ADVANCED LEVEL EXAMINATION

TUESDAY 6 NOVEMBER 2018

(3½ HOURS)

STRATEGIC BUSINESS MANAGEMENT

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

Marks breakdown

Question 1	60 marks
Question 2	40 marks

1. Please read the instructions on this page carefully before you begin your exam. If you have any questions, raise your hand and speak with the invigilator before you begin.
2. Please alert the invigilator immediately if you encounter any issues during the delivery of the exam. The invigilator cannot advise you on how to use the software. If you believe that your performance has been affected by any issues which occurred, you must request and complete a candidate incident report form at the end of the exam; this form must be submitted as part of any subsequent special consideration application.
3. Click on the **Start Exam** button to begin the exam. The exam timer will begin to count down. A warning is given five minutes before the exam ends. When the exam timer reaches zero, the exam will end. To end the exam early, press the **Finish** button.
4. You may use a pen and paper for draft workings. Any information you write on paper will not be read or marked.
5. The examiner will take account of the way in which answers are structured. Respond directly to the exam question requirements. Do not include any content or opinion of a personal nature. A student survey is provided post-exam for feedback purposes.
6. Ensure that all of your responses are visible on screen and are not hidden within cells. Your answers will be presented to the examiner exactly as they appear on screen.

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.

QUESTION 1

Ketch plc is an AIM-listed company which manufactures air conditioning units.

You work as a senior in the business advisory department of Giles, Reaney and Cooper LLP (GRC), a firm of ICAEW Chartered Accountants. Ketch is a client of GRC, but not an audit client.

Hannah Hunter, a manager in GRC, asked to see you and opened the meeting:

"I would like you to work on an interesting new engagement for Ketch. I have provided some background information (**Exhibit 1**).

"The Ketch board requires advice on the expected sale of Ketch's Mumbai operations. Details have been provided by the chief executive, Rohit Reed (**Exhibit 2**).

"Rohit has also asked GRC to provide advice on some proposals made by the directors for the use of surplus cash (**Exhibit 3**). The finance director, Katy Krugman, has prepared summary management accounts for Ketch for the year ended 30 September 2018 (**Exhibit 4**).

"I have provided further information (**Exhibit 5**) about an ethical matter that I would like you to address, after you have considered the matters raised by Rohit.

"I have set out instructions for you, explaining more precisely what I would like you to do with respect to each of the matters raised (**Exhibit 6**)."

Requirement

Respond to the instructions from the manager, Hannah Hunter (Exhibit 6).

Total: 60 marks

Exhibit 1: Background information – prepared by Hannah Hunter

Operations

Ketch manufactures and installs air conditioning units. Its major customers are large businesses such as hotels, restaurants, offices and factories. It also sells units to small air conditioning installation companies which typically install Ketch's units for private individuals and small local businesses.

Ketch's customers for air conditioning units are located in the UK and the rest of Europe.

Ketch's main factory is based in the UK. It also has a factory in Mumbai, India which manufactures cooling components for air conditioning units. On 1 August 2018, the Ketch board decided to sell its Mumbai operation (see Exhibit 2).

Performance

Ketch has performed well in recent years and has large cash balances and significant retained earnings.

The board's view is that investment in more modern plant and equipment will be required in future, but there is a lack of agreement on how urgently this is needed. Some directors believe that investment is needed in the next 12 months, while others believe a five-year time horizon is appropriate.

Ownership and board structure

Ketch was founded in 1989 by Rohit Reed and Katy Krugman who introduced all the initial share capital. In 1997, as the business had grown, Catherine Coase joined the board as production director and was permitted to purchase new Ketch ordinary shares.

Sue Shiller and Zoe Zimmerman joined the board as non-executive directors just prior to Ketch obtaining an Alternative Investment Market (AIM) listing on 1 October 2015. They were also permitted to purchase new Ketch ordinary shares.

