MARK PLAN AND EXAMINER'S COMMENTARY – SBM November 2017

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 - Gemstone Jewellery Ltd

Scenario

The candidate is in the role of working for a venture capital firm, ICF, specialising in providing finance for MBOs in the form of equity and debt capital.

The potential client in the scenario is the management team for a company, GJ, which owns and operates a chain of retail jewellery shops. The management team wishes to acquire the entire ordinary share capital of GJ. It has approached ICF and Farmley Bank for advice and finance.

Candidates are provided with: a proposed structure for an MBO deal; extracts from a business plan outlining future strategies for GJ; and financial and operating data.

A potential ethical issue has arisen with respect to the role of the FD (who is a member of the buy-out team) in the parent company after the MBO deal.

Candidates are required to:

- prepare a forecast for the value of the equity of GJ at two different dates, with supporting explanations
- explain the key potential benefits and risks of the MBO for key stakeholders
- set out the key financial, commercial and operational due diligence procedures
- explain the financial reporting implications for GJ arising from each of the strategies identified
- set out the potential ethical issues arising from the matter identified and state appropriate actions.

Requirements	Technical & Skills	Skills assessed
Prepare a forecast of the value of the GJ equity at 31 December 2017 and 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.	22	• Analyse and assimilate the data provided in a structured manner (eg a table) • Carry out data analysis to identify relevant cash flows • Make adjustments for sale and leaseback of workshop. • Determine free cash flows • Apply appropriate discounting techniques • Use judgement to identify equity value • Demonstrate a clear understanding of key issues of valuation with supporting explanations.
Identify and explain the key potential benefits and risks of the MBO for each of the following stakeholders: • ICF • The MBO team • Farmley Bank.	12	• Use judgement to identify the perspective of each stakeholder group • Assimilate qualitative and quantitative data provided • Identify and explain relevant benefits • Identify and explain relevant risks • Provide reasoned and balanced recommendations
Set out the key financial, commercial and operational due diligence procedures that should be carried out by the due diligence team acting for ICF.	7	• Assimilate the information to provide a structured response for each type of due diligence procedure • Use judgement to determine due diligence procedures which are appropriate to the circumstances and objectives
Explain the financial reporting implications for GJ, if any, arising from each of the strategies identified in Exhibit 3.	8	• Identify and explain the key financial reporting issues • Set out the financial reporting issues for sale and leaseback • Set out the financial reporting issues for sale of workshop, refurbishment and inventory management
Set out the potential ethical issues arising from the matter identified in Exhibit 5. Explain the actions that should be taken by GJ's chief executive (Kevin), its finance director (Geoff) and by ICF in response to these issues.	9	• Use ethical language and principles • Identify transparency, conflict of interest and self-interest as key issues. • Identify key ethical issues for individual directors and their legal duties • Link ethical issues with governance issues. • Assess issues relating to timing of disclosure. • Set out the actions to be taken by relevant parties.
Maximum marks	**58**	

Question 1 – Gemstone Jewellery Ltd

1.1 Forecast value of the equity – Free cash flows

	Current year 2017	**2018**	**2019**	**2020**
	£000	**£000**	**£000**	**£000**
Revenue		63,000	66,150	69,458
Operating costs (excluding depreciation) (£53.58m - £3m)		50,580	50,580	50,580
Rental cost (accruals basis – see below) (550 – 150)		400	400	400
EBITDA		12,020	15,170	18,478
Depreciation [(500 x 15/20) + 300)]		675	675	675
EBIT		11,345	14,495	17,803
Tax at 20%		2,269	2,899	3,561
Profit after tax		9,076	11,596	14,242
Add depreciation		675	675	675
Less Capex		(50)	(50)	(50)
Additional cash rental (see above) (550 - 400)		(150)	(150)	(150)
	At 1 January 2018			
Working capital saving	450			
Leaseback proceeds	5,500			
Deferred consideration		(2,000)		
Sale of workshop	3,000			
Initial refurbishment	(3,000)			
Free cash flow	**5,950**	**7,551**	**12,071**	**14,717**
Bal b/f	0	5,950	13,501	25,572
Bal c/f (cash free acquisition for 2017)	5,950	13,501	25,572	40,289
DF	1.0	0.909	0.826	0.751
PV FCF	**5,950**	**6,865**	**9,976**	**11,057**
Terminal value (14,717/0.1)				147,170
PV of TV (147,170 x 0.751)				**110,571**
Enterprise value at 31 Dec 2017	**144,419**			
Debt - existing	(1,500)			
Debt - Farmley	(18,000)			
Debt - ICF	(10,000)			
Equity value at 31 Dec 2017	**114,919**			

At 31 December 2017, the enterprise value is £144.419m and the value of the equity is £114.919m. The consideration therefore looks reasonable if the revenue growth and cost savings can be delivered.

The free cash flow valuation method

The valuation of an enterprise, based on discounting future free cash flows, determines a total value for equity and debt (enterprise value). From a valuation perspective, the normalised cash flow and earnings figures are used together to estimate the free cash flows of a business. It is the free cash flow that is discounted to deduce an enterprise value for the business before deducting the value of debt to obtain an equity value.

The annual discount rate of 10% is the weighted average cost of capital which is appropriate to the enterprise value as it considers the risk of all cash flows (ie flows to equity and debt).

The free cash flow method of determining the value of the equity is sufficiently flexible to allow for a period of temporary growth, followed by a perpetuity period of EBIT without growth. However, a concern is the sustainability of the cash flows in perpetuity beyond 2020, or indeed beyond a reasonable time horizon where markets may change.

In common with other valuation methods, it is dependent on the forecasts being reliable and the discount rate being appropriate and stable over time. This means that the working assumptions need to be valid, which is questioned further below.

Revenue

Revenue is assumed to grow at 5% per year. This is a fundamental assumption as it drives much of the increase in value of the equity from the MBO.

The PV of the previous revenue stream (which is assumed to be constant) under Ultima is:

£60m/0.1 = £600m

The PV of the forecast revenue stream under the MBO (with 5% pa growth) is:

(£63m/1.1) + (£66.15m/1.1^2) + ((£69.458m/0.1)/ 1.1^2 = £685.97m

Thus, there is a very substantial increase of £85.97m in the value of the enterprise arising from the forecast increase in the revenue stream over the three-year time horizon.

Cost savings

The cash cost savings further add to the increased valuation at 31 December 2020.

These comprise:

Cost type	Change pa £
Staff costs	600,000
Purchases of jewellery	1,400,000
Central service payments to Ultima	1,000,000
Less	
Increased rentals (accruals basis)	(400,000)
Net annual cost savings	**2,600,000**

Therefore, annual operating costs fall by £2.6m from £53.58m in 2017, to £50.98m in 2018 and thereafter.

