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Paper P10

Test of Professional Competence in Management Accounting

Relevant for **May & November 2006** examinations

- Outlines criteria of the new assessment matrix
- Complete skills and technical toolkit
- Review of past cases focusing on the skills being tested

Helping you to pass your CIMA exam

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Test of Professional Competence in Management Accounting

Heather Barnwell

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Guide to the Icons used within this Text

 Key term or definition

 Equation to learn

 Exam tip to topic likely to appear in the exam

 Exercise

 Question

 Solution

 Comment or Note

About the TOPCIMA Exam and the Assessment Matrix

1

Learning Outcomes

By the end of this introductory chapter you should

- have an understanding about the aims of the new TOPCIMA exam;
- have a clear understanding of how you can access the pre-seen material and what you should do to prepare for the exam;
- have a clear understanding of the new TOPCIMA assessment matrix and how it will be applied to mark your answer.

1.1 Acknowledgements

The author Heather Barnwell would like to thank all contributors to this edition of the TOPCIMA CIMA Learning System, especially to Adrian Sims, who contributed to an earlier edition to this Learning System. Whilst every effort has been made to contact the holders of copyright material, if any have been inadvertently overlooked, the publishers will be pleased to make the necessary arrangements.

This edition of the TOPCIMA Learning System has been THOROUGHLY updated. Many of the previous CIMA Final Level Case Studies (FLCS) have been removed from this edition of this book and most of the analysis and comments are based on the three recent TOPCIMA exams, sat in May, September and November 2005. This CIMA Learning System also includes the exam material for the March and May 2006 TOPCIMA exams. It must be stressed that you should prepare yourself for the TOPCIMA exam by working through past case studies, but a maximum of three previous cases is recommended. This is the reason why many of the old FLCS cases have now been removed from this Learning System and the three most recent TOPCIMA cases have been put in.

The author has been involved with CIMA examinations for over 20 years and is currently the TOPCIMA Lead Marker. She has also written nine CIMA case studies. Four cases were examined under the old syllabus FLCS exam and Heather Barnwell has written all of the five TOPCIMA cases examined in May, September and November 2005 and also those being examined in March and May 2006.

This CIMA Learning System contains a wealth of personal and inside knowledge of the TOPCIMA exam process and it gives you a valuable insight into how your answer will be marked against the TOPCIMA assessment matrix.

The author is confident that this CIMA Learning System will help you to prepare for the TOPCIMA exam. Working through two or three cases will give you the skills required to enable you to PASS your TOPCIMA exam. Remember – it is not enough to just read this book – you MUST work your way through these past cases.

1.2 The International Federation of Accountants (IFAC)

The International Federation of Accountants (IFAC) states that their mission is 'the world-wide development and enhancement of an accounting profession with harmonised standards, able to provide services of consistently high quality in the public interest'.

CIMA is a member of IFAC and is a recognised leading accountancy body worldwide. CIMA has decided to change the final CIMA exam, previously called *Final Level Management Accounting – Case Study (FLCS)*, to bring it in line with the recommended IFAC criteria. The TOPCIMA exams that will be set in 2005 are the FIRST totally IFAC compliant exam world-wide, and confirms CIMA position as one of the leaders in the accountancy profession.

The TOPCIMA assessment matrix (detailed in Section 1.9) is based on the nine recommended IFAC criteria.

IFAC has published an International Education Statement (IES) called IES 6 on the 'Assessment of Professional Capabilities and Competence', which becomes effective from January 2005. It is the responsibility of IFAC member bodies (of which CIMA is one of the many member bodies) to have in place assessment procedures that ensure that candidates admitted to membership are appropriately qualified. In IES 6 IFAC have set out that candidates need to be able to demonstrate that they have the necessary skills under nine headings. These nine headings form the basis of the new TOPCIMA assessment matrix.

1.3 Aims of the TOPCIMA exam

The TOPCIMA exam can only be sat by candidates who have *passed* all three Strategic level exams and, unlike its predecessor FLCS, is taken as a stand-alone exam. The aim of the TOPCIMA exam is to test higher level skills of candidates as a final gateway to CIMA membership. CIMA has recommended that it be sat by those who have already had their practical experience assessed and approved.

The TOPCIMA exam aims to test the candidate's ability to

- apply strategic management accounting techniques and technical knowledge to the organisation given in the case material and to prepare appropriate strategic recommendations.

The TOPCIMA syllabus aim is to test the capabilities and competence of candidates, to ensure that they:

- have a sound technical knowledge of the specific subjects within the curriculum;
- can apply technical knowledge in an analytical and practical manner;

- can extract, from various subjects, the knowledge required to solve many-sided or complex problems;
- can solve a particular problem by distinguishing the relevant information from the irrelevant, in a given body of date;
- can, in multi-problem situations, identify the problems and rank them in the order in which they need to be addressed;
- appreciate that there can be alternative solutions and understand the role of judgement in dealing with them;
- can integrate diverse areas of knowledge and skills;
- can communicate effectively with users, by formulating realistic recommendations, in a concise and logical fashion;
- can identify, advise on and/or resolve ethical dilemmas.

! There is a much heavier emphasis on technical knowledge and techniques than there used to be under the old FLCS exam, and **the techniques included in Chapter 4 of this CIMA Learning System are now vital** to ensuring that case material is analysed using this technical knowledge and techniques.

Using the above syllabus aims the TOPCIMA case material requires candidates to

- analyse and identify the current position of the organisation (position audit);
- analyse and identify the relevant problems facing the organisation in the pre-seen material;
- Appraise possible feasible courses of action;
- evaluate and then choose specific proposals (using the unseen material on the exam day);
- identify and evaluate priorities related to the proposals;
- recommend a course of action, with reasoned arguments for each course of action;
- prepare and present information in a format suitable for presentation to senior management.

Preparing your answer in the exam hall is difficult, due to pressure of time and exam conditions, but the report should be presented in a logical fashion, covering all of the above requirements and should conclude with clear well-reasoned recommendations. The report should be able to be read by a senior manager who could act on each of the recommendations made. A jumbled, confused or repetitive report would not be well received by a senior manager – or by the TOPCIMA examiner!

1.4 About the TOPCIMA exam material

The TOPCIMA exam material is split into two parts

- the pre-seen material, which is available on the CIMA website (www.cimaglobal.com) about six weeks before each TOPCIMA exam;
- the unseen material and the requirement, which is available on the exam day.

The pre-seen material will be available on the CIMA website several weeks before the exam sitting. This is typically available in early March for the May exam sitting and early September for the November exam sitting each year.

CIMA offers students advice on its website (cimaglobal.com) and has also prepared two guides for students sitting the TOPCIMA exam. The CIMA guide S11 (freely available on the CIMA website) is an introduction to the aims of the TOPCIMA exam. The CIMA guide S12, again available from the CIMA website, explains the new TOPCIMA matrix (which is analysed in Section 1.9).

CIMA also recommends that students read relevant articles from CIMA's magazine and that students concentrate on developing the skills described in the assessment matrix, and should aim for the 'clear pass' level. CIMA also recommends that students should complete at least three case studies under exam conditions and that you should review your answers carefully, using the assessment matrix.

CIMA also recommends that you should read the 'Post exam guidance' reports on its website, which the TOPCIMA examiner writes after each exam sitting. From reading these reports you will get an insight into what students do right and also the common errors made. Learn from others mistakes made in the past so that you DO NOT make the same mistakes.

The CIMA website offers much support to TOPCIMA students and you can freely access ALL past TOPCIMA exam material (pre-seen, requirement and unseen material and case writer's answer) soon after each exam. All of this material is available free of charge. Many of these past cases have been included in this CIMA Learning System.

All of the past TOPCIMA cases (and two of the FLCS cases) are included in this comprehensive CIMA Learning System, with each case analysed and discussed in depth. This CIMA Learning System also includes the case writers answer for each exam.

The best way to pass any exam is to practice, practice, and practice! TOPCIMA is no different – but there is a lot of material to read, understand and interpret. By the time you start work on preparing your third practice case, we are sure that you will find it easier than it was with the first case you looked at.

Only when you have practised analysing and answering previous case studies should you start work on the pre-seen material for the TOPCIMA exam that you have entered.

1.5 Four TOPCIMA exams each year

CIMA intend to move towards providing four TOPCIMA exam sittings each year. This is a totally new venture for CIMA who have traditionally always had only two sittings each year (except for Foundation level computer-based assessment (CBA) papers).

It is planned that for each pre-seen material there will be two separate sittings of the TOPCIMA exam, using *DIFFERENT* unseen materials, and a different 100 mark requirement.

The timing of the different sittings and the introduction of the four TOPCIMA exams is being piloted at present and will remain a pilot programme until CIMA are ready to have four sittings per year at all of its exam centres worldwide. So far there has been a pilot exam in September 2005, with only 200 candidates, at a few centres only, and there is a larger pilot exam planned for March 2006.

It is advised that you update yourself on exam dates and availability of pre-seen material using the CIMA website (www.cimaglobal.com).

1.6 The pre-seen material

The pre-seen material, typically around 16 pages long in total (including appendices) sets the scene for the industry and gives details on one or more companies operating in the industry. The pre-seen material usually gives organisational structures, with short biographies of key personnel, financial data (historical as well as future forecasts and plans) and also text discussing how the company (or companies) are operating, with details of past and current successes and problems and also discussion of future plans in outline form.

You then have several weeks to thoroughly read and understand this pre-seen material and to research the industry in which it is set. Research can be undertaken in several ways, perhaps using the Internet, reading the financial pages in quality newspapers to pick up current industry data and problems being experienced by real life companies in the industry. Additionally, there are also some articles (on CIMA website and CIMA Insider) and also some specifically written texts on the pre-seen material. Whichever method you choose, it is vital that you understand both the industry and also the issues facing the company (or companies) in the pre-seen material.

! Also it is advised that you should use Chapter 4 of this CIMA Learning System to guide you through the techniques that you should use to analyse the pre-seen material.

While the techniques in Chapter 4 are *all* very important, it is vital that you understand how to construct a position audit (Section 4.8), so that you can fully understand where the company (or companies) stand now, so that you can correctly assess future strategy. Additionally, the position audit should be updated for information included in the unseen material on the exam day.

Furthermore, the position audit will help you to earn marks in the prioritisation criteria of the assessment matrix (see Section 1.9).

With the introduction of the TOPCIMA exam in May 2005, when you have read the pre-seen material, you will realize that the pre-seen material is less specific than in some previous cases and that the requirement or possible unseen material is harder to guess. The TOPCIMA exam is aimed at CIMA students who have passed all other CIMA exams, who should have acquired the analytical skills needed for this exam.

In order to pass the TOPCIMA exam there is a far greater emphasis on the business skills that should be understood and used to analyse and interpret the company and the industry in which the case is set. This CIMA Learning System will teach, or help you to revise, ALL OF THE NECESSARY SKILLS.

It should be noted that many other publishers only produce texts based on the actual case pre-seen material and do not teach the skills required to pass the exam. They simply do some of the research for you. One of the many reasons for a case study exam at TOPCIMA level is to help you to learn these skills that you will need in your career as a CIMA accountant – learn them properly now using this CIMA Learning System!

1.7 The unseen material

On the day of the exam, you will also be given additional material relevant to the case, which is usually a further 6 pages long. This is given to you in the exam hall, together with a 'clean' copy of the pre-seen material, which you should already be very familiar with. It is very important that you thoroughly read the unseen material and incorporate all of the new factors into your answer.

From May 2005 TOPCIMA exam, an extra 20 min READING time will now be given for all TOPCIMA exam candidates. In addition to the usual three hour exam time CIMA is now allowing candidates to have an additional 20 min of reading time to read and absorb the material given in the unseen material and the requirement.

The wording on your TOPCIMA exam booklet from May 2005 will show the following:

> You are allowed 20 min reading time before the examination begins during which you should read the question paper and, if you wish, make annotations on the question paper. However, you will not be allowed, under any circumstances, to open the answer book and start writing, add any loose sheets/supplements to the answer book or use your calculator.

The unseen material usually gives details of changes in the company since the pre-seen material, and alternative strategic options. These should be carefully considered and incorporated into your answer.

Candidates who fail to incorporate data given in the unseen material into their answer, such as in a SWOT, or do not discuss all of the new strategic options, but simply write out a pre-prepared answer, will not be able to earn all of the marks available under each of the criterion in the assessment matrix. Therefore, do ensure that all new data given to you is analysed, discussed and that your recommendations incorporate all of the new relevant information.

It is planned that each of the TOPCIMA exams will have two exam sittings for each set of pre-seen material, with two different sets of unseen material and two different requirements available on the exam day for each sitting. For example, one set of unseen material could discuss expansion strategies and give alternative strategic plans, whereas the other later TOPCIMA sitting may give a totally different picture, such as the company choosing to divest some of its divisions to meet a change in the company's strategic direction. Each unseen material will have a different 100 mark requirement.

It is not yet known when the four sittings will be available for all TOPCIMA students worldwide, as it is currently being piloted. Candidates are advised to check availability from the CIMA website (www.cimaglobal.com).

It is vitally important that all of the new information given to you on the exam day in the unseen material is used and incorporated in your answer. The main reasons for candidates failing is lack of appreciation or use of several of the new facts given in the unseen material. It is relevant to the company and must be understood and incorporated in your answer. For example, in November 2005, the company faced a major cash flow problem, and this should have formed the main focus for the answer. However, many candidates chose not to discuss cash at all and instead discussed longer term strategic alternatives. Candidates are reminded that the company would not have a long-term, if it did not survive the case problem in the short term!

1.8 The requirement

Unlike all of the other CIMA exams, the TOPCIMA exam includes a 100-mark requirement. This is usually broken down into several sections, and it is VERY IMPORTANT that your report answers the requirement of the question. The requirement given to you on the exam day may be different to what you had expected or prepared for. However, it is the requirement that has been set that must be answered – NOT the one that you wanted!

Additionally, your report should be prepared to include the new data that you will have been given in the unseen material on the exam day. Many students have not been successful in their TOPCIMA exam for the following reasons:

- they have not prepared a position audit or review and prioritisation of the issues facing the company;
- they have not related their answer to the new material and the requirement set but have simply written out their pre-prepared answer;
- they have not prepared clear and well-reasoned recommendations (it is inadequate to simply make a recommendation without clearly stating the justification for it);
- they have not demonstrated their technical knowledge or applied it to the company.

As you will see from the next paragraph it is important to understand how your report will be marked using the new TOPCIMA assessment matrix. However, the underlying rule must be that your report must be a stand alone report that reads well and covers all of the key issues and makes well-reasoned and justified recommendations and is supported by appropriate calculations. It should be the sort of report a non-financial manager (as many Boards of Directors include non-financial managers) could understand and act upon.

Your report should include a report heading, a brief introduction, a terms of reference (which should help the candidate to understand who is writing the report and to who the report is aimed). An executive summary is NOT required. The body of the report should then be divided up into a review of the issues facing the company, a discussion of the main alternative strategic alternatives, followed by clear recommendations, which should be justified. Reports should end with a short conclusions paragraph and all supporting calculations, financial ratios and SWOT analysis etc. should be included in appendices to your report.

In Chapter 7 there is a suggested report format and an explanation of how you should prepare and structure your answer. All in all, Chapter 7 will tell you what to do, and what NOT to do, on the exam day.

1.9 The TOPCIMA assessment matrix

1.9.1 The new TOPCIMA assessment matrix

The TOPCIMA assessment matrix will be used to assess, i.e. to mark, all scripts from May 2005. This new assessment matrix differs quite significantly from the previous matrix that has been in use with the FLCS exams since May 2001.

The new TOPCIMA assessment matrix is analysed into nine criteria and the marks available have changed a little for the last few TOPCIMA exams. The marks available for each of the nine criteria for the March and May 2006 TOPCIMA exams are as follows:

Criterion	*Suggested marks available*
Technical	5
Application	10
Diversity	5
Focus	15
Prioritisation	10
Judgement	15
Integration	10
Logic	20
Ethics	10
Total marks	100

Please be aware that the weightings of marks available by each of the nine assessment criteria may change between cases and you should ensure that you are familiar with the availability of marks for the exam that you are planning to take.

The new TOPCIMA assessment matrix is shown at the end of this chapter, and has also been included with each of the TOPCIMA cases included in Chapter 5.

As in any exam, you need to achieve a minimum of 50 marks in order to pass the TOPCIMA exam. As with other exams, there are a number of ways to achieve 50 marks. It is NOT necessary to pass every criterion, so a poor mark in one criteria may be offset by a good mark on another criteria. However, you should always aim to achieve a 'clear pass' in each criterion

1.9.2 Discussion on the definition of each of the new assessment criterion

Technical

This 5-mark area of the assessment matrix rewards the knowledge itself and will reward students who have a sound technical knowledge of the subjects in the CIMA curriculum.

This area of the matrix rewards students for knowledge, such as an understanding of relevant business techniques such as SWOT and PEST analysis, suitable financial ratios and financial techniques, such as DCF.

Much of the technical knowledge that will be rewarded under this criterion is detailed in Chapter 4 of this TOPCIMA *CIMA Learning System*.

Application

This area of the assessment matrix rewards students for their ability to apply their technical knowledge to the information in the case.

The TOPCIMA assessment matrix places a much greater emphasis on the use of technical knowledge, and further demonstrates the need for students to ensure that they have brushed up their technical skills and that they are able to apply the knowledge to the case itself. It is not enough to be able to simply quote names of theorists or ratios, but marks will now be awarded for your application of the technical knowledge for the particular case. Some of the marks are available for correctly applied numerical skills (which now does not have its own criteria). For example, if the data given in the case suggested that

NPV calculations are relevant, marks will be awarded for correctly applying DCF techniques for the numbers given in the unseen material.

Diversity

The TOPCIMA assessment matrix will reward students for their ability to use the business knowledge to solve complex problems. This will also be used to award marks for a wide range of relevant business issues and an understanding of the business environment on which the company is set. Therefore a good understanding of business awareness and knowledge of the industry is important to gain marks here. It will also help you make valid, commercial decisions which are rewarded under Judgement below.

Focus

This criterion will reward students for their ability to solve a particular problem by distinguishing the relevant information from the irrelevant. It relates to a student's ability to sift through all of the data given (in both the pre-seen and the unseen and appendices) and to select which data is relevant to the question asked in the requirement.

This new category is particularly important as there is a plethora of data given in the pre-seen and unseen material and it is important to be able to discuss the most important key information as a priority for senior management. For example, your line manager will not want a report on a departmental budget covering all of the many assumptions made, but would require a report which highlighted the most important or most sensitive of the assumptions.

This new assessment criterion should also help candidates to concentrate their answer on the key issues that need to be addressed and not to discuss at length some of the minor problems that the company may be experiencing. Your answer should be able to demonstrate to the TOPCIMA examiner that you have correctly identified the key issues and made appropriate recommendations, and have sorted and dealt with the relevant data, out of the wealth of information presented to you.

The main focus of your report should be the top five or six issues that you will have prioritised early in your report. These issues should all be discussed a good degree of detail. There are usually between 1 and 3 marks available in this assessment criterion for the detailed discussion of the relevant key issues.

The main reason for candidates loosing marks here is for not discussing all of the key issues or for not discussing them in depth.

Prioritisation

This criterion rewards students for their ability to identify the issues facing the company and to place those issues in priority. Therefore, in multi-problem situations (and all case studies give students a very wide range of small and large problems) marks will be awarded based on a student's ability to rank the problems in the order in which they need to be addressed.

A relevant example of this criterion came in the Domusco case in November 2005 in which the company faced forecast cash shortfall. If immediate urgent action was not taken, the company could face liquidation. Therefore, this issue should have appeared as either the top or second priority. Many candidates did not identify the urgency of the situation and had other issues as priorities.

Students should remember that where they have prioritised several issues in the prioritisation area at the beginning of their report, which they need to ensure that in later sections of their report that all these prioritised issues have been thoroughly discussed. Additionally that each of the issues has appropriate recommendations, which are justified.

Judgement

This is a very important assessment criterion, which now carries 15 marks. This rewards students for recognising alternative strategies available and for selecting and recommending what the student feels is the optimum solution. The ability of students to make professional, commercial judgement is rewarded here, and is the link from the discussion of the key issues (rewarded under Focus) and the recommendations made (rewarded under Logic).

An example is in the Domusco case sat in November 2005, in which the company urgently needs to address its cash requirements, but the two main routes for raising cash, which are debt or an equity issue, were closed off, as the unseen material stated that Domusco had loan covenants restricting further debt. Also with such a depressed share price and lack of investor confidence, a rights issue would not be successful at this time. Therefore the cash issue had to be handled differently. Students who recommended more loans or to issue shares, or even to have an overdraft displayed a LACK of commercial judgement and earned low, or no, marks. What was required here was to state that as the issues of more shares or more debt was not an option, the company would need to severely cut back on construction expenditure and put Phase 2 on hold, as well as to sell parts of the company, including some of its valuable land bank.

There is no clear-cut answer to any case (although CIMA do publish the case writer's suggested answer) and marks will always be awarded for well-reasoned arguments and for applying their technical skills and commercial judgement to the issues raised in the case.

The TOPCIMA paper is a strategic paper – not a calculation paper – and will always have several alternative answers, and marks are awarded based on the candidate's skills to convey their recommendations, based on the judgement that the candidate has made upon all of the key issues.

Candidates are able to pass the TOPCIMA exam even if their answer differs from the case writers recommendations, as long as the candidate has used his or her own judgement to decide courses of action and has justified each of the recommendations made.

It is expected that the TOPCIMA exam will give students much more scope for applying their own judgement and for exercising their commercial judgement concerning a variety of possible courses of action. Therefore you need to be able to demonstrate to the TOPCIMA examiner that you can choose between alternative courses of action and that your decisions have been made after consideration of all of the appropriate factors.

It is the display of sensible, commercially based recommendations and thinking that will earn marks in this crucial 15 mark criteria. There is more in Chapter 7 on how you can develop and hone your skills.

Integration

This assessment criterion is testing the students' ability to integrate his knowledge skills effectively. The CIMA guide quotes 'this criterion checks whether you are able to integrate the various skills and knowledge areas into a cohesive answer'. In effect this is a type of business communication and presentation criteria, and it also includes an element of business awareness and how the candidate has used his knowledge of the industry and applied it to the case.

The most important point about this assessment criterion, is whether the entire report reads well, is comprehensive, and has clear convincing, well-reasoned and justified recommendations.

In simple terms, marks will be awarded under the integration criteria on the basis of whether your report can be read by the TOPCIMA examiner like a professionally prepared business report that understands all of the issues affecting the industry in which the company is operating.

The marks here are NOT about presentation, but on whether your report answers the question and has focused on dealing with the key issues.

The key to getting pass marks in this criterion is by spotting the key issues correctly, prioritising them, discussing them and preparing sensible commercially viable recommendations. If the report reads well "holistically" then you will be awarded pass marks in this criterion.

Logic

Logic represents the recommendations and communication skills and this should be the most important area of your report and can often make the difference between a pass and a fail.

There will usually be around 20 marks for logic and it is very important that exam time is managed effectively so that clear well-justified recommendations are prepared. After all the main purpose of the report is to make recommendations, so ensure adequate time is allowed for *this key area of your report*. If your recommendations are not clear or are simply stated with no reasoning, they will earn low marks in this key area of the assessment matrix.

This criterion carries around 20 marks – the most out of all of the 9 assessment criterion and it is the most important. As candidates are usually time pressured writing their report in the exam hall, it is all too easy to allow insufficient time for detailed recommendations. However, what is the meaning of preparing a report (whether it is for the TOPCIMA exam or for your line manager or a Board report) if it does not have clear well-argued recommendations that have been justified in your discussion.

Therefore, a rushed recommendations paragraph at the end of your report that lists a range of recommendations (without the underlying reasons for the recommendations) will earn very low marks in the assessment matrix for logic.

It is necessary to clearly state all recommendations, with supporting justification and reasons (perhaps supported by your calculations) in order to earn high marks. Also the main recommendations that are key to the business should be presented first, with lesser or less urgent recommendation following (which should also be justified). You are referred to Section 3.13 for more advice about preparing and writing your recommendations.

Ethics

The TOPCIMA matrix has 10 marks available for the discussion of and recommendations on how to deal with the ethical dilemmas given in the case material. Each TOPCIMA case will have a number of conflicts and ethical issues in both the pre-seen and the unseen materials, so that candidates can discuss the ethical issues involved and make recommendations. This criteria includes personal and professional ethics, business ethics, corporate governance and social responsibility.

The major accountancy bodies, including CIMA, formed the Consultative Committee of Accounting Bodies (CCAB) during the 1970s. The CCAB offers guidance to accountants in business on ethical matters, based around five fundamental principles. These are

1. integrity – not merely honest, but fair and truthful,
2. objectivity – having regard to all considerations relevant to the task,
3. competence – undertaking professional work only with the required level of competence,
4. performance – carrying out work with due skill, care and diligence,
5. courtesy – showing courtesy and consideration to all.

If we extend the above fundamental principles to business in general, there are several ethical issues involved in each TOPCIMA case.

In your report you should have a separate section that deals with the ethical issues. The ethical issues may be about safety issues, good (or bad) business practice or poor staff training. Your report should show how each of the five CCAB fundamental principles shown above have, or have not, been put in place by the company, and where changes and improvements need to be made. You should also recommend what changes and improvements should be made and in what timescale (immediately or within 6 months, for example).

Ethics are the standards of professional behaviour that CIMA expects its members and students to adhere to. Ensuring that our members and students maintain the highest ethical standards helps to safeguard the integrity of the qualification, its value to employers and public trust in management accountancy.

The CIMA website gives details on CIMA's new Code of Ethics for Professional Accountants, which applies to all CIMA members and students as of 1 January 2006. The Code of Ethics establishes fundamental principles that all members and registered students must adhere to. Under the new Code, accountants are required to analyse situations to identify and assess threats to compliance with the principles and then to apply appropriate safeguards to remove or reduce them.

This approach is considered by many to be more comprehensive than a rules-based approach. While rules can sometimes be circumvented, principles are applicable across a wider variety of circumstances. CIMA's Code draws on, and is aligned with, international standards including, in particular, the International Federation of Accountants (IFAC's) Code of Ethics, which was itself developed with input from CIMA and the global accountancy profession.

CIMA's Code of Ethics contains specific guidance for Professional Accountants in Business (Part C) and Professional Accountants in Public Practice (Part B) as well as examples of threats and safeguards to clarify the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. These principles are defined and explained in Part A of the Code of Ethics, where there is also guidance on how to go about resolving an ethical conflict. As part of our commitment to supporting and assisting members to uphold the Code, CIMA will be undertaking a range of initiatives to promote ethics throughout 2006, so do monitor CIMA's website for up-to-date details.

1.10 Using the CIMA website

It is recommended that all TOPCIMA students should regularly access the CIMA website (www.cimaglobal.com) which has been referred to several times in this chapter. The CIMA website has all of the past cases which can be accessed free of charge, and also contains relevant articles and advice for TOPCIMA students.

Another useful resource that is available on the CIMA website is the examiners report on the previous exam sitting, called a "Post Exam Guidance" or PEG for short. These reports give students advice on the common errors made by candidates in the previous exam and also the areas that were well prepared. The report is broken down by each criterion from the assessment matrix, which should help you to more fully understand what the TOPCIMA examiner of looking for in your answer. Whether you are sitting TOPCIMA for the first time, or whether you have failed before, it is useful to read this valuable feedback on candidate's performance.

Read the TOPCIMA Post exam reports on previous exam sittings so that you understand the common errors or omissions made by candidates in the last exam – so that you don't make these same mistakes. These last few Post Exam Reports on the May, September and November 2005 exam have been included in this CIMA Learning System as they offer such valuable advice. They are included in Chapter 5 after the discussion of each TOPCIMA case.

1.11 Using this TOPCIMA *CIMA Learning System* to pass the TOPCIMA exam

The approach in this *CIMA Learning System* recommends that you adopt the systematic approach to passing TOPCIMA as described in Figure 1.1.

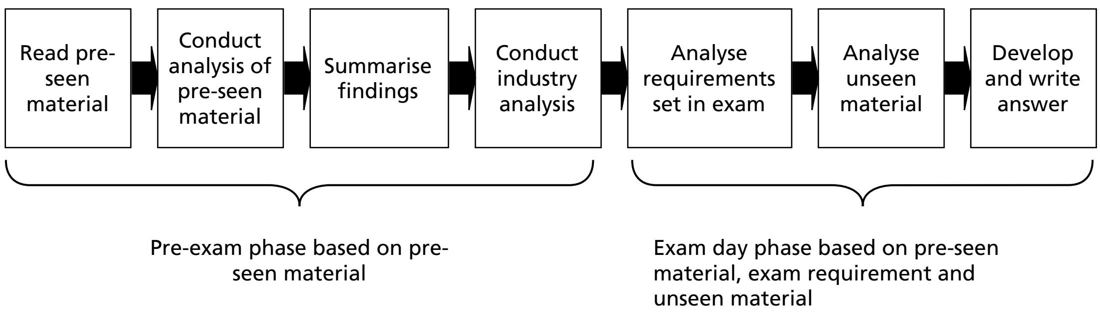


Figure 1.1 Diagram of process to pass TOPCIMA

The chapters of this *CIMA Learning System* take you through this process using past cases, the three TOPCIMA cases to date as well as two past FLCS cases, in order to illustrate the skills and knowledge you will need.

The remainder of this CIMA Learning System is set out as follows:

Chapter 1	Description of t he TOPCIMA exam detailing the purpose of the exam, the skills you will need and the assessment criteria you must satisfy. Chapter 1 also explains each of the TOPCIMA assessment matrix criterion and how each will be used to mark your answer.
Chapter 2	Review of the past TOPCIMA cases in 2005 and also a brief summary of the past FLCS cases since November 2001. This provides a quick way for you to appreciate the breadth of skills and knowledge you are likely to need to demonstrate in the TOPCIMA exam. Also included, for the first time, is the CIMA Examiner's Post Exam Guidance report on each of these 3 TOPCIMA exams. The full TOPCIMA cases and the answers are given in Chapter 5.
Chapter 3	Skills toolkit. This is a reference chapter that shows you some ideas on how to tackle the problems you will encounter as you work through TOPCIMA. Each skill is illustrated and applied in the later chapters. Chapter 3 takes you through the processes of how to read, understand and research the pre-seen material and how to plan your answer on exam day.
Chapter 4	Technical toolkit. This provides a reminder of how to perform many of the technical tasks you will need to perform in your analysis of the pre-seen and unseen material in TOPCIMA. For example, ratio analysis, risk assessment and application of strategic modeling. You should thoroughly read this important chapter and decide what range of techniques you may include on exam day. Practice writing answers using as many of these techniques as possible.
Chapter 5	Past TOPCIMA cases. Chapter 5 contains the case material for all 3 TOPCIMA cases that were examined in 2005. This chapter also includes the case writers answer and some comments on each case.
Chapter 6	How to analyse the pre-seen material using 2 past cases. One is the TOPCIMA Domusco case (September and November 2005) and the other is the FLCS case on the company called Homejay from November 2003. Chapter 6 also contains advice to help you to research the industry for the TOPCIMA exam that you are preparing for.
Chapter 7	What to do on exam day! This is a very important chapter – as so much advice and research is available to help you to deal with the pre-seen material – but then you walk into the exam hall, read the unseen material and think – WHAT SHOULD I DO NOW? This chapter will give you the confidence to deal with the unexpected twists that always occur in the unseen material. This chapter will also use case material from Domusco – September 2005 and the FLCS case Homejay Inc. from November 2003. The material will give you an analysis of the pre-seen material but focuses particularly on how to analyse the requirement, undertake a revised analysis based on the unseen material and to develop a structure for satisfying the requirement.
Chapter 8	Final tips and advice and a summary report from the Examiner written after the first 2 TOPCIMA exams had been sat. Contains much of the same information that is in other Post Exam Guidance reports, but in a short summary format.
Appendices	Appendix 1–3 Contains the complete case (including answers), for Zubinos, which was examined in March and May 2006.

1.11.1 Where to start

First, I recommend that you read through Chapter 2 to gain a better understanding of the nature of a case study exam like TOPCIMA. Chapter 2 will help you to understand the industries that previous cases have been set in and the problems facing these companies in each case.

You should then thoroughly read and revise the Skills toolkit (Chapter 3) and the Technical toolkit (Chapter 4). Remember the emphasis of marks towards technical knowledge in the TOPCIMA assessment matrix – so make sure that you thoroughly understand and can apply the techniques in Chapter 4.

Next you should work your way through the TOPCIMA cases included in Chapter 5. Remember to use the toolkits in Chapters 3 and 4 to help you if you get stuck. Draft out your answers and compare them to the case writer's answers. Check where you went right – and also where you went wrong. Don't forget to thoroughly read the Post Exam Guidance reports on each exam – did you make some of the mistakes the others did? If you did make mistakes – donít worry – this is only a practice – it is good to make mistakes now – so that you can improve BEFORE exam day!

Chapter 6 is very helpful in explaining how to get to grips with the pre-seen material and how to undertake research on the industry setting.

The most important chapter is Chapter 7 – this explains what to do on the exam day. A MUST READ.

Chapter 8 contains some last advice and tips to empower you and to give you the confidence to go into the TOPCIMA exam hall and to know what to do when you have read and understood the new information contained in the unseen material.

The key to passing this final CIMA exam is by improving your technical skills and by practicing writing case study answers – not just the case you will be sitting, but using 2 or 3 of the past TOPCIMA cases. After all, you probably practiced past papers for your other CIMA exams - you should do the same here.

I will not wish you good luck but instead will wish you good preparation – as I am confident that with the right preparation, which this CIMA Learning System will give you, you WILL pass.

So get working on the next chapter now!

March and May 2006 – Assessment Matrix for TOPCIMA-Zubinas

Criterion	*Marks**	*Clear Pass*	*Pass*	*Marginal Pass*	*Marginal Fail*	*Fail*	*Clear Fail*
Technical	**5**	Thorough display of relevant technical knowledge. **5**	Good display of relevant knowledge. **4**	Some display of relevant technical knowledge. **3**	Identification of some relevant knowledge, but lacking in depth. **2**	Little knowledge displayed, or some misconceptions. **1–2**	No evidence of knowledge displayed, or fundamental misconceptions. **0**
Application	**10**	Knowledge clearly applied in an analytical and practical manner. **9–10**	Knowledge applied to the context of the case. **6–8**	Identification of some relevant knowledge, but not well applied. **5**	Knowledge occasionally displayed without clear application. **3–4**	Little attempt to apply knowledge to the context. **1–2**	No application of knowledge displayed. **0**
Diversity	**5**	Most knowledge areas identified, covering a wide range of views. **5**	Some knowledge areas identified, covering a range of views. **4**	A few knowledge areas identified, expressing a fairly limited scope. **3**	Several important knowledge aspects omitted. **2**	Many important knowledge aspects omitted. **1–2**	Very few knowledge aspects considered. **0**
Focus	**15**	Clearly distinguishes between relevant and irrelevant information. **13–15**	Information used is mostly relevant. **9–12**	Some relevant information ignored, or some less relevant information used. **8**	Information used is sometimes irrelevant. **5–7**	Little ability to distinguish between relevant and irrelevant. **1–2**	No ability to distinguish between relevant and irrelevant information. **0**
Prioriti-sation	**10**	Issues clearly prioritised in a logical order and based on a clear rationale. **9–10**	Issues prioritised with justification. **6–8**	Evidence of issues being listed in order of importance, but rationale unclear. **5**	Issues apparently in priority order, but without a logical justification or rationale. **3–4**	Little attempt at prioritisation or justification or rationale. **1–2**	No attempt at prioritization or justification. **0**
Judgement	**15**	Clearly recognises alternative solutions. Judgement exercised professionally. **13–15**	Alternative solutions or options considered. Some judgement exercised. **9–12**	A slightly limited range of solutions considered. Judgement occasionally weak. **8**	A limited range of solutions considered. Judgement sometimes weak. **5–7**	Few alternative solutions considered. Judgement often weak. **1–2**	No alternative solutions considered. Judgement weak or absent. **0**
Integration	**10**	Diverse areas of knowledge and skills integrated effectively. **9–10**	Diverse areas of knowledge and skills integrated. **6–8**	Knowledge areas and skills occasionally not integrated. **5**	Knowledge areas and skills sometimes not integrated. **3–4**	Knowledge areas and skills often not integrated. **1–2**	Knowledge areas and skills not integrated. **0**
Logic	**20**	Communication effective, recommendations realistic, concise and logical. **16–20**	Communication mainly clear and logical. Recommendations occasionally weak. **11–15**	Communication occasionally unclear, and/or recommendations occasionally illogical. **10**	Communication sometimes weak. Some recommendations slightly unrealistic. **5–9**	Communication weak. Some unclear or illogical recommendations, or few recommendations. **1–4**	very poor communication and/or no recommendations offered. **0**
Ethics	**10**	Excellent evaluation of ethical aspects. Clear and appropriate advice offered. **9–10**	Good evaluation of ethical aspects. Some appropriate advice offered. **6–8**	Some evaluation of ethical aspects. Advice offered. **5**	Weak evaluation of ethical aspects. Little advice offered. **3–4**	Poor evaluation of ethical aspects. No advice offered. **1–2**	No evaluation of ethical aspects. Unethical, or no, advice offered. **0**
TOTAL	**100**						

Review of Past TOPCIMA Exams

2

2.1 TOPCIMA exams to date

2.1.1 The three TOPCIMA exams held during 2005

During 2005, following the introduction of the new syllabus, there were three TOPCIMA exams held. However, before we outline the details of these exams, it is worth noting a few of the changes that affected the sitting of the TOPCIMA exam. These were:

- All of the 3 Strategic Level papers now have to be passed before candidates are eligible to sit the TOPCIMA exam. The three Strategic Level papers are Management Accounting Business Strategy – Paper 6, Management Accounting Risk and Control Strategy – Paper 3 and Management Accounting Financial Strategy – Paper 9.
- Therefore, TOPCIMA is now sat as a stand-alone paper.
- Candidates who are sitting TOPCIMA exams will have successfully passed the other 3 Strategic Level subjects, and should be better prepared for the task of tackling a detailed Case Study exam.
- In May 2005, there were a small number of eligible candidates for the first TOPCIMA exam, and the profile of these candidates demonstrated that a high majority had sat and been unsuccessful in previous FLCS case study exams, despite having passed the other 3 Strategic Level subjects.

It is very important for candidates to prepare carefully for this final CIMA exam and there are many ways in which the pre-exam preparation can help improve your chances of success.

! This is what this CIMA Learning System is here to help you achieve – improved preparation leading to a successful outcome in your TOPCIMA exam. However, it is not easy, but it can be done if you work through this CIMA Learning System and follow much of the advice given to you.

2.1.2 The three TOPCIMA exams in 2005

- May 2005 – Two companies, ReuseR and NOW, set in the growing recycling industry. More details on this TOPCIMA case are shown below in Section 2.3.

- September 2005 – A pilot TOPCIMA exam sitting with only around 200 candidates sat the first of 2 DIFFERENT exams using the Domusco case material, set in the construction industry. More details on this case are shown in Section 2.4 below. This TOPCIMA exam was totally new for 2 reasons:

  1. It was the first CIMA exam to be sat in September (except for the CBA exams for the subjects in the Certificate of Business Accounting).
  2. All of the candidates sat the exams using a PC, and used Word and Excel instead of writing their answers in an answer booklet.

- November 2005 – The second (totally DIFFERENT) unseen material, based on the same pre-seen material of the Domusco case, based in the construction industry was sat by over 1,600 candidates using the usual handwritten answer booklets. More details on this case are shown in Section 2.5 below.

Before we discuss each of these three TOPCIMA cases, it would be useful for you to be aware of the previous FLCS case studies, which are summarised below.

2.2 Overview of past case studies

2.2.1 The 2001–2004 Final Level Management Accounting – Case Study examination (FLCS)

- CIMA has included a case study as a final qualifying exam since May 2001. Before the first TOPCIMA exam in May 2005 this was called the *Final Level Management Accounting Case Study examination* (FLCS).
- The format for assessment for TOPCIMA is in some ways similar to that of FLCS, although FLCS candidates were assessed against a different Assessment Matrix. The previous FLCS assessment matrix had significant differences to the TOPCIMA assessment criteria you will face. The new TOPCIMA assessment matrix is explained in Chapter 1, Section 1.9 and again the Post Exam Guidance reports included in this chapter and also in Chapter 7 on "What to do on exam day".
- The author has decided that now that there have been 3 TOPCIMA cases examined (May, September and November 2005) it will have more value to TOPCIMA candidates to be familiar with these last 3 Case Studies that in the 8 previous FLCS Case Studies.
- Therefore the 8 previous FLCS Case Studies have been removed from this CIMA Learning System, as it is considered that the 3 recent TOPCIMA exams are far more relevant in preparing you for sitting the TOPCIMA exam.

2.2.2 Business settings for the 8 previous FLCS Case Studies

So that you are familiar with the types of industry settings and the names of the past 8 FLCS Case Studies, summarised below are some brief details. If you want to research any of these cases as part of your preparation, details of the entire case material (pre-seen material, the requirement and the unseen material that was given on exam day) you may access them on the CIMA website. However, the published case writer's answers to these old FLCS cases are only available to purchase from Elsevier.

However, they have only been excluded from this learning system as the author considers that it is good preparation for a future TOPCIMA exam, if you practice using 3 past cases. As there has been 3 TOPCIMA cases to data, all of the case material INCLUDING THE PUBLISHED ANSWERS are in this CIMA Learning System – there is no need to go anywhere else at all – unless you want to do additional research.

So, finally, before we look at the recent 3 TOPCIMA exams, here is a brief list of the 8 previous FLCS exams:

- May 2001 – Proton Quest Ltd set in the pharmaceutical research industry.
- November 2001 – IRS Ltd based on a manufacturer of control systems for refrigeration equipment.
- May 2002 – Global Inc based on an ailing large supermarket, which had lost market share and had a reduced share price.
- November 2002 – Constro (Pty) Ltd was set in North Africa and concerned a construction company that was considering diversifying into the mobile telephony business.
- May 2003 – Sparkle Plc was a chain of health and leisure clubs set in Europe which in the unseen material un-expectantly faced a hostile take-over bid. The case was examined coincidentally at the same time that a number of high-profile take-over bids were going on in this industry, which should (but disappointedly did not) give candidates plenty of relevant real life material.
- November 2003 – Homejay Inc was a USA-based retailing and manufacturing conglomerate with a range of stores in Europe. On the exam day, candidates were presented with a range of possible acquisition and divestment information to make recommendations on its future strategic direction. Disappointedly, many students did not grasp that with little available finance, any further acquisitions could only be made if parts of the current business were divested. This case explored the issues about the value of a diversified business by confronting candidates with an opportunity to focus resources on a core DIY business, as Kingfisher had recently done in the UK at that time.
- May 2004 – Ofood4U concerned a privately owned organic food manufacturer and distributor. The unseen material on the exam day gave candidates material concerning Ofood4U's choice of strategic direction. It could expand in accordance with its 5-year plan, albeit with reduced profitability levels, continue to open organic food shops which so far were loss making, accept the proposal to open stores in FFT garden centres or enter into a strategic alliance with TZ (a major international food manufacturer) to jointly manufacture a range of organic baby foods. The company also faced a severe cash shortage to achieve some of its current plans.
- November 2004 – Mayah Hospitals. This was the first case set in the public sector and concerned three proposals for change. The three proposals were a total rebuild of a new hospital, a new build as well as merging some service out to private organisations or a minimum change proposal. Details were also given on two contractors, but in the unseen material on the exam day, it was stated that one of the contractors (LinMel) did not want to tender for the contract. Therefore, many candidates who had considered that this case would be based on the choice of contractor were surprised that this alternative was ruled out. The requirement was about which of the three proposals should be chosen and why and how the chosen proposal for change would address the strategic issues.

2.3 TOPCIMA exam in May 2005 – ReuseR and NOW

The pre-seen material, the requirement and unseen material for ReuseR and NOW is shown in Chapter 5 of this CIMA Learning System, together with the case writers answers.

2.3.1 The pre-seen material

The pre-seen material gives details on two companies, ReuseR and NOW, that operate in the recycling industry. Both companies are growing fast and ReuseR, a listed company, has just secured additional loan finance to pursue its acquisition strategy.

2.3.2 The issues in the pre-seen material

This case is different to previous FLCS cases as it gives details on two companies and also the information given on these companies is less specific than in some previous cases. Additionally there is less financial data given on each of the companies in the pre-seen material.

Using the pre-seen material, candidates should research the recycling industry and the main European companies that are operating in this industry. Candidates should also research the supply chain for recycled waste, both industry waste and government initiatives on domestic waste. In addition, candidates should research the demand and the end customers who purchase recycled waste and the social and financial benefits of using recycled materials as part of the manufacturing process.

The pre-seen material gives data on proposed acquisitions by ReuseR and candidates should revise the alternative techniques for valuing listed and unlisted companies, which are shown in Chapter 4 of this Learning System in Section 4.15.

2.3.3 The pre-exam preparation

The new TOPCIMA assessment matrix (shown in Chapter 1, Section 1.9) has a far greater emphasis on technical knowledge. The assessment matrix has more marks available for the display and application of technical knowledge. Technical knowledge is now assessed in 5 of the 9 assessment matrix criteria, as shown in Chapter 4, Section 4.2.

Successful candidates need to have a sound knowledge of relevant analytical techniques and also to be able to demonstrate how they can be applied to the material in the case, including the unseen material that will be given to you on the exam day. The Technical Toolkit in Chapter 4 is a very useful reminder to candidates of the many relevant techniques that you will have learned in earlier CIMA exams

Additionally, the Skills Toolkit in Chapter 3 gives advice on how to analyse the pre-seen material. It is often useful for candidates to prepare a SWOT analysis (Strengths, Weaknesses, Opportunities and Threats) on the pre-seen material. For the May 2005 case, this will necessitate candidates to prepare a SWOT analysis on each of the two companies, ReuseR and NOW, given in the pre-seen material.

On reading the pre-seen material it is possible that ReuseR may wish to acquire NOW or that NOW may want to become listed in the near future. Therefore one element of student's preparation should be to value both companies using a variety of methods. ReuseR is a listed company and has a quoted share price, which should reflect the future expected cash flows of the company (assuming a perfect market). However, NOW is unlisted and a range of valuation methods can only attempt to place a value on the company.

2.3.4 The May 2005 unseen and the requirement

In this first TOPCIMA case the unexpected twist was the introduction of Shard in the unseen material. Shard is a glass manufacturing company, which had also successfully diversified into the newspaper publishing and printing industry and was considering the option of acquiring one of its suppliers of recycled materials, either ReuseR or NOW, in the form of backward integration.

Many manufacturing companies have chosen to backwardly integrate their suppliers of recycled raw materials and this could have been identified from candidate's research into companies in the recycling industry.

The key to passing TOPCIMA is your ability to apply your technical knowledge and understanding of the industry using the new data supplied in the unseen material on the exam day. Unfortunately, many students were not prepared for another company in the unseen material. They had come into the exam hall with pre-prepared SWOTs for ReuseR and NOW and wrote them down regardless. What was required instead was an analysis of whether Shard should acquire ReuseR or NOW and a SWOT of Shard was required instead.

It was necessary to attempt to value ReuseR and NOW and to establish which would add the greater shareholder value for Shard. The more that is paid for a company the more the impact on shareholder value. The unseen material gave details of the value of forecast cash flows for Shard and it was necessary to prepare NPVs for these cash flows. Then it was necessary to compare the value of future cash inflows to the proposed acquisition prices for both companies and to establish what the maximum price that could be offered was and whether the acquisition would be a good strategic fit.

A further area of discussion was whether Shard had the management skills required to manage the acquisition and whether it could retain either ReuseR or NOW's management teams.

It was also expected that students should recognise that as NOW is an unlisted company and its shares are privately held, that it cannot simply be acquired.

Another strategic issue that should be recognised in this case was that is ReuseR was to be acquired at a higher price than the discounted value of future cash flows, then this will not create shareholder wealth for Shard's shareholders.

This first TOPCIMA case caught many students by surprise by the introduction of a new company, which in this case was Shard. This has happened before (when Company F launched a take-over bid for Sparkle in May 2003) and no doubt this will happen again.

The key message here is for students to be prepared for anything that crops up in the unseen material and the only way to be prepared is to practice – and this CIMA Learning System included all details of the 3 TOPCIMA exams to date. CIMA also recommend that you practice using a maximum of 3 cases – so this CIMA Learning System contains ALL you need to practice using past papers.

By the time you have reached the end of Chapter 7 you will have practiced and worked your way through the 3 past TOPCIMA cases and be far more prepared for your TOPCIMA case.

Remember the key to passing is not just about the case you will be sitting – but is about what preparing and knowing how to analyse a case (pre-seen and unseen) and how to construct a coherent report that covers all aspects of the TOPCIMA assessment matrix. You can ONLY prepare yourself by practicing on past papers.

2.3.5 The skills needed to pass the May 2005 TOPCIMA exam

The skills required included valuations of the two target companies and the preparation of NPVs on the forecast expected future cash-flows.

The unseen material also asked for a discussion on Shard's strategy for procuring recycled materials and whether the acquisition of a recycling company was the right strategic move. Other alternatives were the organic expansion of Shard's own recycling department which to date had not expanded to meet the company's increasing need for recycled goods.

The proposed expansion of Shard's own recycling department should also have been discussed and its long-term procurement policy and the increased need to improve the levels of recycled goods as the pressure from EU authorities increase.

To sum up, much strategic thinking was required and you needed to put yourself in the position of a consultant reporting to the Board of Shard. Many students were still thinking that they would be advising the Board's of ReuseR or NOW, and their advice on strategic issues was very weak.

There was a need for shareholder value to be created if an acquisition was to be recommended. Many students know the term "shareholder value" but many demonstrated that they did not understand how value could be created or indeed destroyed.

It is recommended that all students should have a firm understanding that shareholder value will ONLY be created if the NPV of future cash flows that will be generated from a proposed acquisition are LESS than the price paid for the acquisition. Sounds simple and straightforward – but practice these skills with the numbers in this case.

2.3.6 The May 2005 Post Exam Guidance Report

This first TOPCIMA exam was only sat by only 800 candidates, many of whom had sat (and failed) the previous FLCS case study exam. It was expected that as these students now ONLY had the case study to prepare and revise for, and not the 3 other Strategic level papers, that they would have prepared more thoroughly.

However, what was discovered was that many candidates were poorly prepared for this TOPCIMA exam, with little evidence of industry research and little demonstration of appropriate technical knowledge and relevant theories.

Please read this Post Exam Guidance report as it will give you a better understanding of what the CIMA Examiner is looking for and the skills that need to be demonstrated. More importantly it will also tell you what candidates did wrong. You may laugh or sympathise with their mistakes – but PLEASE LEARN from these common errors. Don't make these errors (and omissions) when you sit the TOPCIMA exam that you are preparing for!

TOPCIMA – May 2005 Post Exam Guidance report

1.0 General overview

The TOPCIMA exam is designed to test candidates' higher level skills and to test their ability to apply their knowledge and use their judgement to solve multi-faceted problems given in the pre-seen and unseen material.

There were a much smaller number of candidates sitting the May 2005 TOPCIMA exam, around 800 candidates, due to the change in the eligibility rules to sit this final CIMA exam. Under the previous syllabus, many candidates chose to sit the Case Study exam along with their other three final level papers. However, from May 2005, the new syllabus does not allow candidates to sit the final TOPCIMA exam until all three Strategic Level papers have been passed. Therefore the majority of candidates sitting TOPCIMA in May were those who had passed the final level exams, but who had either not sat the Case Study exam previously, or had been unsuccessful.

This unusual profile of candidates has resulted in a lower pass rate than in some previous Case Study exams. The reduced pass rate is **not** related to the changed assessment matrix in any way, but simply due to less well prepared candidates entering this exam sitting despite these candidates only having to concentrate on the TOPCIMA paper.

The industry setting for the first TOPCIMA case was the recycling industry, which is a new and growing industry, which has received much publicity due to EU legislation that is putting pressure on companies and individuals to increase the volume of recycling.

The unseen material always gives an unexpected twist to the case, so that candidates can be tested to see whether they can apply their knowledge to the case. In this case the unexpected twist was the introduction of Shard. Shard is a glass manufacturing company, which had also successfully diversified into the newspaper publishing and printing industry. Shard was considering the option of acquiring one of its suppliers of recycled materials, either ReuseR or NOW, in the form of backward integration. Candidates who had researched the recycling industry would have found many instances of manufacturing companies who have chosen to backwardly integrate their suppliers of recycled raw materials.

The key to passing TOPCIMA is candidates' ability to be able to apply their technical knowledge and understanding of the industry to the requirement set, using the new data supplied in the unseen material on the exam day.

From marking and reviewing a large number of scripts from the May 2005 TOPCIMA exam the following three points are relevant to candidates who were not successful:

1. There were a sizable number of scripts that did **not** demonstrate a sound understanding of a number of areas of financial and business strategy. Some candidates did not grasp many of the strategic issues contained in this case. One example is that NOW cannot simply be acquired as it is a private company. Another strategic issue that many candidates failed to grasp concerned ReuseR valuation price. If ReuseR were to be acquired at a higher price than the discounted value of future cash flows, this will not create shareholder wealth for Shard's shareholders. Candidates are advised to learn or revise all of the business and financial techniques that are included in the Strategic level syllabus.

2. The majority of scripts demonstrated little understanding of the industry setting and no research or real life companies were cited as experiencing the type of problems that ReuseR and NOW are experiencing. More extensive research into the industry in which a case is set is required, and a better understanding and familiarity with the pre-seen material is also recommended.
3. The candidates who demonstrated some understanding of business and financial techniques in general, mainly earned low marks in the assessment criterion for Application, as they did not demonstrate their ability to apply their knowledge to the actual situation in the case. It is vital in the business world to have a sound understanding of business techniques and the ability to apply them to solve business problems. More practice is required using past Case Study papers and other past Strategic level or Final level exam papers. For example, many candidates prepared SWOT analyses, but most were for ReuseR and NOW and not the company in the question, which was Shard. Additionally, most of the SWOT appeared pre-prepared, and did not incorporate new information presented in the unseen material.

In summary, the TOPCIMA paper is trying to prepare you for the role of an ACMA. Part of this role is the ability to "think on your feet", which requires a sound understanding of a variety of business and financial techniques and commercial understanding, as well as the ability to apply this knowledge to new information presented to you. This is what you will have to do in your future career. This final test of professional competence was testing just that – candidates' competence in applying their knowledge to the case.

2.0 Areas that were well attempted by candidates

It was apparent that the additional 20 minutes reading time had assisted many candidates, with very few scripts showing time management problems. The 20 marks Logic criteria covering recommendations had been very well attempted by the majority of candidates. Additionally almost all candidates earned pass marks for the display of relevant technical knowledge. Another area that has shown improvement from previous exams is that candidates had prepared accurate and well presented calculations to support their discussion. Detailed below, by assessment criteria is a detailed analysis of each criterion and where improvements can be made.

3.0 Areas that were not well attempted by candidates

The two areas that had not been well attempted were the prioritisation of the key issues and the application of knowledge to the case. It was particularly disappointing that many candidates had not identified, or not prioritised, the key issues facing Shard. This opening paragraph to the report should assist candidates with writing the rest of the report. However, where the issues had not been identified, then in many cases the rest of the report was muddled and unclear and not all issues had been discussed.

4.0 Assessment matrix and areas for improvement

4.1 Overview of the TOPCIMA assessment matrix

The new TOPCIMA assessment matrix has a number of areas of overlap, as indeed the previous matrix had. However, overall, it is considered that a well-prepared candidate was not penalised in any way by the introduction of the new matrix. Reasonable marks were awarded for the majority of candidates for the display of relevant technical knowledge, although it was the criterion of Application, where these candidates did less well.

4.2 Technical

Around 90% of candidates achieved pass marks in this criterion by demonstrating several aspects of technical knowledge. These included valuation techniques, ratio analysis, SWOT's and other relevant techniques. However, candidates earned low marks for quoting the names of relevant theorists, without fully explaining the relevant theory and why the theory was applicable or relevant to the case. Overall, this criterion was well attempted.

4.3 Application

Whilst most candidates earned marginal pass marks in this criterion, it was disappointing that many candidates were unable to demonstrate their application of technical knowledge to the case. Many candidates had not even attempted to prepare any calculations for the two companies being considered for acquisition. However, what was more worrying was that many candidates did not calculate discounted cash flows (DCFs) using the forecast cash flow data given in the unseen material to calculate whether either of the acquisitions would increase, or decrease, Shard's shareholder value, depending on what price would be paid for the acquisition. The lack of recognition that a company will only add value if the price paid is less than the value of future discounted cash flows is an area that candidates need to understand much more thoroughly.

Overall, the application criterion was not well attempted and it was disappointing to see a sizeable number of candidates earning lower than pass marks. However, it must be noted that the candidates who had prepared detailed calculations, had generally prepared well presented and mainly correct calculations.

4.4 Diversity

There was a very limited range of issues discussed by the majority of candidates. Additionally, there was little evidence of any research or understanding of the recycling industry demonstrated by most candidates. The pre-seen material had been available for over eight weeks, and this should have allowed candidates time to gain a far greater understanding of this new, high profile industry. This would have enabled them to make far better informed comments. The industry life cycle analysis was an appropriate knowledge area that should have been discussed for higher marks. More industry research is recommended in the future.

4.5 Focus

Overall, most candidates earned good marks in this assessment criterion and were able to focus the report to meet the requirement of the question and not to discuss unimportant non-strategic issues. The only reason for some candidates not earning high marks was where they had not discussed all three ways in which Shard could secure supplies of recycled materials, as some candidates only discussed the acquisition option, and not the long term contracts or growing Shard's own recycling division. Generally, this criterion was well attempted.

4.6 Prioritisation

It was very surprising, and disappointing, that this criterion was so badly attempted and the majority of candidates earned below pass marks. This criterion and the 10 marks available was the same as in the previous Case Study assessment matrix. Furthermore, candidates are advised to always prepare a position audit first.

A company cannot decide how it should progress in the future unless it knows where it stands now. It is important to prepare a PRIORITISED list of the key strategic issues at the start of the report. This should then be followed up, in the body of the report, to discuss each of these issues in depth. The key strategic issues should be clearly identified and discussed in a priority order to earn marks under this assessment criterion.

Many candidates simply produced a SWOT for ReuseR and for NOW (that had been pre-prepared and not updated for new material) and they had not prepared a SWOT for Shard (the company in the case) nor had any of the issues in the SWOT's been discussed in the body of the report or prioritised in any way. Therefore, these relatively easy marks for prioritisation had not been awarded to many candidates.

This assessment criterion was badly attempted at this sitting and marks were lost by many candidates for either not producing any analysis of the key issues, or for not prioritising these issues. It is recommended that a position audit should be prepared in future by all candidates clearly prioritising the issues facing the company in the case.

4.7 Judgement

This was an important criterion, which was poorly attempted by the majority of candidates and is an area that needs to be improved for the future. This criterion is to reward candidates for their reasoning ability and demonstration of commercial judgement concerning the possible acquisitions of ReuseR and NOW or for entering into long-term contract with some suppliers. Some candidates clearly did not recognise the crucial issue that if Shard pays more to acquire ReuseR or NOW than the value that future discounted cash flows will generate, then it will damage Shard's shareholder value.

Three further issues that were handled weakly (or not at all), and rather naively by many candidates concerned:

- The price to acquire NOW for. Many candidates simply stated acquire NOW for €73.8 million with no other calculations of future cash flows or a range of possible prices that could be paid for this profitable high growth company.
- Many candidates did not identify that as NOW is a private company, an attractive price would need to be offered to entice the Patel brothers to sell. Additionally, they may simply decline all offers and wish to remain a private company. Shard cannot simply choose to acquire NOW and for the acquisition to proceed.
- Again, many candidates did not produce a range of possible acquisition prices, but more importantly did not produce a maximum price, which should not be exceeded for each of the two target companies.

Candidates must demonstrate a far better commercial understanding of acquisitions and the importance of maintaining (and enhancing) shareholder value. Most candidates quoted the key words "shareholder value" with no apparent understanding of this most important concept.

4.8 Integration

This criterion rewarded candidates for their ability to discuss diverse areas of knowledge and skills and to integrate them effectively. Unfortunately the majority of candidates did not attain a pass in this criterion, as the reports produced were often badly integrated. Most candidates produced calculations (which were generally well presented and clear) in an appendix to their report, but then did not discuss any figures at all in the body of their report.

Some simply picked up a value and included it in a recommendation. All of the data calculated or presented in appendices to the report should have been further discussed, or at least referred to, in the main report.

If a candidate's report flowed well and discussed all of the issues in a logical sequence culminating in a justified recommendation, then the candidate would be awarded at least pass marks in this criterion. Like much of the TOPCIMA assessment matrix, there is a degree of overlap between each criterion. This has been apparent with the integration criterion, where candidates who wrote a good well reasoned answer earned pass marks in Logic (see below) as well as in integration.

4.9 Logic

This crucial 20 mark criterion rewards candidates for preparing justified, well argued recommendations and for the clear presentation of their report. In any business report, the most important section, as far as many managers are concerned, is the recommendations section and how clearly and well justified the recommendations have been made. This criterion rewards candidates for doing just that.

The body of the report should be discussing all of the issues identified, and the recommendations section should be making clear justified recommendations on all of the issues identified earlier in the report and needs to follow on logically from what has been discussed earlier. Many candidates chose to end each paragraph, within the main body of their report, with a recommendations section. This is acceptable but the recommendations should additionally be summarised at the end of the report. Additionally recommendations on an issue should not be made at the end of the report. Additionally recommendations on an issue should not be made at the end of the report if it had not been identified and discussed earlier.

All TOPCIMA candidates attempted the recommendations section quite well with the majority earning at least pass marks. Almost all candidates earned high marks for a well-presented report and there was less evidence than in previous exams of time pressure. Hopefully the additional 20 minutes reading time has allowed candidates to assimilate the new data in the unseen material. This appears to have been translated into candidates spending longer on the recommendations section and earning good marks. The two areas that should be improved for candidates who were unsuccessful are:

- Preparing fully justified, well reasoned recommendations. Candidates should not simply state "I recommend . . ." but instead should state "I recommend that Shard does . . . because . . .".
- Recommendations should cover all areas of the report, not simply the proposed acquisition of ReuseR or NOW. Many candidates did not prepare any recommendations on how Shard should proceed with its own recycling division or whether, or not, it should enter into long-term contracts with its suppliers for recycled materials.

4.10 Ethics

This new criterion was not well attempted by the majority of candidates, with the majority not earning pass marks. However, there were many very good answers that did correctly identify a range of ethical issues in the case and offered advice on how these ethical problems could be dealt with.

To earn good marks in this criterion, it was not sufficient to simply list issues such as poor health and safety, the dual roles of Kurt Finehart etc. What the examiner was looking for was for the candidate to identify what the ethical issues were (and there were many) and to then briefly justify why each issue had an ethical dimension. Higher marks were then awarded for candidates who further offered realistic advice on how to overcome the ethical issues, such as improved safety training and higher rates of pay and improved conditions of employment for NOW workers.

This new criterion is one where candidates need to **identify, justify** and **recommend advice** on how to overcome the ethical dilemmas to earn pass marks. Discussion of the ethical problems alone is insufficient to earn pass marks.

5.0 The requirement

Candidates are reminded to ensure that the answer that they write does fully answer the requirement stated, and not the requirement that they expected or wanted it to be. The answer given should be focused to the actual requirement set. Furthermore, candidates should ensure that their answer covers all aspects of the TOPCIMA assessment matrix, which is used to assess their answers.

In the Shard case, candidates were asked to discuss the points minuted from a Shard Board meeting. The minuted points concerned not just the proposed acquisition of ReuseR or NOW but also whether Shard should enter into long-term contracts for recycled materials and how it could grow its own recycling division. Many candidates only discussed the proposed acquisitions and therefore they had not fully answered all aspects of the requirement. Candidates are reminded to ensure that all aspects of the requirement have been discussed and that recommendations on all aspects of the question are presented.

6.0 Advice for candidates re-sitting TOPCIMA in future

It is advised that some form of tuition or study method be used to ensure that candidates who are re-sitting TOPCIMA are fully prepared for this final CIMA exam.

CIMA advises that candidates should practice on at least three cases prior to sitting the TOPCIMA exam, so research and preparation using past TOPCIMA or case studies is advised.

Additionally, candidates are referred to the TOPCIMA CIMA Learning System textbook, (published by CIMA Publishing through Elsevier) which is the recommended reading text for this exam. This CIMA Learning System takes candidates through past cases and demonstrates how to analyse the pre-seen and unseen material and how to prepare their answers. It also contains a chapter on Technical issues, including revision of all of a range of business and financial techniques that candidates should understand and incorporate in their answers. Candidates are reminded that the TOPCIMA assessment matrix is heavily weighted towards the application of technical knowledge to answer the case.

It is necessary for many of the candidates who were unsuccessful in this sitting to learn, understand and revise thoroughly the underlying strategic issues, as well to improve their ability to apply financial and business knowledge and techniques to the case material to a **far greater degree** than was demonstrated in their answers at this exam sitting, before they attempt the TOPCIMA exam again.

7.0 Recommendations and conclusions

As the final step before candidates are eligible to become an ACMA, CIMA has set the TOPCIMA exam at a high level to test candidates' abilities to analyse and interpret multifaceted problems – in the same way that ACMA's in business have to tackle difficult problems.

This exam is designed to prepare you for the world of a qualified accountant that is ahead of you. The examiner appreciates that learning the necessary skills and how to apply them to each case is not easy, but it is necessary in order to prepare you for becoming an ACMA in the future.

Finally, it should be noted that candidates who prepare thoroughly for the TOPCIMA exam, and who are able to demonstrate their ability to apply their knowledge to the requirement in the question will put themselves in a far better position to be able to pass the TOPCIMA exam. Therefore, preparation and research are vital, but this is **not** enough to pass this exam. You must also have a thorough understanding of the required techniques and how to apply them to the case material.

To summarise, the four key tasks that will put you in a better position of passing TOPCIMA in the future are:

- Thoroughly research at least 3 past cases. Then write your answer and compare it, and mark it, against the case writer's answer.
- Research thoroughly the industry setting for the case that you will be sitting and familiarise yourself totally with the pre-seen material.
- Learn and understand business strategies and techniques (as detailed in the CIMA Learning System) and learn how to **apply them to the case material.**
- Familiarise yourself with the TOPCIMA assessment matrix, to ensure that your answer covers all nine of the criteria that your answer will be assessed against.

Remember – prepare well and write a thorough, well-reasoned answer to all aspects of the requirement and hopefully you will be successful.

2.4 TOPCIMA exam in September 2005 – Domusco

The pre-seen material for this first "double case" was issued to candidates sitting in September 2005, in July 2005. Those sitting the November 2005 exam were issued with the identical pre-seen material in Early September 2005.

2.4.1 The issues in the pre-seen material

The pre-seen material gave details on Domusco, a multinational listed company operating in the fictitious country of Zee, outside of the Euro zone. The company has three main subsidiaries, house building, office building and major construction projects.

The pre-seen material gave details on some of the projects it has been involved in as well as the history surrounding its latest construction project in its home country of Zee. A major area of land is being developed in the area called Hadsi. Initially Domusco purchased the entire plot from the Zee government but it has since sold approximately 51% of the Hadsi land to other construction companies and the Board agreed to limit its overall exposure on this project to 40%. Therefore it still has 9% of the Hadsi land to sell.

Details were given on the scale of the development and the loans, financed from overseas banks, to fund the initial construction work until some of the houses and offices are sold. The two new loans are denominated in US dollars and Euros and therefore there is some currency exposure, although no information is given on whether these currencies match, or worsen, Domusco's existing cash flows generated in other currencies.

The cast states that the company currently constructs houses in the USA and also in other parts of Europe and the Middle East. As this is a strategy paper, it is possible that candidates would be asked to discuss possible new projects in a different area of the world than it has to date operated in.

The pre-seen material also gave details on a large European Sports stadium contract which it has just been awarded which it is concerned that it does not have sufficient manpower resources to construct in the agreed very challenging timescale. This is very similar to the Wembley contract awarded to Multiplex, which we now know will be delivered late and over budget resulting in a large loss on the project to Multiplex.

Newspaper articles on the construction industry are easy to find and it was expected that candidates could research this industry very well and quote realistic real life examples. In order to demonstrate your understanding of the industry setting you should comment on how companies with the types of problems that Domusco faces have overcome these challenges and the affects (both positive and adverse, such as a fall in its share price).

The construction industry faces high risks in its global operations and in each major construction project and the understanding and discussion of risk management and project management skills and techniques was required.

2.4.2 The September 2005 unseen and the requirement

Firstly we shall deal with the requirement. The requirement happened to be the same for both the September and the November 2005 exams – although this may NOT be the case in future.

The requirement was:

You are the consultant appointed by the Domusco Board.

Prepare a report that prioritises and advises on the main issues facing Domusco and makes appropriate recommendations.

As you can see from the wording of this requirement, you need to do several things. You need to:

- Prioritise the main issues
- Discuss the main issues
- Make appropriate recommendations on the main issues.

Therefore, the most important facet of answering this requirement in both the September and the November 2005 exams were to IDENTIFY THE MAIN ISSUES.

If you don't identify the main issues, then it is unlikely that you will pass. We will deal with how this CIMA Learning System can help you to identify the main issues later in Chapter 7.

The September unseen material introduced a number of new changes and unexpected twists in the case material. The September unseen material described that the Hadsi project was already a huge success with a high number of houses and offices sold "off plan" and that already Phase 2 of Hadsi was being sold off plan, some 9 months before any construction work was due to begin. This had left Domusco with a positive cash flow situation of over Z$1,000 million.

With the high levels of cash, the Domusco Board was looking at alternative projects which included the development of Metsa, another region in Zee, or a joint venture with Olan to build a large sport stadium. The board had also discussed alternatives ways of using the cash, which included:

- Loan repayments
- Expand the USA house building subsidiary
- Share repurchase.

There were also some details given about the mix of employees and sub-contractors and some HR problems that Domusco was experiencing as well as a decision for Domusco not to undertake any further Government funded projects in the country of Wye following the recent losses on a contract. The unseen material also gave details of an ethical dilemma concerning a fraud where the "whistle-blower" had been sacked after discovering and exposing the fraud.

However, the overriding issue to be discussed concerned the cash surplus. A listed company such as Domusco could not leave such a large cash surplus in its Balance Sheet, or it could become the target of a hostile take-over bid.

The principle with cash, as you should recall from your Financial Strategy studies, is that cash should always be either:

- invested in projects that generate a positive NPV (and this could be internal growth or acquisitions);
- returned to shareholders (using a variety of methods, although the usual route is a dividend or a special dividend).

The main problem that students had with this exam, as you will see from the Post Exam Guidance Report shown below, is that they did not deal with the cash surplus. Many did not know what to do with it – so they chose to ignore it. A cash surplus of Z$1,000 million (equal to Z$ 1 billion) CANNOT and SHOULD NOT be ignored.

2.4.3 The skills needed to pass the September 2005 exam on Domusco

Given that the company has a cash surplus, there was a need to advise how this cash could be effectively used and to recognise the need to invest in projects that generate a positive NPV or to return the cash to shareholders.

Many candidates did not deal with the cash issue well and instead discussed the other issues in the case including manpower resources and the use of sub-contractors. There was also the need to discuss the proposed Joint Venture with Olan to construct a large sports stadium and the problems associated with joint venture.

There was a need to prepare NPVs of the proposed Metsa development and to recognise the different probabilities associated with the high cost and the normal cost cash flow data supplied to candidates.

It was also necessary for students to be able to discuss risk management issues and the need to remain flexible so that it can respond to changes in levels of work loads, but to maintain its quality reputation.

2.4.4 The September 2005 Post Exam Guidance Report

After each TOPCIMA exam, the TOPCIMA examiner writes a report on candidate's performances in the exam and highlights areas where candidates did well and where errors or omissions have been made. It is especially useful to read what other candidates have done wrong so that you DO NOT REPEAT the same mistakes. The Post exam guidance reports are to be found on the CIMA website (www.cimaglobal.com).

For your convenience, the September post exam guidance report is shown below.

TOPCIMA – September 2005 – Post Exam Guidance report

1.0 General overview

The TOPCIMA exam is the final CIMA exam, taken by candidates who have successfully passed all three strategic level exams. This final exam is designed to test candidates' higher level skills and to test their ability to apply the knowledge they have already learned in previous CIMA exams and in their real life work experiences, and to use their judgement to solve multi-faceted problems given in the pre-seen and unseen material.

The September 2005 examination was a pilot with around 200 candidates, who sat the exam in 15 UK centres and 4 overseas centres only. The other difference with this pilot exam, is that all candidates prepared their answers on a PC, using Word and Excel. There was no difference to the usual 3 hour exam and they also were given the same 20 minutes reading time.

There were no apparent problems displayed by the candidates that using a PC presented them with any time constraint problems or problems with using Word and Excel.

The majority of the candidates in the UK sitting the September exam had attended tuition courses and it was expected that the standard of the answers would be very good. Indeed, there were certain centres that achieved very high marks and 100% pass rates. However, the standard of the answers from many other centres were not as good as expected, as many candidates did not use or refer to many of the new issues raised in the unseen material given to them on the exam day.

The industry setting for this TOPCIMA case was the construction industry. The company in the case was Domusco, which was a listed company in the country of Zee, a non-Euro based country in Europe, which has overseas subsidiary companies and undertakes much international construction work.

The unseen material always gives an unexpected twist to the case, so that candidates can be tested to see whether they can apply their knowledge to the case. In this case the unexpected twist was that Domusco has been going through a very successful phase and has a cash surplus of Z$1,000 million at the end of August 2005, rising to a forecast surplus of Z$1,300 by the end of 2005. The unseen material also gave details on two proposed construction projects, one in the Metsa area of Zee and the other a joint venture proposal with Olan to build a large sports stadium in another European country. The unseen material also gave details on the Domusco Board's decision not to undertake any more government funded work in the country of Wye, the results of the latest employee survey, details on a fraud in Zee and details of the Domusco's Board discussion on possible uses for the forecast cash surplus.

The key to passing TOPCIMA is candidates' ability to be able to apply their technical knowledge and understanding of the industry to the actual requirement set, using the relevant new data supplied in the unseen material on the exam day.

From marking and reviewing scripts from the September 2005 TOPCIMA exam the following points are relevant to candidates who were not successful:

1. There were many candidates who failed to discuss AT ALL the Z$1,000 million cash surplus. These candidates were determined to write a report based upon what they had expected to come up in the exam, and they wrote a very good report covering employee issues, sub-contractors and the construction industry in general. Some did also discuss the proposed Metsa and Olan construction projects, but they had not related their answer to either the requirement of the 100-mark question nor many aspects of the unseen material.
2. Another disappointing area that candidates did not display the expected level of knowledge on was Judgement. The underlying decision with a company that has a cash surplus, is that one of two decisions can be made, or a mix of both. This is that cash can either be invested back into the business to fund growth and expansion (either organic growth or an acquisition) OR it can be returned to shareholders.

   Cash can be returned to shareholders in a number of ways, including the brief Board discussion given in the unseen material via a buy back of shares. The most usual form of returning cash to shareholders is to pay dividends. Very few candidates suggested paying a higher or a special dividend to reduce the cash surplus. Furthermore, the majority of candidates failed to appreciate that if this level of cash were to be left in Domusco's balance sheet then Domusco would be the target of a hostile take-over, as a predator would want to access Domusco's cash resources. In summary, the top priority is to decide on what Domusco should do with the cash surplus. It surprised the examiner that so few candidates dealt with this topic well.
3. It was disappointing how few candidates discussed risk management. The construction industry is a high-risk industry and Domusco undertakes a number of large projects. It does not have a risk management strategy in place and some candidates correctly discussed the types of risks involved in the Metsa and Olan proposals, but again many candidates failed to discuss risk and made their recommendation solely based on financial calculations. It is recommended that candidates should have a far better understanding of risk management strategies before sitting a future TOPCIMA exam.
4. While some scripts demonstrated some knowledge and understanding of the construction industry, many scripts did not display any research into this industry or quote relevant details from real life companies about the types of problems experienced. More extensive research into the industry in which a case is set is required, and a better understanding and familiarity with the pre-seen material is also recommended.

In summary, the TOPCIMA paper is trying to prepare you for the role of an ACMA. Part of this role is the ability to "think on your feet", which requires a sound understanding of a variety of business and financial techniques and commercial understanding, as well as the ability to apply this knowledge to new information presented to you. This is what you will have to do in your future career. This final test of professional competence was testing just that – candidates' competence in applying their knowledge to the case.

Therefore, in order to pass TOPCIMA you MUST discuss the relevant data given in the unseen material on the exam day and ensure that your answer relates to requirement that has been set. Despite the many practice answers you may have written using the pre-seen material before the exam, it is recommended that you come into the exam hall with an open mind and not a pre-prepared answer.

Then when you have read the new unseen material and the requirement, you should ensure that your answer covers the relevant new issues raised in the unseen material and that the answer is tailored to answer the requirement that has been set.

2.0 The first TOPCIMA exam using pre-seen material that will cover two exam sittings

The pre-seen material for the September 2005 exam was made available to candidates some eight weeks before the exam date, as usual. The pre-seen material is exactly the same pre-material that was put on the CIMA website (www.cimaglobal.com) for candidates who are sitting the November 2005 exam.

The case writer has prepared two different sets of unseen materials (4–6 pages each) and two requirements. Each of the unseen materials follows on directly from the pre-seen material. It must be stressed to candidates sitting the November exam that it is **not** necessary to be aware, or familiar with, the first unseen (or the requirement of the first exam) in order to prepare for the second sitting of the TOPCIMA exam using the same pre-seen.

Candidates should remember that the two different unseen materials will deal with Domusco in different ways. Therefore any familiarity or knowledge of the first unseen material has no bearing or influence whatsoever on the second sitting. Therefore **each** of the two unseen materials **follows directly on from the pre-seen material**, and NOT the previous unseen.

Overall, any candidate that did not sit the September 2005 exam is advised **not** to become familiar with the September 2005 unseen material, as it could confuse them and detract from their understanding of the November 2005 unseen material. If you did sit the September 2005 exam and were unsuccessful, and you are planning to sit the November 2005 exam, you should re-familiarise yourself with the pre-seen material and forget about all of the new data that had been introduced in the September 2005 unseen material. The November 2005 exam will ignore this data totally and will follow on **only** from the pre-seen material.

3.0 Areas that were well attempted by candidates

It was apparent that the additional 20 minutes reading time had assisted many candidates, with very few scripts showing time management problems. The general structure and presentation of reports was again well presented, although there are some improvements require. Almost all candidates earned pass marks for the display of relevant technical knowledge, although it was on the application of technical knowledge to the case where some candidates earned lower marks.

Detailed below by assessment criteria is a detailed analysis of each criterion and where improvements can be made.

4.0 Areas that were not well attempted by candidates

The two areas that had not been well attempted were the prioritisation of the key issues and display of judgement.

It was particularly disappointing that many candidates had not identified, or not prioritised, the key issues facing Domusco. Many candidates now prepare a SWOT analysis, but it is further necessary to identify the key issues and prioritise them according to the impact they could have on the company. Candidates who identified the issues correctly but did not prioritise, earned marks under Focus, but missed out on marks under prioritisation. Prioritisation of the issues should assist candidates with writing the rest of the report. However, where the issues had not been identified, the rest of the report was muddled and unclear, and not all issues had been discussed.

Judgement requires the clear demonstration of professional judgement to deal with the issues facing the company in the case. In the September 2005 exam, judgement should have been used to decide what Domusco should do with its large cash surplus, as retaining it was not an option, as it could face a hostile take-over bid. Many candidates handled this poorly. If a company has a large cash surplus, candidates should immediately respond by stating that cash could be retained for investment or returned to the owners of the company. Many had not considered this.

5.0 Assessment matrix and areas for improvement

5.1 Overview of the TOPCIMA assessment matrix

The majority of candidates appear to have attempted to ensure that their answer covers all nine of the new assessment criteria. However, the three criteria that were not attempted well were Application, Prioritisation and Judgement.

The weighting of marks had been changed for the September (and November) 2005 exam, giving higher marks for Application and Judgement, which are now worth 15 marks each. This reflects the importance of demonstrating the application of technical knowledge to the case material and also the demonstration of professional and commercial judgement when considering alternative courses of action. Under Judgement marks were awarded for identifying alternative courses of action for Domusco's cash surplus and whether the cash should be invested into the Domusco business or returned to shareholders. Generally this was poorly attempted.

As noted above, there were a number of excellent scripts and several small centres achieved a 100% pass rate. Within these very good centres, many candidates were awarded full marks for many of the criteria, proving that a well prepared and considered answer can achieve full marks in many of the criteria.

5.2 Technical

There were only 5 marks available for Technical in the updated assessment matrix weightings for the September 2005 exam, but the majority of candidates achieved either 3 or 4 marks (marginal or pass marks). Some candidates, who demonstrated a good range of techniques, were awarded the full 5 marks.

Candidates earned marks mainly for preparing SWOT analyses, NPV calculations and discussion on risk management techniques. Higher marks were available for a better display of relevant technical knowledge, such as PEST analysis, Porter's Generic Strategies, Ansoff's growth vector matrix or the BCG matrix, all of which could have been discussed in the context of this case.

5.3 Application

The Application criterion was now worth 15 marks as the examiner considers that it is how the technical knowledge is applied to the case material that is important to the TOPCIMA exam.

Whilst some candidates earned marginal pass marks in this criterion, it was disappointing that many candidates were unable to demonstrate their application of technical knowledge to the case. Many candidates had not prepared accurate NPV calculations for the high and low cost scenario for the proposed Metsa development. Furthermore, the updated forecast cash forecasts were poorly attempted, or in many case not attempted at all. There were some good SWOT analyses, that had incorporated many of the new issues introduced in the unseen material, but there was little other application of all of the varied techniques that candidates should be familiar with.

Following the syllabus change, candidates can now only sit TOPCIMA when they have passed all of the Strategic Level papers. It is necessary to revise all of the business theories and techniques that you have learned in the Strategic level subjects and to use them to solve some of the business problems facing the company in the case. It is expected that candidates should prepare a SWOT and PEST analysis and use at least one other technique, perhaps the Balanced Scorecard or the BCG matrix. Candidates should use some of these techniques, with data from the case, to demonstrate how these techniques could assist management.

A further area that is always helpful in understanding the case material is ratio analysis, including revenues, profitability, liquidity and gearing. Some candidates prepared a good selection of relevant ratios, but few candidates discussed them adequately or discussed, which should be improved or suggested ways to manage the improvements required.

5.4 Diversity

The assessment matrix weighting for Diversity has been reduced to only 5 marks and these marks are available for demonstrating a breadth of technical knowledge and a range of views. Many candidates earned pass marks in this criterion for a good discussion on HR and sub-contractor issues and for relevant examples of real life companies in the construction industry and the problems facing them, and the similarities to the problems (and opportunities) facing Domusco.

However, many candidates came into the exam hall with much pre-prepared information on HR issues and sub-contractors and were determined to write about these issues. Whilst the discussion was very good, and did earn marks, in many instances it was to the detriment of the rest of their answer as they used up too much exam time on these issues and their answer did not cover many of the high priority issues. Many answers did not discuss Domusco's cash situation at all, although their comments on the use and quality control of sub-contractors was excellent. However, there were limited marks available for this discussion as the main focus of the report should have been the suggested investment proposals and what to do with the cash surplus.

In this exam sitting, there were many candidates who did quote relevant examples of real life construction companies and much research and understanding of the construction industry was evident. However, there was still a minority of candidates who did not demonstrate any research at all. This differed greatly from the little research that had been apparent of the recycling industry in the May 2005 exam. So, well done, and continue to read widely on the industry in which the case is set, to enable you to quote examples and to explain how real companies have overcome many of the problems facing the company in the case material.

5.5 Focus

The 10 marks available for Focus are for discussion of the key issues. Overall, the majority of candidates earned high marks in this assessment criterion as they correctly discussed in a good amount of depth the key issues. Many candidates achieved a clear pass. Generally, this criterion was well attempted.

To ensure high marks here it is necessary to identify the key issues in the case and to set up a "check list" of report headings, to ensure that **all of the relevant issues** have been discussed. The process of planning your answer, at the start of the exam, is to firstly identify the key issues, then prioritise them, and then discuss each of them in depth. If all of the issues are discussed in detail then high marks will be awarded under focus. Some candidates lost marks under this criterion for not discussing the proposed expansion of the USA house building division, and the proposed loan repayments and share buy back proposal.

5.6 Prioritisation

It was again very surprising, and disappointing, that this criterion was so badly attempted, with the majority of candidates earned below pass marks. This criterion has 10 marks available for the prioritisation of the key issues facing Domusco.

Many candidates earned low marks in this criterion for the identification of the main issues only. As the issues had not been prioritised, higher marks could not be awarded. It is recommended that the opening paragraph (after an introduction and terms of reference) should identify the relevant key issues facing the company and put them in a priority order. There is no single correct priority, but the Z$1,000 cash surplus should have appeared somewhere in the top few priorities. Such a large cash surplus could make Domusco the target of a hostile takeover, and therefore the cash surplus should be managed. Cash should either be invested in positive NPV projects or returned to shareholder, in a number of ways, including dividends. Other top priorities are the employees' issues and the resource management required for it to meet its ambitious 5-year plan.

The key strategic issues should be clearly identified and discussed in a priority order, with comments justifying your choice of priority, in order to earn high marks under this assessment criterion. It is not necessary to give each and every issue a priority number, but candidates should identify and prioritise at least the top 3 or 5 key issues. It is recommended that a position audit should be prepared in future by all candidates clearly prioritising each of the top 5 key issues facing the company in the case.

5.7 Judgement

This is an important criterion, which now carries 15 marks, and is for the demonstration of alternative solutions and the display of professional judgement. It can also be considered as the "link" between the discussion of the issues and the recommendations. Marks are awarded on the basis of what professional judgement candidates have demonstrated in reaching their recommendations.

This criterion was poorly attempted by the majority of candidates and is **an area that needs to be improved for the future**. Many candidates did not discuss how the Z$1,000 million cash surplus could be used. The answer should have discussed that this surplus could be invested in positive NPV projects or returned to shareholders. This should be an immediate response to any company which has a large cash surplus and is an area that was covered in the Financial Strategy syllabus, which candidates should be familiar with.

Many candidates were awarded marks for discussing the investment proposals but did not discuss the proposals for repaying loans or the proposed share buy back. Furthermore, very few candidates discussed any of the other ways of returning cash to shareholders, such as exceptional dividends, or an increase in normal dividends.

However, a few well prepared candidates earned full marks for this criterion for thoroughly discussing all of the options available to Domusco, and how it could use the cash to enhance shareholder value. Candidates need to be able to demonstrate a far better commercial understanding of how Domusco could enhance shareholder value. Only a few candidates quoted the key words "shareholder value", and most showed little clear understanding of this most important concept. In addition, other stakeholders' interests should also be considered here.

5.8 Integration

This criterion rewarded candidates for their ability to discuss diverse areas of knowledge and skills and to integrate them effectively.

In the small number of candidates who sat the September 2005 exam, about half attained a pass for this criterion, however, the remaining reports were badly integrated and this resulted in a low marks. Most candidates produced calculations (which were generally well presented and clear) in an appendix to their report, but then did not discuss any figures at all in the body of their report. Some simply picked up a value and included it in a recommendation. All of the data calculated or presented in appendices to the report should have been further discussed, or at least referred to, in the main report.

If a candidate's report flowed well and discussed all of the issues in a logical sequence culminating in a justified recommendation, then the candidate would be awarded at least pass marks in this criterion. Like much of the TOPCIMA assessment matrix, there is a degree of overlap between each criterion. This has been apparent with the integration criterion, where candidates who wrote a good well reasoned answer earned pass marks in Logic (see below) as well as in integration. This is a difficult criterion to mark, but it is the overall view of the candidate's report and whether it has covered many of the key issues, and not discussed one of the minor issues in great depth. Candidates who did not discuss Domusco's cash situation AT ALL did not earn pass marks in this criterion, and this resulted in many instances in a marginal fail, despite earning reasonable marks for several other assessment criteria.

In real life, if you employed a consultant to advise on the key issues of this case and stated that the company has a large cash surplus and that a number of alternatives are being considered (Metsa, Olan, USA expansion, loan repayments, share buy backs etc) and many of these were excluded from the report, it would not be considered to be a comprehensive professional report. This criterion is used to assess the entire report in a holistic way and to attain pass marks, the report needs to cover most of the key issues well.

5.9 Logic

This crucial 20 mark criterion rewards candidates for preparing justified, well argued recommendations and for the clear presentation of their report. In any business report, the most important section, is the recommendations section and how clearly and well justified the recommendations have been made. This criterion rewards candidates for doing just that.

The body of the report should be discussing all of the issues identified, and the recommendations section should be making clear justified recommendations on all of the issues identified earlier in the report and needs to follow on logically from what has been discussed earlier. Many candidates chose to end each paragraph, within the main body of their report, with a recommendations section. This is acceptable for full marks but generally it would be better if the recommendations are at the end of the report. This is because a recommendation cannot be made until all of the other issues are discussed and assessed, as many are competing for the same scarce resources, manpower and finance.

Most TOPCIMA candidates attempted the recommendations section quite well with the majority earning at least pass marks. Almost all candidates earned high marks for a well-presented report and there was less evidence than in previous exams, of time pressure. Hopefully the additional 20 minutes reading time has allowed candidates to assimilate the new data in the unseen material. This appears to have been translated into candidates spending longer on the recommendations section and earning good marks.

The areas that should be improved for candidates who were unsuccessful are:

- Preparing fully justified, well reasoned recommendations. Candidates should not simply state “I recommend . . .” but instead should state “I recommend that Domusco should not repay loans because . . .”.
- Recommendations should cover all areas of the report. Each of the issues that have been identified and discussed elsewhere in the report should have a clear justified recommendation.
- It may be that some of your recommendations need to be only a few lines long (certainly not only a few words) but should cover every issue discussed elsewhere in the report. As above, you should have a “check list” of issues to be discussed, you should use this same “check list” to ensure that a clear justified recommendation has been made for each issue.
- It is necessary to make recommendations on all facets of the company, such as changes to the Board (such as replacement for Tom Micol who is nearing retirement), use of IT, and other areas such as strengthening financial controls, to stop any further frauds occurring and ways to improve Domusco’s strategic planning process, which is clearly very weak.

5.10 Ethics

This new criterion was better attempted in this exam sitting than in May 2005, with many candidates earning pass marks. However, many candidates only discussed some of the ethical problems, without clearly identifying why they had an ethical dimension, and many did not offer any advice.

To earn good marks in this criterion, it was not sufficient to simply list issues such as the fraud and Olan’s poor reputation. What the examiner was looking for was for the candidate to identify the ethical issues (and there were many of them) and then to briefly justify why each issue was considered to have an ethical dimension. Higher marks were then awarded for candidates who further offered realistic advice on how to resolve the ethical issues, such as better training to overcome Domusco’s skill shortage, tighter financial controls to try to stop further cash frauds, introduction of a “whistle-blower” policy to try to encourage employees to report issues. Other related issues were the unfair dismissal of Jaz Grue and possible suggestion for re-instating him and the many other employee issues, including stress related problems.

To summarise, in order to earn pass marks it is necessary to **identify, justify** and **recommend advice** on how to resolve several of the ethical dilemmas included in the case material.

6.0 The requirement

Candidates are also reminded to ensure that the answer that they write does fully answer the requirement stated, and not the requirement that they expected or wanted it to be. The answer given should be focused to the actual requirement set, although the requirement is usually fairly open ended. It usually asks candidates to advise on the key issues. Therefore, in order to pass you need to identify what the key issues are. It is recommended that candidates prepare answer plans, or "check lists" to ensure that all areas are covered.

Additionally, candidates are reminded that they should ensure that their answer covers all nine criteria of the TOPCIMA assessment matrix, which is used to assess their answers.

In this exam sitting, it was very surprising that a sizeable minority of candidates had not discussed the Z$1,000 million cash surplus that Domusco had. A company's cash situation (whether cash rich or short of cash) has a major impact on its future strategies and cannot be ignored, particularly in the construction industry, which is heavily influenced by the high levels of working capital required to undertake projects.

Therefore, in summary, candidates are reminded to ensure that all aspects of the requirement have been discussed and that their recommendations do cover all of the key issues from the case material.

7.0 Advice for candidates re-sitting TOPCIMA in future

It is advised that some form of tuition or study method be used to ensure that candidates who are re-sitting TOPCIMA are fully prepared for this final CIMA exam. It is necessary for many candidates to revise the subjects contained in the 3 Strategic level papers, particularly Business Strategy, so that relevant technical knowledge and theories can be discussed in the context of the case material.

CIMA advises that candidates should practice on at least three cases prior to sitting the TOPCIMA exam, so research and preparation using past TOPCIMA or case studies is advised.

Additionally, candidates are referred to the TOPCIMA CIMA Learning System textbook, (published by CIMA Publishing through Elsevier) which is the recommended reading text for this exam. This CIMA Learning System takes candidates through past cases and demonstrates how to analyse the pre-seen and unseen material and how to prepare their answers. It also contains a chapter on Technical issues, including revision of all of a range of business and financial techniques that candidates should understand and incorporate in their answers. Candidates are reminded that the TOPCIMA assessment matrix is heavily weighted towards the application of technical knowledge to answer the case.

It is necessary for many of the candidates who were unsuccessful in this sitting to learn, understand and revise thoroughly the underlying strategic issues, as well to improve their ability to apply financial and business knowledge and techniques to the case material to a **far greater degree** than was demonstrated in their answers at this exam sitting, before they attempt the TOPCIMA exam again.