At 30 September 2018, the directors and shareholders of Ketch were as follows:

Director/Shareholder	**Board role**	**Number of £1 ordinary shares (million)**
Rohit Reed	Chief executive	30
Katy Krugman	Finance director	30
Catherine Coase	Production director	5
Sue Shiller	Non-executive director	5
Zoe Zimmerman	Non-executive director	5
Individual shareholders (each owning less than 1%)	-	25
Total		**100**

Rohit and Katy maintain a majority shareholding, but they no longer have a majority vote at board meetings.

Dividend policy

Ketch has a policy of paying a constant level of total annual dividend each year of £10 million. This is expected to continue.

Share price and share transactions

The directors all believe that the AIM market has underpriced Ketch's shares, despite the company's good financial performance in recent years.

There have been no changes in director shareholdings since the AIM listing and only low volumes of shares have been traded on AIM. These were all traded by individual shareholders as follows:

Year to 30 September	**Number of Ketch shares traded on AIM**	**Average price per share**
2016	1.15m	£2.56
2017	1.58m	£2.68
2018	1.11m	£2.33

Incentive scheme

Ketch's executive directors each receive an annual bonus based on a multiple of EBITDA per share.

Exhibit 2: Mumbai operation - prepared by Rohit Reed

Background

Ketch's Mumbai factory was purchased in 1999. Investment was immediately made in plant and equipment and the factory became operational in 2000.

The Mumbai operation manufactures low-cost cooling components to be fitted into air conditioning units. It produced 180,000 identical cooling components in the year ended 30 September 2018.

90,000 of these cooling components were transported, by ship, to the Ketch factory in the UK for fitting into its air conditioning units. These shipments occurred once a month. The other 90,000 cooling components were sold to third-party companies in India which manufacture air conditioning units.

The Mumbai operation is managed autonomously as a profit centre.

Transfer prices to the Ketch factory for cooling components are set at full cost plus 20%. These transfer prices averaged £186 per cooling component in the year ended 30 September 2018.

Selling prices to third-party Indian companies are denominated in the local currency (rupees) and vary according to market conditions. This price volatility is increased in £ sterling terms due to exchange rate fluctuations. Prices of the cooling components sold in India averaged £120 per unit in the year ended 30 September 2018.

Sale of the Mumbai operation

On 1 August 2018, due to increasing market competitiveness, Ketch reorganised its supply chain. As a result, the Ketch board made a strategic decision to sell the Mumbai operation and withdraw from the Indian market. The tangible assets of the Mumbai operation comprise property, plant and equipment (PPE) and inventories.

Following the board's decision, the sale of the Mumbai operation was immediately advertised in India. Production is continuing at the Mumbai factory, but can cease at short notice at any time.

The board is keen to understand the impact on the financial statements of its strategic decision.

The board would ideally like to sell the Mumbai operation in a single transaction as a going concern. Relevant financial information is as follows:

	At 1 August 2018	**At 30 September 2018**
	£'000	**£'000**
Advertised selling price - as a going concern (Note)	30,000	30,000
Selling costs	1,620	1,620
Carrying amounts of PPE	31,000	30,000
Fair value of PPE	28,700	28,250
Carrying amounts of inventories	500	500
Fair value of inventories	600	600

Note
The sale price as a going concern comprises: PPE, inventories and any unrecognised intangible assets.

An alternative means of procuring cooling components will need to be found when the Mumbai operation is closed. If a buyer for the Mumbai operation is found quickly, the directors will look for a short-term, third-party supply contract. This would be a temporary solution, before finding a more favourable long-term source of cooling components.

Exhibit 3: Proposals for the use of surplus cash – prepared by Rohit Reed

The sale proceeds from the Mumbai operation, together with existing cash balances, will create a large surplus cash balance. The board has failed to reach agreement on how Ketch should use this surplus cash. Three mutually exclusive proposals have been put forward by directors.

There is a working assumption that each proposal would commence on 1 October 2019.

The board requires independent, expert advice from GRC regarding which proposal makes the best use of its surplus cash.

Katy Krugman, the finance director, has provided summary management accounts (Exhibit 4) to help you.