The PV of the costs savings before tax amounts to £26m (£2.6m/0.1) according to the working assumptions.

Enterprise value at 31 December 2020

The value of the enterprise at 31 December 2020 is the discounted sustainable free cash flow beyond 2020 which amounts to:

£14.717m/0.1 = **£147.170m**

Equity value at 31 December 2020

Over the three-year period 2018 to 2020, GJ has generated free cash flows of £40.289m before interest (per the above table) which is used to pay the interest and repay the Farmley Bank debt and ICF debt at 31 December 2020 as follows:

	£'000	**Interest rate**	**Annual interest £'000**	**Interest net of tax £'000**	**3 year CF**
Original loan	1,500	0.05	75	60	180
Farmley Bank	18,000	0.06	1,080	864	2,592
ICF loan	10,000	0.09	900	720	2,160
					4,932
				Cash bal c/f	40,289
				Cash C/f net of int	**35,357**
			ICF debt	10,000	
			Farmley debt	18,000	
					28,000
				Surplus cash balance	**7,357**

The equity value at 31 December 2020 can normally be determined by deducting the remaining net debt value at that date.

However, the cash available of £7.357m is greater than the Roatt Bank debt of £1.5m at that date giving a surplus of £5.857m.

This gives an equity value of:

	£
Enterprise value	147.170m
Surplus cash	5.857m
Equity value	**153.027m**

This assumes that the surplus cash can be distributed to shareholders and does not need to be retained for investment to generate the future cash flows.

1.2 Potential benefits and risks of the MBO for stakeholders

A key risk factor for all stakeholders is the reasonableness of the price paid to Ultima.

It terms of a 'safety net' the net asset value is:

Per SFP	£8.7m
Fair value uplift (£4.3m - £3.2m)	£1.1m
Net assets at fair value	£9.8m

There may be some unrecognised asset value in intangibles (eg brand name) but in the absence of this the £40m valuation gives a high goodwill figure of £30.2m (£40m - £9.8m).

As a going concern, the continuing valuation to Ultima (ie without the MBO induced changes) is:

(£5.186m/0.1) - £1.5 m = £50.36m

The price of £40m therefore looks favourable compared to this figure of £50.36m.

With the MBO changes the above table shows PV of free cash flows to give an enterprise value of £144.419m and after deducting debt of £29.5m an equity value of £114.919m. The suggested deal price looks favourable compared to these values, but these are based on forecasts which may not be achieved. This is considered further below.

Overall, subject to the sustainability and reliability of these forecasts, the £40m sale price suggested seems reasonable.

(a) ICF

If the forecasts and working assumptions are valid, then the value of the ICF share of equity at 31 December 2020 is (per workings in 1.1 above):

£153.027m x 90% = £137.724m

ICF's initial equity investment (per the deal structure in Exhibit 4) is £9m

The compound annual return over the 3-year period is therefore $(£137.724m/£9m)^{1/3}$ = 148.3%

While this is significantly in excess of the 35% annual return required by ICF, this is only the equity element of the ICF investment. It also has £10m of subordinated debt which is at risk if the MBO fails, and this only earns an annual return of 9%.

The weighted average return is therefore:

[148.3% x (9/19)] + [9% x 10/19)] = 75% pa

Therefore, to the extent that the forecasts and working assumptions can be delivered by the management team, the expected return is significantly above ICF's required annual rate of 35%.

In particular, the assumption that the cash flows are indefinite needs to be evaluated as much of the fair value at the AIM flotation date at the end of 2020 depends on this long tail of cash flows which may not be realistic given the short termist strategy of reducing quality and increasing prices.

Risks

There are a number of key risks which may question the forecasts, the working assumptions and therefore the valuations that can be achieved.

Management team

The GJ management team appears to possess the core skills required, have inside knowledge of the business and hence are aware of the reliability of the forecasts. However, there are some concerns which may cause risks for the MBO in general, and for ICF in particular.

Geoff Boynott appears to have some conflict of interest between the MBO and Ultima. This may mean there is a risk he will not negotiate the most favourable terms with Ultima for the management team and for ICF (eg the total consideration). The fact that he intends to work part time after the MBO may be indicative of low commitment to the MBO and the lack of suitable finance expertise for the MBO. (see 1.5 below for further consideration of this issue, including its ethical implications).

In addition, Sally Bothan is responsible for the workshop, but the MBO strategy intends to close this, so it is not clear how a key member of the management team will contribute to the post-MBO operations and whether she has a skill set that will then be required.

Governance

In order to be at less risk from the management team decisions, ICF may want to appoint at least one member of the GJ board to represent its interests and have access to inside information.

Business strategy

The future business strategy of the management team appears to include reducing the actual quality of the jewellery sold. This includes:

- lower cost precious metals and gem stones
- no longer manufacturing its own jewellery, which were: higher priced items; improved reputation; and met 10% of customer needs
- fewer staff, so possibly a poorer service to customers.

In contrast GJ management appears to want to raise perceived quality through:

- refurbishment of stores to improve appearance
- increase prices by 5% per annum, perhaps where price is signal of perceived quality when it is difficult for customers, for example, to determine the quality of gem stones.

This is a risky policy as offering customers less and charging a higher price in a competitive market is unlikely to be sustainable. If customers perceive this and revenues fail to increase, or even fall, then, as noted above, the valuations are extremely sensitive to the forecast growth rate and the entire MBO financing structure could be at risk, affecting all stakeholders.

Financial gearing

Financial gearing is high with £28m of the £40m consideration being financed by debt which is 67.5%. This is in addition to the £1.5m debt already in the statement of financial position.

This means that any shortfall in operating profit is magnified significantly by the gearing affect.

In addition, annual interest is £4.932m (see above). This amount needs to be earned before any profit is made and before any cash flows can be generated to repay debt. Failure to repay debt from operating cash flows leaves a major risk of GJ not being able to repay the Farmley Bank debt or the ICF debt in 2020 as they fall due.

If this is the case, then ICF is at risk not just for its £9m equity but also for its £10m subordinated debt.

(b) The MBO team

The management team is only investing £250,000 per person.

If the forecasts and working assumptions are valid, then the value of the management team share of equity at 31 December 2020 is (per workings in 1.1 above):

£153.027m x 10% = £15.3027m (ie £3.826m per manager)

The management team's initial total equity investment (per the deal structure in Exhibit 4) is £1m

The compound annual return over the 3-year period is therefore $(£15.3027m/£1m)^{1/3}$ = 148.3%

ie this is the same % return as ICF as the shareholdings are linear.