The other important advice, is to empower yourself with the required research and pre-prepared material, but be ready to "discard" some (or all) of this material if you find it is no longer relevant to the question or relevant to the new material in the unseen material on the exam day. In summary, do plenty of research, do prepare material for your report, plan the layout and lots of other preparation using the pre-seen material – but on the exam day, ensure that the relevant key issues raised in the unseen material are discussed. This may (or may not) include some of your pre-prepared material – so, be prepared to write a relevant report that covers the new issues. The key word here is relevant.

Also, it may be helpful for candidates to use the following report format for their answers, which should provide a check that all areas have been covered, especially prioritisation and ethical issues. A recommended report format is:

- Contents page.
- Introduction (brief 5 to 10 lines of background on the company).
- Terms of reference (brief 5 to 10 lines to set the scene of who you are – e.g. a consultant, and to state who the report was commissioned by, and who it is aimed at)
- Identify and prioritise the main issues facing the company, showing the top 5 items in priority order. This area of the report should also include discussion on your position audit or SWOT analysis.
- The main body of your report should discuss in depth all of the issues you have identified above and should be supported by numerical evaluation of the proposals, which should be shown in appendices. Note: key data and analysis given in appendices should also be discussed within the body of the report.
- Separate section on Ethical issues, covering a number of ethical issues and offering advice on how these issues could be resolved.
- Recommendations. The most important part of the report and should pick up on each of the issues discussed earlier. Each recommendation should be clear and well justified as to why you are recommended a particular course of action. Do NOT recommend that more information needs to be collected before a recommendation can be made.
- Conclusion (brief 5 to 10 lines for closing comments).
- Appendices. Note: key data and analysis given in appendices should also be discussed within the body of your report.

8.0 Recommendations and conclusions

As the final step before candidates are eligible to become an ACMA, CIMA has set the TOPCIMA exam at a high level to test candidates' abilities to analyse and interpret multi-faceted problems – in the same way that ACMA's in business have to tackle difficult problems. This exam is designed to prepare you for the world of a qualified accountant that is ahead of you.

Finally, it should be noted that candidates who prepare thoroughly for the TOPCIMA exam, and who are able to demonstrate their ability to apply their knowledge to the requirement in the question will put themselves in a far better position to be able to pass the TOPCIMA exam. Therefore, preparation and research are vital, but this is **not** enough to pass this exam. You must also have a thorough understanding of the required techniques and how to apply them to the case material.

To summarise, the five key tasks that will put you in a better position of passing TOPCIMA in the future are:

- Thoroughly research at least 3 past cases. Then write your answer and compare it, and mark it, against the case writer's answer.
- Research thoroughly the business setting for the case that you will be sitting and familiarise yourself totally with the pre-seen material.

- Learn and understand business strategies and techniques (which are detailed in the CIMA Learning System) and learn how to **apply them to the case material.**
- Ensure that your report covers **the relevant key issues raised in the unseen material** and that your answer relates to the exact requirement of the question.
- Familiarise yourself with the TOPCIMA assessment matrix, to ensure that your answer covers all nine of the criteria that your answer will be assessed against.

Remember – do your research and prepare for the exam – but on the day, ensure that you write a thorough, well reasoned answer that covers the relevant key issues raised in the unseen material and that your answer covers all aspects of the requirement. If you do this, you **will** be successful.

2.5 November 2005 – Domusco

2.5.1 The unseen and the requirement

On the day of the exam, candidates were given details of a major cash shortage that was forecast due to a fall in sales over the last year. Sales of houses and offices were also not selling well following a rise in interest rates in Zee following some exchange rate turbulence against the Euro in the past few months.

The unseen also stated that Domusco had also acquired a small competitor in Zee, in order to give it access to markets in Europe and to increase its market share in Zee. However, the acquisition, which had been for cash and shares, had required an additional loan. Following the exchange rate turbulence the exchange rates of the US Dollar and the Euro against the Zee dollar had changes, resulting in a far larger loan liability. The unseen material stated that Domusco had a loan covenant that stated that loans could not exceed 40% of Shareholders' equity plus loans and that Domusco was close to breaching the loan covenant.

The unseen material also gave details of Domusco's falling share price, which stood at Z$7.50, a fall of 46% since the pre-seen material! Quite a material reduction! The case material stated that investors had a lack of confidence in Domusco's ability to improve returns and that some investors were threatening to sell their shares. Therefore urgent action was required to improve shareholder confidence and to demonstrate that the Domusco management team could put plans in place to improve the current situation.

The last bit of bad news in the unseen material was that the Finance Director resigned over the point of principle of not being allowed to announce a profits warning, as forecast profits for 2005 were Z$535 million against it plan of Z$783 million.

Interestingly, the wording of the requirement was EXACTLY the same as the September 2005 exam, which was:

You are the consultant appointed by the Domusco Board.

Prepare a report that prioritises and advises on the main issues facing Domusco and makes appropriate recommendations.

Therefore, the only thing that has changed since the September exam is that the "MAIN ISSUES" that need to be prioritised, discussed and recommendations are different.

In order to pass this exam, it is necessary to identify the main issues. This exam paper and the issues that need to be identified are covered in Chapter 7 below.

2.5.2 The skills needed to pass this exam

The main skills needed to pass this exam is the ability to analyse the unseen material and to identify the new issues. From this list (and there are over 12 issues) is to pick out the top 5 or 6 priorities and to discuss them well.

The company is clearly going through bad times, and is close to breaching its loan covenants, its profits are well below what its investors think and want, the companies share price has fallen dramatically and its key investors are unhappy and threatening to sell. Then the Finance Director resigns. What Board position is vital during a period of financial difficulty – yes – that's right – the company needs a new Finance Director.

Now, which is more urgent for Domusco – dealing with the forecast cash shortfall or getting a new Finance Director? It's a close call – as it would be the new FD that would need to prepare revised plans, meet with Domusco's bankers and help the Chairman to prepare revised plans to re-assure shareholders. Therefore it could be argued that getting a new FD is the top priority and then the next priority must be establishing what actions need to be taken to stop Domusco getting into the forecast Z$2,500 million cash deficit position.

There is a need to prepare a cash forecast from the data given in the unseen material and to revalue the overseas loans and to calculate what Domusco's loan covenant is now and what it is forecast to be at the end of 2005. Then a revised plan needs to be prepared to show the estimated value of each action and how that could save or generate cash to the order of Z$2,500 million over the next 6 months.

Discussion on risk management and the other key issues are also required. This is dealt with in Chapter 7 below.

2.5.3 The November 2005 Post Exam Guidance Report

After each TOPCIMA exam, the TOPCIMA examiner writes a report on candidate's performances in the exam and highlights areas where candidates did well and where errors or omissions have been made. It is especially useful to read what other candidates have done wrong so that you DO NOT REPEAT the same mistakes. The Post exam guidance reports are to be found on the CIMA website (www.cimaglobal.com).

For your convenience the Post Exam Report on the November 2005 exam is shown below:

TOPCIMA – November 2005 Post Exam Guidance report

1.0 General overview

The TOPCIMA exam is the final CIMA exam, taken by candidates who have successfully passed all three strategic level exams. The November 2005 TOPCIMA exam was sat by over 1,600 candidates, of which over half had sat a TOPCIMA or the previous Final level Case Study exam before, and been unsuccessful in previous attempts.

The industry setting for this TOPCIMA case was the construction industry. The company in the case was Domusco, which was a listed company in the country of Zee, a non-Euro based country in Europe, which has overseas subsidiary companies and undertakes much international construction work.

As the TOPCIMA exam is taken on its own, with the pre-seen material available over 8 weeks before the exam, it was envisaged that candidates would be well prepared and would have researched the industry setting, the construction industry. However, it was apparent from many answers that little research or background reading on the construction industry had been undertaken. This contrasted with the candidates who did discuss relevant real life examples and how the problems particular companies had experienced were similar to those facing Domusco. It cannot be stressed enough that the TOPCIMA exam relates as much as possible to real life scenarios and it is very important to read the financial press and research the industry setting to prepare yourself as much as possible to understand the business environment in which the case is set. Overall, far more background reading and research are recommended.

The unseen material always gives an unexpected twist to the case, so that candidates can be tested to see whether they can apply their knowledge to the case. In this November 2005 unseen material the unexpected twist was that Domusco had a cash forecast that showed a deficit of almost Z$2,500 million in the next 6 months and that urgent action was needed to manage the company through this difficult time. If the cash issue was not urgently addressed, then the company could either go into liquidation or could be the target of a hostile taken over. Many candidates failed this TOPCIMA exam as they had not identified cash as a key issue, despite the size of the forecast cash deficit.

To further compound the problems that Domusco was facing, the unseen material gave details on a recent take-over of KLT that market analysts felt had been over valued. Domusco's share price had fallen in value from Z$13.85 to Z$7.50 in the last few months due to a number of factors including exchange rate fluctuations, which led to local interest rates rises, so leading to a slow down in sales in Zee. The company urgently needs to address its cash requirements, but the two main routes for raising cash, which are debt or an equity issue, were closed off, as the unseen material stated that Domusco had loan covenants restricting further debt. Also with such a depressed share price and lack of investor confidence, a rights issue would not be successful at this time. Therefore the cash issue had to be handled differently. There were also a number of other issues included in the unseen material, including low investor confidence, the resignation of Domusco's Finance Director, a bribery issue and some organisational problems.

Some candidates did not recognise these two major restrictions and simply advised that Domusco should "issue more shares" or "take out a further loan". These demonstrated a lack of commercial awareness and earned very low marks.

The key to passing TOPCIMA is candidates' ability to be able to apply their technical knowledge and understanding of the industry to the actual requirement set, using the relevant new data supplied in the unseen material on the exam day. It is very important to identify the new issues and to understand which are the most important issues. For example, the proposed reorganisation of Domusco's project planning department is far less important than the huge forecast cash shortfall.

From marking and reviewing scripts from the November 2005 TOPCIMA exam the following points are relevant to candidates who were not successful:

1. There were many candidates who failed to discuss how the forecast cash shortfall could be overcome. There were even some candidates who missed this entirely and stated that Domusco was a "cash rich" company. (Maybe they had sat the September TOPCIMA exam – in which Domusco had been depicted as being cash rich – but the November 2005 unseen material had clearly shown a slow down in sales and a forecast cash shortfall of Z$1,150 and Z$1,030 in the next two quarters). The advice here is to read (and reread!) the unseen material and to note down the key issues in your answer plan. Cash was a crucial issue in this case – as it is for all construction companies operating in the real world – and a forecast cash shortage needs urgent action. The proposals made by some candidates such as "monitor cash closely" or "generate more cash" were inadequate to earn marks. The company needs to actually take action NOW and the report needed candidates to clearly discuss and recommend what actions should be taken. Monitoring cash will not stop the company sliding into liquidation!
2. Another disappointing area that candidates did not display the expected level of knowledge on was Judgement. Marks were awarded for discussion on alternative ways in which the forecast cash shortfall could be overcome and for ways in which investor confidence could be improved. Marks were available for discussion about renegotiation of loan covenants with the ALT and BRG banks and for slowing down construction work on unsold houses and offices in Zee, especially on the Hadsi project. Alternative ways of generating cash were to sell parts of Domusco's substantial land bank (including the land bank that was acquired with KLT) or by selling parts of Domusco, such as the office building subsidiary or the USA housing subsidiary.
3. The majority of candidates demonstrated little technical knowledge, although it was pleasing that so many candidates did at least prepare a SWOT analysis. However, many SWOT analyses missed the key issue of cash. There were many relevant techniques that could have been prepared and applied to the case material including PEST analysis, the use of the Balanced Scorecard and Porter's generic strategies. A small number of candidates did correctly refer to Argenti's corporate collapse model and identified that Domusco had demonstrated a number of relevant features.
4. It is disappointing that some candidates are writing at length on a broad spectrum of pre-prepared subjects, including corporate governance, business strategy HR issues and risk management, but are not relating their comments to the new material given in the unseen material on the exam day. It must be stressed that candidate's reports should be tailored to discuss and recommend on the key issues identified in the unseen material.
5. While some scripts demonstrated some knowledge and understanding of the construction industry, many scripts did not display any research into this industry or quote relevant details from real life companies about the types of problems experienced. More extensive research into the industry in which a case is set is required, and a better understanding and familiarity with the pre-seen material is also recommended.

In summary, the TOPCIMA paper is trying to prepare you for the role of an ACMA. This means that you have to analyse the new material presented to you on the exam day (the unseen material) and absorb the impact of the key issues. Many candidates did not appreciate the severity of the low share price and the size of the forecast cash shortfall, and instead discussed how Domusco can improve its profitability and its management structure in the longer term. However, what was needed in this TOPCIMA case was an appreciation that Domusco simply will not have a long term, if it does not survive the next 12 months. Drastic action is needed to be made in the short term to both overcome the cash shortfall and to reassure shareholders that Domusco is taking action that will have a positive effect on their confidence, and ultimately the company's share price. There were many other issues to be discussed, including filling the role of Finance Director, especially as it would be this post holder who would be needed to guide Domusco through the difficult year ahead.

Therefore, it cannot be stressed enough that in order to pass TOPCIMA you MUST discuss the relevant data given in the unseen material on the exam day and ensure that your answer relates to the requirement that has been set. While it is important to practice and prepare material before the exam, it is more important that you come into the exam hall with an open mind and not a pre-prepared answer. Your answer must relate to the key issues as raised in the unseen material, which may, or may not, coincide with what you were expecting to come up.

2.0 Domusco – the first TOPCIMA case that had two exam sittings

The Domusco case was the first TOPCIMA case that had two different exam sittings using the same pre-seen material. There was a pilot sitting of a few hundred candidates in September 2005, using the first unseen material and the November 2005 sitting used a different unseen material. Both were totally exclusive, as both unseen materials followed directly on from the pre-seen material. Knowledge of what transpired in the first unseen material was NOT required for those candidates who sat the TOPCIMA exam in November, Indeed, in order not to confuse candidates, it is recommended that candidates do NOT familiarise themselves with the previous unseen material. For your information, the September 2005 unseen material depicted Domusco as going through a very successful phase and that it had a cash surplus of Z$1,000 million and identified a number of projects that it was considering.

Candidates should remember that the two different unseen materials will deal with the company in the case in different ways. Therefore any familiarity or knowledge of the first unseen material has no bearing or influence whatsoever on the second sitting. Therefore **each** of the two unseen materials **follows directly on from the pre-seen material**, and NOT the previous unseen.

In these two cases, the over-riding issue happened to be cash, in the September 2005 exam, Domusco did not know what to do with the Z$1,000 million surplus and in November 2005, Domusco had identified a forecast cash shortfall of Z$2,500 million. Both exams covered large cash sums – and in both exams some candidates chose not to discuss cash. They failed.

3.0 Areas that were well attempted by candidates

To assist candidates in their preparation for the November 2005 exam, CIMA emailed all candidates with details of some guidance notes that had been put on the CIMA website (www.cimaglobal.com). It was apparent that this document has helped many candidates as a much higher than usual number of candidates had prepared a SWOT analysis (many of which were very good and earned reasonable marks).

Also the format of candidates' report were improved and many chose to follow the suggested report format, and this ensured that there was a separate paragraph near the start of the report in which the main issues were identified and prioritised. There is, however, still room for improvement, as detailed below under the Prioritisation heading. However, for the first time over the last few years it is pleasing that the majority of candidates did correctly identify and attempt to prioritise the key issues facing Domusco near to the start of the report. This has no doubt helped these candidates to prepare a much better report. Furthermore, many candidates had a separate report heading to discuss ethical issues, so ensuring that these are not omitted from their report. Generally, report format and presentation issues have greatly improved over the last few exam sittings.

High marks were earned by the majority of candidates under the criterion of Focus, as detailed below. It was apparent that the additional 20 minutes reading time had assisted many candidates, with very few scripts showing time management problems.

4.0 Areas that were not well attempted by candidates

The two main areas that had not been well attempted were the display of Judgement and the recommendations made under Logic.

Judgement requires the clear demonstration of professional judgement to deal with the issues facing the company in the case. In the November 2005 exam, judgement should have been used to decide what Domusco should do to overcome the large cash shortfall that has been forecast. Carrying on with the planned construction work was not an option, as this could lead to insolvency and corporate collapse. Many candidates handled this poorly by stating that the company should have a bank overdraft (very unlikely for Z$2,500 million) or take out more short term loans. Other candidates simply stated "have a rights issue" and shareholders will generate the required cash. Many did not appreciate that most of Domusco's shareholders, who have already seen the value of their shares fall by 46% in the last few months are unlikely to want to invest a further Z$2,500 million at this point in time. A further complication is that a rights issue would take some time to organize and to generate cash (assuming it was successful) and the forecast cash shortfall was happening now and forecast to continue for the next 6 months. Therefore, a right issue could not solve the problem in the required timescale. Many had not considered that the only solution would be to sell some of Domusco's assets (whether this is land or parts of the company) and that this would also take time. Therefore a combination of ways to generate and to save cash would be required including the scaling back of construction work, especially in Hadsi, and various other cost cuts.

Recommendations made under Logic were also weak. The candidates who correctly recommended that Domusco could sell land should have expanded the recommendation to state that land may need to be discounted for a quick sale or that land in Europe would be easier to sell than land in Zee. Furthermore, it should have been recommended that the sale of land, or parts of Domusco, would have an impact on the future profitability of Domusco, but that the need for cash now to ensure the very survival of Domusco was greater than the need to maintain future profitability levels. Overall, more detailed justified recommendations are required to earn higher marks.

5.0 Assessment matrix and areas for improvement

5.1 Overview of the TOPCIMA assessment matrix

It is clear that the email that was sent to candidates before the November 2005 exam advising them to read the TOPCIMA guidance notes on the CIMA website has helped many candidates to earn better marks than perhaps they would otherwise have done. The three main areas of improvement that have been identified as being a direct outcome from the guidance notes, were:

- Improved report format (which also ensured that all nine criteria were covered)
- Better prioritisation of the key issues by a far larger number of candidates, together with the preparation of SWOT analysis by more candidates
- Ethical issues were discussed well by far more candidates than in the two previous TOPCIMA cases, in which a sizable minority hardly discussed ethical dilemmas at all.

The weighting of marks had been changed for the September and November 2005 exam, giving higher marks for Application and Judgement, which are now worth 15 marks each. This reflects the importance of demonstrating the application of technical knowledge to the case material and also the demonstration of professional and commercial judgement when considering alternative courses of action. Under Judgement, marks were awarded for identifying alternative ways of overcoming the forecast cash shortfall and for issues surrounding shareholder confidence. Generally, many candidates did **not** demonstrate good judgement, which is a very important aspect in the role of an ACMA. This is an area that unsuccessful candidates need to work on to improve.

5.2 Technical

There were only 5 marks available for Technical in the updated assessment matrix weightings for the (September and) November 2005 exam, and it was disappointing that many candidates only earned 2 or 3 marks for the poor display of technical knowledge. However, some candidates, who demonstrated a good range of techniques, were awarded the full 5 marks. It must be noted that many overseas candidates displayed a sound understanding of several relevant techniques which they had also applied to the case material well. However, many overseas candidates failed this TOPCIMA exam due to low marks earned in several other assessment criteria including Focus, Judgement and Logic.

Candidates earned marks mainly for preparing SWOT analyses, ratio analysis (including gearing calculations that were relevant to the loan covenant) and for discussion on risk management techniques. Higher marks were available for a wider display of relevant technical knowledge, such as PEST analysis, Porter's Generic Strategies, Ansoff's growth vector matrix, Argenti's corporate failure model, the Balanced Scorecard technique or the BCG matrix, all of which could have been discussed in the context of this case. As candidates have already passed the Business Strategy exam, they should be familiar with these techniques and should be capable of earning all 5 marks.

5.3 Application

The Application criterion was now worth 15 marks for the (September and) November 2005 exam as the examiner considers that it is how the technical knowledge is applied to the case material that is important in the TOPCIMA exam. Whilst some candidates earned marginal pass marks in this criterion, it was disappointing that many candidates were unable to demonstrate their application of technical knowledge to the case material. There were some good SWOT analyses, which incorporated many of the new issues introduced in the unseen material, although it was surprising that a significant number of SWOT analyses omitted key weaknesses, such as the loss of the Finance Director and the forecast cash shortage. It is very important that all of the new issues that have been introduced in the unseen material on the exam day are incorporated into a SWOT analysis. Again, it is repeated that while it is important to plan and practice before the exam, it is crucial that the new material given to you on the exam day is used in all of your answer, including technical analysis in your appendices, such as a SWOT analysis.

It is worth noting that a higher proportion of candidates did prepare a SWOT analysis than in previous TOPCIMA exam sittings, perhaps due to the reminder in the guidance notes sent out to all candidates shortly before the exam. So, well done if you did prepare a SWOT analysis for the first time – but in future, ensure that all of the key issues have been included in the relevant area of your SWOT. For example, an Opportunity could be to sell some of Domusco's land bank to alleviate the forecast cash shortfall.

A further area of concern was that a number of students prepared valuations of KLT and advised against acquiring the company. Clearly they had not read and understood the unseen material which stated that Domusco had already acquired KLT and that the decision to acquire or not had already been taken.

In order to gain high marks in the Application criterion, it is expected that candidates should prepare a SWOT and a PEST analysis and use at least one other technique, perhaps the Balanced Scorecard or the BCG matrix. Candidates should use these techniques, with data from the case, to demonstrate how these techniques could assist management. A further area that is always helpful in understanding the case material is ratio analysis, including revenues, profitability, liquidity and gearing. A particularly relevant ratio in this TOPCIMA case was the gearing calculation in relation to the loan covenant, which had been defined in the unseen material. It was surprising how few candidates calculated this correctly, and about half of those sitting this exam did not even attempt to calculate this critical ratio.

A further worrying area that the examiner identified was some candidates' inability to prepare an accurate cash flow forecast. There were many candidates who had correctly accumulated the cash data given in the unseen material to produce the forecast size of the cash shortfall facing Domusco, and they were awarded marks. However, a sizable minority of candidates did not understand what to do with the cash flow data and assumed that the quarterly movements were quarter end cash balances, which was incorrect. A further worrying aspect was that several candidates added the forecast profits for 2005 of Z$535 million into the cash flow forecast. This was clearly incorrect and demonstrated a total lack of understanding of the differences between profits and cash generated. This should have been clearly understood at this stage of their CIMA studies. It cannot be stressed enough that candidates should improve their understanding of cash flow data and the importance of cash in a business, as this will be invaluable in their future careers as an ACMA. The subject of cash will be examined again as there was clear evidence of a lack of basic understanding of this key aspect of business management by many candidates.

5.4 Diversity

The assessment matrix weighting for Diversity has been reduced to only 5 marks for (September and) November 2005 and the marks are available for demonstrating a breadth of technical knowledge, business awareness and for demonstrating a wide range of views. It was surprising how few candidates (only around 20%) gave ANY examples of real life companies in the construction industry. This is an industry that appears in any National newspaper and it is very easy to identify companies who are experiencing similar problems to those faced by Domusco, in terms of working capital problems and risk management and cost overruns. Any candidate that had undertaken any research into this industry should have identified the importance of working capital and how quickly it can change with the economic conditions prevailing in each country. Therefore, it was especially disappointing that relevant examples from this industry were not cited by the majority of candidates.

In May 2005 there had been little evidence of industry research into the recycling industry, but candidates who sat the September 2005 pilot on Domusco seemed better prepared. This contrasted with that demonstrated by the candidates who sat the November 2005 exam. Therefore, it is recommended that candidates should read widely on the industry in which the case is set, to enable them to quote examples and to explain how real companies have overcome many of the problems facing the company in the case material. A few candidates quoted examples of building companies such as Taylor Woodrow, Laings, Westbury, and other relevant examples where cost overruns had occurred such as the Millennium stadium in Cardiff, the Channel Tunnel and Wembley stadium. Some candidates even quoted relevant examples of companies that had given profit warnings.

5.5 Focus

The 10 marks available for Focus are for discussion of the key issues. Overall, the majority of candidates earned high marks in this assessment criterion as they correctly discussed in a good amount of depth the key issues. Many candidates achieved a clear pass. Generally, this criterion was well attempted. To ensure high marks here it is necessary to identify the key issues in the case and to set up a "check list" of report headings, to ensure that **all of the relevant issues** have been discussed. The process of planning your answer, at the start of the exam, is to firstly identify the key issues, then prioritise them, and then discuss each of them in depth.

Good marks were awarded to many candidates for discussing the cash shortage that had been forecast for the next six months, the loan covenant restrictions and the ways in which cash could be generated, including boosting sales, reducing construction and other expenditure and selling some of Domusco's land bank. Some candidates also discussed the need to recruit a new Finance Director following Martin Lite's resignation, although some candidates mistakenly simply stated that Martin Lite should be invited back. When a main Board Director of a listed company resigns over a point of principle (the final straw being the lack of a profits warning) it is unlikely that he would want to return to the company. Also there were some good discussions on Domusco's falling share price and the proposed organisation changes, which the majority of candidates agreed (correctly), were a low priority compared with the other urgent issues facing the company.

5.6 Prioritisation

Unlike the May and September 2005 exams, in which few candidates identified and prioritised the key issues, it is pleasing to report that the majority (over 90% of candidates) **did** prioritise the key issues facing Domusco. Most also got the prioritisation correct. Whilst there is no single correct answer, the two key priorities were to address the severe cash shortfall that had been forecast and to fill the Finance Director role.

Therefore, the majority of candidates earned pass marks for this criterion. It is hoped that the guidance notes sent out to candidates alerted them to the need to identify and prioritise the key issues facing the company, taking into account the issues raised in the unseen material presented to them on the exam day.

The examiner is very pleased with the significant improvement made in this assessment criterion, but there is still room for improvement. As well as preparing a position audit and a SWOT analysis, additional marks can be earned if the reasons for the choice of priority are explained and justified.

For example, a candidate could have identified that the forecast cash shortfall for Domusco is the top priority. Further marks would also have been awarded, if the answer had then explained that cash is crucial to the very survival of Domusco and that it could face liquidation, or a hostile take-over bid, if this is not addressed by a series of urgent actions. Therefore, the justification of why the candidate considers each of the issues to be the top, or a lesser, priority should be clearly stated. Perhaps, the candidate is even thinking of the reasons, which is how he/she has reached the conclusion of why a particular issue is the second or third priority for example, but unless the candidate actually writes down the reasoning, then the examiner cannot reward the thought process!

To summarise, it is vital to identify and place in priority order the issues facing the company in the question, taking account of the events given in the unseen material on the exam day. It is not necessary to give each and every issue a priority number, but candidates should identify and prioritise at least the top 3 or 5 key issues. Additional marks, up to the maximum of 10 marks, are available for the justification and reasoning behind your choice of priorities.

5.7 Judgement

This is an important criterion, which now carries 15 marks, and is for the demonstration of alternative solutions and the display of professional judgement. It can also be considered as the "link" between the discussion of the issues and the recommendations. Marks are awarded on the basis of what professional judgement candidates have demonstrated in reaching and justifying their recommendations.

This criterion was poorly attempted by the majority of candidates and is **an area that needs to be improved for the future**.

A small minority of candidates did not discuss how the Z$2,500 million forecast cash shortfall could be addressed. They simply stated that Domusco needs to generate more cash, or naïve comments like increase sales or to stop all construction expenditure. Whilst it is agreed that construction expenditure on unsold houses and offices in Zee (and especially the Hadsi site) should be stopped, it is simply not feasible for a company to stop doing what is its "raison d'etre" i.e. to build. Additionally, all of its employees would still need to be paid and there is a lead time in which construction work could be stopped and that is not immediate.

Many candidates were awarded marks for discussing that a rights issue would not be suitable at the present time due to low investor confidence and the low share price and that more loans would not be possible due to the loan covenants. A surprisingly high number of candidates who were trying hard to think how else cash could be generated at short notice went on to recommend that Domusco should get a bank overdraft. Domusco is a listed company which generated global profits of Z$686.2 million in 2004, and would have access to a bank overdraft – but NOT to the level of Z$2,500 million (almost Z$2.5 billion!). Furthermore, the use of a bank overdraft, which could be called in at any time is risky and this type of recommendation earned no marks and further demonstrated candidates' lack of commercial awareness.

Marks will only be awarded in the criterion of Judgement for recommendations and comments that are commercially viable and realistic. Another example was to sell the office building subsidiary. This is a viable recommendation but it is unrealistic that Domusco could get this agreed by the Board, find a buyer, do the legal work and receive the cash within the next six months that Domusco has forecast that it has a net cash shortfall. The divestment of part of a listed company can take years, and this further demonstrated a lack of professional judgement. However, a few well prepared candidates earned high marks for this criterion for thoroughly discussing all of the options available to Domusco, and how it should sell part of its land bank (especially land held in Europe and that acquired with KLT) to generate cash in the short term, together with a structured cutback of expenditure of unsold houses and offices and a delay to starting phase 2 in Hadsi. Some candidates also suggested a number of widely used sales techniques that are used by house builders to sell completed housing stock, such as discounts and cash back incentives.

It was clear that overseas candidates generally earned low marks in judgement as they did not demonstrate their ability to discuss alternative solutions and the display of commercial and professional judgement was poor, resulting in the low pass rate in some overseas centres.

5.8 Integration

This criterion rewarded candidates for their ability to discuss diverse areas of knowledge and skills and to integrate them effectively. Unfortunately the majority of candidates in November 2005 produced reports that were badly integrated and this resulted in low marks. Most candidates produced calculations (which were generally well presented and clear) in an appendix to their report, but then did not discuss the relevance of the figures in the body of their report.

If a candidate's report flowed well and discussed all of the issues in a logical sequence culminating in a justified recommendation, then the candidate would be awarded at least pass marks in this criterion. Like much of the TOPCIMA assessment matrix, there is a degree of overlap between each criterion.

Candidates who did not discuss the severity of Domusco's cash situation did not earn pass marks in this criterion. In real life, if you employed a consultant to advise on the key issues of this case and stated that the company has forecast a cash shortfall of almost Z$2,500 million, and low investor confidence and that the Finance Director had just resigned, you would expect these three key issues to be addressed. However, as many candidates did not discuss (let alone make realistic recommendations on) these three crucial issues, the examiner considered the reports not to be a comprehensive professional report and awarded low marks. This criterion is used to assess the entire report in a holistic way and to attain pass marks, the report needs to identify and discuss, in the correct degree of urgency, the key issues.

5.9 Logic

The criteria of Logic carries the most marks in the assessment matrix and in November 2005 there were 20 marks available for candidates who prepared clear, justified, well argued recommendations and for the good presentation and communication skills demonstrated throughout the report.

All business reports, whether financial or non-financial reports, include recommendations of alternative courses of action, together with justification of why one, or more, courses of action are recommended. In your future role of an ACMA you will need to prepare reports for general management or for Board members. These senior managers will want to see a clearly laid out, well presented report that discusses all of the issues and then culminates in firm, clear, concise recommendations that show why the particular courses of action that you are recommending should be approved. Additionally, where appropriate, recommendations should also have a suggested timeframe in which the recommendations should be actioned, although these could be divided into short term (within the next year) and longer term recommendations.

Your report in the TOPCIMA exam should be prepared in the same way and should culminate with clear recommendations that follow through from discussion of alternative courses of action that were discussed within the main body of the report. Additionally there should be clear reasons why the recommended courses of action have been selected. Unfortunately, many candidates still end their report with a page (sometimes a half page) of short bullet points in a random fashion stating "do this, do that" with no justification as to why those courses of action have been recommended. The examiner cannot read your thoughts. No doubt when the recommendations are written by candidates, they know in their own minds why they are choosing a particular course of action – BUT unless you clearly state (i.e. justify) why you are choosing a particular course of action, you will be rewarded with lower marks than you would be if you had given all of the underlying reasons.

However, it must be stated that a growing number of candidates have prepared a set of very good, clear logical recommendations that clearly showed the short term recommendations that Domusco must undertake immediately to overcome the forecast short term cash shortfall. Then there were further recommendations that should be taken to improve Domusco's longer term profitability, risk management issues and growth in its share price.

Another comment is where in the report should recommendations be made? Should recommendations be put at the end each paragraph, within the main body of their report, or should the recommendations be made at the end of the report in a separate recommendations section. It should be stated that either is acceptable for full marks. However, it is generally better if all of the recommendations are made at the end of the report. This is because a recommendation cannot be assessed and justified until all of the other issues are discussed and assessed, as many are competing for the same scarce resources, manpower and finance.

Most TOPCIMA candidates attempted the recommendations section quite well with the majority earning pass marks. Almost all candidates earned high marks for a well presented report and there was far less evidence than in previous exams, of time pressure, presumably due to the additional 20 minutes reading time.

The areas that should be improved for candidates who were unsuccessful are:

- Preparing fully justified, well reasoned recommendations. Candidates should not simply state "I recommend . . ." but instead should state "I recommend that Domusco should sell some of its land bank to generate cash because . . .".
- Recommendations should be prepared covering all areas of the report. Each of the issues that has been identified and discussed elsewhere in the report should have clear justified recommendations.
- It may be that some of your recommendations need to be only a few lines long (certainly not only a few words) but should cover every issue discussed elsewhere in the report. As above, you should have a "check list" of issues to be discussed, (that you should prepare in your answer plan) and you should use this same "check list" to ensure that a clear justified recommendation has been made for each issue. Each issue should have a recommendation to either action it or not to proceed, with clear reason why that recommendation has been made. For example, in this case, it could be that Domusco should not obtain additional loan finance as the company's gearing is already close to the agreed 40% loan covenant agreed with its bankers, and it must not breach this limit as the bankers could withdraw the current loan facility.

- It is necessary to make recommendations on all facets of the company, such as changes to the Board (such as replacement for Tom Micol who is nearing retirement and the recruitment of a new Finance Director), use of IT, and other areas such as strengthening financial controls, to stop any further frauds occurring and ways to improve Domusco's strategic planning process, which is clearly very weak.

5.10 Ethics

This new criterion was much better attempted in this exam sitting than in both previous TOPCIMA exam sittings, with many candidates earning pass marks. However, higher marks could have been awarded for more advice as to how Domusco could overcome the ethical dilemmas.

To earn good marks in this criterion, it was not sufficient to simply list issues such as the bribery payment to win the European stadium contract, the way employees and sub-contractors are dealt with as the level of construction is reduced in the short term (due to the cash shortage) and the lack of a profits warning to investors. What the examiner was looking for was for the candidate to identify each of the ethical issues (and there were many of them) and then to briefly justify why each issue was considered to have an ethical dimension. Higher marks were then awarded for candidates who further offered realistic advice on how to resolve the ethical issues, such as the introduction of a code of conduct in contract negotiations, and a tightening of financial controls to stop unethical payments being made. It was disappointing that very few candidates offered advice on employee issues such as redundancy as a result of the recommendations that construction work in Zee should be severely reduced.

To summarise, in order to earn pass marks it is necessary to **identify, justify** and **recommend advice** on how to resolve several of the ethical dilemmas included in the case material.

6.0 The requirement

Now this advice seems obvious – candidates are reminded to ensure that the answer that they write fully answers the requirement stated. The answer given should be focused to the actual requirement set, although the requirement is usually fairly open ended. It usually asks candidates to advise on the key issues. Therefore, in order to pass you need to identify what the key issues are. It is recommended that candidates prepare answer plans, or "check lists" to ensure that all areas are covered.

The most common reason for candidates failing in November 2005 was that many candidates did not recognise the severity of the forecast cash shortage and the potential impact on the company. Many reports stated "when the cash flow problems have been solved . . . . then Domusco should . . .". It must be stated that a company will NOT have a long term if it does not survive in the short term. It was quite clear that a forecast cash shortfall of Z$2,500 million was very significant and urgent drastic action was required or corporate failure could occur. Candidates who discussed longer term issues without making clear recommendations as to how the cash shortage could be overcome could not pass.

However, some candidates did clearly identify the importance of the forecast cash shortage, but still failed as their only recommendations were "more loans" (which were not possible due to the loan covenant restriction) or "issue shares" (which was not commercially viable at this point in time and would also take too long anyway). Therefore, in order to pass the candidates needed to identify the main few key issues (cash, the need for a new Finance

Director and the lack of investor confidence in Domusco) and to discuss these key issues and make realistic commercially viable, recommendations that displayed a good degree of professional judgement.

Additionally, candidates are reminded that they should ensure that their answer covers all nine criteria of the TOPCIMA assessment matrix, which is used to assess their answers. However, it must be stated that in this sitting of TOPCIMA there was far less evidence of candidates omitting areas of the assessment matrix (such as prioritisation and discussion of ethical issues) than in previous TOPCIMA exams.

Therefore, in summary, candidates are reminded to ensure that all aspects of the requirement have been discussed and that their recommendations do cover all of the key issues from the case material.

7.0 Advice for candidates re-sitting TOPCIMA in future

It is advised that some form of tuition or study method be used to ensure that candidates who are re-sitting TOPCIMA are fully prepared for this final CIMA exam. It is necessary for many candidates to revise the subjects contained in the 3 Strategic level papers, particularly Business Strategy, so that relevant technical knowledge and theories can be discussed in the context of the case material. There are two of the nine assessment criteria that relate primarily to the use and application of technical knowledge. Do not miss out on these marks.

CIMA advises that candidates should practice on at least three cases prior to sitting the TOPCIMA exam, so research and preparation using past TOPCIMA cases is strongly advised.

Additionally, candidates are referred to the TOPCIMA Study System textbook, (published by CIMA Publishing through Elsevier) which is the recommended reading text for this exam. This Study System takes candidates through past cases and demonstrates how to analyse the pre-seen and unseen material and how to prepare their answers on the exam day. It also contains a chapter on Technical issues, including revision of all of a range of business and financial techniques that candidates should understand and incorporate in their answers.

It is necessary for many of the candidates who were unsuccessful in this sitting to learn, understand and revise thoroughly the underlying strategic issues, as well as to improve their ability to apply financial and business knowledge and techniques to the case material to a **far greater degree** than was demonstrated in their answers at this exam sitting.

The other important advice, is to empower yourself with the required research and pre-prepared material, but be ready to “discard” some (or all) of this material if you find it is no longer relevant to the question or relevant to the new material in the unseen material on the exam day. In summary, do plenty of research, do prepare material for your report, plan the layout and lots of other preparation using the pre-seen material – but on the exam day, ensure that the relevant key issues raised in the un-seen material are discussed. This may (or may not) include some of your pre-prepared material – so, be prepared to write a relevant report that covers the new issues. The key word here is **relevant**.

Also, it may be helpful for candidates to use the following report format for their answers, which should provide a check that all areas have been covered, especially prioritisation and ethical issues. A recommended report format that could be used is:

- Contents page
- Introduction (brief 5 to 10 lines of background on the company)

- Terms of reference (brief 5 to 10 lines to set the scene of who you are – e.g. a consultant, and to state who the report was commissioned by, and who it is aimed at)
- Identify and prioritise the main issues facing the company, showing and justifying the top 5 items in priority order. This area of the report should also include discussion on your position audit or SWOT analysis.
- The main body of your report should discuss in depth all of the issues you have identified above and should be supported by numerical evaluation of the proposals, which should be shown in appendices. You should also incorporate real life examples that are relevant to the industry setting or the situation the company is facing. Also, remember that all of the key data and analysis given in appendices should be discussed within the body of the report.
- Separate section on Ethical issues, covering a number of ethical issues and offering advice on how these issues could be resolved.
- Recommendations. The most important part of the report. This area should make clear, fully justified recommendations on each of the issues discussed earlier in your report. Each recommendation should be clear and well justified as to why you are recommending a particular course of action. Do NOT recommend that more information needs to be collected before a recommendation can be made.
- Conclusion (brief 5 to 10 lines for closing comments)
- Appendices. Note: key data and analysis given in appendices should also be discussed within the body of your report.

8.0 Recommendations and conclusions

Finally, it should be noted that candidates who prepare thoroughly for the TOPCIMA exam, and who are able to demonstrate their ability to apply their knowledge to the requirement in the question will put themselves in a far better position to be able to pass the TOPCIMA exam. Therefore, preparation and research are vital, but this is **not** enough to pass this exam. You must also have a thorough understanding of the required techniques and how to apply them to the case material.

To summarise, the five key tasks that will put you in a better position of passing TOPCIMA in the future are:

- Thoroughly research 3 past TOPCIMA cases. Then write your answer and compare it, and mark it, against the case writer's answer.
- **Research thoroughly the business setting for the case that you are planning to sit** and familiarise yourself totally with the pre-seen material.
- Learn and understand business strategies and techniques (which are detailed in the CIMA Study System) and learn how to **apply them to the case material**.
- On the day of the exam, you need to ensure that your report covers **the relevant key issues raised in the unseen material** and that your answer relates to the exact requirement of the question.
- Familiarise yourself with the TOPCIMA assessment matrix, to ensure that your answer covers all nine of the criteria that your answer will be assessed against.

Remember – do as much research and reading about the industry setting as you can, and use the internet to help with your research. Prepare yourself as much as possible for the exam, using the advice above – as this report gives details of where candidates have gone wrong in the past. But most important of all – on the day, ensure that you write a thorough, well reasoned answer that covers the relevant key issues raised in the unseen material and that your answer covers all aspects of the requirement. If you can do this, you **will** be successful.

2.6 Summary – how to pass TOPCIMA

The most important factor to your success in the new TOPCIMA exam is to answer the requirement. This may sound obvious, but surprisingly many candidates write their answer to the question they thought would come up, or their lecturer has taught them!

In many instances, whilst their answer was good, if the answer presented is not relevant to the actual requirement set, then the answer will not earn good marks under the assessment matrix.

Candidates MUST remember that on the exam day, it is very important that if a SWOT analysis is included in your answer, it is UPDATED to include data given in the unseen material and not just data that was pre-prepared prior to the exam.

It must be remembered that data given in your answer must be relevant and applied to all of the case material, including the unseen material given to you on the exam day.

2.6.1 The skills needed to pass the TOPCIMA exam

You should ensure that your answer:

- displays appropriate technical knowledge including a position audit and a SWOT analysis which MUST be updated for data given in the unseen material;
- You must prioritise the main issues, including a justification of why you have prioritised them in that order. For example, in the Domusco November 2005 case, the top priority is the recruitment of a new FD, so that this crucial role is filled so that the new FD can help the company to prepare revised plans to ensure that Domusco overcomes the forecast cash shortfall in the next year;
- discusses the ethical issues raised in the case – both those in the pre-seen material and also any new ethical dilemmas posed in the unseen material;
- answers fully the requirement of the question set.

2.7 Summary

2.7.1 The knowledge required in TOPCIMA exams

The knowledge that has been required in the past TOPCIMA (and FLCS) examinations has included the following:

- cash flow analysis,
- business valuations,
- Shareholder value creation,
- sources of capital for developing firms,

- mergers, acquisitions and divestments,
- SWOT analysis,
- PEST analysis,
- Balanced Scorecard technique,
- investment and project appraisal,
- divisional performance measures,
- business portfolio analysis,
- risk in overseas operations,
- stakeholder analysis,
- strategic alliances,
- management skills to manage change,
- IT strategy,
- Board level skills and identification of Board weaknesses,
- Joint ventures,
- Risk management,
- Change management.

This list is not exhaustive – so now move on to Chapters 3 and 4 and revise your skills and techniques so that you are ready to work through real cases in Chapters 5, 6 and 7.

Skills Toolkit

3

3.1 Introduction

(1) The approach adopted in this *CIMA Learning System* follows the 7-step model shown in Figure 3.1.
(2) TOPCIMA poses different challenges because it requires you to display different competences. Unlike the previous nine papers in the CIMA syllabus (or 16 for candidates who have studied under the pre-2005 syllabus) TOPCIMA does not seek primarily to assess your knowledge of the technical content of a syllabus. TOPCIMA seeks to assess your skills as an advisor to management. Therefore, in order for you to pass, TOPCIMA requires that you practice these skills and hone them down.
(3) This chapter introduces you to the process needed in order to pass TOPCIMA and suggests some approaches and techniques that will help you. These skills are illustrated using real CIMA cases in Chapters 5–7.

You should practice these as you approach the case study exercises in Chapters 6 and 7 and in the three TOPCIMA cases contained in Chapter 5 of this *CIMA Learning System*

3.2 Initial reading of the pre-seen material

(1) The TOPCIMA pre-seen material and the assessment matrix will be available as a download in PDF (portable document format) from the CIMA website www.cimaglobal.com about six weeks prior to the exam date. Ensure that you have an up-to-date version of the Adobe Acrobat reader ready for when you want to take the TOPCIMA exam.
(2) In the past the pre-seen material has been between 11 and 18 pages long. You are expected to be thoroughly familiar with it and to use information from it in your final report.

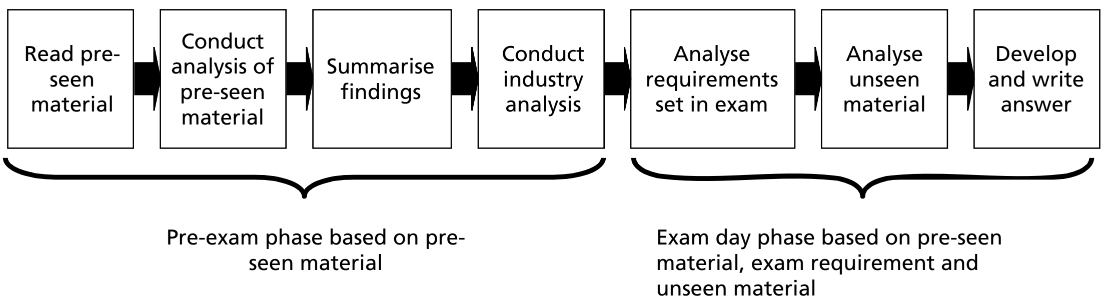


Figure 3.1 Diagram of process to pass TOPCIMA

Speed read the pre-seen material: The technique of SQ3R will help you to get into the pre-seen material quicker. It is also a skill you will need for dealing with the unseen material on exam day where time is very precious.

You will need to have some paper and pens for this.

S *Scan* the material. Pay attention to main headings, dates and subjects to get a feel for what you have been given and how it fits together. Do not read the fine detail yet. You are just getting an initial impression.

Q *Question*. Using a scrap of paper try to jot down some initial questions and answers to them. These could include things such as:

- What is the sequence of events here?
- What are the main issues in the situation?
- Who is who and who reports to whom?
- What is the financial situation of the firm?

R *Read* the case closely. Try to underline key points (or better still write them on a separate sheet of paper) and conduct any ratio or other calculations. It's a good idea to write this on the face of the material. The spider diagram technique described below is useful here.

R *Recap* what you know. Look at your initial questions and the notes you have made since.

- Note any questions that are still unanswered.
- Draw organisations charts.
- Write quick character sketches of any characters in the case.
- Summarise the key financial information.

R *Review* the case material by reading it through again. This may expose additional insights you have not noticed so far or contradict your initial assumptions. If so jot down these points too.

3.3 Making effective notes on the pre-seen material

3.3.1 Introduction

Psychologists tell us that using conventional linear notes on their own use only a small part of our mental capacity. They are hard to remember and prevent us from drawing connections between topics. This is because they seek to classify things under hierarchical headings.

Here are some techniques that candidates find useful. See which ones work for you as you practice on the past cases in this *CIMA Learning System*.

The examples that follow use the November 2001 case study IRS Ltd (reproduced in the appendices to this *CIMA Learning System*). You may like to read it first before looking at the techniques below.

3.3.2 Page summaries

Page summaries are a précis of what each page tells us about the firm and an attempt to understand the significance of what we have been told.

The following headings can be used (here illustrated using IRS Ltd from November 2001):

Page 2	*Main information*	*Significance*
	• IRS founded in 1992 as Intelligent Systems (burglar alarms) changing to Intelligent Refrigeration Systems in 1993 • Grew by exploiting problems of CE Ltd in making temperature controls for OEMs • Found it hard to crack the OEM market by offering partnership due to competition • Grew by retrofitting 'Innate' controls to existing equipment in relationship with supermarkets • Main rival CML	• Strategy emergent or opportunistic not planned • OEMs have buyer power • Supermarkets also have buyer power • Must be a limit to number of legacy systems so growth will stop eventually

3.3.3 Spider diagrams

Spider diagrams (or clustering diagrams) are a quick graphic way of summarising connections between subjects.

The pre-seen for IRS Ltd. told us that the company made something called an OEM controller, which provided 20% of its turnover, and something called Innate that provided the remaining 80%. This main product was sold to food stores, mainly in the United Kingdom, with OEM sales being to refrigerator manufacturers. It had been unsuccessful in selling domestic thermostats in Japan.

This information could be quickly summarised in a spider diagram as shown in Figure 3.2.

You cannot put much detail into a spider diagram, just a few key words. However, it does help you to 'visualise' the information in the case study.

Notice also the attempt to connect across the different legs of the diagram, in this case between overseas and domestic thermostats. A few of these can be helpful although trying to draw in a lot of links will make the spider diagram very messy and hard to follow.

You must expect to update your spider diagram as you go along and to redraft it when it starts to get too messy. It's all part of the learning process.

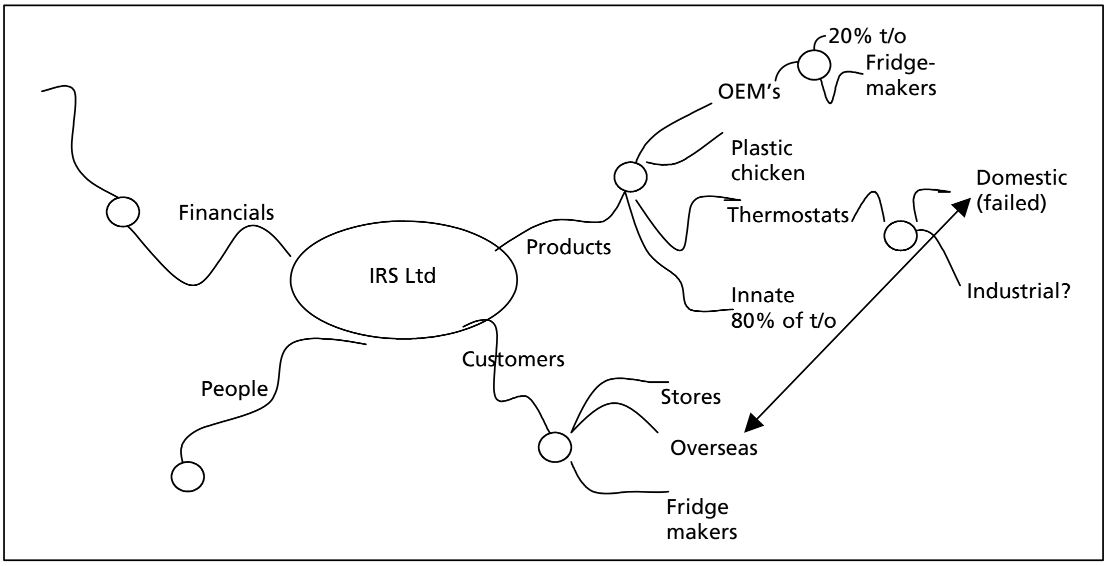


Figure 3.2 Spider diagram

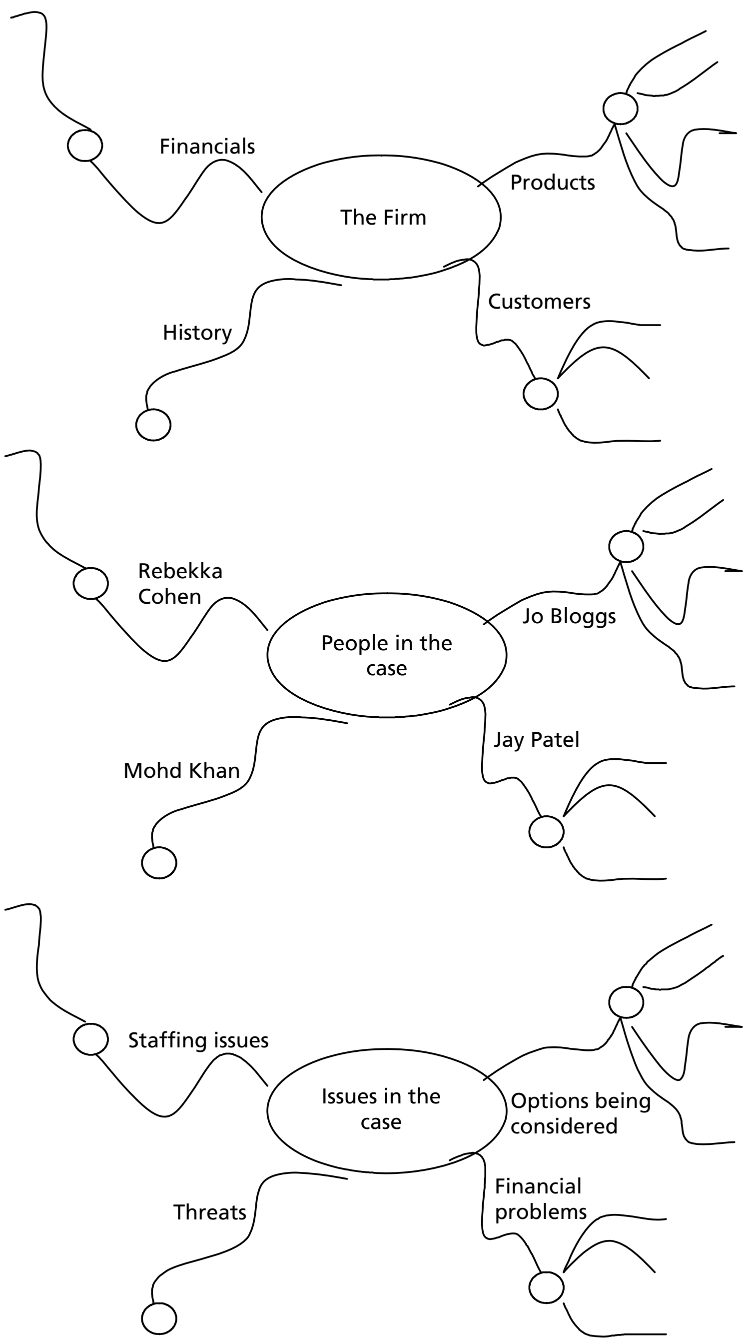


Figure 3.3 Typical spider diagrams for TOPCIMA cases

Candidates usually draw several of these diagrams exploring different aspects of the case. Each one can be drawn on a single piece of A4 paper *landscape format* (apparently we think laterally not vertically!).

The drawings shown in Figure 3.3 are commonly used as the basis for spider diagrams.

3.3.4 Timelines

Timelines are valuable to make sense of the sequence of events in the pre-seen and to understand where the firm presently stands.

TOPCIMA takes place in real time so you need to be clear how long is likely to elapse between the data in the pre-seen and the actual exam. This is the time period during which the author can spring surprise changes in the circumstances of the firm on you. The time-line does not need to be to an exact scale (such as an inch equalling a month) but you do need to get things in the right sequence. The pre-seen material will be given to you with real dates on the accounts and other exhibits such as memos and reports. You know the date on which you will be taking the exam. Therefore in drawing up your timeline you should:

- start at the right-hand side of your sheet with the date of the exam;
- work back from right to left slotting in a summary of the information you have at each crucial date;
- try to use the vertical axis to record the sales turnover or market capitalisation of the business. It will help you to notice whether the firm is growing, stagnant or contracting. You may have a separate line for profit too.

Using the November 2001 case as an example, an illustration of timelines is depicted in Figure 3.4.

3.3.5 Organisation maps

Here is an organisation map (Figure 3.5) for the November 2001 Case Study on IRS Ltd. Note how it reveals an essential feature of the case, that there is ambiguity in roles in both marketing and in project management.

3.3.6 Biodata files

A biography of each character is also useful for several reasons:

- they may be an important source of strength or weakness to the business;
- you may be required to write your report to them and so will need to understand their perspectives;
- the unseen material may involve them, for example, perhaps they leave or you need to find someone suitable for a new venture, and you will need to recall quickly what you know about them.

Here are the biographies of the characters in the IRS Ltd. Case Study (Figure 3.6).

3.3.7 Post-It-Notes[1]

Post-It-Notes can be used to jot key points on. For example, one for each person named business division or product. If questions occur to you as you read through put each of these on a Post-It-Note too. Stick the notes on your desk, a notice board or wall so that you can keep glancing at them to remember who's who in the case.

3.3.8 Colours

Colours help you remember things you may want to draw upon in the exam room. You could write down all your financial calculations and observations in green whilst having red

[1] Post-It-Notes are a registered trademark of the 3M corporation.

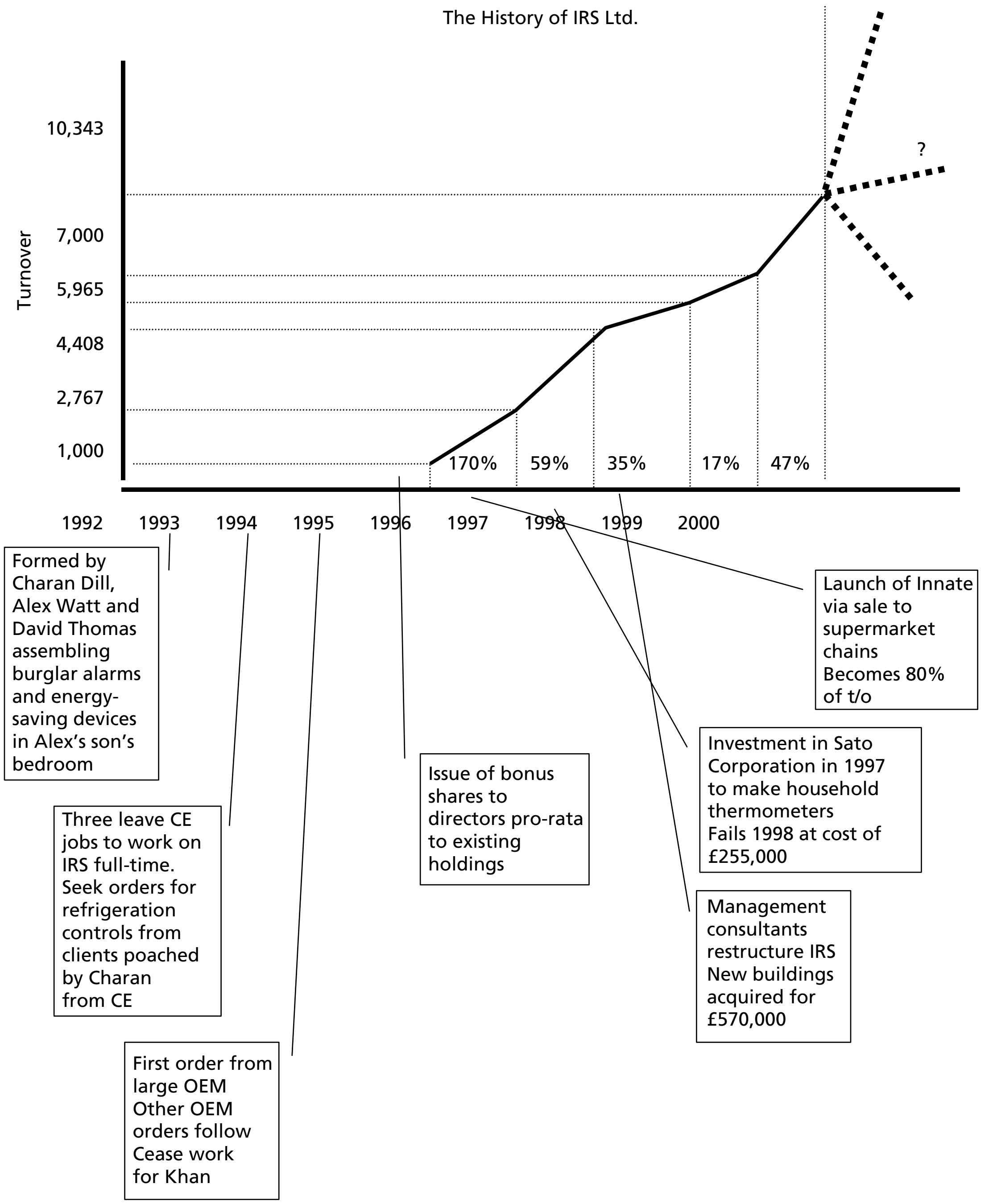


Figure 3.4 Illustration of a timeline applied to November 2001 case

for organisational and blue for strategic. Some candidates use different colour highlighter pens to emphasise different aspects of the pre-seen material perhaps using the same colour coding suggestion.

3.3.9 Cut and paste analysis

Some candidates glue each page of the pre-seen on the left-hand side of an A3 sheet to enable them to write comments and conduct analysis in the blank space on the right. Other

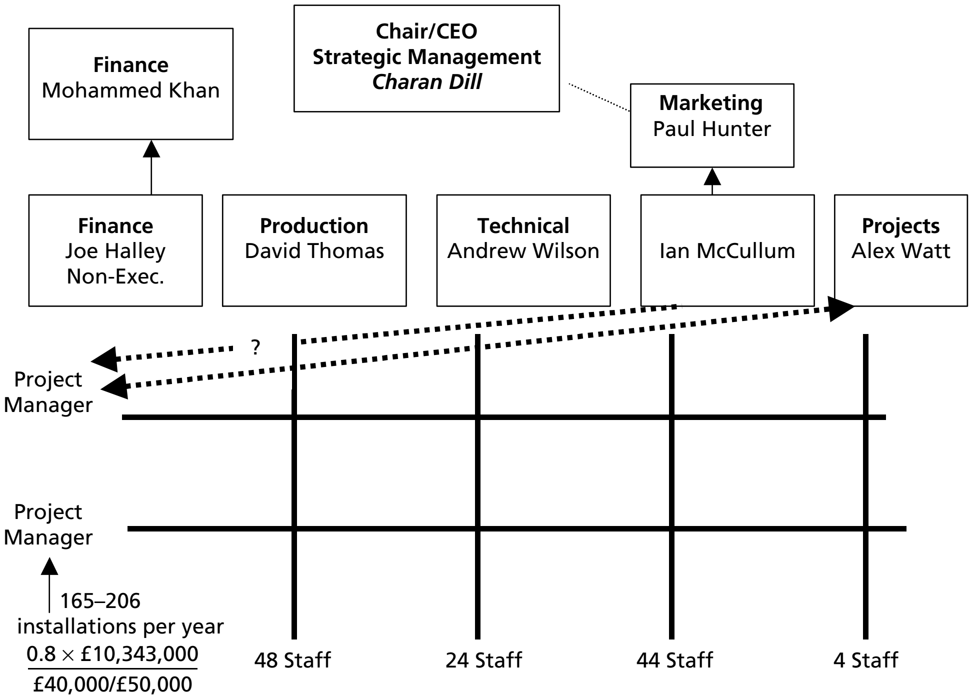


Figure 3.5 Illustration of an organisation map

candidates choose to stick the page of the pre-seen in the centre of the A3 page and use call-outs and thought bubbles to make their notes in.

3.3.10 Pictures

Pictures can help you. Where a case study has a lot of people some candidates cut pictures of people from magazines to represent the people in the case and create a biography file

Charan Dill
Chairman and CEO

Background
41 years old
Graduate in Electrical Engineering
Married, 2 children
Wife accepts workaholic ways needed to *establish* IRS
1st generation Malaysian from wealthy Indian family (property development)
Family are close friends of Mohammed Khan

Role
Shifted from closely involved in everything to 'strategist'
Key account liaison in UK
Develops business ideas in Far East: Japan? ('ideas' = customers?)
Main link to Khan (Khan in for reasons of family loyalty or for prospect of gain?)

Characteristics
Ambitious and driven
Thinks 2 years ahead not 2 weeks
Lives IRS
'Obsessed' with customer service and partnering customers
Autocratic/Dictatorial style from 1998 – sees co-directors as 'not keeping pace with him'
Anti-union views

Issues
Undervalued dynamo of business (same 23% of shares as lesser directors)
Seems to override formal roles (Hunter is Marketing Director)
Combines Chair and CEO (not acceptable if new listed co.)
Style may not be suitable for larger organisation
(Greiner: growth through creativity? crisis of leadership ? growth through control)
Will external investors want him in charge?
Will he (and his wife) support IRS once it is established and shares have a value?

Figure 3.6 Illustration of biodata files for November 2001 case study

Mohammed Khan
Non-Exec. Director – Finance

Background
Accountant by training
Successful Malaysian businessman selling and designing energy-saving devices for hotels and burglar alarm systems
Family friend of Dill family (mainly C's father?)
Many business interests in Japan
Supported early bedroom operation of IRS with work
Invested in IRS in early 1990's and guarantees bank facilities (£1.8m: 2000)

Role
Main financial backer and largest shareholder (30%)
Main risk bearer/potential beneficiary of IRS
Possibly contributor to decision on Sato project
Mentor to Charan Dill
Quasi-FD role and organising influence

Issues
Not a good FD – balance sheet seems out of control
Will want to realise investment soon and restructure finances
Not convincing to external investors (not really non-Exec due to close relationship with Charan Dill)
Would support Charan Dill in any crisis over management or strategy for IRS
30% holding is maximum allowed for listed co.
Potential acquirer of IRS

Alex Watt
Projects Director

Background
47 years old, married with kids
Bourgeois Scottish family (Father a Bank Manager)
Graduate in Electrical Engineering
15 year career in design with EP Group and CE Ltd. before jointly founding IRS in 1992 with Charan and David
4 years in South Africa
Trained Charan
Friend of David Thomas

Role
Initially technical design but shifted to project management with arrival of Andrew Wilson
Responsible for 'critical path management' of project
Manages 4 subordinates
Shareholder (23%)

Characteristics
Not ambitious at all
Homebody – marriage caused him to leave SA and join CE.
Wants money but doesn't put himself out to get it
Impressionable and led by Charan
Potentially awkward to deal with on matters of company policy/strategy
A deadweight

Issues
Sidelined in management and not a major stakeholder other than through shares
Will benefit more than he deserves in flotation/buyout
Minority holding
Not convincing to external investors
Potentially resents Charan
Expendable but may be awkward if able to form alliance with David Thomas

David Thomas
Production Director

Background
46 years old, graduate of Engineering and Economics
Seemingly not Scots (English/Welsh?)
Design background
2 years management experience in India (1987–1989)
Made redundant
Formed IRS with Charan Dill and Alex Watt in 1992

Role
Director and shareholder (23%)
'Key lieutenant' to Charan Dill since 1998 (formally)
'Production and administration' role until 1998
Production only since 1998
48 staff

Characteristics
None given

Issues
Has management experience for CEO role perhaps
India exposure may help working relationship with Charan Dill (and Mohammed Khan?)
Could run home operation if Charan Dill goes abroad
Significantly no personal info.

Andrew Wilson
Technical Director
(engineering and support)

Leads Engineering and support (24 staff)
Collaborates as functional head in matrix
Has got Alex Watt's former job
Board member but no shares

Paul Hunter
Marketing (Sales) and Customer Service Director

Leads Sales support (44 staff = highest number)
Some involvement in project teams
Role seems eclipsed by intervention of Charan Dill

Joe Halley

Ian McCallum
Customer Service Manager

Figure 3.6 (Continued)

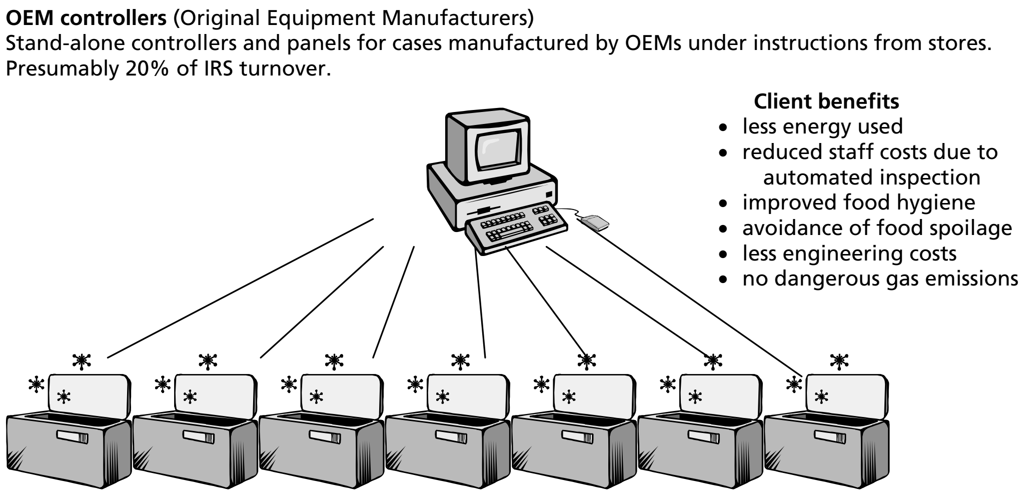


Figure 3.7 Diagram to support November 2001 case study

with each character and the main facts about them. These pictures help to make the case seem more real.

Here is an example of a picture created to help candidates remember the details of a product, the OEM Controller, made by the company in the November 2001 case study (Figure 3.7). The company, IRS Ltd., provided thermostats and computer monitoring of refrigeration installations for food stores.

3.4 Detailed analysis of the pre-seen

(1) You are seeking to show competence as a management accountant. This means that you must apply the knowledge from your CIMA studies to the TOPCIMA case.
(2) The approach we have adopted in the de-brief to all the cases in this *CIMA Learning System* has been based on the following template. We recommend that you follow it as a step-by-step guide, perhaps photocopying the template to fill in.
(3) You will find the techniques above used in analysis of the cases in Chapter 5.

3.5 Analysing requirements in the TOPCIMA exam

(1) This is the first of the skills highlighted in Figure 3.8.

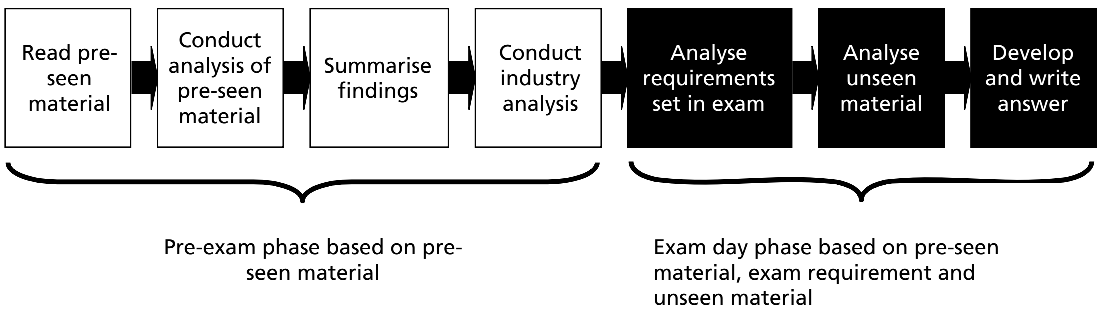


Figure 3.8 Diagram of process to pass TOPCIMA

STRATEGIC ANALYSIS TEMPLATE

Step	Analysis Tool	Key Conclusions
1	Asses the four elements of strategy (Competitive, Financial, Investment and Risk)	
2	Conduct financial analysis of company position (performance and fund sources)	
3	Assess business portfolio	
4	Conduct industry analysis on basis of information given	
5	Produce position audit of firm (see Chapter 4 section 4.8 for more information)	
6	Conduct managerial and organisational audit	
7	Identify critical success factors for industry and evaluate firm's performance against them	
8	Assess suitability of IT and of information systems strategy (see Chapter 4, Section 4.11 for more information)	
9	Assess level of corporate risk and adequacy of policies for its control	
10	Estimate cost of capital and compare firm's returns to this	
11	Conduct business valuation (see Chapter 4, Section 4.15 for more information)	
12	Draw up a corporate appraisal (SWOT) involving all the above (see Chapter 4, Section 4.14 for more information of how to prepare a SWOT analysis)	

(2) In the TOPCIMA exam you will be given three documents:
- A booklet containing a fresh copy of the pre-seen material followed by the exam requirement and then several pages of new unseen material. This will also contain mathematical tables and formulae.
- A full-length answer booklet.
- A continuation answer booklet.

We recommend that you reserve the full-length booklet for your main answer (e.g. a report) and that you use the smaller booklet for appendices and for rough working.

The second half of the continuation booklet should be for rough working.

The first double page spread following the centre staples will be needed for your skeleton plan (see below).

(3) Before you read the unseen material first read the requirement(s) and make an immediate note of the following elements in your rough working papers:
- *Your role or position*. For example, whether you work for the firm or an outside interest and your organisational position.
- *Format of response(s) required*. This is likely to be a report but could also involve a letter, presentation or memo.
- *Who it is addressed to*. This should influence the tone and content of what you write (e.g. your line manager, the board, a regulatory body).
- *What you are reporting upon*. There may be more than one thing required, for example a report that contains both a strategic analysis and an evaluation of a business plan.

Here is the requirement for Homejay Incorporated:

> *You are the independent management consultant appointed by the new Chairman, Ken Kato.*
> *Prepare, for the Chairman, a review of the issues facing Homejay. Your review should discuss and evaluate each of the four strategic options that have been identified. Your report should conclude with recommendations.*

We can see several things in this requirement:

You are an independent management consultant	• This means we have to be objective and professional. It also means we must consider a broader range of issues than just management accounting ones
We are writing to the Chairman	• This means we do not need to worry about criticising members of the Board of Homejay
The Chairman, Ken Kato, is a new name in the case	• This means we can criticise Ralph Black • It also means that we will need to explain things about Homejay in more detail because Kato may not know them all
We are writing a report	• Indicates required format of response
Review of the issues facing Homejay	• This mean an updated SWOT (see Chapter 4, Section 4.14) which MUST analysis incorporate data given in the Unseen material • You should also include a position audit at the start of your report summarising the key issues for the company • Look for the changes between the Pre-seen and the Unseen
Evaluate each of the four strategic options	• We need to find out what these four options are
Conclude with recommendations	• We are supposed to advise Ken Kato on what to do with the firm he has just joined. The recommendations section of the report is very important (and carries 20 marks in the new assessment matrix). All recommendations made should be well argued and justified

3.6 Reading the unseen material in the exam

(1) To a large extent this will use the same skills you have developed reading the pre-seen material. However you will find it quicker because the scenario, and the issues and characters in it are now familiar to you.
(2) The following steps should be taken:
  – Update your analysis of the position of the firm(s) in the case in your rough workings.
  – Conduct preliminary rough analysis on any proposals in the unseen material.
  – Perform any necessary calculations in a presentable form, clearly identifying the figures used, as appendices to the report. Try to avoid performing calculations in rough workings, and then rewriting them. Remember that it will be necessary to refer to the results of these calculations and explain their significance in the main report.
(3) To help you make sense of the material you need to write some of it down. This could be in the form of the analysis template in Figure 3.9, or as a spider diagram as shown in Figure 3.10.

3.7 Update your SWOT analysis

In the Technical Toolkit in Chapter 4 of this *CIMA Learning System* there are a wide range of techniques for you to revise and be familiar with. One of these techniques is how to conduct a corporate appraisal such as a SWOT analysis or Gap analysis (see Chapter 4, Section 4.14 for more details).

In Section 3.5, the strategic analysis template suggested the use of a number of analysis tools to help you understand the pre-seen material, of which one of them was to prepare a SWOT analysis. When you read the unseen material on the exam day, there will have been a number of changes to the company that have been introduced. Because things will have changed since the pre-seen, you will need to redraft your SWOT analysis and update it for the new factors.

Page	Main Information	Significance
19		

Figure 3.9 Analysis template for unseen material

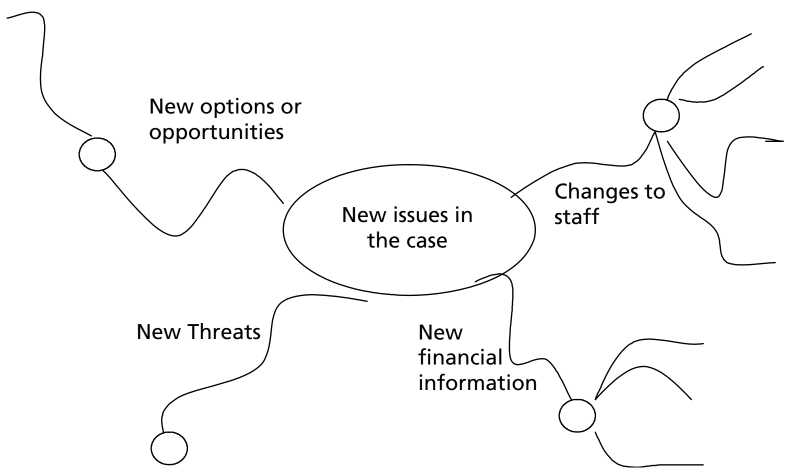


Figure 3.10 Spider diagram for unseen material

We recommend that you draw a new Cruciform Chart as your first appendix, that is, as the first page of the continuation booklet. You should refer to your SWOT and discuss it in your main report to justify your recommendations.

If you include a SWOT analysis in your answer, you must ensure that it has been updated to include material that has been given to you in the unseen material on exam day.

3.8 Conduct calculations

(1) It is certain that there will be calculations to present and that these will be the justification for the central core of your recommendations. It will be very hard for you to provide a discursive recommended for action if later you discover that financially it doesn't stack up.

(2) In past FLCS cases the calculations have included:
- NPV of projects,
- valuation of shares or a company,
- cash flow and profit forecasts,
- EPS forecasts.

(3) Because of pressure of exam time, whilst it is unlikely that you will produce these in a presentable form at first, you may wish to do some rough workings and calculations. However, remember that TOPCIMA is a strategy paper not a numbers paper – so spend your time carefully and ensure that calculation time is kept within sensible bounds (probably no more than 20 minutes).

(4) All calculations should be clearly set out and well spaced, with any assumptions made clearly stated. For example, if you are preparing NPV calculations, these should be prepared for the time period set out in the unseen material, such as 10 years. Therefore a 10-year NPV calculation should be prepared – not 5 years or into perpetuity. Therefore, the rule is to follow the instructions given.

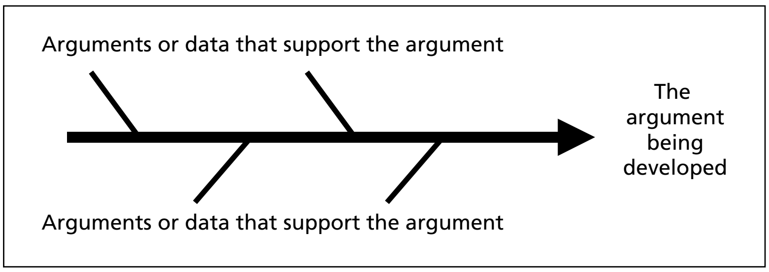
(5) Additionally if you are given a cost of capital, then use it. You may be given additional marks for including comments in your report as to why you consider a higher, or lower, cost of capital should be used, but the calculations should be prepared using the data given to you.

3.9 Decide structure of your argument

(1) The requirements set in the TOPCIMA exam must be met before you start branching off to discuss other issues you think relevant.

(2) Candidates report that having a clear idea of what they want to say is the hardest part of passing an exam like this.

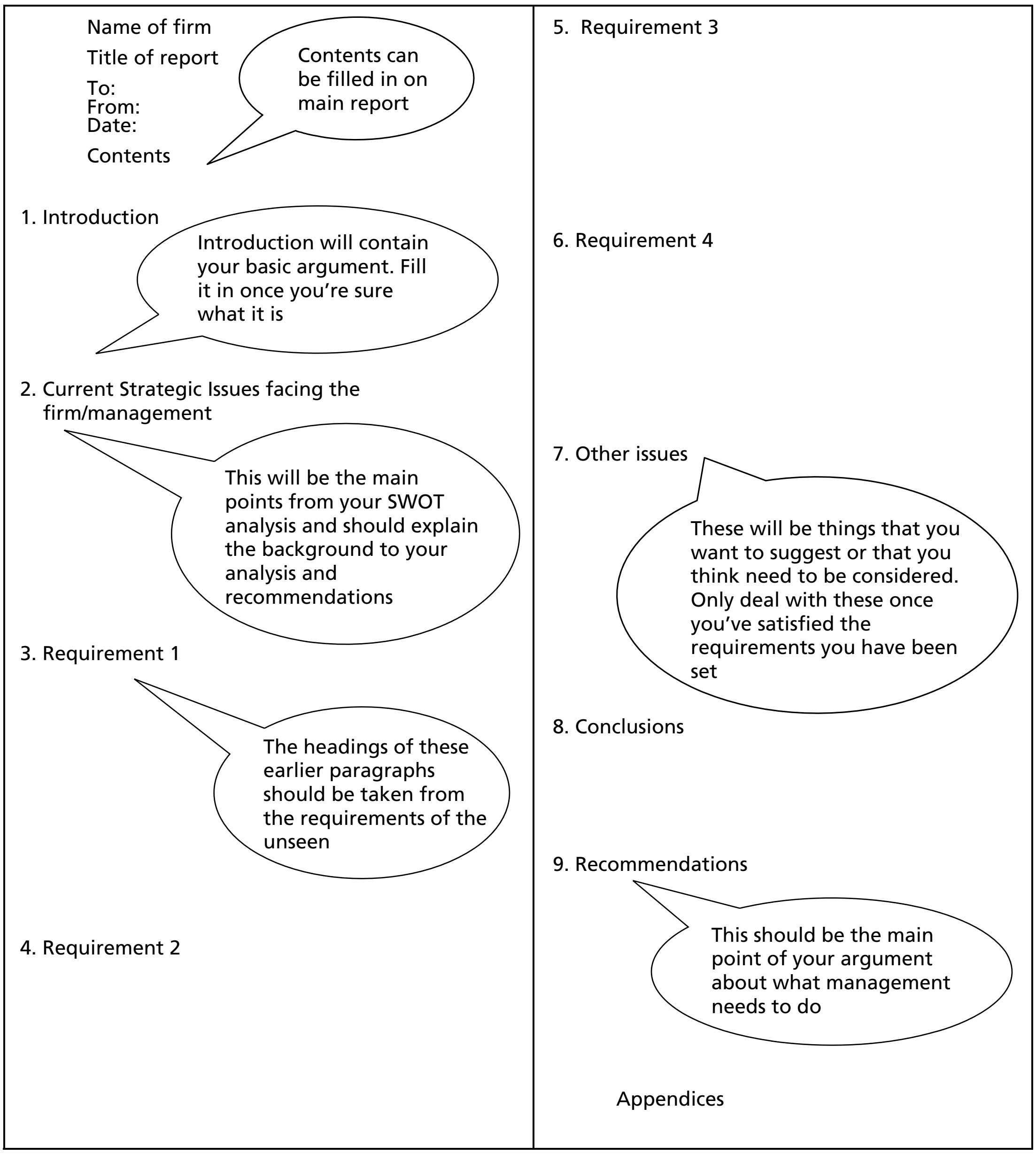
Some candidates have found *fishbone diagrams* a good way to plan their development sections.



(3) You should draw the fishbone(s) in the rough workings section of your answer books. Using pencil helps you to shift ideas about, although sometimes it's just as quick to redraw them if a better sequence of ideas comes to mind:
- write the argument at the point of the fishbone;
- put each separate piece of data analysis or evaluation that lead to the conclusion of the argument as spines;
- ensure that each spine is essential to supporting the argument;
- ensure the spines are in the best sequence for leading the reader through your argument.

3.10 Developing a skeleton plan

(1) You should attempt to map your answer out on a double-page spread in your answer book.
(2) The following template is useful:



3.11 Adding depth to your answer

3.11.1 Appreciation of the many issues in a case

TOPCIMA candidates are required to show a broad appreciation of the many issues in a case. This means making connections between material in the pre-seen and unseen material and between these and the underpinning technical knowledge of a management accountant. You should also consider the 'bigger picture' in commercial terms and the competitive environment in which it operates.

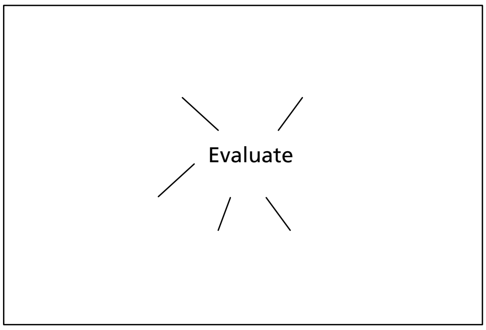
Your answer and recommendations should concentrate on the main strategic issues, but should also include recommendations on organisational structure and any changes required as well as Board positions and responsibilities and IT issues and solutions.

3.11.2 Radial thinking

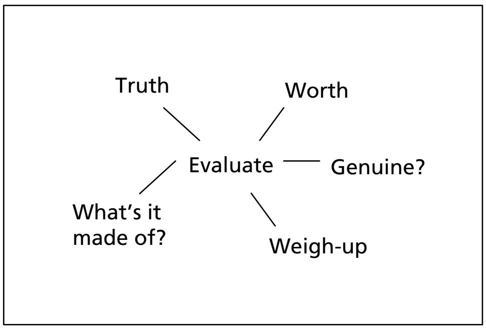
This technique is a kind of structured brainstorming or word association.

Write a key word or phrase in the middle of a sheet in the rough workings section of your second answer booklet (tip: put the sheet on its side) and then draw 4 or 5 rays from it.

For example, 'evaluate the options'.

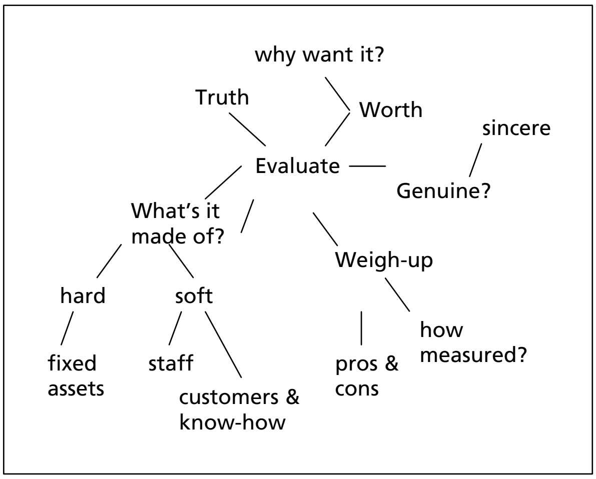


At the end of each ray, write a word or phrase that comes to your mind as being connected with the central word. The important thing here is to suspend your critical filter. Rely on word association and do not worry if the words you write down seem silly or out of context. The fact you thought of them means that somewhere in your mind there is a connection between them.



A quick consideration of some of the words on this map may help us to realise that our report should discuss business valuation ('worth'), the future earnings, assets, management and technologies of the firm.

If you still have a problem getting ideas then repeat the exercise with the more promising words on the original rays and so on, for example,



These further associations have reminded us to consider the validity of the accounting information ('how measured'); to itemise the benefits and risks clearly in our report ('pros and cons'); to check on the assets and protections available ('hard and soft') and also to consider the strategic logic to our assessment of value.

The skeleton plan can be further filled out.

3.12 Writing the introduction to your report

(1) Great thriller writers keep their readers in suspense until the last chapter or page to find out what happens. Sometimes there is a twist and the ending is the opposite of what the reader had been anticipating. However, this is NOT suitable for your TOPCIMA exam report!

(2) Your TOPCIMA report should be the complete opposite of a novel:
- the reader should be clear from the start what the conclusion of your report will be;
- the report should show the reader how you arrived at this conclusion in a way that builds the argument and shows how one point leads on to the next and makes your conclusion inevitable;
- it should end with a set of clear recommendations on what management should do next.

This opening paragraph has power and compels attention.

(3) A useful discipline is to ensure the first sentence of your Introduction begins with one of the following phrases:
- 'This report will argue that....'
- 'This report will present the case for.... (a given course of action or decision)'
- 'The central conclusion of this report is its recommendation that...'
- 'This report will demonstrate that...(the following situation is the case or certain actions are essential)'.

This only works if this sentence is the first thing you actually write in your skeleton plan and final report. Do not cheat by leaving a space and inserting the sentence once you have finished your report and finally decided what you think.

3.13 Dealing with conclusions and recommendations

(1) Conclusions should be drawn in two places during your TOPCIMA report.
   (a) At the end of each main section. This will help the reader understand what you have concluded from each evaluation or argument.
   (b) In the conclusions section. However there should be no new conclusions or surprise twists here, although your main recommendations paragraph could include a range of less important recommendations that have not been discussed elsewhere. These could be about strengthening the Board, recruitment of non-executive directors or IT issues.

(2) The conclusion need to be the one you promised in the introduction.

(3) The conclusions section should be the shortest one in the report because it does not add any extra information and so cannot gain any extra marks. However, do ensure you have reached a conclusion on all the issues you were asked to address in the requirement.

(4) Recommendations are plans of action and next steps. You should ensure these are clearly prioritised into the things that should be done immediately and the things to be done later.

(5) For example, one of the common errors in the Sparkle case was where candidates discussed the long-term future and the 5-year plans of Sparkle and almost ignored the fact that the unseen material changed the case into a hostile take-over situation. The priority for Sparkle was how to defeat the hostile take-over bid. If the company was taken over, then Sparkle would simply NOT have a long term! Prioritise your recommendations to take account of the new data in the unseen – which will probably be different to what you have prepared prior to the exam.

The recommendations should be the most important area of your report and can often make the difference between a pass and a fail. In the TOPCIMA exam there are 20 marks under the heading of ‘logic’ in the TOPCIMA assessment matrix.

There will usually be 20 marks for logic and it is very important that exam time is managed effectively so that clear well-justified recommendations are prepared. After all the main purpose of the report is to make recommendations, so ensure adequate time is allowed for *this key area of your report*. If your recommendations are not clear or are simply stated with no reasoning, they will earn low marks in this key area of the assessment matrix.

Technical Toolkit

4

Learning Outcomes

By the end of this chapter you should:

- have a sound knowledge of specific technical subjects within the CIMA curriculum;
- be able to apply technical knowledge in an analytical and practical manner;
- extract, from various subjects, the knowledge required to solve many-sided or complex problems;
- integrate diverse areas of knowledge and skills.

4.1 Introduction

The purpose of this chapter is to remind you of some key knowledge areas from your previous *CIMA* studies (Figure 4.1).

But despite the learning outcomes cited above, drawn from the TOPCIMA Learning Aims, this toolkit is merely an additional resource for you to dip into. We cannot cover the technical content of the whole *CIMA* curriculum in a single chapter. When you are using this chapter, if you come across subject knowledge that you do not fully understand we recommend that you consult the relevant *CIMA Learning System* to ensure your technical knowledge is up to scratch.

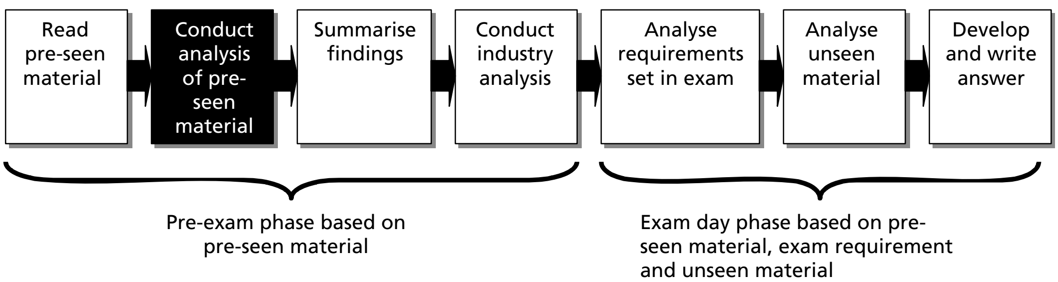


Figure 4.1 Diagram of TOPCIMA process

The technical knowledge in this chapter should be applied to the pre-seen material and also to the unseen material on the exam day. It is deliberately arranged in a logical sequence. You should consider each technique and assess whether it can be used to shed light on the pre-seen.

Refer immediately to Section 4.4 to refresh your memory on the breadth of technical knowledge you may be required to call upon.

4.2 Assessment of technical knowledge in TOPCIMA

Technical knowledge is assessed under 5 of the 9 assessment criteria, which are explained in Chapter 1 of this *CIMA Learning System*:

Technical	A sound technical knowledge of the specific areas of the curriculum
Application	Apply technical knowledge in an analytical and practical manner
Diversity	Extract from various subjects the knowledge required to solve many-sided or complex problems
Focus	Solve a particular problem by distinguishing the relevant information from the irrelevant in a given body of knowledge
Integration	Integrate diverse areas of knowledge and skills

As you can see, demonstrating technical knowledge will gain your TOPCIMA script a lot of marks. But note the key words. As well as being 'sound' this knowledge must be 'analytical, practical, diverse and relevant'.

TOPCIMA is not a theory exam. Technical knowledge will only gain marks if it is relevant to helping management to understand the problems of the organisation or is used to justify the course of action you are recommending. You will not get marks for brandishing technical knowledge for its own sake.

It must be stressed that you should incorporate in your answer on the exam day a range of technical knowledge. It is suggested that the use of a SWOT and a PEST analyses are prepared, which MUST incorporate the new data given in the unseen material on the exam day. You should also refer and discuss a range of theories, perhaps two or three, that are relevant to the case.

It must be stressed that no marks at all are awarded for "name dropping" such as the mention of "Porter". For marks to be awarded in a TOPCIMA exam, it is important that the theory is explained and applied to the case material. Further marks are then awarded for explaining how the use of a relevant technique could help the company in the case overcome some of its problems.

The TOPCIMA examiner ensures that all of the material used in TOPCIMA cases is covered in this CIMA Learning System. However, for additional depth of knowledge and understanding on particular topic, such as Joint Ventures, it is suggested that students refer to the other CIMA Learning Systems.

Therefore, be assured that all the Technical Knowledge you need to know to pass TOPCIMA is contained in this chapter, but additional reading is always advisable.

