Practice Script A

Question 1

(1)

Practice Script A

Financial Benefits:

The Mumbai operation is managed autonomously. It is likely that there are substantial administrative duties carried out and that it operates a separate human resources and financial department. If the operation is to be closed down and the components subsequently manufactured in the UK the additional HR and admin responsibilities could be handled by the UK operation thus giving a cost saving.

Manufacturing these components in the UK would also save on logistical costs. Given that 50% of the cooling components manufactured in India are transported to the UK it is likely that shipping costs are substantial.

It is also possible that shipping the components from India results in tarriffs and red tape. Again, if the 90,000 components that are currently shipped from India were to be made in the UK, this should result in reduced tax costs.

Manufacturing in Mumbai means that Ketch are exposed to foreign currency risks. The cost paid by Ketch for components manufactured in India are based on a 20% markup on costs. If the Ruppee appreciates then even if costs are stable, Ketch will incur a higher sterling cost for the components.

Selling the Mumbai operation and using a third party would also decrease operational gearing. In-house production generally means a higher level of fixed costs and greater sensitivity to sales. If a third party is found most of these costs will now be variable.

Risks:

If the shortfall in components is to be made up using an expansion of the UK operations there will likely be high up front costs. Depending upon the cash reserves this may require new financing. Whichever method of finance chosen this will result in additional costs for the business.

It is likely that the costs to manufacture in India are cheaper. The costs of living are generally lower and as such Ketch will likely find the staff costs cheaper in India than they would be in the UK.

90,000 components are sold in India. If the Mumbai operations close these costs will either be foregone or the sales will still be made but the components will be manufactured elsewhere. This will mean that the high logistical costs will still be incurred.

If a third party supplier is found then prices will have to be negotiated each time a new contract is drawn up. This makes it harder to forecast cash flows in the future and increases the risk of Ketch having to pay a higher price for their components than they currently do.

Producing in-house as opposed to using a third party would also give Ketch more control over quality and delivery as the relationships would be stronger and the supply chain is effectively internalised.

3	Once the board advertised the Mumbai operations in India the operation would likely meet the criteria as assets held for sale. This treatment is contingent on the assets being available for sale in their present condition and the sale being highly probable. At this point the carrying amount of the assets should be compared to their fair value less costs to sell. This results in an impairment of 2,300 for the PPE (see calcs below). This impairment must go to the P&L. These assets will then be taken out of non-current assets, depreciation will cease and they will be classified as held for sale within current assets. Any profits subsequently arising from the Mumbai operations will be disclosed in a separate line within the SPL as profits from discontinued operations. If the operation is sold for its advertised cost a loss will arise of -820,000(30,000-1,620-28,700-500). This will be shown in the SPL for the following year should the operation be sold within 12 months.	
4		
5	CA PPE	31,000
6	FV PPE	(28700)
7	Impair	2,300
8		
9	(2) New UK Factory: Assuming that we are calculating the value of the cost savings at 30 September 2018 then the present value of the cost saving is 15,104 (see calc below). Given that this is positive it indicates than the value of the future cost savings will be worth the intital outlay of 50m. That being said there are other factors that should be considered before Catherine's proposal is implemented. Use of the factory would mean higher operational gearing as mor of the costs would be fixed. This means they would be more sensitive to decreases in sales. One of the positives is that the use of the factory would give Ketch more control over product quality and delivery as they would be in charge of these rather than a third party. If demand increases then variable costs would be low meaning profit would rise more rapidly than if a third party was being used. Given the high competiveess in the market a substantial increase in demand would seem unlikely	

Third Party:

The financial saving discussed above relies on a big assumption of the cost saving growing in the future . Evidence would be required to corroborate this and even so it does mean there is an increased level of risk.

Using a third party means that exist costs are low should Ketch want to cease production.

As speficied above, use of a third party would mean lower operational gearing meaning that they wouldn't be as sensitive to falls in demand.

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11			
12	saving in perp	5000*(1/0.07-0.01)	83,333
13	PV of Factory	50000*(1/1.07)	(46729)
14	Saving in perp @t20	5000*(1/0.07-0.01)*0.258	(21500)
15			15,104
16			

(3)

To determine the price per share Ketch should consider future earnings. The sale of the operation in Mumbai means significant uncertainty regarding future costs and any valuation would need an accurate forecast to what these may be.