The low initial investment may question the incentives and commitment of the management team if they do not have enough personal assets at risk if the MBO fails (ie downside potential).

Also, as their share of equity is a fixed 10% whether there are enough incentives for upside potential (eg share options, or increasing the management team equity share if a target valuation is achieved in three years' time). Closer alignment of interests between ICF and the management team may reduce the risks from lack of management commitment.

In essence, it is not the absolute amount of the investment of managers in the context of the MBO that matters, but rather the significance to each individual's perception of risk. If, in order to raise the £250,000, it has been necessary to engage in personal borrowing perhaps giving security on their houses, then this may be a sufficient commitment to give reassurance to other investors taking risks with larger absolute amounts.

(c) Farmley Bank

The bank has senior debt so is at less risk than the ICF debt.

However, if the MBO forecasts turn out to be optimistic then there is limited security available for the Farmley loan to be repaid.

The fair value of the five properties in the sale and leaseback arrangement is £4.3m. These have been sold, but the fair value for the remaining 15 shops (given they are equal size and value) is £12.9m. This is insufficient to cover the Farmley debt and existing debt from Roatt Bank totalling £19.5m, so there is a significant risk if operating cash flows are not sufficient to draw down at least some of this debt.

It is important to ICF therefore that Farmley commits to the MBO (notwithstanding these risks) before ICF itself makes any firm commitment.

1.3 Due diligence

Financial due diligence

The validity of GJ's free cash flow valuation model depends mainly on the revenue and cost cash flow forecasts and the discount rate.

The forecast revenue growth rate is critical. The financial due diligence would need to validate the underlying assumptions of price increases and cost savings to ascertain whether they are consistent with the forecasts and sustainable. The credibility of achieving these sales also needs to be assessed under commercial due diligence (see below).

The staff cost savings also need to be evidenced in terms of wage rates and the number of staff reductions needed to achieve the total claimed savings. The impact on staffing for each shop would also need to be considered under operational due diligence (see below). There is no mention of redundancy costs hence this would also need to be investigated under financial due diligence.

Due diligence procedures would also need to attest the fair value of the shops under the proposed sale and leaseback arrangement and for the 15 remaining shops as an assessment for the security for the loans.

This information would support the net asset valuation as a base line valuation, although as noted above this is well below the sale price.

The appropriateness of the discount rate will need to be assessed from market interest rates. This can be observed from listed companies by modelling share prices, but adjustment would need to be made for an unlisted company such as GJ.

As the working assumption is for constant future cash flows indefinitely, the discount rate may be viewed as a real rate, rather than a money rate (ie it compensates for future inflation). The 10% should therefore be evaluated against real market rates in this context.

While financial due diligence may provide limited assurance, typically it will not involve the detailed level of testing that would be carried out in a statutory audit. Due diligence procedures could be extended to cover detailed audit procedures, but this would inevitably cause a delay in completing the MBO. Even if audit procedures were to be carried out, the key issue for valuation and risk is the validity of the forecasts, where only limited assurance could ever be obtained.

Commercial due diligence

Commercial due diligence work complements that of financial due diligence by considering the markets and the external economic environment. Information may come from the GJ management team but also other business contacts. Alternatively, it may come from external information sources.

Such information is useful for ICF to understand the appropriate post-acquisition strategy.

Commercial due diligence work should be carried out to test the revenue growth assumption for future periods, to enable ICF to assess whether the GJ growth being forecast by the management team is credible. The due diligence team should look at likely changes in demand on a shop by shop basis considering: regional growth, changes in local competition, and plans for future advertising.

Customer reactions to the 5% pa price increase should be considered, perhaps reviewing the response at each shop to historic price changes.

Operational due diligence

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

- Validate the implications of assumed operational cost savings eg with staff cost savings can a reasonable service continue to be provided to customers.
- Identify operational upsides that may increase the value of GJ (eg the impact of the proposed refurbishing on footfall).

1.4 Financial reporting

Sale of workshop

Unless it had reached the end of its useful life, the workshop should not have been fully depreciated as IAS 16 requires the useful life of PPE to be reviewed on a regular basis and adjusted as a change in an accounting estimate in accordance with IAS 8 if the useful life has changed from previous expectations.

Given however that the workshop has been fully depreciated, then the proceeds of £3m should be recognised in full as a profit in the statement of profit or loss in the year of sale.

The workshop may be treated as a discontinued operation per IFRS 5 as it is a separate major line of business, cash flows can be distinguished and it will be disposed as part of a single co-ordinated plan.

Refurbishment

To the extent that the refurbishment costs are repairs, these costs should be recognised in profit or loss as incurred. Where the refurbishment is PPE or an improvement they should be capitalised and depreciated over their useful lives in accordance with GJ's accounting policy on PPE.

Inventory management

Inventory should continue to be recognised in accordance with IAS 2 at the lower of cost and net realisable value. The reduction in inventory levels has no direct effect on financial reporting but the process of reviewing inventories may reveal slow moving items which should be written down to their net realisable value.

Sale and leaseback

As the risks and rewards of ownership are not to be reacquired under the leaseback contract, they have passed to the lessor. Also, the 8-year term is unlikely to be for a substantial part of the life of the shop buildings so the risks and rewards in the residual value to the lessor are likely to be substantial.

As a result, the leaseback arrangement will need to be classified as an operating lease.

A profit of £1.1m should be recognised immediately, being the difference between the fair value and the carrying amount (£4.3m - £3.2m). The difference between the sale proceeds and the fair value of £1.2m (£5.5m - £4.3m) should be deferred and recognised over the 8-year lease period at £150,000 per year.

The net charge to profit or loss per year for rental will therefore be £400,000 (ie £550,000 - £150,000).

From 2019, IFRS 16 will apply to this leaseback arrangement, requiring nearly all leases to be recognised in the statement of financial position.

1.5 Ethical issue

Ethics pertains to whether a particular behaviour is deemed acceptable in the context under consideration. In short, it is 'doing the right thing'.

In making any ethical evaluation, it is first necessary to establish the facts. In this case, it would seem that the source of information is from the Ultima CEO. Given the current negotiations with Ultima its CEO may not be an entirely reliable source of information.

Also, it would seem that "Geoff is in the process of arranging a new contract with Ultima" so nothing appears to be signed or finalised and there may be reasons for Geoff suggesting he might work as a consultant. These facts need to be verified.

If, after investigation, it is true that Geoff intends to sign a consulting contract, then the primary ethical issues appear to be transparency and conflict of interest.