4.3 Summary of the key areas of technical knowledge covered in this chapter

We have selected the following topics based on a consideration of past CIMA Case Study exams and also our experience of the difficulties facing learners and candidates:

Technique	*Sections*
The four elements of strategy (competitive, financial, investment and risk)	4.4
Using ratios to conduct a financial analysis of a company's position	4.5
Assessing a business portfolio	4.6
Industry analysis	4.7
Position audit	4.8
Conducting a managerial and organisational audit	4.9
Critical success factors	4.10
Assessing information systems strategy	4.11
Assessing corporate risk	4.12
Assessing the cost of capital	4.13
Conducting a corporate appraisal (SWOT and Gap analysis)	4.14
Business valuations	4.15
Generating strategic options	4.16
Sources of business finance	4.17
Evaluating strategic options	4.18

4.4 The four elements of strategy

(1) According to the syllabus 'TOPCIMA (. . .) requires students primarily to apply strategic management accounting techniques to make and support decisions'.
Where the following definitions apply:

Strategy: A course of action, including the specification of resources required, to achieve a specific objective.

Strategic plan: A statement of the long-term goals along with a definition of the strategies and policies which will ensure achievement of these goals.

Strategic management accounting: A form of management accounting in which emphasis is placed on information which relates to factors external to the firm, as well as non-financial information and internally generated information.

CIMA: Management Accounting Official Terminology

(2) The following discussion provides an overview of the issues in strategy and how they interrelate (Figure 4.2). The reminder of this chapter is devoted to a detailed treatment of the main topics raised here.

4.4.1 Competitive strategy

This deals with how the firm competes for business and where its earnings come from.

Considerations in competitive strategy:

- which countries, markets and customers to target (affects volumes, revenues and risks);
- the positioning of firm in each market and the quality of its offerings (affects costs of production and cost of developing, supporting and defending brands);

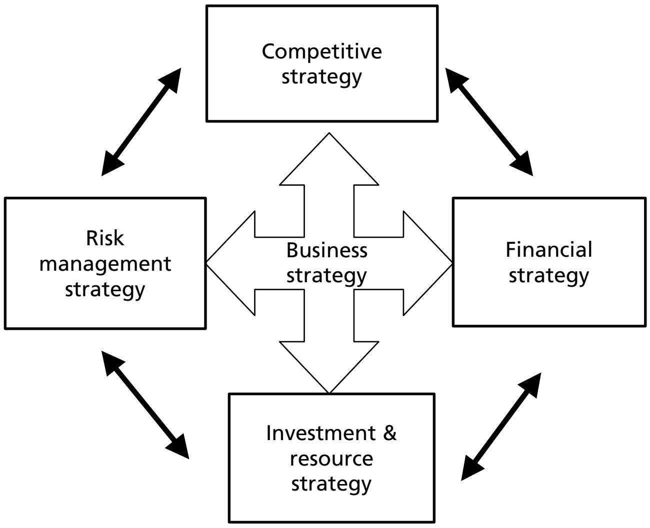


Figure 4.2 The four elements of strategy

- what products or services to provide (affects costs and the assets the firm must invest in);
- methods of gaining access to customers, markets and products (may lead to acquisitions, mergers, joint ventures, etc.);
- creating appropriate organisational structures and systems to support strategy;
- the role of the corporate parent in controlling strategy and maintaining control over divisions in the implementation of strategy.

Technical content:

- Porter's generic strategies (cost leadership, differentiation, focus);
- Ansoff product/market growth vector matrix (market penetration, market development, product development, diversification);
- Theories of resource-based strategies (distinctive competences and strategic architectures);
- Goold and Campbell: strategic styles;
- Strategy and structure: for example, Chandler's theory of stages, Greiner's model of organiSational growth, virtual organisations, learning organisations, flexible organisations;
- Strategic cultures (e.g. Miles and Snow);
- Multidimensional performance measures (e.g. balanced scorecard).

Importance of competitive strategy:

- competitive strategy influences the operating margin of the business (profit/sales turnover ratio) and also the assets it needs to support its business (assets/turnover ratio);
- competitive strategy therefore determines the return on shareholders' investment (i.e. ROCE = operating margin × asset turnover) from the firm's core business;
- success of competitive strategy (e.g. sales growth, winning new orders, adequacy of margins, etc.) will influence investors' opinions of management and therefore the firm's share price or ability to borrow investment funds;

Application to passing TOPCIMA:

- evaluate the causes of the financial performance of the firm in terms of the adequacy of its competitive strategy in each if its markets/businesses;

- assess adequacy of management and organisation for carrying out the strategies being considered by the firm;
- justify any recommendations you make in terms of its strategic rationale and potential impact on ROCE and share price;
- ensure you consider all the implications of the strategy you recommend (e.g. implications for structures, control systems and performance measures).

4.4.2 Financial strategy

This deals with the firm's relations with its investors and other providers of credit. Management must meet the wishes of the shareholders of the business. They must also bear in mind the banks and suppliers who are also sources of capital.

Considerations in financial strategy:

- ensuring the return to shareholders exceeds the costs of equity in order to create shareholder wealth;
- maintaining appropriate relations with investors;
- ensuring that the business has sufficient funds available to meet its present and forecast cash needs;
- developing a capital structure appropriate to the financial needs of the business and the dynamics of the parts of its business.

Technical content:

- operation of stock markets (e.g. efficient markets hypothesis);
- methods of flotation and of raising equity finance (e.g. rights issues, warrants, venture capital);
- raising long-term debt finance (e.g. bonds, bank borrowing, project finance, sale and leaseback of assets);
- raising short-term finance (e.g. trade credit, factoring, hire purchase, leasing, bills of exchange);
- calculation of cost of capital;
- methods of share valuation (e.g. net assets, income flow, dividend, price/earnings, sustainable cash flow);
- theories of optimal capital structure (e.g. Modigliani and Miller);
- dividend policy.

Importance of financial strategy:

- activities of corporate treasury can improve or reduce earnings of shareholders;
- loss of support from shareholders will lead to changes in management and strategy;
- inadequate financial support can lead developing businesses to overtrade (i.e. to run out of cash) despite being profitable.

Application to passing TOPCIMA:

- evaluate the financial performance of the firm, and its share price, using ratios to assess whether management are acting in the interests of shareholders and able to maintain shareholder support;
- use cash flow forecasting to assess the adequacy of its financing its current strategy;

- value the company to assess the likelihood of being able to raise further capital, takeover another firm or resist a takeover itself;
- prepare financial analysis to advise management on how to restore investor support or raise additional finance.

4.4.3 Investment and resource strategy

This area of strategy concerns how management uses funds retained from profits or otherwise borrowed from investors. These provide the resources needed to carry out the firm's competitive strategy.

Considerations of investment and resource strategy:

- ensuring the business has the tangible and intangible assets it requires to carry out its strategy;
- ensuring all business investments are undertaken only if it can be shown that there is a reasonable prospect of a net return in excess of the costs of capital involved;
- evaluating whether existing assets, including entire business divisions, are yielding an adequate return or whether they should be divested or outsourced;
- appropriateness of potential asset investments (e.g. business acquisitions, tangible asset acquisition, programmes of marketing or human capital development);
- ensuring that performance measurement systems encourage management to utilise assets for the best long-term financial return.

Technical content:

- project appraisal (e.g. IRR, NPV);
- risk and project appraisal including sensitivity analysis;
- mergers and acquisitions;
- de-mergers;
- divisional performance evaluation (e.g. return on investment, residual income, shareholder value approaches);
- post-investment audit.

Importance of investment and resources strategy:

- the quality of management's investment decisions will determine the company's ability to make a healthy return on shareholder investment through time;
- present financial performance can be improved if assets returning less that the cost of capital are liquidated and the funds invested elsewhere or used to repay capital;
- strategic investments often contain loose forecasts of earnings, outlays and costs of capital that should be questioned before approval is given;
- post-audit of investments can reveal issues in the quality of management forecasting and also of its ability to manage projects to generate shareholder returns.

Application to passing TOPCIMA:

- assessment of investments undertaken to date will help you to draw conclusions about the quality of management, its strategy and the reliability of its forecasts;
- be prepared to advise on the suitability of investments being proposed by management in the pre-seen or unseen material;
- be ready to recommend investments or divestments to management, backed up by appropriate numerical analysis.

4.4.4 Risk management strategy

Considerations include:

- *Business or operational*: relating to the activities carried out within an organisation.
- *Financial*: relating to the financial operation of a business.
- *Environmental*: relating to changes in the political, economic, social and financial environment.
- *Reputation risk*: caused by failing to address some other risk.
- *International risk*: resulting from exposure to different currencies or political systems.

Technical content:

- *Risk management policy*: this defines the organisation's approach to risk management and its attitude to, and appetite for risk.
- *Resourcing risk management*: the resources required to implement, monitor and co-ordinate the risk management process including risk reporting.
- *Implementation of risk management*: formalizes the processes involved in identifying and defining risk, the assessment of risk in terms of likelihood and impact, and the key aspects of the business processes that are used to respond to risk. This includes *internal controls* such as planning, internal audit and the impacts of corporate governance on the top board.
- *Risk management review and reporting*: includes the form and regularity of reporting and the risk reporting structure.

Application to passing TOPCIMA
You should be prepared to:

- assess the risks presently run by the organisation in the pre-seen material;
- consider the adequacy of the firm's current risk management and reporting procedures;
- forecast how those risks will change in the light of strategies it proposes or environmental factors in the pre-seen or which you subsequently research;
- identify the risks implicit in any strategies you propose;
- recommend techniques and procedures to manage risk in future.

4.5 Financial analysis of a company's position

(1) As a management accountant it's your job to advise management on the financial position of the business. Other functional experts will advise them on the detail of the firm's marketing, human resource or operational position. You must therefore base your analysis of the pre-seen material in the firm's financial position.
(2) Financial analysis seeks to assess two factors:
   - the quality of earnings management are returning in relation to the shareholders funds they control;
   - the risks investors, and other stakeholders, are exposed to as a consequence of management's decisions.

Note that although we are analysing a company's figures we are really seeking to draw conclusions on the quality of its management, the strategy they have followed to date, and the control they exercise over the firm's operations.

When you qualify as a CIMA accountant you will use financial ratios to assess performance within your company or division or to review companies operating in your industry for benchmarking purposes or for possible acquisition. It is very important that you know how to calculate these key business statistics accurately.

In your TOPCIMA exam, the correct calculation and interpretation of these financial ratios demonstrates to the examiner that you are competent in calculating and understanding these key business indicators. It is surprising that in this last CIMA exam, there are still students who appear to be unable to correctly calculate even basis financial ratios such as earnings per share (EPS). I have seen EPS calculated on pre-tax profits and even on retained profits after dividends. EPS should, of course, be calculated on profit for the period, that is, post tax and post finance charges, but before dividends, divided by the number of ordinary shares in issue.

4.5.1 A tree of ratios

Poor management performance means that they have failed to increase the value of the business. Good business management means the opposite.

Increasing the value of the business depends on being able to increase the returns to ordinary shareholders, measured as the earnings per share.

The diagram in Figure 4.3 shows the ratios driving EPS and therefore shareholder value.

To analyse the causes of the financial performance of the business adopt the following approach to work down the two branches that determine ROCE.

Calculate changes in the EPS and/or the ROCE. If they are falling through time management is failing. If they are rising management is working and the strategy is successful.

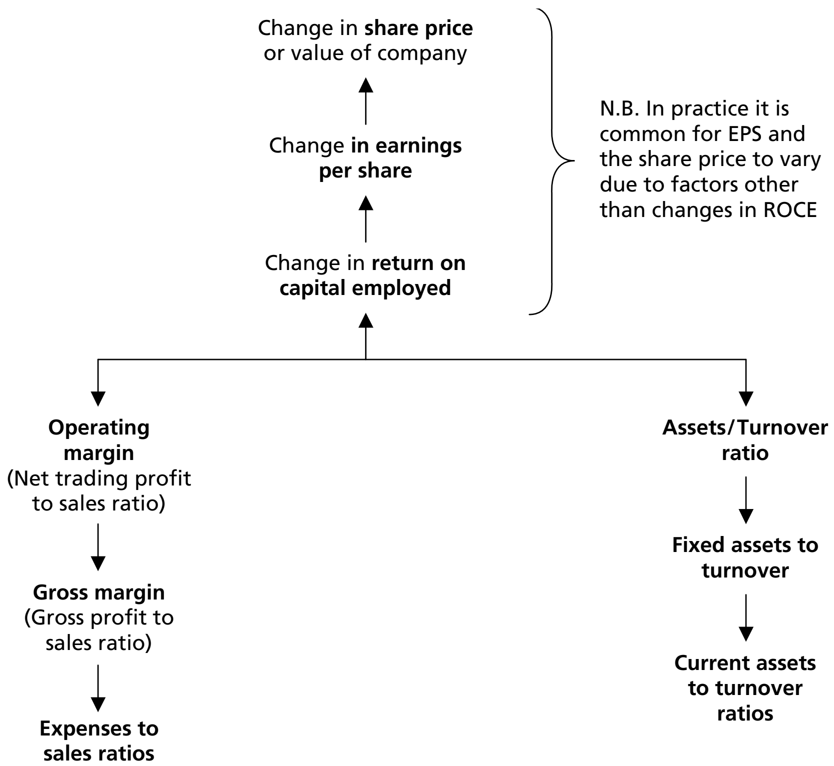


Figure 4.3 The tree of ratios driving earnings per share

Check the margins and costs

- Calculate operating margin for each year to look for trends. If it is constant it is not the cause of the changes in ROCE and EPS. Alternatively, if it is changing through time then look for causes by inspecting the gross margin.
- Changes in gross margin are due to changes in prices or changes in the costs of sales. If the gross margin is falling it suggests competitive pressure on prices, rising costs of sales or that the volume of the firm's business is not expanding as fast as its capacity.
- If gross margin is not obviously the cause of changing profitability then check some expenses to sales ratios. Things like administration costs or marketing costs may be changing.

Check asset/turnover ratios

These ratios check that whether management are utilising the firm's assets properly or not. If the TOPCIMA pre-seen material contains similar details for previous years or for similar companies then you should conduct a *comparative analysis*.

- Check fixed assets to turnover first. If this ratio is high (or increasing) it suggests that the growth of the business needs to be supported by high fixed investments. In other words, there will be negative free cash flows. This means that management will need to gain further external finance (e.g. debt or additional equity) to help the firm grow. It also means that management will not be able to finance strong dividends from current cash flows.
- Check the ratios of the various current assets to turnover. For example, stock and debtors. These are uses of working capital and if the ratio is high or increasing it suggests that the strategy being adopted is tying up excess amounts of cash.

4.5.2 Using ratios to assess the potential of a business

The previous section shows how ratios can be used to indicate the origins of a firm's comparatively poor financial performance.

They can also be used to estimate the potential financial gains to made from getting things right.

This approach is often adopted as a first assessment by investment analysts, corporate raiders or venture capitalists that are assessing an under-performing company and considering changing its management.

Example 4.1 Turnaround plc

The following financial analysis has been conducted on Turnaround plc and a close rival Sitting Pretty plc.

	Turnaround plc $m	*Sitting Pretty plc $m*
Turnover	1014	2880
Operating profit	62	192
Capital employed	780	1600
Fixed assets	620	1382
Current assets	160	218
Costs of sales	628	1810
Admin and other costs	324	878

The following ratios can be derived

	Turnaround plc	*Sitting Pretty plc*
ROCE	7.9%	12%
Net margin	6.1%	6.7%
Asset turnover	1.3	1.8
Fixed asset turnover	1.6	2.08
Current asset turnover	6.3	13.2
Gross margin	38%	37%
Admin sales ratio	32%	30%

It can be seen that Turnaround plc is doing poorly compared to Sitting Pretty plc. By applying Sitting Pretty's ratios to Turnaround it becomes possible to assess the potential for improving Turnaround plc's results.

Management who prefer to cut costs would take the following approach to increasing ROCE (and therefore EPS)

		Improved financial performance $m
Savings from better administration on existing business	$324 − ($1014 × 0.30)	19.8
Reduction in fixed assets available	$620 − ($1014/2.08)	132.5
Reduction in current assets available	$160 − (1014/13.2)	83.2

Increase in operating profit = $19.8m

Reduction in capital employed = $215.7m

Potential ROCE

$$\frac{(\$62 + \$19.8)}{(\$780 - 215.7)} = 14.5\%$$ [1]

A near doubling of ROCE. In shareholder wealth terms this amounts to the destruction of shareholder value to the tune of $51.4m [$780m × (0.145 − 20.0791)] per year by Turnaround plc's current management through poor margin management and excessive use of assets.

A more aggressive management team might see the potential to derive a greater turnover from the fixed assets of Turnaround plc as well as improve its profit margins. This would give rise to the following analysis:

		Improved financial performance $m
Turnover available at improved fixed asset turnover	$620 × 2.08	1289.6
Gross profit at current gross margin	$1289.6 × 0.38	490
Admin costs at improved ratio	$1289.6 × 0.3	386.9
Current assets at improved ratio	1289.6/13.2	97.7

Potential operating profit = $490 − $386.9
= $103.1m

Potential capital employed = $620 + $97.7
= $717.7m

Potential ROCE = $103.1/$717.7
= 14.4%

[1] The potential ROCE of Turnaround plc here is actually higher than the 12% achieved by Sitting Pretty plc. This is because Turnaround enjoys a 38% gross margin compared to 37% for Sitting Pretty. This improves its earnings by ($1014 30.01) $10m as year. If we deduct this from its profits the ROCE of Turnaround plc falls to (71.8/564.3) 12.7%. Allowing for rounding this is the same as Sitting Pretty plc's ROCE.

In your TOPCIMA assessment you should be prepared to conduct calculations like the ones above to demonstrate a number of things:

- the failures of management of the firm in financial terms;
- the potential impact of recommendations of changes in management or adoption of different competitive or investment and resource strategies;
- the true potential value of a company if it could be run correctly;
- the synergies available by combining firms (say Sitting Pretty and Turnaround from Example 4.1).

However, there are caveats to bear in mind in using ratios in this way:

- The ratios only suggest where things could be improved. They do not give clear guidance on how to change margins and asset usage. You will need to provide this in your exam.
- They assume that it's possible to make one company like the other. Where there are differences of location, production technology, operating conditions or products you will need to point out that this may not be possible.
- It assumes that accounting treatments in both firms are identical. If fixed or current assets are valued in different ways this will affect the reliability of your recommendations.
- The figures may be massaged by the present management, or subject to questionable accounting treatments which can distort your analysis.
- It ignores the costs of changing the business. For example, a strategy or rationalisation of costs and assets will carry one-off costs of redundancies, disposals, etc. Also there may be asset write-offs to consider.

4.6 Assessing the business portfolio

Portfolio means 'collection'. A portfolio analysis can be useful in the following situations:

- Where the TOPCIMA Pre-seen involves a firm with several business divisions. These could be different industries or perhaps in different parts of the world. This was the situation confronting candidates in both the May 2002 and May 2003 exams under the old syllabus *Final Level – Management Accounting Case Study Exam*.
- Where the management of the firm are contemplating adding a new, and different, line of business to their current business. This was important in the November 2002 exam on Constro and also in the November 2003 exam on Homejay.
- Where the firm has a number of different products that it relies on for its earnings or is considering adding a product to this mix. This engaged candidates in the November 2001 and May 2004 exams.

4.6.1 The key issues in portfolio analysis

Business portfolio analysis was originally developed in the 1970s to mirror the portfolio analysis developed for financial strategy and investment analysis. According to the latter

Table 4.5.3 A refresher on reading financial data

Aspect	Indicator	Calculation	Interpretation
Profitability	Net profit of division or firm	Available from profit and loss	If profits are negative or falling through time the firm has difficulties: • will be disappointing investors leading to problem with share price or loan renewal • will not be able to invest in new or replacement assets • may be target of takeover if a listed company
	Contribution	Sales revenue − variable costs	Used to check: • whether having particular product lines (or customers) is beneficial to the firm • assess scope for further price falls
	Contribution margin or Contribution to sales ratio	Contribution/sales turnover × 100%	Commonly used by multi-product firms to rank alternative products and identify poorly performing ones.
	Contribution per unit of limiting factor	Annual contribution/units of limiting factor	Used where firm has a scare resource to maximise total profits by focusing on providing products with high contributions per limiting factor, for example, • retail stores consider product contribution per square metre of store space • factory considers contribution per hour of machine time
	Gross margin or Gross profit percentage	(Sales − cost of sales)/sales revenue × 100%	Falling gross margin can indicate: • industry or market is maturing and competitive pressure increasing (compare with gross margin of rivals) • firm is not controlling its cost of sales (e.g. supplier power high or bad internal control)
	Net margin or Profit to turnover ratio	Net profit/sales revenue × 100%	Summary of the overall profits made from activities of division or firm. Falling or low net margin can indicate: • highly competitive market (if gross margin also low) • poor control of costs and expenses by management (check ratio of particular expenses to sales to discover which costs are out of control) • need for firm to consider entering new business areas to sustain profits and perhaps ultimately dispose of under-performing business
	Return on capital employed or Return on net assets or Return on investment	No single accepted way of calculation • Profit before interest and tax/year end capital employed	Summary measure that indicates the rate of return the business or division is making on the capital it has. Used to: • Consider whether the firm is maximising shareholder wealth. If ROCE of firm is less that a rival then it isn't because investors would be better-off if they had put their capital in the rival. This tends to lead to share price falls

		• Profit before interest and tax/average capital employed during year • Profit before interest and tax/net assets	• Assess whether investing extra capital is worthwhile. If firm's cost of capital is higher than its ROCE then borrowing further capital will destroy shareholder • Compare divisions (and quality of divisional management) within the firm or with rivals to assess where improvements could be made wealth • Justify disposing of lines of business with relatively low ROCE to invest liquidation proceeds in divisions with higher ROCE to increase overall ROCE of group • Trend of falling ROCE may indicate increasing competition or history of poor investment decisions by management
	EBITDA	Earnings before interest, tax, depreciation and amortisation	This is an investment analysts' approach. The rationale is that share prices are determined by the present value of free cash flows and so to assess this, a firm's profit figure should be restored to its cash value. EBITDA is one measure given by taking earnings before interest and tax and: • adding back depreciation for the year • adding back amortisation of goodwill during the year This measure is also used as the basis for recalculating ROCE and, after deduction of interest, tax and preference dividends, EPS
	Residual income	Profit before interest and tax – (net assets × required rate of return)	Alternative divisional performance measure that calculates the actual amount the division has contributed to shareholder value in a year
	Operating leverage or operational gearing	Calculation depends on data given: • fixed costs/total costs × 100% • Annual change in pre-tax profit/ annual change in sales × revenue	Ratio denotes how volatile profits will be in relation to changes in activity or turnover Consequences of a high operational gearing ratio are: • sharp profit volatility in response to changes in the level of sales turnover • high financial risk, particularly if combined with high capital gearing, because a fall in activity may endanger ability to pay interest liabilities • high profit growth if firm increases sales • need for sales to reach forecast if firm is to ensure it breaks even
Liquidity & cash	Balance sheet figures	• Cash balance • Overdraft and borrowings • Current liabilities	High short term borrowings and current liabilities are a danger signal: • the lenders can call in the loans or force the firm into liquidation if it does not pay up • lenders may refuse to extend credit further which will bring growth of business to an end

Table 4.5.3 (*Continued*)

Aspect	Indicator	Calculation	Interpretation
			• the firm's profits may be depressed due to paying large amounts of interest If these borrowings are increasing disproportionately to the growth in the firm's sales turnover it indicates overtrading • firm may have budgeted for too little permanent capital to support its growth plans. This suggests bad financial management • the firm has problems in debtor control and working capital management • the firm does not have a coherent financial strategy and is borrowing ad hoc. At some point it will run out of lenders • high 'burn rate'. The business overall, or the work of a division, is cash using. This means that despite being profitable the firm will not be able to reward lenders and shareholders in the short-run and will need continual cash injections (a Problem Child according to BCG matrix)
	Free cash flow	The profit figure is adjusted using some adjustments familiar to you from constructing cash flow statements: • add back depreciation • add back amortisation • deduct any increase in stocks during the year • deduct any increase in debtors during the year • add any increase in creditors during the year • deduct any increase in fixed assets during the year	• A strategic financial consideration is whether the growth of the business yields cash or whether it will demand cash to support it • To assess this the profit figure is adjusted to take it back to a cash profit basis • If the firm has a negative free cash flow then it will have liquidity problems if it cannot raise additional finance • A negative flow may reflect poor working capital management or spendthrift investment decisions
	Quick assets ratio or Quick ratio or Acid test ratio	Current assets – stock at end of period/current liabilities at end of period	Normally ratio should be at least 1 if firm is to be able to pay creditors in the short run even if they cannot sell stock • Retail stores often have quick ratios less that 1. This reflects their confidence that stock will sell in a shorter time period than their creditor days (check relative stock turn and creditor days to verify)

Current ratio	Current assets and end of period/ current liabilities at end of period	• Overall measure of firm's liquidity and should always be in excess of 1 • Ratio below 1 means that firm cannot pay creditors without selling fixed assets. This will be hard to do within the time available (danger of creditors applying to have firm wound-up) and would mean that firm is contracting • Ratio less than 1 in a growing firm suggests that trade credit is financing fixed assets. Some growing retailers buy on 90 days credit and sell for cash within 3 days, using the 87 days of credit to build new stores and expand sales. They rely on continually expanding revenue to repay suppliers. The capital is free but strategy will cause cash flow crisis if sales growth rate falters
Creditor days	Calculation depends on information given in case: • Average trade creditors/average daily purchases on credit terms • Trade creditors/purchases × 365 • Trade creditors/cost of sales × 365	Indicates the number of calendar days taken to pay creditors. A long (e.g. >30) or increasing number of days could suggest: • good working capital management because trade credit is finance for free • using supplier credit as a sales aid in a competitive market (e.g. firm sells product on to customer with similar generous credit terms) • cash flow problem. Management are deliberately delaying payments to suppliers because they are not receiving sufficient sales revenue • vulnerability of firm's finances to withdrawal of supplier goodwill • exploitation of suppliers and potential harm to their long-term survival
Debtor days	Calculation depends on information given in case: • Average trade debtors/average daily turnover on credit terms • Trade debtors/credit sales × 365 • Trade debtors/sales revenue × 365	Indicates the average time taken for credit customers to pay. Generally the firm should aim to have debtor days below or equal to creditor days to avoid working capital problems A long (e.g. >30 days) or increasing number of days could indicate: • poor working capital management. The firm may be extending its overdraft to support debtors and so eliminating its profits by higher interest charges • poor credit control. The firm is not controlling customer debts or has a lot of bad debts it has not written off. This may also mean its balance sheet is misleading • credit is being used as a sales aid in a competitive market

Table 4.5.3 (*Continued*)

Aspect	Indicator	Calculation	Interpretation
	Stock turnover	Stock value/average daily cost of sales	Can be used to indicate several things: • how long the firm can continue business without further deliveries of stock (e.g. in the case of a disruption in the supply chain) • how well in manages its working capital (i.e. low stock turn suggests too much money tied up in stock) • its vulnerability to obsolescence of stock due to changes in technology or fashion
		Profit *before* interest and tax/gross interest payable	• Assesses how many times over the firm's profits could pay its interest liabilities. • A low number (say 3) indicates that a fall in business activity would promote a high risk of default and subsequent liquidation by creditors • Measure suffers from being based on profit and not cash. A profitable firm may still not have the cash it needs to pay its interest obligations
Efficiency and asset utilisation	Fixed asset turnover ratio	Annual turnover/average net book value of fixed assets	Measures how well the firm is using its assets. Used to compare branches or similar companies • A higher number indicates the machines and premises and generating a lot of saleable output • Apply ratio of well-performing branch to the assets of a poor performing branch to assess potential for increased sales if managed properly • Low ratios indicate opportunity to dispose of fixed assets and gain cash providing remaining assets can be worked harder (e.g. branch rationalisation or reduction in number of lorries)
	Sales per employee Profit per employee Customers served per employee	Annual sales revenue/average number of employees Annual gross profit/number of employees Number of customers served/number of employees	Measures how well the firm uses its human resources • Usually a comparative measure between divisions/rivals or through time • Generally higher values are signs of efficient use of human resources and lower values indicate over-manning • Where personal service is important then low customer/staff ratios are better

	Activity per limiting factor	Examples • Sales per m^2 of sales space • Output per machine hour • Annual bookings per hotel room	Shows how intensively used the resource is Low ratios indicate: • lost profit opportunities • poor capacity utilisation planning • disappointed customers
	Capacity fill	Actual utilisation/maximum available capacity e.g. for a hotel number of room nights sold per year/number of rooms in hotel × 365	May be used to compare branches or to compare with competitors Low capacity fill suggests: • inefficient management of resource • excess capacity with possibility of redeployment or liquidation of capacity • unabsorbed overhead and consequent low profit • potential for growth in sales volume without need for increased investment in capacity or operating costs
Capital availability and risk	Asset cover	Net tangible assets before deducting overdraft and other borrowings/total borrowings including overdraft	A high level of cover indicates low risk for investors and potential for further borrowing. Can be used in three ways: • to indicate the security of lenders money by showing that there are enough assets to liquidate to pay it back • to indicate the scope for further borrowing by the firm • to show equity holders the value of un-pledged assets available for distribution in the event of company liquidation However interpretation needs care: • ignores the value intangible assets which may also be valuable • book value of assets is not the same as market value in liquidation • ignores other liabilities of the firm that may rank higher in liquidation such as deferred tax and wages
	Capital gearing or Capital leverage	Several methods of calculation • Total long-term debt/shareholders funds + long-term debt • Total debt financing/total shareholders funds • Total debt + overdraft/total debt + overdraft + shareholders funds from data in case	Shows the proportion of finance that comes from debt (or the ratio of debt to equity) A high capital gearing ratio has the following implications: • high financial risk to equity holders of dividend volatility and liquidation of firm if it cannot pay interest • limited potential for future borrowing (but compare with asset cover) • questions raised about why shareholders will not provide more finance to the business High capital gearing is less of a risk if: • the firm works in a market where earnings are not volatile • there are adequate tangible assets to give lenders security • the debt is owed to a related company such as a holding company

Table 4.5.3 (*Continued*)

Aspect	Indicator	Calculation	Interpretation
			• the debt is short term due to seasonal factors or investment in particular projects • the debt holder is accustomed to high risk (e.g. venture capitalists)
Investor perspective	Share price		Rise in the share price through time has following implications: • earnings of the investors are expected to rise. Usually this will be due to anticipated profit growth by the firm • shareholders support management • firm will find it relatively easy and cheap to raise extra capital • sudden rises in share price without similar improvements in profit suggest market anticipates a takeover bid for firm or a needed change of strategic direction or management
	Earnings per share	Profit attributable to ordinary shareholders/number of shares *issued* The profit attributable to ordinary shareholders is usually the profit for the period (after tax and finance charges, but before dividends)	• Summary measure of how well the firm earns money for its equity holders • Usually compared from year to year for the firm • Meaningless to compare EPS of rival firms • Growing EPS will generally cause share price to rise • declining EPS suggests firm is in difficulties in its market and will pull down the share price or force firm to pay higher dividend to bolster share price
	Price earnings ratio	Market price per share/ earnings per share	A measure of investor confidence in management's strategy for the firm A high P/E ratio generally indicates: • earnings are expected to grow in the future • firm will be expensive to acquire in a takeover • investors are happy However a sudden rise in P/E could mean: • rise in share price due to bid rumour • improved dividend payout expected from nervous management • a collapse in earnings that investors hope will be a one-off event A P/E ratio is usually industry specific – you should research what the P/E ratios are for other real life companies operating in the industry in which the case you are working on is set.

Dividend yield	Dividend per share/market price per share × 100% Total dividend to ordinary share holders/market capitalisation × 100%	Essentially the income yield on the share. High dividend yield suggests: • investors are income seeking and the firm is a cash stock • share price is held up by high dividend policy that will be difficult to reverse • profit growth is not expected • potentially low level of retained earnings (check dividend cover)
Dividend cover (Dividend payout ratio is reciprocal of dividend cover)	Earnings per share/ dividend per share Earnings attributable to ordinary shareholders/ total dividend	The ability of the firm to continue paying its present level of dividend. A low dividend cover (high payout) ratio indicates: • high financial risk for investors because a fall in profit will threaten dividend and potentially therefore share price • high reinvestment of profits into the company, which may support growth

financial markets invest in shares as a bundle of investments with different returns, prospects and risks but seek to evaluate them in terms of their contribution to the returns, risks and prospects of the investment portfolio as a whole.

Early proponents of business portfolio analysis saw a parallel between the situation of the Wall Street fund manager and the board of a large firms looking down at their businesses. The board seeks to manage shareholder wealth by managing business investments to improve the financial returns of the overall corporation. Therefore, they concluded, it's important to look beyond the current performance of each business unit in isolation, as ratios do, and in addition consider how the business portfolio fits together and what its prospects are.

Portfolio analysis has since been adopted by many business functions including marketing and information systems. Each will have its own special areas of interest. However, as a management accountant sitting a final Test Of Professional Competence In Management Accounting you should focus yourself on the following issues:

- how well does the portfolio of businesses and products contribute to the current financial performance of the business?
- what is the rationale for management to have invested shareholders' funds in these businesses and how do they support each other?
- what are the prospects for each business or product and its implications for future financing needs or financial returns?
- what are the risks attached to each business and to the portfolio as a whole?
- is there a case for disposing of any of the businesses in the portfolio?

4.6.2 The Boston growth share matrix

The BCG model requires management to plot the position of their business units (or products) against two axes:

1. *Relative market share*: This is calculated as the firm's market share against their largest rival, so a firm with a 20% share of the market which has a rival with a 60% share would have 0.3 (20/60 = 0.3x) whilst the rival would calculate their relative share as 60/20 = 3x.
2. *Market growth rate*: This is the annual percentage change in sales volume in the industry as a whole.

This allows the business units to be plotted on a two-dimensional space as shown in Figure 4.4.

An additional factor is the inclusion of sales turnover in the model. The proportion of total group sales turnover accounted for each division is converted to the radius of a circle with its centre as the co-ordinates of the division.

High relative share brings several benefits:

- The enjoyment of lower unit costs and therefore higher current margins than competitors at the same price levels.
- the ability to be a price leader. If the firm decides to cut price other must follow to maintain their sales but in so doing may find themselves selling at below unit cost.
- The dominance of the market means the product will become the benchmark product, 'the real thing' against which others may be seen as pale imitations.

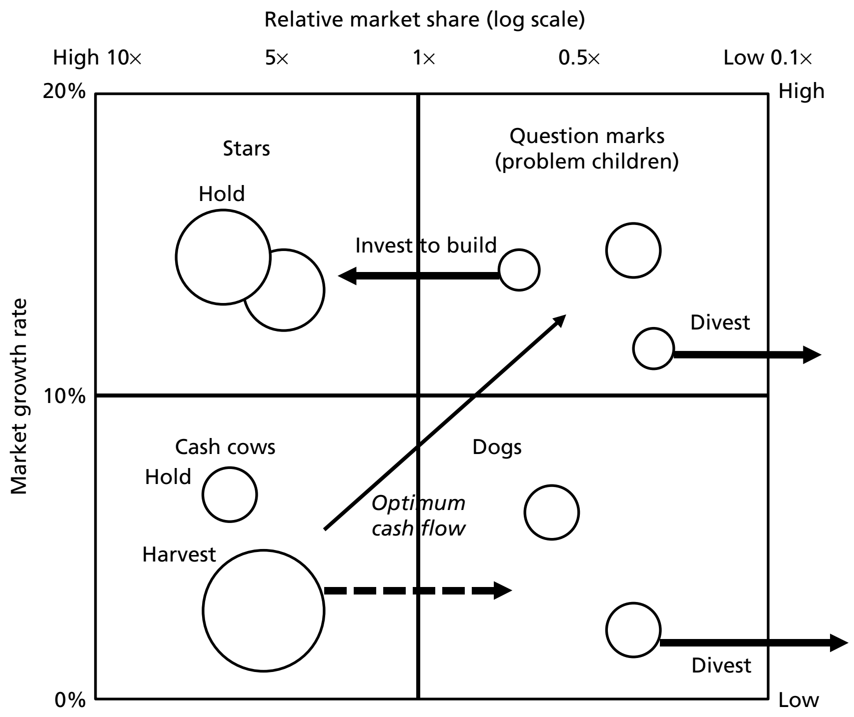


Figure 4.4 The BCG matrix

Even if you do not have market shares and market growth rates, you can still compare or liken different divisions or different products in the case that you are answering to the BCG matrix categories of Question marks (problem children) or Cash cows, for example. These are commonly used and recognised business terminology and adds credibility and understanding to your answer if it is correctly applied to the case.

1. Question marks (problem children)

These products are in a high growth market that means that it is early in the product life cycle and therefore has the potential to repay present investment over its life cycle. Indeed the high market growth rate means that the firm will already be investing considerable sums in it.

The low relative market share however means that this business unit is unlikely to survive in the long run because it will have a lower cost competitor.

Management must decide between investing considerably more in the product to *build* its market share or shutting it down now before it absorbs any further investment which it will never repay. Investing to build can include:

- price reductions,
- additional promotion and securing of distribution channels,
- acquisition of rivals,
- product modification.

2. Stars

Very competitively strong due to high relative market share although its current results will be poor due to the need to invest considerable funds into keeping up with the market growth rate.

The strategy here is to *hold* market share by investing sufficient to match the commitment of rivals and the requirements of the marketplace.

3. Cash cows

This is a mature product (low growth rate) which retains a high relative market share. The mature stage means that its prospects are limited to falling prices and volumes. Therefore, investment will be kept under strict review and instead the priority is to maximise the value of free cash flows through a policy of *harvesting* the product.

Harvest means to minimise additional investment in the product to maximise the cash the division is spinning off. This cash can be used to support the Question Mark products as well as satisfy demands for dividends and interest.

Holding may also be used for early mature stage products where the market may repay the extra investment.

4. Dogs

Dogs come from two directions:

- former cash cows who have lost market share due to management's refusal to invest in it;
- former question marks which still had a low relative share when the market reached maturity.

In either case the BCG recommend divestment of the product or division. This can mean selling it to a rival, or shutting it down to liquidate its assets for investment in more promising business units.

In deciding whether or not to divest a dog the following considerations should be taken into account:

(a) Whether the dog still provides a positive contribution or not?
(b) What is the opportunity cost of the assets it uses? For example, the contribution from products that could be made using its factory or the interest on the net proceeds from liquidation of the SBU.
(c) The impact on the rest of the portfolio that would result from divesting the SBU. Is it essential to attract customers, for example?

In later versions the BCG introduced the notion of a *cash dog* to accommodate another strategy of creating a niche position for a dog product based on its nostalgia value (e.g. Mini cars) or because a group of loyalist customers remain who will continue to pay high prices for the product (e.g. hand-made cigars).

4.6.3 Directional policy matrix

Portfolio analysis seeks to guide management in the deployment of shareholders investment. The likely NPV from any investment undertaken in an industry will be the product of the competitive strength of the firm in that industry and the long-term outlook for the industry.

A limitation of the BCG matrix is its simple reliance on relative market share to denote competitive strength and on industry growth rate to imply future potential. Critics argue there is likely to be a lot more than these two involved in determining the value of an investment.

The directional policy matrix (or 'McKinsey/Shell Matrix' or the 'GE Business Screen' depending on which version you read) seeks to overcome this limitation by having the two broader axes as shown in Figure 4.5.

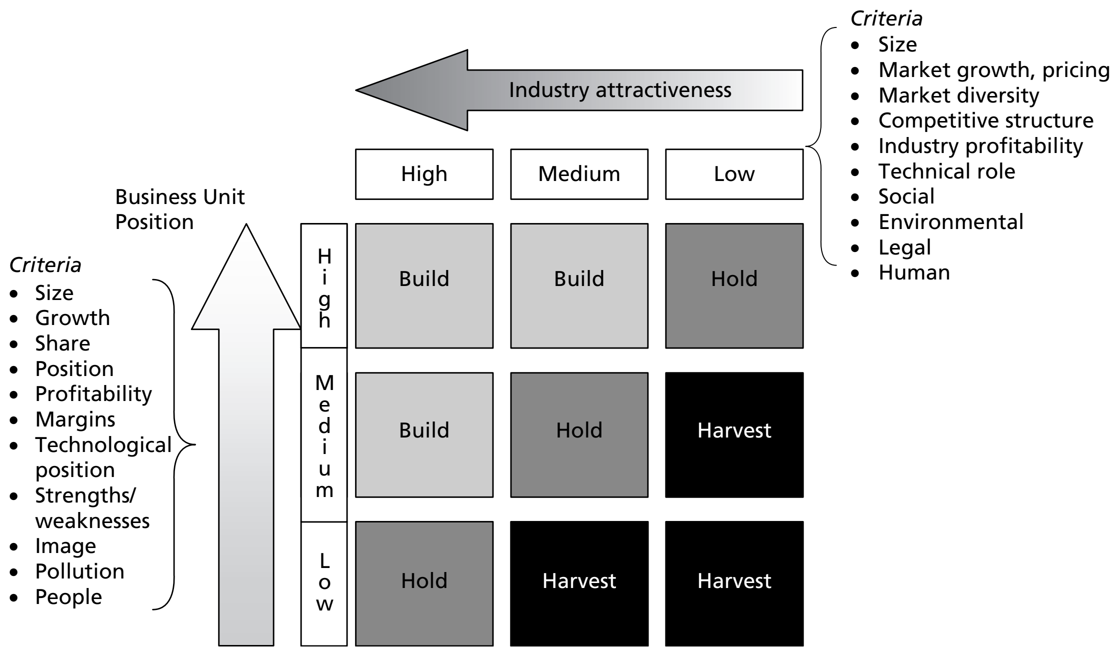


Figure 4.5 Directional Policy Matrix

Management consider each of the criteria for business unit position and for industry attractiveness and assign each business unit a score against it. Having considered all criteria, they calculate a general score for business unit position and for industry attractiveness and locate the division in the portfolio.

4.6.4 Other considerations in portfolios

Business portfolio analysis gained popularity in the 1970s. This was an age when diversification of the business (i.e. deliberately investing in dissimilar businesses and industries with the intention of reducing overall corporate risk) was in vogue as a strategy. Since the 1990s there has been a 'U-Turn' in strategic thinking in favour of honing a firm down to focus on core business and core competences (sometimes termed 'sticking to the knitting').

Diversified portfolios are frequently criticised for being:

- *Unnecessary*, because shareholders can diversify risk in how they construct their portfolio of shares.
- *Unwise*, because it frequently involves management in taking on lines of business they cannot run.
- *Value destroying*, because acquisitions rarely improve in value when purchased as part of a diversification strategy and shareholders mark down the prices of conglomerates due to not being able to evaluate the risks properly.
- *Self-serving*, because diversification is frequently undertaken to boost managerial prestige or provide opportunities for personal development at the expense of shareholders.

The scope of the techniques discussed above is also constrained by their origins as analogues to financial portfolio construction. In a share portfolio there are no business relationships between the assets held. This leads business portfolio analysis to ignore the interrelationships that might exist between business units or products. These could include:

- better utilisation and retention of a common customer base through offering a wider product range (e.g. supermarkets having divisions offering clothes, utilities and petrol in addition to food);
- better harnessing of distinctive competences such as technology (e.g. a plastics manufacturer operating divisions making data media, food packaging, adhesive tapes for parcels and sutures for use in first aid and hospitals);
- spreading of fixed costs across a more diverse range, and therefore greater volume of, products (e.g. a turbine manufacturer using its research and development and production technologies to make aero engines, turbines for power stations, marine engines and guided weapons);
- a division or product may be a small strategic marker to reserve the firm a place in a market with much greater potential (e.g. a firm having a small sales office in a developing economy which can be used later as a bridgehead for more business if the economy develops).

You should be able to demonstrate in your TOPCIMA exam answer that there are always advantages and disadvantages to diversification and you should come to a reasoned conclusion as to why you consider that diversification in the case that you are answering is recommended or not, with well reasoned and justified recommendations.

4.6.5 Using portfolio analysis in TOPCIMA

When assessing the businesses or products in the TOPCIMA pre-seen you should consider the following issues:

- How well are the businesses performing in their own right?
- Is the investment strategy being followed by management appropriate to the position of the division in the portfolio?
- Are there other strategic reasons for keeping any under performing businesses in the portfolio?
- Is the firm excessively dependent on a particular product or business division and what risks is this division subject to?

In your final report you should be prepared to back up recommendations for disposal, acquisition or development of a business unit or product by reference to its position in the portfolio and the strategic logic of your recommendation. You should additionally consider whether the proposed strategies do fit with the company's core competences or not and whether management has sufficient experience to manage the proposal.

Use the BCG in an appendix to identify the different products, divisions or businesses of the firm in the case.

4.7 Industry analysis

(1) Industry analysis seeks to understand the factors most likely to have an impact on the firm's present and future success. This in turn will affect:
  - the present financial results of the firm;
  - the likely success of its current or proposed strategies;

- its future financial returns and therefore ability to keep shareholders and other providers of finance satisfied;
- the decisions it must take to avoid threats or to capitalise on opportunities.

(2) In the TOPCIMA exam you are required to apply the following models specifically to the industry of the firm(s) in the pre-seen. Some of the data you need may be in the pre-seen material, and the rest you should research for yourself. You should also familiarise yourself with events in the industry by reading the business pages of the quality press.

4.7.1 Industry life cycle stage

A generalised account of the stages through which an industry passes from birth to death (Figure 4.6). The factors that drive industries through the life cycle are:

- *Technical innovation*: This creates new industries but at the same time can render old industries obsolete (e.g. as DVD grew so VHS declined).
- *Adoption of the product*: For example, in 1995 mobile phones were a growth product with about 15% of persons in developed economies owing a handset. By 2005 it will be a mature industry with about 85% penetration.
- *Fashion and taste for the products of the industry* (e.g. off-road MPVs were a growth product during the mid-1990s but by the end of the decade they had given way to small cars and pickups as the fashionable vehicle to own).
- *Legislation and government policy*: For example, the liberalisation of financial markets in the UK created a boom in personal financial services from the mid-1980s. The market declined following a series of miss-selling scandals and the introduction of a tighter regulatory regime in the late 1990s.

To analyse the industry(s) covered by your TOPCIMA pre-seen material you should identify

- which stage the industry is at;
- how durable the industry is and whether the forces that developed it are likely to decline or supersede it soon;
- the financial and strategic implications to management of the current and future stages of the industry.

The main characteristics of each stage are explained in the following sections.

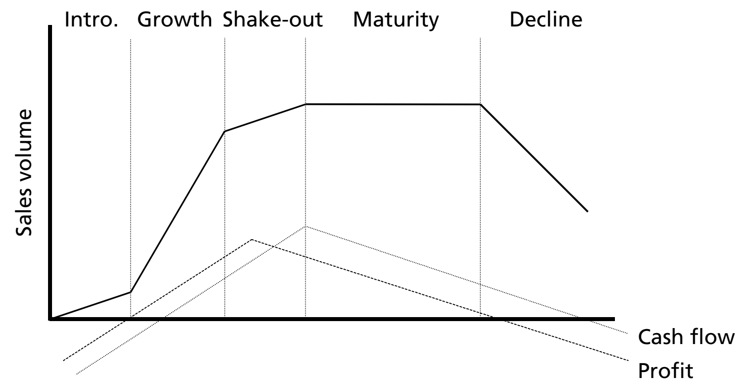


Figure 4.6 The product life cycle

1. Introduction stage

A new product and hence will be unfamiliar to the market. Firms in this stage of an industry will need to invest considerable resources in developing and launching the product (including promotion, stock-building, staff training, etc.) without any guarantees that the product will succeed. Therefore

- strongly negative cash flows,
- high risk due to product novelty,
- single or limited product range to avoid confusing the customer,
- few if any competitors willing to take similar risks,
- high need to induce recognition and trial of the product,
- very high costs per customer.

2. Growth stage

Rapidly increasing sales due to acceptance of the product and a 'bandwagon effect' developing as buyers copy each other. The substantial investment needed to keep up with demand depresses cash flows. The most significant feature of this stage is increasing complexity as rivals enter the market and the range of products widens as producers seek to attract customers from each other with novel features

- negative cash flows,
- reducing risk due to product having achieved acceptance,
- market entry by 'copycat' or 'me-too' producers,
- growth sustained by attracting additional types of customers, sometimes through reductions in price or new product features,
- marketing focus switches to seeking to differentiate the firm's product and brand in the minds of customers.

3. Shakeout stage

The sales growth rate turns down (i.e. becomes ex-*growth*) due to the market having become saturated. Initially there will be an imbalance between supply and demand because participants will not have forecast the downturn.

- overcapacity creates stimulus for price-cutting;
- number of producers reduce due to failures or industry concentration;
- peak levels of profitability.

This is usually resolved by a wave of product or business failures or amalgamation of businesses through takeover or merger.

4. Maturity stage

Purchases settle down into a pattern of repeat or replacement purchasing. For fast-moving consumer goods (FMCGs) like canned foods, soft drinks and confectionery these may be habitual purchases. For durables such as televisions, computers, cars and furniture the frequency of re-purchase will be influenced by changing technical features, fashions and wearing-out of old product. The main features will be

- Reduction in investment in additional capacity leads to improved current cash flows.
- Gradual price decline as firms compete against each other for a larger share of a fixed-size market. During this stage buyer and supplier power (Porter) increase because of the large number of industry members to choose between.

- Firms seek to capitalise on product loyalty by launching spin-off products under the same brand name.
- Gradual fragmentation of the market as firms seek out buyer groups to monopolise with special value-added features on products (e.g. premium quality foods in addition to regular and budget lines).
- Peak profitability and least risk.

The later phases of the mature stage are often characterised by a second wave of consolidations as some firms pursue industry rationalisation to restore profitability. This has been noticeable in recent years in industries such as oil and banking.

5. Decline stage

The industry declines into obsolescence as technically better substitutes replace it. The existence of such substitutes will cause sharp profit reductions amongst producers of the product. Many firms will have already found alternative industries whilst those remaining will be looking for an orderly way to exit the industry:

- falling profitability and marginal cash flows;
- firms seek to leave industry.

There may be a last-ditch wave of consolidations amongst the few remaining firms in the dwindling industry.

When you are researching the pre-seen material for the case that you will be sitting, you should understand the industry life cycle for that industry. For example, the May 2005 TOPCIMA exam on the recycling industry, it would be relevant to comment that this industry is relatively new and is still in its growth stage.

4.7.2 Five forces analysis

This analysis was developed by Professor Michael Porter (Figure 4.7). Argues that competition in an industry is determined by its basic underlying economic structure, the five competitive forces.

The collective strength of these forces determines the profit potential, defined as *long-run return on invested capital*, of the industry.

Porter identifies three successful types of strategy (or *generic strategies*) to deal with these forces:

1. *Cost leadership*: Management aim the cut the costs of providing services and products to below that of rivals.
2. *Differentiation*: Management aims to escape the pressure of price competition by developing product features or reputation of premium perceived value.
3. *Focus*: Improve long-run ROI by avoiding the margin pressure and high investment needed to serve a mass market. Instead seek to dominate a niche market.

To analyse the industry(s) covered by your TOPCIMA pre-seen material you should identify:

- whether the industry is presently subject to forces of significant strength;
- whether any of the forces are likely to grow or decline in strength in the coming years;

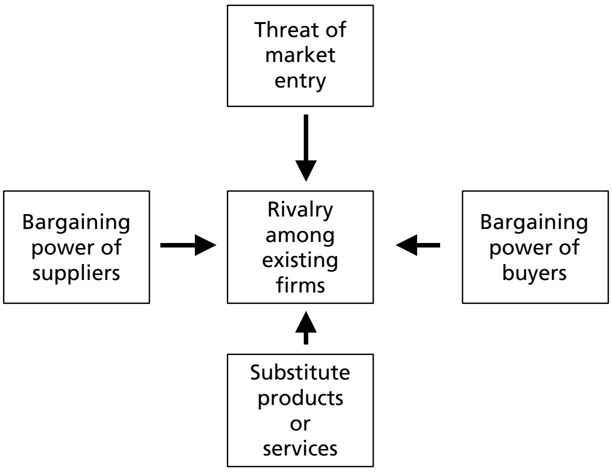


Figure 4.7 Porter's five forces model (adapted from Porter 1980)

- the consequences of the above for long-run profitability and therefore the value of the firms in the industry;
- whether management is or can adopt competitive strategies to avoid the power of these forces and so restore its profitability.

You should be prepared to use Porter's terminology in your final report on exam day. A clear understanding of Porter's five forces and its application to the material will be rewarded providing its relevant.

Threat of entry

Influenced by

1. *Economies of scale* available to incumbent firms giving them the ability to charge prices below the unit costs of new entrants and hence render them unprofitable.
2. *Product differentiation*: Strong brands, unique product features or established good relations with customers that it will be hard for an entrant to overcome.
3. *Initial capital requirements* that exclude poorer entrants or ones not prepared to take the risk.
4. *Switching costs*: One-off costs for a customer that deter them from switching to the new rival.
5. *Access to distribution channels* where established firms have locked in distributors and retailers by deals or vertical integration.
6. *Government policy* forbidding imports or preventing rival firms from setting up in competition.

Rivalry amongst existing competitors

Cut-throat competition reduces profits for all in the industry. Porter suggests that the factors determining competition are:

1. *Numerous rivals of various sizes* encourage individual firms to reduce price to grab share.
2. *Low industry growth rate*, where growth is slow the participants will be forced to compete against each other to increase their sales volumes.
3. *High fixed or storage costs*: sometimes called operating gearing it puts pressure on firms to increase volumes to take up capacity.

4. *Low differentiation or switching costs* mean that price competition will gain customers and so be commonplace.
5. *High strategic stakes* where a lot depends on being successful in the market so firms fight for a share and to survive.
6. *High exit barriers*: Economic or strategic factors making exit from unprofitable industries expensive such as costs of redundancies or scrapping of dedicated assets.

Pressure from substitute products

Products from a different industry that satisfy the same need. The power of substitutes depends on:

1. *Relative price/performance*: If performance is similar but price is lower it is more of a threat.
2. *The extent of switching costs* (see above).

Bargaining power of buyers

Buyers use their power to trade around the industry participants to gain lower prices and/or improvements to product or service quality. Their power will be greater if:

1. *Buyer power is concentrated in a few hands*: This denies the industry any alternative markets to sell to if the prices offered by buyers are low.
2. *Products are undifferentiated*: This enables the buyer to focus on price as the important buying criterion.
3. *The buyer earns low profits*: In this situation they will try to extract low prices for their inputs. This effect is enhanced if the industry's supplies constitute a large proportion of the buyer's costs.
4. *Buyers are aware of alternative producer prices*: This enables them to trade round the market. Improvements in information technology have significantly increased this by enabling a reduction in 'search costs'.
5. *Low switching costs*: In this case the switching costs might include the need to change the final product specification to accept a different input, or the adoption of a new ordering and payments system.

Bargaining power of suppliers

The main power of suppliers is to raise their prices to the industry and hence take over some of its profits for themselves. Power will be increased by

1. *supply industry dominated by a few firms*;
2. *the suppliers have proprietary product differences*: unique features making it impossible for the industry to buy elsewhere.

4.7.3 Competitive position of the firm: three generic strategies

For a private sector organisation the object of competitive strategy is to maximise shareholder wealth. This requires that the firm makes a better long-term return on shareholders invested capital than the return achieved by rivals in the industry. Porter's three generic strategy model is a useful starting point for understanding a firm's competitive strategy (Figure 4.8).

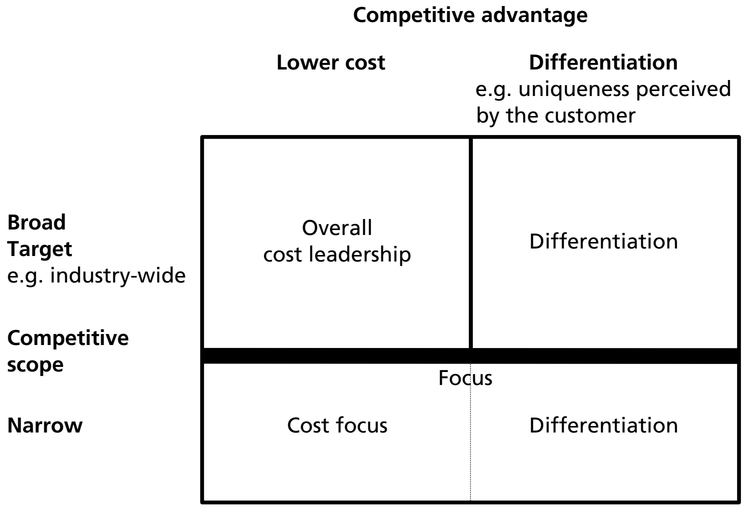


Figure 4.8 Porter's three generic strategies model (adapted from Porter 1980 and 1985)

Porter's strategic prescriptions are rooted in his analysis of the impact of five competitive forces on a firm's profits. He argues that a firm must adopt a strategy that combats these forces better than the strategy developed by its rival if it is to deliver superior shareholder value. According to Porter (1980) 'there are three potentially successful generic strategic approaches to outperforming other firms in an industry'. He terms these:

1. *Overall cost leadership*: Low cost relative to competitors.
2. *Differentiation*: Creating something that is perceived industry-wide as unique.
3. *Focus*: Serving a narrow strategic target more effectively than rivals who are competing more broadly.

Management must dedicate themselves to *just one* of the three types of strategy to risk dilution of their competitive advantages. This is the only way that firms can out perform rivals and deliver high or satisfactory returns to shareholders.

1. *Lower cost*: Achieve the industry's 'lowest delivered cost to customer' by analysis of the entire *value chain* to achieve substantial cost savings.
2. *Differentiation*: Premium perceived value in the eyes of the buyer.
3. *Focus*: Sometimes called a *niche* strategy this relies on the firm being able to address itself better to a segment of an industry than its broader scope rivals can. This enables smaller firms to survive by exploiting one of two failings by rivals:
   - *Underperformance*: They do not understand or make a product that fully meets the needs of the buyer in a segment.
   - *Overperformance*: The broad scope competitor is giving the segment more than it really requires and in the process is incurring extra costs.

Stuck in the middle: This competitive position is not recommended by Porter. Management's failure to make the firm either a differentiator or a cost leader leaves the firm 'stuck in the middle' both unable to access the high-volume customers who demand low costs and also the high margin customers who may be put of by its mass market offerings.

In TOPCIMA you can use Porter's model in several ways:

1. to help analyse the competitive position of rivals;
2. to analyse the current competitive position and strategy of the firm;

3. to decide on a competitive strategy for the firm;
4. to analyse the risks of the present strategy.

Porter suggest that each generic strategy carries intrinsic risks.

(a) Differentiation:
- brand loyalty may fail if the cost differential between it and the cost leader becomes too great;
- buyer becomes more sophisticated and needs the differentiating factor less (such as ease of use or technical expertise);
- imitation reduces the differentiation of the brand.

(b) Cost leadership:
- technological change could eliminate low cost base or past learning effects;
- imitation of low cost techniques by industry entrants;
- product becomes out-of-date because firm won't invest in it;
- domestic inflation or exchange rate changes destroy cost advantage at home and abroad.

(c) Focus
- broad target firm develops economies of scale which overtake the cost focus player;
- differences between needs or tastes in the market narrow, for example, the invention of the word-processor destroyed the niche strategies of typewriter manufacturers;
- competitors find sub-segments within the focus segment and out-compete the firm;
- segment collapses and leaves the firm with no other source of earnings.

! In the May 2003 Sparkle case on sports clubs, discussion on Porters model and differentiation would have earned good marks for understanding this theory and applying it to the case.

4.7.4 PEST Analysis

This model segments the environment of the industry into:

Political/Legal	Laws affecting the industry and political support for it
Economic	Economic outlook, costs of borrowing, exchange rates
Social	Social norms, fashions and make-up of the population
Technological	Impact of technology on costs and demand patterns

An alternative categorisation is DEEPLIST standing for:

Demographic	Composition, location and size of population
Ecological	Concern over preservation of natural environment
Economic	As above
Political	As above
Legal	As above
Informational	Impact of networks on work, leisure and trade
Social	As above
Technological	As above

This latter typology has the advantage of drawing particular attention to the some significant sources of turbulence in the modern business environment such as aging population and that coming from concern over the natural environment plus the impact of the third industrial revolution: that based on information technology.

It is not possible to cover all possible applications of PEST (or DEEPLIST) to industry in a Toolkit like this. You will need to look at the pre-seen and research these factors for yourself.

4.7.5 Globalisation

Globalisation refers to the ability of firms from any country to exploit markets or productive resources in other countries.

In the TOPCIMA exam this means that the industry you are faced with may be an industry in which there are increasing competitive challenges coming from abroad. Or perhaps major opportunities available to the firm in foreign markets, or the ability to transfer aspects of production abroad to gain skills or save costs.

The main drivers for globalisation are:

1. economic and political realignments (e.g. EU, NAFTA, MERCOSUR, ASEAN, APEC, etc.) creating zones of free trade between their memberships;
2. the impact of the World Trade Organisation in its policing and development of the General Agreement of Tariffs and Trade to reduce trade barriers through stamping out protectionism;
3. improved communications (telecommunications, travel and common languages) enabling easier co-ordination of offshore operations;
4. increased mobility of staff across national boundaries, often as employees of global firms. This transfers tastes globally;
5. convergence of tastes and lifestyles, such as due to the influence of common cultural drivers such as technologies, media, music and sports.

You should be prepared to assess the following factors:

1. the power of the drivers making the industry in the pre-seen into a global one;
2. the potential for firms from abroad to invade the market in the pre-seen;
3. the potential for the firm(s) in the pre-seen to penetrate foreign markets;
4. the potential for the firm(s) to move parts of its operation offshore to save costs and boost margins;
5. the danger that the firm(s) in the pre-seen may find themselves having to cope with competition from new rivals with very different technologies, working methods or levels of costs.

4.8 Conducting a position audit

CIMA defines a position audit as

Part of the planning process which examines the current state of the entity in respect of:

- resources of tangible and intangible assets and finance,
- products brands and markets,
- operating systems such as production and distribution,
- internal organisation,
- current results,
- returns to stockholders.

CIMA: Management Accounting Official Terminology

The position audit will be the basis of the marks allocated under the prioritisation criteria and will be worth around 10 marks. Your report should commence with a corporate appraisal of the company that includes the main points from the position audit. It is very important that you prepare a position audit that includes the unseen material given on the exam day.

4.8.1 The Ms model

A simple model that divides the items in a position audit into factors beginning with 'M'

Manpower	The human assets of the firm such as their availability, skills, morale, relative costs and flexibility (e.g. ratio of full-time to flexible staff).
Management	The quality, expertise and experience of the top team. Is the firm well managed and does it have the skills and vision it will need to progress? (Section 4.9 explains how to conduct a management audit for TOPCIMA.)
Money	The financial health of the business and the support management receive from its shareholders and bank. Key factors here are likely to be current results and the availability of capital to finance investment (Section 4.5 described how to conduct a financial appraisal for TOPCIMA.)
Make-up	The organisational structure and culture of the firm. For example, is the firm centralised or not and how willing are business, unit managers and other staff to take responsibility? (Section 4.9 explains how to conduct an organisational audit for TOPCIMA.)
Machinery	This covers the physical assets of the business. For example, their flexibility and the relative costs and quality of what they produce. In the case of property assets it would include location, appearance and functionality.
Methods	The processes adopted by the business. Issues here could include the extent to which activities are outsourced and whether the firm uses capital or labour intensive production processes. Just-in-time systems are an important business method in many markets.
Markets	The firm's products and the markets it currently serves. The position audit should examine the relative quality and position of the firm's outputs and the extent to which it is exposed to threats from buyer power.
Materials	This covers the relationship the firm has with its suppliers. In modern manufacturing there has been a trend towards 'partnering relationships' with suppliers where the firm agrees not to shop-around for lower prices providing its suppliers work with it to improve quality and to reduce inventory costs. Some managers would regard reliance on a single supplier as a weakness and instead hope to see that the firm sources from a wide number of suppliers in order to enjoy better prices.
Management information	This evaluates the quality and timeliness of the information available to managers (and others) and its suitability for basing their business decisions on. Factors to consider here would be whether it is suitably structured to allow managers to see the effects of their actions, its intelligibility to the user and whether it contains any environmental and competitor information. As a CIMA candidate you should expect to be asked to pass judgement on the quality of the management accounting information available (e.g. cost and profit analysis). This is covered in more detail in Section 4.11.2.

4.9 Organisational and managerial audit

The need for you to assess the organisation and its management team may arise in TOPCIMA for several reasons:

- for a firm with a poor financial and competitive position it will help you decide how much of this is down to poor organisational structure or management and, if so, where to make changes;
- to assess the vulnerability of the business to the loss of particular individuals;
- to assess the suitability of the organisational structure and management team to taking the business into the next stage of its development;
- to recommend changes to the organisational structure and management team as part of a more general strategy.

4.9.1 Elements of organisations

There are numerous theories on what makes up an organisation and distinguishes one from another. Use the headings of the theories as check lists for things to consider in coming to an understanding of organisations.

Five systems of control, if configured properly, will help the organisation achieve its goals:

- *Task*: The ways job roles are defined and constructed. Distinctions here include between having 'programmed tasks' and 'un-programmed tasks'. The former are closely controlled by rules or the technology (e.g. factory production or a call centre) whilst the latter requires that the operative exercise more discretion (e.g. a professional consultancy or provision of an education service). The former is closely controlled and can permit low cost operation but may result in a lack of *flexibility* in an organisation such as in catering for non-standard requirements or when reducing headcount during bad times because staff cannot cover for absent colleagues.
- *People*: The quality and numbers of persons employed and how they interact. Under this heading will come considerations of skills, culture and the balance between full-time and flexible staff. People factors drive costs and quality, the ability to cope with growth or change and the costs (through redundancy or training) of changing the firm's direction.
- *Structure*: How the firm fits together. The basis building blocks are provided by divisionalisation: how teams are grouped (e.g. by function, region, customer, etc). Once grouped the next question is 'who-whom?': how do they report to management and what sorts of span of control and scalar chains result. This leads on to considerations of where power lies and whether it is centralised (e.g. at head office so that decisions are reserved for senior management) or whether it is decentralised (in which case business units are powerful and staff are empowered). Finally the systems of control should be considered. To what extent does this organisation adopt bureaucratic techniques of rules, standard operating procedures and formal meetings to decide things? Does it instead permit discretion to work teams in deciding how to do their work?
- *Reward systems*: How are individuals and teams rewarded and for what? Consider also whether the reward system is stick or carrot: primarily one of recognising high achievement or one that threatens low achievers. This is part of the *culture of control*. The dimensions to look for here are: whether rewards are for individual or group performance; whether they are primarily financial or whether instead they promise security, fulfillment and progression; whether they are given for short- or long-run performance; and whether

they are within the control of the person receiving them. Managers and operative staff can be expected to do what they get rewarded for doing and avoiding what they get punished for. So to achieve a certain type of business performance (say cost consciousness, growth, quality, customer service or innovation) the reward system must encourage it.

- *Information and decision processes*: A reflection of power and empowerment. Who knows what, who takes which decisions and what processes are used? For example, the information and decision processes of a small entrepreneurial organisation will be the head of the entrepreneur with little consultation or formality of process. Very flexible and low cost but also runs the risk of wrong decisions and poor communication of decisions. A larger firm may use committees, formal planning and budgeting to enable detailed implementation and control. As a consequence it may sacrifice dynamism. The way a firm uses IT/IS will also have impacts on this aspect of organisation.

4.9.2 Chandler: structure follows strategy

According to Chandler organisations progress through four broad organisational forms as their strategies develop:

In TOPCIMA you should apply these models to the firm(s) in the pre-seen material and be prepared to consider and discuss:

- the *appropriateness* of the organisational form of the business to the strategy it is adopting, or to the strategy that you are recommending;
- the risks and drawbacks of the structure it is adopting at present.

Simple (entrepreneurial) structure (Figure 4.9)

Formation stage of the organisation is principally concerned with *resource gathering* such as getting initial capital and assets and building a team.

Usually the entrepreneur has a key skill set (e.g. solicitor, plumber, lorry driver, printer, farmer) which forms the core of business in its early days. Many small businesses remain at this stage.

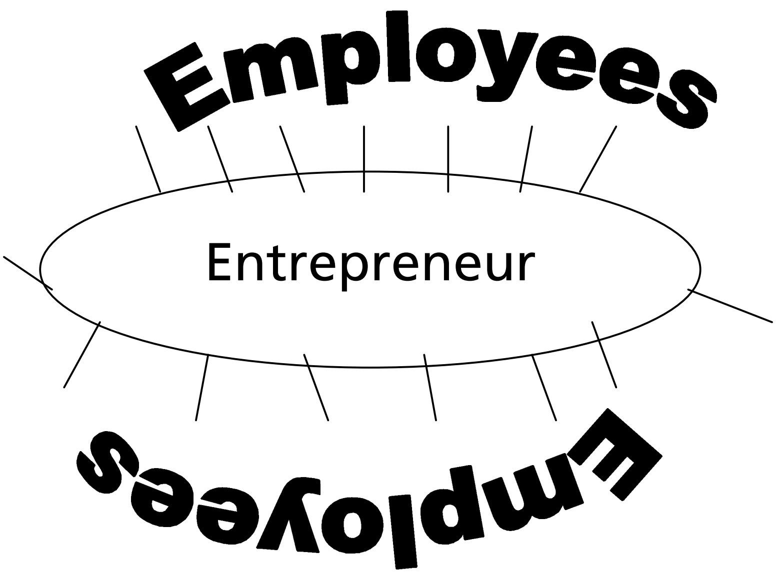


Figure 4.9 Simple/entrepreneurial form organisation

Advantages	*Drawbacks*
Suits personal qualities and personality of entrepreneur	Lack of specialist managers leads to errors or waste
Avoids expensive control systems	Growth limited to personal capacity and vision of entrepreneur
Able to respond quickly to developments	Unattractive to external investors due to high dependence on entrepreneur
Entrepreneur understands the business	Lack of checks and balances from broad leads to costly errors in decisions

Functional structures

Growth and rationalisation stage. Business growth overburdens entrepreneur who gradually factors out parts of their role (say sales, then accounts, next operations) to other more specialist staff. This eventually creates entire business functions such as a finance function or a marketing function.

Each function will develop information and control systems for what it does and will become the subject of budgetary control systems (Figure 4.10).

Advantages	*Drawbacks*
Permits senior management to focus on strategic issues	Senior managers overburdened with operational matters and may not use their management skills fully
Board in touch with and co-ordinates all functions behind strategic decisions	Senior management may neglect strategic issues in favour of running their teams
Simplifies control by providing clear structure of responsibility	Co-ordination between functions difficult due to the build up of 'functional silo mentality'
Specialists at senior and middle management level	Danger of functional interests disrupting corporate decisions
Clear career paths enables organisation to attract and retain good staff	

Multidivisional structure

Development stage in which separate business divisions are set up. This is to cope with greater physical distance from corporate centre (e.g. off-shore) or greater diversity in products, markets or processes to be managed.

This leads to need for additional control systems including:

- strategic planning systems,
- multidivisional control measures (e.g. ROCE, sales growth, etc.) (Figure 4.11),
- management recruitment and development.

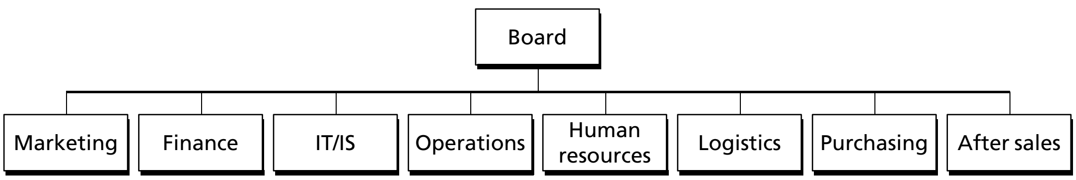


Figure 4.10 Functionally structured organisation

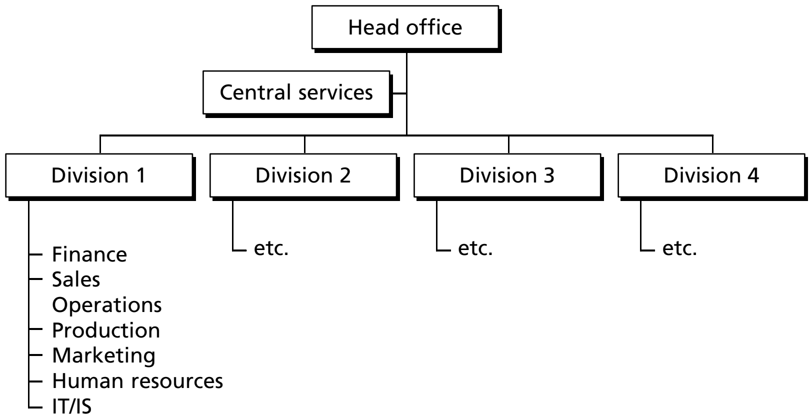


Figure 4.11 Multi-divisionally structured organisation

Advantages	*Drawbacks*
Enables management to concentrate on its individual business area	Dynamic tension and confusion over responsibility versus autonomy
Easier measurement of unit performance because it has separate sales and costs	Conflict between divisions likely: for example trespassing on each other's business areas
Leaves corporate parent free to look after strategy	Problems over basis of inter-trading between divisions (transfer pricing) and allocation of central costs (overheads)
Provides a pool of general management expertise for the future	Co-ordination problems if too many divisions

Holding company structure

Diversification leads to the development of conglomerate firms and joint venture partnerships (Figure 4.12).

Advantages	*Drawbacks*
Low central overheads due to autonomy of units	Exposes corporate centre because it does not seem to add value. This invites it to meddle to show its value.
Spreads risks of holding company because its involved in several businesses	Risk of divestment of individual businesses reduces morale and trust
Easy to sell off divisions because they are separate businesses	Hard to pool skills and learning throughout the group
Facilitates decentralisation	No attempt to leverage group assets (or synergies) such as common technologies or customers
Avoids high degree of central recharges and transfer prices common to divisional form organisations	Difficulties of maintaining central control over the individual strategies of the divisions

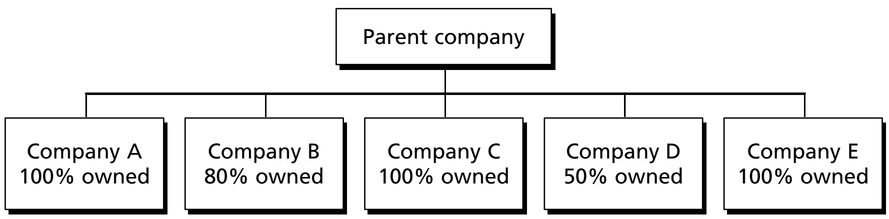


Figure 4.12 Holding company structured organisation

Many of the TOPCIMA cases explain the current organisational structures and any recent changes. As part of your research on the pre-seen material you should understand the current organisational structure and any improvements or changes that could be made to enable the group to operate more effectively. These recommended organisational changes should be included in your answer, if they are still relevant after you have taken into account the new material presented to you in the unseen material on exam day.

4.9.3 Greiner's model of organisational growth

Greiner (1972) adapts an 'evolution of species' view of organisations to suggest that change will occur episodically as an organisation grows and develops as shown in Figure 4.13.

The rate of evolution is determined by the growth rate of the industry in which the firm operates. The points to note for TOPCIMA are:

- Firms will only grow if they are able to overcome the crises at each stage. In the pre-seen consider which stage the organisation is at and whether there are any signs of the end-stage crisis. Does management have what it takes to overcome it?
- The role of the corporate centre changes as the stages pass. At first it is the well-spring of creativity, next a leader, then a controller of devolved divisions, this is followed by its becoming a co-ordinator of powerful units and finally it merely facilitates collaboration. Once again, in pre-seen does the corporate centre have the right competences and approach for what it must do? What are the implications for corporate centre, its control systems and the senior managers mentioned of the changes to the next stage?

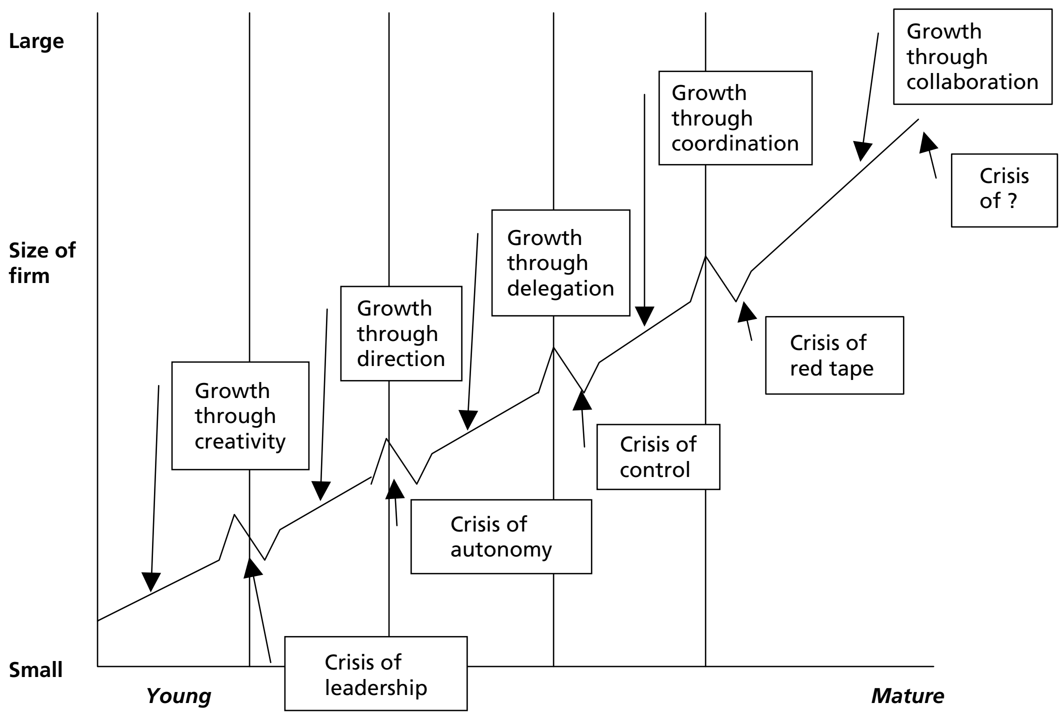


Figure 4.13 The five phases of growth

Source: Greiner 1972

4.9.4 Modern organisational forms

Since Chandler's work several additional forms or organisational arrangement have been identified.

Matrix organisations

These were developed as a response to the rigidity of conventional divisionalisation.

Management leaves the current structure in place and superimposes on it a team of additional managers with special focuses. Typically these will be key account managers, brand or product line managers and special project managers. The result is usually drawn as a net (Figure 4.14).

The task manager has the authority to call upon support from the functional managers to carry out the project task. This includes the right to demand the support of staff from each department, intervene in decisions and affect budgets. The power of the task manager is entirely dependent on the support they receive from top management and their personal ability to build consensus. The term 'matrix structure' is misleading because in practice the effect seems to be to create the chaos of ambiguous roles and muddied lines of reporting with inevitable conflict.

Advantages	*Drawbacks*
Better co-ordination of functional divisions	High degree of conflict between authority of task manager and autonomy of divisional manager
Task orientation overcomes functional rivalry	Unclear job and task responsibilities
Direct contact at meetings replaces bureaucracy	Unclear cost and profit accountability
Provides clear point of responsibility for the project	Lack of career for task manager who is outside of conventional hierarchy and depends on patronage of senior management

Virtual organisations

Sometimes called *network organisations* this form stems from the liberating potential of modern network information technologies for organisational arrangements (e.g. Davidow and Malone, 1993).

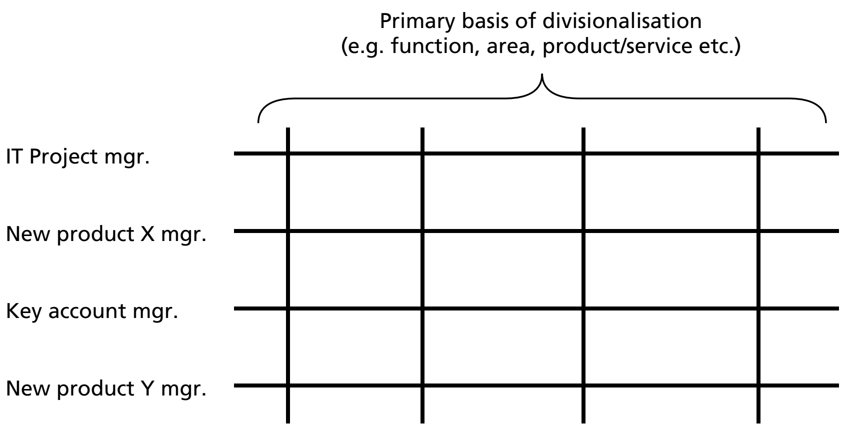


Figure 4.14 Specimen matrix structure

Modern networks link remote sites and this provides management with the opportunity to abandon the 'all under one roof' approach to employment and supervision that grew up with the factory system at the time of the industrial revolution of the late 18th century and intensified with the fashion for vertical integration of operations during the 20th century.

Common features are:

- Fixed functional departments abandoned in favour of multi-disciplinary teams focused on products, customers or aspects of the value chain. For example, a management accountant may cease to work for the finance function and instead become part of the customer support team.
- Team members may not be in physical proximity but rather communicate via firm's intranet. Their actual locations may be in different parts of the same building, in different countries or even working from home (teleworking).
- Some reliance on outside human resources such as special consultants or contract operative workers to make skills and costs more flexible.
- Factoring-out of the value chain via outsourcing to partners linked together by extranet technologies. This permits sharing of core competences and shifts fixed costs and risks to where they can be born more cheaply.

Advantages	*Drawbacks*
Greater organisational flexibility (costs and skills) due to abandonment of fixed roles and functions	Problems of maintaining control over remote staff
Improvement in customer end service due to replacing generalist skills of firm with a partnership based on the core competences of the partners	Erosion of firms core competences and culture as it becomes a network of contactors
Improvement in organisational learning through close collaboration of the networks. This stimulates innovation	Costly forms of control needed (e.g. legal contracts with partners)
	Danger of loss of confidentiality over firms operations
	Loss of security for staff and management may lead to loss of key personnel

4.9.5 Conducting a management audit

In the pre-seen material for past CIMA Case Studies there has often been quite detailed biographies of the management concerned. Candidates have been required to make assessments of them and to make recommendations for changes. TOPCIMA is likely to continue this tradition. Additionally your recommendations should include any proposed changes to the board or management team such as recruitment of non-executive directors or better senior managers (such as marketing, finance, etc.).

Assessing the top team – Belbin types

Belbin tells us that a top performing management team should contain a sufficient mix of managerial types to cover the following roles:

Type	*Features*	*Strengths*	*Weaknesses*
Company worker	Conservative, dutiful, predictable	Organising ability, common sense, hardworking	Inflexible, dislikes new ideas
Chairman	Calm, self-confident, controlled	Welcomes contributors. Strong sense of objectives	Ordinary in terms of intellect and creativity
Shaper	Highly strung, outgoing, dynamic	Drive and readiness to challenge complacency and Inertia	Prone to provocation, irritation and impatience
Plant	Individualistic, serious-minded, unorthodox	Genius, imagination, intellect, knowledge	Up in the clouds, ignores practical details
Resource investigator	Extrovert, enthusiastic, communicative, curious	Able to contact people and explore new ideas. Responds well to challenge	May lose interest once the initial fascination has passed
Monitor-evaluator	Sober, unemotional, prudent	Judgement, hard-headedness, discretion	Lacks inspiration or ability to motivate others
Team worker	Socially orientated, mild, sensitive	Responds to people, promotes team spirit	Indecisive at moments of crisis
Completer-finisher	Painstaking, orderly, conscientious, anxious	Follow through, perfectionism	Worries about small-things Won't let-go
Specialist	Single-minded, self-starting and dedicated	Provides knowledge & skills in short supply	Dwells on technicalities to frustration of others. Overlooks 'big picture'

For TOPCIMA consider:

- does the top team have the right mix of people?
- are the people with the important skills in the right positions to be able to influence things?
- what additional skills are needed or need to have more influence?

Management style

Conventional wisdom might suggest that small businesses are run by *leaders* whereas large corporations are controlled by *managers*. It seems to suggest that in a large corporation the systems employed somehow become depersonalised with less opportunities for particular individuals to make their mark on events.

Modern thinking (and research) demonstrates that this is a myth of the textbooks. The top team, and in particular the CEO, do have the ability to affect things in a positive direction for the firm (e.g. Rupert Murdoch at News Corporation) or sometimes with less beneficial effects (e.g. Lord Simpson at Marconi).

Reddin proposes a 3D Model of managerial effectiveness (Figure 4.15). Based on the familiar Blake and Mouton grid it goes beyond being merely a typology of styles and instead focuses on potential effectiveness.

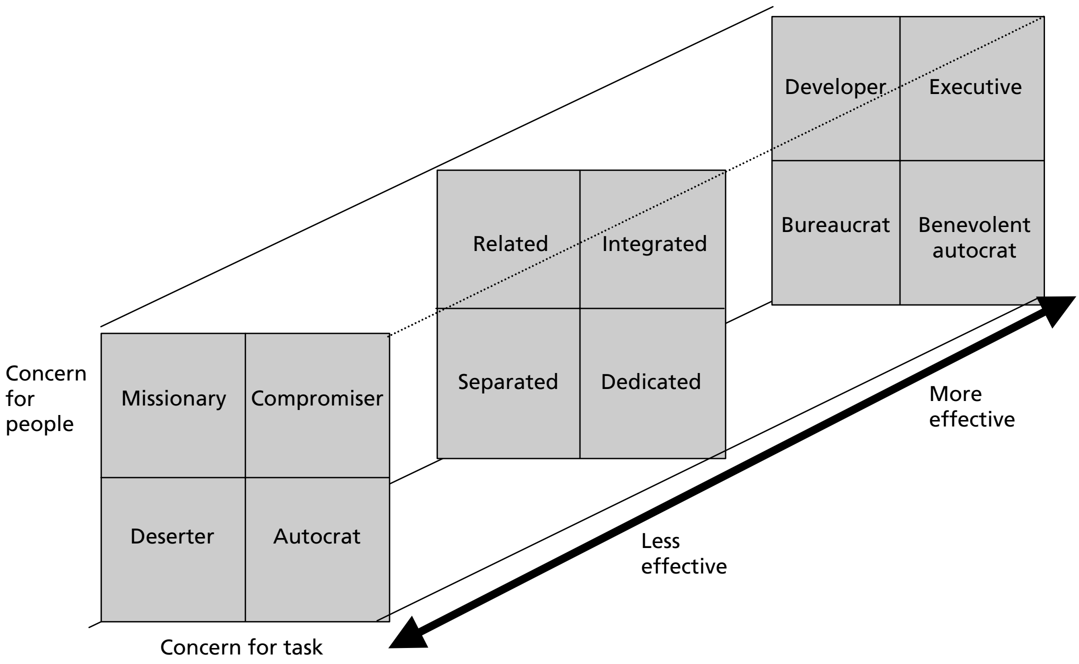


Figure 4.15 Reddin's three-dimensional model

Understanding the effectiveness of management is the skill you will need to demonstrate to pass TOPCIMA.

Because TOPCIMA is not another examination in management theory like *Organisational Management and Information Systems* or *Integrated Management* (*Organisational Management* under the pre-2005 syllabus) you will not be required to describe this theory. Instead let us look for the symptoms and circumstances that cause a style to be effective or ineffective.

1. *Bureaucrat*: Conscientious manager who is mainly concerned with upholding rules and procedures to control situation. Only effective if the organisation is already successful and the business environment is not changing.
2. *Benevolent autocrat*: Knows how to get what they want without causing resentment. Low concern for people. This would be effective if the contribution and commitment of staff were of low intrinsic value to the business.
3. *Developer*: High concern for relationships and developing people based on trust. This would be effective in a knowledge-based business but costly in any other.
4. *Executive*: Manager seen as a good motivator, favours team management, treats staff as individuals and sets high standards. Clearly an ideal style for all situations.
5. *Deserter*: Lacks involvement and is passive or negative. Indefensible approach of no value to the business and should be eliminated.
6. *Autocrat*: Lacks confidence in others, unpleasant and only interested in immediate tasks. This slave-driver may think they are effective but only if they ignore the costs of sabotage, high staff turnover, control systems and missed business opportunities that no-one told them about.

7. *Missionary*: Mainly interested in preserving harmony. Danger that this precludes any change or downsizing. Should remember that 'nice guys (and firms) finish last'.
8. *Compromiser*: Poor decision maker, swayed by pressure and avoids hard decisions. Likely to leave the firm several steps behind the market and behind rivals.

Strategic cultures

Culture is the patterns of values and beliefs in the organisation. Cultures will tend to both influence structure and be sustained by the structure. Culture can influence strategic decisions.

Miles and Snow (1978) identify four types of strategic culture which they believe stem from the attitudes and behaviour of top management.

(a) *Defenders*: Conservative with narrow areas of technical expertise and a preference for tried and tested solutions to challenges. Concentrate on internal efficiency rather than innovation.
(b) *Prospectors*: Innovative firms which seek for new markets and are prepared to undertake high-risk strategies. More concerned with innovation than internal efficiency.
(c) *Analysers*: Have stable formal structures for assuring efficiency but also monitor competitors for signs of change. Tend to follow rather than lead strategic initiatives in their industry.
(d) *Reactors*: Unable to respond effectively to change pressures and adjustments are forced on the firm to avert crises.

These categories may help shed some light on the present strategic culture of the business and what the culture will need to be if the firm is to be successful in the future.

4.10 Critical success factors

These are the things that must go right in order for the firm to be a success in its industry.

(1) The CSFs will vary from industry to industry. In the TOPCIMA exam you will be given the industry context in the pre-seen material and will have time to research the real industry. Things to look out for are
   - articles on struggling firms in the industry: what went wrong?
   - articles on successful firms in the industry: what went right?
   - general industry articles with a competitive analysis of the firms and their prospects.

(2) Critical success factors drive the long - term shareholder value created by the firm. This is its return on employed capital. They can be identified by answering four questions:
   - what factors drive costs in the industry?
   - what factors influence the revenues the firm can generate?
   - what drives asset investment?
   - what poses risks for the firm (and hence will affect its cost of capital)?

4.10.1 Some suggestions on what to look out for

The following table expands on these by indicating what to look for in the industry and in the TOPCIMA pre-seen material.

Critical success factor	*Considerations*
What factors drive costs in the industry?	• if fixed costs are high this means that gaining sales volume is critical • if complexity (e.g. special customisation of products or width of product range) is being used to gain orders it will drive overheads up. Firms must understand and allow for this (e.g. by using ABC/ABM) • if economies of scale (volume) or economies of scope (breadth of product range) are available this makes relative size a critical success factor • if market necessitates high spending on advertising, research and development or asset refurbishment in order to compete firm must be able to afford it • where costs can be reduced by merger/acquisition the firm needs to gain size and be proactive in its own merger activity • if costs are affected by exchange rates or availability of cheaper supplies or service provision abroad the firm needs to have foreign exchange hedging and cross-border supply chains.
What factors influence the revenues the firm can generate?	• if the firm's product commands a premium price this means that promotion, consistent delivery of the promise of the brand image and technical quality are critical • if the product competes by low prices it is critical that is market segment continues to feature high price elasticity of demand, that is has a substantial number of buyers willing to buy on price • if revenue growth has been gained by accessing new customers and wider locations the marketing and logistic skills of the firm are critical • if revenue growth has been accomplished by new products and exploiting the early product life-cycle it means that innovation and launch marketing are critical • competitors and new entrants will put pressure on revenues and so it is critical that they be kept out.
What drives asset investment?	The critical success factors in industries subject to high ongoing asset investment are: • ability to afford the costs of investment • ability to project manage and implement investment swiftly and successfully Ensure that the firm's management (and you) appreciate that • asset investment includes intangibles such as human resources and brands. Modern shareholder value techniques rework balance sheets to include these. • in consumer industries their rising expectations will necessitate continuous improvement and updating of premises, customer service and facilities • in technological industries there will be need for continuous investment in R&D and production technology • sales growth drives asset investment if it needs extra production or distribution capacity • industries utilising IT strategically will need to ensure systems are kept up to date. The progress of IT applications is swift and continuous.
What poses risks for the firm?	Risk is discussed in more detail in Paragraph 4.12. Here we are narrowing it down to the risk to business operations from the firm's competitive strategy. These are events that could close the business down or severely restrict its space to operate and its earnings. • *Asset risk*: Factors that could result in loss of productive assets or their earning power (e.g. theft, destruction, legal challenges to their use) • *Commercial risk*: Reduction of earnings below forecast due to loss of customer, failure of new products, out-competition by rivals • *Operational risk*: Breakdown of ability to provide product/service leading to loss of earnings and potential costs of legal claims by customer, suppliers and staff • *Financial risk*: Loss of value of investments due to volatility of markets, adverse foreign exchange movements or adverse interest rate movements.

4.11 Assessing info systems strategy

The learning outcomes of TOPCIMA are primarily concerned with strategic and business management decisions. Therefore, you should be prepared to make comments and recommendations on the following issues:

- the quality of the operational systems to support the transactions underlying the business strategy and to provide the information needed by management;
- the quality of information being provided to management and its suitability as the basis for decision making;
- the quality of the alignment between the firms information systems and its business strategy including whether management are making the best use of the potential of modern information systems;
- the risks attached to the firm's reliance on IT/IS.

It is crucial to the success of all businesses today and it can create or lose the company's competitive advantage. It's also a significant source of risk for the firm.

Your report should include some relevant comments on the firm's IT systems and IT/IS management and, where necessary, make recommendations for improvement.