Proposal 1 – Capital investment in a new UK factory with advanced technology

Ketch needs to find a new long-term source of cooling components following the sale of the Mumbai operation. Two ideas are being considered by the board.

- Catherine Coase, the production director, has proposed using the surplus cash to purchase a new factory in the UK with automated plant and equipment to manufacture the cooling components.

- The finance director, Katy, has made an alternative counter-proposal that Ketch should instead buy its cooling components from a UK-based third-party supplier and use the surplus cash elsewhere.

Katy has made the following forecasts:

> If the factory is purchased, there will be an initial cash outlay of £50 million on 1 October 2019.
>
> However, the annual cash outflows will be £5 million lower if the cooling components are made in the new factory, rather than being purchased from a third-party supplier (using 1 October 2019 prices). This £5 million cost saving will increase by 1% per annum over the useful life of the factory of 20 years. The factory is expected to have no residual value at the end of 20 years. The annual weighted average cost of capital of Ketch is 7%.

Proposal 2 – Share buy-back (ie, purchase of own shares)

The proposal is for Ketch to offer to buy-back 20 million of its own shares using the surplus cash. The buy-back would be offered only to individual shareholders, as the directors currently seem unwilling to sell any of their own shares. The repurchased shares would then be cancelled. The price at which the repurchase would take place is uncertain, but the current price per share is £2.30.

I made this proposal together with Katy Krugman and we would both vote for it at a board meeting or shareholder meeting. The Ketch shareholder agreement and Articles of Association require a 75% majority of shareholders to approve the share buy-back process.

All Ketch shares are fully paid.

Proposal 3 – Invest in corporate bonds

The two non-executive directors, Zoe Zimmerman and Sue Shiller, have been critical of Ketch's cash management policy. They believe that Ketch has held large, idle cash balances which have not been earning an appropriate return for shareholders and the proceeds from the sale of the Mumbai operation will add to the amount of cash balances.

However, they do not believe that purchasing a new UK factory is currently an appropriate use of the surplus funds, either financially or operationally. Neither do they believe that a share buy-back is in the best interests of all stakeholders.

Zoe and Sue therefore propose that, while waiting for a better capital investment opportunity to arise, the surplus cash should be invested in corporate bonds. These bonds would be issued by UK and international companies, denominated in both £ sterling and other currencies. Zoe and Sue propose that the bonds should all be listed so they are sufficiently liquid for a quick sale if a suitable capital investment opportunity arises at short notice. The expectation is that the bonds would be sold and then reinvested in manufacturing assets within four years.

Zoe and Sue's proposal is to invest in a portfolio of long-term corporate bonds, with a credit rating of at least BBB. However, they are concerned about the risks relating to this type of investment and how such risks may be mitigated.

Two examples of corporate bonds that could be purchased as part of the portfolio are as follows:

- Bonds in Ploome plc currently quoted at £97.50, with a 3% nominal interest rate paid annually. These bonds are redeemable at par in four years and have an ABB credit rating.

- Zero-coupon bonds in Ghlast plc currently quoted at £95. These bonds are redeemable in 10 years at a premium of 45% on par and have a BBB credit rating.

Zoe and Sue have differing views:

- Zoe prefers the Ploome bonds, as the 4-year period to maturity is consistent with the time when the funds will be needed for investment.

- Sue prefers the Ghlast bonds, as the 10-year period to maturity generates a higher yield and, because the bonds are quoted, they can be sold whenever the funds are needed, without needing to wait until they mature.