It would appear that, although Geoff has disclosed to the GJ board that he wants to work only part time for GJ after the MBO, he did not disclose the reasons. In particular, given that Ultima is in negotiations with the GJ management team and other key stakeholders, it is a matter of significance that any dealings with Ultima should be disclosed to the other three members of the GJ board, as a minimum. The question of disclosure to ICF is more tenuous but, given the nature of the joint interests in the MBO deal with Ultima, then this disclosure to ICF may also be expected as a matter of business trust.

A conflict of interest arises for Geoff in that his future income will come partly from the success of the GJ MBO, but also partly from Ultima. If Geoff could negotiate a lower consideration than £40m this would be beneficial to the GJ management team but would harm Ultima. In so doing, Geoff may feel his future consulting contract may be jeopardised, incentivising him not to push for the best deal for the GJ management team in negotiating the amount of the consideration.

If the actions of Geoff are a deliberate attempt to reduce the consideration in return for payments from Ultima then, if this is successfully carried through, this may be illegal and legal advice should be taken. However, given that the other board members are now aware of the issues and nothing has yet been signed for Geoff's contract and for the MBO then this now seems unlikely, even if originally intended by Geoff.

Other ethical issues are:

Effect – whom does the issue affect? If the terms of the MBO deal are unduly favourable to Ultima, then some stakeholders may lose out (eg other GJ directors, ICF and Farmley Bank who may earn lower returns and could be at more risk).

Fairness – would the arrangement be considered fair by those affected? Clearly, if the negotiated MBO agreement is influenced by the personal interests of Geoff, then those adversely affected may regard this as unfair in not satisfying arm's length conditions. However, the greatest unfairness may be seen with respect to the other three GJ directors who are entitled to trust Geoff as colleagues sharing investment interests. ICF and Farmley Bank should have a degree of professional scepticism of other stakeholders as well as Ultima in establishing the facts (eg through due diligence) and need to make their own judgements, but nevertheless a degree of business trust may be expected from Geoff.

Actions

As an ICAEW Chartered Accountant, Geoff is bound by the ICAEW ethical code. If there is a belief that the transaction is illegal, ICF should obtain advice (eg ICAEW helpline). In this case, they should not speak to Geoff as this may be tipping off.

If advice is received that this is not an illegal transaction, but it may be unethical, then Kevin should raise the issue formally at a GJ board meeting and ask Geoff for an explanation. Geoff's response should be recorded in the minutes.

It may be that the GJ board no longer wants Geoff to be part of the MBO team, but this would need to be agreed with other stakeholders and Ultima, unless the three other GJ board members want to withdraw altogether from the deal.

As part of business trust and transparency the GJ board should inform ICF and Farmley Bank of what has occurred.

From ICF's perspective, business trust in one of the key MBO management team may be damaged. In the extreme they could withdraw from the deal or only continue if Geoff is excluded from the deal.

As an ICAEW Chartered Accountant I should consider reporting Geoff to the ethics committee if on the basis of the established facts there is a reasonable suspicion that there has been an ethical, legal or other disciplinary breach by Geoff.

Examiner's comments

Requirement 1 – Valuation

There was a mixed performance on this question, with many candidates demonstrating errors in their basic knowledge and approach.

The narrative element was often overlooked by candidates, thus missing the available marks, and very few candidates were able to deal accurately with the 2020 valuation and corresponding use of surplus cash to repay debt.

Most candidates achieved reasonable marks from the discounted cash flow approach for the first 3 years (2018, 2019 and 2020) to achieve a 31 December 2017 valuation. A common error was to include the 2017 free cashflows in the valuation, despite the benefits only arising from the 1 January 2018 management buyout date.

Generally, the revenue growth and adjustment to operating costs were correct, and most candidates recognised the need to remove depreciation and then add it back, however the depreciation amount was often incorrect as many failed to adjust for the reduction in owned shops to 15 from 20 due to the operating sale and leaseback. The most common computational error in this respect was to use a depreciation figure of £800,000.

The sale and leaseback proceeds were often ignored or placed in the wrong year. Other 1 January 2018 cashflows (such as working capital and workshop cashflows) were also overlooked or placed in the wrong year. Many candidates also incorrectly included interest cash flows in their calculations.

The discounting was generally well attempted, with most candidates recognising the need for a deferred perpetuity calculation for 2021 cash flows onwards. Most candidates arrived at an enterprise value and made an adjustment for debt.

A significant number of candidates ignored the 2020 valuation altogether. Alternatively, the equity valuation was sometimes calculated, but the enterprise value ignored.

Other common errors included:

- The working capital saving being shown every year, rather than just in 2017.
- No terminal value calculated or, if it was calculated, it was not then discounted back to 31 December 2017.
- Only considering the (£1,500,000) loan to determine the equity value from the enterprise value.
- No consideration of the equity and enterprise values for 2020.

It was not uncommon for no explanations to be provided whatsoever for this requirement, despite the clear requirement for them. For other weaker candidates, the explanations were very general and tended to only focus on the disadvantages of the valuation method. However, many candidates did provide reasonable explanations and normally made some good points.

Requirement 2 – Benefits and risks of MBO

This was generally well attempted, with a large majority of candidates structuring their answers into the three subheadings provided for each stakeholder group and giving a range of both benefits and risks that applied to the scenario.

Most candidates commented on the acquisition price and made reference to ownership percentage, interest rates on loans, and the strategic ideas of the buyout team.

Common errors included;

ICF

- No reference to the management, in particular the position of Geoff Boynott, or the future of Sally Bothan.
- Few comments on the future governance structure.
- Few comments on the future business strategy, and the risks involved.
- Few comments on the financial gearing situation.

MBO Team

- Many commented on the fact that £250,000 could be a substantial amount for an individual. Few went on to calculate any numbers or look at the potential return.

Farmley Bank

- This element if the question was generally well answered.

Requirement 3 – Due diligence

This question was usually well attempted with many candidates producing good answers.

Weaker candidates did not give specific procedures, and instead talked generally about the difference between the different procedures (financial, commercial, and operational) rather than explaining the specific procedures required in the scenario.

Requirement 4 – Financial reporting

Most candidates made a reasonable attempt at this requirement.

Many candidates discussed the lease and correctly identified that this was an operating sale and leaseback and normally showed the correct financial reporting treatment for this.

Some candidates did not scope their answers widely enough and failed to address any financial reporting issues other than the sale and leaseback.

Many candidates discussed IFRS 5 at length – some credit was given for this, although only strong candidates considered the timing of the disposal and the fact that some aspects of IFRS 5 may not be relevant for the period in question.

Some straightforward marks were missed by not stating that the profit of £3 million is to be recognised or that the improvements costs should be capitalised.

The refurbishment tended to be ignored, with candidates instead talking at great length about inventory management. Again, this was often a case of not identifying a sufficiently wide range of the financial reporting issues applicable.