4.11.1 Four levels of information system

Information systems operate at four levels in an organisation:

1. *Operational systems*: Support the day-to-day activities of the business. Examples include stock control, electronic point of sale, sales ledger, automated call routing, and performance measurement systems.
2. *Knowledge work systems*: Decision support systems and workflow systems to provide information to and help knowledge workers to do their jobs. Examples include customer call records, stock availability, external databases, CAD, financial models and spreadsheets, intranet, knowledge management systems.
3. *Management information systems*: Summaries drawn from the operational and knowledge level systems that enable divisional managers to control their businesses. Examples include budget reports, sales data, competitor intelligence reports, performance measurement reports (e.g. balanced scorecards).
4. *Executive information systems*: High level, often graphical, summaries to enable senior management to assess the performance of the business and its competitive position. Distinctive features of information at this level are the much greater amount of external information, its use of soft and conjectural data (e.g. on competitors' intentions or potential changes in laws affecting the business) and its highly aggregated nature that enables senior management to concentrate on the 'big picture'.

As Figure 4.16 shows, the operational systems are dedicated to supporting the operations of particular business functions whereas at higher levels this information is aggregated and combined to enable management to take a view of the business as a whole.

4.11.2 Management accounting information

A key aspect of demonstrating competence as a management accountant will be your ability to assess the reliability and quality of the management accounting information available to management.

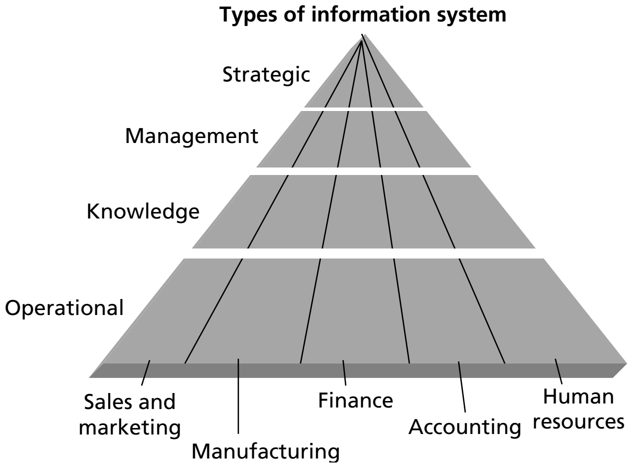


Figure 4.16 Four levels of information system

The power and comparatively low cost of modern IT/IS has greatly increased the *potential* for improving the financial results of a firm through better understanding of costs and revenue streams. Management cannot afford to be ignorant of these matters any longer. In tightening markets, it's vital that they fully utilise any savings that could be made, or enhance any revenue streams where possible. If they do not, then their rival firms will and this will ultimately lead the laggard firm to record comparatively poor financial performance.

Factors to consider include:

1. *How are costs attributed to lines of business?* Generally management accounting attributes costs to product lines to estimate contribution by product. Where a firm has diverse customers (say in terms of loyalty, volumes bought, location or methods of attracting and retaining them) it may be useful to carry out a one-off exercise to attribute costs to customer type (e.g. wholesale customers versus retail customers) to assess *Customer Account Profitability*.
2. *How are overheads and other fixed costs treated?* Conventional management accounting pools these costs and concerns itself with *allocating* them to divisions and products. There is little attempt made to understand the causes of them. Cost *attribution* involves understanding what causes these overheads and fixed costs. For example, a bank might conclude that all the fixed costs of its branch network are actually caused by a minority of customers who still require a branch to visit to exchange cash and receive a personal service; a mobile telephone supplier may realise that the majority of its advertising and promotion overhead stems from its attempts to sell air time to pay-as-you-go High Street consumers rather than from selling to corporate users. This would require an *activity based management* (or activity-based costing) analysis. This could identify the true value of each client or product. Perhaps it would increase profits by closing branches or by abandoning the pay-as-you-go market? By spreading fixed costs across all lines of business management is not in a position to understand the true profitability of each of the customers or products in its portfolio.

4.11.3 Some modern IT/IS applications

From your studies in CIMA you will be aware that IT/IS has moved beyond the simple mechanisation of former manual and bureaucratic tasks. Today it is responsible for a 'third industrial revolution' which will have profound consequences for the world of work and society as a whole.

The following applications should be recalled:

1. *Customer relationship management systems (CRM)* IT/IS configured to streamline and reduce the cost of customer service as well as improving the information content of such service. Examples of CRM include:
   - common database recording salient details of customer correspondence and conversations which can be used by anyone subsequently in contact with the customer;
   - expert systems and intelligent agents able to assess customer account behaviour and to alert management to intervene if erratic behaviour or patterns associated with loss of client emerge;
   - profiling of customers and their purchases and tastes; This enables recommendation of additional products or services to be targeted at the customer.
2. *Supply chain management systems (SCM)* network based technology that facilitates the co-ordination of the supply to the final customer from receipt of the order back the purchase of element.
3. *Enterprise resources management (ERM)* systems track all orders and components through a production process from arrival of initial order to final delivery. As well as controlling allocation of production resources it can also manage payments for sales and purchases, monitor inventory and provide forecasts of revenues and costs for budgetary control and cash flow purposes.
4. *E-commerce (E-Comm)* has effectively become a generic term for 'network-enabled business' and hence incorporates any of the applications above. Features that may be regarded as distinctively e-commerce include the use of websites to manage customer relationships (e.g. information provision and order taking), electronic transmission of funds, e-procurement (e.g. firms using purchasing exchanges to buy/sell commodity products such as oil, foodstuffs, logistics capacity) and virtual communities (e.g. on-line auctions, support groups, purchase aggregators). The extension of networks to 3G mobile phone networks and wi-fi technology, both of which can be accessed by portable wireless units (e.g. mobile phones and PDAs), has led to the growth of *m-commerce* (mobile commerce) in addition to the fixed line PC, interactive TV and intelligent appliance based versions of e-commerce.

4.11.4 Assessing the quality of IT/IS

The quality of information systems can be assessed against eight criteria (all commencing with a 'c' sound):

1. *Quickness:* How long does it take to process transactions or generate reports? This will be important for costs, customer service and ability of management to respond to developments.
2. *Capacity:* Does the system have enough slack to cope with the growth of the business or any fluctuations in demands upon it (such as seasonality in sales)?
3. *Capture*: How broad a range of data does the system capture? This could include, at operational level, compulsory fields in a customer order system, headings on a job application form, whilst at higher levels the range of benchmark or other external data should be considered. Although broader data capture increases processing and storage costs it is also necessary for better business decision-taking.
4. *Classification:* Is the data organised in a way that enables management to gain useful information? Modern multi-relational databases do permit much greater cross tabulation and

analysis of data (e.g. customers to products or faults to suppliers) to enable action to be taken. However if the way the data is initially classified is not standardised this becomes impossible (e.g. if different divisions assign costs to products in different ways then comparisons become difficult).

5. *Communication*: Is the information available to those who need it? Depending on the style of management adopted there may be a need for lower level managers or operative staff to have access to information normally sent only to senior management. This brings up a second aspect, the method of communication and whether it is timely and appropriate to the interest and understanding of the recipient.
6. *Collapse*: Are the information systems protected against failure? Normally this requires that the architecture be distributed to allow processing on other systems if one collapses. Management should have a disaster recovery plan.
7. *Cost*: This will include on-going costs of support, telecoms and updates but also the high depreciation intrinsic to IT investment. Does the information system represent a sensible level of investment? Obviously improving speed, scope and communications is possible with funds. You must be prepared to pass an opinion on whether the firm will gain an adequate return on such spending.
8. *Competence*: Finally does management have the necessary skills and organisational structure to make a success of its systems or should they be outsourced to experts?

4.11.5 Scaling frameworks for IT/IS

A *scaling framework* helps assess the amount of funding and management attention that should be devoted to IT/IS.

The considerations for you in analysing the TOPCIMA pre-seen material are:

- whether the scale of management and resource commitment is appropriate to the firm's operations and strategy;
- whether the firm has sufficient resources to support the IT/IS implications of management's strategy;
- whether it has the IT/IS expertise it will need to make a success of its strategy.

Earl's grid

This framework considers the level of investment appropriate for a firm's IS/IT (Figure 4.17). It points out that high technical quality, which will include capacity, speed, access, range of applications and security, is likely to be expensive and only justifiable where it is of potentially high business value. This should be remembered and set against claims from management, particularly those from an IT/IS background, for greater financial commitment to IT/IS.

However Earl's grid alone does not give any guidance to what applications or situations may be of high business value. This requires the use of impact frameworks.

McFarlan's Grid

A second *scaling framework*, which, unlike Earl's grid, explicitly considers future as well as current business value. A similar model was developed by Peppard and called the Applications Portfolio (Figure 4.18).

McFarlan draws attention to the significance of IT/IS shifting from left to right across the matrix. This would imply that a management team accustomed to investing in IT/IS solely to

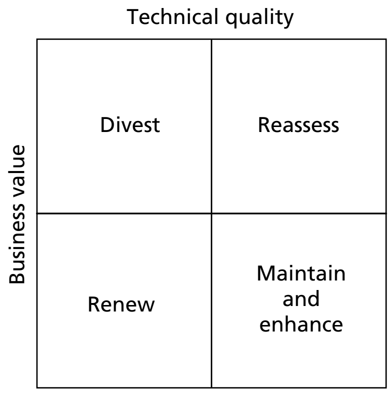


Figure 4.17 Earl's Grid

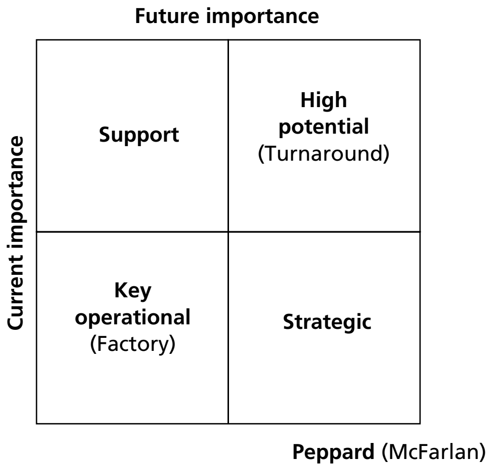


Figure 4.18 Applications portfolio

support current operations would need to consider investing for future benefits as well. This is most marked if the firm is shifting from Support (low current importance and assumed low future importance) to Turnaround (low current value but high future value). This sort of repositioning affected many small traditional retailers with the advent of e-commerce, jobbing printers with the advert of desk top publishing, colleges seeking to embrace e-learning, or garage service providers as IT/IS became more important in the functioning of cars.

The questions raised by a shift across the matrix are:

- does the firm have the funding to support the necessary expenditure?
- will shareholders and other investors accept the fall in cash flows and gamble that higher investment implies?
- does management have the necessary expertise and organisational structure to manage IT/IS at a more intense level?
- does the risk management strategy of the firm allow for the sorts of risks such a move entails?

McFarlan identifies two forces driving the strategic role of IT/IS around the grid:

1. *Internal forces:* These include the strategies chosen by the firm (e.g. to deliberately embrace e-commerce) and/or the rising influence of groups within management committed to greater IT/IS (e.g. growth of dedicated IT/IS function)

2. *External forces*: These include changes in customer demands (e.g. the assumption that it should be possible to order 24/7/365), the strategies of competitors and the arrival of new IT/IS applications (e.g. the development of the internet).

In TOPCIMA you should be prepared to identify the present role of IT/IS and consider whether there are forces driving it across the matrix and if so, whether the firm will be able to make the step change successfully. You should be prepared to advise management accordingly.

Porter and Millar: the information intensity matrix

A final scaling framework, which takes a different slant on the factors that determine the importance (or 'intensity') of IT/IS to the firm (Figure 4.19).

The model reminds us that IT/IS can have importance both in the product and also in the process of getting the product to market. Using the example of newspapers and banking, IT/IS is most important here because the product is information and the process of supply involves gathering information from diverse places and communicating it to where decisions can be made. Risk from security lapses or breakdown are also greatest here.

4.11.6 Strategic management of IT/IS

This involves three sets of decisions:

1. *Information systems strategy:* Identifying how IT/IS is to support the business strategy and information needs of managers.
2. *Information technology strategy*: Decisions on the hardware and software configurations that the firm will use.
3. *Information management strategy:* Who will manage the IT/IS for the firm and the methods they will use to ensure IT/IS aligns with the business strategy and operational needs. This includes project management.

Detailed knowledge of these was assessed in earlier papers (P4, P5 and P6) and covered in the *CIMA Learning Systems* for these papers. A summary is presented here of the key points about alignment of IT/IS to business strategy (Figure 4.20).

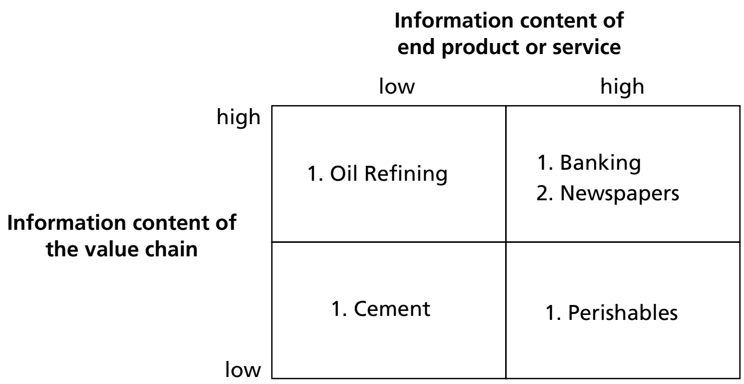


Figure 4.19 Information intensity matrix

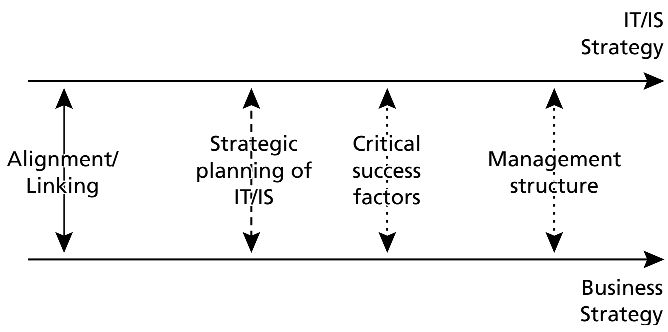


Figure 4.20 IT/IS alignment mechanisms

There are three methods of aligning IT/IS to current and future business needs:

1. *Strategic planning of IT/IS*: This involves IT/IS becoming a sub-set of the firm's strategic plans in the same way as HR, Finance and Marketing might be. Depending on the approach to strategic planning taken by the firm (e.g. top-down or bottom-up and whether it is done at corporate level or at business unit level) the opportunities presented by IT/IS for the strategy will be considered and the consequences of the adopted business strategy for IT/IS will be thought through.
2. *Critical success factors* is an approach in which IT/IS experts work with general and functional managers to identify how IT/IS can help then achieve the performance critical to the success of their department or division (Figure 4.21).

Figure 4.21 demonstrates that the goals of the SBU managers and divisional managers are derived from the business strategy. These are general business goals which, if they are to be attained, require that certain Critical Success Factors are in place. The IT/IS expert meets with the responsible management team and identifies ways in which IT/IS can help assure these. For example, it may be through providing operational and transactional systems (e.g. making check-out quicker, tracking stock better or improving efficiency of data input) or it may support and improve decisions at the knowledge, managerial or strategic levels.

Management structures to align IT/IS to business strategy involves considerations such as:

- the degree of centralisation of IT/IS at corporate centre versus the decentralised approach of allowing business divisions to specify their own systems;

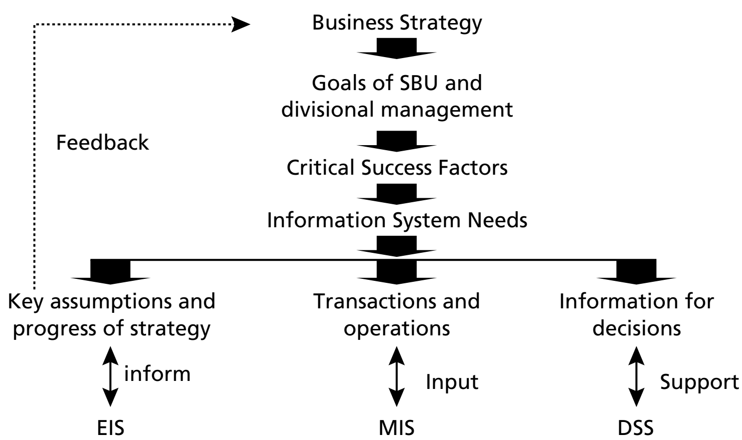


Figure 4.21 Critical success factor approach to IT/IS management

- whether there is a senior manager responsible for IT/IS. This will influence (and reflect) the degree of importance top management place on IT/IS in their business decisions;
- whether management decides to treat IT/IS as a service centre, a cost centre, a profit centre or indeed outsource it altogether;
- whether it will be run as a hybrid with routine operational applications managed one way but strategic ones operated through a different management structure.

A rough rule of thumb is that the more critical IT/IS is to business success the more it will be regarded as a core competence. This means it is more likely to be kept in-house, enjoy representation at senior management level and have its use rationed out using prices and the requirement that it make a profit.

A final model that can help you make sense of the issues in a TOPCIMA case is Nolan's six stage hypothesis (Figure 4.22). Although originally formulated in the 1970s to help understand the adoption and diffusion of early data processing systems this model has since been generalised into a way to understand waves of IT/IS applications that have occurred since such as office automation, intranets, mobile telephony and e-commerce applications.

1. *Initiation* stage is the first appearance of the technology in the firm. Using a contemporary example, some managers may have purchased a Personal Digital Assistant (PDA) and be showing it off to colleagues. There is no control over spending and senior management will not have noticed it.
2. *Contagion* phase is where more and more managers, and their subordinates, are requesting or buying PDAs because they are perceived to be useful or perhaps because they are a status item. Expenditure is rising sharply but most is 'off-budget'. There will be many different sorts of PDAs circulating around the firm and all carry data which must be secure.
3. *Control* occurs where management realise that a lot of expenditure and assets are now tied up in PDAs and also that risks are rising (e.g. loss of asset, key data being lost or leaked externally). So far the business benefits have been hard to see. Management clamp down on further spending and adoption of PDAs.
4. *Integration* is a stage when the technology is evaluated against the future plans of the firm and it starts to become part of the business strategy (or otherwise is jettisoned). If the company is committed to teleworking then PDAs may be seen as better than laptop computers due to lower price, portability and increased functionality (telephony, photographic, video, sound etc.) and so gradually laptops are replaced by a standard issue PDA. Training and support is given to users of PDAs.

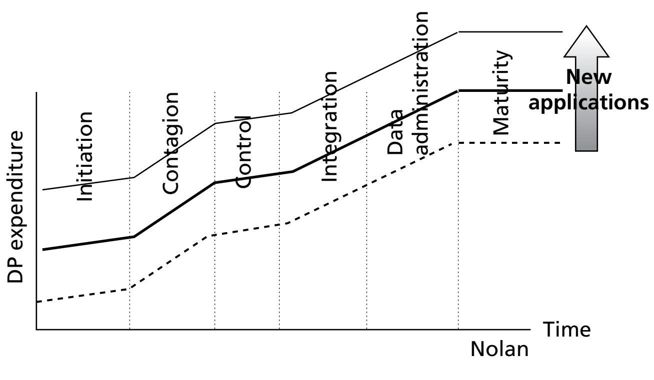


Figure 4.22 Nolan's six stage hypothesis

5. *Data administration* is the point at which the technology switches from being something managed as a special project to something with set administrative procedures. Perhaps the firm will incorporate PDA expenditure into its budget forecasts and regulations will be issued on protocols for how they may and may not be used and what may be stored on them (just as the firm did before with mobile phones and the internet/intranet).
6. *Maturity* is where the application has reached steady state and is fully integrated with the business strategy and operations.

4.12 Assessing corporate risk

A model developed by The Institute of Risk Management *et al.* in their *Risk Management Standard* demonstrates the various sources of risk (Figure 4.23).

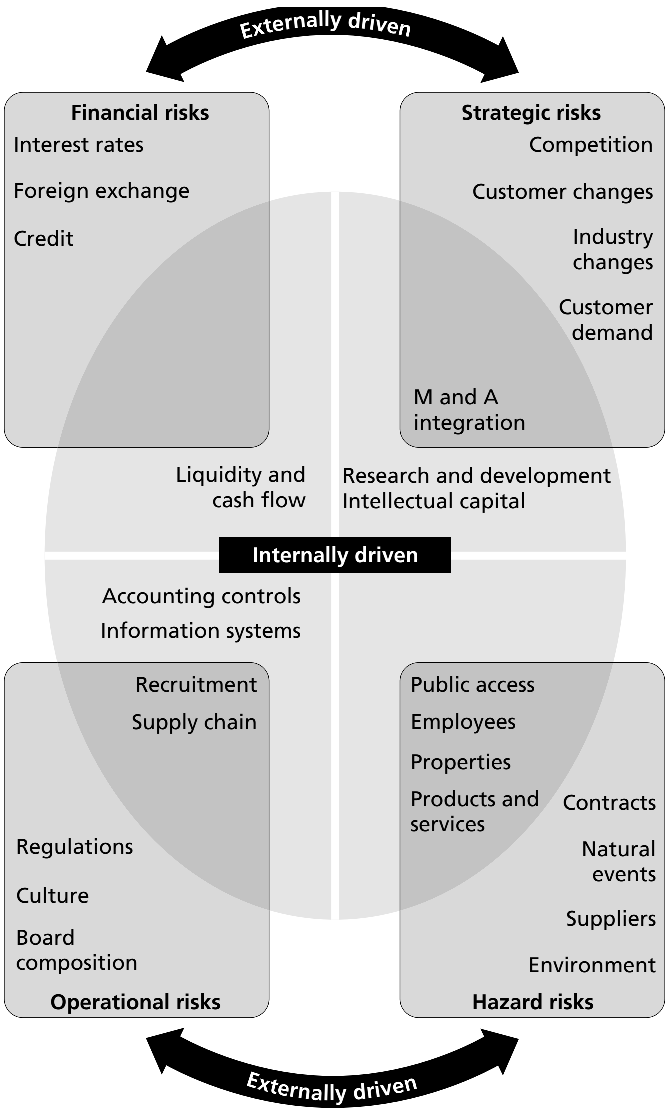


Figure 4.23 Sources of risk
Source: A Risk Management Standard IRM *et al.*

Risk can be understood in a number of different ways:

- *Risk as hazard or threat:* This entails a reduction in business effectiveness and financial return.
- *Risk as uncertainty:* This causes problems for decision-makers at strategic, managerial and operational levels.
- *Risk as opportunity:* This involves managing the upside of a risk to come out of it better than rivals.

The range of risks can be considered under the following headings:

1. *Business or operational risk.* Business or operational risk relates to the activities carried out within an organisation, arising from structure, systems, people, products or processes. Business or operational risks include business interruption, errors or omissions by employees, product failure, health and safety, failure of IT systems, fraud, loss of key people, litigation, loss of suppliers, etc. These are generally within the control of the organisation through risk assessment and risk management practices, including internal control and insurance.
2. *Financial risk.* Financial risk relates to the financial operation of a business, such as credit risk, liquidity risk, currency risk, interest rate risk and cash flow risk. Some of these risks arise from cultural and legal differences between countries, such as the demand in some countries for cash payments to arrange local sales. Obtaining money from customers in other countries or recovering the cost of lost goods in transit may also be difficult due to different legal or banking regulations. While these are typically outside the organisation's control, organisations can take action to mitigate those risks, for example by credit control procedures, hedging, export insurance, etc.
3. *Environmental risk.* Environmental risk relates to changes in the political, economic, social and financial environment over which an organisation has little influence. Environmental risks include legislative change, regulations, climate change, natural disasters, loss of business, competition, economic slowdown and stock market fluctuations. These are outside the organisation's control but can be mitigated to some extent through environmental scanning and contingency planning.
4. *Reputation risk.* Reputation risk is caused by failing to address some other risk. This is within the organisations' control but requires the organisation to take a wider view of its role in society and to consider how it is seen by its customers, suppliers, competitors and regulators.
5. *International risk.* Financial risks associated with international operations such as transaction (e.g. fraudulent client), translation (e.g. currency risk), economic (e.g. recession or tax changes) and political (e.g. change of policy towards overseas trade).

4.12.1 Risk management process

The Institute of risk management *et al.* have developed the model shown in Figure 4.24.

- *Risk assessment:* Analysis and evaluation of risk by identification, description and estimation.
- *Risk evaluation:* Estimation of probability and impact of risk to reveal its significance leading to a decision on whether each specific risk should be accepted or treated.
- *Risk reporting:* Regular reports to the Board and to stakeholders setting out risks, the organisation's policies in relation to them. This enables monitoring of effectiveness of policies.

Figure 4.24 Risk management process
Source: A Risk Management Standard: IRM *et al.*

- *Risk treatment* (also called risk response) is the process of selecting and implementing measures to modify the risk such as risk control/mitigation, risk avoidance, risk transfer, risk financing (e.g. insurance).
- Residual risk reporting draws board attention to any untreated risk.

4.12.2 Techniques of risk management

1. Identification of risk

- Risk can appear in different ways to different people according to their backgrounds and experience. This leads to collective techniques for risk identification such as brainstorming, stakeholder consultations and scenario analysis.
- Structured techniques include checklists, incident investigation, fish bone (breaking down a business process into its component parts to examine all the risks to that process).

2. Risk estimation

Risk estimation looks at the likelihood of occurrence and the possible impacts.
Methods include:

- scenario planning,
- computer simulations, for example, Monte Carlo,
- decision trees,
- sensitivity analysis,
- real option modelling,
- SWOT or PEST analysis,
- likelihood/consequences matrix.

3. Risk evaluation

Risk evaluation is concerned with making decisions about the significance of risks to the organisation and whether those risks should be accepted or whether there should be an appropriate treatment or response.

4. Risk reporting

This includes:

- A systematic review of the risk forecast at least annually.
- A review of the management responses to the significant risks and risk strategy.
- A monitoring and feedback loop on action taken and variance in the assessment of the significant risks.
- An 'early warning system' to indicate material change in the risk profile, or circumstances, which could increase exposures or threaten areas of opportunity.
- The inclusion of audit work as part of the communication and reporting process.

5. Risk treatment

Risk treatment selecting and implementing measures to modify the risk.

Risk response may be:

- *Avoidance:* Action is taken to exit the activities giving rise to risk, such as a product line or a geographical market, or a whole business unit.
- *Reduction:* Action is taken to reduce the risk likelihood or impact, or both.
- *Sharing:* Action is taken to transfer a portion of the risk through for example insurance, pooling risks, hedging or outsourcing.
- *Acceptance:* No action is taken to affect likelihood or impact.

4.13 Assessing cost of capital

4.13.1 Importance of cost of capital

The principal uses of the cost of capital in TOPCIMA are:

(a) to provide a discount rate for project appraisals using discounted cash flow methods;
(b) to use as basis for business valuation (see Section 4.15)
(c) to utilise in measuring shareholder value or for setting divisional performance measures related to shareholder value.

4.13.2 Cost of equity

The cost of equity (or K_e) is the rate of return payment that management must make on the equity in the company if shareholders are to keep their funds in the company.

Assume the situation where a firm financed entirely by equity (i.e. zero capital geared) and where K_e is 15%. In this case management would use K_e:

- as the discount rate for project appraisal, that is, so that any new assets purchased would have to demonstrate a positive NPV after deduction of 15% p.a. for the capital used;

- as the hurdle rate for performance evaluation of divisional managers that is, they would be required to show that they were achieving at least a 15% return on the legacy assets in their divisions;
- as shareholder value measures, that is, the management of the firm would seek to ensure a positive economic profit (otherwise called a residual income or, following some adjustments, Economic Value Added$^{(R)}$[3]) after multiplying divisional and overall group assets by 15%. In the case of a division with assets of \$20m it would need to show an income in excess of \$3m (i.e. \$20m × 0.15).

Cost of equity can be derived in two ways:

1. dividend valuation method,
2. capital asset pricing model (CAPM).

Example

A firm's shares trade at \$1.75. Its most recent dividend was \$0.10. Historically dividends have grown at 5%.

The market rate of return is 11% whilst the risk free rate is 5%. The industry equity beta is 1.

Using DVM

$$P_0 = \frac{D_0[1 + g]}{K_e - g}$$

and reformulating it as

$$K_e - g = \frac{D_0[1 + g]}{P_0}$$

$$K_e - g = \frac{0.10(1 + 0.05)}{\$1.75}$$

$K_e = 11\%$

Using CAPM

$r_f + \beta_e (r_m - r_f)$

$5\% + 1(11 - 5)$

$K_e = 11\%$

In this case the required rate of return for the shareholder is 11%.

The above approaches have a number of practical difficulties:

- *Problems with divided*: Growing firms may not have paid any dividends (so $D_0 = 0$) or they have recently paid their first dividend ($g = \infty$). In these situations the model cannot be applied to the firm. K_e can only be assessed by applying the model to a similar firm in the same industry and generalising it by assuming that shareholders in either firm require the same rate of return to compensate them for the risks of their investment.
- *Problems with share price*: In the above example P_0 is assumed to be a market price of the share and hence incorporate all the knowledge about the future prospects and risks of the business. Once again a new or growing firm may not have a share price due to not yet being quoted on a public market.
- *Problems with beta coefficient*: A beta coefficient is an index of the *unsystematic risk* of the equity, that is, the volatility on its value compared to the volatility in the value of equities as a whole. The above example used a beta of 1 which means that the shares moves

[3] Economic Value Added (EVA) is a registered trademark of Stern-Stewart New York.

up and down imperfect unison with the general value of shares in the stock market (the so-called *market risk* or *systematic risk*). Betas are more readily available for standard large industries like telecommunications or construction because there are many firms and also there are a lot of shares traded. However, for emerging industries or niche industries (such as biotechnology research or auction houses) there are not likely to be such reliable betas available and so users are forced to make generalisations from similar, but not identical, industries (in the above example say pharmaceuticals and retailing sectors).

- *The impact of the strategy being followed*: A firm's K_e probably relates to its current line of business and hence the risks and returns intrinsic to its current industry. If however the cost of capital is being used to evaluate an investment in a new line of business (or new country perhaps) than it should be evaluated using a K_e appropriate to the risks or the new industry.

4.13.3 Cost of debt

At its simplest the cost of debt is the post-tax cost of the interest upon it (since unlike dividends to equity, interest payments are tax deductible).

Examples

Suppose a company issues debt at par (i.e. receives \$100,000 for each \$100,000 bond it issues) with a coupon rate of 8% in a country with 30% tax rates.

$$K_d = 8\% \ (1 - 0.30)$$
$$= 5.6\%$$

The situation is complicated where the firm has issued debt at a discount (i.e. below par) because in addition to the coupon interest it must also take into account the increased redemption value of the bond.

Suppose a firm issues its 8% coupon rate debt, redeemable in 5 years time at a discount of 5% to par (i.e. it receives \$95,000 for every \$100,000 of debt it sells). Tax is 30%.

Here the after-tax cost of debt will be given by the formula:

$$95 = 8(1 - 0.3) \times \text{AF } 5@K_d + \frac{100}{(1 + K_d)^5}$$

K_d can be obtained by interpolation using two different assumed rates for the annuity factor (AF).

	Cash flow	*AF @ 10%*	*PV*	*AF @ 5%*	*PV*
Year 0	95,000	1	95,000	1	95,000
Year 1–5	(8,000)	3.791	(30,328)	4.329	(34,632)
Year 5	(100,000)	0.621	(62,100)	0.784	(78,400)
			2,572		(18,032)

$$K_d = 10\% - \frac{18{,}032}{18{,}032 + 2{,}572}(10\% - 5\%)$$

$$K_d = 10\% - 4.38\%$$
$$K_d = 5.62\%$$

4.13.4 Weighted average cost of capital (WACC)

This is the percentage rate of return that must be achieved to add shareholder value taking into account all the various sources of finance used by the firm. It is the weighted average of the costs of the individual courses of capital using market values.

Example

A firm has a capital structure made up as follows:

Equity: 2,000,000 shares with a market price of \$1.62 and a K_e of 8%
Debt: 12,000 bonds with a market value of \$98 and a K_d of 6%
The WACC is calculated as

$$\frac{(2{,}000{,}000 \times \$1.62 \times 8\%) + (12{,}000 \times \$98 \times 6\%)}{(2{,}000{,}000 \times \$1.62) + (12{,}000 \times \$98)}$$

$$= \frac{32{,}976{,}000}{4{,}416{,}000}$$

$$= 7.47\%$$

The WACC is the more usual basis for calculating the cost of capital because most corporate treasurers will ensure they have a mixture of debt and equity in the balance sheets of their companies to reduce the overall cost of capital.

But the WACC has a number of limitations stemming from its dependence on a *pool of funds* concept. Put simply it assumes that new projects (and existing assets) are financed from a homogenous reserve of funds the costs of which will remain unchanged by alterations in the amount of funds used and variations in the sorts of businesses they are used to support.

The WACC is therefore not an appropriate cost of capital under the following situations:

- where the funds are being used to support operations or assets exposed to significantly different risks from those faced by the majority of the firm's business;
- where raising the extra funding will significantly change the capital structure (notably the debt/equity ratio) of the firm;
- where the amount of funds being raised is a significant addition to the total capital employed by the firm.

Under these situations it is usual to use the marginal cost of capital.

You may be given a discount rate to use in the pre-seen or unseen material. You should always use this rate in your calculations. Do not waste time in the exam room trying to calculate a different cost of capital or in trying to prove the rate you have been given.

However, additional credit will be given for comments or arguments about why this rate might be too high or too low providing this is backed up by reference to the theory here.

4.13.5 The marginal cost of capital

This assesses the impact on the costs of capital of raising funds for a project. This will include the costs of the capital raised for the project but also include the impact on the costs of existing capital due to changes in the risks faced by the firm and changes to its capital structure.

Example

A firm operates solely in one country making a basic industrial material. Presently its financing is made up as follows:

Equity: 2,000,000 shares with a market price of \$1.62 and a K_e of 8%,
Debt: 12,000 bonds with a market value of \$98 and a K_d of 6%.

As calculated in the example above, its cost of capital is presently 7.47% on capital of \$4,416,000.

Management decides to diversify the firm by buying a chain of leisure centres in an overseas market for \$3,450,000 paid for in debt issued at par. As a consequence of the greater risks and capital gearing K_d for the firm as a whole rises to 8% and the original K_e of 8% rises to 10%.

The firm has raised an additional \$3,450,000 of capital but it must now make a return of \$69,408,000[4] and not the \$32,976,000 previously.

Therefore the marginal cost of capital for the project is

$$\frac{\$3,450,000}{(\$69,408,000 - \$32,976,000)} = 9.47\%$$

[4] (2,000,000 × \$1.62 × 10%) + (12,000 × 8%) + (\$3,450,000 × 8%).

4.13.6 Adjusted present value (APV)

This is an appropriate approach to evaluating a strategy or project involving diversification.

The formula is

APV = Base NPV + side effect of financing

- calculate the base NPV of the diversification project using the CAPM approach using the beta of a firm already in that industry (this would be given in the pre-seen or unseen TOPCIMA material if it was required);
- allow for any side effects of finance such as tax shield on debt introduced and add this on to the base NPV;
- the APV should be positive if the project is to be accepted.

4.13.7 Real options theory

This is another approach to strategic investment. It is an alternative to traditional NPV evaluations for where investments are being made under conditions of high uncertainty. It suggests that management could mimic the sort of investment behaviour of investors in derivative investments such as futures and options covered in the *CIMA Risk and Control* syllabus.

Traditional NPV takes all the cash flows of a project over its lifetime and discounts them back. In a strategic decision these cash flows are far from certain and so very high required rates are applied. The effect is that tentative strategic investments come up showing negative NPVs and are not undertaken.

Real option theory seeks to take the project apart by pointing out that a small level of investment in a project is rather like paying a deposit to secure the right to subscribe for future financial benefits if matters go a certain way (just like the premium on an option).

Consider a firm thinking of entering a line of retail for the first time. Instead of conducting an NPV on building a chain of shops across the country the theory time-slices the investment decision by pointing out that the first investment is buying the land to build the shops on. Once the firm owns the land it has a number of options (i.e. decisions which can be taken at a later date):

1. *The expansion option* which means to go ahead and build the shops and perhaps buy more land too. This decision could wait until the future became clearer.
2. *The abandonment option* is where management decides not to build the shops after all, perhaps because of a recession in the economy. The firm would forfeit some of the money they spent buying the land. However this loss was worth it because it did buy them the opportunity to participate had the economic circumstances been more favourable.
3. *The timing options*. This suggests that there may be points in the rolling-out of a project at which management can decide to delay or to bring forward further investments. This will affect the NPV of the project.
4. *Strategic investment options.* These are follow-on opportunities over which the firm has an option if it makes the original investment. These spin-offs are added into the core investment appraisal as a series of 'what-if' analyses to try to get a full view of the potential value of the investment.

The effect of real options approach is to give a *true NPV* for a project calculated as follows:

$$\text{True NPV} = \text{Crude NPV} + \begin{array}{l}\text{NPV}\\ \text{of}\\ \text{expansion}\\ \text{option}\end{array} + \begin{array}{l}\text{NPV}\\ \text{of}\\ \text{abandonment}\\ \text{option}\end{array} + \begin{array}{l}\text{NPV}\\ \text{of}\\ \text{timing}\\ \text{option}\end{array} + \begin{array}{l}\text{NPV}\\ \text{of}\\ \text{strategic}\\ \text{option}\end{array}$$

4.14 Conducting a corporate appraisal (SWOT and Gap analysis)

Corporate appraisals have two elements:

- a SWOT analysis,
- a Gap analysis.

The most commonly used corporate appraisal method in TOPCIMA exams appears to be a SWOT analysis. Candidates can (and should) prepare a SWOT to help them understand the pre-seen material and to understand the weaknesses of the company and the opportunities facing the company or the industry in which it is operating in.

If you include a SWOT analysis in your answer, you must ensure that it has been updated to include material that has been given to you in the unseen material on exam day.

For example if you prepared a SWOT with a Weakness stating that the company's Chairman was ineffective, but the unseen material included that a new Chairman had been appointed (as in the Homejay November 2003 case) this would reduce the marks awarded for the SWOT. You MUST update your SWOT for data in the unseen material for the SWOT to earn reasonable marks.

4.14.1 Conducting a SWOT analysis

The TOPCIMA exam is likely to require you to make recommendations about what to do with the organisation in the pre-seen material. This will require you to base your advice on an analysis of its present position.

The approach recommended here is to prepare a SWOT analysis using the pre-seen material, which can be adapted or modified in the light of any additional unseen material on exam day. This SWOT analysis should appear in two places in your final report:

1. As a cruciform chart in the appendix to your report. This will be brief bullet points showing the breadth of issues that you have noted.
2. As the second section of your report, immediately following the introduction, in which you will highlight the most important conclusions from the SWOT in terms of its implications for the business (Figure 4.25).

1. *Strengths and Weaknesses are usually internal and specific to the firm.* A strength is something that, from the information in the pre-seen material, you consider the firm is good at or it is a resource it can call upon to reach its goals. They are sometimes termed *distinctive competences*. A weakness is generally a resource shortage or inadequacy which renders the firm vulnerable to competitors.

   A quick recap through the mental checklist of the 9 Ms model will give you some ideas.
2. *Opportunities and threats are generally external to the firm.* Opportunities and threats are strategic challenges to the firm. Again these may be obvious to you from the pre-seen material or perhaps from your own research into the background of the industry.

   Here frameworks like PEST and five forces can help.

   Ensure that these are 'clear and present' opportunities and threats that you can back up with data from the case or other source. Too many candidates seek to pad out their SWOT analysis with various generic threats like 'there could be a takeover bid' or 'interest rates may rise' without bringing forward any evidence that this is a possibility.

   Also avoid confusing opportunities with strategies. The best way to do this is to ensure that nothing you write could have the words 'management could' put before it.

Your SWOT could include under the heading of Threats any external industry problems, if, for example, the industry as a whole is under price pressures, or is in the decline stage of

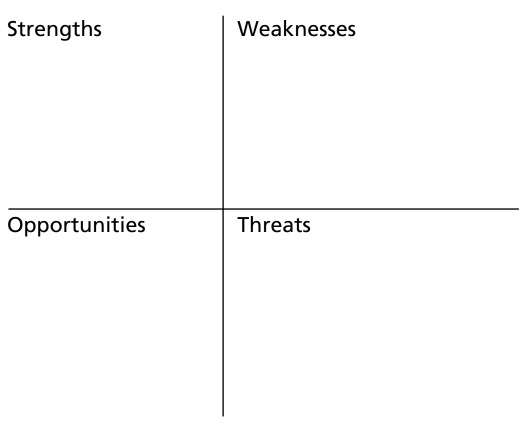


Figure 4.25 The cruciform chart

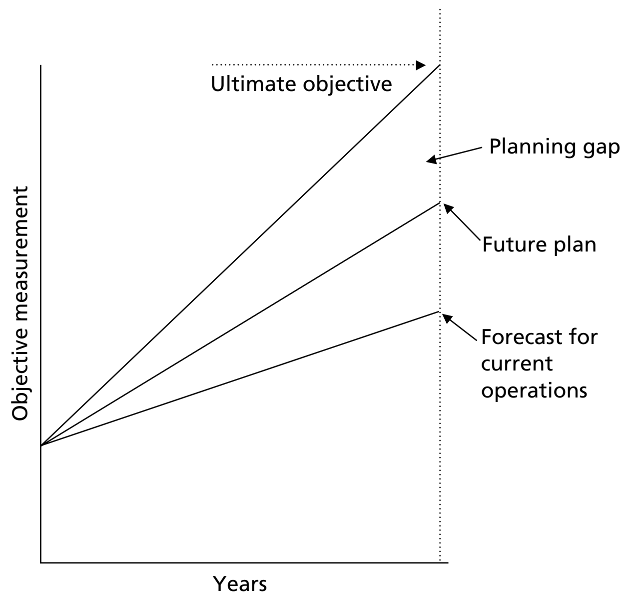


Figure 4.26 Gap analysis

its life cycle. Alternatively another threat is that of obsolescence if other companies are introducing superior products or services which could affect the sales and profitability of the company in the case, or impending changes in EU or UK legislation that could affect the company.

4.14.2 Gap analysis

A gap analysis (Figure 4.26) can only be carried out if the pre-seen material or unseen material gives an indication of the strategic goals of management.

In past CIMA cases these goals have appeared in the following ways:

- as statements of intent at floatation of the firm,
- in the records of planning meetings,
- in a 5-year plan for the firm.

Figure 4.26 shows the firm's performance towards a single objective. In TOPCIMA there may be several objectives sought by management simultaneously. For example, in a past CIMA case the strategic objectives for one firm were:

- to achieve a certain number of outlets within 5 years,
- to maintain a given ROCE,
- to have the largest market share in the industry.

You should be prepared to express an opinion on the following matters:

- Does the forecast performance of the firm show that it's likely to reach its strategic objectives in all areas?
- Are the strategic objectives still realistic and relevant?
- What will be the likely effect on stakeholders, in particular shareholders, of missing the objectives?

4.14.3 Getting from corporate appraisal to strategy

Frequently the corporate appraisal can throw up appropriate strategies (Figure 4.27). Here are some techniques that can help with that process:

1. Matching, converting and remedying

- *Matching.* The firm should build on those strengths that enable it to take advantages of the opportunities in the marketplace.
- *Converting.* This is a more complex process in which management question their interpretation of a factor as a threat or weakness and consider whether it can be re-interpreted or turned to its advantage (sometimes called flip siding the negative).
- *Remedy.* Removing weaknesses that leave the firm exposed to threats or unable to grasp opportunities is a priority for strategic action.

2. TOWS approach

This uses the extended matrix shown in Figure 4.28.

Strategic options are identified in the four internal quadrants:

- *SO Strategies* – ways in which the business could use its strengths to take advantage of opportunities;

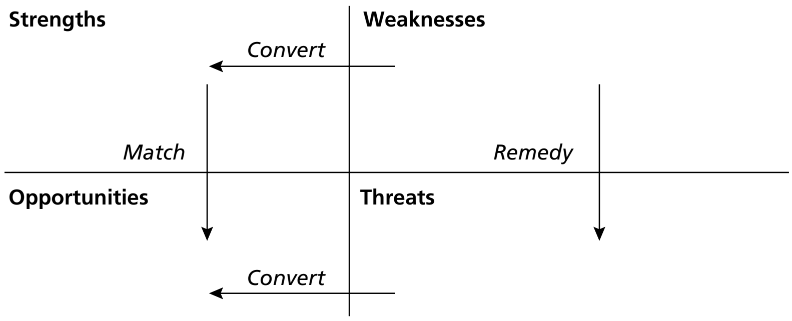


Figure 4.27 Strategic fitting

Internal factors / External factors	Strengths (S)	Weaknesses (W)
Opportunities (O)	SO Strategies	WO Strategies
Threats (T)	ST Strategies	WT Strategies

Figure 4.28 TOWS matrix

- *ST Strategies* – considering how to use company's strengths to avoid threats (It can be hoped that rivals will be less able to do this and hence they will suffer deteriorating relative competitive performance.);
- *WO Strategies* – attempting to take advantage of opportunities by addressing weaknesses;
- *WT Strategies* – primarily defensive and seek to minimise weaknesses and avoid threats.

3. Closing a planning gap

The strategies which may be used to fill the remaining gap are classified as:

(a) *Efficiency strategies*: Designed to increase profits (or throughput) by making better use of resources or cutting them.
(b) *Intensive strategies*: These exploit the firms existing products and markets further.
- *market penetration* to increase sales to existing markets;
- *market development* to find additional markets for the products;
- *product development* to find additional products for the firms existing customer base.

(c) *Diversification strategies*: These aim to reduce the risks of the business or increase its growth prospects by taking it into new industries.

4.15 Business valuations

Business valuation has been a common theme in past CIMA case studies. It can be of use in several situations:

- to evaluate an approach of takeover bid from another firm. Are they offering enough?
- to set a potential price for shares that will be issued in a floatation to issued to new investors
- to set a value on shares to see how well an unquoted company has performed to date
- to set a price to buy back shares from a shareholder who wishes to exit the company.

4.15.1 Two approaches to business valuation

Business valuation is not an exact science. Rather it is a matter of judging where a firm's value lies between two methods of valuation:

- asset-based methods,
- earnings-based methods.

4.15.2 Asset-based methods of business valuation

A simple approach is to value the firm at its net assets value. This takes the view that anyone who buys the company will in fact have purchased assets to a particular value, less liabilities such as debt or creditors.

Example

The following items are extracted from the balance sheet of a company:

Fixed assets	\$380,000,000
Current assets	\$120,000,000
Current liabilities	\$103,000,000
Long-term debt	\$98,000,000
Called up share capital (\$0.50 shares)	\$200,000,000
Net asset value of company	\$299,000,000
Value per share	\$299,000,000 (200,000,000/0.5) = \$0.75

Asset-based valuation methods suffer from the following limitations:

1. *Net asset values are not reliable*. A predator buying another company may do so to get its assets. However, the book value of the assets may not convey their true value to the predator. The true value could be their *replacement value* (i.e. how much it would cost the predator to buy them on the market) or their *net realisable value* (i.e. how much the predator would earn if they liquidated the assets).
2. *Method ignores valuable intangible assets*. A predator may seek to buy a firm to get access to its staff skills, customer contracts or brands. These are valuable but for good financial accounting reasons do not appear on the balance sheet.
3. *Method ignores earnings potential*. The management of a successful firm can take ordinary assets and earn supernormal profits on them. For example, a modern thriving club may be located beside an old-fashioned hardware store in a High Street. According to a real estate surveyor both properties have the same asset values, but because the club generates a much better income than the store it is worth more.

Asset valuations should be regarded as a floor or minimum value for a firm.

4.15.3 Earnings-based methods of valuation

1. Dividend yield approach

Here the firm is valued according to the annuity value of its dividends using the formula

$$\text{Market value} = \frac{\text{Dividend}}{\text{Dividend yield}}$$

The dividend yield of a similar firm is calculated and applied to the firm for which a value is sought.

Example

Company A has a share price of \$1.28 and a dividend of \$0.32. Company B pays a dividend of \$0.17. It has 22.2m shares in issue. What is the value of B?

Dividend yield for A	= \$0.32/\$1.28	= 25%
Value of B	= \$0.17/0.25	= \$0.68 per share
Total value	= \$0.68 × 22.2m	= \$15.1m

In effect this is the same thing as using the formula

$$\text{Value of firm} = \frac{\text{Dividend}}{K_e}$$

that is, it values the firm as the annuity value of its dividend assuming that the dividend yield it has taken from the other firm equals K_e for the industry.

2. Dividend growth approach

This accepts that in most cases firms are expected to pay higher dividends in the future because the firm is growing.

$$\text{Value of firm} = \frac{D_0(1 + g)}{K_e - g}$$

where g is the forecast growth rate of dividends estimated from past history or by application of *Gordon's growth model* where $g = b \times r$ in which b is the retention ratio and r is the rate of return on retained earnings.

Example

A company paid a total dividend of $230m last year. This represents a 5% increase on the previous year. The industry has a K_e of 12%

$$\text{Value} = \frac{\$230\text{m}\,(1 + 0.05)}{(0.12 - 0.05)}$$

$$= \$3{,}450\text{m}$$

This approach assumes that the firm will be able to grow its dividends at 5% per annum in perpetuity and, despite its growth, that K_e will remain unchanged. Both are probably unrealistic assumptions.

This approach breaks down in the following cases:

1. Where the firm does not pay a dividend. Microsoft was formed in 1983 but did not pay any dividend until 2002 yet clearly it had a very high value during the intervening years.
2. Where the growth rate of the firm's dividend exceeds K_e. In this situation the denominator becomes a negative and therefore gives the firm a value of infinity.

3. Earnings growth approach

The dividend valuation approach effectively values the firm from the point of view of its existing shareholders. These shareholders are not able to determine the dividend payout decided by management. This is, however, a useful figure for understanding the minimum price that is likely to be acceptable to the target's shareholders.

Another firm which takes control of the board of a firm can enjoy the entire earnings stream and not just the dividend. Therefore, the dividend valuation model is subtly adapted:

$$\text{Value of firm} = \frac{E_0(1 + g)}{K_e - g}$$

Where E_0 refers to the total earnings attributable to ordinary shareholders. There may be arguments for using the profit before interest and tax instead. For example, if the acquiring firm enjoys a K_e below the acquired firm's cost of debt it would presumably redeem the debt with equity and avoid the interest payments. Similarly is its cost of debt were lower it might be able to refinance the debt at lower interest. Finally its tax rate could be different from that of the target company.

4. Price earnings approach

The formula for this approach is

Value of firm = maintainable earnings × price earnings ratio

Maintainable earnings are a floor level of future earnings which actual earnings are not expected to fall below.

Operating profit less tax is the basis for this calculation.

The price earnings ratio will be a ratio from another firm in the same industry, assuming one exists.

Example

Company A has earnings after interest and tax of $755m and balance sheet debt of $238m at an interest rate of 15%. Company B is in a similar industry to Company A and has a PE ratio of 17. What is the likely value of Company A?

Maximum value of Company A is $755m × 17 = $12,835m

The balance sheet debt is ignored and not deducted from the value. This is because the interest on the debt has already been deducted from profits before arriving at the $755m. The valuation assumes that anyone who acquires Company A will simply maintain the debt out of earnings in the same way.

However, if there are any reasons to believe that a firm's debt has been used to purchase a wasting asset (such as a renewable license to exploit a resource) then it seems likely that interest will not be repaid out of sustainable earnings but rather the capital sum will need to be written off over time. In this situation, it is prudent to deduct the debt from the valuation.

This valuation method makes a number of assumptions that should be highlighted if you choose to use it in your TOPCIMA exam:

- It depends on how similar the industries of the two firms are. Clearly if Company A is in a more risky industry than Company B we should use the potential PE of the joint company. This is because the higher risk if the combined company will increase K_e and so depress the P/E ratio.
- It assumes that the share price of the acquiring company is set by a liquid market in its shares and hence, according to the efficient market hypothesis, its price reflects its future earnings power.
- It assumes that the management of the two firms will be able to grow earnings at the same rate as the management of the acquiring company could.

Where a company is not listed it is possible to generate a share price by applying a 'proxy' P/E from a listed company in the same line of business. However, some deduction from the resulting value should be made to reflect the non-tradability of the share.

5. Discounted cash flow approach

This values the business at the present value of its free cash flows and is based on the assumption that the stock market will arrive at a value for a share that is equivalent to the present value of its free cash flows.

A free cash flow is the cash profits of the firm. However, there is considerable disagreement about what this may include or exclude in practice. A rough rule of thumb is:

Operating profit

- less interest,
- less tax,

- plus depreciation and amortisation,
- plus increase in provisions for tax or doubtful debts,
- less any increases in fixed or working capital = free cash flow.

The second issue concerns how far ahead to forecast these free cash flows. If they are expected to continue indefinitely at their present amount per year then valuation is simply an annuity value

$$\frac{\text{Current annual free cash flow}}{\text{Cost of capital}}$$

Otherwise it is usual to adopt one of the following approaches:

- discount the free cash flows from the present business plan to arrive at a present value and then add on a notional amount for the earnings for the years after the plan;
- assume and annuity value for a set number of years corresponding to the lifecycle of the product or industry.

A final issue is arriving at a suitable discount rate. This was discussed in the section on the cost of capital above.

6. Valuation to include synergies

Some acquisitions are carried out with the intention that the resulting group of companies will have higher profitability than the sum of the profits of the constituent parts. Summarised as *the 2 + 2 = 5 effect.*

Potential synergies include

- elimination of the fixed costs of duplicated assets (e.g. factories, offices etc.);
- reduction in operating costs due to combination of administrative functions;
- greater capacity fill through better loading of assets (e.g. instead of two firm's with half-full lorries there will be one firm with half as many lorries, each running fully loaded);
- increased sales revenues through cross selling to common customers;
- higher prices if the strong brands of one firm can be conferred on the mundane products of the other.

To calculate the *maximum* value of a company where synergies are available you should use the increase in group earnings post acquisition as the basis for valuation.

Example

Company A seeks to acquire Company B. Both are logistics firms.

Company A presently has turnover of $1397m, post tax profits of $293m and long-term borrowings of $217m at 7%. It estimates its WACC at 8%.

Company B presently has turnover of $987m, post tax profits of $187m and long-term borrowings of $300m at 8%.

Company A has estimated the following data about Company B:

- it has a chain of warehouses which could be sold for $280m within a year of acquisition and all functions absorbed within A's, own warehouses at an increased cost of $28m. B's warehouses presently cost $132m per year to operate, and closure would lead to redundancy costs of $117m;
- it's administration costs of $200m could be reduced by 50% if it were to adopt B's computerised ordering systems;
- reducing competition from company B will increase prices of logistics contracts by 12%.

What is the maximum price that A should pay for B?

Combined profit of A & B ($293 + $187)	$480m
Increase in profit from 12% rise in revenues	
0.12(1397 + 987)	$286m
Increased profits due to transfer of warehousing (132–28)	$104m
Reduction in administration costs (0.5 × 200m)	$100m
Reduction in interest costs (300 − 280) × (8%−7%)	$0.2m
Total group sustainable earnings	$970.2m
less existing earnings of Company A	$293m
Increased earnings	$677.2m
Assume earnings continue 10 years at WACC of 8% AF =	6.145
PV of increased earnings	$4161.4m
plus net proceeds from disposal of warehouses	
($280 – $117) × 0.926	$150.9
Total value	**$4312.3m**

Of necessity these calculations can be rough and ready and shareholders in A might question why they are paying 23 times current earnings for B. Of course Company A would not offer $4,312.3m for B but something less in the hope that the synergies here would come to its own shareholders rather than all being given to the shareholders who are selling B.

4.16 Generating strategic options

The following models can be used in two ways to help you pass TOPCIMA:

1. The pre-seen or unseen may contain information on strategic options being considered by management. These models will help you critique these options.
2. You may be required to recommend options of your own. These models may help you generate them.

4.16.1 Choice of generic strategy

Porter's prescriptions for generic competitive strategy were reviewed in Section 4.7.3.

The point to recall here is that high levels of profitability are believed to result from a firm dedicating itself to one of the generic strategies.

4.16.2 Product market strategy - the Ansoff matrix

Demonstrates the choices of strategic direction open to a firm in the form of a matrix (Figure 4.29).

1. Market penetration strategy

Firm increases its sales in its present line of business. This can be accomplished by

- price reductions,
- increases in promotional and distribution support,
- acquisition of a rival in the same market,
- modest product refinements.

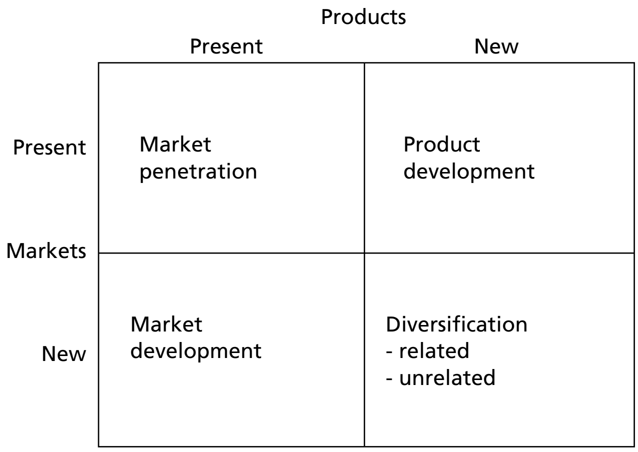


Figure 4.29 The Ansoff product-market scope matrix

These strategies involve increasing the firm's investment in a product/market and so are generally only used in markets which are growing and hence the investment may be recouped. In this respect, the strategy is similar to the *invest to build* and *holding* strategy discussed by the Boston Consulting Group.

2. Product development strategy

This involves extending the product range available to the firm's existing markets. These products may be obtained by:

- investment in the research and development of additional products;
- acquisition of rights to produce someone else's product;
- buying in the product and 'badging' it;
- joint development with owners of another product that need access to the firm's distribution channels or brands.

The critical factor to the success of this strategy is the profitability of the customer group for which the products are being developed. Also the firm's present competitive advantages in serving the market must confer on to the new good. These can include:

- customer information that allows accurate targeting,
- established distribution channels,
- a brand which can be credibly applied to the new product.

3. Market development strategies

Here the firm develops through finding another group of buyers for its products. Examples include:

- different customer segments: for example, introducing younger people to goods previously purchased mainly by adults;
- industrial buyers for a good that was previously sold only to households;
- new areas or regions of the country;
- foreign markets.

This strategy is more likely to be successful where:

- the firm has a unique product technology it can leverage in the new market;
- it benefits from economies of scale if it increases output;
- the new market is not too different from the one it has experience of;
- the buyers in the market are intrinsically profitable.

4. Diversification strategies

Here the firm is becoming involved in an entirely new industry, or a different stage in the value chain of its present industry.

Ansoff distinguishes several forms of diversification:

1. *Related diversification*. Here there is some relationship, and therefore potential synergy, between the firm's existing business and the new product/market space.
   (a) *Concentric diversification* means there is a *technological* similarity between the industries, which means that the firm is able to leverage its technical know-how to gain some advantage.
   (b) *Vertical integration* means the firm is moving along the value system of its existing industry towards its customers (*forward vertical integration*) or towards its suppliers (*backward vertical integration*). The benefits of this are assumed to be:
   - taking over the profit margin presently enjoyed by suppliers or distributors;
   - securing a demand for the product or a supply of key inputs;
   - better synchronisation of the value system;
   - reduction in buyer or supplier power.

   However, it also means increasing the firm's investment in the industry and hence its fixed cost base.
2. *Unrelated diversification*. This is otherwise termed *conglomerate growth* because the resulting corporation is a *conglomerate*, that is, a collection of businesses without any relationship to each other. The strategic justifications advanced for this strategy are:
   - to take advantage of poorly managed companies which can then be turned around and either run at a gain to the shareholders or sold-on at a profit;
   - to spread the risks of the firm across a wide range of industries;
   - to escape a mature or declining industry by using the positive cash flows from it to develop into new and more profitable areas of business.

4.16.3 Strategic development and risk

Developing a firm beyond its present product/market space exposes it to a combination of four sorts of risks. These risks are particularly acute where diversification is concerned because of the simultaneous novelty of both product and market.

(a) *Market Risk*: The firm has entered a new market where established firms already operate. The risks here are:
- not correctly understanding the culture of the market or the needs of the customer;
- high distribution costs due to lack of economies of scale;
- failure to be seen as credible by the buyers in the market due to lack of track record or brand;
- exposure to retaliation by established firms with more entrenched positions.

(b) *Product Risk*: The firm is involving itself in a new production process, which is already being conducted by rival firms: The risks this poses are:
   - higher production costs due to lack of experience;
   - initial quality problems or inferior products causing irreparable harm to reputation in the market;
   - lack of established production infrastructure and supply chain relations which will make costs higher and may limit product innovation and quality.

(c) *Operational and managerial risk*: This boils down to the danger that management will not be able to run the new business properly. This carries with it the second danger that management will also be distracted from running the original business effectively too.

(d) *Financial risk*: This relates to the share price of the business. Shareholders are generally suspicious of 'radical' departures (and particularly diversification) for the following reasons:
   - the product and market risks lead to volatile returns;
   - the firm may need to write off substantial new net assets if the venture fails;
   - the investment needed will reduce dividend and/or necessitate new borrowing;
   - a diverse and unique portfolio makes it harder to compare the firm to others in the same industry when trying to evaluate its risks and returns.

The effect will be for the share price to decline to reflect the uncertainties created by the strategy.

4.16.4 The expansion method matrix

Lynch (1997) presents the alternative growth strategies as shown in Figure 4.30.

1. Internal development (organic growth)

Here the firm grows by using its own capital sources to invest in new capital assets, product development and staff development. The principle benefits of this approach are:

(a) firm does not need to assimilate the differing personal, cultures or operating systems of another organisation;
(b) investment can be controlled and incremental unlike acquisition when the firm must commit substantial funds in an all-or-nothing gamble;
(c) provides development and learning opportunities to staff;
(d) avoids the need for a goodwill premium at acquisition; instead assets are acquired at just their market value;
(e) demonstrates to investors the ability of management to grow their own business and create opportunities. This should improve the share price.

The drawbacks are:

(a) firm will not at first enjoy the economies of scale and experience effects available to rivals;
(b) market entry may be too slow if the industry is developing quickly;
(c) increases the number of firms in the industry which increases complexity and may provoke hostile responses from established firms;
(d) firm may lack access to key resources or customers if the industry features complex long-term supply contracts.

		Company	
		Internal development	External development
Geographical location	Home country	Internal development	Merger Acquisition Joint venture Alliance Franchise/license
	International	Exporting Overseas office Overseas manufacture Multinational operation Global operation	Merger Acquisition Joint venture Alliance Franchise/license Turnkey

Figure 4.30 Lynch's expansion method matrix (adapted from Lynch 1997)

2. *Mergers and acquisitions (external growth)*

Benefits of a firm pursuing strategic development into a product/market space by mergers or acquisition are:

(a) firm acquires the goodwill (expertise, contacts customers and reputation) of the acquired firm;
(b) eliminates a potential rival in the market;
(c) swifter access to the industry than internal development;
(d) possibility of some risk spreading if the acquired company has businesses in unrelated areas;
(e) lower commercial risk because the target will have already established itself in the industry;
(f) possibility of acquiring assets cheaply if the target is undervalued by investors, for example, due to poor present management.

Drawbacks of acquisition led growth are:

(a) difficult to arrive at the correct price for the acquisition due to lack of financial information, bid fever and possibility of third parties bidding against the predator;
(b) high cost of integrating systems of work, management controls, human resource procedures and information systems;
(c) need to rationalise operations will incur costs of redundancies, asset disposals, cancellation of leases and supplier contracts;
(d) failure of most mergers and acquisitions to realise the benefits originally envisaged;
(e) problems of uncontrolled staff losses and falling morale due to rationalisation programme and clashes of culture amongst staff from senior management down;
(f) very high initial capital costs because the predator must compensate the target's shareholders for at least the expected present value of the profits from the target;

(g) excessive reliance on external growth will depress the predator's share price because investors cannot assess the level of future earnings of the business without knowing what the next acquisition will be;
(h) high degrees of share price volatility fuelled by bid rumours;
(i) failure to win a bid will leave the impression that the predator's strategy is failing.

3. Joint development strategies

These involve the firm working with another firm under an arrangement of greater or lesser formality.

1. ***Joint venture***. The partners form a separate company in which each holds an equity stake. Usually management is provided by the parties to the agreement and is able to draw on the expertise of the parties.

   Benefits are:

   (a) reduces risk because the firm's capital commitment is halved;
   (b) each party gains access to the competences of the other;
   (c) avoid developing the opportunity separately and ending up in competition;
   (d) partnership with firms in host economies allows foreign firms a route into otherwise protected markets.

   Drawbacks are:

   (a) disputes over operational matters such as use of trademarks, pay levels and approach to markets;
   (b) possibility that partners will gain confidential information about each other which may be used to compete elsewhere or if the venture breaks down;
   (c) disputes over the amount of effort being put in, the allocation of partner's costs and the division of rewards;
   (d) lack of support from joint venture management from parent companies because neither feels they own it.

2. ***Strategic alliances***. Two or more firms agree to work together to exploit common advantages. The precise arrangements will differ from merely an informal agreement between management, through a legal arrangement, to a cementing of the relationship with the swapping of equity.

   The benefits are similar to joint ventures but in addition a strategic alliance is often used to allow smaller firms to present an effective alternative to a large dominant player in the market.

   However there are some special difficulties:

   (a) ambiguity in the alliance agreement or the breakdown of trust between partners will jeopardise the alliance;
   (b) some informal alliances risk breaking laws against collusion and cartels;
   (c) because partners remain essentially separate many alliances fail to achieve the integration and commitment necessary to gain significant strategic advantage.

The May 2004 case on Ofood4U introduced an opportunity for a strategic alliance in the unseen material and candidates were required to calculate the NPV of the proposed strategic alliance and to comment on whether this was a suitable expansion strategy for Ofood4U. Answers were generally disappointing as many students simply commented on the financial results and not the long-term strategic effects, and risks, of the proposed strategic alliance. This expansion strategy has been examined once, and therefore it could come up again!

3. ***Franchises***. Here the firm expands its business by granting other firms the right to use its business systems.

The firm (the *franchiser*) will provide a variety of supports to the buyer of the business package (the *franchisee*). These may include:

- management training,
- a set of procedures and instructions for supplying the product/service,
- central marketing support (e.g. inclusion in national advertising),
- inputs such as materials or products to sell-on,
- technical and business consultancy,
- staff training programmes,
- preferential access to capital.

In return the franchisee will provide

- an initial lump sum to buy the franchise,
- a share of earnings (usually turnover),
- specific payments (e.g. for training).

The benefits of franchising to the franchiser include:

(a) quicker business expansion than would be possible using its own management and financial resources;
(b) reduced risk due to the capital having been provided by the franchisee;
(c) retains the dynamism of local management because they run their own business;
(d) control over the activities of the franchisees to the extent provided for in the franchise agreement;
(e) reduced costs of control due to franchise manager being responsible for finances, assets and staffing.

The drawbacks of franchising include:

(a) reduced profits because they must be shared with franchisee;
(b) need to monitor franchisee to assure consistency of product service (quality, pricing, product range, sales methods);
(c) danger that poor franchise performance will harm the parent's brand;
(d) problem of protecting intellectual capital from being copied by franchisees who later become rivals.

Licenses are very similar to franchising in their financial aspects. However, the degree of central control and support is usually less. Licenses include:

- the right to exploit a natural resource (e.g. a logging license);
- the right to use a brand or image on a product;
- the right to produce a product using the licenser's recipes and brand names (e.g. computer manufacturers installing Windows XP).

4. ***Agency agreements***. These are usually restricted to marketing and product support arrangements. They are particularly useful in the following situations:

- where the customers like to compare a range of products and take advice (e.g. financial services, carpets, software);
- the sales volumes are too low to justify a dedicated distribution channel (e.g. specialist holidays);
- the sales are enhanced by social and family networks (e.g. cosmetics, children's books and toys).

The agent receives a set of samples, literature and product training. They also receive a commission from their sales that are supplied from the parent company.

Agency agreements have a number of problems:

(a) the danger that the product will be miss-sold by agents anxious for commissions;
(b) the firm fails to build a relationship with the customer, or gain data, because this would undermine the agent and make them suspicious of being cut out;
(c) the danger that agents will desert the firm and take the best customers with them.

4. International growth strategies

1. *Exporting strategies*. The firm sells products made at home to buyers abroad. Often this starts with the receipt of a chance order or perhaps poor sales at home force the firm to export or perish.

As a strategy it has a number of advantages over other international growth strategies:

(a) firm can make use of any economies of scale it enjoys to compete in the foreign market (and home market too);
(b) no need for any extra fixed capital investment;
(c) does not expose the fixed capital investments of the firm to risk;
(d) helps to insulate the firm from recessions in their home economy.

The disadvantages are

(a) distance from the customer means customer relationship cannot be developed nor goods customised;
(b) increased working capital needed to support stocks in transit;
(c) the firm exposed to foreign exchange risk which will affect its earnings or the competitiveness of its prices;
(d) firm has less information about the credit status of the customer.

By establishing an overseas office or appointing an agent the firm can overcome some of the problems of lack of customer contact or the need for minor modifications.

2. *Overseas Manufacture*. This strategy has two aspects:

(a) The firm arranges for its products (or some parts of them) to be manufactured abroad and then imported back to its home economy.
(b) The firm arranges for its products to be manufactured in a foreign country for sale there.

In both cases the firm is involved in *direct foreign investment* because it is purchasing productive capital assets in the country. This brings certain advantages:

(a) firm can benefit from lower costs of local economy (labour, buildings and inputs);
(b) reduced transportation costs;
(c) reduced foreign exchange exposure because production costs are now incurred in the same currency as the good are paid for in;
(d) because it provides jobs the firm may gain access to markets previously closed to foreign goods;
(e) cheaper goods bolster margins in home markets.

The drawbacks are:

(a) Assets exposed to risk in the foreign economy (e.g. war, sequestration, sabotage, or collapse of the local market).
(b) Firm may have difficulty obtaining its profits due to currency controls or punitive taxation on exported dividends.
(c) Absence of an exit route if production depends on a license because if the firm wants to sell the factory the national government can decide who it goes to (and the price) because it's worthless without the license.

3. *Multinational operation.* Two features setting multinational enterprises (MNEs) apart from other firms with foreign trading activities:
   (a) It has a deliberate policy of coordinating its value-adding activities across national boundaries.
   (b) It *internalises* the cross-border trades (i.e. it does not rely on a market to carry them out but rather uses its own bureaucratic processes).

   The advantages of this arrangement are:
   (a) The firm can take maximum advantage of natural resources and lower production costs.
   (b) The firm is insulated from the effects of hostile governments or trade unions in any specific country because it can always switch (or threaten to switch) output elsewhere.
   (c) The firm can manage its taxation by arranging to make its profits in low tax economies.

   The main drawback is that the multinational is often viewed with suspicion by the governments of host countries because of its foreign ownership and high-potential power.
4. *Turnkey operations.* These are factories and facilities in foreign countries with which the home firm can establish production contracts. When the firm requires output it exercises the contract (i.e. it turns the key). This is sometimes termed *contract manufacturing*.

4.17 Sources of business finance

1. TOPCIMA may require you to comment on the ways in which a firm is financed or to suggest ways it could improve its financing or raise more capital.
2. The principal sources of finance will be reviewed in this section. Broadly they can be divided into two forms:
   - *equity capital*: investors buy a share in the business;
   - *debt capital*: the firm takes on a legal obligation to repay interest and capital.

4.17.1 Issuing equity to raise capital

The main equity markets available to UK firms are:

- *The Official List:* Admission to this allows a firm's shares to be traded on the 'main market' of the London Stock Exchange. Listing costs are many hundreds of thousands of pounds and the requirements for entry, administered by the United Kingdom Listing Authority, are stringent and include a 3-year trading record (except new technology stocks which can join techMARK with 1 years' record), that no person or connected persons should hold more than 30% of the equity and that at all times at least 25% of the shares should be in public hands in order for a liquid market to exist. These requirements and initial costs that run into several millions of pounds effectively prohibit small and young companies from joining.
- *The Alternative Investment Market (AIM):* A cheap and less regulated market operated by the London Stock Exchange where small and young companies can have their shares traded. There is no minimum size nor minimum trading record. There are no restrictions on the percentage of shares that can be closely controlled. Although cheaper than a full listing it will still cost between £250,000 and £1,000,000 to achieve admission.
- *Private markets:* Some brokers operate screen-based markets (e.g. Ofex) where shares can be traded on a matched trade basis. Effectively this is a bulletin board where buyers and sellers of a stock post offers and bids and conduct matched trades.

Some global firms elect to have listings on several markets (say London, New York and Tokyo) for the following reasons:

1. to broaden the shareholder base to get a better price for shares;
2. to gain access to more capital than the domestic market alone can provide;
3. to raise greater global awareness of the company.

The process for gaining a listing (or designation on AIM) is:

1. Appoint a sponsor: This will be a member firm of the London Stock Exchange such as a large bank or brokerage. They will:
   - advise on method of floatation and issuing of shares;
   - ensure directors and firm is of sufficient quality to join the market;
   - arrange a broker and market maker to hold stock and buy and sell it;
   - advise on price and timing of floatation;
   - arrange for underwriting of shares (i.e. standby buyers who to agree to buy at a minimum price if the float is under subscribed).
2. Produce a prospectus outlining history of firm, trading record, future plans and reasons for seeking finance.
3. Engage solicitors, accountants/auditors and registrars acceptable to investors and the market.
4. Decide method of selling shares and issue price.

Issue methods include:

1. *Offer for sale:* Shares are advertised at a set price and buyers subscribe for them. Alternatively in and *offer for sale by tender* buyers write in and bid for set amounts of shares at a price of their own choosing. Shares are then allotted starting with the highest bidder and working down.
2. *Introduction.* This raises no capital but merely allows the shares to be traded on the market. It can be a good exit route for otherwise locked-in shareholders.
3. *Placing:* The sponsoring broker arranges for the shares to be sold to their own private clients. This saves money on advertising and gives a more certain value for the shares. It can also avoid the shares falling into hostile hands.

4.17.2 Venture capital

Specialist firms well connected to banks and networked well into the business world who rely on their judgement to make deals to provide equity capital for start-up businesses and developing or recovering businesses. The high risks lead these equity investors to expect a 500% + return within 5–10 years from the sale of their equity:

- in a floatation,
- in a trade sale of the business to another firm.

Average investment is £5–10m for which very high-annual rates of return are required (e.g. up to 80% ROCE) in order to ensure the EPS rises sufficiently to give a large capital gain on sale of the shares.

VCs will often effectively control the company by:

- allocating themselves special voting rights,
- selecting the Chairman and several of the non-executives,

- building in further releases of equity to themselves if the required ROCE is not hit in order to maintain earnings at the expense of other shareholders,
- providing the means by which a bank will agree to provide debt to the firm, based on the participation of the VC.

Equity may be provided for a number of purposes:

1. Seedcorn capital – to support a new business concept by financing R&D or writing of a business plan (in the dot.com era this was called 'incubator capital').
2. Start-up capital – investment in initial capital assets to start production.
3. Development capital – fast growth companies with negative cash flows will use this to continue building their businesses.
4. Management buy-outs (MBOs) – members of the management team gain capital and buy the firm from its present owners.
5. Management buy-ins (MBIs) – an outside team of managers, often known to the VCs, borrow the money and purchase the business from its present owners.
6. Buy-in management buyout (BIMBO) – a hybrid of an MBO and an MBI.

4.17.3 Raising debt capital

Methods are:

1. *Corporate bonds:* Sometimes called *loan stock* these are a long-term contract to borrow money in return for a periodic payment of interest and eventual repayment of capital. *Debentures* are bonds secured on specific assets or on a floating charge over a group of assets.

   Bonds often carry covenants constraining management: for example, from issuing further debt; paying dividends above a certain level; disposing of assets or breaching certain financial ratios.

   Specific forms of bond include
   - *Deep discounted bonds* which carry very little coupon interest but which are sold at a substantial discount to face value to give a large capital gain at redemption. This enables firms with little or no free cash flows to borrow without struggling to pay the interest.
   - *Mezzanine debt* (or junk bonds): Pay high rates of return because they are issued by firms with little collateral and are hence high risk.
   - *Convertible bonds* (or equity-linked bond): In addition to carrying interest, this bond also gives the holder the right to exchange them for a set number of shares at a future date. The hope value of the equity leads lenders to accept a lower rate of interest than they would seek for a plain bond.
   - *Foreign bonds* (or eurobonds): These bonds are denominated in a foreign currency. Firms that receive revenues in the same foreign currency may prefer these in order to hedge some of their foreign exchange risk by matching the servicing currency for debt to their earnings currency.
2. *Commercial paper*: Sometimes called *commercial bills* these are short-term IOUs issued by a firm under a revolving underwriting agreement with a bank. They are issued at discount to redemption value and the holder makes a capital gain at maturity. They principally finance cash flow needs.
3. *Project finance*: finance raised specifically for a discreet project and hence separate from the financial structure of the rest of the firm. This insulates the parent company from some of the risks of the project and also avoids a risky or unusual project pulling up the

WACC of the whole firm. It also provides a vehicle for attracting funds from sources with a special interest in a project such as a key supplier, the World Bank or a sovereign government in the project's home country.

4. *Sale and leaseback*: Firm sells assets such as buildings, cars or machines to a finance house and then leases the use of them back. This releases a cash sum that can be ploughed into the business (or to pay a dividend if the firm is struggling). The drawback of this method is that the firm will now have to make a perpetual payment for the use of the assets which, although tax deductible, will still reduce distributable profits. Therefore, it is critical that the released funds can be invested in projects with a higher rate of return than the effective cost of the lease.
5. *Bank loans*: The most common form of debt finance for firms. Usually between 5 and 20 years with a floating or fixed charge against assets of the firm and liable to a fixed or floating interest charge.
6. *Bank overdraft*: This carries a high rate of interest and can be called in at very short notice. It should only be used for financing short-term cash flow needs.
7. *Trade Credit*: Provided by suppliers of materials, stocks or services. This initially seems free credit but recipient firm that relies on this may find itself tied to a particular supplier or forced to accept less good prices or early payment discounts on invoices.
8. *Debt factoring*: Firm seeks to liquidate its trade debtors by assigning them to a discount to a finance house in return for an initial cash sum. This sum increases with the quality of the debtors assigned and under a recourse factoring arrangement the sums ultimately received by the firm will only be what debtors pay, less an administration fee to the finance house. Non-recourse factoring arrangements shift the risk of non-payment to the debt factoring house but this will involve a smaller amount of cash being paid for the debts when they are assigned.
9. *Leasing*: Paying for the use of an asset, which remains owned by the finance house. With *finance* leases the firm is obliged to continue to pay for the use of the asset whether it needs it or not. An *operating* lease holds out the prospect of returning an asset if it is not needed which can help reduce the fixed cost base of a firm.

4.18 Evaluating strategic options

In TOPCIMA you may be called upon to comment on the appropriateness of a strategy being suggested by the board. Alternatively you may decide to argue for a strategy you have thought-up yourself.

To do either you must evaluate strategies against three criteria.

4.18.1 The three criteria for strategic choice

Johnson and Scholes (1997) outline three tests for assessing whether a strategic option should be undertaken:

1. *Suitability test.* This considers whether the option is the right one *given the circumstances of the firm.* This boils down to its fit with the SWOT analysis and its accordance with the firm's mission.
2. *Acceptability test.* Considers whether the option will gain the support it needs to be successful. This involves an assessment of the likely response and power of key stakeholders such as
   - shareholders,
   - management,

	Level of interest: Low	Level of interest: High
Power: Low	A Minimal effort	B Keep informed
Power: High	C Keep satisfied	D Key players

Figure 4.31 Mendelow's power-interest matrix

- customers,
- regulators and government,
- employees,
- suppliers.

3. *Feasibility test.* This considers questions such as:
   - the reliability of the data or assumptions that support the strategy;
   - the availability of resources or competences to make a success of the strategy;
   - the firm's track record in similar strategies.

4.18.2 Stakeholder mapping

Mendelow (1991) proposes the diagram shown in Figure 4.31 to help analyse stakeholders:

Scholes (1998) suggests the following strategies to deal with stakeholders in each quadrant:

Box A	*Direction.* This means their lack of interest and power makes them malleable. They are more likely than others to accept what they are told and follow instructions
Box B	*Education/Communication.* The positively disposed groups from this quadrant may lobby others to support the strategy. Also if the strategy is presented as rational or inevitable to the dissenters, or a show of consultation gone through, this may stop them joining forces with more powerful dissenters in C and D
Box C	*Intervention.* The key here is to keep the occupants satisfied to avoid them gaining interest and shifting into D. Usually this is done by reassuring them of the likely outcomes of the strategy well in advance
Box D	*Participation.* These stakeholders can be major drivers of the change and major opponents of the strategy. Initially there should be education/communication to assure them that the change is necessary followed by discussion of how to implement it

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The Complete Case Materials for TOPCIMA Cases

5

5.1 Introduction

In this chapter are the actual TOPCIMA cases for:

- May 2005 – ReuseR and NOW recycling industry case
- September 2005 – Domusco construction industry case
- November 2005 – Domusco construction industry case

The September and the November exams used the same pre-seen material about a construction company called Domusco but the unseen materials were TOTALLY different. Each unseen material follows directly on from the pre-seen material and there is no need whatsoever to be familiar with the September unseen material if you sat the November exam sitting. In fact the reverse may be true – DO NOT read the September exam as it may confuse you.

Depending on what exam sitting you are preparing to sit (March or May or in September or November), if there is a previous exam sitting using the same pre-seen material – IGNORE it and concentrate on understanding and analysing the pre-seen material only.

In the chapter for each case the following sections are included:

- Section 5.2.1 ReuseR and NOW – pre-seen material
- Section 5.2.2 ReuseR and NOW – unseen material and requirement for May 2005
- Section 5.2.3 ReuseR and NOW – assessment matrix
- Section 5.2.4 ReuseR and NOW – Case writer's answer

- Section 5.3.1 Domusco – pre-seen material
- Section 5.3.2 Domusco – unseen material and requirement for September 2005
- Section 5.3.3 Domusco – Assessment matrix – September 2005 (same as November 2005)
- Section 5.3.4 Domusco – Case writer's answers for September 2005
- Section 5.4.1 Domusco – Requirement and unseen material for November 2005
- Section 5.4.2 Domusco – Assessment matrix – November 2005 (same as September 2005)
- Section 5.4.3 Domusco – Case writer's answer for November 2005

What I want to ask you to do is to keep this chapter (Chapter 5) as a reference book and use the case material in other chapters of this CIMA Learning System to help you to analyse the case material – both the pre-seen and the unseen materials.

We will deal with how to analyse the pre-seen material in Chapter 6 and then we will move onto what to do on the exam day and how to analyse the unseen material in Chapter 7.

PLEASE do NOT read this entire chapter including the unseen material and the case writer's answers UNTIL YOU HAVE WORKED THROUGH CHAPTERS 6 AND 7. If you do read all the material, it will not be as useful as working through each past TOPCIMA case. The author felt that it would be useful to keep all of the past TOPCIMA case materials together in one chapter rather than split them all up into different areas of this book!

Now choose which of the 3 past TOPCIMA cases you want to try to work through and analyse with the help given in Chapters 6 and 7. You may wish to start with the May 2005 case set in the recycling industry or either of the two Domusco cases set in the construction industry.

The unseen material for the November 2005 Domusco case has been analysed for you to help you understand what to do on exam day, in Chapter 7.

5.2.1 ReuseR and NOW – pre-seen material

Recycling – ReuseR and Now

Background

The marketplace

Recycling has two significant impacts on the global environment. First the use of recycled materials reduces the consumption of the world's natural resources. Second, recycling waste avoids the over-use of landfill refuse sites, which in turn reduces the level of potential pollution of contamination. Additionally, manufacturing costs can be reduced, as energy savings of around 5% can be achieved when, for example, new cans are manufactured using recycled aluminum. Also, recycled aluminum cans may end up being manufactured into sheet metal for car or aeroplane bodies.

Glass recycling is very efficient because a glass container is 100% recyclable and can be recycled over and over again with no loss in quality or purity. The use of recycled glass is also not restricted to making new glass, as it can also be recycled into construction aggregate and abrasive material for blasting and also into garden paving slabs. Another significant area of recycling is paper. In western European's household waste, around 40% of it is paper waste, and paper is currently one of the fastest growing recycled products. Aside from waste reduction, paper recycling makes ecological sense as recycling around 17 pounds (which is less than 8kg) of paper can save one tree. Paper is usually recycled into new paper products, such as tissues, printing paper and clipboard.

More and more businesses are also seeing the sense in selling off their waste paper and many new companies are entering into, or expanding their own, recycling business. Additionally, in today's business world, a company's image is one of its most important assets. A company that has a positive environmental profile will attract quality customers, employees and suppliers. It can also command a share price premium, as corporate investors are increasingly aware of the demand for "green" investments. There is also increasing external pressure to demonstrate effective environmental practices and to recycle waste. It is likely that within the next decade there will be a statutory requirement for businesses within the European Union (EU) to adopt process such as waste recycling. To assist companies to reduce and recycle their waste a large number of service companies have entered this growing market.

Over ten years ago, recycling companies were small and operated only within their home country, but with the freedom to operate across boundaries within the EU, many of the larger recycling company have made acquisitions to strengthen have become more aware of waste and "green" issues and have established their own recycling departments, which recycle waste materials from other parts of the company.

Most European governments have established a variety of ways in which both domestic and industrial waste can be minimized and materials recycled. To support the various government initiatives, a wide range of specialist companies has been able to increase the volumes of materials recycled. There are many companies of all sizes in the recycling industry, which is still in its early stages, and the recycled materials market is expanding rapidly.

Details follow on two recycling companies

This material gives details on two fictitious companies operating in the recycling industry, mainly in Europe. The two companies are Reuse Refuse (ReuseR) and No Waste (NOW). Details on both companies and their operational and financial data are shown below.

Reuse Refuse (ReuseR)

Reuse Refuse (which trades as ReuseR) is a quoted company operating in a northern European country, with subsidiary companies across Europe. The company collects waste and recycles a wide range of products, but its single largest recycled product, which is also one of its most profitable, is recycled glass. It currently supplies recycled glass to twelve customers spread over eight countries in Europe. It sources its recycled glass supplies from hundreds of sources, including its many contracts for the collection and recycling of domestic waste. ReuseR also recycles a range of other waste products, including wood paper, metal, tyres and a number of other materials.

ReuseR has expanded its operations across Europe by the acquisition of many smaller recycling companies. Since 2000, with the pressure on governments and the general population to recycle waste materials, it has introduced several innovative ways in which various types of waste are collected for recycling and sold to a range of manufacturing companies.

Enterpreneur Kurt Finehart, who is the Chairman and Chief Executive, had acquired the company in the 1980's when it was small and operating only in one country, Kurt Finehart always had ambitious plans for the company and was ahead of his time, with his vision of recycling waste. In the late 1980's the company became listed and the current directors and employees collectively own over 53% of the shares. The rest of the shares are spread over a wide range of investors with no large shareholdings.

The key senior management team in ReuseR is as follows:

Kurt Finehart – Chairman and Chief Executive

Kurt Finehart is a very flamboyant 48 year old, who has strong Government connections in his home country. He is from a wealthy family, which helped him to acquire the company initially. He has proved himself to be a serious businessman, with close links with several of his key customers. He is a non-executive director of two other companies, one of which is a glass manufacturing and printing company, to which ReuseR sells some of its recycled glass and paper. Kurt Finehart is also actively involved in many global environmental groups and is highly respected in the recycling industry. His catch phrase, which the press repeats often, is "re-use, not refuse".

Jean Paul Gamell – Finance Director

Jean Paul Gamell joined ReuseR over ten years ago and has improved the company's financial strength and its ability to manage its increasingly complex business covering eight EU countries. He has a small, strong head office team and has established finance teams in each country where ReuseR operates. In each country in which ReuseR operates, a separate subsidiary company manages its operations and acts as an autonomous business unit. Communication between some of the finance teams in the subsidiaries and head office needs to be improved and it is a problem area that Jean-Paul Gamell is aware of and he as planned to concentrate on, but he has continually been under pressure with the many recent acquisitions that ReuseR has made.

Clement Weiss – Business Development Director

Clement Weiss joined ReuseR five years ago and has been the driving force behind many of the company's recent acquisitions. The recycling industry is very fragmented and many small, privately owned, local companies operate successfully and profitably. Clement Weiss believes that economies of scale can be achieved by building upon ReuseR's existing collection and distribution network that it operates in eight EU countries. Some of the small companies that ReuseR has acquired in the last two years handle a range of recycled products that ReuseR had not dealt with previously. ReuseR is currently recycling these additional materials, including electronic waste, old vehicles and plastics and is considering which of these recycled materials should be continued with a view to future expansion of its recycling business.

Allain Chambers – Operations Director

Allain Chambers, now 53 years old, had worked in the transportation business for over 20 years before joining ReuseR in 1994. He had previously managed his own small fleet of lorries, but when a large European logistics company had acquired his company, he felt that he wanted to stay in the industry, and personally felt strongly about recycling. The opportunity to manage the European operations and logistics at ReuseR was a challenge, but he felt he had a lot of experience to help ReuseR achieve its goals of cost reduction and improved operational safety and performance. He has been key in the selection and implementation of a €12 million IT project using satellite navigation technology that enables the company to track and monitor its large fleet of specialized vehicles.

During the early 1990's the company had experienced a few minor safety incidents, prior to his joining the company. The safety problems arose where employees had been involved with hazardous materials, which had resulted in personal injury claims. Allain Chambers feels strongly that the assets of the company are its staff, who should always be looked after as its first priority, and that a 100% safety record should be aimed for, despite the company's complex, and sometimes difficult, business.

Ellouise Matin – Human Resource Director

Ellouise Matin had joined ReuseR eight years ago after the unfortunate health and safety problems had occurred. She agreed with Allain Chambers that the staff should be better managed and safety procedures improved. These two directors have both put pressure on the Board to improve pay and conditions and to reduce working hours. In the past some staff had worked excessively long hours with large payments for overtime. Ellouise Matin considered that staff could not work effectively for long hours on a regular basis. She had initiated a recruitment drive to replace overtime with full and part-time employees. She is well respected by the ReuseR workforce for many of the Human Resources (HR) changes that have occurred.

The company has experienced problems with recruiting and also retaining, employees, despite providing training, good rates of pay and allocation of free shares for staff after two years of employment. The company is still experiencing a high staff turnover in some countries and in certain sectors of the business. HR and operational management are looking at ways in which team building and more flexible working could improve staff retention commitment to the company.

Cost control and international logistics in ReuseR

The ReuseR Board has asked Jean-Paul Gamell to investigate why the increased volumes and increased turnover has not resulted in corresponding increases in margins. At the December 2004 Board meeting, Jean-Paul Gamell tabled an analysis of costs. This demonstrated that the current level of spend on improved IT facilities was one of the contributing causes of the lower than expected margins, together with training and recruitment costs of new staff, which he explained was an ongoing high cost as the company was continuing to expand.

The Board approved a new IT project in December 2004, which has been outsourced, following on from the successful implementation of the satellite navigation tracking system in 2003. This minor additional software solution will improve the reporting of waste materials collected and the location, and status, of recycled materials. The system will additionally incorporate the automatic production of legal paperwork for cross border delivers. This IT project is forecast to cost a total of €1.5 million and to be operational before the end of 2005. The project is justified financially on the basis that it will eliminate delays due to incorrect or missing paperwork, and it will also speed up deliveries of recycled waste to ReuseR's customers.

Two of ReuseR's main costs are staff costs, in respect of the collection of waste, and secondly distribution costs associated with recycled materials. As the volume of waste collected has increased, the collection costs have reduced as a proportion of the volume of waste collected, due to economics of scale. However, ReuseR has identified that its distribution costs of recycled materials have increased significantly more than changes in volumes of materials handled would justify in recent years. Allain Chambers has left a project team to identify what costs are currently incurred and to benchmark the costs against other European recycling companies, as well as other European distribution companies.

It is planned that the investigation and report will be completed in March 2005 and that a report recommending changes will go to the ReuseR Board in April. Early findings are that transportation costs have increased significantly, while waste sorting and handling costs have fallen, mainly due to the introduction of new recycling plants in some countries. Allain Chambers has stated that the bulk of some types of recycled products, some of which have a low resale value, have contributed to the reduced margins that ReuseR has experienced in the last few years. He wants his team to identify which materials are not cost effective to transport and recycles, so that the company can take a strategic decision not to handle these products.

However, Clement Weiss has pointed out that ReuseR has won a number of long-term waste collection and recycling contracts (many with local government departments for the recycling of domestic value) on the basis that over 80% of all materials collected will be recycled. He therefore argues that the company cannot renege on its contracts, some of which are 10 and 15 year contract periods, and that the company cannot change its strategy by selecting which materials it will, or will not, handle.

Allain Chambers is therefore under pressure to identify which costs within the distribution and waste handling operations could be reduced. In some of the countries in which the company has only been operating recycling plants for a short period of time, ReuseR has not yet reached a critical mass, which would enable it to enjoy economies of scale. One additional factor is that recycled glass is currently sold to only twelve customers in Europe, whereas only three years before, ReuseR sold glass to over thirty companies. The company changed its customer profile to generate higher revenues. However, it now has higher transportation costs to move this bulky product to fewer customers over greater distances. Allain Chambers pointed out that ReuseR was able to secure longer-term contracts for the supply of recycled glass to its twelve main customers and that the contracts secured higher prices per tonne. However, the contracts stated that ReuseR would bear the transportation costs to customer's factories. Allain Chambers agreed to provide a detailed analysis of margins by recycled product for the next Board meeting.