Exhibit 4: Summary management accounts – prepared by Katy Krugman, finance director

Summary draft statement of profit or loss for the years ended 30 September

	2018 Draft £'000	**2017 £'000**
Revenue	248,000	242,400
Cost of sales	(155,100)	(151,900)
Gross profit	92,900	90,500
Distribution and administration costs	(43,400)	(42,900)

Operating profit	49,500	47,600
Finance costs	(5,500)	(5,500)
Profit before tax	44,000	42,100
Tax	(8,400)	(8,000)
Profit for the year	35,600	34,100

Other data	**£'000**	**£'000**
EBITDA	62,600	60,700
Ordinary dividend paid	10,000	10,000

Summary draft statement of financial position at 30 September 2018

	£'000 Draft
Non-current assets	
Property, plant and equipment	334,000
Current assets	
Inventories	18,200
Trade and other receivables	24,200
Cash	21,700
Total assets	**398,100**
Equity	
£1 ordinary shares	100,000
Share premium	18,400
Retained earnings	123,300
Non-current liabilities	
Bank loan (repayable 2026)	140,000
Current liabilities	
Trade and other payables	16,400
Total equity and liabilities	**398,100**

Exhibit 5: Ethical matters – prepared by Hannah Hunter

I overheard Katy Krugman and Rohit Reed having an angry conversation yesterday. I was working in the next room. However, the walls are thin and I could not help but hear them as they were shouting at each other for most of the time.

I recorded the conversation on my smartphone, so I know exactly what they said. The key points of the conversation were as follows.

Rohit commenced the conversation: "We have made some big mistakes and most of these were your ideas, Katy. It was a big mistake taking on the other directors, as we lost control of board meetings. It was a big mistake to let them have shares, as we no longer have a 75% majority between us in shareholder meetings. It was a big mistake to go for an AIM listing, as we are now subject to more regulations and small individual shareholders are able to tell us what we can and can't do.

"However, between us we still have a majority of shares, so I want us to vote together to dismiss the other directors. Also, although we can't make them sell their shares, if we withdraw our AIM listing and Ketch goes back to being a private company, they will soon agree to sell their shares or they will be stuck with shares they can't sell. We can then take back control of Ketch, which is what I want."

Katy retorted: "I don't care what you want. I have had enough of Ketch and I am tired of working. I want to retire, but nobody will buy my shares at a reasonable price. I want the share buy-back scheme like you do, but for different reasons. I cannot sell my shares under the proposed buy-back scheme as it is for the individual shareholders. However, if the buy-back scheme increases the market price of the shares, then I will sell my shares on AIM to anyone who will buy them. I will then retire. The last thing I want is for Ketch to return to being a private company."

Rohit replied: "The one thing that we both agree on is that we want the share buy-back to go ahead. I am doubtful that enough individual shareholders will participate in the buy-back, so we need to make sure that GRC strongly supports this option in its advice. We can then pressurise the other directors and maybe get one or more of them to sell their shares, if we can get the board to extend the share buy-back scheme to the other directors. Let's at least work together to do this."

Exhibit 6: Instructions – prepared by Hannah Hunter

I would like you to do the following:

(1) With respect to the decision to sell the Mumbai operation (Exhibit 2):
- Explain the financial benefits and risks. For this purpose, ignore the three proposals for the use of surplus cash.
- Set out and explain the financial reporting implications for Ketch's financial statements for the year ended 30 September 2018.

(2) Evaluate and compare the two alternatives for the long-term sourcing of cooling components (Exhibit 3 – proposal 1):
- Purchase a new UK factory; or
- Use a UK-based third-party supplier

(3) With respect to the proposed share buy-back (Exhibit 3 – proposal 2):
- Explain the factors to be considered in determining the price per share to be offered in the buy-back arrangement.
- Explain the benefits and problems of the share buy-back for each stakeholder.

(4) With respect to the investment in corporate bonds (Exhibit 3 – proposal 3):
- Explain the benefits and risks of using the surplus funds to buy corporate bonds and explain how any risks could be mitigated.

- Evaluate the differing views of Zoe and Sue.

Use the Ploome and Ghlast examples to illustrate your points. I do not need the financial reporting treatment.

(5) Recommend, with reasons, which of the three proposals is the best use of the surplus cash for Ketch.

(6) With respect to the conversation that I overheard and recorded (Exhibit 5):
  - Set out any ethical implications for Rohit and Katy.
  - Explain the ethical implications for GRC.
  - Recommend actions that GRC should now take.

