial reporting treatment in Hayfield's financial statements for each of the two alternative strategies for expansion.

(c) Assuming that the board decides to engage in a joint venture with CTB, explain the assurance risks that arise for Hayfield and identify the assurance procedures that BBB could undertake to help Hayfield mitigate these risks.