ReuseR shareholdings, share price and earnings per share (EPS)

At the end of November 2004 there were 200 million authorised shares, with a nominal value of €20 per share, and 90 million shares were issued and fully paid up. The main shareholdings were as follows:

	Number of shares ('000) at 30 November 2004	*% shareholding*
Kurt Finehart	20,500	22.8%
Jean-Paul Gamell	7,300	8.1%
Clement Weiss	5,900	6.6%
Allain Chambers	4,100	4.6%
Ellouise Matin	1,000	1.1%
Institutional and other investors	41,800	46.4%
Employee shares*	9,400	10.4%
Total number of shares issued	90,000	100.0%

* *Note*: Employee shares are purchased by ReuseR and issued to employees free of charge.

The share price of ReuseR had risen slowly during the 1980's and 1990's and during 2004 ranged from €1.91 to €2.61. ReuseR has a current P/E ratio of 10. The industry average P/E ratio is 9. The company achieved EPS of €0.24 in 2004. The company plans to increase its EPS, in accordance with its five year plan, to €0.39 per share by 2009.

Appendix 2 shows an extract from the accounts for ReuseR.

Establishment of ReuseR's first recycling operation in the Middle East

ReuseR opened a recycling plant in October 2004 in a country in the Middle East. The move is to a stable country in the region, which has a very high record of recycling. This country is keen to establish itself as an example of high recycling levels to the rest of the world. ReuseR had wanted to establish a base in this country before the market for waste became too competitive and this would enable ReuseR to establish its name as a leading waste recycling company. However, it is forecast that this will result in operational loses for the first two years. The company has had many meetings with the large companies operating in this country and to date has signed two contracts for the recycling of waste.

Potential acquisitions by ReuseR

ReuseR has expanded its operations in the past mainly by acquisition, both by expanding into recycling different products and also into others countries. ReuseR is planning to make a number of further acquisitions to grow the business and also to give it access to new markets in other EU countries, and elsewhere, in which the company does not currently operate. The management of ReuseR believes that it has the business skills to recycle a range of materials, and that the company has existing customers who want these recycled materials. However, if recycled materials are transported back to existing customers in the EU, it is forecast that transportation costs could increase in the short term. However, within two years of ReuseR expanding its operations into a new country, it is forecast that ReuseR will have located new customers to which it could sell the recycled materials produced within that country.

The ReuseR Board had set the following criteria as a guideline for possible acquisitions:

- Gross margins (defined as sales less all direct costs, variable and fixed) must be similar or higher than achieved by ReuseR (ReuseR gross margin is over 50%);
- Sales revenue of between €10 – €30 million per annum;

- Must be a stand alone company, rather than a recycling division a larger company. ReuseR has historically found it quite difficult to manage the merger of operations post acquisition, when it has acquired the recycling division only of larger company;
- Must be willing to be acquired (for cash or share exchange), as ReuseR's management do not want to pursue a hostile take-over.

The business development department of ReuseR, headed by Clement Weiss, had identified a list thirty possible targets for acquisition, of which most are operating in EU countries. However, some potential acquisitions are operating in countries in which ReuseR does not currently operate, as well as some countries outside of Europe. From this initial list, Clement Weiss has eliminated fifteen companies as unsuitable for acquisition and he has selected three companies that he considers would be particularly suitable for ReuseR to acquire.

Clement Weiss has requested his managers in the business development department to - prepare further detailed reports on a few of the other potential acquisitions from the original thirty that had been identified, and to continue to identify new companies that are emerging in this growing marketplace. Depending on the size of the company and the price required, and whether shares or cash are used, ReuseR is planning to acquire as many as eight companies over the next eighteen months.

Jean-Paul Gamell has been in negotiations with a leading European bank to secure loan financing of €40 million in order to fund ReuseR's aggressive acquisition plans. **Appendix 1** shows an extract of the news report about the announcement of ReuseR's new financing plans agreed with this European bank.

ReuseR Board meeting in February 2005

Following on from strategic planning meetings attended by ReuseR senior managers during January 2005, a proposal was put to the Board meeting in February 2005 to agree to the three proposed acquisitions. All three companies are privately owned companies.

Jean-Paul Gamell announced to the Board that financing plans had been finalised for the loan of €40 million over eight years, at a variable interest rate of 2.15% above European lending rate, repayable in 2013. ReuseR will now have loans totaling €60 million.

The Board agreed in principle to the three acquisitions, of RED, KLL and MER. Details of these companies are shown in **Appendix 4**. The basis for ReuseR's proposed acquisitions is as follows:

1. Acquisition of RED on the basis that ReuseR does not have any recycling operations in this Eastern European country (now in the EU) and wishes to expand its geographical coverage. All investigations have shown that RED's operations are efficient and the company is operating profitably. However, it has not invested in advanced recycling plants and much capital expenditure on equipment, plant and vehicles will be necessary post acquisition.
2. Acquisition of KLL on the basis that this will help consolidate operations in a northern European country where ReuseR already has established recycling operations and has a growing customer base. This will enable it to acquire a larger customer base and better utilise the new recycling facilities that it has opened in two regions of this country to achieve operating synergies.
3. Acquisition of MER, which was one of the first recycling companies operating in the same Middle East country in which ReuseR set up a recycling plant in October 2004.

The country has seen recycling rates increase rapidly and the ReuseR Board agreed that there is huge potential in this country. Additionally, ReuseR considers that this privately owned company would benefit from ReuseR experience and expertise.

No Waste Recycling Services Ltd (NOW)

No waste recycling Services Ltd (which trades as NOW) recycles a range of product and has established long-term relationships with a number of its customers from whom it collects waste materials. Some of these customers are local government departments and divisions of multi-national companies. NOW is highly regarded as a leader in waste management and it provides its customers a high level of customer service.

NOW is a privately owned company whose shares were originally owned by two families, who ran a transportation company. However, after over 20 years in the transportation business, and increasing wage costs and competition, the company changed its trading name to NOW in 1996 and decided to enter the growing business of recycling waste. NOW handles a number of recycled products, but its two dominant business areas, which together account for almost 50% of its sales revenue are the recycling of waste paper and wooden pallets. The next most profitable sector of its recycling business is recycled glass, which accounts for almost 20% of the company's sales revenue.

When NOW first started in the recycling industry, it was able to establish very good links with a number of companies, and commenced with recycling these companies' waste paper. It soon established a high reputation as a recycling company and it has been able to forge strong links with several European wide manufacturers, to whom it sells recycled products.

The shareholders and management team of NOW at the end of 2004 are detailed below.

Imran Patel – Chairman

When his parents, who started the family's transportation business, retired, Imran Patel took over as Chairman, in 1996. As a shrewd businessman, Imran Patel, then 38 years old, saw the gap in the market for companies requiring recycled products and for their need for a specialized waste disposal and recycling service. He had worked in the transportation business all of his career and understood logistics and the need to provide customers with a quality service. Imran Patel strongly believed that the company could rapidly gain a good reputation in the growing recycling industry by exceeding customers' expectations, both in service quality and price. He is a perfectionist and very hard working, which has helped NOW maintain a high growth in turnover.

Ernst Heist – Chief Executive

Ernst Heist, now aged 48, had identified a gap in the market for recycling domestic waste and he had established quite a reputation for himself and the media dubbed him the "the man who made gold out rubbish". Fifteen years ago he had worked as an adviser to Government departments and had close political links with central government in his home country in northern Europe. Then he founded his own recycling company and was its Managing Director, until NOW acquired it in 1999. This acquisition enables NOW to expand geographically in Europe and also to almost double its turnover. For the past five years Ernst Heist has held the role of Chief Executive of NOW.

NOW's acquisition of Ernst Heist's previous company had given NOW the opportunity to expand its operations into neighbouring countries, which are all operating profitably. By 2001 the company decided to expand its recycling facilities and to commence handling certain waste materials from local industries. With the help of a government grant and bank loans the recycling facilities were quickly operating at almost maximum capacity.

Peri Patel – Operations Director

Peri Patel, who is Imran Patel's younger brother by 3 years, had not previously worked in the family's transportation company. He was the first member of the family that had graduated from university (with a degree in marketing management), and he then joined an international shipping company. Later he moved to an electrical manufacturing company. When his brother took over the family business in 1996, Peri agreed to join the company and to head up marketing and operations. Since the company has grown, a new marketing director has been recruited and Peri Patel has concentrated on operations. Peri Patel has sound management knowledge and experience and he has been the driving force behind the professionalism that NOW has established within the company. Together with his brother's demand for high-quality service, they make a formidable team.

Val Rines – Sales and Marketing Director

Val Rines, then 33 years old, joined NOW in 2000 as sales and Marketing Director. Initially she had no equity interest, but has since invested €0.9 million (financed by a personal loan secured on her family property) in the company. Val Rines had previously worked in a local government department responsible for refuse and recycling and then as the sales director for a small competitor in the recycling industry. She has much knowledge of recycling and had graduated with a degree in environmental studies.

Rik Mal – Finance Director

Rik Mal, then 45, joined NOW in 1997 shortly after the company started in recycling business and he bought shares in NOW during 2001. He is a steady, reserved character and has a close bond with the Patel brothers who respect his conservative attitude to business. They fully appreciate that Rik Mal has managed to keep the company's finances under control, given the company's rapid expansion over the last nine years.

NOW shareholdings

NOW has 20 million authorized shares, at a nominal value of €0.50 each, of which 10,620,000 shares have been issued and are fully paid up. The main shareholdings are as follows:

	Number of shares ('000) *at 31 December 2004*	*% shareholding*
Imran Patel	4,000	37.7%
Ernst Heist	2,500	23.5%
Peri Patel	1,700	16.0%
Val Rines	320	3.0%
Rik Mal	300	2.8%
Employee shares*	1,800	17.0%
Total number of shares issued	10,620	100.0%

**Note*: The employee shares have been given to employees free of charge.

Appendix 3 shows an extract from the accounts for NOW.

Growth of NOW since 1996

NOW had grown the recycling business rapidly since 1996 and has expanded its operations into six European countries. The business has always been a strong cash generator and the company has reinvested much of the cash generated from operations into expansion. It has also invested in a number of recycling plants, many of them small plants, which are located close to the main cities in which it operates waste collection services. This gives the company flexibility and reduces transportation costs.

The company has also embraced the use of IT in the business, which enables its customers that it collects waste from, to monitor volumes collected as well as collection dates and times. Its IT systems also enable customers who purchase recycled materials to place their orders and get immediate confirmation of delivery dates and volumes.

During early 2004, one of Ernst Heist's innovative came to fruition with the introduction of new recycling containers at over 800 large shopping centers in several countries. Previously most of the domestic wastes that was recycled relied on the continued social pressure to recycle goods and the increased publicity of environmental problems caused by landfill sites. Ernst Heist's new plan was to pay cash to the members of the public for each and every item of waste that was recycled, based on weight or type of waste, for example per glass bottle. Therefore, the public could now recycle paper, clothes, glass, batteries and certain other items and the new recycling containers weighed or measured the input and reimbursed coins. These newly-designed recycling containers had the added advantage that waste collected was also pre-sorted, which reduces labour costs at recycling depots.

Following a month's trial at 30 sites during 2003, the level of recycled goods had increased dramatically. The financial justification of these new "recycle for cash" containers was that if the level of recycled goods increased by more than 70%, then this would cover the increased costs, primarily the cash payments, and the higher costs for logistics for emptying the recycling containers and filling up the cash payment machines. At one site during the trial, one of the containers filled up within one day and the cash payment machine was empty, whereas the old containers were usually less than half full when they were emptied weekly. Therefore daily emptying of the 30 trial sites proved necessary to maintain public confidence in the scheme.

At end of the one-month trial, the overall level of recycling had increased much more than the required 70%, with some sites achieving 300+% higher recycling rates. This proved that cash payments do appeal to the public. NOW decided to invest in these new "recycle for cash" recycling containers for over 800 sites. This involved an investment of over €3 million. However, it was decided that the company would move the existing, old style, recycling containers (which had no payment mechanism) from these sites, when the new "recycle for cash" containers were installed, to other sites.

After monitoring the ongoing volumes of recycled goods, which generate increased turnover for NOW, most sites showed a substantial increase over previously experienced recycling levels. Overall the level of recycled goods at "recycle for cash" sites was increased by over 180% (that is the recycled goods volume had almost trebled).

However, it has since been established that collection of domestic waste (by NOW's regular weekly collection that NOW operates on behalf of local government departments) has been a decline in volumes recycled. Therefore NOW's management has reached the conclusion that some of the waste that it used to collect as part of the local government contract for domestic waste recycling, NOW is collecting via the "recycle for cash" containers, and is having to pay for. Therefore the increased volume is not entirely due to customers recycling more goods, or even new customers recycling goods for the first time, but is due to astute customers who are now recycling their waste using a different method and getting paid for recycling it.

During 2003 and the start of 2004, the company consolidated its position after a period of three years during which several acquisitions had been made. Peri Patel, the Operations Director, ensured that all of the sites that had been acquired were rationalised, and some waste storage sites were closed. Additionally, in some of the businesses that NOW had acquired, it was decided to cease handling some waste materials. NOW had no plans to be involved with liquid waste treatment and this had formed a small part of one of its recent acquisitions. NOW has been able to sell some areas of recycled waste that it did not wish to be involved with, to other waste recycling companies. NOW decided that it wanted to concentrate on its core strengths, which are the collection and processing of paper waste and reselling of the pulp to manufacturers of paper products; the recycling of wood products and glass recycling.

NOW's secure collection and pulping of waste paper for recycling

Another new development during 2003 was that NOW opened three new paper pulping plants which handle all of the waste paper collections in two of the Northern European countries in which it operates. By supplying paper pulp to several newspaper printers, rather than the waste paper itself, the transportation costs were reduced as the bulk being transported was reduced. Additionally, the revenue rate per tonne of pulped recycled paper was significantly more than the price achieved for waste paper that needed treatment and pulping. The company considered that this new change to the way in which it handled the paper side of its business could generate an additional 12% gross margin, on top of the 40% gross margin currently achieved in this recycled product sector, even after taking into account the direct incremental fixed costs of treatment and pulping.

NOW has also been innovative in the collection of waste paper and has been building up the number of companies to which it supplies a secure collection and destruction of waste paper service. It operates a fleet of purpose-designed vehicles that collect confidential waste paper and then pulps the paper on customer's premises. NOW the removes the pulped paper from customer's premises, which it then sells onto its customers who require recycled paper pulp. This service gives many companies the reassurance that all confidential material is being securely disposed of.

By the end of 2004, NOW had contracts with eight large international companies to dispose of their office waste paper securely on their premises, as well as a number of smaller customers. NOW has a contracted schedule to collect and pulp customers' waste paper. Generally it has met the agreed schedule. However, it has experienced a high staff turnover in this area of the business. TO maintain the company standards, new recruits have undergone on-sit training, which has slowed up the collection and pulping service even more. Recently there have been repeated instances where customers have been left without a collection. Customers are disappointed but so far have only complained. No contracts have been cancelled as NOW has been able to reassure customers and it is putting in place to ensure that agreed customer collections are met.

During January 2005, NOW secured two major new contracts; the first was from a local government department in a northern European country. This will generate turnover of €1.5 million per year and is for 6 years. Also, NOW is hopeful that securing this contract could lead to other contracts within that country. The other major contract was from a large international IT company to collect, pulp and recycle, in a secure manner, all of its waste paper. The IT company has appointed NOW for a trial period of two years in two European countries. If it is satisfied that NOW can meet its collection requirements within the contract terms, it may lead to a European-wide contract for waste paper collection and pulping, which could generate an additional turnover for NOW of over €5 million per year. NOW currently operates waste recycling plants in all of the European countries in which the IT company has offices, but it does not operate the specialized waste paper pulping vehicles in all countries. However, these could be purchased if NOW were to be awarded the European-wide contract in two years time.

NOW Board meeting to discuss future strategy

In January 2005, the quarterly NOW Board meeting had an item on its agenda concerning future growth strategies. During 2003 and part of 2004, NOW had not acquired any other smaller recycling companies, and Imran Patel considered that the time was right for further expansion, following a small acquisition in December 2004. He also felt that the company had a strong balance sheet and was generating cash from operations and the NOW should speed up its acquisition and expansion plans, so that economies of scale and synergies can be achieved. NOW had recently announced that it would be paying a final dividend of €0.245 per share to its shareholders.

Imran Patel stated at the meeting that NOW could not just sit back and continue to see cash being generated, as the company cannot control its destiny. In order to survive and grow it will have to continually balance its performance with its suppliers, customers, competitors and the community in which it operates. He stated that this would not be an easy task as NOW is operating in several European countries.

As NOW has grown it has reviewed and changed its business structure. Only five years ago, each country operated as a stand-alone strategic business unit. Follow a review of operating activities and a reassessment of the European market, the company changed its organization structure to enable it to deliver better customer solutions. This also involved out-sourcing of some activities, which Ernst Heist felt the company did not have the correct skill mix to retain within the company. The treasury function was outsourced to its bankers and IT development and implementation work to a global IT company. The company now has one centralized financial department in its Europe-wide HQ building with small teams operating in a few offices around Europe. IT operations were also centralized in the HW building following the review. NOW has established business units by type of recycled product, such as paper, wood or glass. This enabled line managers within each business to better serves its European customers.

After much discussion on alternative expansion plans, some of which are included in NOW's current five year plan, Imran Patel has requested Ernst Heist and Rik Mal to prepare an updated plan of future expansion for the next Board meeting in April 2005.

Pricing

NOW used to set its prices for recycled products based on the customers' ability to pay. However, with the increasing number of companies and governments involved in collecting and recycling a wide range of products, NOW has identified, in the last two years, a decline in the prices it can command for some recycled products, particularly with some of its major customers, who buy large quantities of recycled paper, wood, glass and metal.

Ernst Heist has requested Val Rines review prices and customer mix, and consider whether NOW should change its customer mix. He considers that if the company were to sell a lower quantity of recycled products to its few large customers, and more to smaller companies, it could achieve at least 15% more in sales revenue. Val Rines stated that NOW's larger customers had continued demand for its recycled materials and NOW should not put at risk its customers' loyalty, to achieve higher margins in the short term. Val Rines wants to set up long-term supply contracts so that its long-term waste collection contracts can be matched by region and by product type. Val Rines does not feel that the company should be looking to make short-term profits by selecting higher revenue generating customers, at the expense of long-term customer stability.

Appendix 1

European News

25th February 2005

Finehart secures loans of €40 million today with a leading European bank

Entrepreneur, Kurt Finehart, Chairman and Chief Executive of leading recycling company, ReuseR, today announced that loan financing had been secured to fund further European acquisitions of recycling companies, as well as expansion into the rapidly growing recycling industry in some of the Middle East countries.

Finance Director, Jean-Paul Gamell stated, "this loan will enable ReuseR to expand its operations to other European Union countries which will enable the company to benefit from further economies of scale. I am confident that ReuseR's planned growth strategy will have a long term positive effect on the company's share price".

Finehart stated "the financing package agree is good for the company, good for the EU and good for the environment." He added, "With ReuseR handling higher volumes of waste for recycling throughout Europe, this will result in more materials being recycled and less waste and pollution".

The news was received positively in the market and ReuseR's share price rose 5.8% to €2.68 per share at the close of trading today.

It is believed that negotiations with possible companies that ReuseR is planning to acquire are well underway. The market expects that bid announcements will be made over the next few weeks.

Appendix 2

Notes: All data in the Appendices are presented in International Financial Reporting format.

ReuseR

Balance Sheet	*As at 30 November 2004*		*As at 30 November 2003*	
	€ million	*€ million*	*€ million*	*€ million*
Non-current assets (net)		**131.9**		**123.3**
Current assets				
Inventory	20.8		19.9	
Trade receivable	46.5		39.1	
Cash and short term investments	6.4		4.1	
		73.7		63.1
Total assets		**205.6**		**186.4**
Equity and liabilities				
Equity				
Paid in share capital		18.0	18.0	
Share premium reserve		21.6	21.6	
Profit and loss reserve		109.8	95.1	
			149.4	**134.7**
Non-current liabilities				
7% Loan notes (redeemable in 2011)			**20.0**	**20.0**
Current liabilities				
Trade payables		22.5	19.6	
Tax		6.1	5.9	
Accruals		7.6	6.2	
			36.2	**31.7**
Total equity and liabilities			**205.6**	**186.4**

Note: Paid in share capital represents 90 million shares at €0.20 each.

Income Statement	*Year ended 30 November 2004 € million*	*Year ended 30 November 2003 € million*
Revenue	214.2	184.0
Total Operating costs	185.0	155.9
Operating profit	185.0	155.9
Finance costs	29.2	28.1
Tax expenses (effective tax rate at 22% after allowances)	−1.4	−1.4
Profit for the period	**21.7**	**20.8**

Statement of changes in equity year ended 30 November 2004

	Share capital € million	*Share premium € million*	*Retained earnings € million*	*Total € million*
Balance at 30 November 2003	18.0	21.6	95.1	134.7
Profit for the period	–	–	21.7	21.7
Dividends paid	–	–	−7.0	−7.0
Balance at 30 November 2004	**18.0**	**21.6**	**109.8**	**149.4**

Appendix 3

Note: All date in the Appendices are presented in International Financial Reporting format.

NOW

Balance Sheet	*As at 31 December 2004* € *million*	€ *million*	*As at 31 December 2003* € *million*	€ *million*
Non-current assets (net)		**53.8**		**44.8**
Current assets				
Inventory	5.9		7.1	
Trade receivables	12.9		12.1	
Cash and shot-term investment	2.3		0.4	
		21.1		**19.6**
Total assets		**74.9**		**64.4**
Equity and liability				
Equity				
Paid in share capital	5.3		5.2	
Share premium reserve	4.0		3.6	
Profit and loss reserve	44.4		34.7	
		53.7		**43.5**
Non-current liabilities				
Bank loan (repayable in 2005) at 10% interest per year		**0.0**		**43.5**
Bank loan (repayable in 2009) at 10% interest per year		**11.9**		**11.9**
Current liabilities				
Bank loan (repayable in 2005)	2.5		0.0	
Trade payable	3.3		3.2	
Tax	2.9		2.2	
Accruals	0.6		1.1	
		9.3		**6.5**
Total equity and liabilities		**74.9**		**64.4**

Note: Paid in share capital represents 10.26 million shares at €0.50 each at 31 December 2004.

Income Statement	*Year ended 31 December 2004* € *million*	*Year ended 31 December 2003* € *million*
Revenue	55.8	48.3
Total operating costs	39.2	35.1
Operating profit	16.6	13.2
Finance cost	−1.4	−1.4
Tax expense		
(effective tax rate at 19% after allowances)	−2.9	−2.2
Profit for the period	**12.3**	**9.6**

Statement of changes in equity year ended 30 November 2004

	Share capital € *million*	*Share premium* € *million*	*Retained earnings* € *million*	*Total* € *million*
Balance at 31 December 2003	5.2	3.6	34.7	43.5
Shares issued during the period (to employees)	0.1	0.4	–	0.5
Profit for the period	–	–	12.3	12.3
Dividends paid	–	–	−2.6	−2.6
Balance at 31 December 2004	**5.3**	**4.0**	**44.4**	**53.7**

Appendix 4

Data on ReuseR proposed acquisitions

All figures have been restated in € million for latest financial year	*RED*	*KLL*	*MER*
Geographic location	Eastern European EU	Northern European	Middle East
Turnover	12.0	18.0	28.0
Gross margin	6.1	10.1	18.2
Net profit (after tax)	1.0	2.0	7.6
Gross margin %	51%	56%	65%
Net margin %	8%	11%	27%
Company status	Privately owned	One operating division of a privately owned company	Privately owned
Form or acquisition:	Cash	Cash or	Cash or
Cash or shares		ReuseR shares	ReuseR shares
No. of Employees:	96	220	292
Recycled products	Glass tyres, industrial waste	Domestic recycled waste only	Glass, chemicals, paper and some other industrial waste
Other relevant data:	Local press reports state that company is struggling with a cash shortage and that it has been unable to secure further loans	This is a small competitor of ReuseR that has secured a number of government domestic waste recycling contracts by under-cutting ReuseR on price. Reuse would like to eliminate this competitor before it grows larger and becomes more of a threat. It would also help ReuseR to achieve greater economies of scale in this country	This would be ReuseR's first acquisition of a company operating outside of Europe. MER is operating in the same Middle East Country in Which ReuseR opened a Recycling plant in October 2004 ReuseR's five-year plan had identified a number of regions globally that have an increasing recycling industry. The Middle East is achieving high levels of recycling and this company could provide ReuseR with a customer base in this country from which to increase trade

5.2.2 ReuseR and NOW – unseen material and requirement for May 2005

ReuseR and NOW – Unseen material provided on examination day

Additional (unseen) information relating to the case is given on pages 00 to 00. Read *all* of the additional material before you answer the question.

ANSWER THIS QUESTION

You are Franc de Loore, the Business Development Director at Shard.

You have been requested to write a report to the Board of Shard, following the recent Board meeting, concerning how Shard could secure the sources of recycled materials in the longer term.

Your report should cover the issues discussed at the Board meeting, as minuted in *Appendix 5* of the unseen material.

Note: *The TOPCIMA Assessment Matrix, against which your script will be marked, is on the next page for your reference.*

ReuseR and NOW – Unseen material provided on examination day

Read this information before you answer the question

Shard

Background

In recent years many large international manufacturing companies have been building up their own recycling divisions. Shard is a major European company, listed on a European stock exchange. Shard has two main business areas, manufacturing glass and newspaper publishing and printing, which are both profitable. The company manufactures glass for a significant proportion of the new cars manufactured in Europe and it also manufactures over six billion glass jars and bottles annually. Shard also owns eight European newspaper titles, which it acquired in a move to diversify over nine years ago. All titles are operating profitably, but margins are becoming tighter.

Shard operates three divisions, which are glass, newspapers and recycled materials. The glass division is the largest and in the year ended February 2005 generated over 82% of Shard's operating profit. The newspaper division generated almost 16% and the balance of Shard's operating profit was generated by sales of recycled products.

Shard has achieved significant growth in turnover, profitability and EPS in the last 10 years through internal growth, geographic growth and external growth through acquisitions. The company has a stated aim of achieving productivity gains of over 4% per year and of continually improving its EPS. The company's share price has fluctuated due to global economic factors, but is currently near its high for the last 12 months at €13.95 per share.

Shard is also at present negotiating for a major new contract, which could result in an increase in glass production from its current level of 81% of capacity, up to 89%. However, there are several other manufactures bidding for the contract and Shard may, or may not, be successful in being awarded it. The outcome will not be known until the end of 2005.

Shard and recycling

Shard plans to achieve cost savings by continually upgrading its industrial efficiency and also by acquiring some of its key raw material suppliers, thereby controlling supply and price of these crucial inputs into its glass manufacturing and newspaper printing process. Furthermore, like many industries, the glass and newspaper industries are under increasing pressure to meet recycling targets. Shard currently uses recycled glass for about 38% of its raw materials in the glass division and around 16% of its total paper supply for newspaper printing is recycled paper.

In a benchmarking exercise, Shard's Finance Director identified that some competitors use higher levels of recycled materials. Shard's Finance Director has reported that he considers that Shard should aim to significantly increase the levels of recycled materials used by the glass and newspapers divisions within the next three years. He considers that Shard should have targets of 60% for recycled glass and 75% for recycled paper.

Shard currently operates a small number of recycling plants in several countries that supply glass and paper to the main businesses, but these have failed to grow significantly over recent years. Shard has believed for a long time in the importance of recycling glass and the cost benefits of obtaining recycled glass for its raw materials. The higher the proportion of recycled glass, the better the gross margin is on that batch of glass output, due to lower raw material costs and also lower energy costs in production. The glass industry globally is under pressure to reduce costs to remain competitive. In addition, the European glass industry is being put under pressure to increase the level of recycled glass by the EU authorities. Furthermore, the newspaper industry is also trying to reduce costs without affecting quality.

Shard has been obtaining higher levels of recycled glass and paper over the last five years by establishing links with over twenty recycling companies, of which two are ReuseR and NOW. ReuseR has supplied and worked closely with Shard for many years. ReuseR's Chairman and Chief Executive, Kurt Finehart, is also a non-executive director of Shard, having been invited to join its Board three years ago.

Proposed expansion of Shard's recycling division

The Shard Board of Directors has long been considering expanding its recycling division and feel that the time is right to embrace the challenges of corporate social responsibility. Not only do they feel that it is right for society, it also makes good commercial sense as each euro saved on raw materials improves Shard's profitability. Its own recycling division currently acquires waste materials, including glass and paper as well as other materials from a range of sources, mainly from contracts to collect waste from other manufacturing companies. Shard's recycling division sells unwanted recycled materials to other companies, but retains all recycled glass and paper for Shard's two businesses.

The Shard Board met on 23 May 2005 and France de Loore, Shard's Business Development Director, was requested to investigate the possible acquisition of a recycling company. It was considered that this would enable Shard to have access to a much higher level of recycled materials much more quickly than it could if it continued to build up its own recycling division, which has not grown as expected. The Business Development Director had already eliminated a number of recycling companies from the shortlist of possible companies to acquire, as they handle a wider range of recycled goods than Shard is interested in. The two alternative recycling companies that Shard is considering acquiring are *ReuseR or NOW*.

The Shard Board is not united in its decision to progress the acquisition of a recycling company and the comments made by Directors at the Shard Board meeting on 23 May 2005 are shown in an extract from the minutes of the meeting in **Appendix 5**.

Kurt Finehart (a non-executive director of Shard) was present at the Board meeting on 23 May 2005, and he also had access to the Shard Board papers concerning the potential acquisition of ReuseR, where he is Chairman and Chief Executive. His reaction to the possible acquisition of ReuseR is also shown in **Appendix 5**.

At the meeting, Franc de Loore was requested to prepare a report for the next Shard Board meeting in June, concerning whether either company was suitable for acquisition.

Shard's key financial data

Summary key financial data for Shard is shown below:

		Year ended February 2005	*Year ended February 2004*
Shard group revenue (€ *Million*)		2,040	1,940
Operating and administrative costs (€ *Million*)		1,692	1,595
Operating profit (€ *Million*)		348	345
Interest and other finance charges (€ *Million*)		(68)	(72)
Taxation (30%) (€ *Million*)		(84)	(82)
Profit for the period (€ *Million*)		**196**	**191**
No of shares fully paid up		214 million	214 million
Earnings per share (EPS)	€	0.92	0.89
Dividends per share (DPS)	€	0.37	0.35
P/E ratio		15	15
Market capitalisation (at end February each year) (€ *Million*)		2,941	2,870
Net debt (€ *Million*)		802	895
Capital expenditure during year (€ *Million*)		87	82
Share price – range in year	€	13.24–14.01	12.68–13.45

Due to Shard's current long-term debt repayment schedule and continued expansion, the company has decided that it is not able to acquire either recycling company for cash.

Shard's post tax cost of capital is 9%. Shard's share price at 20 May 2005 is €13.95 per share.

Shard does not yet have access to detailed management accounts from either ReuseR or NOW, which would give a breakdown of profitability by sector. The only accounting data that Shard currently has access to is the statutory accounts for both companies (of which extracts are included in **Appendices 2** and **3** to the pre-seen material). From the statutory accounts, Shard also has details of operating cash flows generated, which are shown below.

Forecast effect on Shard's cash flows if a recycling company is acquired

It is forecast that Shard could achieve operating efficiencies and cost savings through the use of higher levels of recycled glass and recycled paper, assuming that the majority of production of recycled glass and paper that is currently sold by ReuseR or NOW is supplied to Shard and contracts with existing customers are not renewed.

The after-tax effect on the Shard group's cash flows is forecast to be as follows:

After-tax effect on Shard's group cash flows	*If ReuseR is acquired € million*	*If NOW is acquired € million*
Glass manufacture:		
Savings to Shard due to price differential between recycled glass and "new" raw materials	3.6	0.8
Energy savings (through the use of greater amounts of recycled glass)	3.5	0.7
Increased transportation cost to Shard factories	(1.6)	(0.3)
Newspaper printing:		
Savings to Shard due to price differential between recycled paper pulp and new paper	4.0	2.8

It is forecast that if Shard chose to acquire ReuseR, it would sell some areas of the ReuseR business and the effect would be a one-off net benefit to Shard of €5 million (post-tax). This benefit to Shard is not included in the cash flow figures in the table above. The management of Shard does not forecast any substantial changes if NOW were to be acquired.

The two companies being considered for acquisition have generated the following post-tax operating cash flows in the year ended during 2004:

	ReuseR € million	*NOW € million*
Post tax operating cash flows for year ended during 2004 (as extracted from latest statutory accounts)	33.6	17.8

Franc de Loore has forecast that if ReuseR was acquired, its post-tax operating cash flows could grow by around 10% per year. He has also forecast that if NOW was acquired post-tax operating cash flows could grow by around 20% per year.

Shard's acquisition policy states that it evaluates potential acquisitions over a 6 year period.

Investigations on ReuseR and NOW

Franc de Loore has investigated ReuseR and NOW as part of his research prior to the possible acquisition of either of these two companies. He has been able to obtain the following information about the companies.

ReuseR

ReuseR's audit

ReuseR's audit identified a number of problems:

- Criticisms of how a recent acquisition had been accounted for, including an overstatement of the valuation of stocks and other assets.
- A number of minor frauds had occurred during 2004, one involving substantial cash movements, which had already been identified by ReuseR management and the employee involved has left the company.
- Weaknesses in the ReuseR's finance team, particularly in certain countries.

Safety issues at ReuseR recycling plants
During April 2005 there were two separate accidents at different ReuseR recycling plants and in one of these accidents there were two deaths. One worker had got trapped in a machine. A fellow worker tried to help and both were fatally injured. Safety instructions had not been followed.

The Health and Safety (H & S) authorities had investigated the latest accident and their preliminary report found that there was widespread ignorance of safety issues and that at some ReuseR plants they had visited, there were inadequate safety instructions and a shortage of safety equipment (including safety goggles and safety hats). The report gave ReuseR management 28 days before a further inspection during June 2005. There is a possibility of the H & S authorities imposing fines or the possibility of one, or more, of the recycling plants being closed down until safety measures have been improved.

ReuseR share price
ReuseR's share price has fluctuated between €1.91 and €2.61 during 2004. Following news of the accidents at ReuseR recycling plants in April 2005 and subsequently the H & S report, ReuseR's share price had slipped to around €2.20 by early May 2005. On Friday 20 May 2005, ReuseR's share price had been boosted to €2.31 as it had just announced the successful acquisition of RED in an Eastern European country.

NOW

1. *NOW's staff problems*
   France de Loore has identified that NOW is experiencing staff recruitment and staff retention problems. The terms and conditions of employment in NOW are poor in relation to industry practice. Although NOW employees receive regular training, they work long hours and many NOW employees are less skilled than those in other recycling companies. Many NOW employees feel under pressure from working long hours and they have a demanding waste collection schedule to achieve. Many of NOW's staff feel that they cannot meet the demands of their jobs.
2. *NOW's problems with its secure waste paper collection and pulping service*
   NOW operates a fleet of specialised waste paper recycling vehicles that deal solely with pulping confidential waste paper materials on customers' premises. Franc de Loore has investigated NOW and has identified that it is experiencing problems with its secure collection and pulping service. The information has come from reliable sources.

   In early May 2005, NOW had one of its contracts terminated by one of its largest customers, LW, which has also filed a legal charge against the company. LW has claimed that NOW did not securely dispose of all of its confidential waste paper, which should have been collected and pulped on LW's premises. LW has discovered that large quantities of commercially sensitive papers were instead disposed of in a standard waste disposal site. LW's management is very concerned at this major lapse of NOW's secure collection and pulping service of LW's confidential papers. NOW is investigating how this lapse in its confidential waste paper disposal service has occurred, when the papers should have been pulped at LW's premises. NOW is tightening procedures, and trying to rebuild confidence in its waste paper pulping service before other customers learn of this problem.

   Franc de Loore has been advised that the lapse with LW's confidential waste paper is not the first time such an incident has occurred. He is also reliably informed that the NOW

Board is aware of the problems with its collection and recycling service for confidential waste paper. He has also been made aware that Val Rines (NOW's Sales and Marketing Director) is very annoyed that she had not been informed of all of the previous problems. Val Rines is understood to have been in favour of temporarily suspending the confidential waste disposal service, but the NOW Board disagreed.

3. *Valuation of NOW*
NOW is not a listed company. The Shard Board has an acquisition policy of valuing non-listed companies using a multiple of six times the level of its latest post tax earnings.

Appendix 5

Extract from the minutes of Shard Board meeting held on Monday 23 May 2005

Item 5 from agenda: Securing long-term supplies of recycled materials		***Responsibility***
5.1	There was a detailed discussion about how Shard could secure long-term supplies of recycled materials.	–
5.2	The Director of Glass and the Procurement Director both consider that Shard should enter into long-term contracts with its key suppliers, not acquire them. The latter has been very outspoken in his criticism of the proposed strategy to strengthen the recycling division of Shard.	–
5.3	Shard's Chairman and Finance Director of Shard are in favour of Shard's proposed enlargement of its own recycling division. Both directors consider that this would lead to significant cost savings in raw materials and energy costs. Shard's Chairman and Finance Director are both in favour of acquiring a recycling company to enlarge Shard's own recycling division. The Board agreed that a strategic analysis of the benefits and problems of acquiring a recycling company is required. The Chairman also wants the Board to consider recommendations of which, if either, of the two alternative companies (ReuseR or NOW) should be acquired.	–
5.4	The Finance Director stated that there is a need to ensure that the acquisition valuations recognise the need to improve Shard's shareholder value. The Finance Director also reminded the Board that the success of any acquisition is usually determined by the acquiring company's ability to plan and implement a successful post acquisition strategy.	–
5.5	Kurt Finehart, a non-executive director of Shard (who is also the Chairman and Chief Executive of ReuseR) stated that he personally was not in favour of Shard acquiring ReuseR. He proposed that Shard acquired NOW.	–
5.6	The Business Development Director has been requested to prepare a report for the next Shard Board meeting.	**de Loore**

5.2.3 ReuseR and NOW – assessment matrix

May 2005 – Assessment Matrix for TOPCIMA – (Recycling – ReuseR and NOW)

Criterion	*Marks*	*Clear Pass*	*Pass*	*Marginal Pass*	*Marginal Fail*	*Fail*	*Clear Fail*
Technical	**10**	Thorough display of relevant technical knowledge. **9–10**	Good display of relevant knowledge. **6–8**	Some display of relevant technical knowledge. **5**	Identification of some relevant knowledge, but lacking in depth. **3–4**	Little knowledge displayed, or some misconceptions. **1–2**	No evidence of knowledge displayed, or fundamental misconceptions. **0**
Application	**10**	Knowledge clearly applied in an analytical and practical manner. **9–10**	Knowledge applied to the context of the case. **6–8**	Identification of some relevant knowledge, but not well applied. **5**	Knowledge occasionally displayed without clear application. **3–4**	Little attempt to apply knowledge to the context. **1–2**	No application of knowledge displayed. **0**
Diversity	**10**	Most knowledge areas identified, covering a wide range of views. **9–10**	Some knowledge areas identified, covering a range of views. **6–8**	A few knowledge areas identified, expressing a fairly limited scope. **5**	Several important knowledge aspects omitted. **3–4**	Many important knowledge aspects omitted. **1–2**	Very few knowledge aspects considered. **0**
Focus	**10**	Clearly distinguishes between relevant and irrelevant information. **9–10**	Information used is mostly relevant. **6–8**	Some relevant information ignored, or some less relevant information used. **5**	Information used is sometimes irrelevant. **3–4**	Little ability to distinguish between relevant and irrelevant. **1–2**	No ability to distinguish between relevant and irrelevant information. **0**
Prioriti-sation	**10**	Issues clearly prioritised in a logical order and based on a clear rationale. **9–10**	Issues prioritised with justification. **6–8**	Evidence of issues being listed in order of importance, but rationale unclear. **5**	Issues apparently in priority order, but without a logical justification or rationale. **3–4**	Little attempt at prioritisation or justification or rationale. **1–2**	No attempt at prioritization or justification. **0**
Judgement	**10**	Clearly recognises alternative solutions. Judgement exercised professionally. **9–10**	Alternative solutions or options considered. Some judgement exercised. **6–8**	A slightly limited range of solutions considered. Judgement occasionally weak. **5**	A limited range of solutions considered. Judgement sometimes weak. **3–4**	Few alternative solutions considered. Judgement often weak. **1–2**	No alternative solutions considered. Judgement weak or absent. **0**
Integration	**10**	Diverse areas of knowledge and skills integrated effectively. **9–10**	Diverse areas of knowledge and skills integrated. **6–8**	Knowledge areas and skills occasionally not integrated. **5**	Knowledge areas and skills sometimes not integrated. **3–4**	Knowledge areas and skills often not integrated. **1–2**	Knowledge areas and skills not integrated. **0**
Logic	**20**	Communication effective, recommendations realistic, concise and logical. **16–20**	Communication mainly clear and logical. Recommendations occasionally weak. **11–15**	Communication occasionally unclear, and/or recommendations occasionally illogical. **10**	Communication sometimes weak. Some recommendations slightly unrealistic. **5–9**	Communication weak. Some unclear or illogical recommendations, or few recommendations. **1–4**	very poor communication and/or no recommendations offered. **0**
Ethics	**10**	Excellent evaluation of ethical aspects. Clear and appropriate advice offered. **9–10**	Display of relevant knowledge. **6–8**	Some evaluation of ethical aspects. Advice offered. **5**	Weak evaluation of ethical aspects. Little advice offered. **3–4**	Poor evaluation of ethical aspects. No advice offered. **1–2**	No evaluation of ethical aspects. Unethical, or no, advice offered. **0**
TOTAL	**100**						*© CIMA – July 2005*

5.2.4 ReuseR and NOW – Case writer's answer

TOPCIMA – Recycling case
Case writer's answer

To: Shard Board
From: Franc de Loore

Report Contents:

1.0 Introduction
2.0 Terms of reference
3.0 Review and prioritisation of the issues facing Shard
4.0 Alternative sources of recycled materials for Shard
5.0 Implications of alternative ways of sourcing recycled materials in the longer term
6.0 Strategic analysis of the benefits and problems of acquiring a recycling company
7.0 Appropriate valuations of the possible acquisitions
8.0 Recommendation of which recycling company should be acquired
9.0 Discussion on post acquisition strategy
10.0 Recommendations and conclusion

Appendix 1: SWOT analysis for Shard
Appendix 2: BCG matrix analysis
Appendix 3: Financial analysis of Shard, ReuseR and NOW
Appendix 4: Valuations for acquiring ReuseR
Appendix 5: Valuations for acquiring NOW (assuming 20% growth)
Appendix 6: Alternative valuations for acquiring NOW (assuming 10% growth)

1.0 Introduction

Shard is a large, listed company based in Europe, which manufactures glass products and through a move to diversify, Shard also publishes and prints eight European newspaper titles. It is currently examining ways in which it can source a much greater volume of recycled products, both glass and paper, to use as raw materials. Shard is considering a range of alternatives, including the possible acquisition of either of two recycling companies, both of which currently supply recycled materials to Shard.

Shard is profitable, and has a stated aim of achieving productivity gains of over 4% per annum. Its share price is near its high for the last 12 months at €13.95, giving Shard a market capitalisation of almost €3,000 million. Shard is around 14 times larger (in market capitalisation terms) than ReuseR, the larger of the two recycling companies that it is considering acquiring, in order for it to secure large volumes of recycled materials for its own glass manufacturing and printing purposes.

2.0 Terms of reference

I am the Business Development Director Of Shard and have been instructed by the Shard Board to prepare a report for the next Shard Board meeting on how the company can secure supplies of recycled materials in the longer term. The Board has also requested that the report should include a strategic analysis of the benefits and problems of acquiring a recycling company, together with recommendations of which, if either, of the two companies that have been identified, should be acquired. The report will also cover valuations of the two alternative acquisitions and the need to improve Shard's shareholder value. The report will discuss the post acquisition strategy that would be required if a recycling company were to be acquired by Shard.

3.0 Review and prioritisation of the issues facing Shard

There are a number of issues facing Shard, but the over-riding crucial issue to be addressed first is what business is Shard in? It has successfully diversified into newspaper publishing and printing, but margins are being squeezed and this industry is become much more price competitive. So how can Shard deliver growth in EPS and growth in its share price for its shareholders?

There is also increasing EU authority pressure for companies to recycle and to use more recycled materials in their manufacturing process. Additionally there are the cost savings that can be achieved, through the greater use of recycled materials, as less energy is required in both the glass manufacturing business and the printing business.

The strengths, weaknesses, opportunities and threats facing Shard are shown in Appendix 1.

However, does Shard really want to diversify into the recycling industry? Is the company planning to acquire a recycling company because it wants to diversify and improve profitability, or does it simply want continuity of supplies, given the EU pressure (and cost control pressure) to increase the volume of recycled goods? It could simply enter into a long-term contract for increased supplies of recycled glass and recycled paper from ReuseR, NOW or other companies. This is discussed in paragraph 4.0 below.

Shard needs to continue to grow its EPS, which has only increased by 3.4% over the last year, which is a little less than the 4% productivity gains that the company has a stated aim of achieving. Some financial analysis for Shard, as well as for ReuseR and NOW, are shown in Appendix 3.

If Shard were to acquire a recycling company, it could achieve the following three benefits, which would have a significant long-term impact on Shard's EPS:

These are:

1. Shard would enjoy the profitability generated by either of the recycling companies, which are achieving higher net margins and higher growth than Shard's main businesses.
2. It would benefit from cost savings in raw materials because of the cost differential between buying recycled glass and paper and the cost of "new" raw materials.
3. Using more recycled materials, especially glass, would lead to energy savings in glass production. These are estimated to be €9.5million if ReuseR is acquired and €4.0 million if NOW is acquired.

The Shard Board is split on whether it should acquire a recycling company. However, the two companies being considered for acquisition are both highly profitable and growing fast and would also lead to significant cost savings in the Shard group.

The next critical question is which one of the two companies being considered, ReuseR or NOW, would be a better strategic fit? Another factor that should be considered is which company would result in the greater post acquisition synergies and be the easier of the two companies to manage post acquisition. The other key factor is what price the target company could be acquired for, and which would create the greater shareholder value for Shard's shareholders.

4.0 Alternative sources of recycled materials for Shard

Shard has a number of ways in which it can source recycled material for glass production and newspaper printing. These include:

1. Improving and expanding its own "in-house" recycling division, which the case material states has "not grown as expected". Shard could expand its own recycling division by changing and improving the top management within its recycling division. It should also set realistic but challenging targets for increased volumes of recycled materials. Management could have performance related pay linked to volumes of recycled materials available for Shard's other divisions. The current operations of Shard's recycling division should be reviewed, together with its supply chain, in order to expand and improve the flow of recycled materials available for Shard's other divisions. It could benchmark itself against its competitors.
2. Entering into long-term contracts with its key suppliers, which include ReuseR and NOW. It should be noted that NOW is currently considering changing its customer mix to increase its sales revenue and Shard may find that NOW will not want to supply to them unless the prices are increased. This conflicts with Shard's stated aim of productivity and cost savings. Many recycling companies supply their recycled materials on long-term contracts to a small range of companies.
3. Shard could enter into long-term contracts with a large range of smaller suppliers, but this could increase its operational complexity and its administrative costs.
4. It could acquire either ReuseR or NOW.
5. It could do any combination of the above four alternatives.

It is recommended that Shard should expand its recycling division and a new Director of the recycling division is appointed with clear achievable targets for volumes of recycled materials.

In the real world, there are a large number of smaller companies in the European recycling industry such as the Glade group, Shredfast, Bywaters and Wastecycle. It is companies such as these that Shard could enter into long-term supply contracts with. Alternatively, small companies such as these types of companies, who are smaller than NOW, could perhaps be possible future acquisition targets for Shard, if they are not acquired by other recycling companies in the meantime.

If a recycling company were to be acquired, the role of Director of Shard's recycling division could be filled by a director from the company being acquired. The offer of a main Board appointment in charge of the entire recycling division at Shard, a major European listed company, would add to the benefits of acquiring ReuseR or NOW. This is because both companies have extensive experience in this specialised segment and it would ease the problems that could be experienced post acquisition. It would also allow the management of the company being acquired to take on a senior role at Shard.

5.0 Implications of alternative ways of sourcing recycled materials in the longer term

The main implications of alternative ways of sourcing recycled materials in the longer term comes down to two factors, which are:

1. Availability
2. Price.

As EU authorities increase its pressure on companies to increase the levels of recycled goods, there will be more companies all competing for a limited, albeit growing, volume of recycled materials. Companies who have secured their long-term sources of recycled materials, either through long-term contracts or through their own recycling activities, will be better placed to meet these recycling targets.

The other aspect is that companies who use increasing levels of recycled materials will have cost, and therefore pricing, advantages over their competitors, due to lower material and energy costs involved in the manufacturing process.

Another factor, is that companies who are actively recycling materials and using large volumes of recycled materials in their manufacturing process are viewed positively by investors, the stock market and its customers. If Shard were to expand its recycling department by acquiring either ReuseR or NOW, it may be more likely to be awarded the major new contract for glass manufacturing. This may be because Shard's decision to use more recycled material will convey to the potential customer that it has secured sources of supply. It could also give Shard a positive "green" image and companies will want to be associated with it.

In the real world a large number of manufacturers, including the global glass manufacturer St Gobain, have all significantly expanded their recycling divisions. These companies have seen significant growth in their sales, which is partly due to their "green" image.

The Waste Recycling group has grown very rapidly in the recycling industry and it has made a large number of acquisitions in order to grow its business. It has long-term supply contracts with its key customers. This company could be compared to ReuseR.

The second implication of using recycled materials is the price. As the commercial needs, and also the pressures from EU authorities, increase over the next 10 years for companies to increase their use of recycled materials, the price for recycled materials will rise. Therefore recycled material will become a, relatively, scarce source of raw materials. Companies who have already secured long-term contracts for the supply of recycled materials, or have their own recycling divisions, will have a supply advantage, and also a cost advantage, over their competitors.

The move to become more actively involved in recycling has far reaching effects and is generally viewed positively by business as well as society and governments. All businesses should be considering the ways in which environmental issues can secure competitive advantage.

Most fund managers state that the best companies should aim to exceed the existing legislation, and this is seen to benefit investors by reducing business risk.

6.0 Strategic analysis of the benefits and problems of acquiring a recycling company

6.1 Industry life cycle

Shard currently has two businesses, the manufacture of glass, which is in the shake-out or possibly in the maturity stage of its life cycle as an industry. Many smaller manufacturers have been acquired or have ceased trading and the global glass market remains very competitive with many companies competing for glass manufacturing contracts, as stated in the un-seen material.

Shard's other business unit, the newspaper publishing and printing business, is also in a competitive industry and margins are being squeezed. This business is in the maturity stage of its life cycle.

No financial data is given in the un-seen material on the profitability or cash flows for each business unit, except that it stated that both businesses are operating profitably. It is likely that the newspaper business will become less profitable over the next 10 years as there is a trend to get news from other media sources (TV, Internet, radio) and fewer people are buying newspapers. This trend is outside the control of Shard.

The recycling marketplace that ReuseR and NOW operate in is in its growth phase of its life cycle. If Shard were to acquire either company, this investment could generate stronger cash flows over the next ten years, when it is likely that the cash generated by the newspaper business starts to decline. Additionally, depending on Shard's current market share (which is not given) and its success, or otherwise, in winning new contracts over the next few years, the company could see declining cash generation from the glass business also.

It is also possible that if Shard were to acquire a recycling company which would provide it with secure long-term supplies of recycled materials, this would put Shard in a better competitive and environmental position, from which it is likely to be more successful in winning further glass manufacturing business.

Therefore it is recommended that Shard does diversify into the recycling business, which is in the growth phase of its life cycle. The recycling industry is certainly growing rapidly at present and there is much more growth expected, both in Europe and globally. If companies are going to be able to meet the recycling targets that governments are likely to set as legal requirements over the next decade, this could prove to be a very profitable and high growth acquisition.

6.2 The BCG matrix

The un-seen material does not give market share data or profitability information about each of Shard's two businesses. However, we can conclude that the newspaper publishing and printing business is currently generating cash for Shard, as much of the infrastructure for the business was probably in place when Shard acquired the newspaper business nine years ago.

Shard's glass manufacturing business has a low market growth rate, but the company has retained its market share. Therefore in the BCG matrix, it would be classified as a "cash cow".

Similarly, the newspaper business is cash generating, but may be in a declining industry, which may result in this business moving from a "cash cow" to a "dog" in the next few years.

The recycling companies are classified in the BCG matrix as "stars", although it is possible that with the safety problems that ReuseR is experiencing, and the operational problems with its secure waste paper disposal service that NOW has identified, that these two companies would be classified as "Question marks" or "problem children" in the BCG matrix.

This interpretation of Shard's businesses, and the companies that are being considered for acquisition, is shown in the BCG matrix format in Appendix 2.

6.3 General strategic benefits of acquiring a recycling company

Shard's Chairman and the Finance Director are in favour of Shard's proposed enlargement of its recycling division. Both Board members consider that a related diversification into the recycling industry, which is growing rapidly, could help Shard increase its EPS and also make the company appear more socially acceptable.

An acquisition of a recycling company will also positively affect Shard's global image and make it appear as if it is recycling materials itself, rather than buying in recycled materials, so enabling its corporate image to appear "more green".

In the real world, the French glass manufacturer, St Gobain, has built up its own recycling division, which is operating profitably and producing a large quantity of the raw materials required for its manufacturing companies.

Other general strategic benefits are as follows:

- How would Shard's shareholders and the market view the acquisition? In the real world, most of the acquisitions by manufacturing companies of companies in the recycling industry have been viewed positively and have resulted in a greater demand for shares, which has had a positive effect on the share price.
- Which company would be easier to merge into Shard and would achieve the greater benefit. ReuseR is a listed company and is four time larger (in turnover terms) than NOW and could be easier to integrate into Shard.
- Although ReuseR is almost four times larger than NOW in turnover terms, NOW has higher net profit to sales ratios and also a higher ROCE and its growth is higher (forecast at 20% rather that ReuseR's 10% growth).
- A new head of the Recycling division at Shard should be appointed, possibly with a place on Shard's main Board, as the current manager has failed to grow this division, which has led to the proposed acquisitions. This post could be filled with one of the key senior managers from the company acquired.
- Tax issues – both ReuseR and NOW are paying tax at a lower effective tax rate, perhaps because of capital allowances, and this could lower Shard's overall tax rate, as Shard is currently paying 30% tax.

6.4 General strategic problems of acquiring a recycling company

Two members of the Shard Board, the Director of Glass and the Procurement Director, are both critical of the proposed strategy to strengthen the recycling division of Shard. They both consider that securing long-term contracts with key suppliers is how Shard should procure long-term supplies of recycled materials.

Another strategic problem with the possible enlarged recycling division is whether Shard could retain key management skills from the recycling company acquired after the acquisition.

Shard needs to ensure that whatever bid premium is paid does not destroy Shard's shareholder value. Therefore the price paid should not exceed a realistic expectation of the net present value of future cash flows generated by the company plus synergy savings. What premium will Shard have to pay to acquire ReuseR or NOW? Which acquisition could create the higher increase in shareholder value? These points are discussed in paragraph 7.0 below.

Management skills are required to manage Shard's recycling department. It is stated that the current manager has failed to grow Shard's existing recycling division as expected and therefore it is unlikely that he would have the skills to manage the greatly enlarged recycling division if Shard acquired ReuseR or NOW.

Other general strategic problems are as follows:

- How quickly could Shard divert much of the sales of recycled glass and paper to Shard's own factories, instead of selling them to existing customers? What contract lengths and terms have been agreed with ReuseR's and NOW's customers?
- Shard's EPS could be diluted in the short-term with the additional numbers of shares that Shard would have to issue to acquire either recycling company, before the forecast benefits flowed through to annual profit results.
- Is it feasible and cost effective to transport large quantities of bulky recycled goods across Europe to Shard's few manufacturing sites, or is it more cost effective to sell to more local customers.
- Conflicts with long-term procurement contracts for recycled glass and paper with other recycling companies. Would these be terminated or continue to enable Shard to use even higher volumes of recycled materials?

6.5 Ethical issues involved with either acquisition

The UK's CCAB offers guidance to accountants in business on ethical matters, based around five fundamental principles. These are:

1. integrity – not merely honest, but fair and truthful
2. objectivity – having regard to all considerations relevant to the task
3. competence – undertaking professional work only with the required level of competence
4. performance – carrying out work with due skill, care and diligence
5. courtesy – showing courtesy and consideration to all.

If we extend the above fundamental principles to business in general, there are several ethical issues involved in this case, but the main three are shown below.

Firstly, in ReuseR, the audit report highlights that improvements are needed as ReuseR's finance team is weak and there have been some accounting problems identified. Additionally there was a minor fraud; and procedures and management should be put in place to ensure that this is not repeated.

Secondly, ReuseR has been experiencing problems with the legal safety requirements and a number of major breaches have been identified by the H & S authorities, who are threatening possible recycling plant closures. Clearly ReuseR are not managing three ethical issues here:

1. Competence – they are not undertaking the work with the required competence as safety issues are being ignored.
2. Performance – by not carrying out the work with due skill and care, leading to accidents.
3. Courtesy – ReuseR are not showing courtesy to its employees by not managing the required safety procedures, which has led to accidents at its recycling plant and fatalities.

It is imperative that these H & S issues are promptly rectified and that a culture of safety and training is put in place in ReuseR, whether it is acquired or not.

If ReuseR were to be acquired by Shard, the safety procedures that are in place in Shard could be rolled out to encompass the recycling plants within ReuseR and Shard's management could oversee a thorough safety training programme for all employees.

A main Board Director should be responsible for all safety issues at ReuseR.

The third ethical issue concerns NOW, and the problems that it is experiencing with its secure disposal and waste paper pulping service. NOW is facing litigation by its customer, LW, who has discovered that some of its confidential waste, which NOW had been contracted to collect and pulp at its premises, was not pulped and the papers had been discovered. This is unprofessional and NOW's management have admitted that this is not the first occasion that it has happened. This lapse was probably caused by NOW's overworked, and underpaid, employees. If the employees of NOW had been properly trained, motivated and their work correctly scheduled, these problems would probably not have occurred. Management at NOW are not operating in an ethical manner as they have not suspended the secure waste collection and pulping service until these problems are corrected.

Therefore, NOW is not giving the correct performance that its customers expect, as they are not showing due skill, care and diligence in their work.

NOW has a reputation in the market place for poor working conditions, and poor staff recruitment and retention problem, which demonstrated that the NOW directors are not showing integrity and objectivity to its employees.

6.6 Strategic benefits of acquiring ReuseR

There are a number of strategic benefits of Shard acquiring a very large recycling company such as ReuseR. These include the following:

- ReuseR is a very large supplier of recycled materials with a turnover of over €214 million in 2004, which has increased by over 16% since 2003.
- ReuseR has close links with local government departments for the supply of waste materials for recycling.
- Shard already knows ReuseR well, and it is currently one of its main suppliers of recycled materials.
- Kurt Finehart already knows the senior management at Shard, as he is also a Shard main Board non-executive director, and therefore there already exists an element of managerial trust between these managers. He is a "known quantity".
- ReuseR has recently announced a new loan to continue with its aggressive growth strategy, and has recently acquired RED. This indicates that ReuseR is a successful market driven company with strong management skills.
- ReuseR has a strong positive cash flow.
- Savings totalling €9.5 million could be achieved if Shard acquired ReuseR.

6.7 Strategic problems of acquiring ReuseR

Shard would have to put a number of changes in places very quickly if ReuseR were to be acquired in respect of the Health and Safety issues that ReuseR is experiencing. The H & S authorities are threatening closure of some recycling plants due to poor plant safety.

If Shard were to acquire ReuseR, then Shard's experienced operational management could help ReuseR's management post acquisition, to overcome some of the safety problems and give reassurance to the H & S authorities.

It is recommended that if ReuseR is chosen as the acquisition target, then H & S issues should be given a high priority and that a specific Board Director is allocated responsibility for all safety issues.

Additionally, the costs of improving safety and instilling a culture in ReuseR should be taken into account when the valuation of ReuseR is considered.

There is also a concern that if ReuseR were acquired, the problems with safety issues at ReuseR could damage Shard's reputation. It could also lead to a reduction in growth and profitability at ReuseR, which would affect the price that Shard should pay if it chose to acquire ReuseR.

The recent audit report has identified a number of financial control weaknesses that Shard would also have to improve if ReuseR were to be acquired.

Another problem with Shard proposing to acquire ReuseR is that the Chairman and Chief Executive, Kurt Finehart has stated at the recent Shard Board meeting that he is not in favour of ReuseR being acquired. This could lead to a hostile bid situation and damage Shard's long-term relationship with both Kurt Finehart and also ReuseR.

It is noted that ReuseR's net profit margin declined from 11.3% in 2003 to 10.1% in 2004. We do not know why the profitability is declining, but this would need to be investigated.

ReuseR is also operated outside of Europe, where Shard does not have any operations. Would Shard need to sell some recycled materials in the Middle East if ReuseR were to be acquired, or would these bulky materials be transported back to Shard's glass and paper factories in Europe?

6.8 Strategic benefits of acquiring NOW

NOW is a much smaller company than ReuseR and is unlisted. Shard may not be successful in acquiring NOW. Much would depend on the price offered, and managerial or directors' positions at Shard that may be offered to NOW's management. There is much to negotiate.

Generally it is the target company that gains most on acquisition and while NOW is growing rapidly and has some impressive results, the time may be right for it to be acquired by a large listed company such as Shard.

If Shard is not successful in acquiring NOW, NOW's management should be made aware that its profile may be raised by the bid negotiations, which would be bound to be in the financial press. This would open the gates for other companies to bid for it. Therefore, NOW's management should also consider that in the long-term, it would be acquired. Therefore, NOW should decide which company it would like to work with long-term. Shard may look quite favourable.

As NOW is a much smaller company, fewer Shard shares would need to be offered, around 6.9 million shares, which is only 3.1% of the total Shard shares.

NOW is growing fast and it could be a very good acquisition for Shard. It has achieved an impressive 28.1% growth in its net profit in 2004 and its net margin has increased from 19.9% to 22.0%. See Appendix 3 for financial statistics.

Other strategic benefits of acquiring NOW are as follows:

- NOW has a large volume of recycled paper.
- NOW has recently secured two large contracts for recycling paper.
- NOW has already invested in its own recycled paper pulping plants.
- NOW's net margins are not only growing fast, but at 22.0% is over double ReuseR's net margin, which is 10.1%.
- NOW's Board are in conflict as to the way forward on sales pricing and customer mix, and this may be a good time to acquire the company as a suitable price may be attractive to NOW's shareholders.

6.9 Strategic problems of acquiring NOW

A key strategic problem with the proposed acquisition of NOW is that it is a privately owned company, and whether its shareholders are willing to sell to Shard. 77.2% of NOW's shares are held by only three people, with the Patel brothers holding a majority of 53.7% of shares. Therefore these three directors would need to be convinced if Shard were to be successful in acquiring NOW. However, this would give NOW's Directors (and its employees) a mechanism to realise the value of their shares.

If the directors of NOW did decide to sell to Shard, and they exchanged NOW shares for Shard shares, they could easily sell these on the stock market and realise the cash. This may act as a direct dis-incentive to remain with the company after acquisition as the previous NOW directors would be financially secure and may not wish to work for Shard. This could seriously damage Shard's ability to integrate the company post acquisition and to continue to operate the business, in which it has limited experience.

A further problem to Shard is how, and at what cost, can the problems that NOW is experiencing with its secure waste paper disposal and pulping service be overcome. Will these problems damage its reputation and will it lead to further loss of key contracts, following the legal case that LW has filed against NOW for not pulping and securely disposing of its confidential waste papers at LW's premises recently.

If Shard acquired NOW, an agreement would have to reached concerning the cost and possible penalties associated with the outstanding litigation by LW, for NOW's failure to collect and pulp confidential waste paper.

There is also the concern that if this problem became known by other NOW customers, this could have an adverse affect on the volume of waste paper collection and pulping business that NOW could secure. A further loss of customers, particularly the newly won contracts, could result in a large loss of volume in the recycled paper business. This would reduce the amount of recycled paper available to Shard if it chose to acquire NOW, and could reduce the forecast value of the synergies.

There is also the ethical issue that NOW's management appear to have been aware of the problems with its secure collection and pulping of confidential waste paper, but did not take action to ensure that waste paper had been securely disposed of.

Additionally, NOW has a reputation in the market place for poor working conditions, and poor staff recruitment and retention problems, which should be addressed. This may increase operational costs and reduce NOW's profitability.

Shard has assumed a 20% growth rate in its valuations, see paragraph 7.0 below, but if growth in post tax cash flows is lower, there is a concern that Shard should not pay too much to acquire the company which could lead to Shard's shareholder value being destroyed, rather than increased. A continued 20% growth in post tax cash flows, even in this industry, looks very optimistic.

7.0 Appropriate valuations of the possible acquisitions

There are a number of valuation techniques and there is no correct price that should be offered for the acquisition of either company. However, there are a number of techniques that can determine the minimum price and also the maximum price that could be offered. Therefore within the range between minimum and maximum lies the price that Shard could offer in order to acquire either company, which would not destroy shareholder value.

In order to increase Shard's shareholder value, the acquisition price should be less than the NPV of realistic future cash flows plus synergies that could be achieved, through raw material price differences and energy savings.

7.1 Valuation of ReuseR

The valuation of ReuseR, based on current market value (of €2.31) is €207.9 million. This is the **minimum** that could be offered for a listed company. A bid premium would be required for the bid to be successful – but how much should the bid premium be, so that Shard's shareholder value is not destroyed?

Appendix 4 shows a range of values that could be bid for ReuseR that ranges from €228.6 million (market price plus a bid premium of 10%) to €270.0 million (market price plus a bid premium of 30%).

The NPV of future cash flows, over the 6 year period that Shard uses to value acquisitions is €261.7 million. If a bid premium of 25% were added, the bid value would be €260.1 million, which is a little lower than the NPV of future cash flows over 6 years.

A recommended bid price is €260.1 million, which equates to €2.89 per share. This is almost 10% of the current market capitalisation of Shard.

If this bid were to be accepted, then this would result in issuing a further 18.6 million Shard shares with the share exchange terms being 1 Shard shares for 5 ReuseR shares.

However, it should also be considered that this is based on the ReuseR generating a NPV of €261.7 over the six year period, assuming growth at 10%, which could be over optimistic if the Health and Safety authorities temporarily close some recycling plants due to safety issues. This needs to be urgently addressed. Additionally, the costs of improving safety and instilling a safety awareness culture in ReuseR should be taken into account when the valuation of ReuseR is considered.

7.2 Valuation of NOW

The valuation of NOW, based on Shard's principle of valuing non-listed companies at a multiple of 6 times current post tax earnings, results in a valuation of only €73.8 million. Whilst this may be Shard's acquisition policy, this level of bid would clearly be unacceptable to NOW shareholders, particularly given the strong growth in profitability.

All calculations for the valuation of NOW are shown in Appendices 5 and 6.

The discounted value of future cash flows, assuming growth at 20% per year (which is very optimistic) is €169.9 million over 6 years. Therefore, Shard could bid between €74 million and €169.9 million without damaging Shard's shareholder value.

A further method of valuing NOW would be based on the industry average P/E ratio, but this should be scaled upwards for NOW's strong growth and scaled down for the fact that NOW is unlisted. The amount of these adjustments is not known. If a simple assumption is made that they each cancel out, then the valuation based on a P/E ratio of 9 is €110.7 million.

Appendix 6 shows the NPV of future cash flows if NOW's growth was only 10% per year, instead of 20%. This reduces the NPV for the 6 year period to €128.7 million. This is a more realistic figure for continued growth.

A bid of around €96 million (a bid premium of 30% over the base price of €74 million) is recommended. If a bid of €96 million were to be accepted by NOW, then this would result in share exchange terms of 13 Shard shares for every 20 NOW shares. This would only require the issue of 6.9 million shares to acquire NOW, much lower that the 16.6 million shares required for ReuseR.

7.3 Summary of valuations

NOW would give Shard a greater opportunity to increase its shareholder value, depending on what price NOW shareholders accepted, assuming they accept a bid at all.

The NPV of future cash flows is very close to the price of €2.89 per share that would need to be offered to ReuseR's shareholders (market price plus a bid premium of 30%) and therefore, with acquiring ReuseR, there is little opportunity to create shareholder value. Additionally, as Kurt Finehart is against the bid, it would be treated as a hostile bid, which could increase the price that Shard would need to pay for the bid to be acceptable. This would not add to Shard's shareholder value.

It is therefore **not** recommended to bid for ReuseR.

An opening bid of €96 million, perhaps rounded up to €100 million, for NOW is recommended, with a maximum price of €128.7 million, which is the NPV of future cash flows over a 6 year period assuming only 10% growth.

8.0 Recommendation of which recycling company should be acquired

It is recommended that Shard does make a bid to acquire a recycling company, in addition to strengthening its own recycling division. It is also recommended that Shard enter into long-term supply contracts with some of its key suppliers of recycled materials so as to secure availability of supply and to agree prices over the next five years.

The recycling company that is recommended that Shard should try to acquire is NOW. A bid of around €100 million is recommended. It may be necessary for Shard to offer part cash and part shares to secure the acquisition if Shard can raise the necessary cash.

If Shard is unsuccessful in acquiring NOW, it is **not** recommended that a bid be made for ReuseR as it could turn into a hostile bid and Shard could end up destroying shareholder value, as there is such a small difference between the proposed bid price and the NPV of future cash flows. Shard would also not want to damage its long-term relationship with ReuseR, with whom it could, instead, secure a long-term supply contract.

Therefore, if Shard is unsuccessful in acquiring NOW, it should investigate what other alternative recycling companies could be acquired in the future.

I recommend that NOW is acquired.

9.0 Discussion on post acquisition strategy

The success of any acquisition depends much on how the company is managed post acquisition. It is recommended that key managers from NOW are offered senior management positions, or Shard Board positions, to further make the proposed take-over attractive. Shard will also need their specialised management skills and knowledge of the recycling industry.

NOW's management have proved their ability to grow NOW in the competitive recycling marketplace and to deliver to its shareholders significant growth in revenue and net profitability.

Other areas of the acquisition that Shard needs to manage professionally post acquisition, to ensure that the forecast future cash flows do materialise, are as follows:

- Shard should review NOW's sales contracts and decide which should be cancelled or allowed to lapse at the end of the contract period, so that the recycled glass and paper materials can be diverted to meet Shard's own manufacturing requirements.
- Shard should also review all waste collection and waste handling contracts and decide whether there are any recycled products that it does not wish to handle.

- Shard's finance department, which is part of a large listed company with a turnover of over €2,000 million, should review NOW's financial controls. As NOW is a smaller unlisted company, it is likely that its financial controls may lack the discipline of a larger company, and they should be formalised.
- Shard should review safety issues and procedures at NOW (particularly in the light of ReuseR's current problems).
- Shard should review NOW's staff operating procedures, and identify, and rectify, the problems that led to the non-pulping of LW's confidential waste papers.
- Shard should review NOW's staff and management contracts, with a view to retaining NOW's management and workforce skills.
- Shard's IT department should review NOW's systems, to enable swift integration into Shard's management reporting structure, both financial reporting and for management control.
- Shard should review NOW's IT strategy and planned future IT developments.
- Shard's business development team should review what level of NOW's recycled glass and paper should be transferred to Shard's glass and newspaper divisions. It may be more profitable to sell some volumes of glass and paper to other companies that are local to NOW's recycling plants, so as to reduce transportation costs.

The success of the acquisition of a recycling company will depend on how well managed the enlarged recycling division at Shard is, so that the forecast cash flows do materialise. NOW's management has much experience and they should be retained.

10.0 Recommendations and conclusion

It is recommended that Shard does acquire a recycling company, to significantly strengthen its recycling division. It is recommended that a bid be made for NOW.

It is also recommended that Shard should strengthen its own recycling division and review operations, and appoint a new Director of the recycling division.

It is also recommended that Shard should enter long-term contracts for the supply of recycled glass and paper with a number of key suppliers, including ReuseR.

This would provide Shard with a greater volume of recycled materials for the longer term and it would also assist Shard to be better placed to meet growing EU authority pressures on recycling. It would also give Shard the opportunity to achieve significant operating synergies and procure larger volumes of cheaper, recycled, raw materials.

Of the two alternative recycling companies being considered, it is recommended that Shard acquire NOW, for the following reasons:

- Lower purchase price.
- More dynamic management – Ernst Heist and the Patel brothers would bring good management skills to the company.
- NOW is the smaller of the two possible companies to acquire and would be easier to integrate and manage post-acquisition.
- Higher value of savings relative to the cost of the acquisition.
- No conflict of interest with Kurt Finehart at ReuseR.
- NOW is growing rapidly and has a higher forecast growth rate.
- As a first acquisition of a recycling company, NOW is recommended. If this were successful, it would be possible, in a year or two, to make further acquisition of other

recycling companies. It would be better placed to make a larger acquisition after it has had some experience of this industry.
- Shard only operates in Europe and all of NOW's recycling business is in Europe. A further complication with ReuseR is its recent expansion into the Middle East, in which Shard does not operate.

NOW has proved itself to be the far more dynamic of the two companies being considered for acquisition and has been able to grow its earnings per share (EPS) by 26.1% compared to ReuseR's EPS growth of only 4.3%, as shown in Appendix 3. Furthermore, if NOW was valued based purely on the recycling industry's P/E ratio of 9, it would be worth €110.7 million. Usually this would be scaled down as the company is not listed, and the valuation would increased due to NOW's strong growth. For simplicity, if these two factors were assumed to cancel each other out, then NOW could be valued at around €111 million. This further confirms the valuation of €100 million as a starting bid price, which was based on 6 times current post tax earnings plus a bid premium of 30%.

It is recommended that NOW is acquired for a price of around €96–100 million, by offering NOW shareholders 13 Shard shares for every 20 NOW shares.

It is also recommended that Shard enter rolling long-term procurement contracts with a number of its suppliers of recycled materials, including ReuseR, for a period of three to five years. These long-term procurement contracts would enable both Shard and its suppliers to have certainty over volumes and prices.

Appendix 1

SWOT analysis for Shard

Strengths	Weaknesses
• Established large international company with profitable businesses	• Shard is repaying its long term debt and any acquisition would be made by share exchange, which may be unacceptable to ReuseR or NOW, as most shareholders of an acquisition prefer cash
• Share price at €13.95 near its high for last 12 months	• Weak management team responsible for Shard's own recycling division
• High capacity utilisation in glass manufacturing business	• Shard's own recycling division has not grown as expected. Changes would have to be made in the way the recycling division was managed if an acquisition was made
• Strong management team, that successfully diversified Shard into the newspaper industry nine years ago	• The Shard Board is not united in its long-term approach in securing supplies of recycled materials. The Chairmen and FD are in favour of an acquisition, but the Director of Glass and the Procurement Director are not.
• Shard's management have identified the need to increase the use of recycled materials before forced to do so by EU legislation	• Shard has little management experience of the recycling industry and the problems that the companies being considered for acquisition are experiencing

Opportunities	Threats
• Possible new glass business to manufacture flat glass and increase capacity utilisation, and securing sources of recycled glass through an acquisition of a recycling company could improve Shard's ability to win this new business	• Increased competition in both glass and newspaper businesses
• Increased usage of recycled materials will lead to cost savings and give Shard a competitive advantage	• Shard's EPS could be diluted in the short-term with the additional numbers of shares that Shard would have to issue to acquire either recycling company, before the forecast benefits flowed through to annual profit results
• Increased use of recycled materials would give Shard a "green" image	• If Shard decides not to acquire either ReuseR or NOW, it must secure supplies of recycled materials through other sources, such as long-term supply contracts, and the demand for recycled materials may cause prices to rise.
• An enhanced environmental image could have a favourable effect on its share price, risk factor and general corporate image	• If Shard decides not to acquire either ReuseR or NOW, it may find that its cost base is uncompetitive in its markets
• An acquisition would give Shard a more integrated business and generate a source of recycled materials for glass and paper businesses	• With the increasing EU threat to impose stricter waste legislation in the next decade, Shard could find itself left behind its competitors in terms of the percentage of recycled materials that is input into its manufacturing cycle
• If Shard were able to acquire either ReuseR or NOW at the right price, the acquisition could generate substantial cost savings and other financial benefits for Shard	• If Shard does not acquire ReuseR or NOW another manufacturer or a larger recycling company may acquire them

Appendix 2

BCG matrix analysis

Stars ReuseR ←------- NOW ←---------	Question marks (problem children) --------------- ReuseR ------------------ NOW
Cash cows Shard – Glass manufacturing Shard – Newspapers ------------	Dogs ------→ Shard – Newspapers

Appendix 3

Financial analysis of Shard, ReuseR and NOW

	Shard		ReuseR		NOW	
	Year to Feb 2005	**Year to Feb 2004**	**Year to Nov 2004**	**Year to Nov 2003**	**Year to Dec 2004**	**Year to Dec 2003**
Revenue (€ million)	2,040	1,940	214.2	184.0	55.8	48.3
Growth (%)	+5.2%		+16.4%		+15.5%	
Profit for the period (€ million)	196	191	21.7	20.8	12.3	9.6
Growth (%)	+2.6%		+4.3%		+28.1%	
Return on revenue (%)	9.6%	9.8%	10.1%	11.3%	22.0%	19.9%
EPS (€)	0.92	0.89	0.24	0.23	1.16	0.92
Growth in EPS (%)	+2.6%		+4.3%		+26.1%	
Number of shares (million)	214	214	90	90	10.62	10.40
Market capitalization (€ million)	2,941	2,870	216	207	(not applicable)	(not applicable)
P/E ratio	15	15	10	(not given)	(not applicable)	(not applicable)
Net debt (€ million)	802	895	20*	20	14.4	14.4
Shareholders' capital employed (end year) (€ million)	(not given)	(not given)	149.4	134.7	53.4	43.5
Return on shareholder's capital employed (%) (based on post-interest and post-tax profit for the period)	–	–	14.5%	15.4%	23.0%	22.1%

* *Note*: ReuseR had a new loan of €40 million in February 2005.

Appendix 4

Valuations of acquiring ReuseR

		Year 1 2005 € million	Year 2 2006 € million	Year 3 2007 € million	Year 4 2008 € million	Year 5 2009 € million	Year 6 2010 € million
After tax 2004 cash flows		33.6					
Estimate of cash flows for RED		1.0					
Total ReuseR forecast cashflows		34.6	38.1	41.9	46.1	50.7	55.8
Growth at 10% per year a forecast		3.5	3.8	4.2	4.6	5.1	5.6
Total cash flows including growth		38.1	41.9	46.1	50.7	55.8	64.4
Glass: price differential	3.6						
Glass: energy savings	3.5						
Glass: increased transportation	−1.6						
Paper: Price differential	4.0						
Total cost savings to Shard*		9.5	9.5	9.5	9.5	9.5	9.5
Total after tax cash flows		47.6	51.4	55.6	60.2	65.3	70.9
One off net (after tax) benefit of selling some areas of ReuseR		5.0					
Total after tax cash flow affect		52.6	51.4	55.6	60.2	65.3	70.9
Discount factor (9%)		0.917	0.842	0.72	0.708	0.650	0.596
Discounted cash flows		48.2	43.3	42.9	42.6	42.4	42.3
Cumulative discounted cash flows		48.2	91.5	134.4	177.0	219.4	261.7
NPV		261.7					

* *Note*: Total cost savings to Shard have not been increased by growth, as not all of the growth may be recycled glass and paper that Shard could achieve savings on, but alternative answers from candidates would be acceptable.

Therefore the future cash flows (for a 6 year period only) are worth almost €262 million to Shard

Market capitalization of ReuseR:				*No. of shares (million)*	*€ million*
At current share price	2.31			90,000	207.9
At highest price for 2004	2.61			90,000	234.9
Total cost of acquiring ReuseR:		Bid premium			
At 10% price premium	2.31	10%	2.54	90,000	228.6
At 25% price premium	2.31	25%	2.89	90,000	260.1
at 30% price premium	2.31	30%	3.00	90,000	270.0

This demonstrates that at ReuseR's forecast growth at 10% per year, if Shard offered a bid premium of 25% and paid €2.89 per share, the price would be €260 million and shareholder value would not be destroyed (considering only a 6 year forecast), as forecast cash flows would generate almost €262 million.

Summary of alternative valuations:

NPV of future cash flows:	**6 years only**	261.7
Share price plus bid premium of 10%		228.6
Share price plus bid premium of 25%		260.1
Share price plus bid premium of 30%		270.0

Appendix 5

Valuations for acquiring NOW (assuming 20% growth)

Valuation of NOW based on future cash flows		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
		€ million	**€ million**	**€ million**	**€ million**	**€ million**	**€ million**
Post tax 2004 cash flows		17.8	21.4	25.7	30.8	37.0	44.4
Growth at 20% per year as forecast		3.6	4.3	5.1	6.2	7.4	8.9
Total cash flows including growth		21.4	25.7	30.8	37.0	44.4	53.3
Cost savings to Shard:							
Glass: price differential	0.8						
Glass: energy savings	0.7						
Glass: increased transportation costs	−0.3						
Paper: Price differential	2.8						
Total cost savings to Shard*		4.0	4.0	4.0	4.0	4.0	4.0
Total after tax cash flows		25.4	29.7	34.8	41.0	48.4	57.3
One off costs:		0.0					
Total after tax cash flow effect		25.4	29.7	34.8	41.0	48.4	57.3
Discount factor (9%)		0.917	0.842	0.772	0.708	0.650	0.596
Discounted cash flows		23.3	25.0	26.9	29.0	31.5	34.2
Cumulative discounted cash flows		23.3	48.3	75.2	104.2	135.7	169.9
NPV		169.9					

* *Note*: Total cost savings to Shard have not been increased by growth, as not all of the growth may be recycled glass and paper that Shard could achieve savings on, but alternative answers from candidates would be acceptable.

Therefore the future cash flows (for a 6 year period only) is worth almost €170 million to Shard

The un-seen material states that the Shard Board has an acquisition policy of valuing non-listed companies using a multiple of six times the level of its latest post tax earnings.

Valuation based on a multiple of 6 times post tax earnings of €12.3 = **73.8**

Clearly a valuation of around €74 million would be unacceptable to NOW, particually given its strong growth. XXX bid premium of 30% were added to the multiple of 6 times post tax earnings, this would be:

73.8 +30% **95.9**

Therefore a bid of around €96 million could be made.

The floor value of the company is its Net Assets value =

Total assets	74.9
less loans	−11.9
less Current liabilities	−9.3
Net Assets	**53.7**

Valuation based on P/E ratio

The industry average P/E ratio is 9. Therefore profit for the period of €12.3 million × 9 = **110.7**

This valuation has not been scaled down as NOW is an unlisted company nor has it been scaled upwards for growth.

Summary of alternative valuations:

NPV of future cash flows:	**6 years only**	**169.9**
Multiple of 6 times post tax earnings with no bid premium		**73.8**
Multiple of 6 times post tax earnings + 30% bid premium		**95.9**
Net assets value		**53.7**
Valuation based on industry average P/E ratio		**110.7**

Appendix 6

Alternative valuations for acquiring NOW (assuming 10% growth)

Valuation of NOW based on future cash flows		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Post tax 2004 cash flows		17.8	19.6	21.6	23.8	26.2	28.8
If growth is only **10% per year**		1.8	2.0	2.2	2.4	2.6	2.9
Total cash flows including growth		19.6	21.6	23.8	26.2	28.8	31.7
Cost savings to Shard							
Glass: price differential	0.8						
Glass: energy savings	0.7						
Glass: increased transportation costs	−0.3						
Paper: Price differential	2.8						
Total cost savings to Shard		4.0	4.0	4.0	4.0	4.0	4.0
Total after tax cash flows		23.6	25.6	27.8	30.2	32.8	35.7
One off costs:		0.0					
Total after tax cash flow affect		23.6	25.6	27.8	30.2	32.8	35.7
Discount factor (9%)		0.917	0.842	0.772	0.708	0.650	0.596
Discounted cash flows		21.6	21.6	21.5	21.4	21.3	21.3
Cumulative discounted cash flows		21.6	43.2	64.7	86.1	107.4	128.7
NPV		128.7					

Therefore the future cash flows (for a 6 year period only) is worth around €128 million to Shard if growth is only 10% per year (instead of 20%)

5.3.1 Domusco – pre-seen material for September and November 2005 exams

Domusco

Background

Domusco was formed 42 years ago, and became a listed company 30 years ago, in its home country of Zee, a fictitious country in Southern Europe. Zee is not in the European Union (EU).

The Domusco group structure comprises a number of wholly-owned subsidiary companies operating in different construction business segments. The three construction business segments that Domusco has are:

- Major construction projects;
- Office building construction;
- House building.

Domusco's group structure, together with its key personnel, are shown in **Appendix 1** (on page 218).

Domusco's major construction project subsidiary company is structured around the type of project undertaken. The Domusco Office building subsidiary company manages all office construction work from its Head Office based in Zee, for all office construction work in Zee, other areas of Europe and the Middle East. Domusco's house building subsidiary company is structured differently, as it has separate subsidiary companies for geographic areas. It has house building subsidiary companies based in Zee, another European country as well as a subsidiary in the USA, to enable management to be closer to the markets in which they operate.

The Domusco group has been involved in residential house building since the company was formed. It entered the major construction projects segment over thirty years ago and then expanded into the office building construction segment twelve years ago. Domusco has established itself as a builder of high quality housing and apartments at the top and middle segment of the market. The Domusco group has been able to command premium prices, because of its good designs and quality specifications. Domusco has not been involved in any low cost or social housing projects to date.

Domusco has recently been awarded two contracts in a European country in which it has not previously operated. One is for the construction of a large office building. The other is for the construction of five blocks of high-rise apartments. Both projects commenced in early 2005 and are planned to last for three years. The latter project generated much international publicity because of Domusco's innovative designs and high technology features that have been incorporated into each apartment. The Board is hopeful that these latest contracts will lead to other contracts being awarded to Domusco.

Domusco personnel

The following Directors are on the main Board of Domusco and their career histories and functional responsibilities follow:

Tom Micol – Chairman

Tom Micol, now 63, has been Chairman of Domusco for the past six years and previously was one of its non-executive directors. He is currently working part-time, following a recent spell of ill health. Tom Micol has worked in the construction industry all of his life and is proud of Domusco's recent expansion. He wants to see the company grow even stronger before he plans to retire in three years' time. Tom Micol is a close ally of Peter Kaye, and believes that Peter Kaye has brought in a huge amount of the new business since he joined.

Will Umm – Chief Executive

Will Umm, now 49, joined the company fourteen years ago when the previous Chief Executive retired. Will Umm has seen the company's revenue grow at over 15% per annum for most of the last ten years. He has personally been the driving force behind many of the large construction projects that Domusco has been awarded over the last few years. He qualified as a civil engineer in Asia and has lived and worked in several countries.

Will Umm has good government connections and has always found time to deal with many personnel matters. He often visits sites and speaks to workers to hear what thoughts they have. He is considered to be fair in his business dealings and has been able to maintain Domusco's reputation as being scrupulously fair in its contract negotiations. He is very much in touch with his workforce and is well liked and respected by most of the Domusco Board as well. It is only the Finance Director, Martyn Lite, with whom he has not established a good rapport. This is primarily because Martyn Lite often argues that what Will Umm wants to do is not in the shareholders' interests. Martyn Lite often states that a project that appears to be profitable can be too risky, or that Domusco has taken on too much construction work and has insufficient management resources. On most occasions, Will Umm has over-ruled him, and although he respects Martyn Lite, he considers him to be too conservative.

Martyn Lite – Finance Director

Martyn Lite, now 52 years old, qualified as an accountant in his twenties while working for a major construction company in Europe. He moved to Zee and worked his way up in the finance department of a small construction company to become Finance Director. Within two years he transferred into a general management position, but decided that he missed the finance side of the role. He then reassessed his career and joined Domusco when its previous Finance Director retired in 1996.

He has now been with Domusco for over nine years and still has some challenging tasks ahead. He has been involved in much IT development and has tried to introduce the concept of shareholder value into Domusco. While the Domusco Board has accepted the principle, the ability to cascade down the identification of value on individual projects has been difficult. In the meantime, he has put more emphasis on growth in EPS and has had several boardroom clashes with the Chief Executive. He finds Will Umm too visionary with little understanding of financial matters. However, even Will Umm would admit that their joint skills have contributed towards the growth achieved over the last decade.

Peter Kaye – Director of Major Construction Projects

Peter Kaye, now 48, is an American citizen who joined Domusco five years ago when Domusco acquired a house building company in the USA, where he had held the role of Chief Executive. After successfully merging the US house building company into Domusco's group structure, he was appointed as Director of Major Construction Projects.

It is Peter Kaye's subsidiary company within the Domusco group that is responsible for contract negotiations for all of Domusco's major construction projects. These projects involve construction work that will be undertaken by the Major Construction Projects subsidiary company or by other subsidiary companies within the Domusco group. For example, if Domusco bids for a major construction project involving the construction of office buildings and motorway access, the relevant companies within the Domusco group are involved in costing and resource planning, but it is Peter Kaye's team which negotiates and signs contracts on behalf of Domusco. After contract signing, budgets will be allocated to the appropriate Domusco group companies and each company within the group will have operational authority for delivering to the agreed contract terms. Therefore, although Peter Kaye is bringing business into the company and negotiating delivery dates and pricing, it will be other areas of Domusco that will be responsible for delivery of the contracted construction work. There is much cross company liaison and involvement in all major projects at an early stage, prior to signing of contracts.

Peter Kaye has worked for several international companies, but has only been involved in the construction industry for sixteen years. He has helped Domusco to win several major construction projects in the last four years, some of which have been joint venture projects, and he has established a good reputation for bringing in business to Domusco. However, Peter Kaye has had many clashes with Martyn Lite. Martyn Lite finds Peter Kaye to be too outspoken, egotistic, and not very financially astute.

Tan Lee – Director of Office Building Construction

Tan Lee, now 54, joined Domusco over twenty years ago and has worked his way up in the company from structural surveyor. When the office building construction subsidiary company was formed twelve years ago, he was appointed as a main Board director responsible for this business segment that was new to Domusco. He is technically excellent and has good business and financial awareness. He usually supports Martyn Lite in any Board disagreements as he feels that the company has been expanding too fast in the last few years. He is a sound manager who has a proven track record of delivering the construction projects under his control on time and to budget. However, with the demands of international competition and the innovative features that Domusco now incorporates into its office buildings as standard, far exceeding legal requirements, margins have decreased from the levels achieved a decade ago.

Marma Winge – Director of House Building

Marma Winge, now aged 39, has progressed rapidly in his career with Domusco. He started as an architect and he has won awards for both innovative designs and the use of high technology to reduce energy consumption. His energy efficient house designs have been built extensively in Zee, as well as in many of the European countries that Domusco has expanded into. He was appointed as Director of House Building in 1997, and has overall responsibility for the three house building subsidiary companies (in Zee, other areas of Europe and the USA). He established a good working relationship with Peter Kaye during the acquisition of the USA based house building company in 2000, and they have mutual respect for each other's abilities.

Piers Moore – Director of Sales and Marketing

Piers Moore, now aged 42, joined Domusco twelve years ago from a large international house building company where he had held the role of Sales Manager. He brought with him the mix of skills needed to complement Domusco's other directors' skills. He established a small corporate marketing department that supports the sales and marketing teams that are in place within each subsidiary company of Domusco.

In each of Domusco's subsidiary companies, the staff numbers in the sales and marketing departments vary greatly. Most of the construction work undertaken by the Major Construction Projects and Office Building subsidiary companies is specifically commissioned and these Domusco group companies have only a small sales and marketing support team.

Within the last five years, Domusco has been involved in the construction of many smaller office buildings which had not been specifically designed and built for a company prior to commencement of construction, but were instead sold during the construction period. The construction of these smaller edge-of-town office buildings has increased the working capital requirements of Domusco's office building construction subsidiary, but has improved the office building construction subsidiary's sales revenue and profitability.

Each of the house building subsidiary companies requires a large sales and marketing team to secure sales and ensure that all properties are sold before completion of construction work, or shortly after all work has been completed. Domusco has seen the type of house building change in the last decade, with a higher percentage of lower priced houses and apartments being built and fewer larger houses being constructed. House building companies also attempt to sell some of the planned properties "off-plan" as soon as building plans have been approved. Off-plan purchase of houses or flats is defined as a customer committing to purchase the housing unit and paying a deposit prior to any construction work commencing on the housing unit. During the last decade, Domusco has seen a change in the timing of when customers purchase their houses or apartments, and they are making their decisions later in the construction process and the level of off-plan sales has fallen. All of these factors have adversely affected cash flows within Domusco's house building subsidiary, although profitability has increased year-on-year within the house building subsidiary.

Jackie Paul – Human Resources Director

Jackie Paul, now 46, has been involved in the construction industry all of her working life and her father managed a small construction company in the Far East where she grew up. She knows and understands the industry, which has helped her to reach her current position. She joined Domusco nine years ago as Human Resources Director, and has been involved in numerous changes, not least the doubling of the company's workforce, to make it less dependent on sub-contractors and due to growth in the volume of its construction work. She has been dominant in introducing performance related pay for most levels of staff. She has also been heavily involved with some other Board members in the development, implementation and target setting for Domusco's corporate social responsibility reporting. She has been instrumental in establishing the Advisory Committee, which reports to the main Domusco Board.