Requirement 5 – Ethics

Mixed responses were received to the ethics element of the question.

Many candidates adopted the transparency/effect/fairness (TEF) framework in a rather wooden manner. There was tendency to give equal emphasis to each of these principles, rather than selecting and emphasising those most relevant to the circumstances in the question. In so doing, the scenario was often squeezed into the framework, rather than the framework being used flexibly to elucidate the issues in the scenario.

A further weakness of the unthinking application of the TEF framework is that other ethical principles were excluded which were important in the scenario.

Better candidates identified and emphasised conflict of interest and transparency as key ethical issues in the scenario.

Weaker candidates did not separately identify the ethical actions for ICF, Kevin and Geoff, as specifically required in the question. Instead, they tended to produce a general list of ethical actions, without specifying to whom they were applicable.

The coverage of the actions was generally thin and sometimes only fairly weak points were made. Many concluded that Geoff should be reported to the ICAEW helpline.

The better scoring answers did consider the actions from each stakeholder group’s perspective.

Question 2 – Hayfield

Scenario

The candidate is a junior manager working for a firm of ICAEW Chartered Accountants in a business advisory capacity. The scenario relates to a company, Hayfield, which manufactures high-quality equipment for the construction industry, including mechanical diggers, bulldozers, excavators and cranes. Currently, its only factory is based in the UK.

The profit for the year ended 30 September 2017 was significantly below the level expected when the budget was set and the board wants a better understanding of the extent to which various identified factors caused the shortfall in profit. A management information pack is provided.

One factor affecting profit was losses on foreign currency hedging. The correct financial reporting for these losses is an issue.

To increase future profit, the board wants to expand into new markets and set up a new factory producing tractors in South Africa. Two alternative strategies have been identified for the expansion plan. Either enter into a joint arrangement with a South African company; or set up a new subsidiary which will operate independently in South Africa.

Financial reporting for the expansion strategy and assurance risks and procedures are matters of concern.

Candidates are required to:

(a) Prepare:
- a statement which reconciles actual operating profit and budgeted operating profit
- notes to explain each of the reconciling factors and a conclusion

(b) Explain:
- why a loss was made on foreign currency hedging contracts
- the financial reporting treatment of the loss on foreign currency hedging

(c) Compare and evaluate the two strategies for expanding into South Africa

(d) Explain the financial reporting treatment of the two strategies for expansion

(e) Explain the assurance risks that arise and identify the procedures that could be undertaken to help mitigate these risks.

<table>
<tr><th>Requirements</th><th>Technical & Skills</th><th>Skills assessed</th></tr>
<tr><td>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
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.</td><td>16</td><td>Analyse and assimilate the data provided in a structured manner (eg a table)
Adjust for foreign currency movements for both revenue and purchases of engines
Assimilate the data provided adjust for sales volumes changes.
Carry out data analysis to reconcile budgeted and actual profit including all adjustments
Prepare notes evaluating and explaining key adjustments and why profit differs from budget
Address and articulate the key issues succinctly
Provide reasoned conclusion</td></tr>
<tr><td>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.</td><td>7</td><td>Assimilate information to explain loss on hedging
Identify arrangement as a cash flow hedge
Set out the treatment of the cash flow hedge
Critically appraise managements treatment of fair value movements
Explain the movements in other comprehensive income</td></tr>
<tr><td>Compare and evaluate the 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.</td><td>7</td><td>Use judgement to identify and select key issues for each strategy
Demonstrate a clear understanding of key issues of overseas production.
Evaluate relationship with joint venture partner
Identify and explain relevant risks of JV relationship
Provide reasoned recommendations</td></tr>
<tr><td>Explain the appropriate treatment in Hayfield’s financial statements for each of the two alternative strategies for expansion</td><td>6</td><td>Set out and explain the key financial reporting issues of joint arrangements
Set out and explain the key financial reporting issues of setting up a separate subsidiary
Set out the financial reporting issues for foreign currency aspects of proposals</td></tr>
</table>

Assuming that the board decides to engage in a joint venture with CTB, explain the assurance risks that arise for Hayfield and identify the procedures that BBB could undertake to help Hayfield mitigate these risks.	6	• Use judgement to determine assurance procedures which are appropriate to the circumstances and objectives of the service level agreement • Understand and assimilate the information and data provided to assess assurance risks • Use judgement to compare and conclude on assurance for the joint arrangement • Set out the initial assurance procedures in establish joint arrangement • Set out the assurance procedures in subsequent monitoring of JA partner for continued assurance.
Maximum marks	**42**	

Question 2 – Hayfield

Analysis and reconciliation

	Actual	**Budget**
Sales volume:		
UK (units)	4,400	4,800
EU (units)	11,200	14,400
Total	15,600	19,200
Sales price:		
UK	48,000	50,000
EU (euro)	70,000	70,000
EU £ (translated)	63,636	56,000
Exchange rates:		
$	1.20	1.50
€	1.10	1.25
Engine cost $	12,000	12,000
Engine cost £ (translated)	10,000	8,000
Other VC production per unit	16,500	18,000
Revenue:		
UK	211.2	240.0
EU (euro)	712.7	806.4
Total	923.9	1,046.4
Cost of sales		
Engines	156.0	153.6
Other variable costs	257.4	345.6
Fixed costs	265.0	240.0
Total	678.4	739.2
Distribution and administrative	170.0	175.0
Operating profit	75.5	132.2

Reconciliation

Budgeted profit	**132.20**
W1 Automation (Fav)	5.40
W2 Sales volume changes	(105.60)
W3 Price	(8.80)
W4 Foreign exchange (fav)	54.33
W5 Fixed costs	(7.00)
W6 Distribution and admin (Fav)	5.00
Actual	**75.53**

Workings

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W1 Automation

FC increase (9/12 * £24m)	(18.0)
Variable cost saving (15,600 x £2,000)x9/12	23.4
Cost saving (favourable)	**5.4**

W2 Sales volume changes

<u>UK units</u>	
(4,800 - 4,400) x (£50,000 - £18,000 - (12,000/1.5)	9.6
<u>EU units</u>	
(14,400 - 11,200) x (€70,000/1.25) - £18,000 - ($12,000/1.5)	96
Total (adverse)	**105.6**

W3 Price

<u>UK</u>	
(£48,000 - £50,000) x 4,400	8.8
<u>EU</u>	0

Total (adverse)	**8.80**
W4 Foreign exchange	
Euro sales	
((€70,000/1.1) - (€70,000/1.25)) x 11,200 (Favourable)	85.53
US engines	
(($12,000/1.5) - ($12,000/1.2)) x 15,600 Adverse	(31.20)
Total FOREX (Favourable)	**54.33**
W5 Fixed costs (excluding automation)	
£(265 - 240)m - £18m (adverse)	**(7.00)**
W6 Distribution and admin	
£175m - £170m (Favourable)	**5.00**
Budgeted profit	**132.20**

NOTES

Introduction

The actual operating profit at £75.5m was only 57% of the budgeted profit. In analysing the factors giving rise to this it can be difficult, without further information, to discern whether the shortfall was due to poor performance or over-optimistic budgeting. Moreover, even if the differences were due to poor performance, it is not clear of the extent to which this is due to controllable factors or unexpected factors beyond the control of the company (eg new competition).