QUESTION 2

"Amy Ahmed, our recently appointed chief executive, is not happy. She wants changes to be made as soon as possible and she wants our department to set out a plan for change."

Simon Smyth, the head of Zeta plc's strategy and marketing department, was speaking at a planning meeting with you.

Zeta plc is a UK-based company, which sells high-quality sports equipment for golf and skiing. Simon's department is responsible for developing new strategies and for evaluating and delivering digital marketing operations. You are an ICAEW Chartered Accountant who has recently joined Zeta, working for Simon.

Simon continued: "I realise that you are new to Zeta, so I have provided some background notes about the company (**Exhibit 1**). As you know, Amy has recently completed a review of Zeta's strategic position and direction and some key conclusions have been reached.

"An extract from the executive summary of Amy's review is as follows:

> Profit has been falling. We need to understand our markets and our customers better to make good marketing decisions. As a consequence of falling profit, the value of the Zeta brand is in decline and we need to reverse this trend.

"Amy has asked our department to establish why profit has been falling and to identify strategies that will reverse this decline.

"I have provided you with some financial information regarding performance (**Exhibit 2**). I have also set out some notes on improving the effectiveness of the way we use our existing database and how this can be linked with new digital marketing strategies (**Exhibit 3**).

"In addition, I have prepared some notes regarding the possible acquisition of a supplier, Ski-Gear Ltd, or the purchase of its brand (**Exhibit 4**).

"I have set out instructions on the contents of a report which I would like you to prepare (**Exhibit 5**)."

Requirement

Respond to Simon's instructions (Exhibit 5).

Total: 40 marks

Exhibit 1: Background information – prepared by Simon Smyth

Company history

Zeta has a long history, having been established in 1922 as a retailer of golf equipment. It now sells good-quality sports equipment and clothing for golf and skiing. All products are sold under Zeta's own brand name.

Zeta has made many operational changes over the years, but it has retained a policy of having high-quality products and good customer service.

Procurement

Almost all Zeta products are imported from sports equipment manufacturers, located in Europe and the US, or from clothing manufacturers in Asia. Many products are purchased under UK exclusivity agreements, so Zeta may be a supplier's only UK retailer for the period of the exclusivity agreement.

Branding

All products are sold under the Zeta brand name. However, a number of Zeta's suppliers also sell to other customers using their own well-known brand names.

Over many years, the Zeta brand has been perceived as traditional and up-market, being identified with good quality products and good service. However, recent market research shows that the brand is perceived as delivering below average value to customers for the sports retail sector. Customer surveys also show that the perception of quality has declined.

Sales

Sales are made in the UK through two distribution channels:
- A chain of 10 retail shops owned by Zeta.
- Online sales through Zeta's website.

Zeta does not sell to third-party retailers as it wishes to protect the brand by controlling the level of service provided to customers with each sale.

All Zeta stores sell equipment and clothing for both skiing and golf. The proportion of floor space for each sport varies between stores and according to the time of year. Customers are advised by Zeta staff with knowledge of the relevant sport.

Customers are mostly high earners and over 35 years old. About 70% of customers for golf products and about 52% for skiing products are male.

Exhibit 2: Financial information

Summary of gross profit for the years ending 30 September:

	2017 Skiing £000s	2017 Golf £000s	2018 Skiing £000s	2018 Golf £000s
Revenue:				
Stores	8,500	15,700	8,600	13,700
Online	2,800	4,300	3,700	4,900
	11,300	20,000	12,300	18,600
Cost of sales	(7,910)	(15,000)	(8,856)	(14,508)
Gross profit	**3,390**	**5,000**	**3,444**	**4,092**

Notes

- The selling price per item is the same for sales through stores and online.
- The cost of sales per item is the same for sales through stores and online.
- Cost of sales comprises the cost of purchasing products for sale.