An extract from Domusco's Corporate Social Report is shown in **Appendix 2** (on page 219).

Desmond Luna – Director of Health and Safety

Desmond Luna, now 50, was injured in a construction accident when he was in his twenties and has worked very hard to reach his current role. He works tirelessly and often turns up on site unannounced to see for himself what is happening and the types of problems that are being experienced. Despite a good track record on safety in the last ten years, Domusco had two accidents involving the deaths of several construction workers, in Zee and in the Middle East, last year. Desmond Luna is working on improving site safety awareness and accident prevention, so that the events that led up to these accidents do not recur.

Carlos Freer – Director of Business Planning

Carlos Freer, now 47, joined Domusco eight years ago and has seen the company grow rapidly. He works closely with Martyn Lite, who he respects enormously, but finds the planning role frustrating at times due to the uncertain nature of the industry. It is difficult to plan when the company is usually only successful in being awarded contracts for around 25% of the projects that the company has bid for. Furthermore, some major construction projects are awarded to the company with a very short time span between contract signing and start of the construction work. This makes manpower planning, as well as financial planning, difficult.

Non-executive directors

Domusco has three non-executive directors who are well experienced in industry and commerce.

Economic growth in Zee

The country has been a democracy for over 50 years and is experiencing a period of growth in consumer spending. Annual inflation has remained at a little over 4% per year for the last few years and the GNP is forecast to grow at 4% per year over the next few years. The country is a net importer, marginally, and its principal export market is the EU. The country's currency is the Zee dollar (Z$) and the exchange rate at 30 June 2005 is Z$3.25 to US$1 and Z$2.55 to €1.

Competitor analysis

In Domusco's home country of Zee, there are eight large construction companies, some of which only operate within Zee, whereas Domusco and three other companies are involved in construction work internationally. Domusco is one of three leading house builders in Zee, and during 2004, Domusco completed 6,924 housing units (one unit is equal to one house or one apartment) in Zee. On the basis of completed units, it constructed a little less than 12% of all new units during 2004 in Zee. Its operations in some European countries and in part of the USA are very small compared to other international companies and Domusco is likely to build less than 1% of all new housing units in these countries.

Domusco's international office building construction work is very small compared to many other international companies. However, Domusco has a substantial market share in the office construction market in its home country of Zee. However, the volume of new office construction in Zee has fallen in the last five years, but Domusco has achieved around 20% of new office buildings in Zee during the last three years.

The Major Construction Projects subsidiary companies of Domusco have been awarded more contracts within the last three years than they had undertaken in the decade prior to that. This has necessitated Domusco's Major Construction Projects subsidiary company recruiting over two hundred more employees in several countries, as well as them using a high proportion of sub-contractors, to enable them to meet contract deadlines. Peter Kaye is the driving force for much of this new business and he is confident that he can grow this high margin business much further.

Domusco shareholding and share prices

Domusco has 441.6 million shares of Z$0.50 each in issue and has a total of 800 million authorised shares. Its share price at 30 June 2005 is Z$13.82, which is at an all-time high for the company, due partly to its good 2004 results. Institutional shareholders own over 80% of its shares, with no single large shareholder. Domusco's directors, staff and general public own the rest of Domusco's shares.

Major construction projects currently under construction

The Major Construction Projects subsidiary company within Domusco, headed up by Peter Kaye, had five main contracts under construction during 2004. These were:

- The construction of a sports stadium in the Middle East (in a country where it has undertaken many projects before), which is due for completion in February 2007. The total profitability on this project is forecast to be Z$78 million over four years.
- The construction of motorways and bridges in the neighbouring European country of Wye. More details on this project are shown later.
- The construction of a motorway in a different country in the Middle East, which is due for completion in September 2005. The overall updated forecast profitability on this project is Z$380 million over 2.4 years.
- Road and motorway construction and road improvements in Zee. The project spans two years and is due to be completed by mid-2005 and the forecast profitability is Z$220 million.
- Construction work on a new marina in Zee. Work commenced in August 2004 and is due for completion in November 2005. The total project profitability is forecast to be Z$270 million.

Domusco has not yet signed contracts for any other major construction projects. However, Domusco has bid for several other major construction projects. It is also currently negotiating a major construction project in the USA. If the USA contract were to be awarded to Domusco, it would be its first major construction project in the USA. Domusco currently has house building operations in the USA, but has no other construction work there to date.

Motorway construction project in Wye

Domusco has been involved in several motorway construction projects previously and it was selected from a shortlist of four international companies, for a particularly difficult motorway construction project in a neighbouring country of Wye, because of its experience of building roads in difficult terrain. The motorway project commenced in Spring 2004 and was due for completion by the end of 2006. However, the project is currently behind schedule, on account of unforeseen extra construction work that will be required, because of the exceptionally heavy rainfall during late 2004, which caused some of the completed sections of the motorway and other foundation and bridgework to be partially washed away, or damaged. Some areas of the motorway will require totally new, stronger foundations to be constructed.

Peter Kaye and one of his managers, Weng Zen, the Head of Motorway Construction in Domusco, are currently trying to renegotiate the budget for the project with the Wye government. Peter Kaye has put forward the case to Wye's government that the entire cost of 14 lost weeks and the additional construction costs should be met by Wye's government's road building budget, due to the exceptionally heavy rains, which were unforeseen. Wye's government minister for transport has publicly stated that the agreed budget cannot be exceeded and that Domusco should have ensured that the quality of the foundations were stronger, to have withstood the heavy rainfall. However, in private it is understood that Wye's government were surprised at the devastation caused in many areas of the country by the high rainfall. Peter Kaye has put forward the case to Wye's government that all of the completed foundations had been fully inspected and approved by Wye's government department, prior to the heavy rainfalls that damaged or destroyed them. He therefore stated that the re-building costs should be borne entirely by the Wye government road-building budget. The Wye government has strongly disagreed with any claims and has refused to pay any compensation for the delays or any rebuilding work.

Peter Kaye reported to the May 2005 Domusco Board meeting that he did not want to harm the delicate relationship with the Wye government at this early stage of this project, particularly with possible future major construction projects in Wye that Domusco is planning to bid for in the next few years. Peter Kaye advised the Domusco Board that the motorway project had a planned profitability of Z$105 million. However, it is now forecast to make an overall loss of Z$35 million, unless the Wye government changes its mind on any compensation payments.

At the May 2005 Board meeting, Martyn Lite stated that Peter Kaye should not allow the possibility of future projects to adversely affect Domusco's negotiations with the Wye government concerning payment for the delays and rebuilding costs. The Chief Executive, Will Umm, over-ruled Martyn Lite and stated that this was the first of many projects in Wye and that long-term profitability was more important than one single project. Martyn Lite disagreed and in a heated discussion stated that the Wye government must assume the company's management is weak. Martyn Lite also stated that it would be more difficult to negotiate prices in the future if Domusco did not pursue compensation for the delays on this motorway construction project.

Office building construction

The sales revenue for Domusco's Office Building construction subsidiary company has risen from Z$732 million in 2003 to Z$768 million in 2004 and is forecast to be around Z$1,248 million in 2005, but profitability on some buildings has fallen.

Up until five years ago, all construction work of office buildings were bespoke projects commissioned by organisations. Recently, Domusco has constructed office buildings, both in Zee and in two European countries, where the office buildings have not been sold until part way through the construction process, or after completion of the building. Domusco has been involved in several office buildings construction projects in edge-of-town locations, where several construction companies have each constructed a range of buildings. These edge-of-town office developments have proved profitable and have enabled Domusco to expand its range and size of office building designs.

Tan Lee was pleased to see the revenues generated from his company grow, although it is the smallest of Domusco's three main subsidiary companies, with sales revenue in 2004 only a little over 12% of the total Domusco Group sales. In 2004 profitability fell significantly for two reasons. Firstly, one office building that remained unsold for over one year after completion of construction was sold at a reduced price and resulted in an overall loss. Secondly, there have been some cost over-runs on two large office construction projects in Europe that were specifically commissioned by Domusco.

House building construction

Domusco's house building subsidiary company is split geographically into three companies. One is responsible for all house building in Zee, another for house building in other European countries and the third for house building in the USA.

Domusco had acquired a small house building construction company based in the USA in 2000 for several reasons. Primarily it was to acquire its innovative designs and have access to its high profitability, which was due to its relatively low construction costs. It has managed to apply the principles learned from this acquisition and Domusco's house building subsidiary has used them in other countries to improve operating margins. Some cost savings have been due to a change in building techniques, which have removed some of the build stages in the construction process. This allows some construction processes to take place at the same time, resulting in labour savings and a reduction in the costs associated with late alterations. Peter Kaye, who is now Director of Major Construction Projects, joined Domusco from this USA based house building company.

Traditionally in the construction industry, profitability and success has been measured by the company's return on capital employed (ROCE). However, Marma Winge found this measure misleading when comparing ROCE for the three subsidiaries. This is because the ROCE in one subsidiary has been depressed by the purchase of some state-of-the-art construction machinery. A summary of the return on capital employed achieved by geographic region for Domusco's house building subsidiary companies for the past two years is as follows:

		Zee	*Other European countries*	*USA*	*Total house building*
Operating profit – 2004	(Z$ million)	193	165	91	449
Operating profit – 2003	(Z$ million)	183	150	82	415
ROCE – 2004		23.1%	25.0%	27.4%	24.0%
ROCE – 2003		21.0%	22.5%	26.1%	21.7%
Number of completed housing units					
2004		6,924	4,463	2,811	14,198
2003		6,700	4,607	2,695	14,002

There are also two other influences on the return on capital employed that is achieved. One is the size of the housing development. Generally, smaller developments achieve lower returns than a larger quantity of housing units that are constructed at the same site. Secondly, the type of housing influences returns achieved. Large apartment blocks generally achieve a higher ROCE than medium priced houses. However, some of Domusco's new housing developments in Europe have been achieving exceptionally high returns, as Domusco had purchased the land plots at a low price a few years ago, compared to current land purchase prices, which have risen considerably.

Domusco's staffing levels and sub-contractors

Most companies operating in the construction industry use a mix of their own employees and sub-contractors. The mix varies by country and also by construction segment. In the house building segment, Domusco employs its own staff for site surveying and site management, as well as for a proportion of the house building construction work. Specialised sub-contractors undertake the rest of the house building construction work. Domusco also directly employs all of the sales and marketing teams and administrative support for Domusco's house building subsidiary companies. The majority of the sub-contractors that Domusco uses have worked closely with Domusco for several years.

In major construction projects, particularly motorway construction, specialized sub-contractors undertake the majority of the construction work. The location and the level of staffing required varies enormously with each major project and Domusco does not wish to employ large numbers of staff that may be located in the wrong area or with unsuitable skills. The use of sub-contractors gives Domusco flexibility.

Peter Kaye's operational management has experienced problems with the use of some sub-contractors. Although Domusco has repeatedly used the same sub-contracting companies as on previous occasions, the make-up of the teams used on projects that undertake the work change far too often. Despite supervision by the sub-contractors' management and subsequent inspections by Domusco's project management, there are large numbers of unskilled workers who are not capable of completing certain stages of construction to the required standard, which causes delays while the extent of the faulty work is identified and rectified. In Zee and some other European countries, there is currently an increase in the amount of construction work being undertaken, and many sub-contractors are employing workers who have entered into this industry with little or no training and are both inexperienced and unskilled, which inevitably leads to quality issues. Additionally, as sub-contractors are paid a fixed fee for various stages of construction, they want to complete the job in the least possible time, so that their employees can move onto the next job. This leads to jobs being rushed and not thoroughly or professionally completed.

In the office building construction subsidiary of Domusco, Tan Lee has recruited a strong team of experienced staff and is less dependent on sub-contractors than the other subsidiaries of Domusco.

Domusco always uses its own staff for project management and surveys and inspections. One of the recent reports that Marma Winge's operational management is currently reviewing is whether Domusco's house building companies should increase their staffing levels, so that their dependence on sub-contractors would reduce. This would have a number of benefits including reducing costs, as sub-contractors cost more and secondly, the quality of work is usually higher with their own staff. Domusco has had a number of incidents where sub-contractors have employed workers who were less skilled than usual which has resulted in delays and the need for rectification work. Marma Winge is particularly keen to increase the staffing levels that are employed in the house building subsidiary companies in Zee and other European countries and to reduce their dependence on some sub-contractors and has presented a paper at the May 2005 Domusco Board meeting with a proposal to increase staffing levels.

The development of the Hadsi area of Zee

For the last few years the government of Zee has been planning to sell for development a large amount of land in the area of Hadsi. There has been much speculation as to which construction company would buy the land and what type of development would be built on it. Media speculation in Zee feared that it would become another tourist area and this would not help local companies and local people with their housing needs. Despite expanding urbanization of some cities in Zee, the large site in the Hadsi area of Zee, is still mainly empty and undeveloped. The Hadsi area is 40 kilometres east of the city of Prine. The Zee government has launched an initiative to move people out of crowded cities to better housing. The government also wants to attract companies in the IT industries to relocate to the Hadsi area. All office buildings are to be built with the latest high tech equipment to support "intelligent buildings". The Zee government will be funding the transport infrastructure, which will mainly be the construction of all roads in the Hadsi area.

The Zee government currently owns the land and wants to sell the entire area to one construction company. The Zee government would prefer that the construction company that purchases the entire Hadsi area should then sell plots of land onto other construction companies. In this way, the development of Hadsi could be completed in a shorter period of time, possibly within four years, than if only one construction company were to be involved. Tom Micol and Will Umm had been invited to several meetings with Zee government ministers regarding the future development of the Hadsi area and they reported back to the Domusco Board in Summer 2003 that it was likely that the Hadsi land would be used for residential housing. In addition, a commercial centre is planned, as several international companies had expressed interest to the Zee government and had indicated that they would establish offices in Hadsi. The government ministers had also informed Tom Micol that the Zee government planned to commission some community buildings, including schools, sports and recreational facilities. The media in Zee soon picked up this information, possibly leaked by the Zee government, and the general reaction in Zee was positive, with much interest in this development project.

September 2003 Domusco Board meeting

The Chief Executive, Will Umm, reported back to the board on the discussions held with the Zee government about the proposed development of the Hadsi area. Will Umm surprised the Board when he reported in total confidence that his government connections had reliably informed him that the Zee government had decided that its first choice to sell the entire Hadsi land to was Domusco. The Zee government envisages that over 23,000 housing units could be built on this land, together with schools and sports buildings and a large commercial centre. Will Umm stated that he felt strongly that Domusco should be involved in this major construction project in its home country and the other Board members agreed.

Will Umm advised the Board that the cost of the entire Hadsi land that the Zee government was offering to sell would be around Z$900 million. Some of this cost would be recouped in a short period of time when plots of land were sold onto other construction companies. Will Umm completed his presentation to the Domusco Board by stating that this could be the single largest project the company had ever undertaken, and that his government contacts had confirmed that it was Domusco's to take, if it wanted it. After much heated discussion, the Domusco Board agreed by a majority vote that Domusco should seize this opportunity and acquire the Hadsi land if it were to be offered to it by the Zee government. The Board requested Martyn Lite to arrange loan finance to cover this land purchase and Carlos Freer was requested to prepare financial forecasts for construction costs on the area of land that Domusco planned to develop itself. In deference to Martyn

Lite's concerns about risk and Domusco stretching its financial and manpower resources too thinly, the Domusco Board agreed that Domusco would only undertake construction work on no more than 40% of the Hadsi land area. The other 60% of the Hadsi land would be sold off to other construction companies.

Acquisition of the Hadsi land

The Zee government finalized the sale of the Hadsi land to Domusco during January 2004 at a final price of Z$830 million, a reduction of Z$70 million from the estimated price. The reduction had been negotiated by Peter Kaye, to enable Domusco to undertake the necessary land surveying and other environmental studies, prior to the start of development and the sale of plots of land to other construction companies. Martyn Lite was also able to negotiate with the Zee government that only one half of the price would be paid on signing contracts in January 2004, and the balance would be paid in December 2005.

As part of the contract for the purchase of the Hadsi land, the Zee government also undertook to spend Z$20 million over two years on promotional and marketing costs to help support the marketing programme that Piers Moore felt would be necessary in order to generate public interest and sales of houses and commercial property in the Hadsi area. It was agreed with the Zee government that any construction company involved with buildings in Hadsi would also markets its own construction work to the general public, so that the early sales of offices and housing could reduce the amount of working capital required to finance this major development.

Domusco's construction plans in Hadsi

In January 2004, the Domusco Board requested Marma Winge to prepare outline plans for the housing development and to recommend what size plots of land Domusco should retain for its own planned construction work, and not, therefore, sell to other developers.

In March 2004, the Domusco Board agreed to construct 12,000 housing units over three years, which will significantly increase the volume of its house building in Zee. This will result in significantly higher revenues and profits for Domusco's house building company over the next few years and will create many new jobs. In addition to housing construction, the Domusco Board agreed to construct a total of fifty commercial office buildings. In addition, the Domusco Board agreed to bid for a contract to construct some roads and motorways connecting the Hadsi area to the nearby city of Prine, which are to be financed by the Zee government. The Domusco Board had previously agreed in September 2003 that the total area of the Hadsi land that Domusco would use for construction work would not exceed 40% of the total area being developed, which the above planned construction work conforms to.

Sale of some of the Hadsi land to other construction companies

The Zee government sold the entire Hadsi plot of land to Domusco in January 2004 for Z$830 million and it envisages that the entire development of the area would be completed in about three to four years. The Zee government has given outline planning permission for Domusco's plans for the entire Hadsi area, but formal Zee government approval will still be required prior to the start of any specific construction work by Domusco or any company to which Domusco may sell plots of land.

Representatives from Domusco held several meetings with other Zee based and international construction companies about this specific high profile construction project in early 2004. These companies ranged from small and medium sized construction companies based in Zee to international construction companies who were keen take a part of this major development. Peter Kaye, Tan Lee and Marma Winge met with these companies and selected five companies to which Domusco contracted to sell plots of land on the Hadsi site. The five companies who have purchased land on the Hadsi site from Domusco will be involved with the construction of housing, public buildings, including schools and government funded sport facilities and office buildings. The five companies will also be involved in bidding for road and transport infrastructure construction work.

Contract negotiations on the sale of land plots to these five companies continued throughout 2004 and the sale to all five companies occurred in early 2005. In the first half of 2005, Domusco received payments totaling Z$428 million for the sale of plots of land from the five other construction companies. The total volume of land sold was just over 51% over the total land. The Domusco Board has agreed that Domusco would retain a maximum of 40%, which still left 9% to be sold, which is located in the commercial area of Hadsi. However, by the end May 2005, Domusco had still not identified a construction company that was interested in acquiring some or all of this area of land for the construction of office buildings, until firm buyers for office space had been identified. Therefore this plot of land remained within Domusco's land bank and reported as inventory, together with other plots of land that Domusco owns worldwide.

Financing plans for the Hadsi development

At this early stage of the project, the forecast total construction costs for Domusco's planned construction work will be around Z$5,000 million in total over the four years ending 2007, as shown in the table below. The construction costs shown below do not include Domusco's share of the cost of the Hadsi land.

		2004	*2005*	*2006*	*2007*	*Total*
Housing units (completed)		0	3,000	4,000	5,000	12,000
Office buildings (completed)		0	12	16	22	50
Forecast construction costs:						
Housing	(Z$ million)	300	700	900	1,100	3,000
Office buildings	(Z$ million)	300	500	600	600	2,000
Total construction costs	(Z$ million)	600	1,200	1,500	1,700	5,000

Martyn Lite has negotiated loans with two international banks for the equivalent of Z$900 million. The loan finance is for a five-year period at 9% interest per annum, payable quarterly. The loan is forecast to cover working capital requirements for the start of the construction work.

The initial payment for the cost of the Hadsi land was paid from cash generated by the Domusco group's operations. Subsequently, payments have been received from other construction companies for the sale of plots of land in the Hadsi area.

It is planned that the balance of the required payment to the Zee government for the land, due in December 2005, would be financed by the sales of housing and offices that will be under construction. The amount of working capital cannot be forecast exactly as it is unknown what proportion of the housing will be sold "off-plan" (sold in advance of construction commencing) but a conservative amount has been forecast. The two international banks, ALT and BRG, have confirmed that they are interested in providing Domusco with additional financing if required during the course of construction work.

Domusco's existing loans, to Zee based banks, totaling Z$1,020 million are denominated in Zee dollars. The details of Domusco's new loans with ALT and BRG, denominated in US dollars and Euros, for the equivalent of approximately Z$900 million as detailed below:

	Currency of loan	*Loan value (million)*	*Exchange rate (as at loan date of 30 June 2004)*	*Z$ million*
Bank ALT	US$	200	3.18	636
Bank BRG	Euros	105	2.51	264
Total new loans				900

Bad publicity for the Hadsi development

There has been a growing amount of adverse publicity concerning the Hadsi development, generated by lobbyists who are concerned that the Hadsi area will become another concrete area. The Hadsi area currently has a few endangered species of small wildlife animals, which are dependent on the existing habitat. While every effort has been made to preserve as many trees as possible, which enhances the appeal of the completed development, it was planned that there would be the need to clear a large area of forest where some of the housing and the commercial office buildings area would be constructed.

The adverse publicity about the removal of trees in parts of the wooded areas in Hadsi, and the changes to the local habitat that this has caused, has been growing. The management at Domusco has asked the Zee government to support it, and the other construction companies, and to increase the amount of marketing it should undertake about the benefits of the completed Hadsi development, in order to counteract the level of adverse media publicity.

Sports stadium contract awarded to Domusco

At the Domusco Board meeting held in June 2005, Peter Kaye announced that after negotiations lasting several years, Domusco had been awarded the contract for the construction of a large national sports stadium in a European country. He stated that he had understood that Domusco had been eliminated from the short list some months ago in favour of the leading construction company in that European country. It had come as a surprise when government officials from the European country had contacted him to confirm that Domusco had been awarded the contract. Contracts are due to be signed within the next month.

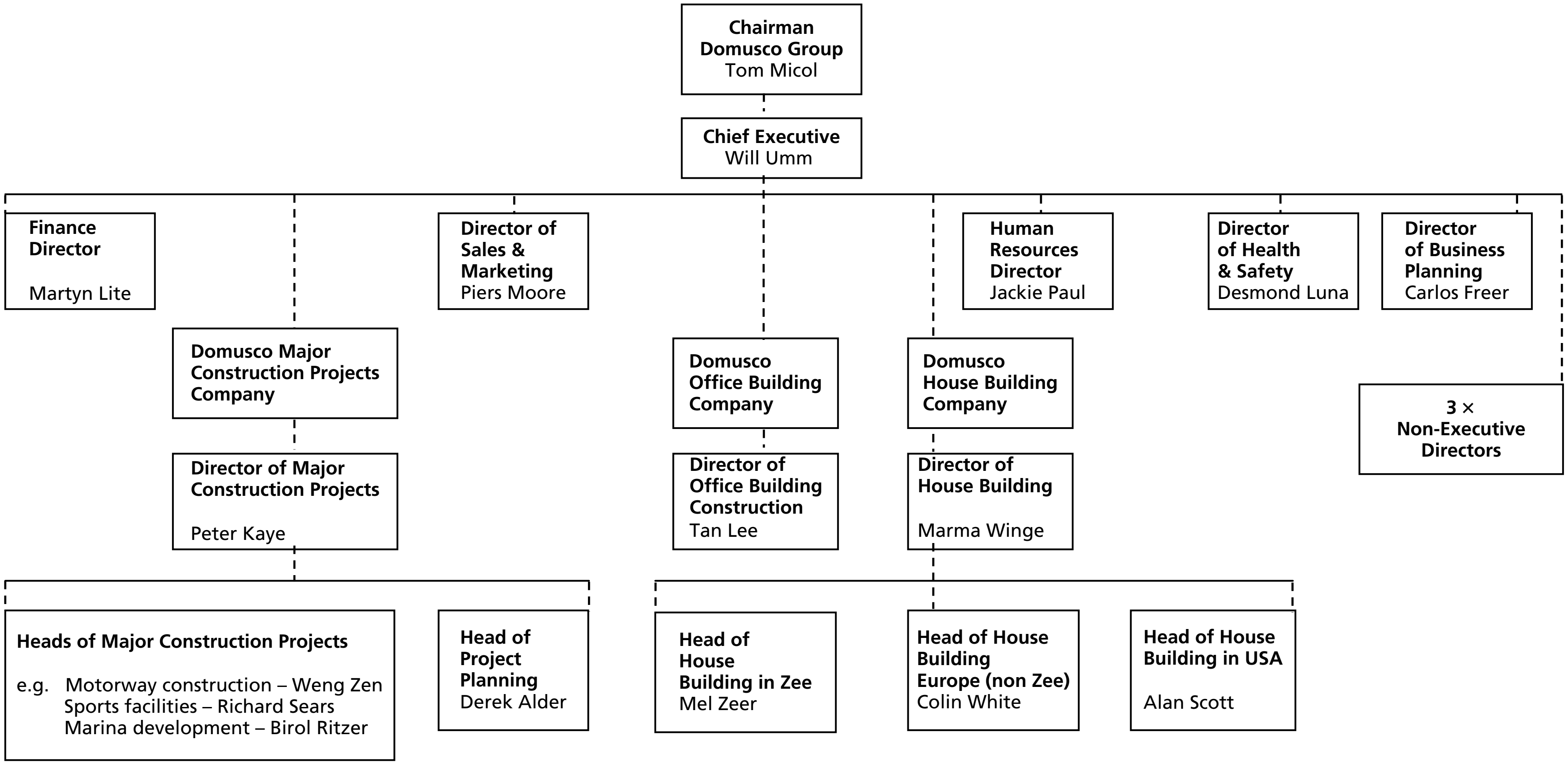
The sports stadium contract is for €180 million (approximately Z$459 million) and all payments to Domusco are to be made in Euros. The forecast profitability for this contract, which will span 18 months and must be completed by April 2007, is the equivalent of almost Z$83 million. However, if the contractual terms are not met, and the stadium is not completed on time, the final stage payment will be reduced by approximately Z$31 million.

Whilst Peter Kaye is pleased that Domusco has been awarded the contract, he is concerned at Domusco's available manpower and the very tight construction timetable, upon which the final stage payment would be made. Peter Kaye stated that he would not have accepted the same proportion of the Hadsi development proposal if he had believed that Domusco would have been awarded this contract. The contractual terms state that work has to be commenced no later than December 2005 and completed by end of April 2007. For a stadium of this size, the construction period could be as long as five years, and therefore the high price reflects the extra amount of manpower needed on this large project.

The Board discussed the problems of taking on this project, but agreed that it would not want to damage its reputation by not accepting it, which could put at risk its ability to win any future contracts of this type.

Appendix 1

Organisation chart for Domusco



Appendix 2

Extract from Domusco's Corporate Social report for 2004

	Key achievements in 2004	**Major targets for 2005 and beyond**
Social Responsibility	Established an Advisory Committee, which meets quarterly and reports to the Domusco main Board.	Continue to clarify Domusco's responsibility to its shareholders, its suppliers and its customers. Improve the supply chain.
	Improved internal controls and risk awareness.	Continue to improve risk awareness among all managerial levels and train senior staff in risk management techniques.
Health & Safety (H & S) issues	100% of staff trained in H & S issues. 90% of our contractors inducted in H & S procedures.	Targets set for reduced number of incidents.
	Reduction of accident levels for both serious incidents and moderate incidents, although the company had fatal accidents in 2004.	Tighter safety procedures in place to prevent the types of accidents that caused fatalities in 2004.
Environment	Trained 90% of site management in environmental management. Established a site specific environmental action plan.	Survey of suppliers' environmental policies. Increased use of technology to reduce energy waste during construction.
	Trained 60% of sub-contractors on environmental issues.	Train 100% of site management in environmental management. Continue to train sub-contractors.
	Improved the amount of site materials that are recycled.	Increased recycling targets set.
Employees	Results of third employee survey published and action plan to address issues drawn up.	A fourth employee survey, in an updated format, will be undertaken.
	Introduced new HR strategy, concerning working hours and performance related pay.	Increased management training and more emphasis on supporting staff to gain relevant qualifications for their job.
	Increase of 18% in training hours per employee	New training programme planned

Appendix 3

Domusco Balance Sheet, Income Statement and Statement of changes in equity

Note: All data in this appendix are presented in international financial reporting format.

	As at 31 December 2004		As at 31 December 2003	
	Z$ million	*Z$ million*	*Z$ million*	*Z$ million*
Domusco Balance Sheet				
Non-current assets (net)		124.8		120.3
Current assets				
Inventory (including land bank, work-in-progress and inventory of materials)	5,339.6		4,470.5	
Trade receivables	841.2		727.1	
Cash and short term investments	501.6		98.2	
		6,682.4		5,295.8
Total assets		6,807.2		5,416.1
Equity and liabilities				
Equity				
Paid in share capital	220.8		220.8	
Share premium reserve	327.6		327.6	
Retained earnings	2,880.8		2,469.6	
		3,429.2		3,018.0
Non-current liabilities				
9% Loan notes (redeemable in 2007)		324.0		324.0
10% Loan notes (redeemable in 2008)		696.0		696.0
9% Loan notes (redeemable in 2009)		900.0		–
Current liabilities				
Trade payables	747.4		728.0	
Tax	296.6		259.8	
Accruals	414.0		390.3	
		1,458.0		1,378.1
Total equity and liabilities		6,807.2		5,416.1

Note: Paid in share capital represents 441.6 million shares of Z$0.50 each.

Income statement	**Year ended 31 December 2004**	**Year ended 31 December 2003**
	Z$ million	*Z$ million*
Revenue	6,216.0	5,810.8
Total operating costs	5,104.8	4,861.5
Operating profit	1,111.2	949.3
Finance costs (net)	−128.4	−98.1
Tax expense	−296.6	−259.8
Profit for the period	686.2	591.4

Statement of changes in equity	*Share capital*	*Share premium*	*Retained earnings*	*Total*
	Z$ million	*Z$ million*	*Z$ million*	*Z$ million*
Balance at 31 December 2003	220.8	327.6	2,469.6	3,018.0
Profit for the period	–	–	686.2	686.2
Dividends paid	–	–	−275.0	−275.0
Balance at 31 December 2004	220.8	327.6	2,880.8	3,429.2

Appendix 4

Extracts for the next 5 years from Domusco's 10 year plan

	Actual 2004 Z$ million	2005 Z$ million	2006 Z$ million	Plan 2007 Z$ million	2008 Z$ million	2009 Z$ million
Revenue						
Major projects	2,592.2	2,748	3,022	3,264	3,493	3,842
Office building	768.0	1,248	1,473	1,811	1,902	1,997
House building	2,855.8	3,541	3,896	4,246	4,671	5,231
Total revenue	6,216.0	7,537	8,391	9,321	10,066	11,070
Pre-tax operating profit						
Major projects	576.0	616	684	746	805	894
Office building	86.1	138	158	195	205	215
House building	449.1	561	629	691	774	883
Total pre-tax operating profit	1,111.2	1,315	1,471	1,632	1,784	1,992
Post tax profit for the period	686.2	783	876	999	1,121	1,274
Shareholder capital employed (Equity)	3,429.2	3,900	4,424	5,023	5,696	6,460
Loans (at end year)	1,920.0	2,420	2,420	2,096	1,900	1,900
Number of shares (million)	441.6	441.6	441.6	441.6	441.6	441.6
Earnings per shares (EPS) Z$	1.55	1.77	1.98	2.26	2.54	2.88

Note: Plan approved by Domusco Board in November 2004 and includes construction work for all contracts signed at that date (including Hadsi development).

5.3.2 Domusco – unseen material and requirement for September 2005

Domusco – Unseen material provided on examination day

Additional (unseen) information relating to the case is given on pages 22 to 27. Read all of the additional material before you answer the question.

ANSWER THIS QUESTION

You are the consultant appointed by the Domusco Board.

Prepare a report that prioritises and advises on the main issues facing Domusco and makes appropriate recommendations.

Note: The TOPCIMA Assessment Matrix, which your script will be marked against, is on the next page for your reference.

Domusco – Unseen material provided on examination day

Read this information before you answer the question

Success of Hadsi development to date

Domusco is planning to construct a total of 12,000 housing units in the Hadsi area over a three-year period. When Domusco's housing plans were launched during 2004 for the first phase of 3,000 housing units, the public interest was good. By the end of August 2005 Domusco had cumulative sales in the Hadsi area of over 78% of the first phase of 3,000 housing units. This comprised a higher level of pre-sales (defined as sales made prior to the start of construction work) as well as a high level of sales made after the start of construction. Interest in Domusco's housing remains strong and Domusco are confident that all 3,000 housing units in the first phase, will be sold before the completion of construction work. Domusco decided to bring forward the launch of the second phase of housing units in Hadsi and in August 2005 has pre-sales of over 18% of the phase two housing units, some six months before construction is even due to commence. Domusco's sales of housing in other areas of Zee were also strong, as well as in other areas of Europe and the USA. Domusco forecast that its total completed housing units in 2005 might be as high as 18,800 units, including the sale of the first phase of 3,000 housing units in the Hadsi area.

The Domusco house building subsidiary company's cash balance had quickly changed from a deficit to a surplus of Z$1,200 million at the end of August 2005.

The development of the Hadsi region of Zee has been acclaimed as a success by the media and many companies were planning to move into the region. Many companies chose to move to Hadsi as the technology incorporated in the new office buildings used ecological and energy saving solutions for air conditioning and heating. The Zee government was very pleased with the success of the Hadsi area and also announced the relocation of one of its government agencies to Hadsi. The Zee government chose to purchase one of the larger office buildings that Domusco was in the process of constructing and contracts for the purchase were signed at the end of August 2005.

In August 2005, Domusco announced that it intended to relocate its offices to one of the most prestigious of all of the new office blocks in the Hadsi region, as it has outgrown its present Head Office building in Zee. The new offices are forecast to meet the requirements of Domusco's Zee based staff for the next eight years, assuming the company expands in accordance with its 10-year plan. In addition to the Hadsi office building that Domusco plans to move to, Domusco had signed contracts with a total of seven other companies for office buildings in Hadsi by the end of August 2005.

Construction of Sport Stadium in Europe

In August 2005 Domusco signed contracts for the construction of a large national sports stadium in a European country. The contract value was €180 million (approximately Z$459 million). Peter Kaye is very concerned at the lack of available experienced manpower within the company that can be allocated to this major construction project. He has been requested by the Domusco Board to consider whether part of the work could be sub-contracted to a large international company (which the contract terms allow) or whether to recruit staff locally in the European country on short term contracts. Peter Kaye is also concerned about the tight deadlines and the final stage payment of €12 million (approximately Z$31 million) that will only be paid if the stadium is built to the agreed deadline of April 2007.

Construction work in Wye

Domusco has been unable to renegotiate the motorway construction budget for the large project that Domusco is currently constructing in Wye. This project is now forecast to make a loss of Z$44 million but Domusco is contractually bound to complete the motorway construction.

At the August 2005 Domusco Board meeting, it was decided that Domusco would no longer undertake any further construction work in Wye that is funded by the Wye government. This will result in Domusco declining to bid for a number of major construction projects for the Wye government, which are in Domusco's current plan. Domusco will continue to build a small amount of housing in Wye, which it sells to private buyers. Therefore Domusco's current plan is overstated. The effect on the Domusco group's post tax cash flows for the next five years due to the removal of Wye government funded projects is as follows:

	2005	*2006*	*2007*	*2008*	*2009*
	Z$ million	*Z$ million*	*Z$ million*	*Z$ million*	*Z$ million*
Reduction in Domusco group cash flows due to removal of Wye government funded projects	80	110	110	120	140

Updated cash flow forecast as a result of recent events

The high sales of housing and offices in Zee, including the Hadsi development, and the high housing sales in other countries, as well as the newly awarded contract for the sports stadium (that was not in the current plan), has been incorporated in an updated cash flow forecast for the Domusco group. However, the updated forecast cash flows, shown below, **have not yet been adjusted** for the removal of government funded projects in Wye.

By the end of August 2005 the Domusco group had a cash balance of Z$1,000 million. The current cash balance and forecast end year cash balances for the next 5 years, after tax, loan repayments and planned dividend payments, are now forecast to be as follows:

	End August 2005 Z$ million	*End December 2005 Z$ million*	*End December 2006 Z$ million*	*End December 2007 Z$ million*	*End December 2008 Z$ million*	*End December 2009 Z$ million*
Forecast cash balance	1,000	1,300	1,800	1,700	1,600	1,400

The above cash forecast assumes that Domusco does not increase its loans during 2005, as included in the current plan (Appendix 4 to the pre-seen material).

Development in Metsa

The Zee government has announced that the area of Metsa, west of the Hadsi region, is the next area of the country that could be developed. It is further along the coast from Hadsi, in rugged terrain and is much smaller than the area of the Hadsi land. The Zee government is pleased with the way that Domusco has managed the Hadsi development. The Zee government has now offered the entire plot of land in Metsa to Domusco at a cost of Z$500 million.

Peter Kaye is proposing that Domusco retain the entire plot and undertake the entire development of the Metsa land. However, Peter Kaye's team cannot forecast the construction costs with any accuracy until further survey work is undertaken and construction work is commenced. As the terrain in this area is more difficult, initial land preparation would be more difficult and more expensive. However, Peter Kaye's team have prepared two levels of cash flows depending on what problems they encounter during construction, together with estimated probabilities.

These cash outflows (before tax), which exclude the cost of the land of Z$500 million, are shown below:

Cash outflows for Metsa construction project	*Probability*	*2006 Z$ million*	*2007 Z$ million*	*2008 Z$ million*	*2009 Z$ million*	*Total Z$ million*
High cost scenario cash outflows	75%	250	340	480	580	1,650
Normal cost scenario cash outflows	25%	130	160	340	380	1,010

The proposed revenues mainly from housing, with some office buildings, for the Metsa development, are forecast to be as follows:

	2006 Z$ million	*2007 Z$ million*	*2008 Z$ million*	*2009 Z$ million*	*Total Z$ million*
Metsa forecast revenues	0	600	850	1,000	2,450

The revenues and cash outflows given above are before tax, and tax should be assumed to be 30%. Martyn Lite stated that a suitable risk-adjusted discount rate for evaluating this construction project is 12% post tax.

Marma Winge stated at the August 2005 Domusco Board meeting that he considered that the housing market in Zee was growing too fast and the level of growth in the sales of new housing could not be expected to continue. He also reminded the Domusco Board that the company had a land bank of around Z$1,900 million of land in Zee for future development. He did not have confidence, despite the success of the Hadsi project so far, that Metsa would be as successful. He was also concerned that Domusco should not undertake the entire development of Metsa on its own. He stated that there was a risk that the housing in Metsa would not sell as well as in the Hadsi area.

Will Umm is concerned about the development in the Metsa area due to concerns from environmental groups. Domusco managed to overcome the environmental issues in its development in Hadsi, by making some compromises and allowing a small forest to remain intact and reducing the size of the commercial area in Hadsi. However, the world's media has already supported the local opposition groups who do not want to see the Metsa area developed, as it has a number of sites of archeological interest. However, the Zee government has publicly stated that the development of the Metsa area is required to help Zee to sustain its economic growth.

Proposed Joint Venture with Olan

The government in a European country is funding the construction of a large sports stadium. Olan is a leading construction company in this European country, but it has not constructed a sports stadium of the size specified for construction. The government has indicated to Olan that it considers that the stadium could be built to budget and on time if an experienced company were to be involved in a joint venture with Olan. Olan has approached Domusco with a proposal for a joint venture. Bids for this stadium are due to be submitted in January 2006 and the decision to award the contract will be announced in March 2006.

Peter Kaye is concerned that most of his employees are already committed on other projects, including the recently awarded contract to construct a sports stadium in another European country. He recognises that Domusco would need to recruit additional staff as he considered that a project of this size, even taken on as a joint venture, could not rely on Domusco's current high level of sub-contract staff. Peter Kaye's department has estimated that this proposed joint venture with Olan, if awarded, would need an additional 1,200 man-years, over the three-year project timescale. This would result in the recruitment of an additional 400 employees.

If Domusco were awarded the joint venture contract with Olan, it would be Domusco's largest ever contract for a single building, at the equivalent of Z$2,400 million total revenue (which would be shared with Olan in the agreed joint venture split, which has not yet been agreed). If Domusco agreed to be a 50/50 joint venture partner, its share of the contract would be Z$1,200 million and its share of the profits for the contract over 3 years, would be over Z$300 million.

Peter Kaye has estimated that if Domusco did bid for this contract, in a joint venture with Olan, then it could have an 80% probability of being awarded the contract. Martyn Lite is concerned that working capital requirements would be high for this contract, as the European government has stated that stage payments would only be paid after the completion of different stages of construction. Within the first 12 months, the total working capital for the entire project would be the equivalent of around Z$850 million.

Will Umm is not entirely confident about the proposed joint venture with Olan. Olan has suffered from bad press coverage on several occasions. There was a reported incident when Olan had been accused of bribery to win government contracts in its home country, but this was never proved. Additionally, Olan has a bad track record with the way in which it treats its sub-contractors and its employees. Its safety record, which is public knowledge, is poor. Olan is keen to work with Domusco. However, Domusco's non-executive directors are unsure about the proposed joint venture.

Employee survey

Domusco has undertaken its fourth employee survey and the management is now considering the findings. The points raised by employees include the following:

(a) Issues concerning sub-contractors

Domusco employees continue to complain about the quality of the work undertaken by sub-contractors. The employees are also aware that some sub-contractors are paid a larger daily fee than their own salaries, and feel that they are under-valued.

Domusco employees report that there are a greater number of sub-contractors who are employing workers with insufficient training or inadequate experience. Zee is experiencing a construction boom at present, and a variety of inexperienced people, have sought work in the construction industry. Some of Domusco's sub-contractors have employed inexperienced staff, which has led to some workers ignoring safety issues and demonstrating a lack of awareness for the importance of safety. Some Domusco employees have refused to work at one site where there have been a number of accidents caused by sub-contractors.

(b) Employee sickness

Domusco has a number of employees absent on long-term sickness leave. The main reason for long-term sickness is not for work-related injuries, but is due to stress.

(c) Shortage of managers

Some of Domusco's managers have reported that they feel under pressure to complete their jobs in unrealistic timescales. They also state that they have insufficient junior managers to support them and they are under pressure to meet budgets and deadlines.

August 2005 Domusco Board meeting

When the Board met in August 2005, it was agreed that Domusco was experiencing its most successful phase in its building history, despite the forecast loss on the Wye motorway contract. Domusco's share price had risen slightly to Z$13.95.

Carlos Freer announced that the unsold land in the Hadsi area, that Domusco owned, would be sold to either of two office construction companies that were both very interested in it. Both companies were keen to purchase the land following the recent high profile sales of office space in Hadsi and each construction company was trying to finalise its bid price. Domusco is hoping to be able to receive over Z$200 million within the next three months, for the land that it has in the group balance sheet as inventory for Z$102 million.

Martyn Lite was pleased to announce that the Domusco group had a very strong positive cash flow at present, and that the Domusco group had a cash balance of Z$1,000 million at the end of August 2005. The Board discussed a number of ways in which it could expand its business, given its current strong cash position.

In addition to the Metsa and Olan proposals detailed above, some further uses of the cash balance discussed were:

- Martyn Lite is keen to repay loans. The company has a Z$324 million loan which is due to be repaid in 2007, but could be paid back early. Additionally the company took out two loans to finance the start of the construction work on the Hadsi development, which could be repaid early if the Board decided to.
- Marma Winge wants to expand the USA house building operations by organic growth, but needs sufficient working capital to do this. He plans to set up a further subsidiary company that would need around Z$200 million funding to open offices, acquire land, to construct some houses and to market them in this new geographic area within the USA. He considers that there is huge potential for new business and that the USA market is growing rapidly. This expansion in the USA is in the company's ten-year plan, but not until 2007. Marma Winge would like to bring this project forward.
- Will Umm stated that Domusco is permitted to buy back its shares on the stock market in Zee, but asked for advice as to whether the company should use some, or all, of its surplus cash to buy back shares.

Investigations into cash shortages

It had been brought to the attention of Jaz Grue, who is one the senior finance managers based in Domusco's Head Office in Zee, that one of the cash reconciliations could not be reconciled. Jaz Grue was inquisitive and pursued the reconciliation problem, which concerned reconciling deposits paid by customers for their houses in Zee to cheques banked. Jaz Grue works in Domusco's subsidiary for house building in Zee and has a dotted line responsibility to Martyn Lite, but his direct manager is Marma Winge.

With the large volume of sales of houses in Zee, the bank reconciliation between the value of cheques banked and sales receipts issued showed a shortfall of around Z$1.6 million. After his investigations, Jaz Grue discovered that a number of house sales, both in the Hadsi area and elsewhere in Zee, have not had deposits accounted for as paid. Instead he has uncovered what could be a major fraud involving a group of eight of Domusco's employees in the house building subsidiary based in Zee. The missing cheques from Domusco customers had not been identified as the customers are not due to pay a further instalment, or the final payment for their new houses for many months. Initially, the difference was considered to be due to timing differences.

Jaz Grue was unsure of what to do or who to approach. On Friday 2 September 2005, he decided to speak to Jackie Paul, Human Resources Director. On hearing the extent of the fraud, Jackie Paul decided to instantly dismiss Jaz Grue, as she considered that he had been negligent in allowing the fraud to occur and for not identifying the cash shortfall before it had reached such a large sum. Jackie Paul has now advised Marma Winge and Martyn Lite of her action of dismissing Jaz Grue.

Appointment of consultant

The Domusco Group has been through a very busy phase with the high growth of sales in Zee and elsewhere and Tom Micol is undecided on where the company should use its resources.

The Board has decided that it would like to have the advice from an experienced consultant. It has appointed a leading global consultancy company.

5.3.3 Assessment Matrix for TOPCIMA – Domusco – September 2005 examination (same as November 2005)

Criterion	*Marks*	*Clear Pass*	*Pass*	*Marginal Pass*	*Marginal Fail*	*Fail*	*Clear Fail*
Technical	**5**	Thorough display of relevant technical knowledge. **5**	Good display of relevant knowledge. **4**	Some display of relevant technical knowledge. **3**	Identification of some relevant knowledge, but lacking in depth. **2**	Little knowledge displayed, or some misconceptions. **1**	No evidence of knowledge displayed, or fundamental misconceptions. **0**
Application	**15**	Knowledge clearly applied in an analytical and practical manner. **13–15**	Knowledge applied to the context of the case. **9–12**	Identification of some relevant knowledge, but not well applied. **8**	Knowledge occasionally displayed without clear application. **5–7**	Little attempt to apply knowledge to the context. **1–4**	No application of knowledge displayed. **0**
Diversity	**5**	Most knowledge areas identified, covering a wide range of views. **5**	Some knowledge areas identified, covering a range of views. **4**	A few knowledge areas identified, expressing a fairly limited scope. **3**	Several important knowledge aspects omitted. **2**	Many important knowledge aspects omitted. **1**	Very few knowledge aspects considered. **0**
Focus	**10**	Clearly distinguishes between relevant and irrelevant information. **9–10**	Information used is mostly relevant. **6–8**	Some relevant information ignored, or some less relevant information used. **5**	Information used is sometimes irrelevant. **3–4**	Little ability to distinguish between relevant and irrelevant. **1–2**	No ability to distinguish between relevant and irrelevant information. **0**
Prioriti-sation	**10**	Issues clearly prioritised in a logical order and based on a clear rationale. **9–10**	Issues prioritised with justification. **6–8**	Evidence of issues being listed in order of importance, but rationale unclear. **5**	Issues apparently in priority order, but without a logical justification or rationale. **3–4**	Little attempt at prioritisation or justification or rationale. **1–2**	No attempt at prioritization or justification. **0**
Judgement	**15**	Clearly recognises alternative solutions. Judgement exercised professionally. **13–15**	Alternative solutions or options considered. Some judgement exercised. **9–12**	A slightly limited range of solutions considered. Judgement occasionally weak. **8**	A limited range of solutions considered. Judgement sometimes weak. **5–7**	Few alternative solutions considered. Judgement often weak. **1–4**	No alternative solutions considered. Judgement weak or absent. **0**
Integration	**10**	Diverse areas of knowledge and skills integrated effectively. **9–10**	Diverse areas of knowledge and skills integrated. **6–8**	Knowledge areas and skills occasionally not integrated. **5**	Knowledge areas and skills sometimes not integrated. **3–4**	Knowledge areas and skills often not integrated. **1–2**	Knowledge areas and skills not integrated. **0**
Logic	**20**	Communication effective, recommendations realistic, concise and logical. **16–20**	Communication mainly clear and logical. Recommendations occasionally weak. **11–15**	Communication occasionally unclear, and/or recommendations occasionally illogical. **10**	Communication sometimes weak. Some recommendations slightly unrealistic. **5–9**	Communication weak. Some unclear or illogical recommendations, or few recommendations. **1–4**	very poor communication and/or no recommendations offered. **0**
Ethics	**10**	Excellent evaluation of ethical aspects. Clear and appropriate advice offered. **9–10**	Good evaluation of ethical aspects. Some appropriate advice offered. **6–8**	Some evaluation of ethical aspects. Advice offered. **5**	Weak evaluation of ethical aspects. Little advice offered. **3–4**	Poor evaluation of ethical aspects. No advice offered. **1–2**	No evaluation of ethical aspects. Unethical, or no, advice offered. **0**
TOTAL	**100**						*© CIMA – July 2005*

5.3.4: Domusco – Case writer's answers for September 2005

TOPCIMA – Domusco
Case – September 2005 exam

REPORT

To: **Domusco Broad**
From: **Consultant**

Review of Domusco

Report Contents:

1.0 Introduction
2.0 Terms of reference
3.0 Review and prioritisation of the main issues facing Domusco
4.0 Discussion on the effective uses of Domusco's short-term cash surplus
5.0 Ethical issues to be addressed by the Domusco Board
6.0 Recommendations and justifications on the use of Domusco's cash surplus

Appendix 1: SWOT analysis for Domusco
Appendix 2: Porter's generic strategies
Appendix 3: PEST analysis
Appendix 4: Evaluation of proposed Metsa development
Appendix 5: Summary of Domusco's cash balance and alternative uses

1.0 Introduction

Domusco has been a listed company in the country of Zee for over 30 years. It is involved in construction work in Zee, other areas of Europe and has acquired house building operations in the USA within the last five years. The company's revenue in 2004 is Z$6,216 million and the ambitious 5-year plan forecasts revenue growing to over Z$11,000 million by 2009. This represents a growth of 78% over 5 years.

Much of this growth is as a result of taking a 40% share of the major Hadsi development in its home country of Zee, where it plans to build 12,000 housing units and 50 office buildings. The Hadsi development has so far been very successful with a high number of sales early on in the construction process.

2.0 Terms of reference

I have been appointed as a consultant to analyse the main issues facing Domusco and to make appropriate recommendations to the Domusco Board on how Domusco's short-term cash surplus could be used effectively.

3.0 Review and prioritisation of the main issues facing Domusco

3.1 Prioritised list of issues facing Domusco

There are a number of issues facing Domusco, and these are listed in priority order below:

1. Manage its cash resources so as to maximise shareholder value. Domusco's surplus cash should be invested in positive NPV projects that exceed Domusco's cost of capital. If there are no available projects the cash should be returned to shareholders.
2. Domusco should not retain too much cash so that it becomes the target of a hostile take-over. It also will not be in the shareholders' interests for cash to retained by Domusco.
3. Domusco should address the employees' concerns that have been raised in the employee survey. The employees are the people who make the company successful and they need to feel valued and their concerns should be addressed. Domusco's long term success will be directly related to how it values and treats its employees.
4. Domusco should improve its internal financial controls to ensure frauds do not recur in the future.
5. Domusco must urgently improve its staff management procedures so that employees have confidence to speak up about problems without fear of dismissal.
6. Domusco's management must review its ambitious 5-year plan and resource management issues, and decide whether the number of direct employees should be increased to cope with the growing business, so that the company is not over dependent on sub-contractors. The main Board should review the mix of employees and sub-contractors and the effects on quality and safety issues.
7. The Domusco Board should be strengthened, possibly with additional non-executive directors and succession planning, especially for the Chairman Tom Micol (who is due to retire soon), should be commenced.
8. Domusco must use IT solutions to continue to differentiate the products and services provided to its customers.
9. Domusco has two proposed developments that should be reviewed and a decision made whether, or not, Domusco should be involved in the Metsa development and, or, the proposed joint venture with Olan.
10. Domusco should review and update its 10-year plan following the removal of Wye government funded projects and explore how the shortfall from this area could be replaced by other Major Construction Projects.
11. Domusco must review the increasing level of global competition and identify ways in which it can continue to operate in its chosen business segments profitably.

3.2 SWOT analysis

Appendix 1 shows the strengths, weaknesses, opportunities and threats facing Domusco.

Whilst Domusco is operating in several continents and has a turnover of Z$6,000 million in 2004, and is profitable, it has a number of major challenges ahead if it is to remain successful in the competitive international construction market.

Many of the large global construction companies are experiencing reduced margins and are competing not on price, but by differentiating their construction styles and construction methods. Domusco needs to continue to introduce innovative building materials, designs and finishes to its buildings for it to remain competitive in the future. Appendix 2 shows

Porter's generic strategies and demonstrates that Domusco is successful by differentiating itself from its competitors.

It is recommended that Domusco should use the cash surplus that it has in order to grow its business, but expansion needs to be carefully managed. At present, the Domusco Board has a number of staffing and managerial issues that should be urgently addressed.

3.3 Staffing issues

The main issue to be managed as soon as possible is to decide on staffing levels within each of the Domusco subsidiaries to ensure that sufficient staff and sub-contractors are available in the right place to ensure that all contracted projects are constructed on time, and to budget.

Employees should be trained to become tomorrow's managers and the company should introduce, or enhance, its performance related pay. This could be done in relation to individual contracts or projects, or on the results (financial and non-financial measures) within each subsidiary.

3.4 Balanced scorecard

It is recommended that the balanced scorecard approach is introduced and cascaded down to all levels of management within the next 12 months and external expertise enlisted to get this useful management technique implemented. When the measures are in place, it will enable Domusco's managers to be rewarded against the key business measures that are monitored, that go beyond financial measures. The balanced scorecard takes into account safety, the external environment (competitors) as well as innovation. These are just the type of outward looking measures that Domusco should be addressing if it is to remain successful in its chosen markets.

There is no information in the case material about performance related pay and it is suggested that Domusco could use the balances scorecard approach to reward managers in each of the Domusco subsidiary companies based on each company's ability to meet agreed targets.

3.5 PEST analysis

A PEST analysis is shown in Appendix 3. This shows that Domusco has a number of political and economic advantages but that there are challenges for Domusco concerning its employees. Domusco also needs to ensure that it is able to secure a technological advantage over its competitors in order to continue to gain market share.

4.0 Discussion on the effective uses of Domusco's short-term cash surplus

4.1 Alternative uses for surplus cash

Due to the high level of pre-sales in Hadsi and the strong level of sales of offices and houses in Zee, and in other areas where Domusco is operating, the company has a forecast cash surplus of Z$1,300 million at the end of December 2005. This forecast should be reduced by Z$80 million for the forecast loss of Wye government funded projects, resulting in an adjusted forecast cash surplus of Z$1,220 million at the end of December 2005.

This balance also assumes that no further loans are taken on during 2005, as the current 5 year plan had forecast an additional Z$500 million for 2005.

Furthermore, this large cash balance is after the second payment to the Zee government for the Hadsi land of Z$415 million.

The company needs to urgently decide how to use this large cash balance so that it does not become the target of a hostile take-over by another large international construction company.

The Domusco Board can use the cash in two ways:

1. Invest the cash in the business for expansion.
2. Return the surplus cash to shareholders (dividends, special dividend or share buy back).

Some of the cash may be required for working capital if the proposed Metsa or Olan joint venture proposal is accepted. The cash should not be retained as a short-term investment as Domusco is unlikely to be able to earn sufficient interest to cover the return expected by shareholders.

Domusco should retain a minimum of Z$100 million to finance working capital for the business, and therefore the balance should be returned to shareholders or invested to increase growth, assuming that all of the projects undertaken are forecast to produce positive net present values (NPV's) at the company's cost of capital.

Domusco's cost of capital is not given, although the risk adjusted cost of capital for the risky Metsa project is given as 12%. Therefore it is assumed that Domusco's cost of capital would be around 10 to 11%.

The Domusco Board has discussed a number of alternative uses for Domusco's current cash balance, which is Z$1,000 million at the end of August 2005 and forecast to be Z$1,220 million by the end of 2005. These include:

- Proposed Metsa development (evaluated in Appendix 4)
- Proposed Olan joint venture
- Repay loans
- Organic expansion of USA house building operations
- Buy back of shares.

Appendix 5 shows a summary of Domusco's cash flow.

Insufficient cash flow data has been provided to establish what Domusco's working capital requirements are on its other ongoing construction work, but we can assume that they are self-financing and no additional working capital is required.

From the available Z$1,220 million at the end of 2005, it is clear that Domusco cannot undertake all of the above uses for the cash, which could total almost Z$3,000 million.

In addition, Domusco will need working capital to continue to finance the first and second phases of the Hadsi development, which has forecast construction costs (given in pre-seen material) of Z$1,200 million and Z$1,500 million in 2005 and 2006 respectively. However, with the apparent success of Hadsi, perhaps this project can use the customers' deposits and instalment payments to finance the rest of the construction costs.

Each project needs to be discussed on its own merit. If it is to be recommended then the question of how it should be financed is a separate issue. Domusco could finance working capital requirements through short-term borrowings and perhaps the organic expansion in the USA by additional loan finance.

An additional issue is that with the success of the Hadsi project and the increased profitability and higher earnings per share (EPS), comes the shareholders' expectation that this growth in EPS will continue. Domusco's share price will reflect the higher EPS achieved in 2005 in due course, but in the construction industry, the company's share price will reflect its order book and its recent achievement to fulfil its contracts.

Domusco's 10 year plan is very ambitious and it needs to maintain the momentum achieved in the Hadsi project so far, and to continue to expand its construction business in Zee as well as elsewhere.

The adjusted forecast end 2005 cash balance of Z$1,220 million is large enough to perhaps attract an unwanted take-over bid (successful cash rich company), and this should be urgently addressed so that an unwanted take-over bid does not occur. Furthermore, it should be noted that in this industry this size of cash balance is not sufficient to make a major difference in the company's expansion plans. The company will instead be limited in its expansion by its human resources and its management's ability to manage many projects both in Zee and elsewhere globally.

Each of the above alternative uses of the company's resources is now discussed:

- Proposed Metsa development
- Proposed Olan joint venture
- Repay loans
- Proposed organic expansion of USA house building operations
- Buy back of shares.

4.2 Metsa development

It is not recommended that Domusco accept the Metsa development, as the high cost scenario (which has a 75% probability) will only produce a positive NPV of Z$12 million. This is detailed in Appendix 4.

As Marma Winge stated, why buy more land in Zee when Domusco already has a large land bank in Zee. Additionally the cost of the land at Z$500 million seems expensive. Even at the normal cost profile, the ratio of the land cost to the total construction costs is very high at 50% (land cost 500 : normal cost scenario construction costs 1,010). This compares to Hadsi, which was 7% (land cost 40% of 830 = 332 : Domusco total construction costs of 5,000).

There is a high probability of the high cost scenario (75% probability) and there could be other unexpected costs that could arise on this site.

If the normal cost scenario were to occur, then the forecast NPV shown in Appendix 4 is Z$361 million, which is very high but there is only a 25% probability that this will occur. The expected value NPV of Z$99 million is unrealistic as either the costs of construction will be high, or they will be low. It is likely (given the forecast probability) that costs will be towards the higher end, resulting in a low, but positive, NPV.

Overall it is NOT recommended that Domusco proceed with the Metsa development, due to the high probability of the high costs scenario.

Another factor is that Domusco's staffing and sub-contractors should concentrate on the continued success of the Hadsi development and should not be distracted by a further major project. When the Hadsi development is completed in 2007, if the Metsa land remains undeveloped (which is unlikely as the Zee government will probably sell it to another company in the meantime) then perhaps Domusco could consider it then.

4.3 Proposed Joint Venture with Olan for sport stadium contract

The non-executive Directors on the Domusco Board are unsure about the proposed Olan joint venture. Olan has not got a good reputation internationally and this could harm the good corporate name of Domusco, in Europe and elsewhere.

One of the reasons for their concern is that Olan has a known poor reputation for safety issues and the Domusco Board has a duty, legally and ethically, to protect its employees.

There is no guarantee that even if Domusco agreed to undertake the proposed joint venture with Olan that it would be awarded this contract. A further question that the Domusco Board should address is whether this is the right business for Domusco at this point in time? Domusco has recently won a different sports stadium contract and Peter Kaye is very concerned at the lack of available experienced manpower for that project. It is not considered feasible to bid for this additional sports stadium project which could put the other contract in jeopardy, particularly as the contract that has been won already has a final stage payment of €12 million that is only payable to Domusco if it is completed on time. Depending on Domusco and Olan's ability to employ workers with the right skills mix on short term contracts, Domusco could find itself diverting valuable skilled manpower on a project that it is sharing the profits on with Olan.

Additionally the Olan joint venture project has high working capital requirements. In first year, Domusco may need to finance 50% (if a 50/50 JV partner) of the working capital of Z$850 million, which is Z$425 million. This could use up a lot of the surplus cash that Domusco currently has, on only one project.

The proposed joint venture would be Domusco's single largest contract ever, if it were to be awarded. Therefore it has higher risk implications for the entire Domusco group. If anything went wrong, then the repercussions could affect the entire group.

Whilst a joint venture can share this risk, the choice of the joint venture partner in this case is another risk factor, as Olan appears to have a poor record with sub-contractors and safety.

Overall, it is my opinion that Olan needs Domusco more than Domusco needs Olan and the proposed joint venture is not recommended.

4.4 Repay loans

Martyn Lite, Domusco's Finance Director is keen to repay loans. Domusco has a loan for Z$324 million that is due to be repaid in 2007. However, why repay a loan earlier when the company can afford the repayments. By repaying the loan, Domusco would be demonstrating to its shareholders that it could not invest the cash in projects that could generate a positive NPV.

If Domusco is assumed to currently have an optimal proportion of debt in its capital structure, then the loan interest repayments lowers the company's cost of capital, due to the tax shield on debt finance. A lower cost of capital for the Domusco group should allow more positive NPV projects to be accepted, which should help the expansion of the Domusco business.

Therefore it is NOT recommended that Domusco use part of the cash surplus for the early repayment of loans.

4.5 Organic expansion of USA house building operations

The expansion of the USA house building business by organic growth is a good way to expand the Domusco group. This expansion is in the company's current plan for 2007, but would be a good use for the company's current cash surplus. It is presumed that the expansion has been justified by a positive NPV, although details of this have not been included in the case.

Another feature of the proposed expansion in the USA market is the increased risk of operating in an overseas market, which includes exchange rate risk. However, the cost of expansion could be hedged against cash generated by Domusco's existing USA operations.

The proposal for the USA house building subsidiary of Domusco to expand its operations in the USA is a good use of this surplus cash and the company would be showing some financial commitment by opening more offices and constructing houses in new geographic locations.

The ROCE for the USA house building company was 27.4% in 2004, according to the case material, several percentage points higher that house building operations in Zee and elsewhere in Europe. Therefore expansion into this profitable segment appears to be a good reason to bring this project forward.

It is recommended that the expansion of the USA house building subsidiary should be funded to allow it to grow organically.

4.6 Buy back of shares

If Domusco were to buy back shares, it would have to offer a premium above its current share price of Z$13.95. If the premium was only 10%, which may not be too attractive, the share buy back price would be Z$15.35. Therefore if the company used Z$1,000 million of the cash surplus to buy back shares it would only be able to buy back a little over 65 million shares, which represents around 15% of the issued shares.

Whilst a share buy back may temporarily boost the share price, Domusco is not in need of a boost to its share price, which at Z$13.95 is at a high and is probably undervalued.

When the financial impact of the success of Hadsi filters through to the market, Domusco's share price, and investors' confidence, will increase. This could make a share buy back even more expensive or indeed unsuccessful if the offer price is too close to the increased market price.

Overall, it is NOT recommended that Domusco buy back any of its own shares.

Instead, if Domusco has surplus cash that it cannot use for investments or acquisitions, then a more appropriate way to return cash to shareholders would be to pay an exceptional dividend. Whilst this creates expectations for the future, the investors should understand why the dividend has been paid which is as a direct result of the change in the working capital caused by the success of the Hadsi development.

It is recommended that Domusco pay an increased dividend for 2005. The indicative payout ratio for previous years is 40% and it is proposed that an additional dividend, on top of the usual dividend ratio, of around Z$1.00 per share is paid, which would create an additional dividend payment of around Z$442 million.

4.7 Other issues

There are a number of other issues that the Domusco Board should address. These are shown below:

4.7.1 Staffing required for sport stadium contract awarded in August 2005

The Board needs to decide how the manpower for this recently won contract is to be allocated. Domusco needs to decide whether it is to be sub-contracted or whether the company should recruit employees on short-term contracts. It is proposed that a mixture of both should be undertaken, but that experienced Domusco employees are sent to the European country to manage the project. It is important that this stadium is built to the agreed deadline in order to receive the final stage payment of Z$31 million (€12 million).

4.7.2 The loss of all Wye government funded work

The current Domusco plan has Z$110 million of forecast cash flows for 2006 that were planned to be generated by Wye government funded projects, mainly road building. Following a Domusco Board decision in August 2005, not to undertake any further work, following the substantial loss on the current motorway project, this leaves a shortfall in the forecast cash flows for 2006 of Z$110 million. Assuming these cash flows equate to profit, this represents a shortfall of 7.5% of the entire Domusco group's 2006 planned pre-tax profits. This is a substantial shortfall in 2006 and in future years, and the Domusco group needs to be actively searching for other construction work that can replace the Wye road building work.

It is recommended that Peter Kaye, as Head of Major Construction projects, should undertake a search of alternative road building, or other suitable construction work, that can utilise Domusco's employees that would have worked in Wye. Domusco should submit bids to the relevant authorities for these proposed new projects as early as possible, so that the shortfall in forecast profits for 2006 onwards is filled by other new projects.

4.7.3 How should Domusco maintain its current high growth

With the success and the high sales in the Hadsi project and other housing sales in the Domusco group, Domusco will have higher than forecast profits for 2005. This will create expectations for the future and lead to a rise in Domusco's share price. It is important that Carlos Freer, The Director of Business Planning, puts strategic and operational plans in place to ensure that the high levels of profitability continue. It may be an opportune time to acquire a competitor in the construction industry, which would have two benefits. This would provide Domusco with an expansion route and also give it access to a new pool of experienced managers and employees. However, it is important that any acquisition target is carefully chosen and that Domusco does not pay too high a price, so that shareholder value is increased by synergies.

A new 10-year plan should be prepared with a detailed 5-year plan through to 2010 and an outline plan for the following 5 years. The plan should highlight which projects have been contracted for, those that are in the bidding stage and should identify the shortfall of new projects that need to be won by Domusco.

The business planning department should continue to work with finance managers around the Domusco group in order to examine operating costs and to maintain or increase margins. The group should also consider in what areas of the construction business they could incorporate value added concepts. For example, many house building companies sell a range of interior design features directly to their customers.

5.0 Ethical issues to be addressed by the Domusco Board

5.1 Ethical issues

The UK's CCAB offers guidance to accountants in business on ethical matters, based around five fundamental principles. These are:

1. integrity – not merely honest, but fair and truthful
2. objectivity – having regard to all considerations relevant to the task
3. competence – undertaking professional work only with the required level of competence
4. performance – carrying out work with due skill, care and diligence
5. courtesy – showing courtesy and consideration to all.

If we extend the above fundamental principles to business in general, there are several ethical issues involved in this case as shown below.

5.2 Skill mix of employees and skills shortages

It is the employer's duty to ensure that its employees carry out their work with the correct level of skills. In this case there are repeated instances where Domusco's employees or the company's sub-contractors have not had the correct skill mix. Indeed the employee survey shows that employees consider that there is a shortage of skills at the managerial level and therefore Domusco should recruit and train more managers so that the company can demonstrate that it is competent in all aspects of its responsibilities.

5.3 Cash fraud in Zee

One of the senior finance managers based in Domusco's Head Office in Zee is Jaz Grue, who has discovered a cash fraud. He has identified that some customers' cheques for house deposits in Zee have been stolen and not banked into Domusco's bank accounts. There are a number of ethical issues here. Firstly and most important, Jaz Grue has been unfairly dismissed. He was not party to the fraud but was simply the messenger who reported what he had uncovered. The issue of whether it was his responsibility for not discovering the fraud before it had reached this level is a separate issue. Furthermore, by dismissing Jaz Grue the eight employees who have perpetrated the fraud are still employed by Domusco and it is unclear what action is being taken.

It is recommended that Jaz Grue is reemployed and receives an apology from Domusco's management.

It is also recommended that Domusco introduce a "whistle-blowing" policy whereby staff can report incidents, whether fraud or bad workmanship, with no fear of any personal repercussions.

It is also recommended that the eight employees who have committed the fraud are identified and their contracts of employment are terminated.

The last recommendation here is that employees in the Zee based house building subsidiary finance department (and other finance departments around the Domusco group) should be better trained to perform reconciliations to ensure differences between accounts and cash banked do not escalate to this level before they are identified. Additionally, Domusco's internal audit and its external auditors, should perform checks to ensure that all of the necessary controls are in place.

Furthermore, with the expansion of the Domusco businesses, it appears that the finance teams are under-resourced and consideration should be given to increasing staffing levels in all of the support areas including finance departments.

5.4 Proposed joint venture with Olan

Olan has not got a good reputation internationally for its treatment of its employees and its sub-contractors, and has even been accused of bribery to win government contracts in its home country. Domusco has established a good reputation internationally and the proposed joint venture with a company such as Olan, which has this poor reputation for this type of unethical behaviour, is not recommended. It could reflect very badly on Domusco and if the joint venture were to go ahead, Olan's poor safety record could put Domusco's employees at risk.

It is not recommended that Domusco proceed with the proposed joint venture with Olan.

5.5 Employee survey findings

There are concerns expressed by Domusco's employees about the quality of the work undertaken by sub-contractors and also some sub-contractors lack of safety awareness. It is Domusco's responsibility for site safety on all of its sites, irrespective of whether it is its own employees or its sub-contractors who are working on sites.

As a responsible employer, Domusco should ensure that it puts controls in place to ensure that Domusco can show to its employees that it is enabling them to perform in an ethical manner and to show ethical courtesy to all of it stakeholders, whether employees or sub-contractors.

It is also recommended that Domusco should invest in its employees and train its future management. More junior mangers should be recruited and more management training should be given to all levels of management. As management feel under pressure, which is showing in the long-term sickness leave due to stress, it is apparent that Domusco has insufficient managers for the volume of work that it is currently undertaking. It is recommended that until more managers are recruited perhaps additional management skills could be brought into the company from an experienced construction industry consultancy group. This is common practice when companies in this industry need additional expertise, whether for a particular project or to fill skill shortages. Long term, Domusco needs to grow its own managers.

6.0 Recommendations and justifications on the use of Domusco's cash surplus

6.1 Metsa development

It is not recommended that Domusco undertake the Metsa development as the high cost scenario, which has a high (75%) probability of occurring will only produce a small positive NPV of Z$10 million at the risk adjusted discount rate of 12%.

Whilst this project would be highly profitable at the normal cost scenario, this only has a low probability of occurring.

It is recommended that Domusco should concentrate on the house building development in phases 2 and 3 in Hadsi over the next few years and it should also continue to develop other housing projects using land that it has already acquired and is in its land bank as inventory in its balance sheet. It does not need to take on this high risk venture and spend a further Z$500 million on land.

6.2 Proposed Joint Venture with Olan for sport stadium contract

It is not recommended that Domusco should consider a joint venture with Olan. Olan is a company that has a poor safety reputation and a tarnished reputation for winning contracts.

The proposed joint venture would be Domusco's single largest contract ever, if it were to be awarded. Therefore it has higher risk implications for the entire Domusco group. If anything went wrong, then the repercussions could affect the entire group. Whilst a joint venture can share this risk, the choice of the joint venture partner in this case is another risk factor.

Overall, it is recommended that the proposed joint venture should not be pursued.

Furthermore, due to manpower shortages it is not proposed that Domusco attempt to bid for this major contract on its own. It has a different sports stadium to construct and it still has not identified how it will construct this to the agreed deadline. It is not in a position at present to take on further work until it has the manpower resources to fulfil the contract.

6.3 Repay loans

It is not recommended that any of Domusco's loans should be repaid early, as it should be able to invest the funds to generate positive NPV's.

It is not a good use for the surplus cash. The cash should be invested in the business in positive NPV projects or returned to shareholders. Domusco is not highly geared and can afford the loan repayments and therefore there is no reason to repay them early.

6.4 Organic expansion of the USA house building subsidiary

The proposal for the USA house building subsidiary of Domusco to expand its operations in the USA is a good use of this surplus cash and the company would be showing some financial commitment by opening more offices and constructing houses in new geographic locations.

It is recommended that the expansion of the USA house building subsidiary should be funded to allow it to grow organically.

6.5 Buy back of shares and returning cash to shareholders through an additional dividend

If Domusco were to buy back shares, it would have to offer a premium above its current share price of Z$13.95. If the premium was only 10%, which may not be too attractive, the share buy back price would be Z$15.35. Therefore if the company used Z$1,000 of the cash surplus to buy back shares it would only be able to buy back a little over 65 million shares, which represents around 15% of the issued shares.

Overall, it is NOT recommended that Domusco buy back any of its own shares.

It is recommended, instead, that Domusco pay an increased dividend for 2005. It is recommended that an additional dividend of around Z$1.00 per share is paid, which would create an additional dividend payment of around Z$442 million.

6.6 Other recommendations:

- The Domusco Board should be strengthened with additional non-executive directors
- The search for a replacement Chairman for Tom Micol, who is due to retire soon, should be commenced
- The findings of the employee survey should be urgently addressed and the Domusco Board should take bold action to improve skill shortages and the pressures that middle managers in Domusco have found themselves with.
- More employees should be recruited and the sub-contractors who do not take safety issues seriously should not be used again.
- More management training should be undertaken so that Domusco grows its own managers and gives them the skills needed to undertake their challenging roles.
- Domusco should tighten its financial controls to stop further frauds occurring.
- Jaz Grue, who was unfairly dismissed, should be re-instated.
- Domusco should introduce a "whistle-blowing" policy to encourage employees to come forward when they have discovered areas of concern to them.
- A new 10-year plan needs to be prepared and new contracts need to be identified and bid for to cover the shortfall created by the lack of construction work in Wye.
- Domusco needs to continue to innovate and differentiate itself from its global competitors.

Overall, Domusco is a very successful construction company in its chosen areas and for it to continue to be successful it needs to innovate and look after the assets of the company, which are its employees. It is Domusco's employees who will design, bid and win contracts and construct the buildings to the agreed design and cost profile. The employees should be treated with more respect and more managers should be recruited to manage the projects that are in the process of construction.

Appendix 1

SWOT analysis for Domusco

Strengths	**Weaknesses**
• Established large international construction company with profitable businesses in all construction segments	• Problems with recruiting skilled labour
	• Profit margins in office building segment are decreasing despite a planned increase in turnover
• Major company in its own country of Zee	
• Experienced and stable Board of Directors	• Over reliance on sub-contractors, particularly in major construction projects and house building
• Success of the Hadsi development so far with high levels of sales	• Loss making road contract in Wye to be completed
• Good reputation for quality work	• Cash shortages and fraud in house building subsidiary in Zee
• Profitable growing businesses with high profits forecast for 2005	• Weak financial controls
• Share price at an all time high at Z$13.95	• No succession planning for the management team, especially Tom Micol who is due to retire soon
• Strong positive cash flows for the group with a cash surplus of Z$1,000 million at the end of August 2005	
• No additional loans forecast to be taken on in 2005	

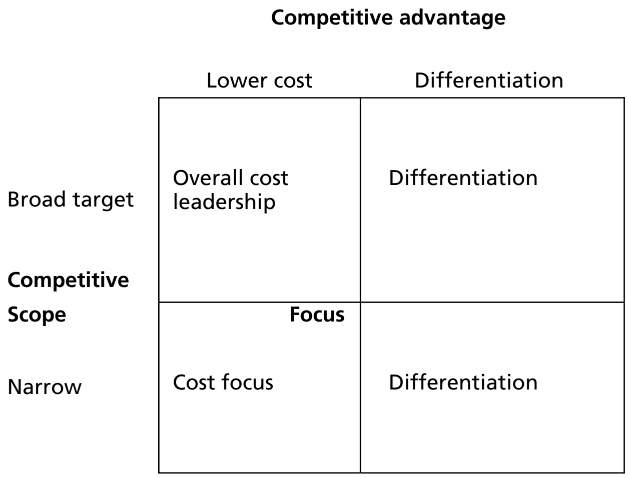
Opportunities	**Threats**
• Current cash surplus to invest	• Greater exchange rate risks as more of Domusco's work is undertaken outside of Zee
• Possible expansion in Metsa project	
• Proposed joint venture with Olan to construct a major sports stadium	• Continued shortage of skilled experienced manpower to work on and manage contracts for construction, especially the €180 million sports stadium contract
• High level of profits forecast for 2005 resulting in high share price and investor confidence	
• Proposed expansion of house building operations in the USA	• Shortfall in planned construction work following the decision not to undertake any new Government funded work in Wye
• High cash balances that could be used to repay loans or be returned to shareholders	
• Possible buy back of shares	• If a joint venture with Olan is undertaken, there is the concern over Olan's reputation
• Increase staffing levels in House Building	• Safety issues, particularly at sites where sub-contractors have caused accidents and Domusco staff are very concerned
	• Managers feel under pressure and there is a shortage of junior management
	• Increasing number of employees on long-term sickness leave
	• Growing risk that Domusco staff issues could result in contract deadlines not being met which could result in losing final stage payments

Appendix 2

Porter's generic strategies

There are three successful generic strategies, which are:

1. **Overall cost leadership** – low costs relative to competitors
2. **Differentiation** – creating something that is perceived as unique in the industry
3. **Focus** – serving a narrow strategic target more effectively than rivals who are competing more broadly



Domusco is not competing on cost leadership.

Domusco appears to have a broad competitive target but has managed to differentiate itself by the quality of houses and offices it builds (which have innovative features as standard). Domusco has also been able to differentiate from competitors for Major Construction projects and has successfully won many contracts outside of its home country of Zee.

Appendix 3

PEST analysis

Political/Legal

- Will Umm has good government connections.
- Having difficulties renegotiating terms of the motorway building contract with the Wye government after delays caused by heavy rainfall, resulting in Domusco Board decision not to undertake any further Wye government funded projects.
- Good track record of delivering contracts on time and to budget.
- Experienced project planning staff in Domusco, particularly the Major Construction projects subsidiary of Domusco.
- Domusco has experienced a high growth in its Major projects construction subsidiary in the last few years, mainly motorway construction work, of which many contracts have been awarded by the Zee government.

Economic

- Zee is experiencing a period of economic growth.
- High demand for new office buildings in Zee.
- Profit on Hadsi land that had previously remained unsold.
- Demand for Domusco to undertake further large projects – Metsa development and proposed joint venture with Olan to build a major sports stadium.
- Domusco is a large employer in its home country of Zee and is planning to increase the number of direct employees and reduce the use of sub-contractors.

Social

- High demand for new housing in all countries in which Domusco is operating, especially in Zee.
- Domusco has a good record on health and safety.
- Domusco prepares a corporate social report annually and has taken a range of steps to becoming a good employer and deals with its various stakeholders in a fair manner.
- Domusco has recently increased its number of employees. Due to volume of work that the company has undertaken it is considering increasing the number of employees again, so that it is less dependant on sub-contractors.

Technological

- Domusco has invested in some state of the art construction machinery in Zee, which depressed the house building subsidiary's ROCE in 2004.
- Domusco has designed some innovative office buildings.
- Domusco has specified that all new office buildings in the Hadsi development will be built with the latest high tech equipment to support "intelligent buildings".
- Domusco has recently been awarded the contract for the construction of a large national sports stadium in a European country, which would incorporate high technology in its design, its construction and its use.

Appendix 4

Evaluation of Metsa project

	End 2005 Z$ million	2006 Z$ million	2007 Z$ million	2008 Z$ million	2009 Z$ million	2010 Z$ million	Total Z$ million
High cost scenario:							
Cash flows: Land	500						500
Construction costs		250	340	480	580		1,650
Revenue		0	600	850	1,000		2,450
Pre-tax net cash flows	−500	−250	260	370	420		300
Tax at 30% (lagged by 1 year)	0	150	75	−78	−111	−126	−90
Post tax cash flows	−500	−100	335	292	309	−126	210
Cost of capital 12%	1.000	0.893	0.797	0.712	0.636	0.567	
NPV	−500	−89	267	208	197	−71	
Cumulative NPV	−500	−589	−322	−114	83	12	
NPV						12	
Normal Cost Scenario:							
Cash flows: Land	500						500
Construction		130	160	240	380		1,010
Revenue		0	600	850	1,000		2,450
Pre-tax net cash flows	−500	−130	440	510	620		940
Tax at 30% (lagged by 1 year)	0	150	39	−132	−153	−186	−282
Post tax cash flows	−500	20	479	378	467	−186	658
Cost of capital 12%	1.000	0.893	0.797	0.712	0.636	0.567	
NPV	−500	18	382	269	297	−105	
Cumulative NPV	−500	−482	−100	169	466	361	
NPV							361

Expected cost scenario:	NPV Z$ million	Probability	Expected values Z$ million
High cost scenario	12	75%	9
Normal cost scenario	361	25%	90
Expected NPV			99

Notes:

1. An alternative approach, where tax was not lagged by 1 year would be acceptable. This would produce the following NPV's:

High cost scenario	10
Normal cost scenario	344
Expected NPV	94

2. An alternative approach for calculating the expected NPV, by adjusting the costs using the probabilities would also be acceptable.

Appendix 5

Summary of Domusco's forecast cash balance and alternative uses for the cash surplus

Z$ million	End August 2005	2005	2006	2007	2008	2009
Forecast cash balance	1,000	1,300	1,800	1,700	1,600	1,400
Less forecast cash flows due to the removal of all new Wye government funded projects – by year		(80)	(110)	(110)	(120)	(140)
Cumulative		(80)	(190)	(300)	(420)	(560)
Adjusted forecast end year cash flows		1,220	1,610	1,400	1,180	840

The 5-year plan had assumed loans would increase by Z$500 million, presumably, to finance build costs in Hadsi. This loan will no longer be necessary as the company is forecast to have a surplus of Z$1,220 million at 31 December 2005.

Alternative uses:	Z$ million
Metsa development – land	500
– 2006 construction costs	130 to 250
Joint venture with Olan (Assumed: 50% share)	
Total working capital in first year is Z$850 million	
= Z$425 million for Domusco	425
Repay loan: due for repayment in 2007	324
Expand USA house building operations	200
Buy back shares:	
At a current share price of Z$13.95, with a premium of 10%, the company could use Z$1,000 million to buy back over 65 million shares, which represents almost 15% of issued shares	1000

Recommended use of cash surplus for 2005:

Expand USA house building operations	200
Pay an additional dividend during 2006 of Z$1.00 per share	442
Retain balance to fund expansion, working capital or for an acquisition	578
Total forecast funds available	**1,220**

5.4.1 Domusco – Requirement and unseen material for November 2005

Domusco – Unseen material provided on examination day

Additional (unseen) information relating to the case is given on pages 247 to 251.
Read all of the additional material before you answer the question.

ANSWER THIS QUESTION

You are the consultant appointed by the Domusco Board.

Prepare a report that prioritises and advises on the main issues facing Domusco and makes appropriate recommendations.

Domusco – November 2005 Unseen material provided on examination day

Read this information before you answer the question

Acquisition of KLT by Domusco

Domusco is experiencing cash flow difficulties, due primarily to the slow selling of houses and offices in the Hadsi development. However, in July 2005 Domusco announced a bid for KLT Construction (KLT), a listed house building company based in Zee, which has house building subsidiary companies in several European countries. KLT is one of the construction companies building over 4,000 housing units in the Hadsi development project.

Peter Kaye was very much in favour of the acquisition of this key competitor and together with Marma Winge, who was keen to see the expansion in his division, persuaded the other Board members to vote in favour of this acquisition.

The three reasons why they considered KLT to be a good acquisition were:

- It would enable Domusco to increase its market share in Zee.
- It would give Domusco access to KLT's European infrastructure, in order for Domusco to be able to expand its European operations into countries in which Domusco has not yet operated.
- It would give Domusco access to KLT's large land bank for future construction projects, mainly in Europe.

Martyn Lite was not in favour of the acquisition of KLT for two reasons. First, the company had insufficient cash for the acquisition, without raising further loans, which he did not want to do. Second, he felt that the company was stretching its management resources at present. However, the Domusco Board agreed to bid to acquire KLT.

KLT's share price, prior to bid announcement in early July 2005, was Z$4.17 per share, which was near to its all time high. Domusco announced an offer equivalent to Z$5.00 per share, valuing KLT at Z$550 million, which was accepted by KLT's shareholders.

Domusco paid Z$400 million in cash and the balance of Z$150 million in shares, resulting in Domusco issuing around 10.85 million new shares for this acquisition, based on Domusco's share price of Z$13.82 per share. In order to finance the cash payment for KLT, Domusco increased its loan finance, as it had insufficient cash generated from operations. Domusco arranged a new 5-year loan of Z$300 million at 9% interest per year, with local bankers in Zee in mid July. This is the only new loan taken on by Domusco so far in 2005.

The synergies from the acquisition are expected to be Z$10 million per year from 2006. However, market analysts did not approve of Domusco's acquisition of KLT, and Domusco's share price fell. By the end of July 2005 it was down from Z$13.82 to Z$12.16, a fall of 12%.

Zee government announcement of interest rate changes

From mid-September 2005, there were a few weeks of exchange rate turbulence in Zee, as well as in several other non-Euro European countries and some Middle East countries.

The Zee government announced a 2% rise in its interest rates on 1 October 2005 in an attempt to protect its exchange rate. The exchange rates between the Zee dollar and the

Euro and the US dollar have now changed and after fluctuations over the preceding few weeks appear to have settled down.

On 31 October 2005 the exchange rates were as follows:

	Z$ to US$	*Z$ to Euro*
Exchange rates on 31 October 2005	3.97	3.12
Exchange rates at 30 June 2005	3.25	2.55
Exchange rates ruling on 30 June 2004 (when Domusco non-Zee dollar loans were signed)	3.18	2.51

Note: Shading indicates information given in the pre-seen material.

When Martyn Lite arranged the new loan of Z$300 million to finance the KLT acquisition he was aware that Domusco's loans would bring Domusco to just within the limits of one of the loan covenants that are attached to the two loans from the ALT and BRG banks taken out for the Hadsi project. This loan covenant states that Domusco's total loans must not exceed 40% of shareholders' equity plus total loans. Shareholders' equity is defined as share capital, share premium and retained earnings.

Domusco had un-audited post tax (pre-dividend) profits of Z$318 million for the first half year to 30 June 2005. Domusco's post tax cost of capital is 10%.

European sports stadium contract

At the June 2005 Domusco Board meeting Peter Kaye announced that Domusco had been awarded the contract to construct a national sports stadium in a European country at a total revenue to Domusco of €180 million (approximately Z$459 million).

Peter Kaye had stated that he was surprised that Domusco had been awarded this contract as he had thought that Domusco had been removed from the shortlist some months before. When Peter Kaye discussed the proposed new contract with Richard Sears, Domusco's Head of Construction for Sports Facilities, Richard Sears openly stated that he had made two payments to government representatives in order to win the contract. Peter Kaye was furious that he had not been consulted about making these payments.

Peter Kaye is very concerned that the media will discover these payments. Peter Kaye discussed the matter urgently with Martyn Lite. After investigations Martyn Lite informed Peter Kaye about the following irregularities:

- Two payments, each for €200,000, had been paid eight weeks previously. The requests for both payments had been made and authorised by Richard Sears. Payments of this amount (totaling over Z$1,000,000) were within his limit of authority.
- The payments had been made by bank transfer and after investigation were not paid to the accounts for the government, nor any company involved in the bid, but to the private bank accounts of two advisors to the government.

Martyn Lite agreed to discuss the matter with the Chairman and Chief Executive, Will Umm, as a matter of urgency and requested that Peter Kaye delays the date for contract signing. The government of the European country that is financing the stadium is keen to announce that the contract will be awarded to Domusco and for construction work to commence. Peter Kaye has so far been able to defer contract signing but has been told by the government of the European country which is financing the stadium, that contracts must be signed by end December 2005 at the latest. The government of the European country is frustrated by Domusco's slow progress with this high profile stadium and is threatening that this could affect Domusco's ability to win further government financed contracts in future.

Low sales of houses and office buildings in the Hadsi development

The Domusco plan assumed that 90% of housing units in Hadsi would be sold before construction is completed, with some housing units sold off-plan (where customers purchase a house or apartment based purely on detailed site plans before construction has commenced) and some sold whilst construction work is in progress. Therefore, Domusco planned to be left with only 10% of housing units to be sold when the site is completed.

However, despite the high amount of publicity and marketing work that Domusco and the other construction companies had generated, the sale of housing units was extremely low. Domusco had achieved sales of only 920 housing units by the end of September, which was less than 31% of the first phase of 3,000 housing units that are currently under construction. Domusco does not want to slow down the construction process, although it may need to as the company is experiencing cash flow difficulties due to lack of sales of housing units in Hadsi, as well as elsewhere in Zee.

In addition, KLT is also experiencing low sales of its housing in Zee (both in Hadsi and elsewhere in Zee). However, KLT's housing under construction in other European countries is selling well and is in accordance with plan.

Piers Moore is very disappointed in the level of sales in Hadsi and has requested an additional promotional budget of Z$5 million to try to boost sales. Will Umm is not keen to spend any more on marketing costs, since the Zee Government has still not fulfilled its undertaking to promote the general development in the Hadsi area, on behalf of all of the construction companies.

The Zee government had previously agreed, as part of the sale of land agreement, that it would spend Z$20 million on promotional campaigns about the Hadsi development to encourage companies to relocate to Hadsi. So far it is estimated that the Zee government has spent less than Z$2 million. Will Umm and Tom Micol have raised their concerns to the relevant government minister, who had promised that the government funded marketing campaign would be continued. However, by the end of October 2005, the Zee government had not undertaken any further promotional work of the Hadsi area.

Domusco's construction costs on the Hadsi project are on budget. However, with the low level of sales, Marma Winge is getting worried that the housing units under construction will remain unsold. Furthermore, Domusco has only signed contracts for the sale of two of the twelve office buildings under construction. Therefore, Domusco's construction costs were far outweighing customers' deposits, and the Hadsi development is becoming a drain on Domusco's working capital.

Domusco had acquired the entire Hadsi site and had sold plots of land to five other construction companies. The amount of land that the Domusco Board agreed to develop was around 40% of the entire site, and Domusco still held 9% of the Hadsi land that it wished to sell, valued at Z$102 million. So far this land remains unsold and is in its land bank, reported as inventory in Domusco's balance sheet. However, Domusco's auditors have advised that this land value may need to be written down significantly, to Z$30 million.

Organisational change

Domusco Office Building subsidiary

At the September 2005 Board meeting the Board considered a proposal to either close down its Office Building subsidiary or to merge it with the Major Construction Projects subsidiary. The Office Building subsidiary is experiencing difficult trading conditions and has recently lost two sales. Both lost sales will receive some level of compensation, but the expected sales revenue, running into millions, will not be achieved.

Additionally there are several office buildings that are behind schedule in construction, with costs higher than forecast, due to poor project management. Will Umm does not want to lose Tan Lee's management skills from the company but also cannot allow this subsidiary to make losses.

Tan Lee defended the track record of his subsidiary and he also stated that he was unwilling to work for Peter Kaye, who Tan Lee considers has mis-managed the Wye motorway project, which has resulted in large losses for Domusco. Tan Lee stated that he considered that Domusco has been stretching its management resources too much and the recent losses of office building sales are merely a temporary setback.

Project planning

A further organisational change that has been raised by Peter Kaye is that the project planning division, headed up by Derek Alder, should oversee all project planning for all of the Domusco group subsidiary companies. At present Derek Alder's team only undertakes project planning and project management for major construction projects. Each of the other two subsidiary companies within the Domusco group is currently responsible for its own project planning and project management work and the professionalism varies between the different Domusco subsidiary companies.

Domusco's share price

With the recent fluctuations in exchange rates, many Zee companies have experienced falls in their share prices. However, since July 2005 Domusco has seen its share price fall from its high of Z$13.82 to just under Z$8.00, due to lack of confidence by the majority of Domusco's institutional investors. They fear that Domusco has taken on too much of the Hadsi project, which to date, has not been successful.

One of Domusco's institutional investors is threatening to sell all of its shares in Domusco, which could lead to a further fall in its share price. This investor is astute enough to realize that Domusco must be starting to suffer an acute shortage of working capital due to the recent low level of sales in Zee. It has asked Tom Micol to take urgent management action to address shareholders' concerns.

By the end of October 2005, Domusco's share price had fallen further to Z$7.50 per share.

Finance Director resigns

The financial press in Zee had been critical of the acquisition of KLT Construction by Domusco. The financial press had stated that Domusco had paid too much for KLT and that the timing of the acquisition was wrong and the media is also concerned about the difficult trading conditions that Domusco is experiencing in Zee. The financial press was also critical of Martyn Lite, as they considered that Domusco did not focus on profitability and was trying to grow too fast.