Automation

The impact of automation had a favourable effect of £5.4m, but only affected 9 months of the year. Given it was such a substantial project it is not clear why an estimate of its effect could not have been made when the budget was set in July 2016, which was only 6 months in advance of implementation.

Sales volume changes

Both the UK sales and the eurozone sales volumes were less than budget but the undershoot against budget in the eurozone (22.2%) was much more substantial than in the UK (8.3%). Price may have been a factor restricting the volume decline in the UK as price was reduced from £50,000 to £48,000 whereas, in terms of euro values, the price was held constant in the eurozone market.

As the eurozone market is far larger than the UK market in absolute value terms, the effect of the volume shortfall was £96m which was by far the largest of all the factors affecting profit. The UK sales volume effect was much smaller by comparison at £9.6m, but is nevertheless a concern.

Price

The selling price in euro at €70,000 was the same as budgeted, hence there was no price effect for eurozone sales. Although the £ sterling price differed from budget, this was due to foreign exchange rate effects.

The average £ sterling price fell by £2,000 from £50,000 to £48,000. This meant a shortfall against budget of £8.8m.

There appears to be price discrimination between the eurozone and UK markets which was £6,000 at the budgeted exchange rate (£56,000 - £50,000), but £15,600 at actual prices and actual exchange rates. This may cause some leakage between markets. (It is asserted that the same sales mix occurs in the UK and the eurozone and so this has been assumed).

Foreign exchange

Foreign exchange impacts on both receipts and payments.

A high proportion of receipts comes from eurozone countries where contract prices are set in euro. When the budget was set, the exchange rate was £1 = €1.25. However, the actual average exchange rate was £1 = €1.1. As Hayfield generates cash in euro this exchange rate movement has had a favourable effect as revenues generated in euro now have a higher value when converted to £ sterling. The scale of this effect is significant amounting to £85.53m.

There is a converse story when considering the exchange rate impact on purchases of engines which are denominated in $. The strengthening of the $ from £1 = $1.5 at the time the budget was set, to £1 = $1.2 as the average exchange rate for the year, meant that the cost of engines in £ sterling increased, even though the $ cost remained constant at $12,000 per engine. The impact of this was to increase production costs by £31.2m.

The overall effect of the above exchange rate movements on operating profit was to give a net currency gain over the year of £54.33m. However, currency hedging also made a loss of £10.8m so, net of this effect, the overall impact of currency movements and currency risk management was a gain of £43.53m (£54.33m - £10.8m).

Fixed costs

The overall increase in fixed costs was £25m. However, part of this was a result of investment in automation in order to lower variable costs (see above). Ignoring this investment effect, the residual effect was an increase in fixed production costs over budget of £7m.

Distribution and administrative costs

These costs fell compared with the budgeted figure by £5m which was a 2.9% reduction. Whilst administrative costs may largely be fixed, part of the reduction in distribution costs may be explained by the fall in sales volumes. This is particularly the case with respect to deliveries to eurozone countries where delivery distances are greater. More information is needed about the scale of distribution costs compared with administrative costs within this total but, given eurozone sales volumes fell by 22.2% and UK sales by 8.3%, the modest fall of 2.9% in distribution and administrative costs is not unexpected.

(b) Hedging activities

<u>Loss on hedging</u>

A forward currency contract is a binding agreement to acquire a set amount of a given currency at a future date at an exchange rate agreed at the time of the transaction.

A forward currency contract therefore fixes the exchange rate for a transaction, and these contracts must be settled regardless of whether or not the actual exchange rate at the settlement date is more favourable than the agreed forward price.

In respect of euro receipts, Hayfield will have entered into forward currency agreements to sell euro at a future date in order to hedge the risk of the euro weakening (thereby decreasing the £ sterling value of receipts from sales).

However, if the euro unexpectedly strengthens in this period against the £, then the forward contract derivative will suffer a fair value loss. Given the euro has strengthened in the year ending 30 September 2017 compared with the budgeted level then the loss on hedging is not unexpected. This is particularly the case as hedging takes place over the forthcoming period of 18 months.

Conversely, however, in hedging $ payments Hayfield will have entered into forward currency agreements to buy $ at a future date in order to hedge to risk of the $ strengthening (thereby increasing the £ sterling cost of engine purchases).

Given that the $ has strengthened in the year ending 30 September 2017 against the £, compared with the budgeted level, then a gain on $ hedging would be expected.

Overall it is not unexpected that a net loss on derivative contracts has been made as the euro hedges (generating losses) are greater than the $ hedges (generating gains) as:

- The value of eurozone sales (£712.7m) is much greater than the cost of engine purchases (£156m) so the hedging contracts are likely to be greater to mitigate the additional risk.
- The euro hedging is over 18 months, compared with $ hedging which is only over 6 months so there will be more euro hedging contracts outstanding, given the longer time period covered.

Financial reporting treatment

The hedged transactions of receipts and payments are highly probable forecast transactions rather than firm commitments as, for example, the time from order to delivery (and receipt of cash) is 3 months whereas the period of the hedge is up to 18 months. As a result of being classified as highly probable forecast transactions, the forward currency contracts must be treated as cash flow hedges (fair value hedges are not permitted).

The purpose of cash flow hedging is to enter into a transaction (purchasing the forward currency contracts as a derivative) where the derivative's cash flows (the hedged instrument) are expected to move wholly or partly, in an inverse direction to the cash flow of the position being hedged (the hedged item). The two elements of the hedge (the hedge item and the hedge instrument) are therefore matched and are interrelated with each other in economic terms.

In the case of Hayfield, the management accounts recognise all changes in fair values of forward foreign currency contracts that have occurred during the year ended 30 September 2017. Given this is the case, then these will include:

1. Hedge contracts taken out in the previous accounting period and realised in the current accounting period
2. Hedge contracts taken out in the current accounting period and realised in the current accounting period
3. Hedge contracts taken out in the current accounting period and realised in the next accounting period
4. Hedge contracts taken out in the previous accounting period and realised in the next accounting period (for euro hedges only that can be up to 18 months)

IAS 39 states that hedge contracts must be highly effective to qualify for hedge accounting and this may not be the case for all of the above. Fair value changes on hedge contracts that are ineffective should be recognised in profit or loss.