75% of shareholders need to agree for the sale to go ahead. Katy and Rohit have both said they would agree to the sale and together they own 60% of the shares. This means that any offer would have to satisfy all three of the remaining major shareholders.

The current valuation must also be considered. The market price is now £2.30. The price offered would also need to be greaterthan this otherwise the existing shareholders could just sell their shares on the open market.

One method that could be used to value the shares is the dividend valuation model. This is relavent because the potential sellers of the shares do not have a controlling interest and therefore don't have power to affect future earnings. This means it is more likely they will only be concerned with dividends. Making the conservative assumption that there is no future growth the dividend valuation model would value the shares at,

10/0.07 = £142. Note that this is using the WACC and should be calculated using the cost of equity. It should be noted that the cost of equity is only an estimation too.

Another appropriate method for determining the buy-back offer would be to take the p/e ratio of a similar listed firm and to calculate the vaulation this would give Ketch.

For the current shareholders the buy back will increase their stake in any future profits. It also increases their risk as the company will be making an up front payment and should the earnings continue to decrease in the future they may not see a return.

For the current minority shareholders they will be receiving an upfront payment for their shares which will have to be above market value. Given that earnings have been declining, many of them will probably see this as a positive.

Another major issue with the sharebuy back is that the cash will no longer be recoverable. Given that there is a large bank loan repayable in 2026 it is likely that substantial cash will be required at this point.

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(4)

Benefits:

The main benefit of investing in corporate bonds is that the company will be seeing a return on cash that otherwise would have been sitting idle in their bank accounts not earning any return. Because of the increased risk corporate bonds generally earn a higher rate of interest than alternatives such as government bonds.

Investing in overseas bonds will provide a hedge against any costs incurred overseas. If for example Indian corporate bonds were invested in and the Rupee depreciated then any inertest received would decrease in sterling terms but at the same time any costs made in Rupees would balance this out.

The yield earned out the bonds is related to the riskiness. Investing in company's with a rating of BBB gives a moderate level of risk and would therefor earn better returns than a company with a better risk rating such as AAA.

Risks:

Corporate bonds are more risksy than government bonds. A return on the money invested is not always possible and given that they intend to inves in companies with a BBB rating this risk is higher.

Investing in coporate bonds increases foreign exchange rate risk. If the currency of the country you are investing in depreciates then returns will fall in sterlng terms.

Comparison:

In order to compare loans the yield should be calculated which takes into account both coupons and the premium on redemption.

Ploome - 3/97.5 + (100/97.5)^1/4 - 1 = 3.7%

Ghlast - (145/95)^1/10 - 1 = 4.3%

The IRR calc gives a higher return to Glast although this doesn't take into account all the relvant factors.

Specifically Ghlast has a higher risk attached and a worse credit rating. This means that the credit rating agencies believe investors are less likely to get their money back if they invest in Ghlast as opposed to Ploome.

Zoe's assertion that the Ploome bonds are prefereable because the term matches the investment time is also relevant. It is beneficial to match the term of the finance with the term of the finance if possible. Although the Ghlast bonds could potnentially besold as Sue stated there could be associated transaction fees with this and it is possible that the bonds could have reduced in value at this time. This is particularly relevant given the increased risk with Ghast bonds.

(5)

Of the three proposals I would recommend that corporate bonds are invested in using the surplus cash and investing some money in both Zoe and Sue's prefered bonds. This means that the risk would be lower than investing in Ghast only but would also generate a higher return than investing in Ploome only. This method is also advisable because of the 140m bank loan repayable in 2026. The cash invested in Ploome will have been released again at this point whereas if another of the proposals was chosen the cash could still be tied up.

Although there is an element of risk of default there are also risks attached to purchasing the factory. The return on proposal 1 requires a long term forecast which is unlikely to be accurate and as such could reduce in a loss. There are also potentially large exit costs if the factory is a failure.

Finding the correct price to offer for the share buy back also means that there is risk attached to this method. It is possible that the valuation method used overvalues the company meaning that the increased profits received by the current majority shareholders is not sufficient to make up for the cash paid out.

(6)

Assessing the ethical implications of the conversation overheard by Hannah can be done by making the following considerations:

Effect - It is clear that both Katy and Rohit intend on taking actions which will hurt the other major shareholders. Rohit has stated that she intends to not only go behind the other directors' backs to vote them out but also withdraw the AIM listing in order to induce them to sell their shares. Withdrawing the listing for this reason would clearly not be putting the bet interests of the company first and would therefore have an adverse effect on the other shareholders. Katy stating that she wants the sharebuy back so she can sell her own shares is also not in the best interests of the company and may lead to her proposing a higher offer than necessary.