Following the exchange rate deterioration many of the Zee based construction companies, including Domusco, are experiencing problems due to low demand for housing and office buildings.

The latest forecast profits for the Domusco group (post tax, pre dividend) for the full year 2005 is Z$535 million. This figure takes account of the forecast profits generated by KLT in the second half of 2005 since acquisition, as well as a significant write down of the remaining unsold plot of Hadsi land to Z$30 million. The forecast is based on current contracted sales and forecast sales that are due to be completed by the end of 2005. Therefore much of the forecast for the rest of 2005 is known with a high degree of certainty.

Martyn Lite considered that Domusco should announce a profits warning for 2005. However, he has been over-ruled by other Domusco Board members. Martyn Lite considered that the decision to announce a profits warning is within his functional responsibility. As a result of not being allowed by the Domusco Board to issue a profits warning, he decided to resign. He left Domusco at the end of October 2005.

Domusco cash flow forecast

The latest quarterly rolling cash flow forecast, based on recent sales projections by Tan Lee and Marma Winge, shows negative cash flows for the office building and house building subsidiaries over the next few quarters, based on the assumption of continuing construction work as originally planned, and being able to secure sales later in the construction process.

A summary of the latest quarterly rolling cash flow forecast, which is considered to be a realistic and achievable forecast, for the next four quarters is as follows:

Post tax net cash movements	*Quarter 4*	*Quarter 1*	*Quarter 2*	*Quarter 3*
	2005	*2006*	*2006*	*2006*
Inflow/(outflow)	*(October–December)*	*(January–March)*	*(April–June)*	*(July–September)*
	Z$ million	*Z$ million*	*Z$ million*	*Z$ million*
Major construction projects	+190	+220	+180	+50
Office building	(550)	(240)	+170	+110
House building (including KLT)	(750)	(970)	(50)	+230
Loan interest (post tax)	(40)	(40)	(40)	(40)
Total post tax cash flows	(1,150)	(1,030)	+260	+350

Other information relevant to the above forecast cash flows is:

1. The final payment to the Zee government for the Hadsi land, totaling Z$415 million is due to be paid in December 2005 (Quarter 4) and is NOT included in the above cash flows.
2. The Domusco group had a cash balance of Z$124 million at the end of September 2005.
3. The Domusco Board has not yet decided what level of dividend should be paid for 2005. Dividends are normally paid in the second quarter of each year.

Appointment of a consultant

The Domusco Board held an emergency meeting at the beginning of November 2005, after Martyn Lite had left Domusco. It was agreed that a consultant would be appointed to advise the Board on the many issues currently facing Domusco.

5.4.2 Assessment Matrix for TOPCIMA – Domusco – November 2005 examination (same as September 2005)

Criterion	*Marks*	*Clear Pass*	*Pass*	*Marginal Pass*	*Marginal Fail*	*Fail*	*Clear Fail*
Technical	**5**	Thorough display of relevant technical knowledge. **5**	Good display of relevant knowledge. **4**	Some display of relevant technical knowledge. **3**	Identification of some relevant knowledge, but lacking in depth. **2**	Little knowledge displayed, or some misconceptions. **1**	No evidence of knowledge displayed, or fundamental misconceptions. **0**
Application	**15**	Knowledge clearly applied in an analytical and practical manner. **13–15**	Knowledge applied to the context of the case. **9–12**	Identification of some relevant knowledge, but not well applied. **8**	Knowledge occasionally displayed without clear application. **5–7**	Little attempt to apply knowledge to the context. **1–4**	No application of knowledge displayed. **0**
Diversity	**5**	Most knowledge areas identified, covering a wide range of views. **5**	Some knowledge areas identified, covering a range of views. **4**	A few knowledge areas identified, expressing a fairly limited scope. **3**	Several important knowledge aspects omitted. **2**	Many important knowledge aspects omitted. **1**	Very few knowledge aspects considered. **0**
Focus	**10**	Clearly distinguishes between relevant and irrelevant information. **9–10**	Information used is mostly relevant. **6–8**	Some relevant information ignored, or some less relevant information used. **5**	Information used is sometimes irrelevant. **3–4**	Little ability to distinguish between relevant and irrelevant. **1–2**	No ability to distinguish between relevant and irrelevant information. **0**
Prioriti-sation	**10**	Issues clearly prioritised in a logical order and based on a clear rationale. **9–10**	Issues prioritised with justification. **6–8**	Evidence of issues being listed in order of importance, but rationale unclear. **5**	Issues apparently in priority order, but without a logical justification or rationale. **3–4**	Little attempt at prioritisation or justification or rationale. **1–2**	No attempt at prioritization or justification. **0**
Judgement	**15**	Clearly recognises alternative solutions. Judgement exercised professionally. **13–15**	Alternative solutions or options considered. Some judgement exercised. **9–12**	A slightly limited range of solutions considered. Judgement occasionally weak. **8**	A limited range of solutions considered. Judgement sometimes weak. **5–7**	Few alternative solutions considered. Judgement often weak. **1–4**	No alternative solutions considered. Judgement weak or absent. **0**
Integration	**10**	Diverse areas of knowledge and skills integrated effectively. **9–10**	Diverse areas of knowledge and skills integrated. **6–8**	Knowledge areas and skills occasionally not integrated. **5**	Knowledge areas and skills sometimes not integrated. **3–4**	Knowledge areas and skills often not integrated. **1–2**	Knowledge areas and skills not integrated. **0**
Logic	**20**	Communication effective, recommendations realistic, concise and logical. **16–20**	Communication mainly clear and logical. Recommendations occasionally weak. **11–15**	Communication occasionally unclear, and/or recommendations occasionally illogical. **10**	Communication sometimes weak. Some recommendations slightly unrealistic. **5–9**	Communication weak. Some unclear or illogical recommendations, or few recommendations. **1–4**	very poor communication and/or no recommendations offered. **0**
Ethics	**10**	Excellent evaluation of ethical aspects. Clear and appropriate advice offered. **9–10**	Good evaluation of ethical aspects. Some appropriate advice offered. **6–8**	Some evaluation of ethical aspects. Advice offered. **5**	Weak evaluation of ethical aspects. Little advice offered. **3–4**	Poor evaluation of ethical aspects. No advice offered. **1–2**	No evaluation of ethical aspects. Unethical, or no, advice offered. **0**
TOTAL	**100**						

5.4.3 Domusco – Case writer's answer for November 2005

TOPCIMA – Domusco
Case – November 2005 exam

Report

To: **Domusco Board**
From: **Consultant**

Review of Domusco

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1.0 Introduction

Domusco has been a listed company in the country of Zee for over 30 years. It is involved in construction work in Zee, other areas of Europe and has recently acquired house building operations in the USA. The company's revenue in 2004 was Z$6,216 million. Until recently it would be fairly described as a very successful company, but has experienced severe cash flow problems during 2005.

An ambitious 10-year plan forecast growth to over Z$11,000 million within 5 years, by 2009. This represents a growth rate in revenue of 78% over 5 years. Much of this growth is as a result of taking a 40% share of the major Hadsi development in its home country of Zee, where it planned to build 12,000 housing units over 4 years and 50 office buildings. The Hadsi development has not been very successful so far with a low number of sales of housing and offices.

The Zee dollar has recently experienced some fluctuations, which has resulted in a weakening against the Euro and the US dollar, which has increased Domusco's loan liabilities and interest costs.

The acquisition of KLT was certainly mistimed and market analysts consider that the acquisition was overpriced. Domusco's management and cash resources have been stretched dangerously. This has resulted in Domusco's borrowings getting very close to breaking the loan conditions imposed by two of the lending banks.

Profits for the current year are now forecast at Z$535 million, for the full year. The first half-year had reported profits of Z$318 million, and this has been followed by a weaker second half-year forecast profits of Z$217 million. This includes the significant write down of the remaining plot of Hadsi land by Z$72 million to Z$30 million. Therefore the underlying trading was a little worse in the second half-year than the first, and furthermore, the second half-year also included trading results from the newly acquired KLT.

The full year forecast figure of Z$535 million compares with the Z$686.2 million made in 2004, a reduction of 22%. Furthermore, Domusco's 5 year plan had included profits of Z$783 million, and it was this forecast profit level that the share issue to support the KLT purchase was based. The latest forecast profit of Z$535 million is almost 32% lower.

The market clearly expects figures at least this bad, even though no profits warning has been given, as the share price has fallen from Z$13.82 to Z$7.50 over the last few months. The market may have over-reacted, as financial markets can easily move too far in a situation where only limited information and rumour is available. It may however be aware of potential cash flow difficulties, as empty unsold buildings (particularly the empty unsold office buildings) are highly visible to even the most casual of surveys.

2.0 Terms of reference

I have been appointed as a consultant to prioritise and advise on the main issues facing Domusco, and to make appropriate recommendations on how these issues could be resolved.

Urgent action is needed to agree on the recommendations made in this report and several Board meetings may be required to agree on the implementation of these recommendations before Domusco's final results for 2005 are published.

3.0 Review and prioritisation of the main issues facing Domusco

3.1 Cash shortage – the main priority

There are a number of issues facing Domusco, but the main priority and the most overriding issue is the short-term cash situation. If the company does not address this urgently and take harsh actions, the company could go into liquidation. The company is profitable, albeit at reduced levels, but has cash flow problems.

The banks will wish to discuss with Domusco's management how the company can survive the forecast cash shortfall, and agree what plans are being put in place for the company's recovery. The banks will want to take an active interest in the action plan that needs to be drawn up, as they will not want to see Domusco's share price and investors' confidence fall any further.

3.2 Other priority issues facing Domusco

The second priority is to recruit and appoint a new Finance Director and strengthen the Domusco Board, possibly with more non-executive Directors. This should give market analysts and shareholders more confidence in the company's ability to manage its recovery. The Finance Director selected should have a proven track record of improving companies in difficulties, and should therefore be well respected in the financial community.

The third priority is to prepare a clear achievable plan for the future, which then needs to be communicated to Domusco's shareholders to restore confidence.

The fourth priority is to address the possible breach of the loan covenants and to arrange additional debt financing if this is possible. Domusco must not lose the confidence of the loan finance providers, or breach the covenants without agreement, as Domusco could find that the loans are called in. This would almost definitely lead to bankruptcy and it is in nobody's interest for this to happen, including the loan finance providers. Therefore an amicable arrangement needs to be agreed upon.

Other priorities are:

- To address the issues which have led to the fall in Domusco's share price and improve the financial markets' view of Domusco's management team. This will necessitate some changes and possible resignations
- Improve Domusco's share price and confidence in Domusco's management team, so that Domusco is not the target of a hostile take-over. Its shares are undervalued at present, due to reduced profitability and cash flow problems, but the company still has valuable assets, including a large land bank, which a predator company may wish to acquire.

The Board and management issues have to be tackled urgently as the banks will wish to discuss with Domusco's management how the company can survive the current cash short-fall and also to put plans in place for the future recovery. Domusco's management must be committed to the painful choice of reducing the assets employed by the company.

3.3 SWOT analysis

Appendix 1 shows the strengths, weaknesses, opportunities and threats facing Domusco.

Whilst Domusco is operating in several continents and has a turnover of Z$6,000 million in 2004, and is profitable, the forecast cash shortage is a major threat, which needs to be urgently addressed.

4.0 Discussion on the main issues facing Domusco

4.1 The forecast cash shortage

This is the most important issue to be addressed as the company cannot be allowed to continue to construct houses and offices, as planned, as the forecast cash shortage will peak in the first half of 2006. By the end of the first quarter of 2006 the cash shortage is forecast to be Z$2,471 million (as shown in Appendix 5), and it is possible that during this quarter, or even during the second quarter, that this level of cash shortage could be further exceeded.

Therefore, sometime in January to March 2006, if the company were to continue building as at present and continue to have low sales, the company has a cash shortage of almost Z$2.5 billion. This needs urgent action so that Domusco does not get into this situation. It is impossible for the company to get loan finance to cover this huge cash shortfall, even on a temporary basis. It is also not feasible to have a rights issue. This is for 2 reasons:

- It is unlikely that the rights issue would be taken up by shareholders who have seen their share value fall from Z$13.82 to Z$7.50, a fall of 46% over the last 3 months.
- Secondly, a rights issue would take time. The usual time span for equity is 12 to 18 months minimum. Domusco has an urgent immediate cash flow problem that needs to be addressed now.

It is essential to deal as quickly as possible with the cash situation.

Following the exchange rate fluctuations, loans have been re-valued at the exchange rate at the end of October. This shows loans valued at Z$2,441.6 million, as shown in Appendix 4. There has been an increase of Z$521.6 million since the end of the last financial year, which is made up of Z$300 million for the new loan, used to finance part of the KLT acquisition and Z$221.6 million due to currency fluctuations.

Appendix 4 also shows how the loan covenants are calculated, and this shows that with the proposed dividends (see later in this report), the loan covenant is forecast to be 38.50% at 31 December 2005. This assumes that the latest profit forecast of Z$535 million is correct, and that the profit forecast does not deteriorate any further.

Domusco must approach the ALT and BRG banks that imposed these loan covenants when the loans were agreed. Perhaps they could be renegotiated, or perhaps, part of the loans could be secured against individual named assets, such as parcels of land. Negotiations should be started with the banks immediately, as it must be done before the loan covenant is broken, because afterwards the company is entirely at the mercy of the bankers, who could call in the loans, or could subsequently decide to put the company into administration, and realise their loans by selling various parts of the company.

With the loan covenant at 38.50% there is only $158.0 million of available headroom for possible additional loan finance up to the agreed 40% loan covenant. Clearly this small amount of possible loan finance is nowhere near the forecast cash shortfall of nearly Z$2,500 million. Therefore, raising additional loan finance to cover this forecast shortfall could **only** be possible if Domusco is successful in re-negotiating the loan covenant with its finance providers.

The Board should fully understand that cash forecasting is not an exact science. There is a significant margin of error, and the timing of receipts is never certain. The margin of error here is extremely tight and the banks must be consulted and informed of Domusco's current cash forecast as soon as possible.

Appendix 5 shows a summary of the cash shortfalls in total by quarter over the next year, which shows that the maximum cash shortfall peaks during quarter 1 in 2006, i.e. by March 2006. By this time, assuming the forecast costs and sales are correct, Domusco would have a cash shortfall of Z$2,471 million. Clearly Domusco cannot continue to construct offices and housing to plan when it has such a large cash shortfall.

A cash shortfall of this magnitude, nearly Z$2.5 billion is far too great a shortfall to cover with any type of loan finance, other than very short term finance linked to a clear plan to liquidate some assets to identified customers.

Therefore, if Domusco is unable to raise additional finance, it has a limited choice of options. These are:

1. Divest part of the Domusco group (which could take over 1 year to realise the cash)
2. Sell some of its land bank
3. Severely cut back on construction expenditure immediately
4. Have a sales drive, with attractive promotional prices on houses and offices, to achieve a higher level of sales now, albeit at lower levels of profitability.

It is proposed that Domusco should seek to divest parts of the group. This is discussed later. All of these potential divestments could take some time to actually generate cash.

In the meantime, if the group carries on its planned construction plans it has a significant cash shortfall of nearly Z$2,500 million. It should therefore **immediately halt construction work on all office building and housing units for which it does not have secured buyers**.

It is proposed that the major projects subsidiary, which is working on contracted projects, should continue in accordance with plans.

The proposals to divest parts of Domusco and sell some of its land bank and to have a sales drive to sell some of its housing and offices are dealt with below.

4.2 Management and the financial markets

These issues must be faced before any meaningful discussions can be held with the banks or with major shareholders.

Until a year ago the top management team was highly regarded as running a successful company. Since then, serious errors have undermined their credibility:

- The acquisition of KLT did not convince the markets; it led to a fall in the share price.
- The continued fall in the share price has undermined confidence.
- There has been no statement on expected profits; the Board should have made a statement to explain the situation and prevent a false market in the company shares. Most Stock Exchange regulations expect such statements when there is a material change in conditions and expectations. A statement should have been made alongside the half year results.
- There will be adverse reactions when the necessary profit warning statement is made.
- The finance director has resigned, and no statement has been made concerning a possible successor.

Domusco needs to urgently appoint a new Finance Director with a proven track record of turning companies around, and who has the respect of the financial community. This person will not be cheap to hire, and may need attractive share options to motivate him to achieve positive changes in the company's financial results.

The Domusco Board will also need to be strengthened. Tom Micol, who is planning to retire early, could step down and a new high profile Chairman should be appointed. Furthermore, the Board should appoint more non-executive Directors to ensure that Domusco does not put the company at risk in the future.

A number of other senior management changes are recommended, including the termination of Richard Sears' contract, as he was responsible for the illegal payments which helped to secure the new sports stadium contract. (This is discussed below.)

4.3 Policy changes and future strategy

Domusco appears to have over expanded in relation to its management resources and financial resources, and does not appear to have a clear strategic focus.

To some extent it is desirable to have a spread of activities geographically and by type of construction project, to reduce risks in a cyclical industry that is always affected by changes in the economy at large and in particular by changes in interest rates.

However, it appears to have taken on a series of major projects in the Major Construction Projects division and in the Hadsi development that have significantly increased the risk exposure of the company. Very large projects, even if potentially extremely profitable, are riskier than a series of smaller projects.

4.4 Dividends

Dividends paid in 2004 were Z$275 million, (Z$0.623 per share), which was approximately 40% of the post tax profits for 2004. Clearly with the current cash shortfall, a payment of dividends would cause further cash flow problems. However, in terms of signaling and messages to Domusco's shareholders, it will be necessary to pay some level of dividends. A non-payment of dividends would cause a further fall in Domusco's share price and further loss in confidence in the company.

Furthermore, the banks are likely to have strong views on what dividend will be permissible, if they are making increased loans. Domusco should argue the case with the banks to be permitted to continue to make a dividend payment to retain investor confidence.

It is recommended that a reduced dividend of Z$0.485 per share is paid. This represents a total payment of Z$214 million, to be paid in the second quarter of 2006. This represents a payout ratio of 40% of post tax profits, as previously, albeit on the lower forecast profits of Z$535 million. This represents a fall of around 22% since 2004, but shareholders would prefer to have a reduced dividend rather than no dividend payment at all. However, it still remains to be identified how this dividend payment is to be funded. The recommended dividend payment is included in the cash flow forecast shown in Appendix 5.

4.5 Exchange rate changes and loans

The recent changes in the exchange rates between the Zee dollar and the Euro and US dollar, by around 22%, has made its loans with the ALT and BRG banks more expensive and this has increased the loan liability in Domusco's balance sheet when the loans are re-valued at today's exchange rates. This is shown in Appendix 4.

However, it should be considered that Domusco has many operations in Europe as well as the house building subsidiary in the USA, so that its overall exposure to the exchange rate changes may be positive. Therefore, while its European costs have increased by 22% as a result of the recent exchange rate changes, all of the sales revenue that customers pay in Euros will also generate a higher level of Zee dollars when remitted back to Domusco head office. The case material does not give an analysis of Domusco's net cash flows by currency in which it is generated, but it is likely that the Euro and USA net cash flows would be lower than the value of the non-Zee dollar loans.

With the change in exchange rates the US dollar loan of US$200 million is now re-valued at Z$794 million, an increase of Z$158 million. The euro loan of €105 million, is also now re-valued at Z$327.6 million, an increase of Z$63.6 million. These non Zee dollar loans now total the equivalent of Z$1,122 million, an increase in Domusco's loans of Z$221.6, due entirely to changes in the exchange rates.

The loan covenant imposed by the ALT and BRG banks was to restrict Domusco's total loans to 40% of shareholders' equity plus total loans. Shareholders' equity is defined as share capital, share premium and the profit and loss reserve. The loans at the end of 2004 were Z$1,920 million and the ratio to shareholders equity plus loans was 35.9%.

However, with the additional loan of Z$300 million (to finance part of the KLT acquisition) and the Z$221.6 million increase due to the exchange rate changes the ratio is now forecast at the end of December 2005 to be 39.43% based on the latest profit forecast.

With the loans so close to breaching the loan covenant of 40%, Domusco needs to approach its bankers, ALT and BRG, and renegotiate this covenant or give the banks some security, perhaps named land plots from its land bank as security against the loans. Domusco should not ignore the situation and breach the covenant, which could lead to the loans being called in. This delicate situation needs to be managed and lines of communication with the banks opened.

4.6 Domusco profitability

The value of the unsold amount of land in Hadsi is currently reported as inventory in Domusco's balance sheet at Z$102 million. The auditors state that this is considerably over stated and needs to be written down to Z$30 million. The latest profit forecast for 2005 of Z$535 million incorporates this land write down. However, following the economic downturn in Zee there may also be other plots of land held in Domusco's land banks which are over valued. This should be assessed.

The profit for 2004 was Z$686 million and the plan for 2005 was an increase of Z$97 million to Z$783 million. The forecast 2005 profits are only Z$535 million, and Domusco's shareholders are unaware of this fall, as no profits warning has been given to date. This will adversely affect shareholders confidence and will lower the EPS to around Z$1.21 per share a fall of 22% from the 2004 EPS of Z$1.55.

However, even at this reduced level of profitability, Domusco's share price is probably undervalued at Z$7.50 assuming that its P/E ratio is around 8 to 9 (P/E ratio for 2004 cannot be calculated as the share price at December 2004 is not given). Assuming a P/E ratio of 8, then Domusco's share price should be around Z$9.68 per share, but the share price reduction reflects many other facets of the company and not just its actual level of profits. Therefore, until Domusco can demonstrate to its shareholders, and to the market, that it has taken steps to improve its cash flows and its sales level, which in turn will generate profits in the future, then its share price will remain low.

The cash shortage is a major problem and will not go away and could lead to Domusco going into liquidation if this urgent problem is not addressed. Additionally the actions that Domusco takes to stem the outflow of cash should also demonstrate to its investors that it is taking strategic positive action to improve cash flows and profitability. After all, constructing offices and houses that cannot be sold will not generate profit.

4.7 The European sports stadium contract

It was reported to the June Board meeting that the contract had been awarded to Domusco. Subsequent discussions between Peter Kaye and Richard Sears, the Head of Construction for Sports Facilities, indicated that payments had been made to government representatives.

Martyn Lite investigated these payments and established that 2 payments had been made to individuals who probably influenced the decision to award the contract to Domusco. Quite apart from the main issue of the nature of the payment, action is needed on tightening internal control procedures.

Martyn Lite had agreed to discuss this matter with the Chairman and the Chief Executive, but it is not clear whether he had done so before he left, and the matter appears unresolved. Contract signing has been deferred, but must be resolved by the end of December.

Bribery is clearly unethical. Receiving bribes is illegal in most countries. Giving bribes is often illegal, but many countries have until recently distinguished between giving bribes at home and abroad. Giving bribes abroad has been legal until recently in many countries. The legal situation in Zee, and in the country where the construction is to take place, requires clarification. However, bribery exists. International pressure groups publish indices ranking countries by the level of corruption prevalent. Certain industries, including defence and construction are frequently regarded as more prone to bribery than other industries. Some countries, notably the USA, are more active in legal action against bribery than others. This may well condition Peter Kaye's views on the issues involved.

Domusco has to take some decisions in principle, given that the legal position, and country-by-country custom and practice can be difficult to clarify. It would be difficult for a Chief Executive, a Chairman, or a Board to take a formal decision supporting the giving of bribes. The formal decision required is that bribes will not be given, even if contracts are thereby lost.

Difficult discussions will be needed with the government of the country requiring the sports stadium. These will have to be conducted at the highest level by the Domusco's Chairman. At risk are:

- the sports centre contract
- future contracts for Domusco in that country
- potential bad publicity for Domusco internationally, which could affect its ability to win other contracts in the future in other countries, as well as contract currently being negotiated.

It is recommended that the Chairman should arrange to see the government minister responsible for the stadium, and make full disclosure. Whether the contract will still be awarded is most uncertain, but this approach is most likely to minimise the reputational risk to Domusco. Given all the recent bad publicity, this is probably essential.

It is recommended that Domusco declines to sign contracts and announces alternative reasons for not undertaking this major construction project.

4.8 Divest part of the Domusco group

This is much more complicated than the sale of a tangible asset such as a parcel of land. It is even more complicated selling a part, even a largely autonomous part, of an existing business. The Office Building subsidiary is a potential candidate for sale. It appears to have limited short-term prospects and difficult trading conditions. It is possible that a buyer may take a more optimistic view of prospects, or that a management buy out might be mooted as an alternative to the business being closed or merged with the Major Construction Projects subsidiary. A management buy out appears the most feasible solution, but is most unlikely to produce significant funds, or any funds within the next six months. However, it would reduce closure and redundancy costs.

The Major Construction Projects subsidiary is probably too complex to be saleable. There are too many problems to be resolved with the Wye motorway project and the European sports centre contract.

Some of the house building subsidiaries in other countries, particularly those acquired as part of KLT, could possibly be sold together with the local land banks. It is not clear that this would produce much more than the sale of the land banks, and it would certainly take more time.

4.9 Sale of some of Domusco's land bank

The most likely key to substantial funds in the short term is the land bank owned by Domusco, including that bought with KLT, but excluding the Hadsi land.

This land bank is the key to the future profitability of the housing construction activities, but some sacrifices may have to be made to ensure the availability of funds.

A review of all the land holdings is required with up to date valuations, as there may be a need for further write-downs, in addition to the Domusco Hadsi land, for which provision has already been made.

There may be land bought some considerable time ago that could be re-valued upwards, or that could provide a windfall profit on sale. This would affect the loan covenant restriction in two ways, increasing the equity as well as reducing the loans.

There may be a number of relatively small parcels of land that would only permit relatively small developments that Domusco would not now wish to undertake.

Potential development land is normally easily saleable, because the prospective purchaser can see exactly what he is obtaining. It is also clear and acceptable security for bank loans. However, conditions in Zee appear to be depressed, and sales could take some time, even if heavily discounted.

4.10 Severely cut back on construction expenditure

In respect of buildings (houses and offices) that are under construction, these will need to be reviewed site by site. The general aim will be to get these to a secure and weather proof state, but without expensive interior fittings, at minimum cost, without any expenditure on overtime working, and the minimum use of sub-contractors.

A real life example of this is that Berkley Homes had a similar cash shortage during 2004, and "downed tools" on a flagship development of 3,000 housing units in London, until the economic situation picked up. This allowed it extra time to secure sales before construction work was re-commenced.

No new construction work at all should be commenced **at any** site (in Hadsi, elsewhere in Zee or any other country) unless sale prospects are imminent. Only houses that have been sold off plan should be commenced in the Hadsi development.

All recruitment should be frozen and require re-justification. Therefore there should be no recruitment of permanent workers to replace subcontractors. It is possible that redundancies will be required, especially for employees currently working on the Hadsi development, although it may be possible to move some staff to other developments.

4.11 Domusco sales promotion to sell unsold houses and offices

Major efforts should be made to sell completed unsold houses and office buildings. These should be sold by offering incentive packages for early completion, such as free fittings, free carpets, payment of first year's mortgage interest, cash-back schemes etc. as well as price reductions to attract customers. It would be better for Domusco in the short term to compromise on profitability and to generate cash, than to retain a high stock of unsold houses and offices.

Due to poor economic conditions prevailing in Zee, it may be necessary for Domusco to heavily discount sales prices to win sales, both for houses and offices.

5.0 Ethical issues to be addressed by the Domusco Board

5.1 Ethical guidelines for contract negotiations

Domusco must formulate a clear ethical code for all employees, and particularly for all negotiators, and ensure that all are fully aware of the code and penalties for any breach of the agreed code. This code should also cover all sales agents and associated companies that may act on behalf of Domusco, even if not directly employed by Domusco.

Richard Sears clearly felt that he was acting in Domusco's interests when he authorised the two payments to assist in winning the European sports stadium contract. However, payments of this kind should not be made. It is recommended that Richard Sears' contract is terminated and that Domusco sets a clear moral stance with the way in which it conducts its business.

5.2 Employees

With the recommended cut back on construction work in the short term, it is likely that there could be some redundancies. These should be handled fairly and employees treated with respect and assisted as much as possible.

Some expenditure may be cut back as a result of the cash shortage, and this may affect training and other HR issues. Domusco should ensure that employees' safety is not put at risk.

5.3 Sub contractors

In the short term, it is recommended that a number of sub-contractors contracts are terminated as construction work on unsold houses and offices in Zee, and in other countries, are cut back. This may result in some of Domusco's long-term sub-contractors making their employees redundant.

It is unlikely that new sub-contractors will be appointed until Domusco has overcome the short term cash flow problems, and experienced labour may be lost and relationships with Domusco could be severely damaged. Domusco must treat its regular sub-contractors fairly and give as much notice of the termination of their work as possible.

5.4 Domusco reorganisation

It is recommended that the Project planning re-organisation should proceed, so that "best practice" on project planning extends across all of Domusco's subsidiary companies.

However, the proposed re-organisation of the Office Building subsidiary should wait, until the other more urgent issues have been addressed. At this crucial time, Domusco should not lose a key member of the management team, Tan Lee, who has openly stated that he would not work for Peter Kaye. This sensitive situation must be addressed and if necessary Tan Lee should leave the company, if it is considered that this reorganisation is in the company's long-term interest, but it should wait while more urgent problems are addressed.

5.5 Board decisions

It was not good business practice for Domusco to have not given a profits warning to market analysts and shareholders. This has now led to Martyn Lite's resignation. The Board needs to maintain good business practice and show a good moral stance on all issues. It is recommended that the Domusco Board is strengthened, a new Chairman appointed and a greater number of non-executive directors are appointed.

6.0 Recommendations

6.1 Discuss Domusco's forecast cash situation with its bankers

The banks should be approached before the loan covenant of 40% is breached. This ratio should be renegotiated if possible, or assets used to secure loans on for the short term. It should also be made clear that in the very short term, say the next 6 to 12 months, the ratio could be higher, even if asset sales are agreed and unsold construction stopped, pending completion and payment for sales.

Domusco's bankers will have to be given information on the current forecast of profit for 2005 together with the likely cash shortfalls over the next year, which is shown in Appendix 5. The banks will then need to see the same forecasts, revised for the actions that are entirely controllable by Domusco. This could be a reduction in costs for items such as the effects of stopping recruitment, discretionary expenditure, and any construction that is not linked to a signed contract. A summary of the alternative ways in which Domusco could overcome the cash shortfall is shown in Appendix 6. Borrowing limits over the next six months probably need to cover the sums indicated by this forecast.

The banks will then need to see a further forecast revision, including:

- forecast future sales in Hadsi, including the effects of any incentive programmes
- forecast sales of unsold office buildings
- possible sale of land from the Domusco land bank, including that acquired with the purchase of KLT
- any feasible sales of sections of the business.

This set of forecasts must show a "respectable" loan ratio being achieved, and will have to be continually revised by increasing the asset sales until the ratio can be brought down to a ratio acceptable to Domusco's bankers.

The banks may well be sympathetic to this approach, provided that they can see that the land bank assets retained by Domusco provide adequate security for their loans. They may well be prepared to lend up to 60–70% of the current value of land (subject to valuations of land being independently confirmed). However, it is unlikely that the banks will be comfortable lending against contract work in progress.

Monthly rolling forecasts of the next 6 to 12 months are probably a minimum requirement – but these will be required in any case by the restructured Domusco Board. The banks will probably impose different conditions:

- They will require an increased rate of interest reflecting the change in the Zee government rate, and their perception of the increased risk.
- They will require close continued contact and disclosure of frequent revised forecasts of economies and asset sales. Loans will almost certainly be tied to specific land assets, so that specific loans will need to be repaid when the assets to which they are linked are sold.
- They will have firm views on how much dividend, if any, Domusco can pay. It is worth arguing strongly that Domusco should be allowed to pay the recommended dividend of Z$214 million to maintain some shareholder confidence.
- They will have firm views about the acceptability of the new Finance Director and the restructuring of the Board.

6.2 Recommendations on how to overcome the forecast cash flow shortage

The possible actions are best considered using the planning framework of feasibility, suitability and acceptability:

- Feasibility: can it actually be carried out, and will it achieve the desired results in the available timescale. There is a need to produce quick results, and many of the possible actions are likely to take far too long to be relevant.

- Suitability: does the proposed action fit broadly with the organisation's strategic plan and with organisational values?
- Acceptability: This is more subjective, and relates to organisational values. The key is whether the policy will cause any major crises with any stakeholders.

In general terms the issue to resolve, action by action, is that the most feasible actions to reduce borrowing requirements, such as selling land from the land bank, are likely to have the most adverse effect on medium term profitability. Actions such as cutting discretionary expenditure will be feasible and acceptable but of little benefit as they will have too little impact to be suitable on their own. Certain very short-term actions must be considered and mainly implemented by management, although they are unlikely to produce major amounts of cash. Staff will be aware of slow sales of properties, and expect to see action being taken by management.

The interim Finance Director must introduce a freeze on discretionary expenditures, in particular identifying expenditures that can be postponed for say 6 months and then reviewed. Items to be reviewed include:

- updating computer equipment
- replacement of company cars
- corporate advertising, not product related
- training expenditures except any that is safety related.

Companies in financial difficulties frequently attempt to delay payments to suppliers and sub-contractors. "Window dressing," such as delaying payments at year-end to change the appearance of the balance sheet is far from rare, but should be avoided. Any such actions should be very limited, and with the prior agreement of creditors, as imposed changes could lead to views being taken that the problems are far worse than they really are. There is a danger of setting off rumours of financial difficulty, which could lead to suppliers being afraid to allow normal trade credit.

It is recommended that all recruitment should be frozen and also that staffing levels should require re-justification. Additionally there should be no recruitment of permanent workers to replace subcontractors.

It is recommended that Domusco should make major efforts to sell completed unsold houses and office buildings. These should be sold by offering a wide range of attractive incentive packages for early completion.

It is recommended that work on all houses and offices that are under construction should be reviewed, on a site-by-site basis, with the stated aim to get the buildings to a secure and weatherproof state, and then all further construction work should stop until sales are secured.

It is recommended that **no** new construction work at all should be commenced **at any** site unless sale prospects are imminent. Only houses and offices already sold should be completed together with housing units sold off plan, where this is possible.

Appendix 6 to this report shows alternative ways to overcome the forecast cash shortfall with a proposed reduction in construction expenditure over the next few months totalling Z$1,000 million. Together with a sales drive to improve sales, which is forecast to achieve sales of Z$500 million, and sales of some parts of Domusco's land bank of a further Z$500 million, the cash shortfall could be reduced down to Z$500 million. If Domusco's bankers were to agree to a change in the banking covenants, or a short term loan secured on a named piece of land, then borrowing of Z$500 million could cover the forecast cash shortfall in quarter 2 2006 of Z$2,500 million.

6.3 Major Construction Projects

Projects currently under construction must be completed as a matter of priority, as the costs of attempting to terminate contracts would be prohibitive.

Contracts bid for, which have not yet been awarded should be reviewed, following the review of the European sports stadium contract which it is recommended that Domusco pull out of, as discreetly as possible.

A critical assessment should be made of contracts that appear to involve high levels of risk, if in countries where Domusco has not previously undertaken major projects, or involving different construction skills.

6.4 Sale of some of Domusco's land bank

It is recommended that a review of all the land holdings is required with up to date valuations, as there may be a need for further write-downs, in addition to the Domusco Hadsi land, for which provision has already been made.

It is also recommended that Domusco try to sell any small parcels of land that would only permit relatively small developments that it would not now wish to undertake.

6.5 Potential sale of some areas of the Domusco group

It is recommended that the Office Building subsidiary is a potential candidate for sale. A management buy out appears the most feasible solution, but is most unlikely to produce significant funds, or any funds within the next six months. However, it would reduce closure and redundancy costs.

Additionally, it is recommended that some of the house building subsidiaries in other countries, particularly those acquired as part of KLT, could possibly be sold, together with the local land banks.

6.6 Recommendations on how Domusco's shareholders' confidence can be improved

Considerable realism is required regarding the extent to which shareholder confidence can be improved until new management is in place, the loans situation resolved, with some asset sales in prospect, and credible statements made on future policy.

Steps that need to be taken to improve shareholders' confidence:

- A new 2005 profits forecast should be prepared and communicated urgently to shareholders together with a warning of the lower profits level for 2005. The year-end is only a month away. This warning should have been issued some months ago.
- Shareholders should be informed of the large land bank that Domusco owns and the potential profits that this may generate if retained, and the extent to which sales of land may reduce borrowings.
- Plans to divest some of the Domusco group activities or part of the land bank.
- Short term plans to cope with the difficult trading conditions in Zee, which could include incentives and discounts for house buyers.
- A new marketing campaign should be drawn up to promote Domusco and particularly the Hadsi development.
- Pressure should be put on the Zee government to promote the Hadsi area as agreed.
- Dividends for 2005 should be agreed and communicated to the market – they will be lower than last year at the recommended level of Z$214 million (Z$0.485 per share).

Statements will have to be made on future trading. It would be very difficult to prepare a formal profit forecast for 2006, but internal forecasts for 2006 must be prepared and communicated to Domusco's investors.

These will have to be used as the basis for a statement that will be required of whether profits for 2006 will be higher or lower than those for 2005. This is the absolute minimum that shareholders will expect.

6.7 The final payment for the Hadsi land

Domusco is due to pay Z$415 million to the Zee government in December 2005. With the forecast cash shortage, it is worth trying to negotiate whether part or all of this payment could be delayed. However, it will be difficult to negotiate with the government, which may well be under financial pressure after the exchange rate changes, but an approach ought to be made, using Domusco's contacts. Zee politicians may well be sympathetic as Domusco is a major employer, and provides work for many local sub-contractors. It is important to have strong local construction companies to enable the government to implement development plans.

Domusco should request that part, or all, of the payment should be deferred. The company should try to establish a link between the final payment and government activity and expenditure in promoting the Hadsi development, little of which has been done to date.

6.8 Recommendations on Domusco Board changes

The minimum change that would be expected at the top would be:

- the appointment of a new Finance Director with previous experience of dealing with institutional investors and banks as the FD of a similar sized company.
- It will not be possible to start any bank discussions until someone is in place on either a permanent or temporary basis.
- The appointment of strong new non-executive directors to ensure a majority on the Board of non-executives.

This may well not be enough to satisfy the institutional investors. Institutional investors may also insist on more radical changes, including a new Chairman, as Tom Micol is nearing retirement and only works part time due to recent ill health. They may also insist on a clear statement that the present Chief Executive will not become Chairman in the future. This is in line with current guidelines for good practice in corporate governance, though many Chief Executives have regarded this progression as normal in the past and highly desirable.

6.9 Recommendations on Domusco's future strategy

Domusco should concentrate on housing development and construction, its original core business, with a deliberate policy of not taking on any future projects beyond a certain size, which needs to be determined. Clearly the Hadsi project was too large for a company the size of Domusco.

The Major Construction Projects Division should be required to formulate a clear policy restricting the type of projects that it wishes to compete for. This should specify

- which countries it wishes to compete in, having regard to the extent of government contact in that country, any potential exchange rate problems or profits remittance problems, and the ability to obtain contracts without bribery.
- Which type of major construction it wishes to undertake. Domusco cannot afford to have specialists in all of sports arenas, motorways and marinas.

The Office Building subsidiary should be run down and eventually closed if it cannot be sold. A management buy out may be the most feasible solution, but this would take time.

The Board needs to review possible alternative competitive strategies and agree to consistently follow one strategy. It is proposed that Domusco should differentiate itself from its competitors by focussing on innovative technologies, especially in domestic construction, rather than attempting to compete on price alone, which is unlikely to be successful.

This strategy needs further development, but provides initial guidance for selecting between short-term alternatives for improving the cash flow.

Appendix 1

SWOT analysis for Domusco

Strengths	Weaknesses
• Established large international construction company with profitable businesses in all construction segments	• Over extended company which has major cash flow problems
• Major company in its own country of Zee	• Stock of unsold houses and offices, some finished and some only part complete
• Experienced and stable Board of Directors	• Profit margins in office building segment are decreasing despite a planned increase in turnover
• Good reputation for quality work	• Poor cash forecasting, which has resulted in current situation
• Profitable construction businesses in many countries	• Badly over extended financially following the acquisition of KLT which involved a high level of loans, and which should have been made with a greater proportion of equity • Vacancy for a Finance Director following Martyn Lite's resignation • Domusco's management are used to success; there is little evidence that they can cope easily with the inevitable more difficult circumstances • An increased risk profile from larger scale developments, such as Hadsi, and very large foreign major construction projects. • Some projects and developments inevitably go wrong; Domusco has undertaken some which are very large in relation to the size of the company

Opportunities	Threats
• Improvement in Domusco's share price from its current low level of Z$7.50	• Acute cash shortage; the company will be very near to breaking loan covenants, and will have to sell assets
• Domusco is already diversified geographically, and there is scope to undertake housing developments in a number of countries where economic conditions are not as problematical as in Zee	• Banks could dictate changes in the Board, and dictate which assets have to be sold
• Scope to compete internationally for Major Construction Projects, subject to availability of working capital, and management resources	• European sports stadium contract appears to have been gained by bribery. The required negotiations to resolve this situation could have unpredictable consequences
• Strengthen and improve Domusco Board and management team	• Greater exchange rate risks as more of Domusco's work is undertaken outside of Zee
• Improved project planning following proposed reorganisation	• Continued shortage of skilled experienced manpower to work on and manage contracts for construction
• Improved profitability and control in the office buildings subsidiary if it is reorganised	• Loss of management skills in Domusco's office building subsidiary if Tan Lee left the company, following the proposed reorganisation

Appendix 2

Porter's generic strategies

Porter's analysis suggests that there are 3 generic strategies

- cost leadership
- differentiation
- niche markets.

The niche market strategy is not feasible for Domusco in Zee. It already has a significant, though not dominant, market share and has already developed markets in other countries.

Cost leadership is difficult to achieve in an industry that is increasingly fragmented and dependent on sub-contractors for all sorts of specialist skills. Direct costs are likely to be broadly similar for most competitors, subject to greater buying power enabling more economical acquisition of materials.

It is desirable to differentiate Domusco's offering from its competitors, and not compete purely on price and cost.

The problem is in being able to deliver identifiable additional benefits, given that all the competitors will use the same sort of sub-contractors.

Possible approaches include:

- an emphasis on corporate social responsibility and in particular on health and safety, as reflected in the previous corporate responsibility report. This would be in line with group values, but action to improve performance is limited by the current shortage of work. It is clear that there is no question of recruiting additional staff to replace sub-contractors in the present climate; there may be great difficulty in retaining present staff, even if they are prepared to move to different construction sites.
- an emphasis on reliable delivery, using the group's projects planning skills and staff. However, it should be questioned whether Domusco's project planning skills are good enough due to problems with the Wye motorway contract and recent office building, which indicates there are still problems.

The most likely may be the emphasis on innovative building techniques gained from transferring American experience to Europe. This has been successful – but needs to be developed from a "one off" improvement to a continuous programme, where new techniques are sought and developed to practical application.

Further review is needed of the best ways to differentiate Domusco's offering in ways that are likely to appeal to potential customers. It is more probable that appropriate ways can be found to develop such a strategy for house building than for other Domusco operations, where competition may well be mainly on price.

Appendix 3

PEST analysis

Political

- good government connections in Zee, but Zee government not currently commissioning much construction.
- limited government connections in other countries in which Domusco trades. Poor political connections with the Wye Government, which did not give any compensation for massive cost over-runs following poor weather.
- Domusco will need a political ally to assist it, following the European sports stadium bribery issue, which could damage Domusco's ability to win other contracts in the future.

Economic

- following the exchange rate realignment and increase in interest rates in Zee, construction will be depressed for some time; there will be limited demand for houses and office blocks in Zee.
- Land banks will be difficult to sell, even to other developers and competitors in Zee due to current economic downturn in Zee.
- Land banks may need to be re-valued downwards, which would have a negative effect on Domusco's profits.
- in current conditions other developers in Zee will face similar problems, even if not as stretched financially, and may not wish to acquire more land for their land banks.

Social

- good record on health and safety and corporate social responsibility.
- high risk of extremely bad publicity if bribery issue with European sports stadium cannot be defused quietly, and becomes public knowledge.
- plans to expand the number of direct employees to replace sub-contractors will have to be on hold in view of limited home demand and financial difficulties.
- risk of need to make some of Domusco's employees redundant.

Technological

- cost of state of the art construction machinery has depressed ROCE and increased fixed costs when volumes are low.
- office buildings are innovative, but demand appears to be low.
- with the cash flow problems and low profitability forecast, Domusco will be unable to invest in new technologies and its R & D expenditure is likely to be severely restricted.

Appendix 4

Revaluation of loans and loan covenant restrictions

Summary of loans:	Interest rate	Loans Z\$ million	US\$ million	€ million	Exch. rate	Total current value of loans at 31 October 2005 Z\$ million	Original value of loans at 31 December 2004 Z\$ million	Change in value of loans Z\$ million
Redeemable in 2007	9%	324.0			1.00	324.0	324.0	–
Redeemable in 2008	10%	696.0			1.00	696.0	696.0	–
Redeemable	9%		200.0		3.97	794.0	636.0	+158.0
in 2009				105.0				
Redeemable in 2009	9%				3.12	327.6	264.0	+63.6
New loan:								
Redeemable in 2010	9%	300.0			1.00	300.0	0	+300.0
Total loans						2,441.6	1,920.0	+521.6

Calculations for loan covenant:	**Z\$ million**
Loans at 31 December 2004	1,920.0
Shareholders' equity	3,429.2
Shareholders' equity + loans	5,349.2
Loan covenant at 31 December 2004	**35.89%**
Forecast position at 31 December 2005 (with revalued loans)	
Shareholders' equity at 31 December 2004	3,429.2
New shares issues to part finance KLT acquisition	150.0
Forecast full year results (including KLT and including Hadsi land write down, but before proposed dividend)	535.0
Sub total: Shareholders equity before dividends	4,114.2
Proposed dividend	−214.0
Forecast shareholders' equity at 31 December 2005	**3,900.2**
Loans (revalued at end October 2005)	**2,441.6**
Shareholders' equity + loans	**6,341.8**
Forecast of loan covenant at 31 December 2005	**38.50%**
Headroom available for additional loans	**158.0**

Appendix 5

Summary of forecast cash flows by quarter

Summary of post tax net cash movements	Quarter 4 2005 Z$ million	Quarter 1 2006 Z$ million	Quarter 2 2006 Z$ million	Quarter 3 2006 Z$ million
Major projects	+190	+220	+180	+50
Office building	(550)	(240)	+170	+110
House building	(750)	(970)	(50)	+230
Loan interest	(40)	(40)	(40)	(40)
Total cash movements (from unseen material)	(1,150)	(1,030)	+260	+350
Hadsi land payment due	(415)			
Proposed dividends			(214)	
Cash balance at end September 2005	+124			
Forecast net cash movements	(1,441)	(1,030)	+46	+350
Forecast cash balance at each quarter end	**(1,441)**	**(2,471)**	**(2,425)**	**(2,074)**

Appendix 6

Summary of the alternative ways to overcome the forecast cash shortfall

	Z$ million
Forecast cash flow shortage: peak during quarter 2 in 2006	**−2,471**
A proposed way to overcome the forecast cash shortfall shown below:	
Reduction in construction expenditure and other expenditure cuts	+1,000
Sales drive to improve sales in the short term	+500
Sale of parts of Domusco's land bank	+500
Increased short-term loan facility (depending on Domusco's bankers agreement concerning the loan covenant restriction)	+500
Total effect on short term cash situation	**+2,500**

Note: It is possible for candidates to come up with a different range of alternative figures or suggested ways in which the cash shortage could be addressed.

6 How to Analyse the Pre-seen Material and Research the Industry Setting

6.1 Introduction

In this chapter we will show you how to analyse the pre-seen material using 2 past cases. The two cases are Homejay, a diversified multinational company, that was examined in November 2003 and Sparkle, set in the competitive health clubs marketplace, which was examined in May 2003.

Whilst neither of these cases are TOPCIMA cases the research needed and the way to analyse the pre-seen material is the same.

CIMA recommend that you prepare for your TOPCIMA exam by working your way through 2 or 3 past cases. You may wish to work through the pre-seen for one, or both, of these cases, which demonstrate the skills needed to analyse the pre-seen material.

You would not have gone into the CIMA exam hall without working through some past papers for the CIMA Strategic level papers, even though you knew that the same questions would not appear. You worked through past papers to prepare yourself for these exams, and working through past cases is no different – except that there is more to read and to assimilate!

The solutions to the TOPCIMA cases in Chapter 5 demonstrate that an understanding of the real-world context of the industry will gain you marks in TOPCIMA (Figure 6.1) by:

- providing examples of actions and strategies that companies operating in the real world would follow which could be used by the company in the case study material;
- demonstrating to the reader of your TOPCIMA report (the CIMA examiner), that you understand the industry and its opportunities and challenges, and therefore your advice is reliable and realistic;
- helping your report to look professional by avoiding suggestions of unrealistic ideas that could make your report look ridiculous and cast doubt on your competence as a management accountant.

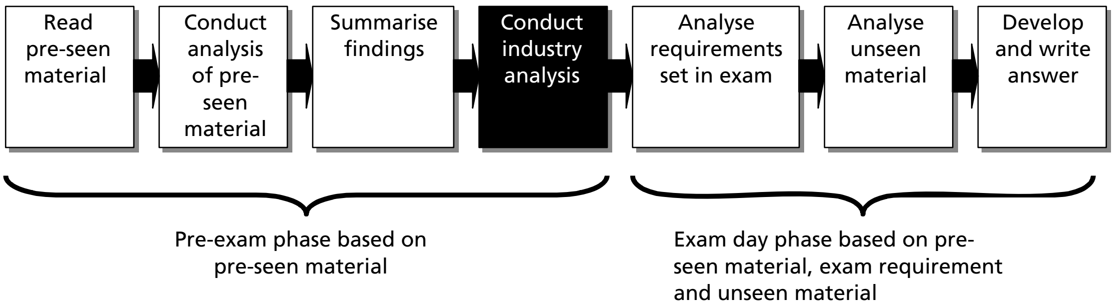


Figure 1.1 Diagram of TOPCIMA process

Before we take you through 2 past cases, Homejay and Sparkle, and show you how to analyse the pre-seen material, below are some ideas on how to research the industry setting.

6.2 What to look for in conducting industry research

The pre-seen material usually contains a good summary of relevant information about the industry. This can be relied on as accurate at the time it is published.

You are unlikely to gain many marks from being able to demonstrate a grasp of the minutiae of the industry. It is likely that the recipient of your report will know this anyway and will not thank you for being told again.

Instead you must put the information into an analytical framework and use it to forecast the issues facing the organisation and, from that, justify your recommendations.

Therefore many of the factors you should look for can be summarised using the Industry Analysis section of the Technical Toolkit in Chapter 4:

1. identify industry life-cycle stage and the factors driving it;
2. identify whether any of the five forces are strong or strengthening and the forces causing this;
3. consider the competitive strategies being followed by companies operating in the real world and how they are achieved (e.g. special technologies, use of brands) and whether they could be adopted by the company in the pre-seen;
4. identify real-world issues against the PEST framework (This may involve some basic research into the laws and technologies of the industry.);
5. consider the impact of globalisation on the future of the industry and on the firm in the pre-seen.
6. consider the problems and challenges facing companies in the real world and to be aware of topical news stories on the issues facing them and how they deal with them.

An additional factor to consider is the state of the investment markets, which will affect costs of capital and share prices.

6.3 Sources of industry information

The four sources of industry information are:

- personal networks,
- visits to similar real-world companies,
- trade media and news media,
- Internet searching.

6.3.1 Personal networks

Some candidates have been lucky enough to find themselves facing a set of pre-seen material describing the industry they work in. In this situation, they have plenty of colleagues they can talk to about.

Alternatively, and depending on the industry in the *Case Study*, it is possible that you know someone in the business from whom you can get information.

Likely contacts include:

- other people in your college class who work in the industry or who have worked in it;
- family members or their friends;
- contacts at work who have dealings with the industry in the case.

Discussing the case and your analysis of the situation of the business with an expert will help you to test out your understanding of what is important.

6.3.2 Visiting similar firms

Again, this depends on the accessibility of the industry. For example, the case studies on Global and Sparkle reviewed in Chapter 5 gave ample opportunity for candidates, at least in the UK, to visit various supermarkets and leisure clubs to see first-hand the product ranges and methods of competing they used.

However, in observing competitive strategy and product range, or in talking to managers (if they will spare you the time) about the industry you should always remember that you are trying to draw conclusions about the future for the industry.

6.3.3 Trade media and news media

A journalist is a paid professional who searches out and presents information about an industry. If you can find a trade journal for the industry in the case it will save you a lot of searching for yourself. It is also easier than a Web page or conversation to cite as a source in your final report.

Trade journals can be located in four ways:

- *Visit a good newsagent*. The difficulty here is that only very large industries such as accounting, financial advising, computing, music and building provide enough customers for a newsagent to consider stocking the magazine.
- *Visit a business library*. Most universities and better colleges will permit you a reader's ticket to consult their journals on a read-only basis. It is a good idea to take along your CIMA membership details to demonstrate that you're a serious student. However, such libraries

will not let you borrow journals and may place restrictions on photocopying them. Good librarians will be able to locate relevant journals for you too.

- Ask someone who works in the industry for the name of the journals for the industry.
- *Use the Internet.* Many trade journals now have websites and, in many cases, can be downloaded as PDFs. Naturally there will be restrictions on logging in if you have not paid but there is a surprising amount of free media available. The best approach is to go to a search engine (see below) and type in a search inquiry such as: "trade magazine for <name of industry> industry" or "articles on, <name of industry or real world firm>" .

News media is more general although some quality business newspapers may carry special supplements on particular industries from time to time.

It is also very important to spend time reading the financial pages of any good newspaper, not necessarily the *Financial Times*. It is relevant to understand what is happening in the real world with acquisitions, mergers, down sizing, boardroom conflicts etc. The more widely that you read the financial press, the more it will help you to understand and fully appreciate all of the many complex factors that affect companies and the selection and implementation of their strategies.

Obviously news media is available in hard copy from shops but also most good newspapers have websites that give you the day's stories and also have searchable archives on past stories about the industry or specific firms within it.

www.ft.com	Website of UK Financial *Times* with searchable articles archive	Useful for • articles on particular firms • articles and surveys on industries • surveys on countries • articles on technologies and management techniques
www.nytimes.com	Website of US *New York Times* with searchable articles archive	As FT above but with greater emphasis on US firms
www.theeconomist.com	Website of Economist magazine with searchable articles archive	Useful for • surveys of large industries • economic surveys of countries • economic forecasts
www.bloomberg.com	Financial information Website	Useful for • investor information on particular firms (including history of share price) • surveys of prospects for particular industrial sectors

6.3.4 Using the Internet

This is the most convenient and commonly used method of researching the industry.

Generally you will be looking for the following sorts of information:

- Websites of firms similar to the one(s) in the TOPCIMA pre-seen material. This can help you learn about the sorts of products and competitive strategies they follow and may also yield financial information that can be compared with the data in the pre-seen material.
- Trade journals of the industry in the pre-seen. This will provide information on real-world environmental issues facing the business.
- Articles on the industry in journals and newspapers. These will keep you up-to-date on developments.
- Stock market information on the real firms.

Internet searching requires the use of a search engine. There are two sorts:

(1) *Proprietary search engines*: These are for subscribers only and will give access to journal articles. It is not worth subscribing to one of these in order to pass TOPCIMA. However, if your employer, or library, already subscribes to one, then it is a valuable resource.
(2) *Public search engines*: These are much less focused on business information but they are free to use (providing you do not mind all the pop-ups and banner advertising you will receive too). Some examples of search engines are given below:

www.allsearchengines.co.uk/business–list.htm	Powerful meta-search engine for business sites
www.searchengineguide.com/pages/Business/	International site giving links to industry specific search engines
www.bizweb.com	Directory of US business websites broken down by industry
www.google.com (or www.google.co.uk) www.yahoo.com (or www.yahoo.co.uk) www.copernic.com www.ask.com (or www.ask.co.uk)	These are familiar public search engines which can access public documents and other search engines

To search on the Internet, it is important to have keywords that will identify the articles and sites you are interested in.

To avoid information overload we suggest you follow these rules:

- Start your search as narrowly as possible. For example, suppose you were researching the food retailing industry as part of your preparation for the May 2002 case study on Global Inc. reviewed in Chapter 5. The keyword "retail" is too broad and it is better to use the keywords "retail, food, UK".
- Where you have the option, instruct the search engine to "search for all words", that is to look for items that contain all the words, rather than "search for any words" which, in the example above, would list all sites with the word "UK" in it.
- Another way to ensure that only items corresponding to all the keywords are selected is to input the keywords with "1" between them, for example, "retail1food1UK".
- Set yourself a time limit for your search; we suggest 30 min, after which you read through what you have found to make sure it is relevant to questions posed in Section 6.2.2. It is very easy to spend a lot of time following irrelevant lines of enquiry in cyberspace.

By using merely one of these public search engines, you may generate around 20 Email "alerts" each day! It is recommended that you read these news alerts on a regular basis and that you properly manage this vast flow of information. Do not get bogged down by information overload – be decisive. If the news alert contains information that is relevant to your research for the case, then retain it for future reference. However, most of the email alerts may not be strictly relevant, so you should delete them after you have read them. If you do not manage this information process as it arrives, you will find a huge mass of data that becomes difficult to manage and absorb. Information overload can be worse than no information. Use your common sense to sort the relevant from the irrelevant.

6.3.5 Using information from company websites

If companies can be identified that are in the same or similar industries to the industry in the *Case Study*, and these are relatively simple companies, not conglomerates, it is possible to gain much information from these websites. It is not helpful, as some candidates and tutors have done, to believe that you have found the company on which the case-writer has modeled their material. No past case has ever been based exclusively on a real-world company and hence data will have been changed significantly.

Company websites of public companies in similar industries can provide the annual report and accounts, any press releases, publicity material and product descriptions, and detailed documentation on such matters as rights issues and share option schemes. Often they contain specially commissioned pieces of market research that you can download. However its worth remembering that this research is there to encourage investors to anticipate higher returns in the future and will tend to put an optimistic gloss on events.

Some US company sites provide exceptional levels of information including all legal document filings, such as company returns. However, remember this is only background: don't spend too long on gathering this information.

You should review the accounts and establish:

- typical industry working capital ratios;
- typical ratios of fixed assets to sales;
- margins;
- growth rates.

You should then compare the accounts with the current share price and compare the market capitalisation with the asset value, and review all the normal investment ratios.

You may provide yourself with some 'normal' industry figures as a basis for any comparisons you may wish to make of the unseen material in due course.

You should also review all the non-financial information provided, looking in particular for:

- new technological developments, new products;
- the competitive situation.

You should also regularly read the business pages of a quality newspaper (at least once a week) to learn what is happening in the business world. It is almost impossible not to find at least one article in any newspaper that is relevant to your research for the TOPCIMA exam, and sometimes there are several, depending on the industry that you are researching.

For example, when the pre-seen material for Sparkle was available, there was a spate of both friendly and hostile take-over bids, and also a floatation of one company, in the private sports club industry. Therefore, well-read candidates were able to relate to these companies and quote real-life examples in their exam answer, which enhanced the credibility of the rest of their answer.

6.4 How to analyse the pre-seen material – Homejay Inc. – November 2003

We will take you through the Homejay case and show you how to analyse the pre-seen material in this chapter. This chapter (Chapter 6) will NOT take you through the unseen material, or the answers to this case, as it has only been included to demonstrate the methods that you should use to analyse the pre-seen material for the exam that you are preparing for. However, in Chapter 7, on what to do on exam day, the unseen material and the answers to this case have been included, so that you can work your way, logically, through this case.

As the pre-seen material for Homejay has not been included elsewhere in this CIMA Learning System, it is shown below:

Homejay Incorporated

Background

Homejay Incorporated (Homejay) has been trading for over a hundred years and has a number of areas of business that include some global brands that are highly profitable. It is a multinational company that predominantly manufactures and retails consumer goods for its home market in the USA and in Europe. It has few business interests in the Far East at present.

It has three main lines of business, which are do-it-yourself (DIY) stores, furniture stores and electrical consumer products. It also owns a cosmetics company and a chain of greeting card shops.

Homejay's shares are traded on an international stock market and are widely held by leading financial institutions and pension funds. Over a period of 50 years up to 1994, Homejay's share price growth has exceeded market analysts' expectations and it has been widely regarded as a good investment. However, for the last nine years its share price has not achieved the expectations of market analysts and the company's earnings per share has fluctuated and is now below the level achieved nine years ago. A number of management initiatives have been undertaken to improve growth, profitability and the company's share price.

Homejay has five business units, which are run as autonomous decentralized businesses, each with a general manager. The business units are:

Fixitco

Fixitco operates over 270 do it yourself stores throughout Europe, and retails both branded and own brand goods. It stocks a wide range of consumer goods including paints and other DIY materials and equipment, as well as garden equipment and garden furniture. It also retails some furniture products and electrical products manufactured by other Homejay business units. Fixitco has contracts with several DIY manufacture which manufacture ranges of products under the Fixitco brand name. It has no DIY stores in the USA. Fixitco expanded the number of stores in the early 1990s, but has not opened any new stores for the last eight years.

Woodyco

Woodyco manufactures and sells mid to lower priced domestic furniture in the USA and in Europe. It has expanded its geographic coverage mainly by acquisitions of small competitors in areas where it did no operate. Its acquisitions have included manufacturing plants as well as retail outlets.

Woodyco manufactures domestic furniture including a number of ranges of kitchen cabinets, living room furniture, bedroom furniture, home-office furniture and storage units. It has nine manufacturing plants. It has 60 retail outlets in the USA and in Europe selling its own brand furniture as well as retailing selected ranges of kitchens and some other furniture through Fixitco stores in Europe. It also sells some of its ranges of products to other furniture retailers. It has not opened any new retail outlets in the past three years.

Electryco

Electryco manufactures its own brand of domestic electrical consumer products. These include laundry products, dishwashers, ovens, hobs, some lighting products and some smaller electrical appliances including food processors, kettles and toasters. It sells 97% of its products to a wide range of retailers in the USA and to some parts of Europe. The remaining 3% of sales are made through Fixitco stores in Europe. Electryco does not have any sales outlets of its own.

Cosmetco

This business unit is a cosmetics manufacturing company, which produces branded low-price cosmetics aimed at the bottom end of this competitive market. It sells is products in the USA and in some European countries, directly to high-street retailers.

Cardco

This business unit retails greetings cards in high-street shops in two European countries. Cardco purchases its greetings cards from a large range of both small and large manufacturers of greetings cards. Cardco owns or leases over 150 outlets in key high-street positions.

Location of Homejay's business units' management

The Homejay head office is located in a large city in the USA, and includes all corporate functions, including Human Resources, Corporate Finance and Corporate Planning departments. Each of the five Homejay business units is located in a different city. Woodyco, Electryco and Cosmetco's senior management are based in different cities in the USA, and Fixitco and Cardco's senior management are based in two different European cities.

Homejay's recent financial results

During the 1970s and 1980s the company went through a period of rapid growth and high profitability was achieved, together with substantial growth in its share price. It acquired a variety of businesses, some at large premiums. Some businesses have continued to operate in much the same way as before acquisition, and now report into one of Homejay's business units.

A summary of the turnover, operating profit and capital employed for each of the business units for the last two financial years is shown as *Appendix 1* (on page 392). This appendix also shows the latest forecast results for 2003/04.

Appendix 2 (on page 393) shows a summary profit and loss and balances sheet for Homejay for the last two financial years.

Since 1994, Homejay has experience an overall decline in its earnings per share, although it has fluctuated within this period. Homejay's earnings per share at \$0.22 in the year to February 2003 was some \$0.06 per share lower than that achieved in the year to February 1994.

Appendix 3 (on page 394) shows Homejay's actual earnings per share compared to its expected earnings per share. The expected figures represent its annual planned results that had been communicated to the market.

Key personnel

Ralph Black – Chairman

Ralph Black, aged 58, is planning to retire at the end of December 2004, after more than 12 years with Homejay. He became Chairman when the company was experiencing a period of expansion. However, in recent years he has been disappointed with the lack of growth that the company has experienced. While Ralph Black has blamed the economic conditions for Homejay's disappointing performance in his last few annual reports, he also understands that the company needs to change the way it manages its business, if results are to improve significantly in the future.

Andy Mottram – Chief Executive

Andy Mottram, Chief Executive, aged 48, joined the company in 1992. He had previously worked for over 20 years with another global retailer, and had enjoyed a challenging business life, with his previous company's financial results improving far beyond inflation level each year. He joined Homejay two years before the company's earnings per share started to decline, and he has had to critically review a number of areas of the business. He has been responsible for much cost cutting, some of it rather random, and he is feared, rather than respected, by most of Homejay's managers.

Barry Milo – General Manager of Fixitco

Barry Milo has been with Fixitco for 16 years and prior to that was a regional manager for a competing chain of DIY stores. He is 45 years old and has a personal philosophy of never leaving his desk until after 8 o'clock each evening. While he works very long hours, he enjoys his work and the challenge of managing the 270 Fixitco stores across Europe.

He joined Fixitco as a regional manager responsible for all stores in two countries. When the previous general manager resigned to join another larger competitor in 1998, he was promoted to general manager as he had produced an impressive growth record in some of the stores under his control.

Joseph Logan – General Manager of Woodyco

Joseph Logan joined Woodyco over 20 years ago. He is 52 years old with a career in manufacturing and is very well liked and respected with Woodyco. He has worked in the furniture business all of his life but has no professional qualifications. He has risen to his current position through a combination of sheer hard work and being in the right place at the right time.

He joined Woodyco in the early 1980s as one of its factory managers, worked long hours, got noticed, and was promoted to become Woodyco's manufacturing operations manager. When Woodyco's previous general manager retired in 1992, Joseph Logan was the one manager within the company who understood the business unit best, and he was appointed general manager. Joseph Logan is responsible for both manufacturing and retailing of Woodyco's products, but has limited retailing experience. He is, however, supported by an able senior management team.

Suzie Green – General Manager of Electryco

Suzie Green is qualified electrical engineer who had worked in Japan for a leading electrical manufacturer in her twenties and then decided to return to the USA in 1990. She joined a small manufacturer of domestic electrical appliances of operations manager but the role and the responsibilities did not live up to her expectations.

She then moved to Electryco as manufacturing operations manager in 1992, and has enjoyed a challenging role for the last 11 years. In 2001, the general manager took early retirement because of ill health, and she eagerly accepted the offered promotion to become general manager.

Jayne Reed – General Manager of Cosmetco

Jayne Reed, aged 44, has worked for several cosmetics companies and has managed Cosmetco since before Homejay acquired the company. She has initiated a number of successful changes within the business unit and has driven forward much product development by her determination to see business unit become more profitable.

Mitch Rayfield – General Manager of Cardco

Mitch Rayfield, aged 48, joined Cardco shortly after Homejay acquired it in 1982, as a shop manager. He worked his way up within the business unit and was appointed general manager in 1998. His experience in this business area was sound and his reputation as a tough, but fair, manager was well known.

Maxine Gill – Finance Director

Maxine Gill had qualified as a management accountant in the late 1980s while working for a car manufacturer, and stayed with that company for a further five years, holding the role of Chief Accountant. She left to join the head office team of a global electrical manufacturing company as group management accountant. She enjoyed this demanding role and was responsible for initiating a number of changes in both electronic data systems and the way that divisions were monitored. She was headhunted to join Homejay as Finance Director in April 2002, when the previous Finance Director, Peter Wade, left to join a larger global retailing company.

Mark West – Corporate Marketing Director

Mark West, aged 51, joined Homejay from another global retailer two years ago and has spent much of his time leaning the business and trying to understand the rationale behind how the marketing budgets are spent by each business unit. He has also been researching how effective alternative marketing methods may be. He has worked in sales and marketing for a number of large multinational companies over the last 30 years. Andy Mottram has challenged him to deliver substantial turnover growth over the next two-year period to February 2006, and has left him to work with the general manager of each of the business units to see how this can be achieved.

Paul Simpson – Head of Corporate Planning

Paul Simpson has been Homejay for over 15 years and has seen the company growth in both turnover and complexity. He has always worked very well with, and was a close friend of, the previous Finance Director, Peter Wade. His department was responsible for preparing one, five and ten-years plans and worked loosely with finance and planning staff within each of the business units.

Since Maxine Gill joined Homejay in 2002, Paul Simpson's department has been under increasing pressure to produce a detailed analysis demonstrating where Homejay's results have differed from plans. Maxine Gill waned to identify whether it was the revenue shortfall or higher costs that resulted in lower net margins. Paul Simpson has also had to prepare reports justifying the basis of how future plans had been prepared. The working relationship between the corporate planning department and the Head Office team is not very good at present. Furthermore, there is a lack of rapport and trust between Maxine Gill and Paul Simpson. The latter cannot understand why Maxine Gill is spending so much time analyzing past plans.

Catherine Business – Director of Human Resources

Homejay employs over 28,000 staff in the USA and in Europe, and the company's Director of Human Resources is Catherine Banes. She joined Homejay in 2000. She has been reviewing a number of areas of the company's HR policies and has recently started to make a number of changes. She has been responsible for encouraging staff not to work long hours and has seen the level of staff training increase for the first time in 2002, to meet the agreed corporate target for staff training days.
Homejay's current organisation chart is shown below.

TQM introduced

In 1992 Andy Mottram had introduced a total quality management (TQM) programme into all areas of the company. This was heralded with a new mission statement and a training programme that aimed to have all employees trained in the ethos of TQM by the end of 1992.

The company's mission statement in 1992 was "to be a leading manufacturer and retailer of quality consumer goods in our chosen markets, with all employees participating in achieving quality standards in every area of the business".

The TQM initiative was initially greeted by most of Homejay's managers with scepticism, but some progress has been achieved in most areas of Homejay. The company decided to focus on quality and improving efficiency. By the mid 1990s there some improvements in all areas of Homejay's business units, but this had been mainly achieved by a disproportionate amount of cost cutting. However, it was considered by many managers that too much emphasis had been placed on achieving short-term performance targets.

All of Homejay's business units have met, or exceeded, quality standards in some areas of their business, but none of the business units has achieved all of the quality targets set.

The balanced scorecard

Ralph Black was at heart a salesman and had seen the company growth significantly, but felt that too much emphasis had always been placed by the Board on financial measures. By 1998, some five years after Homejay started to experience difficulties in increasing its earnings per share, Ralph Black considered that the company should be looking at a more varied selection of performance measures.

Ralph Black decided to introduce the balanced scorecard concept to Homejay in 1999. The four different perspectives were measured and reported by all business units for the financial year ended February 2000. The measures that were agreed to be produced for the financial perspective included some that were already being monitored, such as growth in turnover, gross margins, net margins, return on capital employed and working capital measures. Some new financial measures were also introduced. The majority of the new performance measures that were introduced to each of the business units were in respect of the other three areas of the balanced scorecard. These are the customer perspective, the internal business process and the learning and growth process.

The general manager of each business unit is responsible for ensuring that appropriate measures for all four areas are produced. The measures are reviewed each month and are critically analysed as part of the planning cycle. The business unit general managers use the balanced scorecard measures to identify which areas of their business are improving and which areas need more management attention to address problems. For example, the general manager of Fixitco, Barry Milo, has identified that sales had been lost for certain product lines due to lack of stock, whereas at other times Fixitco has had to sell large amounts of stock at greatly reduced prices when seasonal lines have not produced the expected level of sales.

The customer perspective measures has also identified that Woodyco has a loyal customer base, as over 65% of customers who purchase Woodyco furniture or kitchens, have purchased goods previously from Woodyco.

Each of Homejay's business units has targets for the introduction of new products, which are currently as follows:

Business unit	*Target % of new products each year (as % of turnover)*
Fixitco	2%
Woodyco	15%
Electryco	10%
Cosmetco	20%
Cardco	10%

All of the manufacturing plants have met their safety targets. Furthermore, Homejay's initiative to invest in its staff has resulted in most business units meeting their targets for staff training.

The balanced scorecard statistical reports have confirmed that Electryco is having problems meeting customer's expectations in respect of quality. It is experiencing a higher than usual fault level on some of its products. Furthermore, it is not introducing new products, or new models, as quickly as some of its competitors. Many, but not all, of the current quality problems that Electryco is experiencing have been associated with new products. Some new products appear not to have had all of the manufacturing and design problems identified and rectified prior to launch. So while Electryco has met its innovation target, this has resulted in missed quality targets.

The Homejay business units

Fixitco

Homejay currently has over 270 DIY stores operating throughout Europe. The business unit is concentrating on improving turnover and identifying consumer trends, so that demand can be met at key times.

Barry Milo was concerned that the sales prior to Christmas 2002 could have been higher if a number of stores had been better stocked with some seasonal products. He had experienced the opposite in some stores, when they overstocked of Fixitco's own brand of paints that turned out to sell badly, despite a big marketing campaign.

Some slow-moving stock items, and even entire product ranges, have recently been rationalized as it was identified that they were not selling well and taking up too much floor space. More market research work is being undertaken to ensure that Fixitco stores maximize their sales potential.

It has been identified that the time taken by suppliers to meet orders is too long and Fixitco is working with its external suppliers to try reduce lead times. It is also working closely with the manufacturers of its Fixitco own brand range of products to ensure that goods are manufactured in accordance with contract items terms and are available to meet customers' demand.

Fixitco has been developing and improving its IT systems over the last few years and the latest phase of its management information system is specifically designed to speed up the procurement process and, in particular, to highlight fast-moving stock at an early stage. This should allow management to review its stock levels for these product lines and, where possible, ensure that stock is held at the right stores to meet demand. The new procurement and stock control system became operational in June 2003. The new system has already enabled Fixitco to meet demand for some product lines more quickly than previously achieved. However, the system appears to have prompted orders for items already in stock, causing Fixitco to carry larger than usual stock for sometimes. After investigation, it was found that his was partly caused by some items having more than one stock number. The reason for the rest of the extra stock has no yet been identified. Furthermore, Fixitco management has identified that the new system has created lower stock levels for some product lines, which has not helped the business to meet customer demand at peak times.

Barry Milo has identified that 25 stores need a major refit to make them more appealing to customers, especially where they are in direct competition with other local DIY chains. Some of these stores have seen declining or low growth in turnover in the last few years, and it is now becoming urgent to address the problem. It is estimated that the refit of these 25 stores will entail capital expenditure of around $45 million and reduced sales while he refits are undertaken. Sales at these stores during refurbishment could be up to 35% lower for the three months when work is being carried out. Additionally, increased marketing spend would be required to re-launch the refitted stores, estimated to be around $8 million. The re-launched stores are expected to compete more effectively with other local DIY stores.

Woodyco

Within the furniture market that it operates in, Woodyco manufactures and sells low-cost furniture in its own branded outlets in the USA and in Europe, and also supplies and retails furniture and kitchen cabinets through Fixitco stores in Europe. It also retails some product lines to other furniture retailers. Woodyco currently has 60 retail outlets.

Split of Woodyco actual sales	*2002/03*	*2001/02*
In Woodyco retail outlets	72%	69%
In Fixitco stores	18%	19%
To other retailers	10%	12%

During the 1980s and the early 1990s, Woodyco acquired over eight different furniture manufacturers or furniture retailers and by 1996 was a strong competitor in the highly fragmented furniture business. Many of the products that are manufactured in the Woodyco's different factories, across several countries, complement each other, but there is some duplication of similar product lines. Woodyco operates three large manufacturing plants, as well as six smaller factories, that each produces its own brand of furniture. While the TQM approach has seen an increase in quality and improved operating methods in each of these nine furniture factories, Joseph Logan recognizes that there is a need to review Woodyco's current manufacturing capacity and factory production methods.

The management capabilities in the companies that Woodyco acquired vary widely. The companies are still largely managed as they were pre-acquisition. Woodyco's business performance is subject to the vagaries of furniture design and fashion trends. In 1999, one of the Woodyco furniture manufacturing plants recruited a young design engineer, who has since won a design award for several pieces of furniture. This has resulted in a strong growth of sales in that area of the Woodyco business, but has masked a decline in some other product lines.

Woodyco has a number of well-known brands of furniture, with high consumer awareness of some of its brand names. However, many customers, and potential customers, do not know that Woodyco owns all of the brands of furniture.

An analysis of Woodyco's actual operating profit for the last two financial years is summarized below:

	2002/03	*2001/12*
	\$ million	*\$ million*
Turnover	1,365	1,248
Cost of sales	737	661
Gross margin	628	587
Selling and distribution costs	405	373
Administration	63	61
Allocation of head office costs	95	90
Woodyco operating profit	65	63

Due to the competitive nature of the low-cost furniture market, Woodyco has experienced falling gross and net margins in the last few years. It has targeted a number of areas for cost reduction, but most of these have not materialised. Some efficiency improvements have been made, but more flexibility in production is required. Joseph Logan is planning to review the manufacturing capabilities of Woodyco's nine factories.

The nature of the furniture business is such that sales peak around the times of its twice-yearly reduced-price sales periods in the summer and in January. Sales targets were achieved towards the end of the last financial year by reducing prices further in its post-Christmas sales, but this had a detrimental effect on the margins achieved.

Electryco

This business unit manufactures its own brand of domestic electrical consumer products and does not trade directly with the consumer it supplies a number of large high street electrical retailers and department stores in both the USA and Europe. It also sells some of its appliances in Fixitco stores, but this amounted to only 3% of Electryco's turnover in 2002/03.

In recent years, despite the TQM and balanced scorecard initiatives, some appliances have suffered from an increased level of faults. The business unit management has been investigating how this happened and has identified a number of areas where quality control was lacking and also where product design has been the reason for the recurrent faults in some of its products. Electryco's management has been working hard to improve the quality of these products to retain its good brand image. This has necessitated a fundamental redesign of one entire range of products. It has also resulted in increased repair and replacement costs for faulty appliances that are under warranty.

Electryco's general manager, Suzie Green, is confident that these quality problems can be easily overcome and that they will have no long-term effect on Electryco's other products. However, the business unit has been slow in developing and launching new models in some of its ranges.

The electrical appliance market is highly competitive. It is becoming increasingly apparent that Electryco will have to review its pricing structure for those products that have not been selling as well as planned, mainly due to competitors' products being priced lower than Electryco's. Many of Electryco's products have a number superior features and have achieved a good reputation in the marketplace, although the current fault problems may affect this image.

Electryco's marketing department is planning a major new marketing campaign to promote its products. However, market research has repeatedly confirmed that price is a key selling point, rather than the product's features. The business unit's pricing policy for its entire range of appliances is currently being reviewed.

Cosmetco

Cosmetco had undertaken a three-year product development programme following much market research, which concluded during 2001/02. During this three-year period, substantial marketing and product development costs were incurred. It has produced new ranges of products that are selling well and has established itself in this competitive market. Cosmetco achieved turnover growth of almost 16% in the last financial year to February 2003. Together with reduced product development costs, this helped to achieve a growth of \$5 million in this business unit's operating profit to \$21 million in 2002/03.

Jayne Reed is confident that she can continue to grow this business and has set her sales team challenging targets for the next two years. The marketing of the new product range appears to have been very successful and she feels that the business unit should continue to spend similar amounts of marketing over the next few years, to that incurred in 2002/03.

Cosmetco signed up a young actress for marketing purposes during 2000 for a four-year contract. In early 2003, the actress won an award, and this has resulted in a higher that forecast demand for Cosmetco products, mainly in the USA. However, early discussions about renewing the contract have indicated that a significant rise in the fee would be required. Furthermore, Cosmetco has experienced some problems with the actress fulfilling her contractual obligations at promotional events. Jayne Reed is confident that these problems can overcome, and is hopeful of significantly higher sales in 2003/04.

Cardco

This business unit has seen its turnover and operating profit from the sale of greetings cards grow very slowly. The business was acquired in 1982. While it has always been a profitable business unit, it has not grown at the rate of several of its European competitors. Mitch Rayfield has welcomed all of the corporate initiatives to improve quality and customer service and his business unit has usually met all of the agreed targets.

Meetings with market analysts

When Maxine Gill joined Homejay in April 2002, it was just before the final financial results were due to be published for 2001/02. She was disappointed that the company had not warned the market that the company's earnings per share (EPS) for 2001/02 was likely to be much lower than the \$0.24 expected by the market. The company achieved EPS of only \$0.21 for the year to February 2002, which was its lowest level for 6 years. The business plan for the year to February 2003 indicated that EPS would increase to \$0.25, and this level of EPS had been communicated to the market.

One of the first tasks that Maxine Gill undertook was to review Homejay's performance from the standpoint of its shareholders. She already knew that Homejay had not preformed particularly well for its shareholders over the last few years and that is operating profit had not been as good as the directors and the business unit general managers' had planned for.

Maxine Gill arranged a series of meetings with some of the leading market analysts who were responsible for Homejay's market segments. She was rather surprised at the favourable reception she received from some of them. Apparently, the previous finance director, peter wade, as well as Ralph Black and Andy Mottram, had never met with any of the analyst to understand their views of Homejay.

Maxine Gill quickly established a good rapport with the key market analyst with whom she met, and learned much about the company and why the market had valued its shares down on many occasions. There were two main reasons for Homejay's low market valuation. First, some market analysts had believed that the prices paid for some of the companies that Homejay had acquired in the past were too high. The market analysts explained that they did not see any reasons why some of the companies (some in the Woodyco business unit as well as Cosmetco) were worth more than their pre-acquisition values.

The market analysts had discussed with Maxine Gill that the company's performance was poor, particularly given the strong brands that it had in both Fixitco and Woodyco. Some analysts stated that they were also disappointed with the company's slow progress with building profits in other parts of the company.

One of the analysts with whom Maxine Gill met illustrated why the market lacked confidence in Homejay. The market analyst showed Maxine Gill a graph *(which is shown in Appendix 3)*, which demonstrated that Homejay's actual financial performance, as measured by earnings per share (EPS), has always been lower than the planned EPS that had been communicated to the market.

Homejay management remuneration

Homejay's company policy is to offer its managers a competitive salary and a performance-related bonus. This applied to over 7,000 of Homejay's managers around the company, from junior managers to senior managers.

The performance-related bonus for senior managers is linked to achieving each business unit's target return on capital employed (ROCE) each year. The target ROCE would be agreed before the start of the financial year, when business plans had been approved by the Homejay Board. Junior managers' performance bonuses were not related to ROCE, but instead were linked to achieving their individually set objectives, which include meeting key quality standards. Their line managers are responsible for setting objectives.

Over 85% of Homejay's managers received their performance-related bonuses in the year ended February 2003 despite the company not meeting its EPS target.

Competitor analysis

All of Homejay's business units monitor their market shares and their competitors closely. Except for Fixitco, Homejay's business units do not have any significant market share in their respective markets. Fixitco is one of eight dominant DIY chains in the countries in which it operators, with an estimated market share of about 12%. It is second to another large chain that has a market share of around 18%. There are also a large number of smaller chains of DIY stores that together account for just under 20% of the total market.

Woodyco has increased its market share over the last few years, partly as a result of winning a design award in 2000. However, its market share is still small, at less than 4%, as there are a large number of companies operating in the furniture business.

Electryco has a small market share, less than 4%, in the domestic electrical appliance market, but it has been able to command a price premium for some of its products.

2003/04 latest forecast

The original budget for Homejay for the year to February 2004 was a net profit before interest and tax of $240 million, which was a substantial increase on the previous year's actual results of $214 million. Maxine Gill and Andy Mottram had both been working closely with each business unit to ensure that they were able to deliver this planned level of operating profit. This level of budgeted profit had also been communicated to the market.

However, the half-year results showed that the planned increases in profitability were not materialising, although sales were almost as planned. The latest forecast also confirmed that Homejay was unlikely to meet its expected profits, as shown in *Appendix 1*. The latest forecast shows a forecast net profit before interest and tax of $223 million, which will represent only a 4.2% increase from 2002/03 assuming that this forecast is achieved.

Maxine Gill was very concerned that the market analysts who had started to trust her, would again be disappointed at Homejay's failure to deliver its expected level of growth and profitability. This would, no doubt, adversely affect Homejay's share price.

Introduction of new IT systems

Soon after Maxine Gill joined Homejay in April 2002, she decided to implement some new IT systems for the finance department. The first system to be implemented was a forecasting system. The previous system was cumbersome and did not allow business units to access and manipulate actual data from the company's other systems. The new financial and business forecasting system was now linked into Homejay's other management information systems, thereby allowing staff to access what had happened, using actual data from the company's nominal ledger, and to prepare more realistic forecasts for the rest of the financial year.

Each business unit produces updated detailed forecasts for the rest of the current financial year, every quarter. The new forecasting system enabled each business unit to input new data for their rest-of-year forecast, which would then be added to the actual data for the financial year to date. The system has facilitated both local and head office management to view and interrogate the latest full-year forecast.

The system became operational at the start of the current financial year, in March 2003, and, despite a few teething problems and the need for staff training, the system has worked well. However, what Maxine Gill has found is that business units have continued to prepare over-optimistic forecasts. It appears that the integrity of the forecast for the rest of the financial year is too heavily dependent on unrealistic sales targets and achievement of margins. Margins have always been lower towards the end of the financial year (February), due to two main factors. These are the reduced prices in its January sales and the clearance of old and slow-moving stock at low margins.

Maxine Gill is hoping that cost control within the business units will improve as the next phase of the finance IT system is implemented. The next phase of the new finance system aims to deliver detailed data on costs across all product lines for each business unit, allowing management to monitor product profitability and controls costs more effectively.

2004/05 business plans

Homejay's business planning cycle started in May 2003 with the Homejay Board agreeing the strategic goals and outline plans, which were cascaded down to each business unit for it to use in its plans. Ralph Black continued to issue a directive for strong growth in turnover, but he also wanted to see how each business unit could achieve a much higher level of profitability than they currently appeared to be able to deliver. He also wanted the business units to put together realistic and achievable plans given the problem the company was experiencing with over-optimistic plans in the current financial year.

The business units have prepared the first iteration of their business plans, and have submitted them to Paul Simon's Head Office planning department. These plans comprise a detailed one-year plan and outline plans for a further three years, covering profitability, capital expenditure and working capital requirements for each business unit, together with a commentary that outlines major changes in business operations.

Paul Simpson was concerned that the plans that had been submitted by each of the business units for 2004/05 showed and overall increase in profitability of 19% from the latest forecast for the current financial year, with only a 17% increase in sales. He felt that every year plans were made that appeared to be over-ambitious. He was aware that each business unit's general manager had failed to deliver what he/she had planned in the past. A consolidated plan for Homejay was in the process of being prepared by Paul Simpson's department for consideration at the planning review meeting in early November 2003.

The general managers of Fixitco and Woodyco had defended their forecasts to Paul Simpson by standing that profitability in the past had fallen short of the original plans for a variety of reasons. These included external events beyond their control, including the poor economic conditions. In the Woodyco business, Joseph Logan stated that achieving margins was heavily dependent on selling products at their recommended prices, which in the past have had to be reduced significantly on several occasions to remain competitive and in order to sell slow-moving stock. Additionally, there had been several product lines that had experienced cost over-runs and higher than anticipated rectification costs of furniture items after they had been delivered and fitted in customers' homes. Both general managers considered that their plans for 2004/05 were realistic and achievable, although much, as always, was dependent on their competitors and the general trading conditions.

Andy Mottram has been critically reviewing the level of corporate Head Office costs, which are planned for 2004/05 at around $330 million. The Head Office costs are apportioned and charged to each business unit in accordance with a number of criteria. Andy Mottram considers that the business are not generating sufficient profit to sustain the Head Office corporate functions at this level of costs, and is keen to make changes. He is considering decentralizing some of the Head Office functions directly into each business unit, for each business unit general manager to control directly.

In order to improve the company's profitability, Andy Mottram is keen to acquire other companies. He has commenced early discussions with several suitable companies.

Mark West has proposed a major corporate marketing campaign and the cost implications were submitted to the corporate planning department for inclusion in the consolidated plans for Homejay. This proposed corporate marketing plan would be *in addition* to the marketing expenditure that is included in each of the business unit's plans for 2004/05. Mark West considered that Homejay should promote its corporate brand and this would have a direct favourable result on the volumes sold by all business units. The proposed marketing campaign was due to be discussed at the next planning review meeting in November 2003.

The forecast incremental effect on the turnover for 2004/05 for each business unit was anticipated to be increases of between 4 and 20%, as shown in the table below. The forecast incremental effect of the proposed corporate marketing campaign on each business unit's gross margin (defined as turnover less all direct variable costs) for 2004/05 has been evaluated. This is also shown in the table below.

	Forecast incremental effect of the proposed corporate marketing campaign on turnover for 2004/05	*Forecast incremental effect of the proposed corporate marketing campaign on gross margins for 2004/05*
	%	*$ million*
Fixitco	+6	+39 to 42
Woodyco	+4	+26 to 28
Electryco	+5	+7 to 8
Cosmetco	+20	+26 to 29
Cardco	+5	+2 to 3
Total Homejay		**+100 to 110**

Mark West is firming up on the cost of the corporate marketing campaign, which would include the use of various media, but it is expected that the increase over the existing corporate marketing budget would be over $80 million.

Appendices 1, 2 and 3 follow

Appendix 1

Note: All data in the Appendices are presented in UK format.

Homejay — Business analysis

(*All figures for financial years to the end of February*)

		Latest forecast 2003/04 $ million	*Actual 2002/03 $ million*	*Actual 2001/02 $ million*
Fixitco	Turnover	1,850	1,720	1,650
	NPBI&T	85	78	77
	Capital employed	1,170	1,135	1,110
Woodyco	Turnover	1,500	1,365	1,248
	NPBI&T	70	65	63
	Capital employed	601	594	557
Electryco	Turnover	680	750	713
	NPBI&T	30	41	40
	Capital employed	350	340	330
Cosmetco	Turnover	340	320	276
	NPBI&T	28	21	16
	Capital employed	120	119	105
Cardo	Turnover	140	135	131
	NPBI&T	10	9	8
	Capital employed	90	88	82
Total Homejay	Turnover	4,510	4,290	4,018
	NPBI&T	223	214	204
	Capital employed	2,331	2,276	2,184

Note 1: NPBI&T represents net profit before interest and tax.
Note 2: Net profit before interest and tax for each business unit includes and allocation of head office costs.
Note 3: The capital employed figures include head office net assets which have been apportioned to each business unit.

Appendix 2

Homejay – Summary balance sheet

	Actual End February 2003 $ million	*Actual End February 2002 $ million*
Tangible assets (net of depreciation)	**2,075.0**	**2,056.0**
Current assets:		
Stock	411.0	407.0
Debtors	435.0	363.0
Cash and Short-term investments	81.0	48.0
Total current assets	**927.0**	**818.0**
Creditors:		
Amounts due within one year	726.0	690.0
Net current assets	**201.0**	**128.0**
Creditors falling due after one year:		
Loans	820.0	780.0
Net assets	**1,456.0**	**1,404.0**
Financed by:		
Called-up share capital	240.0	240.0
Share premium reserve	200.0	200.0
Profit and loss reserve	1,016.0	964.0
Total equity shareholders' funds	**1,456.0**	**1,404.0**

Note: Called-up Share capital represents 480 million shares at $0.50 each.

Homejay – Summary Profit and loss account

	Actual 2002/03 $ million	*Actual 2001/02 $ million*
Turnover	4,290.0	4,018.0
Total operating cost	4,076.0	3,814.0
Net profit before interest and tax	214.0	204.0
Loan interest (net)	(64.0)	(62.0)
Tax (at 30%)	(45.0)	(42.6)
Net Profit	**105.0**	**99.4**
Dividends	53.0	50.0
Amount transferred to reserves	**52.0**	**49.4**

Homejay's actual and expected earnings per share since 1994

Data for earnings per share	*Actual $ per Share*	*Expected $ per Share*
Financial year ended February		
1994	0.28	0.35
1995	0.25	0.30
1996	0.20	0.26
1997	0.23	0.29
1998	0.24	0.31
1999	0.24	0.28
2000	0.23	0.28
2001	0.24	0.29
2002	0.21	0.24
2003	0.22	0.25

End of the pre-seen material

6.5 How to analyse the Homejay pre-seen material

Use the techniques in Chapters 3 and 4 to help you unlock this pre-seen material for yourself.

Technique	√
The four elements of strategy (competitive, financial, investment and risk)	
Using ratios to conduct a financial analysis of a company's position	
Assessing a business portfolio	
Industry analysis	
Position audit	
Preparation of Homejay's Strengths, Weaknesses, Opportunities and Threats (SWOT)	
Conducting a managerial and organisational audit	
Critical success factors	
Assessing information systems strategy	
Assessing corporate risk	
Assessing the cost of capital	
Conducting a corporate appraisal	
Business valuations	
Generating strategic options	
Sources of capital	
Evaluating strategic options	

The analysis that follows will help you to check you are on the right lines.

Homejay's position

A key piece of the pre-seen material appears where we are told that Maxine Gill (FD of Homejay) has met with market analysts and has come away with the message that Homejay Incorporated is in danger of losing the trust of key investors. Two reasons are given:

- it has a 10-year history of failing to deliver both either earnings growth and its forecast earnings per share;
- it has lost its way strategically. On the one hand, it has been unable to build on the value of its core brands and businesses, whilst on the other it has not managed to integrated and rationalise acquired firms in a way that delivers shareholder value.

The rest of the pre-seen material confirms the analysts' assessment. It also warns that Maxine Gill's honeymoon period with the analysts is about to come to an end. She won their trust following her appointment in 2002 and will have been exonerated for the poor results of 2001/02 and 2002/03 on the grounds that these were the outcomes of plans put into place before she came into office. She will also have promised great things from the new forecasting systems she has put in place. However, at the mid year point (Homejay has a February year-end) the forecast for 2003/04 already shows that it will miss its published EPS target by more than 7%.