Cash flow hedge accounting attempts to reflect the use the forward currency derivative to hedge against future cash flow movements from exchange rate changes.

For 1. above the gains/losses in hedging instruments from previous periods are recycled from OCI and recognised in profit or loss, in addition to any further gains/losses in the derivative in the year ended 30 September 2017.

For 2. there is no recycling as the derivatives do not cross the year end threshold. As a result, all the gains/losses will be recognised in profit or loss in the year ended 30 September 2017.

For 3. movements in the derivative, in the year ended 30 September 2017, which would normally go through profit or loss, are recognised in other comprehensive income. Such gains/losses on the derivative will be restated/recycled to profit or loss in the year ended 30 September 2018 (ie in the same period in which the hedged highly probable transaction affects profit or loss).

For 4. movements in the derivative, in the year ended 30 September 2017, which would normally go through profit or loss, are recognised in other comprehensive income and added to the gains/losses in hedging instruments from the previous period. Such gains/losses on the derivative will be restated/recycled to profit or loss in the year ended 30 September 2018 (ie in the same period in which the hedged highly probable transaction affects profit or loss).

Proposal for international expansion

(a) Two alternative strategies

Both strategies offer the opportunity to enter new geographical markets, with a new product market. This is ‘diversification’ according to the Ansoff matrix. Whilst offering new opportunities it combines the significant risks of both new geographical area and a new product.

In addition, setting up a new subsidiary adds significant new financial risk by increased borrowing. If the project succeeds, then all of the benefits will come to Hayfield through its subsidiary, AMSA. However, if the project fails then it will suffer all the losses. With a lack of local knowledge then there may also be an increased probability of failure.

In contrast, the joint arrangement has a number of benefits which would not be experienced by the solely owned subsidiary, AMSA.

The costs are shared with the joint arrangement partner. As the capital outlay is shared, joint arrangements are especially attractive to risk-averse firms or, as in this case, where expensive new technologies are being established. CTB may not bring much new financial capital but the utilization of the CTB factory premises appears to reduce Hayfield’s outlay from £55m to around £38m. There are also shared operating costs (eg labour). These common costs and economies of scale are likely to be a financial benefit to Hayfield.

There is also reduced risk from the joint arrangement in a reduction in exit costs if the venture fails, as the set-up costs are lower.

There may be reputational enhancement as CTB is likely to be a more recognizable brand in South Africa as Hayfield has not previously operated in this area. The venture partner may therefore bring increased initial credibility and there may be an opportunity to cross brand to enhance the local reputation.

There are likely to be synergies. One firm's production expertise can be supplemented by the other's marketing and distribution facility. For example, there may be economies of scope in distribution of both venturers’ products throughout Africa. However, this would not seem to apply to any sales to South Asia or South America.

CTB may also provide local knowledge of South African law, culture, customers and language. This may also extend to local knowledge and experience of supply chains.

A joint arrangement may also have a number of problems and risks which would not be experienced by a solely owned subsidiary.

There may be conflicts of interest between Hayfield and CTB. This may be in terms of prioritization of the short-term use of resources (eg use of labour for an urgent delivery). They may also have different longer-term objectives for the joint arrangement – for example, if one is looking for short-term profits, while the other wants to invest in longer-term growth.

Disagreements may arise over profit shares, amounts invested, the management of the joint arrangement, and the marketing strategy. In particular, there needs to be a degree of business trust between the parties requiring openness and access to information.

There may be a finite life of five years if CTB decides to terminate the arrangement after the minimum period. In contrast, a subsidiary would have an open-ended life to be determined solely by the interests of Hayfield.

Recommendation

The joint arrangement appears to offer modest and temporary benefits, but major risks, with possibly only a five-year horizon. The preferred recommendation therefore, despite the higher initial cost, is to set up a subsidiary.

(b) Financial reporting

Accounting for joint arrangements

The terms of the contractual arrangement between parties to a joint arrangement are key to deciding whether, for financial reporting purposes, the arrangement is a joint venture or a joint operation.

The proposed arrangement between Hayfield and CTB does not have a separate entity but falls under a joint operation (per IFRS 11), whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement.

The two parties exercise joint control. The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the consent of the parties sharing control, which is clearly the case.

IFRS 11 requires that a joint operator recognises line by line in its own financial statements the following in relation to its interest in a joint operation:

- Its assets, including its share of any jointly held assets (this would include the plant and machinery in the South African factory).
- Its liabilities, including its share of any jointly incurred liabilities
- Its revenue from the sale of its share of the output arising from the joint operation (this would include the sales of tractors less any amounts attributable to CTB)
- Its expenses, including its share of any expenses incurred jointly.

Each of the amounts relating to items in the statement of profit or loss would be translated into the functional currency of Hayfield normally using the average exchange rate.

In respect of assets and liabilities:

- Monetary items should be translated and then reported using the closing rate.
- Non-monetary items carried at historical cost are translated using the exchange rate at the date of the transaction when the asset or liability arose.

Separate subsidiary (AMSA)

If AMSA is set up in South Africa as a subsidiary, then as it would have a different functional currency to Hayfield. AMSA would therefore be consolidated in accordance with IAS 21 into the consolidated financial statements of Hayfield translated into its presentation currency.

The following procedures should be followed to translate AMSA's financial statements from its functional currency into a presentation currency:

- Translate all assets and liabilities (both monetary and non-monetary) in the current statement of financial position using the closing rate at the reporting date.

- Translate income and expenditure in the current statement of profit or loss and other comprehensive income using the exchange rates ruling at the transaction dates. (An approximation to actual rate is normally used; being the average rate.)
- Report the exchange differences which arise on translation as other comprehensive income.

The loan of £55m from Hayfield to AMSA would be a net investment in a foreign operation. As the loan is in the functional currency of Hayfield, the parent, then any exchange differences will be recognised in the profit or loss of AMSA.

(c) Assurance risks

In the proposed joint arrangement between Hayfield and CTB profits are to be shared equally between the two parties. In this respect, it could be valuable for both of the parties to have assurance that profits have been calculated correctly in accordance with the terms of the agreement.

While the criteria which define the split of profits in the joint arrangement are in the venture agreement, the profit allocation still needs clarification with the two parties. Both parties want assurance that the profit allocation has been calculated properly and in accordance with the agreement in terms of determining the value of underlying transactions and making full disclosures.

This is likely to require initial due diligence and ongoing monitoring of the joint arrangement (JA) to sustain assurance.