Fairness - Both Katy and Rohit's stated actions are damaging to the other shareholders as discussed above and it clear than no reasonable third party would deem it fair.

Transparency - There is also a clear lack of transparency here. The conversation is being had in private rather than a board meeting which would be the appropriate setting.

Legality - The company's shares are publicy listed and as such there is legislation in place to avoid any potential manipulation of the share price. Katy may try to set an artificially high price for the buy back and as such this may result in legal implications.

Although the conversation had was highly unethical the means by which Hannah was exposed to it is also questionable. Recording the conversation in secret is a clear breach of client confidentiality and should not have been done.

In terms of additional actions to take Hannah should consult with GRC who may wish to raise the matter with the rest of the board. Only if GRC think that the law has been broken do they have the right to disclose the matter. If they are unsure about the future steps they should contact the ICAEW.

Question 2

3			2017 Ski	2018 Ski	% Change	2017 Golf	2018 Golf	% Change	2017 Total	2018 Total	% Change
4	Revenue		11300	12300	8.85	20000	18600	-7	31300	30900	-1.28
5	COS		(7910)	(8856)	11.96	(15000)	(14508)	(3.28)	(22910)	(23364)	1.98
6	Gross Profit		3390	3444	1.59	5000	4092	-18.16	8390	7536	-10
7											
8	Rev		2017	2018	Movement						
9	% Rev Golf		63.9%	60.2%	-3.7%						
10	% Rev Ski		36.1%	39%	+2.9%						
11	Rev										
12	% Online		22%	28%	+6%						
13	% Stores		77%	72%	-5%						
14											
15											

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(1)

Overall Gross profit:

From 2017 to 2018 there was an overall fall in gross profits of 854,000(8390K-7536K) which represents around 10% of 2017 profits. This fall was driven both by a decrese in revenue for the year and an increase in costs. It is possible that the fall in revenue is due to the perception of the brand declining.

The reason for the increase in costs is less clear. There has been a fall in the sales made in stores which should incur more costs than online. the majority of Zeta's products are however imported. It is possible that there has been an appreciation in the exchange rates of the asian currencies leading to a higher sterling cost forthe equipment.

Golf/Ski Split:

From 2017 to 2018 there was a decline in the proportion of sales that were made of Golf equipment and an increase in the sales of Skiing equipment. This could just be down to a change in the popularity of the respective sports and may change back again should fashions or seasonal trends make golf more popular than skiing in the future.

It could also be that advertising has been targeted at different demographics in the year to 2018. Given that the vast majority of the sales of golf equipment are made to men, if advertising was changed to be more targeted at women it is possible that the sales of golf equipment would decline.

Stores/Online Split:

There has been an increase in the revenue generated from online sales and a decrease in the revenue generated from in-store sales. This reflects a general trend in the whole of the retail sector whereby consumer prefer the convinence and lower prices offered online.

Total sales from stores still make up the vast majority of total sales 77% of them. Given that sales prices are the same both online and in-store, this indicates that there is a higher volume of sales coming from the stores. This may be because the target demographic of over 35 year olds are less likely to prefer online shopping than younger customers.

(2)

Generally a digital marketing strategy allows companies to provide more targeted and thus efficient marketing to potential customers which helps to minimise marketing costs and also increase the probablity that a potential customer makes a purchase.

The system which keeps a log of customers both online and in-store could help to categorise shoppers into those who research online and then purchase in store and those who only purchase online. Generally making a higher proportion of sales online should help to reduce fixed costs as staff wont have to be employed to work on shop-floors and rent wont have to be paid for premises. As such to reduce these costs in the future Zeta could offer additional benefits for purchasing online to those shoppers who currently come in to store to make purchases. This could be done in the form of discounts or free shipping.

The number of page views could also be used to optimise the website. If for example it is found that users are frequently moving between pages many times it could be that the website has a confusing layout and that it should be simplified. This should improve the image of the company in the eyes of the consumers and encourage them to visit the website more often and make more purchases.

The new startegy could also utilise 'cookies'. These would require pre-approval from visitors of the website but would then allow Zeta to target these people with adverts on other websites. For example if a regular purchase of Golf equipment is tracked Zeta could target them with gold advertisements whenever a new range of gold equipment is launched.