Exhibit 3: Digital marketing and use of the database – prepared by Simon Smyth

The existing customer database and website

When customers make a purchase from Zeta, either in a shop or online, their personal details are normally recorded (name, age, gender, occupation, address and contact details) and a record of the sale is added to their personal sales history.

A customer database is maintained with details of each customer and a history of their purchases. In the past, very little use has been made of this data.

Data collected from Zeta's website includes:

- Visits (ie, the number of times a site is visited).
- Unique visits (ie, the number of distinct individuals requesting pages from the website during a given period, regardless of how often they visit).
- Page views (ie, the number of times a particular page is loaded).
- Online transactions for each product (number and value).

Each time a customer visits the website, the above data is gathered on an individual customer basis. This data is added to existing data already held on the same customer on the database to build up a richer data set.

Customer surveys show that many customers visit the Zeta website to browse online, but they then buy in Zeta stores to obtain personal service and help.

Digital marketing

Amy requires an evaluation of how data analytics and digital marketing using online channels, including social media, can be used to market to existing and new customers.

It is intended to use digital marketing, not only to make short-term sales, but also to build the long-term effectiveness of the brand with both online customers and those buying from shops.

Data analytics will be used on the data extracted from the customer database, digital marketing data and market-wide data. The aim will be to build a picture to predict sales, plan inventory and identify targets for bespoke marketing.

IT consultants' investigation

As part of Amy's review, external IT consultants were hired to investigate the customer database and they produced the following insights:

- Most customers buy either golf products or skiing products. Only about 10% of customers buy both golf and skiing products.
- Approximately 75% of Zeta's sales in a year come from 20% of its customers.
- Approximately 84% of Zeta's sales in a year come from customers who have purchased goods previously from Zeta.

Exhibit 4: Ski-Gear Ltd – prepared by Simon Smyth

Ski-Gear Ltd is a supplier to Zeta. Ski-Gear produces some of the highest-quality and highest-priced skiing products sold by Zeta.

Some preliminary discussions have taken place with the Ski-Gear board about the possibility of Zeta acquiring the entire ordinary share capital of Ski-Gear.

If the shares in Ski-Gear are acquired, there are two views amongst the directors:

- Some Zeta directors want to acquire Ski-Gear and start to sell some products under the Ski-Gear brand but continue to sell most products under the Zeta brand.

- Other Zeta directors want to acquire Ski-Gear but not use its brand. Instead they want to maintain the Zeta brand for all sales, but use the good-quality Ski-Gear manufacturing facility.

An alternative to acquiring the Ski-Gear shares is for Zeta to purchase only the Ski-Gear brand. Zeta would then brand and sell certain products as Ski-Gear, but continue to sell most products under the Zeta brand. Zeta would outsource the manufacture of Ski-Gear branded products.

Brand valuation

There is disagreement on the valuation method that would be used to determine the value of the brand, as Ski-Gear is currently only breaking even.

The directors are concerned about how the brand would be treated in Zeta's financial statements if there is either an acquisition of: Ski-Gear's shares; or a purchase only of the Ski-Gear brand.

The Zeta board would like due diligence procedures to be performed to gain more evidence to support the valuation of the Ski-Gear brand.

Exhibit 5: Instructions from Simon Smyth

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

(1) Analyse and evaluate the financial performance of Zeta in the years ended 30 September 2017 and 30 September 2018. Include an analysis of Zeta's two product lines (golf and skiing) and two sales channels (shops and online).

(2) Explain how a new digital marketing strategy, used in combination with data analytics, could increase revenue and improve the long-term value and effectiveness of the Zeta brand.

(3) In respect of Ski-Gear (Exhibit 4):

  (a) Explain possible methods for determining the value of the Ski-Gear brand.

  (b) Set out and explain the financial reporting treatment of the Ski-Gear brand in the consolidated financial statements of Zeta if:

  - the ordinary share capital of Ski-Gear is acquired
  - only the Ski-Gear brand is purchased.

  (c) Identify and explain the due diligence procedures that should be performed to obtain evidence for Zeta to support a valuation of the Ski-Gear brand.