Initial investigations

- Review JA agreement (in combination with legal advisers) for onerous, ambiguous or omitted clauses.
- Ensure that the purpose of the JA is clear and the respective rights of Hayfield and CTB are established in the initial contractual arrangements.
- Ensure that the scope of the JA is clear so there is separation of the other operations of each company from those falling within the JA.
- Review tax status of JA entity (if applicable) or Hayfield's operations including remittance of funds. Review governance procedures including shared management, control, rights over assets, key decision-making processes to ensure that Hayfield management has an appropriate level of control over key decisions that may damage its interests.
- Establish that any initial capital from CTB has been contributed in accordance with the agreement and that legal rights for Hayfield to use the CTB factory and labour have been established.
- Establish the creditworthiness, going concern and reputation of CTB based on local enquiries from stakeholders and a review of internal documentation as well as that in the public domain.
- Ensure the terms of the disengagement and residual rights in five years' time are clear in the initial agreement so there is a transparent and legitimate exit route.
- Where assets that are to be used in the joint arrangement are already held by CTB or Hayfield then they would normally be transferred nominally at fair value. This needs to be established.
- Clarify revenue the sharing agreement with respect to existing sales under construction or orders contracted for but not yet commenced.
- Health and safety responsibility needs to be established and liability sharing agreed.

Continuing assurance

- Audit rights and access to information need to be established in the contract as this will affect the scope of the audit.
- Ensure that the operations of the JA are within the terms of the JA agreement (eg adequate labour is being provided by CTB and there are no violations of the contractual agreement).
- Ensure that internal controls and accounting systems are being applied and are effective (eg that the revenue from sales in Africa relating to the JA is fully recorded and is separated from other sales that do not form part of the joint arrangement, such as existing customers within Africa or of other types of equipment outside the agriculture industry).

- The accounting systems for a JA entity will need to be capable of recording accurately and completely the costs being incurred and the assets held relating to the JA. However, as the JA is set up as a jointly controlled operation, the costs will mainly be recorded in the individual accounts of each of the venturers (although there may be some joint costs met out of revenue). In this case the key audit issue for the JA is that operations and assets have been supplied in accordance with the contract rather than recording their costs. Risk areas for Hayfield may include overhead allocations as CTB is supplying a factory which has multiple uses.
- If permitted within the terms of the contract, audit access to the accounting records of CTB would provide additional assurance. This may mean however that a reciprocal arrangement may need to be made available to the advisers for CTB, by giving access to the Hayfield accounting systems.
- The eventual dissolution of the agreement (perhaps in five years) creates additional assurance problems in terms of disengagement, return/sale of assets, intellectual property rights, rights to future customer access.
- The level of assurance needs to be determined (reasonable or limited).

Examiner's comments

Requirement 1 – Profit reconciliation statement

Answers to this element of the question were generally weak.

Many candidates failed to structure their answers as a reconciliation of budgeted profit and actual profit, by commencing with one figure and ending with the other. Instead, many candidates showed the movement, line by line, of each item in the management accounts.

Very few candidates correctly calculated the sales volume or FOREX variances, and a common error was to identify a price variance on EU sales, when in fact the movement was due entirely to FOREX changes.

Most candidates managed to determine the automation variances correctly.

The narrative elements were generally of a better standard, but weaker answers were very generic and not particularly well applied to the scenario. Some candidates omitted the element of the requirement to prepare explanatory notes altogether.

Common errors included:

- Not presenting a reconciliation, as required, from budget profit to actual profit.
- Presenting a reconciliation that adjusted each line of the SPL, rather than determining the impact on profit of the specific factors provided in the question.
- Automation: not time apportioning the figures by 9/12.
- Sales volume: combining the volume for UK and EU together.
- Providing no notes/explanations, despite this being clearly asked for.
- An overall lack of understanding of variances being demonstrated.

Requirement 2 – Loss on foreign currency hedging

This was a poorly answered requirement.

Only a minority of candidates correctly identified that the loss was due to the hedging arrangement in place and therefore arose because of the hedging instrument, rather than because of the underlying hedged transactions.

Some candidates simply made vague and ambiguous statements such as "the loss was due to a change in exchange rates" without further explanation of the direction and consequences of the changes. Such open statements received no credit.

An alarming number of candidates failed to realise that a net loss on forward contracts means there was a net gain on the underlying business transactions (and vice versa). As a result, many failed to comment on the fact that both overseas currencies had strengthened, hence higher actual sales revenue, and higher actual purchase costs and therefore their corresponding hedges would result in losses (related to a euro hedge on sales) and gains (related to a $ hedge on purchases). The scale of each hedge, and the time periods involved were also different, but most candidates did not comment on this.

Weaker candidates had the direction of change wrong in stating that the £ strengthened. Other weak candidates thought that a strengthening of overseas currencies for revenue and cost streams has a similar effect. These are fundamental errors at Advanced Level.

Rather disappointingly, candidates often gave very generic answers about how forward contracts work, but then had limited application to the scenario.

In respect of financial reporting, many candidates simply regurgitated the different hedge accounting treatments with mixed accuracy. Where candidates did attempt to apply the rules, many misclassified the hedge as a fair value hedge or did not attempt to classify it at all, merely stating the normal financial reporting treatment of derivatives where they are held outside of a hedging arrangement.

Several candidates failed to give any answer to this part of the paper. This appeared to be due lack of knowledge, rather than shortage of time.

Requirement 3 – Evaluate South Africa expansion strategy

Most candidates provided good quality, applied answers to this requirement, covering both the joint arrangement and the subsidiary, reaching a reasoned conclusion.

It was encouraging that candidates used models to support their answers and they provided reasonable discussion of the benefits and risks of each option. The higher scoring answers were very well structured and discussed separately the financial, commercial and operational risks of the joint arrangement and the subsidiary.

Requirement 4 – Financial reporting for South Africa expansion strategy

Again, there was a mixed response to this requirement.

Most candidates made basic comments about financial reporting for subsidiaries, but only better candidates gave a full explanation of the issues for a foreign subsidiary. Weaker candidates made no mention of it being an overseas subsidiary and did not refer to IAS21.

Regarding the joint arrangement many candidates did not:

(a) State that this is a joint operation for financial reporting purposes, and/or
(b) Know the correct financial reporting treatment for a joint operation. Many stated that it should be accounted for using the equity method and/or identified it as an associate.

Requirement 5 – Assurance for South Africa expansion strategy

This part was generally well done.

Whilst some candidates produced quite general answers, others did focus on the specific risks and resulting assurance procedures that should be undertaken to address each risk.

Weaker scripts often identified only one or two risks and some basic assurance procedures, many of which were only tangentially relevant to the scenario.