18 More extensive profiling of customers could be done with a new strategy. Currently Zeta knows the man/woman split of purchases but this could also be done on age, nationality or social group. This would allow advertising to be made more bespoke. Either customer groups who dont currently make purchases could be targeted or existing groups could be focused on more.

Profiling of customers in this way along side market research focused on this group would allow Zeta to more accurately determine why customers no longer percieve their brand of being high quality.

Currently a high proportion of sales are repeat purchases. In order to increase profit in the future it would be useful to find out why this is. If for example there were a lot of visitors to the website not making purchases it could indicate a problem with the website and new web developers could be brought in to improve this.

A new digital marketing strategy may offer a more secure database of customers than is currently in place. Given the recent increase in legislation surrounding company's uses of an individual's data it is important that all relevant laws are being adheared to. The introduction of a new system such as this would allow Zeta to strengthen their IT controls and ensure adhearance to regulations.

(3)

(a)

IFRS 13 gives guidance on how brands should be valued an specifically sets out three methods that can be used.

The market basis - This uses market price and other transactions. In practice this is very hard to use for brands as each is unique and there is no market where replica brands are traded and from which a valuation can be taken.

The income basis - This method would consider the present value of the incremental income generated. In the case of Ski-Gear it would involve looking at the company's income and taking a judgement to how much of this income is created becasue of the brand. It is likely that products sold under the Ski-Gear brand are likely to generate a premium compared to other identical products without a branding.

The cost basis - This method would be a calculation of the amount that would have to be incurred to create the Ski Gear brand from scratch. For example if the brand was to be recreated it would require additional advertising expenditure, promotion and research and development costs. The present value of these should be calculated and this would become the value.

All of these methods would require a substantial degree of judgement and thus in practice the valuation of a brand is very difficult to do.

(b)

Ordinary share capital purchased:

If all of the share capital was acquired and there were no additional rights to control held by other parties then Ski-Gear would become a 100% subsidiary of Zeta.

In the consolidated financial statements the results of both Ski Gear and Zeta would be included in the financial statements as one entity. The consolidated statement of financial position would include all of Zeta's assets and liabilities as well as all of Ski Gear's assets and liabilities at their fair values. Any profit earned from SkiGear would be included 100% in the consolidated statement of profit or loss however this would have to be adjusted to reflect the proportion of profits which were earned since SkiGear became a subsidiary.

Goodwill would be calculated on acquisiton. This would be based on the fair value of the total consideration paid by Zeta as well as the fair value of the net assets. Goodwill would sit within the assets in the CSFP and would be checked each year for impairment.

If the SkiGear brand had not been developed by SkiGear themselves and had instead been acquired separetely it would be appropriate to recognise this at its fair value within the consolidated accounts.

SkiGear Brand Only:

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As the brand would be being purchased and not created internally, the brand should be recognised as an intangible asset. This would be done at cost which should be the same as its fair value. Each subsequent year the brand should be reviewed for any evidence of impairment.

(c)

Zeta should ensure extensive due diligence procedures have been carried out prior to creating a valuation for acquisition.

Financial due diligence procedures should be carried out. This will involve a review of SkiGear's financial position, financial risk and projections. Primarily this would be done to attest to the fair value of SkiGear's assets and future cash flows.

For example for the valutation of a specialised asset it may be useful to get a valuation from an expert. The assurance provider would be reponsible for ensuring the valuer has the relevant qualifications and is independent. For valuing assets of which there are identical versions being sold in the market the assurance provider should be able to work out what the fair value is.

Any future forecasted cash flows will likely be based on significant assumptions. Procedures should be carried out to attest to the reasonableness of these assumptions and thus the accuracy of the cash flow projections. For example if growth for the industry has been forecasted, an industry expert could be brought in who could verify the forecasted growth.

Commercial due diligence should also be carried out to consider the SkiGear market and overall economic enviroment. Economic forecasts could be reviewed which may indicate and shrinkage of the market in the future and as such a lower valuation than would otherwise be made.

Operational due diligence procedures could also be used such as reviewing the supply chain to identify any operational upsides which could result in lower future costs and higher valuation.

Another operational procedure would be to verify any synergies that the valuation is based on. Specifically if assumptions are made of potential reductions in staff numbers, procedures could be carried out to verify whether the business could still operate properly with a lower number of staff.

Due diligence could also be done by bringin in tax experts who could recalculate future tax payable and ensure that this corresponds to the amounts used.