Maxine's dilemma is one of how to tell investors the bad news without losing their trust and, consequently their support for Homejay's share price. The dilemma for the Board is how to come up with a business strategy that can deliver earnings growth and shareholder gains in a way it has not hitherto managed during the reign of its present Chairman, Ralph Black, and CEO, Andy Mottram.

From the perspective of a potential acquirer (or perhaps the disgruntled General Manager of a business unit) Homejay is a candidate for de-merger. It is a diverse conglomerate with a corporate centre that does not seem to add value.

The 2003/04 Business Plan

An obvious thing to notice about this case is the significance of the date of the final examination for which this pre-seen was issued. It seems to follow a planning review meeting at Homejay scheduled for 'early November 2003'. We are told that two sets of plans will be considered at this meeting:

- a consolidated group plan for 2004/05 forecasting financial performance for the coming year with indicative plans for a further 3 years;
- a major corporate marketing campaign costing over \$80m, equivalent to an astounding 36% of the forecast total group profit for 2003/04.

You may speculate that the unseen and requirement may ask you to prepare a review of one or both of these plans, perhaps on behalf of Maxine Gill.

There is not much numerical preparation you can do in advance to evaluate the consolidated group plan because you do not yet have the forecasts from March 2004 to February 2005. However, you could get ready to express a view on the reliability of such forecasts (including the 2003/04 forecast) by looking at the information in the pre-seen material on past forecast errors and the methods used to assemble Homejay's forecasts.

You can practice your analysis of the numbers for the corporate marketing plan by applying the incremental effects described to the 2003/04 divisional forecasts. Assess whether it would recover the \$80m investment and, if no, what sorts of forecasts would be necessary to justify such an investment. Perhaps you could conduct a sensitivity analysis on the projections.

The planning cycle for 2004/05 began 4 months ago and business unit managers have already submitted to Paul Simpson, Head of Corporate Planning, detailed forecasts for 2004/05 and indicative plans to 2008. These will be consolidated by early November for Board approval.

We do not know much about the content of these submissions although we are told that the GM of Fixitco, Barry Milo, must decide whether to spend \$45m on upgrading 25 stores and suffer revenue losses during the period of the works without, apparently, any prospect of the investments improving revenues once the refit is complete.

What effect would this upgrade have had on Fixitco's ROCE if it had been undertaken in 2003/04? Barry Milo receives a bonus for attaining an agreed ROCE figure. Do you think he is likely to undertake this investment if it jeopardises his ability to reach his target?

We are also told that Cosmetco needs to agree a fee to extend its endorsement contract with an actress. You may be asked to express an opinion on a proposed fee.

However, the most important thing about the Corporate Plan, or any assessment of the strategies of Homejay, must be whether it deals with the issues raised by the analysts and the underlying problems of Homejay. Demonstrating that you could get to grip with these would be the source of the marks in the exam.

The underlying problems of Homejay

The underlying problems of Homejay include:

1. It lacks a coherent business portfolio. A combination of acquisitions and organic growth has turned the firm into a puzzling conglomerate which has gained critical mass in only one of its markets.
2. Its management seem unable or unwilling to innovate or develop its businesses.

3. It has a performance management system which contradicts its desire to innovate and grow.
4. Its unreliable strategic and financial planning systems have resulted in misleading forecasts. These have caused inappropriate stocking and have contributed to disappointing EPS figures.

The corporate portfolio

Homejay is a diversified corporation. This means that it has interests in several industries: DIY retailing, furniture manufacturing and retailing, electrical durable manufacturing, cosmetics and greetings cards retailing. It is possible to see that some are related diversifications, for example furniture manufacturing and retailing through Woodyco and Fixitco. However, Cardco and Cosmetco are unrelated diversifications.

A key question that should be asked of the board of a diversified firm is 'what value does your corporate centre add?' This is sometimes called 'corporate parenting'. The job of the corporate centre of Homejay is to mould the business units to extract shareholder value. You should consider whether the board of Homejay is actually doing this. For example, do you feel that merely by requiring business plans and budgets from divisions and introducing initiatives such as TQM and Balanced Scorecards the board has done enough?

Homejay, as its name suggests, is primarily a retailer of DIY products and furniture to households. Fixitco accounts for 41% of group turnover and 38% of profits whilst Woodyco provides respectively 33% and 31%. Of the latter's turnover 90% is accounted for by sales from its own stores and through Fixitco. The remaining parts of the business together provide only about 26% of total group turnover. Cosmetco and Cardco are unconnected with Homejay's main businesses whilst Electryco gets only 3% of its revenues from sales within the group.

Fixitco is the only division with a significant market share in its industry. It is ranked number 2 with a 12% share against the 18% of its larger rival. Its sales grew 4.2% between the last 2 years and are forecast to grow by 7.6% this year. Following the rationale of the BCG matrix a division should receive investment only if it has a dominant market position in a growing market, or that such investment will enable it to achieve dominant share. Twenty percent of its market is in the hands of small players leaving the remaining 50% spread amongst 5 or more medium-sized players. Acquiring another store with 6%1 of the market could leapfrog Fixitco into first position.

Despite the efforts of its workaholic manager Fixitco presently has a disappointing ROCE that struggles to achieve 7% compared to an overall group ROCE of above 9%. This said some central costs and assets have been allocated out to divisions and we cannot tell how much has come to Fixitco. Neither do we have the ROCE of rival DIY chains to compare it with. However it would be difficult to argue that Fixitco should receive additional funds for its growth at the moment whilst it continues to return the lowest rate of return in the group. There are problems to be addressed including:

- poor rate of innovation (only 2% of revenues are set to come from new products);
- a failure to maintain appropriate stocks;
- excessive space taken up with low value inventory. The pre-seen implies that Fixitco may not fully understand the profitability of its product lines.

Woodyco consists of nine production plants and 60 retail outlets in USA and Europe. It makes and sells furniture under a variety of brands, many of them bought in by acquisition. Historically acquisition-led growth has been a feature of Woodyco's development although there have been no acquisitions for 3 years. Despite this Woodyco grew its turnover by 9.4% last year and forecasts nearly 10% growth this year: twice the rate of Fixitco. To some extent this may be attributable to its higher forecast earnings from new products (15%, the second highest in the group). It also has the second highest ROCE in the group (11.7%).

We are told that the furniture market is fragmented. This means that Woodyco's lack of a significant share (4%) need not be a drawback providing it has good brands. The case material tells us that it has several good brands and loyal customers despite being in the mid to low end of the furniture market.

However, the pre-seen suggests that Homejay's board are not following through the rationale of an acquisition. When Homejay buys another company it must compensate the present owners by paying them at least the present value of the future earnings of the business. Providing Homejay then takes steps to improve the earnings of the acquired firm it can make a good return on its investment. This is termed synergy.

The criticism levelled by the analysts has been that Homejay tends to leave the acquired firms running in the same way as they did before acquisition. Forecast earnings are not improved and so an acquisition merely changes the composition of Homejay's balance sheet: exchanging cash for future earnings (or raising debt to buy an asset of equivalent value). Of course, there will be acquisition fees to be paid to corporate finance and legal advisors and perhaps an initial fall in the target's earnings due to staff losses and uncertainty so the net effect is more likely to be a reduction in the wealth of Homejay's shareholders.

The analysts' criticisms cannot fairly be applied to Cosmetco, an acquired division, which has shown strong growth in sales and profits (16%/31.3%) and has increased its ROCE from 15% to 23% following its 3-year product development programme. Cosmetco should serve as a beacon to Homejay's management signalling the value of innovation.

Woodyco is growing too (9.9%/7.7%) but ROCE is only 11%. Furniture manufacturing will have low margins. Furniture retail is likely to be a more profitable part of the value system although it will need to compete with large players like Ikea. Woodyco has 9 plants, of which 3 are large and 6 small. It is not clear where these plants are located. It has lots of brands of which a few are respected. It also owns 60 shops of which some are in Europe and perhaps selling the same furniture are Fixitco (the latter buys 18% of Woodyco's output). We cannot separate the profitability of the two parts of Woodyco. Rationalisation and integration to increase value could involve:

- rationalising production into the three large factories to save cost, release assets and improve quality assurance;
- focus on the key brands in the portfolio that can provide margin (This will economise on marketing expenditure.);
- try to utilise Fixitco's retail power (270 stores in Europe) by exclusive supply arrangements or store-in-store agreements;
- co-ordinate the supply chain between Fixitco and Woodyco better to eliminate the inventories of both;
- increase sell-through of group products such as appliances;
- share logistics networks if supply chains coincide;
- consider buying-in more furniture and perhaps disposing of Woodyco if manufacturing is pulling down its profitability.

Electryco is the third division of Homejay in order of size, yet less than half the size of Woodyco. It sells only a small part (3%) of its output of electrical appliances through the group. The majority is sold via other US retailers. Financially its results are disappointing.

Its forecast ROCE of 8.6% is below group ROCE (9.6%) and its sales and profit growth have been historically sluggish (5.2%/2.5%) with both forecast to be negative in the present year.

Despite having a premium market positioning for its products the stated problems at Electryco are a lack of sustainable innovation. New ideas have led to faulty products and consequent rising repair costs. This suggests that the TQM initiative started by the CEO, Andy Mottram, in 1992 has not really permeated Electryco. Perhaps this is because Mottram undermined the TQM initiative by insisting on 'disproportionate' cost reductions and achievement of short term profit targets at the same time. TQM may reduce the costs of poor quality over time but initially it would have cost divisional General Managers more than it would have yielded. In addition, Electryco is competing from a high cost manufacturing location in a market characterised by low cost imports.

The board may be tempted to integrate Electryco better within portfolio by increasing its sales within the group. However, it would be foolish to drag down the performance of its retail divisions by yoking them to an inefficient and low quality supplier. You might take the view that giving greater autonomy to Electryco to force it to compete better and, later perhaps, de-merge it would be a better option.

The remaining divisions seem absurd within the portfolio of Homejay. They are small in relation to group turnover (Cosmetco 7.5%, Cardco 3.1%) and it's hard to see any synergies in either operations or sales with the rest of the group. Cardco is presumably valuable for its store portfolio, although being in high streets these are unlikely to be valuable for furniture and DIY and would need to be liquidated. Cosmetco has shown impressive returns and growth and would presumably be easy to sell-off once the future of its brand is better assured by signing the endorsement contract extension with the actress.

Unless these two units can be bundled together, perhaps with Cardco repositioning itself towards the gift or accessories market and also stocking Cosmetco products, it might be worth the board considering selling them off separately either to their management or to interested firms. This would enable Homejay to focus its attention and financial resources on its core homecare businesses.

Certainly the proposal by Mark West, Corporate Marketing Director, to spend \$80 m on creating a corporate brand seems misplaced. There may be value in linking related businesses together under common brands providing this does not cheapen one range by association with a budget range. However its difficult to see what sort of brand values could be applied across a product range from cosmetics to cookers and from greetings cards to gravel. We should notice also that Woodyco has a lower market positioning than Electryco and that Woodyco already has several separate brands.

The situation of Homejay overall is reminiscent of that of Kingfisher Group plc. In 2000 the latter owned DIY businesses (e.g. in UK B&Q & Screwfix Direct, in France Castorama), electrical retail (e.g. in UK Comet & Norweb, in France Darty, in Holland BCC), cosmetics (e.g. in UK retailer Superdrug) in addition to its original business, the high street retailer Woolworth's. Since that date, and to some extent following investor criticism, it has de-merged and sold-off many of its lines of business (most recently bundling its furniture and electricals business into Kesa plc) and today presents itself as 'an integrated international dedicated home improvement business'.

Management at Homejay

Both the Chairman and the CEO have been in position for more than 10 years. During this time the EPS of Homejay has declined at least 28%. Both have sales and retail backgrounds.

This seems to have led, in the case of Ralph Black, to a focus on growth in sales turnover whilst Andy Mottram seems to be concerned with cost reduction. They are both autocratic. Mottram drove forward the TQM initiative in 1992 whilst Black imposed a balanced scorecard in 1999. Neither initiative seems to have worked. They have encouraged a tradition of promotion from within the firm for the core businesses with the GMs of both Fixitco and Woodyco having been with the business for over 20 years. The Head of Corporate Planning has likewise served 15 years with the firm yet has not attained a board position.

An autocratic senior management team will amass power and responsibility to itself leaving divisional managers to wait on its directives and instructions. The comment that Chairman Ralph Black is 'disappointed with the lack of growth' is telling. As Chairman making the firm grow is surely a part of his responsibilities? Doing this takes more than the handing down of ambitious sales growth targets and making requests for balanced scorecard targets.

This brings us back to corporate parenting. The academics Goold and Campbell researched this and identified three different styles of strategic management exerted by the boards of diversified firms:

- The Strategic Planning style features top-down planning of business units by the board with resources allocated in the interests of securing competitive advantage in key areas.
- Boards adopting the Financial Control style allocated funds tightly to divisions, requiring achievement of key financial performance targets (e.g. ROI/ROCE). It left the strategy of the business units to divisional management and instead busied itself with acquisitions and disposals.
- They named the third style, a halfway-house between the other two, Strategic Control. Here the corporate board were actively husbanding a strategy for the group as a whole whilst leaving considerable operating autonomy to divisions. It did this by setting a wider range of financial and non-financial targets to steer managers, but left the managers to find ways to reach them. Today Balanced Scorecards are an indicator of this third style.

Which style does Homejay exhibit? We can see that on the whole, and despite the facade of strategic planning systems and also balanced scorecards, it seems to be essentially a Financial Control style.

Which style should they adopt? Goold and Campbell argue that this depends on two considerations:

- The nature of the business: For example, whether the portfolio is related or unrelated; the stability of the competitive environment; the size and payback of investment.
- The resources in the organisation: For example, its financial condition; the personality of the CEO; the skills of senior and divisional management; the organisational culture.

The pre-seen contains plenty of information on some of these. In researching the industry to gain business awareness you should uncover the reminder. Consider what we know:

- We can agree that the prevailing culture within Homejay seems to be what Miles and Snow term a 'defender' culture, doing business the way it always has and with a resistance to new ideas.
- The Chairman, who has been asleep at the wheel for 12 years, is set to retire in 2004.
- In the manufacturing divisions they have appointed people with operational backgrounds whilst the GM of Fixitco has spent 16 years with the firm. It is significant that only Jayne Reed comes from outside the culture of the firm and it is she that has the best record in

innovative investment and growing her cosmetics business. However, Joseph Logan is building a good business too despite limited commercial experience because he has a good team behind him.

- The planning system is almost guaranteed to exclude radical strategic initiatives being short-termist and predominantly financial.
- The largest part of the portfolio is potentially related, and the smaller part is unrelated.
- Andy Mottram's has suggested that divisions should have more autonomy. This would increase the dominance of the financial control style further as well as exposing the corporate centre further as a useless, value-destroying overhead.

The corporate centre needs to get a grip on the strategic future and shape of Homejay. Financial Control style would only be suitable for divisions they intended to de-merge. The board lack the skills to make a success of Strategic Planning and, in any case, the market is too competitive to risk the loss of flexibility this might cause. The solution seems to be some form of Strategic Control style, providing divisional managers are up to the job, and providing the board can first decide what strategic direction they want the group to head in.

But this would need broader performance measures.

Performance measures

Homejay focuses too much on short-term performance measures such as EPS and ROCE to the detriment of building its long-term business. This is because it has allowed itself to become boxed in by its poor relationship with investors. It must break out of this if it is to grow.

EPS is not an end in itself for any investor. Investors want the value of their shares to rise and/or to receive dividend. EPS and its growth rate is really only a flawed proxy measure for this. If a company raises its EPS from one year to the next then the market price of its shares will rise. This adjustment restores the firm's share to its historic P/E ratio. The P/E ratio itself is a reflection of the confidence the investors have that the earnings of the firm will increase through time. This is in part determined by its historic ability to grow its earnings. It also reflects the outlook for the industry and the faith investors have in the firm's strategic vision.

Homejay is unimpressive. Its EPS has fallen every year despite the fact that it retains nearly half of its profits each year and has increased its gearing. Put simply, since 1994 Homejay has been making lower profits on an increased capital base. To some extent the fact that it misses its forecasts is irrelevant. Its earnings are falling whilst its capital base is increasing so therefore it is destroying shareholder value. This is condemnation enough of its record. However by consistently failing to deliver on its forecasts over a period of at least 10 years it conveys the impression that it has lost control of its financial affairs. That it is set to do so again this year may crush investors hopes that Maxine Gill will turn things around.

By permitting its shareholders to become fixated by its EPS figure Homejay has boxed itself in. Investing for future shareholder value requires that the firm invest in projects with a positive NPV. However, such long-term projects will not repay the expenditures associated with them in the first year. Earnings can be shielded if we treat the investments as assets and not expenses by capitalising them. But it may not be enough. The firm will still incur costs that cannot be capitalised (the pre-seen mentions examples such as training and promotion) and these will reduce profits. As it stands, Homejay does not have sufficient earnings growth from its portfolio to enable it to invest for the future without harming its EPS.

Homejay compounds this problem by using ROCE as a managerial performance measure. Even if the board were prepared to weather the storm of a falling EPS in order to build for the future, the divisional managers still would not undertake the investment, regardless of its NPV, if it would jeopardise their bonuses. Any divisional investment without immediate returns would hike-up their capital employed whilst at the same time potentially reducing their profits. The issue of store refitting at Fixitco alerts us to this problem.

There are other interesting anomalies in the case around its managerial performance measures.

We are told that 85% of its managers receive ROCE linked bonuses despite the group not meeting EPS targets. Given that EPS is falling they are seemingly rewarding themselves for failure. There could be several explanations:

- The ROCE targets are not ambitious enough. If ROCE targets are to promote EPS growth then they should rise each year. Homejay pays out even if EPS falls!
- There is a mismatch between ROCE and EPS. Divisional profit is calculated before deduction of interest and tax, whereas EPS uses the earnings after interest and tax. This does not incentivise divisional managers to control interest and tax. Something of this effect can be seen in Appendix 1 where we can see Homejay's overall ROCE rising from 9.3% to a forecast 9.6% yet elsewhere we find that EPS has fallen over the period. Homejay pays tax at 30%, which may suggest poor tax planning, and its interest payments and loans are rising at a similar rate to profits.

An added problem to Homejay's use of ROCE is the fact that managers may not be fully in control of their balance sheets or profits. We have already discussed the problem of distortions created by allocation of corporate costs and assets to divisions. Another problem will be transfer prices between divisions.

Woodyco sells 72% of items from its manufacturing divisions through its own shops and a further 18% through Fixitco's stores. The transfer price of these items within a division (from factory to Woodyco's stores) and between divisions (from Woodyco and Electryco to Fixitco) will affect:

- the prices that retail charge for the product and hence their competitiveness in the market;
- their willingness to use the in-house supplier instead of buying on the market;
- the profits of the divisions involved;
- the stock values on the balance sheets of the divisions according to who owns the stock, where it is held and how much it costs.

You should ensure that you are aware of the practical problems that confront firms like Homejay in arriving at appropriate and acceptable transfer prices.

We are also told that the firm has adopted a balanced scorecard approach to performance management. However, the targets handed down by senior management are sales growth and margin targets. This leads to plans that are focused principally on short-term financial variables.

Only senior managers have bonuses based on ROCE. Others have bonuses based on personal targets, presumably sales and non-financial targets. This raises two concerns:

- are the targets of staff below senior level congruent with ROCE and the financial results the company seeks?
- why do not senior managers have their bonuses based on a balanced scorecard of measures rather than just on a simple headline figure like ROCE?

Finally the two sets of financial targets set down by Ralph Black at the commencement of planning, as well as being short term, may not be congruent with the goals of achieving EPS growth. Increasing sales turnover may not increase profits if sales are achieved by cutting margins. Black also exhorts divisions to improve profitability but it is not clear if this is firmly laid down as targets nor whether he means profitability to mean 'gross margin' or ROCE. If he means margin he is ignoring the need to make a return to the firm's capital base and hence will harm group ROCE and EPS.

However, plans (and resulting KPIs) are only valuable if they are well formulated. This brings us to our third and final underlying problem.

Business planning at Homejay

The planning approach managed by Paul Simpson seems to relate more to financial forecasting than to strategic management. This needs to change.

The style of management at Homejay is what Hopwood describes as 'budget constrained'. Despite the interest expressed in TQM and balanced scorecards the fact remains that financial targets remain paramount. This affects the business planning process too.

The planning process starts in May with the Chairman setting some ambitious sales growth targets for divisions together with some other strategic goals. These are handed down to divisions and are the basis for the annual budgets and plans for each division to submit by September. The targets in these plans will also be used as the basis for the ROCE targets of the managers.

We might assume that the managers will submit conservative estimates in order to assure their bonus. In fact the budget bias seems to be towards optimistic targets. These are compounded up into the EPS projections that are subsequently missed by Homejay. There are several possible explanations for this:

- the divisional managers are using high forecasts to justify the case for additional resources to help them achieve targets;
- the managers lack the information, notably competitor and environmental information, to make better forecasts;
- in a sales-driven environment managers seek to look macho by submitting high forecasts.

Regardless of the reasons, once these forecasts form the basis of agreed business plans they lead to biased budgets. This causes divisions to take on more stock and make more output than they can sell. This leads to overstocking and triggers the deep discounting of prices to shift stocks before year end that are detailed in the case.

This leads to the loss of integrity in the forecast and a failure to reach forecast EPS.

Solutions that might be proposed include:

- improve the business forecasts by including forecasts from external models. Given that the majority of Homejay's business depends on household purchasing of durables and furnishing this should be possible;
- if forecasts are unreliable adopt a system of rolling (or continuous) budgeting to ensure that forecast errors are detected and future budgets corrected;
- pay closer attention to the reasons for forecast error in past plans and correct for these in future plans. Perhaps Maxine's interrogation of Paul shows she is already doing this.

Summary

The pre-seen material for Homejay has many themes and consequently many potential outcomes. Aspects we have discussed include:

- its portfolio of businesses;
- its performance measurement systems;
- its management style;
- its approach to budgeting and forecasting.

Throughout our discussion we have assumed that the board needs to develop a medium-term strategy to restore earnings growth and extract value from the portfolio of businesses it has built and acquired. This seems to be what the investors require. One potential requirement on the day is to evaluate the consolidated business plan in terms of its ability to deliver this.

Some alternatives to consider include:

- approach by an external firm to purchase a division of Homejay;
- convince shareholders not to accept a hostile bid from outside by putting up a strategy to de-merge or sell under-performing units and improve performance of remaining ones;
- advising a bidder on a potential strategy to win Homejay by drawing attention to its problems and also suggesting actions to be taken to turn it around once acquired;
- evaluation of an acquisition suggested by Mottram in the light of the strategic position of Homejay;
- adoption of e-commerce strategy (we are told that West is researching effective alternative marketing methods) or implementation of an ERP system.

6.6 Sparkle pre-seen material (May 2003)

We will now analyse the May 2003 case on Sparkle, set in the competitive sports club marketplace. Below is the pre-seen material which we will analyse in Section 6.7.

After you have read the pre-seen material, start to analyse the pre-seen material BEFORE you look at what has been prepared for you. Remember this is your turn to practice and hone those analysis skills!

Sparkle

The sports club marketplace

In every major European city there are large numbers of private sports clubs, offering their members a range of sports and relaxation facilities. In some capital cities there are in excess of 100 different clubs competing for members, all offering similar facilities.

Membership of a sports club, offering a well-equipped gym, some personal training and usually a swimming pool, is becoming increasingly in demand by many young people and families, who want better facilities than the "pay as you use" facilities offered by local government in various European countries. The monthly cost of membership at a sports club is still out of reach for many, but the market is rapidly growing and is highly competitive.

Leisure time and enjoyment of sports facilities are seen as important parts of the lifestyle of many people. Many sports clubs offer a high standard of facilities and service. Membership of a sports club may be regarded as a status symbol and many people aspire to join a particular chain of sports club, which attracts famous personalities, even if no notable personalities ever attend their local club. Sports clubs cost their members around €1,000 per annum, before additional coaching or personal training costs. Members also spend money in the bar and restaurant at the clubs.

There are a few very prestigious clubs in most of the European capitals that do attract famous sports personalities and show-business stars, but the prohibitively high joining fees and monthly membership fees are unaffordable to all but the very wealthy. However, the companies that own these prestigious clubs use them to promote their own brand of sports clubs to prospective new members. Branding also helps to retain existing members. Marketing promotes the "exclusivity" and high standards that such clubs offer.

There are a number of major companies in the sport and leisure industry which all report very healthy profits and whose share prices have grown strongly in the last few years. Inevitably, there is also a small number of companies who have not been able to deliver the level of growth in profitability that their shareholders expected; some companies' share prices have dropped and some have been acquired by other, more successful, sports club companies. In most towns and cities across Europe, clubs are opening up each month or existing sports clubs are being taken over by another company and re-branded.

Background to the start of Sparkle

James Lellee had been a successful athlete who achieved an Olympic gold for his 1,500-metre run when he was 21 years old. After retiring from competitive sport in his early 20s, he made a comfortable income from being a "sports personality", making speeches, attending promotional events and television sports presenting. However, commenting on sport bored him and he had always wanted to become more involved in a sports-related business.

One day in early 1986, while working out in the gym at the sports club he used regularly, an idea came to him and he wondered why he had not thought of it earlier. Every time he went to the sports club that the had joined years ago, there was always either a piece of gym equipment that was out of order or something minor that went wrong which spoiled his experience at the club. He was paying a substantial membership fee to an exclusive club and he felt that he was not being well looked after. He joked to his friends that he could run the club better. His friends at the club agreed that he probably could, and that set him thinking. After much consideration, he decided that he would like to operate the best ever sports club in the city.

James Lellee then set about researching which of the five clubs in the city he should try to buy and also how and where he could raise the necessary finance to acquire a sports club. He mixed in a social circuit where he had many very wealthy friends, including Charles Juan, a self-made multi-millionaire. After initial discussions, Charles Juan agreed that it would be a fun investment and agreed that he would take a share in the equity of the club that James Lellee planned to operate.

Charles Juan agreed to risk investing the equivalent of €10 million without requiring any security, if James Lellee were to give him a substantial share of the company. He agreed that Charles Juan could have a 40% stake in the company that they set up together. They called this company Sparkle.

They held initial informal discussions with the owners of two of the sports clubs in their home city, who were both sceptical as to whether a successful sportsman could actually have the business knowledge to run a sports club. Both sports club owners were reluctant to sell at the price James Lellee considered the clubs to be worth. He then decided that he would not acquire any of the existing clubs in his home city but would instead build his own sports club.

The first Sparkle club

James Lellee and his fellow director, Charles Juan, located a good accessible site in a respectable district of the city. They were both involved with the design of the club building and interior and exterior layout, and they agreed on the facilities to be offered. Within 18 months, the first Sparkle club was opened in 1988 and it was accompanied by much press coverage due to James Lellee's Olympic achievement some eight years earlier.

James Lellee had recruited a good team, and the service and the excellent facilities offered at the Sparkle club attracted a high number of members in a very short time. The new Sparkle club was recommended by members to their friends, and by the end of the first year membership was over 3,000, and the club was nearing break-even.

The growth of Sparkle clubs across Europe

On the basis of the very successful first year of the first Sparkle club, and the excellent reputation it had achieved in the very short period since it had been open, James Lellee decided that he would like to build other clubs in a number of European cities. An expansion programme was established and designs for a number of new Sparkle clubs in other cities were planned.

However, the company did not have sufficient funds to finance the expansion. James Lellee sought funding from Sparkle's bankers, using his personal property, as well as the first Sparkle club, as collateral for a substantial loan. This enabled him and Charles Juan to retain their original 60/40 share of the company.

James Lellee wanted to raise over €80 million to build Sparkle clubs in other cities, but was successful in raising only €60 million from Sparkle's bankers, who felt that the company should not expand too quickly. The bank insisted on holding the title deeds of the properties being acquired as security for the loan. The loan would be repayable in 15 years and was fixed at 12% interest per annum for the term of the loan. Loan interest is eligible for tax relief at 30%.

However, James Lellee wanted to press ahead with his plans and he had already located suitable sites for five of the planned new clubs. Furthermore, he did not want to build fewer new clubs, nor cut back on their specifications. Again, his fellow director Charles Juan came to the rescue and agreed to put together a loan, obtained from four of his wealthy friends. The terms of the loan required a fixed rate 3% higher than that of the bank loan. The full amount of this new loan of €20 million would be repayable in 15 years. As James Lellee wanted to expand rapidly, he accepted these terms on behalf of the company.

Within two years, the company was operating six Sparkle clubs. All were as successful as the first and membership was growing rapidly. All Sparkle clubs had a wide range of facilities including a large, well-equipped and properly-staffed gym, indoor and outdoor swimming pools, sauna and steam rooms, and a crèche facility. Some Clubs had squash and badminton courts as well as indoor and outdoor tennis courts. And two of the clubs that were built on edge-of-town sites even had company 9-hole golf courses and golf driving range.

Sparkle clubs were recognized as being among the best of the sports clubs, but James Lellee did not want to have the membership costs set too high. Instead, he decided that the success of Sparkle clubs should not be based solely on profitability, but should also measure the growth in membership. If Sparkle clubs could attract and maintain a large enough membership base, he believed that profitability would take care of itself.

Sparkle's policy of allowing free access to promising sportspeople had also attracted a certain amount of funding from various sports organizations. These organizations paid for the facilities used by some promising juniors, and also helped fill off-peak use of some of the tennis courts and this helped to achieve better utilization of facilities.

Many of the members of the Sparkle clubs had been members of other clubs in their respective cities and had switched to Sparkle clubs as the new facilities were better maintained and more competitively priced than other local sports clubs.

By the time that the sixth Sparkle club opened in 1990, James Lellee had recruited a good team of senior managers. He held the role of Chairman and Chief Executive and was actively involved in all areas of the business, especially the development of new clubs.

Charles Juan did not want to take on a full-time role with the company, but he held the role of Deputy Chairman. He helped James Lellee in the early years of the company's development by providing advice. James Lellee valued his judgement and often used him as a "sounding board" to discuss the company's future. Brief career histories of Sparkle's senior management team in 1990, who have since become directors, follow.

Charlotte Fine – Human Resources Director

Charlotte Fine, then aged 30, was previously HR manager at a leading international hotel chain, which had seen profitability rise significantly due to several factors, including the introduction of new working practices and increased staff loyalty due to an improved Employee Share scheme. Charlotte Fine was recruited into Sparkle when there were only 6 clubs, but she saw the HR Director role, her first directorship, as a great opportunity to enhance her career.

Adam Shah – Finance Director

Adam Shah had qualified as an accountant in his mid-twenties while working for a software development company. Since qualifying, he has had three career moves in ten years. Before joining Sparkle, he had spent four years as Chief Accountant for a company that operated a chain of 30 restaurants across Europe. Adam Shah was a member of a Sparkle club in the city where he lived. When he was approached about the role of Finance Director for Sparkle, he seized the opportunity to move into a company while it was still developing. Although he was very commercially mined, he lacked some financial planning skills and had no personal contacts with many of the key financial institutions.

Trevor Smith – Development Director

Trevor Smith, then aged 45, had worked in the construction industry in his twenties. He had then transferred into property management, working for a chain of high street shops, where he was responsible for site selection and development. He then progressed to become Acquisitions Manager for a Europe-wide chain of retail outlets. He saw his move to sparkle as a very exciting step, where he could help this newly-formed company grow rapidly. He was responsible for identifying suitable sites for expansion or other clubs in cities that Sparkle wished to expand to, which could possibly be acquired. He quickly formed a strong friendship with James Lellee and they worked well together in bringing the latter's ideas to life.

Ashley Wilkins – Marketing Director

Ashley Wilkins, then aged 33, had previously worked for a leading international advertising agency, followed by five years working as Marketing Manager for a smaller group of health clubs (Company D in competitor analysis shown in *Appendix 4*). He saw the opportunity at Sparkle as personally challenging and very exciting as the company had much potential. His remit was to promote the strong brand name that Sparkle had already created to boost membership numbers for all Sparkle clubs.

Stock market flotation in 1999

In 1993, after five years of operation and with 30 successful clubs across Europe, his management colleagues advised James Lellee that the company should consider flotation in a few years' time in order to raise additional finance to fund expansion. Initially, James Lellee was against the idea; with time, and discussions with Charles Juan, he agreed that it would be a logical way to grow the company.

By 1998, James Lellee recognized the need for a substantial injection of equity funds in order to reduce the burden of debt. The high levels of interest payments continued to cause cash flow problems as most of the expansion had been debt financed, and Sparkle had taken on a number of further loans from different financial institutions, since the original €80 million worth of loans. Indeed, on two occasions, interest payments had been rescheduled.

James Lellee and Charles Juan agreed to a flotation, and market analysis seemed to favour Sparkle as it had grown so rapidly since its formation only eleven years earlier. At the end of 1998, Sparkle had 42 operational clubs.

At the time of flotation in 1999, the company's stated ambitions were to have over 100 clubs in Europe by 2004, with expansion plans to operate over 200 clubs within 10 years. Sparkle publicised that it aimed to generate a return on capital employed of 20% and that it planned to reward its shareholders with both significant growth in share values and also annual dividends.

James Lellee wanted to retain a significant holding in the company, but Charles Juan, who already had personal wealth, agreed to reduce his shareholding down to 10%. Charlotte Fine proposed that a significant number of shares should be authorised for the use of staff performance-related purposes and that the six directors should also have share options.

The floatation of Sparkle was a public offer and Sparkle's advisers recommended an issue of 315 million shares of €1 nominal value, at a share premium of €0.26 per share because of Sparkle's good press coverage and the then buoyant state of the Stock Market. The issue was popular and was fully subscribed, although not as over-subscribed as analysts had expected. The shares initially traded at €1.41.

At the time of flotation in 1999, of the 400 million authorized shares, 315 million shares were issued and the main shareholding were as follows:

	Number of shares 000s	*% shareholding*
James Lellee	100,800	32.00%
Charles Juan	31,500	10.00%
Sparkle's other four Directors	160	0.05%
Individual investors	40,950	13.00%
Institutional investors	135,290	42.95%
Employee shares*	6,300	2.00%
Total number of share issued	315,000	100.00%

* *Note*: The employee shares were purchased by Sparkle and given to employees free of charge.

Of the shares held by institutional investors, 20% of Sparkle is held by Wye Ltd., a private equity group, which considers Sparkle to be a fast growth company. Wye Ltd wants high returns for its substantial stake in the company.

With the new injection of equity capital, Sparkle was able to repay all of its high-interest loans in full. It also negotiated a new loan of €200 million, which would be used to assist in the financing of further planned new clubs in the next five years. This new bank loan was repayable in ten years at a rate of interest of 9% per annum.

At the time Sparkle was listed in 1999, the company had six directors. An Executive share Option Scheme was established in order to reward these directors in the planned expansion produced the forecast results, which would lead to growth in the share price. The share option scheme allowed all six directors to purchase up to 1,000,000 shares each at any time up to 31 December 2009 at a price of €2.00 per share.

Sparkle in 2002

By the end of 2002, the group owned and operated 81 clubs around Europe. There were also 12 more that were in the pipeline to be built and opened in the next 18 months. By the end of 2002, most Sparkle clubs were continuing to be very successful and profitable, but growth in membership number was starting to slow down. The Sparkle management team had identified that some of the first Sparkle clubs opened had membership levels remaining static and in some clubs membership levels were even falling. This was partly due to these clubs not being equipped with "state of the art" gym equipment. This was particularly noticeable in certain cities where a competing chain of sports clubs had recently opened several clubs which were marketed at he same top level as Sparkle. Sparkle's response was to increase marketing spend to promote the corporate brand name and to run a series of promotional events at certain clubs.

At the end of 2002, Sparkle's membership numbers had reached 325,000 paying members. Many new Sparkle clubs were still establishing themselves in the marketplace and in these newer clubs, membership had not reached target numbers. The brand name of Sparkle was now widely recognized in the sports club marketplace as a premier brand. This had been achieved in two ways. First, the style and facilities of Sparkle clubs had been built to a very high standard and the clubs are exceptionally well maintained. Secondly, Sparkle clubs actually do value their members.

Many companies state that "the customer is king" but few companies in reality treat their customers well and take not of what they need and desire. Sparkle has a good track record of actively looking after its customers and reacting to their needs and wishes. James Lellee is especially pleased about this as this was his intention from the start.

James Lellee knows that most of his members come to Sparkle clubs to get away from the stress and hassle of life. They expect above average facilities that are in full working order and assistance to be available without having to go looking. Sparkle has set its staffing levels at a level whereby it is able to overcome any problems that occur. As with any business, sports centres have their problems such as faulty machines and staff sickness. Sparkle attempts to overcome these everyday problems with either no disruption to members, or with little noticeable inconvenience to members. Each club manager has full, delegated authority to take the necessary action to rectify the everyday problems that occur.

Accounting information and performance measures

Sparkle operates sports clubs in a number of European countries. Sparkle has separate operating companies for each country, which are wholly owned by the Sparkle group. In each country in which Sparkle operates, it has a small regional office, with administrative staff, managed by a regional manager (see Sparkle human resources, page 313).

The regional offices are responsible for all finance, administrative and human resource issues for that country, including the payment of all suppliers in that country. The regional offices are also responsible for the production of management information for Head Office, which they prepare with the help of individual club managers.

James Lellee had always been keen to look at non-financial performance measures. He felt strongly that high achievement in the areas covered by the non-financial performance measures would reflect positively in the financial data. Some of they key non-financial measures that the Sparkle management team reviews on a regular basis are:

- *membership statistics*. These include the number of new members, the number of members leaving and the overall growth, or reduction, in membership for each club;
- *utilisation of facilities*. The weekly statistics that are produced by each club include measures such as the number of people using the gym at certain times, the number of people attending exercise classes, and tennis, squash and badminton court usage at different time periods (including the hours when courts are not used);
- *the number of staff employed*. Staff numbers are expressed in full-time equivalents, as all clubs employ large numbers of part-time staff. For example, an employee who works half of the hours of a full-time employee is half a full-time equivalent;
- *ratio of staff numbers to membership numbers of each club*. James Lellee has always wanted sufficient members of staff to be around to help members and to actively encourage them to use the facilities more effectively;
- *average length of service for staff*. Charlotte Fine's objective was to build a good, high-quality team and she encouraged active participation in running and making improvements to each club. She felt that this helped to maintain good staff relations, so that each employee felt a part of the team and would not want to leave.

The key financial performance measures that Sparkle uses to monitor each club are growth in sales, profitability and return on capital employed (defined as operating profit for the club before interest and tax divided by net operating assets for the club).

Adam Shah is responsible for the company's IT strategy, but due to other demands on his time and demands on Sparkle's finances, the company does not use very sophisticated IT solutions. Sparkle operates some of its administrative systems centrally, such as the membership database, which all clubs are able to interrogate remotely. Each club's management has been left to develop its own forecasting and budgeting systems.

Each regional office a nominal ledger for the clubs in its own country, which can be accessed on a "read only" basis by both Head Office finance staff and individual club managers (for their club only). Therefore club management, and Head Office, can interrogate appropriate and relevant accounting information in the nominal ledgers, or membership details from the membership database, on demand. They can generate reports that analyse income and costs by club and cost code, as well as reports analysing the membership from the membership database.

During 2002, Adam Shah introduced an updated monthly financial report that management at each club, together with its regional manager, are responsible for completing and submitting to Head Office electronically. The report includes a profitability statement for the current month and financial year to date, a rolling 12-months' cash flow forecast and key financial performance indicators. These performance indicators include.

- average turnover per member;
- turnover per full-time equivalent employee;
- profit per full-time equivalent employee;
- return on capital employed;
- profitability per club.

Unfortunately, club management, regional offices and head office have problems producing and interpreting the monthly reports, due to errors with the basic data in the nominal ledgers. For instance, where employees have moved between clubs, there is often a timing problem with obtaining correct payroll details per club. Additionally, there are always large numbers of invoices that are not yet included in the nominal ledger system, as they have been incorrectly sent directly to the clubs by suppliers, instead of to the regional office accounts department. Furthermore, many of the utility bills (for heating and lighting) are invoiced quarterly. The accruals and prepayments, which need to be prepared to ensure that correct charges are incorporated into the monthly accounts, are not always done.

While the managers at each club play an important role in the preparation of accounting information for their respective clubs, there is a general feeling at club management level of a "lack of ownership" of the figures produced for club profitability. Furthermore, some club managers simply do not recognize many of the costs that appear in the nominal ledger for their club and produce alternative management information, which does not always reconcile with the company's nominal ledger. There is a lack of communication and co-ordination between club management, regional office administration staff and the Head Office finance team. The accounting problems are further exacerbated by the fact that many club managers are not very financially astute, despite financial awareness training that is regularly offered to them.

Adam Shah feels that the company needs to invest in improving, and thoroughly overhauling, its management reporting systems, as well as its marketing and membership databases, which proving inadequate to support current membership numbers. A recent internal audit of one under-performing club demonstrated that not all of the existing databases held consistent records. For example, when a member resigns from a Sparkle club, the individual should be removed from the marketing database, as well as the membership and billing database. Another problem had also manifested itself: a very small number of members appeared correctly on the membership and marketing databases, but did not appear on the billing database and had never been billed.

Profitability analysis

In 2002, Sparkle clubs produced a net profit before interest and tax of €40.6 million, a return on turnover of 14.3% (2001 was 17.7%). However, net operating profit after interest and tax fell by €21.3 million in 2002. This was mainly as a result of cash reserves failing, resulting in far lower interest receivable in 2002.

The company had capital employed of €686.7 million at the end of 2002 (average for 2002 was €681 million), which resulted in a return on capital employed of 6.0%. (Sparkle's total return on capital employed is defined as net profit before interest and tax divided by the average total assets less current liabilities for the year.)

The profit and loss account and balance sheet for Sparkle for the last two financial years are show in *Appendices 1* and *2* (see pages 315 and 316).

New Sparkle clubs usually turn profitable by the end of their second year of operation. In the first year of operation, after opening, the average ROCE is around 20% negative, and the second year averages a small negative ROCE. Therefore, within two years of building a new club, that club should have attracted sufficient membership to produce an operating profit. After that, each new club should increase its profitability as its membership grows and the management of each club improves.

The company was looking to achieve a far higher return on capital employed than it was currently achieving. However, the number of newer clubs, which had not yet turned profitable, distorted this statistic. A few of Sparkle's popular city-centre clubs were producing a ROCE of over 30% in 2002, whereas most of the new clubs were either still making losses or producing a ROCE of around only 4%. Additionally, there were eight clubs that had been operational for more than two years that were under-performing and were still showing an average ROCE of 10% negative each year. These clubs had an average capital employed of €9.9 million each.

The turnover of sports clubs mainly comprises fees paid by members either monthly or annually in advance of using club facilities. There is usually an element of prepaid income, which is shown as a current liability in the balance sheet, and there are none of the usual business problems associated with debtors and bad debts. The remainder of the company's turnover is additional fees paid for coaching or income generated in the clubs' restaurants and bars, and rental income generated from space let out to retailers of sports equipment and clothing.

Sparkle analyses its operating costs into five main cost categories. The breakdown of operating costs for the last two years is shown below:

Breakdown of Sparkle's operating cost	*2002* *€ million*	*2001* *€ million*
Staff costs	82.1	63.7
Utilities cost	46.8	39.6
Depreciation	30.2	23.6
Marketing costs	27.1	20.0
Other operating costs	21.3	16.1
Total	207.5	163.0

Sparkle's depreciation policy is as follows:

It is not possible, from information published by Sparkle's competitors, to fully determine their cost profile. However, as many of Sparkle's competitors provide a lower quality of service that is less manpower intensive, their staff costs are likely to be much lower. Some competitors simply offer a sports club that provides gym and swimming facilities only, with a very low staff force. They do not offer the many facilities and training that Sparkle clubs offer.

Sparkle is currently in negotiation with a small competitor, Company Z, which it is planning to acquire. Company Z has 12 clubs, which are operating profitably in a European country in which Sparkle has little presence. The owner of these clubs has given Sparkle's management access to some of the internal management accounts. These give a breakdown of their operating costs, as follows:

Breakdown of Company Z's operating costs	*Company Z 2002*
	%
Staff costs	28.7%
Utilities cost	21.1%
Depreciation	18.2%
Marketing costs	23.6%
Other operating costs	8.4%
Total	100.0%

Capital expenditure

History of date

The cost of building a Sparkle club varies widely, although every Sparkle club is built to the same high specifications. Each club offers different facilities, depending on its location. Some sites are edge-of-town or city suburb sites, whereas others are prestigious city-centre clubs.

Sparkle's policy is to build new clubs on carefully selected sites and to construct purpose-built clubs to its own high specifications. However, on many occasions, a suitable site in a city that Sparkle had targeted had not been available. Where a sports club or a chain of clubs belonging to a competitor had suitable facilities, Sparkle has been able to acquire either an individual club, or a small number of clubs. In order to expand the number of clubs over the next five years, Sparkle plans to build around 60% from new, with the remainder through acquisitions. It has not yet been decided whether the acquisitions will be small numbers of clubs in different European countries or possibly a major acquisition of one of Sparkle's competitors.

The capital cost of building new clubs varies. A large club with tennis, fitness, swimming and golf facilities costs considerably more than the average site, depending on the location of the site itself and of the site itself and the cost of land, which varies depending on the city. Over the last few years, the average cost of newly-built Sparkle clubs has been around €11.5 million each. This average cost has been based on a smaller club costing around €10 million and larger clubs (which offer a greater range of facilities) costing around €15 million.

As a general measure, Sparkle has paid an average of €9 million for clubs acquired from competing companies, which have generally been smaller city-centre clubs with limited facilities, such as only fitness and swimming. Clubs that are acquired are re-branded after acquisition and require a significant amount of capital expenditure, averaging over €2 million per club, to bring facilities in line with Sparkle's corporate guidelines, and to maintain standards across the company.

An exception to these average costs is one club that Sparkle acquired in a major European city centre. This club was previously owned and operated by a competitor, which operates a very small number of high-profile, elite sports clubs, which are frequented by some very famous personalities and also minor members of royalty. For this prestigious club, Sparkle paid a high premium, as it was purchasing a high-profile club with luxury facilities and fittings in an excellent city-centre location. This club already had a large number of wealthy members who were largely insensitive to the country's economic conditions.

Sparkle paid in excess of €50 million for this prestigious club, which is now the "flagship" of the Sparkle clubs. This club generated a turnover of around €10 million in 2002. The elite membership of this club added to the prestige of the Sparkle brand and was marketed to promote membership of other Sparkle clubs across Europe. Ashley Wilkins was very enthusiastic about this acquisition as he felt that it would enhance Sparkle's standing and help boost membership at other Sparkle clubs. At the time of the acquisition, Adam Shah argued vehemently that the company was paying too much. However, James Lellee saw this as an opportunity to acquire the club and, after much negotiation, agreed to this price. The club was profitable and the previous owner was selling it to fund other activities.

Capital expenditure has been running at around €100 million per year for the preceding three years, with a record amount of capital expenditure in 2002 of over €160 million.

Future plans

The company's current five-year plan, prepared in January 2003, shows that the number of Sparkle clubs is planned to grow from 81 clubs at the end of 2002 to 200 clubs by the end of 2007. To achieve this growth in the number of clubs, Sparkle plans to build some new clubs itself, and its management is also looking to acquire existing sports clubs, and to re-brand them. The planned capital expenditure for the next five years is forecast to be around €1,500 million if Sparkle is to grow at the rate that James Lellee and Trevor Smith would like. Details of the five-year capital expenditure plan are shown in *Appendix 3* (on page 317).

Trevor Smith has been examining several small chains of clubs that are operational in cities across Europe where Sparkle has currently little, or no, presence. These could provide Sparkle with a fast entry into those cities, particularly where prime sites are not frequently available.

It is planned that nearly half of all new Sparkle clubs in the next five years will be acquired from a number of competitors around Europe, such as Company Z. Acquiring clubs from competitors has many advantages and also many disadvantages; the key is getting the right sized club in the right location, at an acceptable price. It also speeds up the process of clubs achieving profitability sooner, as clubs acquired already have large number of existing members. While the plan is to acquire a small number of clubs each year from competitors. Sparkle has not ruled out one or more major acquisitions (of large numbers of clubs) if the locations and the acquisition price are acceptable.

Since flotation of the company, Adam Shah has become increasingly worried about the continued fast rollout of new clubs. The loan of €200 million taken out in 1999 has almost entirely been exhausted, and existing clubs are not yet generating sufficient cash from operations to finance the continued capital expansion programme.

Trevor Smith feels that Sparkle ought to diversify into a complementary sphere, and consider acquiring a chain of restaurants. He is pleased that the restaurants that Sparkle currently operates within each club are profitable and he feels that this is an area that Sparkle should expand into. He has brought to the attention of James Lellee a chain of restaurants that has recently been offered for sale by an international company that wants to concentrate on its core business activities. The next Sparkle Board meeting will discuss this proposed acquisition.

Sparkle human resources

Charlotte Fine has been responsible for recruiting and training a large workforce in the past 10 years, which is employed in such diverse fields as fitness training and coaching, catering, sports club management, finance and administration, and marketing. The company's ethos is to deliver a high quality of service to members and each member of staff has been carefully recruited and trained and works as part of a team.

The staff structure of the company is that each club has a manager who is responsible for all staff and activities in that club. As the number of Sparkle clubs grew, covering a number of European countries, it was necessary for James Lellee to introduce a new layer of management between individual club managers and Sparkle's directors. In early 1996, Sparkle appointed its first regional manager, and by the end of 2002 Sparkle had six regional managers. Each regional manager is responsible for managing between 10 to 15 clubs, and reports directly to James Lellee, with a dotted line relationship to the other Sparkle directors. The regional managers are responsible for managing a small finance and administrative staff, and they manage all payroll and human resource issues for their region.

The regional managers oversee the running of clubs and particularly assist with all new clubs. Regional managers assist with staff recruitment and staff training needs and also help to monitor each club's growth in membership and financial results. They are responsible for identifying under-performing areas within a club. Furthermore, if a club fails to become profitable within two years of launch, the regional manager will assist the club manager with implementing remedial action.

James Lellee always wanted every area of his clubs to offer excellent service and he felt that the only way the club could deliver this was to recruit high-quality staff in the first place. The company then trains and rewards its staff, in order to foster good company relations and to enjoy the benefits of low staff turnover and good team morale. The company also offers its staff the ability to move internally within the company, either to a different role within the same Sparkle club or to transfer to other Sparkle clubs around the country or within Europe. This policy has been very popular with many of the staff.

In many areas, Charlotte Fine has recruited graduates and offered them a fast tract to management. The recruitment of young, keen graduates followed by training in the goals and ambitions of Sparkle, enabled individuals to quickly learn the business and progress rapidly in terms of salary and responsibility. Growing its own management in this way is regarded by Charlotte Fine as cost effective, compared to the slow recruitment of managers from competitors or the recruitment of managers with little understanding of the sports club marketplace. The resultant Sparkle management team is young and responsive to the needs of members.

By the end of 2002, Sparkle employed nearly 5,700 staff, of which 3,800 were full-time employees, with the remainder of the employees working part time (averaging 16 hours per week). The number of full-time equivalent employees at the end of 2002 was 4,610.

Since flotation in 1999, the company has adopted a policy of rewarding staff with free shares. The shares that are given to staff free of charge are purchases by Sparkle on the open market. An employee is entitled to free shares from the "Employee Share Scheme" each year in accordance with the following criteria:

- all staff receive a standard fixed allocation each year dependent on the overall profitability of the company;
- staff from each club can be nominated for additional free shares by club managers, based on their personal performance during the year;
- all staff at a club receive an allocation if that club's membership numbers and turnover targets are achieved.

In 2002, staff received a total of 4,300,000 shares. At the end of 2002, Sparkle employees held 18,900,000 shares, which represents 6% of the shares in issue. The total number of shares in issue remains at 315 million.

Competitor analysis

Sports clubs exist in a very crowded marketplace, in which there are many large companies operating chains of sports clubs similar to Sparkle's. There are also individual clubs in most cities that are successful as they differentiate their facilities and service to their members.

The type of customer that is attracted to sports clubs is looking to choose a club that meets several criteria. Some are simply looking for good value for money and will select a club with basic facilities at the cheaper end of the scale. Other, more discerning, customers want more extensive facilities. Location and convenience as well as good service, remain important features, which is why Sparkle has chosen its sites so carefully.

Sparkle has consistently marketed itself as having the best facilities with excellent service and sports instructors. It is recognized as being at the top end of the private sports club market. Some other sports companies operate large number of clubs that provide a fairly basic gym and few other facilities, and have a substantially cheaper membership cost. They are also more profitable than Sparkle as their staff and running costs are lower.

A comparison of Sparkle with six of the many companies in the sports club market place is shown in *Appendix 4* (on page 318).

Appendix 1

Sparkle

	2002	*2001*
Number of clubs – end year	81	67
Number of clubs – average for year	74	63
Profit and loss account	*€ million*	*€ million*
Turnover	284.2	231.0
Operating costs	207.5	163.0
Gross profit	**76.7**	**68.0**
Administration expenses	36.1	27.2
Net profit before interest and tax	**40.6**	**40.8**
Net interest payable	(11.6)	(5.9)
Taxation on ordinary activities	(7.7)	(8.7)
Net operating profit after interest and tax	**21.3**	**26.2**
Dividends paid and proposed	9.9	9.5
Retained profit for the financial year	**11.4**	**16.7**

Appendix 2

Sparkle

Balance sheet	*End 2002* *€ million*	*End 2001* *€ million*
Tangible assets		
Gross book value	845.2	683.1
Depreciation	108.5	87.9
Net book value	**736.7**	**595.2**
Current assets		
Stock	2.8	2.0
Debtors	10.4	9.1
Cash and short-term investments	26.8	132.3
Total current assets	**40.0**	**143.4**
Current liabilities		
Amounts due within 1 year		
Trade creditors	13.7	6.8
Corporation tax	7.1	8.0
Other tax creditors	2.8	2.2
Deferred income*	61.4	41.6
Proposed dividends	5.0	4.7
Total current liabilities	**90.0**	**63.3**
Net current assets/(liabilities)	**(50.0)**	**80.1**
Creditors falling due after 1 year		
Bank Loan	200.0	200.0
Net assets	**486.7**	**475.3**
Financed by		
Called up share capital	315.0	315.0
Share premium reserve	81.9	81.9
Profit and loss reserve	89.8	78.4
Total equity shareholders' funds	**486.7**	**475.3**

* *Note*: Deferred income represents membership fees paid in advance

Appendix 3

Sparkle – five-plan

Analysis of number of clubs and capital expenditure

	2003	*2004*	*2005*	*2006*	*2007*
Number of clubs					
Additions in the year	81	95	115	139	168
New build	9	10	12	17	20
Acquisitions	5	10	12	12	12
Number of clubs at end of year	95	115	139	166	200
Cost per club	*€ million*	*€million*	*€million*	*€million*	*€million*
New build	11.5	11.5	11.5	11.5	11.5
Acquisition	9.0	9.0	9.0	9.0	9.0
Re-branding per acquisition	2.0	2.0	2.0	2.0	2.0
Total forecast capital spend	*€million*	*€million*	*€million*	*€million*	*€million*
New builds	103.5	115.0	138.0	195.5	230.0
Cost of acquisitions	45.0	90.0	108.0	108.0	108.0
Re-branding	10.0	20.0	24.0	24.0	24.0
Improvements	5.0	10.0	10.0	10.0	10.0
Major repairs	5.0	10.0	15.0	25.0	40.0
Total capital expenditure	168.5	245.0	295.0	362.5	412.0
Cumulative gross book value of tangible assets	1,013.7	1,258.7	1,553.7	1,916.2	2,328.2

Appendix 4

Comparison of Sparkle to six competitors in the sports club market place

	Sparkle	*A*	*B*	*C*	*D*	*E*	*F*
Number of clubs in Europe [end of latest year]	81	49	148	45	20	18	62
Turnover (€ million) [latest year]	284	181	370	171	44	74	171
Annual % growth in turnover [latest two years]	23%	6%	18%	19%	5%	4%	22%
Share price:							
End December 2002	€1.60	€2.48	€2.09	€0.76	€0.90	€1.34	€4.43
Highest is 2002	€1.88	€3.19	€4.23	€1.18	€0.94	€3.42	€6.98
Lowest in 2002	€1.27	€2.04	€1.98	€0.45	€0.67	€1.29	€3.60
Earnings (€ million) [latest year]	21.3	13.4	32.9	11.8	3.7	8.9	15.3
Earnings per share	€0.0676	€0.1576	€0.0941	€0.0347	€0.01069	€0.1595	€0.1784
P/E ratio* [December 2002]	23.7	15.7	22.2	21.9	8.4	8.4	24.8
Gross book value of clubs'tangible assets (€ million)	845.2	480.2	710.4	418.5	262.0	181.8	316.2
Return on capital employed**	6.0%	8.2%	15.6%	7.9%	5.4%	13.1%	13.0%
Gearing***	29%	35%	45%	28%	42%	30%	28%
Number of full-time equivalent employees	4,610	2,550	6,070	2,600	560	1,040	2,240

Notes:
* The industry average P/E ratio is 18.4.
** Return on capital employed is defined as net profit before interest and tax divided by the average total assets less current liabilities for the year.
*** Gearing is defined as loans and borrowings as a percentage of total equity shareholders' funds plus loans and borrowings.

6.7 Analysis of Sparkle pre-seen material

6.7.1 Précis of main points of each page

Work methodically through the pre-seen and make a précis of the main information and points.

Page	*Main information*	*Significance*
2	• Case involves the leisure & fitness industry	• Clear indication of differentiation v. cost leadership
	• Industry has premium pricing for quality	
	• Financial performance of clubs has been mixed and take-over's and rebranding common	• Issues in industry
	• James Lellee, sportsman, set up his first sports club due to dissatisfaction with existing provision	• High volatility of industry will make it hard to develop strategy • Some concern over business experience and motivation of Lellee
3	• Initial finance of €10m for first club provided by personal friend Charles Juan	• Clearly a business built on passion
	• Doubts expressed over Lellee's ability as businessman	• More doubts about Lellee's business skills
	• First club opened 1998 and was successful	
	• Break even membership 3,000	
	• Lellee keen to grow rapidly and internationally	• Break even revenue 3m pa (3,000 – average spend of 1000)
	• Initial growth funded by debt secured on Lellee's assets but banks prepared to lend	
	• only €60m not full €80m @ 12%	• High gearing and penal interest rates suggest high risk
	• Balance €20m borrowed informally @ 15%	
	• All loans repayable in 15 years (1988 – 15 – 2003!)	• Note, Juan not prepared to invest more • Lellee blinded to risks by his enthusiasm and vision • Will loans fall due for repayment in May 2003 exam?
4	• Six clubs by 1990 with premium reputation	• Lellee has total power but is not strictly commercial in outlook
	• Lellee thinks success not only profitability	
	• Lellee CEO & Chairman	
	• Building of a management team by 1990	
	• Charlotte Fine seems good recruit as HR Director	
	• Adam Shah lacks planning and investor relations skills needed in a Financial Director	• Sparkle shifted from entrepreneurial to functional structure by 1990
	Trevor Smith seems well-qualified as Development Director	• Weak financial controls not good in a geared company
5	• Ashley Wilkins is Marketing Director and worked for smaller rival D	• Demonstrates that growth leads to cash burn as clubs rose from 6 to 42 in 8 years
	• Debt caused by growth forced flotation in 1999	
	• 42 operational clubs by end of 1998	
	• Key goals at flotation = 100 clubs by 2004 and 2000 by 2009 + 20% ROCE = significant dividend growth	

	• Sparkle shares were issued at €1.26 in 1999 and raised €397m but were issued 11% below market value	• Goal of rapid expansion whilst raising dividends is unrealistic given past record of cash burn. Suggests Shah not good forecaster
	• Lelle and institutions were main	• Sparkle given poor corporate finance advice or stock market hard to forecast?
	• Shareholders in 1999 (74%)	
6	• Wye Ltd. Private equity holds 20% of Sparkle and wants high returns	• Venture capitalists will have conflicting motivation from Lelle
	• New loan €200m @ 9% repayable in 2009	• Average membership/club – 4012 which is above earlier breakeven of 3,000
	• Share options scheme for Directors €2 per share before 2010	• Suggestions of saturation of market
	• 81 clubs and 325,000 members by 2002	• Need for additional capex to maintain membership will strain cash flows if expansion continues
	• Problems in new clubs not reaching target numbers despite good reputation. Older clubs run down	
	• Lelle customer orientated High degree of delegation to club managers and country managers	
7	• Balanced scorecard in place	• How well does balanced scorecard measures track and deliver the financial results shareholders want?
	• Indication that IT/IS is not good	• Suggestion of weak financial control over clubs
	• Club managers responsible for forecasts and Budgets	
	• Systems improved during 2002	
8	• New system not working due to data problems and 'lack of ownership' of budgets	• Further evidence of weak financial control over clubs
	• Low financial awareness at club level	• Expansion strategy in trouble and dragging down profits and cash flows
	• Profitability falling and cash flow problems emerging in 2002	• Issue seems to be that Sparkle is running out of locations or is running into stiffer competition
	• New clubs struggling to become profitable within 2 years forecast (e.g. 8 have 10% negative ROCE after 2 years)	
9	• Data on Company Z's costs compared to Sparkle's	• Comparison between Sparkle and Z will show potential for improvement to Sparkle's financial results
10	• Sparkle has choice on whether to build Greenfield new clubs or acquire existing clubs are re-brand them. Current plan is expansion 60%/40% in favour of Greenfield development	• Expect to be asked whether financial problems can be resolved by using acquisitions more because they're cheaper and repay quicker.
	• Sparkle bought prestigious 'flagship' club for €50m which generates €10m pa. Purchase resisted by Shah (FD)	• Consider other pros and cons of external versus organic growth
	• Commitment to €1.5b capex over 5 years	• Flagship club generates 20% turnover to assets compared to 58% for Sparkle as a whole indicates Shah was right. • What does this say about the commercial judgement of Lellee and his 'strong friend' Wilkins? • Capex looks unaffordable from current diminishing cash flows. Sparkle is in danger of overtrading.

11	• More details on external growth and mentioning that clubs will 'be like' Company Z	• Consider whether applying Sparkle's cost and revenue rations to Z would increase or reduce the value of clubs acquired
	• 1999 loan exhausted indicates that Sparkle needs a capital injection soon	• The viability of the expansion plan is a key issue in this case
	• Trevor Smith (Development Director) wants to diversify into restaurants. This will be discussed at next board meeting	• Expect to be asked to evaluate a restaurant diversification in the exam
	• Some repetition on organisationsl structure and Lellee's vision and commitment	
12	Details of staff incentive and remuneration scheme	• Does Sparkle need to be so generous with its staff and what does it get in return?
	• Repeat detail on market emphasising its competitiveness	• How will staff be affected if Sparkle's share price falls or rises?
13–16	• Detailed financial information to be evaluated separately	• Expect to be asked about acquiring one of these other clubs or, perhaps, receiving an approach to merge or be taken over by one, in the exam
	• Shows falling profits	
	• Shows comparisons between Sparkle and other clubs	

6.7.2 Applying technical knowledge to Sparkle

Working through the techniques covered in Chapter 4 the following additional insights can be gained:

Technique
The four elements of strategy (competitive, financial, investment and risk)
Using ratios to conduct a financial analysis of a company's position
Assessing a business portfolio
Industry analysis
Position audit
Conducting a managerial and organisational audit
Critical success factors
Assessing information systems strategy
Assessing corporate risk
Assessing the cost of capital
Conducting a corporate appraisal (SWOT analysis)
Business valuations
Generating strategic options
Evaluating strategic options

6.7.3 Four elements of strategy

Sparkle is pursuing a competitive strategy of differentiation in the European leisure club industry. It is seeking to grow rapidly to catch up with the much larger, and still growing, competitor B. Its financial strategy has been to use principally equity (71%) raised at flotation and to promise high current returns and promising growth. The finance has been used to build a chain of 81 clubs between 1988 and 2002 and to expand these to 168 by 2007 via a 60/40 mix of new development and acquisition. However this fast growth rate and poor cash flows from recent clubs means it must raise more capital if it is to meet its goals. Its ROCE of 6%, share price growth of 13% in 3 years (€1.60/€1.41) and annual dividend growth of 4.2% (9.9/9.5) means it has not met the promises it made to investors at flotation. Aside from specific operational risks, such as health and safety issues at clubs, the main risks Sparkle runs relates to financial risks as its growth strategy is reducing earnings and straining cash flows (its cash balances have declined by 80% between 2000 and 2001).

6.7.4 Financial analysis

Using the data from Appendices 1–4 on pp. 315–318 of the CIMA Learning System the following information can be extracted:

Ratio	*2002*	*2001*	*Comments*
ROCE (PBIT/TA-CL)	6%	6.04%	Slight reduction due to new clubs having negative ROCE
EPS	€0.0676	€0.0831	19% fall in EPS. This will affect the share price
Gross margin%	27%	29%	Slight fall reflecting poor returns from new clubs unable to gain critical mass of membership
Net margin PAT/Sales	7.5%	11.3%	Serious fall of 3.8% that needs investigation
Admin expenses/sales	12.7%	11.8%	Extra 1% of gross margin absorbed by increased admin costs
Net interest costs/sales	4.1%	2.6%	Extra 1.5% of gross margin absorbed by interest. This will increase if expansion continues
Asset/Turnover Turnover/TA-CL	0.41 times	0.37 times	Apparent improvement mainly due to using up of €105.5m of cash reserves from loan raise din 1999 to open 14 new clubs
Gearing loans + borrowings/ equity + loans + borrowings	29%	29%	No material change and remains moderate. Some room for increased gearing.
Current ratio	0.44	2.27	Sharp fall appears worrying. However this is principally due to fall in cash reserves and rise in deferred income. Unless the firm stops trading there is no reason to expect that Sparkle will be called on to repay these advance fees.
Interest cover	3.5 times	6.9 times	Deterioration underlines the increased risk run by Sparkle as it builds more loss making clubs using cash that previously earned it interest.
Dividend cover	2.15 times	2.76 times	Slight deterioration reflecting negative cash flow implications of Sparkle's growth.

Sparkle seems to be heading into cash flow problems and lower profitability and hence lower EPS.

There also seems to be a falling share price which, according to Appendix 4 in sparkle case, has slipped from €1.88 to €1.60 during 2002. In 2001 Sparkle paid a €0.0302 dividend (9.5/315) so assuming the higher price was the cum div price inflated by this amount, and that the price at the end of 2002 contained no anticipated dividend, it still suggests a fall from €1.85 to €1.60, a fall of 13.5% precipitated by the 19% fall in EPS. The fall in the earnings is due to the rapid building programme of clubs that create more costs than revenues for the first 2 years of their existence. However, assuming that markets are efficient this should not affect the share price if the clubs generate a present value of future earnings in excess of the current costs of development and the present value of future earnings in excess of the current costs of development and the present value of initial losses. The falling share price suggests that investors are beginning to doubt that Sparkle will generate the profits anticipated.

However this observation should be treated with caution. Because the majority of shares in Sparkle are held by directors and Wye Ltd. At most only 38% its shares can potentially change hands on the stock market. Share price volatility is likely to be greater in a thinly traded share like this and so perhaps the share price does not properly anticipate the future earnings of Sparkle in the way assumed by the efficient markets hypothesis (EMH).

The following additional financial analysis is useful:

	Sparkle	*A*	*B*	*C*	*D*	*E*	*F*
ROCE%	6.0	8.2	15.6	7.9	5.4	13.1	13.0
Net margin %	7.5	7.4	8.9	6.9	8.4	12.0	8.9
Asset T/O	0.34	0.38	0.52	0.41	0.17	0.41	0.54
Turnover Per club €m	3.5	3.7	2.5	3.8	2.2	4.11	2.76
Assets per club(€m)	10.4	9.8	4.8	9.3	13.1	10.1	5.1
Turnover per employee	€61,605	€70,980	60,955	€65,769	€78,571	€71,154	€76,339
Employees per club	57	52	41	58	28	58	36

Competitor A shows the benefits of better asset utilisation due to lower growth rate. It has marginally less equipment and staff per club than Sparkle (perhaps marginally smaller clubs?) but better utilisation of assets (staff and fixed assets). Perhaps once Sparkle stops growing it can perform similarly.

Competitor B is the most successful club given its high ROCE (15.6%) resulting in part from a high net margin but mainly from high asset turnover due to low asset investment per club. Its clubs seem to be smaller than Sparkle's (lower assets per club and employees per club) which suggests it is focusing on fitness equipment rather than the more resource intensive activities such as pools and courts.

Competitor C also has better asset utilisation than Sparkle, which gives it a better ROCE despite also having a rapid growth rate.

Competitor D seems in trouble. It has seemingly elected for a capital intensive approach with very few staff and very high asset investment. It forecasts little growth and enjoys the poorest ROCE.

Competitor E has similar levels of staffing and equipment to Sparkle but is able to generate a better ROCE due to greater utilisation or perhaps greater spend per customer as reflected in its better net margin and asset turnover. However with only 18 clubs it is possible that E is focused on a premium segment that is not large enough to accommodate the number of clubs that Sparkle operates. Clearly E does not anticipate much growth.

Competitor F seems to be a cost leader with very low staff and asset investments in the club, which, despite low turnover per club, does generate a good ROCE. Like B is probably focused on simply fitness and avoids the high cost assets of a full leisure club.

Another piece of comparative analysis inferred by the case is to compare Sparkle with Company Z:

	Z *2002*	*Sparkle* *2002*	*Sparkle* *2001*	*Comments*
Staff costs	28.7	39.6	39.0	Reflects Sparkles commitment to higher staffing
Utilities	21.1	2.6	24.3	Improving but perhaps due to other costs rising faster!
Depreciation	18.2	14.6	14.5	Surprising given Sparkles high investment in assets. Could suggest inadequate provision for depreciation in accounts and therefore in budgets?
Marketing	23.6	13.1	12.3	Significantly lower but this could be due to Z being smaller
Other	8.4	10.3	9.9	

6.7.5 Business portfolio

Sparkle's portfolio is simple. There are presently 81 clubs of varying sizes in which the new ones were forecast to be negative return for 2 years but in practice seem to be remaining as Problem Children for longer. Earlier clubs yield an ROCE of 30%, which, if compared to the negative 10% ROCE of the recent clubs and the group ROCE of 6%, seem to be cash cows.

However the positive cash flows from these earlier clubs are not sufficient to finance the growth of Sparkle and so cash balances have declined.

The unusual part of Sparkle's portfolio is the 'flagship club' bought for €50m but returning only €10m turnover: asset turnover of 0.2 compared with group asset turnover of 0.34. Although supposed to add additional respectability to Sparkle's brand by association with its exclusive clientele its hard to see how this will work. The name of Sparkle is unchanged since 1988 and the clientele at the flagship club will presumably not welcome its renaming as Sparkle.

It is worth noting that, according to the data in Appendix 4 (given on p. 318), Sparkle has a relative size of 0.76 by turnover and 0.55 by clubs compared to competitor B (its not possible to assess relative market share as the BCG matrix requires because we are not told the size of the entire market not whether the clubs are evenly spread across Europe). However it is noticeable that B also has the highest ROCE, which does suggest competitive strength.

6.7.6 Industry analysis

Industry life cycle stage seems to be growth for leisure clubs. This is reflected in the high P/Es for the clubs on p. 318 in Appendix 4 that are intending to grow. Given that some of the others are struggling it suggests that some growth will be accomplished by acquiring these.

However, the fact that Sparkle is finding that more recently opened clubs are not returning profits so quickly could suggest that the market is reaching a shakeout phase due to slowing demand growth whilst provision continues to grow.

Competitive position of Sparkle is broad market differentiation whilst it seems Competitors B and F are cost leaders. Competitor E seems to pursue differentiation focus.

This leaves A or C as potential acquisition targets is Sparkle wants to grow. They both have similar operational characteristics to Sparkle and with a lower PE ratio than Sparkle could permit an increase in shareholder value if acquired.

PEST factors are not discussed in the pre-seen material and would need researching. Factors to consider would include:

Political/Legal:

- government policy on encouraging healthy lifestyle through subsidies to government run leisure and sports centers;
- changes in health and safety legislation affecting the staffing and costs of clubs;
- taxation changes on employment, for example, the treatment of self-employed coaches used by Sparkle.

Economic:

- The disposable and discretionary incomes of Sparkle's clientele (Leisure clubs may be luxury that will be cancelled in a recession.);
- Interest rates given that Sparkle may soon be borrowing capital to expand;
- The attitude of the stock market to investments in such intangible businesses as leisure centers.

Social:

- attitudes to fitness and health. Generally we assume people are becoming more conscious of their physical appearance (This will help Sparkle.);
- demographic changes affecting the age of new members.

Technology:

- new fitness equipment (e.g. smart card activated) that will hasten the obsolescence of Sparkles equipment and force additional investment;
- new fitness regimes which may necessitate re-training of staff.

6.7.7 Position audit

Using the M's model we note the following:

- *Manpower*: Staffing is high compared to Z and most other clubs and costs of average €17,809 per employee (€82.1 m/4,610). However they are a source of our differentiation. Effectiveness of employee share scheme to motivate and retain staff will decline if share price continues to fall.
- *Management*: We have doubts about the motivation and commercial acumen of Lellee (and of Wilkins) and also the competence of Shah. There is also a problem of lack of financial know-how at club level, which seems to harm financial control in Sparkle. The shares owned by directors since Sparkle's flotation are falling in value and this may precipitate some action. How long will shareholders put up with the current financial performance before Directors are put under pressure by shareholders to deliver better financial results.
- *Money*: Financial performance has not met the promises at flotation in relation to ROCE (20% promised but only 6% achieved), share price growth (its value has risen slightly but is now heading downward) or dividend growth. Sparkle's growth will force it to raise additional capital soon.
- *Makeup*: Basically a functional structure with large degree of autonomy given to club managers and regional managers. Tier of regional managers seems unnecessary given use of balanced scorecard to evaluate and control club management.

- *Machinery*: Some suggestions that equipment is run down in older clubs, which may be consequence of inadequate depreciation rate. Quality equipment is one of Sparkle's differentiating features.
- *Methods*: No specific points here.
- *Markets*: Second largest club in Europe with wide network and good reputation.
- *Materials*: Nothing specific mentioned.
- *Management information*: Forecasting has been poor and new accounting information systems and balanced scorecard need to be implemented properly.

6.7.8 Organisational and managerial audit

- All key functions except IT/IS have appropriate management.
- Some reservations over Adam Shah (FD) due to lack of financial planning skills and investor contacts. However this statement was made regarding his experience in 1999 and things may have improved since.
- James Lellee seems to lack the clear profit motivation than several significant shareholders will expect.
- Clear weaknesses at club level affecting financial control and management information.

6.7.9 Critical success factors

Revenues in this industry are the key to success because costs are mainly fixed. That is, if a facility is open then health and safety will demand a minimum level of staff cover. Other staff costs, such as coaching, are entirely variable with volume and a profit is built into the mark-up on their fees to clients. Therefore profits increase rapidly once breakeven is passed, as demonstrated in the pre-seen material shown above.

Revenues will be driven by:

- number of members,
- spend per member (e.g. fees, coaching, sports clothing and accessories, refreshments, etc.).

The Pre-seen also makes reference to loading of clubs during the day. This opens the opportunity for price discrimination to boost income, say by having lower fees during the day for non-working members but premium rates in evenings and weekends for working members. If costs are fixed then Sparkle should aim to maximise revenues in this way.

In terms of growth of the club the critical variable would be location of the club. The early clubs were in city centres but it seems likely that with 81 operating clubs that Sparkle will be exploring secondary locations. Moreover facilities like golf courses, pools and courts will not be viable in city centres due to the high costs of space.

6.7.10 Information systems strategy

This seems to be a weakness at Sparkle. We are told that Adam Shah does not have the time to improve it. It is also interesting that it is controlled by the FD. This suggests that it is mainly an operational accounting system and may lack the customer facing attributes of a CRM system.

Using Earl's grid it should be reassessed to see if it can yield:

- better financial information (say on fees and refunds);
- better customer information (e.g. spend per visit);
- better customer support (e.g. bookings, access to fitness records, programming of gym equipment).

6.7.11 Risk

The case does not give examples of particular risks. The issue of cash flow and overtrading has already been discussed.

6.7.12 Cost of capital

A rough cost of equity can be derived from the dividend growth model as follows.

Therefore using 2000/01 as the basis

$$K_e - g = \frac{D_0(1 + g)}{P_0}$$

$$K_e - g = \frac{9.9(1 + 0.042)}{504.81}$$

$$K_e = 6.2\%$$

P_0 is arrived at using data from page 16 being P/E × Earnings, that is, 23.7 × 21.3 = 504.81.
Dividend growth rate is per page 139.9/9.5 = 0.042.
The pre-seen material shown above states that loan interest qualifies for 30% tax relief.
Therefore a rough WACC is given by:

$$\frac{(200 \times 0.063) + (486.7 + 0.062)}{200 + 486.7} = 6.23\%$$

This is higher than Sparkle's 2002 ROCE of 6% which suggests destruction of shareholder value equal to €1.46m in 2002 (6.23% − 6% × total shareholder's funds of €486.7m). However as has been stated, the profits of Sparkle are depressed by the investment in new clubs and the losses in 8 of the recent clubs.

6.7.13 Corporate appraisal – SWOT analysis

Strengths:

- respected brand,
- second in market,
- profitable.

Weaknesses:

- uncommercial CEO/Chairman,
- deteriorating cash position,
- recent clubs loss making,
- loss of financial control at club level,
- high relative staff and equipment costs,
- falling share price,
- failure to live up to promises at flotation.

Opportunities:

- acquisition of struggling clubs,
- fitness lifestyle growing,
- expanding market.

Threats:

- signs of market saturation,
- intervention by Wye Ltd. If growth not delivered,
- expansion may lead to overtrading,
- potential takeover from another club as industry consolidates,
- price competitive market.

6.7.14 Value of Sparkle

Market capitalisation stands at €504.81 which is slightly (3.7%) above its net assets value of €486.7. If share price falls further it would become a break-up target.

For example, if valued on P/E of B or C its market capitalisation would be below its net assets value.

Highest value, using Competitor F's P/E 5 (€21.3 × 24.8) 5 €528.24 m.

6.7.15 Strategic options

This case contains clear guidance on the strategic options being considered by Sparkle's board. These are:

- to grow according to the 5-year plan to 2007,
- within the above, to choose whether to grow by acquisition of by greenfield development,
- whether to diversify into restaurants.

You should expect to be asked to evaluate these both financially and with reference to the issues confronting organic versus external growth.

6.7.16 Evaluating strategic options

These can be evaluated using the three criteria suggested by Johnson & Scholes:

	Option	*Suitability*	*Acceptability*	*Feasibility*	*Preliminary verdict*
Grow	according to 5-year plan	• Sparkle needs to overtake market leader B if it believes there may be a benefit in being able to offer a complete Europe-wide coverage of clubs	• Unlikely to be accepted by Wye Ltd who will be looking for strong capital growth in shares to make a return. This can only be achieved if investment stops	• Doubts over whether Sparkle can afford this growth	• Unless bargain club becomes available do not implement at the moment
		• Will severely strain finances and lead to further decline in earnings	• Lellee will wish to continue with growth despite poor financial return	• Need to improve management control before committing to more clubs	
		• Market may be saturated			
	Organic versus external growth	• Organic growth causes negative cash flows and costs more	• No indication that anti-trust authorities will restrict growth	• Depends on clubs becoming available at the right price and with right clientele to convert to Sparkle clubs	• External growth better is possible
		• External growth gives more immediate cash return and reduces competition	• More likely to increase EPS in short run		
	Diversify into restaurants	• unnecessary distraction from main line of business	• Preferred option of Ashley Wilkins and of James Lellee	• Will strain cash flow too far and will further disappoint investors	• Not a good use of management and finance at a difficult time for Sparkle
		• hard to see any synergies			

6.8 Now for the unseen material

Now we have worked through the pre-seen material and shown you how to analyse the case material and to use the techniques included in Chapter 4, the Technical Toolkit, you should have more confidence in your ability to be able to "get to grips" and be familiar with the case material. You have about 8 weeks to do this with the pre-seen material.

However, on the exam day you do not have 8 weeks to analyse the unseen material, which is why the next chapter, Chapter 7, on What to do on exam day, is SO IMPORTANT.

Do not move onto Chapter 7 and how to analyse the unseen material until you are ready and feel confident with using the skills demonstrated above.

What to do on Exam Day

7

7.1 Introduction

So far, Learning System has discussed the following:

Chapter 1 – How the TOPCIMA exam is examined and assessed.

Chapter 2 – Review of past TOPCIMA cases and past FLCS cases in outline only and the Post exam Guidance reports on each of the 3 TOPCIMA cases examined in 2005.

Chapter 3 – The skills this CIMA how to deal with the exam material.

Chapter 4 – The technical toolkit – a "revision pack" of the financial and technical theories that you will need to demonstrate in your answer on the exam day.

Chapter 5 – Contains the full case material for the three TOPCIMA cases examined in 2005.

Please note that the case material for Zubinos, the coffee shops cases, examined in March and May 2006 is included in the Appendix to this book.

Chapter 6 – Contained the skills needed to research the industry setting and to analyse the pre-seen material. Chapter 6 contains two past cases, Homejay and Sparkle. For both of these cases we have shown you have to analyse the pre-seen material.

7.2 Exam day

Now we come to the important part – what to do on the exam day!

Don't panic – the key to passing TOPCIMA is not good luck – but good preparation. And this is where this CIMA Learning System will really help you – as it will show you HOW to prepare effectively.

In this chapter there is advice on what to do on exam day. We will also show you how to analyse the unseen material using two past cases, which are:

- Domusco – November 2005 exam in Section 7.8.
- Homejay – November 2003 (which we have just analysed the pre-seen material for) we will analyse the unseen material in Section 7.9.

ONLY when you have worked through this chapter and prepared an answer for yourself – and remember, no cheating – as the only way to practice for the real exam is to write a full answer – should you compare your answer to the case writer's answer. You should identify which points you did well, and which areas were weak, and work on them to improve on the areas of weakness. There is no shortage of case material in this CIMA Learning System to practice on.

To help you compare your answers to the case writer's answer, the case writer's answer for Homejay is given at the back of this chapter, but the case writer's answer for Domusco November exam is given in Chapter 5, Section 5.4.3.

7.3 Using the unseen material effectively

It is the author's firm belief that many students do not know how to handle the unseen material presented to them in the exam day and write a report that is good – but does not include the new data given to them – and this results in them failing. You MUST USE the new material and the information in the unseen material that is given to you on the exam day.

Many students feel that they can research and understand the TOPCIMA case from the pre-seen material and write a report about the company using ONLY the pre-seen material. Also some students may even have attended some tuition on the case they are about to sit. Maybe their lecturers have had a variety of guesses about what topics may (or may not) come up in the unseen material. However, it is you (not your lecturer) who has to go into the exam hall and answer the 100 mark question on the case.

It is imperative to your success in the TOPCIMA exam that you read and analyse the unseen material carefully and take note of the changed circumstances that the company in the case may be in. You may come into the exam with some pre-prepared ideas and a plan for your SWOT or PEST analysis (all in your head of course as no papers are allowed into the exam hall) – but when you have read the unseen material – and you now get an additional 20 minutes reading time – you need to have the confidence to decide whether some of the ideas and information and plans that you have prepared and planned to write are now relevant. You need to have the confidence to discard ideas if they are no longer relevant to the unseen material.

In Chapter 5 you will have seen and read the pre-seen material for Domusco, the construction company which is based in Europe but has 3 subsidiaries operating in Europe, the USA and the Middle East. There were 2 exams based on this pre-seen material which were totally different. Each followed directly on from the pre-seen material and the November exam ignored any data that had been given in the unseen material for the September exam.

The 100 mark requirement for both cases was identical and was as follows:

Requirement

You are the consultant appointed by the Domusco Board.

Prepare a report that prioritises and advises on the main issues facing Domusco and makes appropriate recommendations.

Whilst the requirements were identical the MAIN ISSUES FACING DOMUSCO were quite different. The ONLY WAY to pass TOPCIMA is to identify the main issues.

So how do we identify the main issues? This is the key.

First we have to identify ALL of the issues. Then we have to write them out again in order of importance – this is what prioritisation is all about – and you can even get 10 marks in the assessment matrix for doing this.

But how do we decide what is important and what criteria can we use in deciding the order of importance?

In a TOPCIMA case, which is based on real life companies, a lot of changes have taken place between the pre-seen material and the unseen material, which is either 2 months after the publication of the pre-seen material (for March and September exams) or 4 months after (May and November exams are based on the pre-seen material that is available in January and June each year). In real life a lot can happen in a few months and with the pace of technology, compete ion and international pressures, such as changes in exchange rates, interest rates and oil prices, all companies have to be ready to respond to what is happening around them and to review or amend its strategic goals in the light of the changing circumstances.

This is exactly what is happening with the TOPCIMA exam. The unseen material will give you a whole raft of important and some not so important issues and factors that affect the company. It is you job on the exam day to:

- Identify these new issues
- Decide which are important (prioritizing the main issues)
- Discuss each of the issues (main issues as well as some of the less important issues)
- Then reach well thought out and justified recommendations.

Easy? Sounds straight forward – but the unseen material can look daunting on the exam day and you can think – where do I start. Like all problems – break them down into manageable chunks and it will seem easier!

Let's start off with some easy decisions:

The November 2005 unseen material on Domusco introduced a number of issues, which we will go through later on in this chapter. However, let just mention 3 of the issues. They were:

- Low share price and lack of investor confidence
- A forecast cash shortfall of almost Z$2,500 million over the next year due to low sales
- Proposed re-organisation of the project planning team.

Which of these 3 issues is the least URGENT for Domusco at this point in time?

Do you really need more that 20 seconds to decide that the re-organisation of the project planning team is not critical to do just now!

Now which of the other 2 is more urgent? This is harder as you need to weigh up the consequences.

If Domusco's share price is low (fallen by 46% since the pre-seen material) this would be due to low profits and concerns for the future. However, the company could still continue to exist – although it would have unhappy shareholders who may insist on a major Boardroom reshuffle, or certain members of the Board resigning.

But can the company survive with such a major forecast cash shortfall. The clear answer is no. The reason for the negative cash flows is the lack of sales (due to changes in exchange and interest rates) and the plan to continue to build houses and offices in accordance with the original plans, despite low sales. If the cash spending in accordance with plans was allowed to happen – what could happen to Domusco (which had no further ability to raise loans due to an existing loan covenant) – think about it for a few minutes.

Yes – the company really could go bankrupt. Its very survival is in your hands! So if you advise to carry on with building – or DON'T advise to slow down with some of its construction work – you are allowing the company to take the first steps towards corporate collapse. The world has already seen a few very large international companies go into liquidation, such as Enron and WorldCom – Domusco could be next!

Therefore, I think we have reached the conclusion that the cash problem is far more important and urgent than the low share price problem. Also, in sorting out the cash problem and putting measures in place, and demonstrating to investors that action is being taken – all these will help improve investor confidence and ultimately the share price.

7.4 Structure of your report and what it should contain

The TOPCIMA requirement for the past few exams have required candidates to:

- Prioritise the issues
- Discuss the issues
- Make recommendations about these issues.

Therefore you must ensure that the main issues are identified and prioritised. Next ALL of the issues should be discussed in the body of your report. Then it is suggested that a separate recommendations section at the end of your report should be included, rather than recommendations at the end of each section.

The reason for this is not for the benefit of the markers of your answer – but in a professional report you generally find the recommendations at the end. This is because it is difficult to recommend a particular course of action or strategic decision until other decisions and recommendations have been accesses and decided upon, as many will be competing for the same scarce resources – manpower and finance.

It may be helpful to use the following report format for your answer, which should provide a check that all areas of the TOPCIMA assessment matrix has been covered, especially prioritisation and ethical issues. A recommended report format is:

- Contents page.
- Introduction (brief 5 to 10 lines of background on the company).
- Terms of reference (brief 5 to 10 lines to set the scene of who you are – e.g. a consultant, and to state who the report was commissioned by, and who it is aimed at).
- Identify and prioritise the main issues facing the company, showing the top 5 items in priority order. This area of the report should also include discussion on your position audit or SWOT analysis.
- The main body of your report should discuss in depth all of the issues you have identified above and should be supported by numerical evaluation of the proposals, which should be shown in appendices. Note: all numbers and data given in appendices should also be discussed within the body of the report.
- Separate paragraph on Ethical issues, covering at least 3 ethical issues and offering advice on how the issues could be handled.
- Recommendations and conclusions. The most important part of the report and should pick up on each of the issues discussed earlier. Each recommendation should be clear and well

justified as to why you are recommended a particular course of action. Do NOT recommend that more information needs to be collected before a recommendation can be made.
- Conclusion (brief 5 to 10 lines for closing comments).
- Appendices. Note all data and numbers in all appendices should be referred to within your report.

A reminder concerning Ethical issues – you must state WHY you consider the issue to have an ethical dilemma and for higher marks, it is necessary to give advice and make recommendations as to how the ethical dilemmas could be overcome. You could include discussion of ethical issues in the body of your report and recommendations on ethical issues within the recommendations area. You will not get more marks for having a separate section.

However, you are more likely to remember to discuss the ethical issues and make recommendations if they are in a separate section – either method is acceptable – as long as your report does cover the ethical issues in a case. Usually there are 2 or 3 obvious issues and perhaps a further 3 more subtle ethical issues.

Remember to earn high marks under the Ethics criterion in the assessment matrix you must ***identify, justify and recommend advice on how to resolve several of the ethical dilemmas included in the case material***.

7.5 What to do in the exam hall and how to manage your time

You now get 20 minutes reading time, in addition to the 3-hour exam. One of the abiding myths of CIMA exam techniques is the tyranny of the clock and the rule of 1.8 minute a mark as a guide to time allocation (i.e. 180-minutes exam and 100 marks available). This makes candidates think that if they are not writing they are not earning marks.

The 1.8 minute rule is NOT reliable for any exam in the CIMA syllabus and it certainly is NOT suitable for TOPCIMA. You need to allow time for:

- reading the unseen material (including updates to data given previously in the pre-seen material, such as latest share prices);
- reading and fully understanding the requirement set;
- analysing the extra information you have been given and assimilating it into your analysis of the pre-seen material (which you cannot take into the exam room so you must be able to recreate it);
- planning your answer.

Effective from May 2005 CIMA has changed the total time allowed for the TOPCIMA exam. In addition to the usual three-hour exam time CIMA is now allowing candidates to have an additional 20 minutes of reading time to read and absorb the material given in the unseen material and the requirement.

The wording on your TOPCIMA exam booklet from May 2005 will show the following:

> *You are allowed 20 minutes reading time* ***before the examination begins*** *during which you should read the question paper and, if you wish, make annotations on the question paper. However, you will* ***not*** *be allowed*, ***under any circumstances***, *to open the answer book and start writing, add any loose sheets/supplements to the answer book or use your calculator.*

Therefore some more of the precious 180 minutes can be spent in planning and writing your answer.

Use the following as a guide to allocating your time:

Reading, analysis and initial answer	
Planning, including any necessary calculation	40–60 minutes
(the calculation could take up to 15–30 minutes)	
Writing final answer	110–130 minutes
Reading over final answer and checking format and tidying	10 minutes
Spellings, grammar and presentation	

You will notice that we are recommending that you spend a third of the available exam room time preparing and planning, without writing your answer. Candidates who answer from the top of their heads before they figure out what they want to say rarely satisfy the criteria for high marks on the assessment matrix.

7.6 Reading the requirement

The requirement will appear at the front of the booklet of unseen material and will be clearly distinguishable from the rest.

Make an immediate note of the following elements on your rough working papers:

- *Your role or position.* For example, whether you work for the firm or an outside interest and your organisational position.
- *Format of response(s) required.* This is likely to be a report but could also involve a letter, presentation or memo.
- *Who it is addressed to.* This should influence the tone and content of what you write (e.g. your line manager, the board, a regulatory body).
- *What you are reporting upon.* There may be more than one thing required, for example a report that contains both a strategic analysis and an evaluation of a business plan.

When you read the requirement you may find it conforms to something you anticipated. This should give you confidence although you need to ensure that you do not write down the answer you prepared in advance because this may ignore some of the new information in the unseen material.

Alternatively the requirement may be quite unexpected or different to what you had anticipated. What matters in the next 180 minutes in the exam room is that your report attempts the answer the requirement that has been set. Do NOT try to incorporate data that you had pre-prepared if it is not relevant.

Remember, however well your report is presented and whatever technical knowledge is displayed, if your report does not identify the key issues and address the actual requirement that has been set it will not earn high marks. If it helps you to remember the requirement, which is usually quite brief, then rewrite it out within your planning notes before you attempt to start to write your answer.

Here is the requirement for Homejay Incorporated:

> *You are the independent management consultant appointed by the new Chairman, Ken Kato.*
> *Prepare, for the Chairman, a review of the issues facing Homejay. Your review should discuss and evaluate each of the four strategic options that have been identified. Your report should conclude with recommendations.*

We can see several things in this requirement:

We are an independent management consultant	• This means we have to be objective and professional. It also means we must consider a broader range of issues than just management accounting ones
We are writing to the Chairman	• This means we do not need to worry about criticising members of the Board of Homejay
The Chairman, Ken Kato, is a new name in the case	• This means we can criticise Ralph Black • It also means that we will need to explain things about Homejay in more detail because Kato may not know them all
We are writing a report	• Indicates required format of response
Review of the issues facing Homejay	• This means an updated SWOT analysis • It also asking for a position audit or discussion of the key issues (in priority order) that the Board of Homejay should be addressing • Look for changes between the pre-seen and the unseen
Evaluate each of the four strategic options	• We need to find out what these four options are
Conclude with recommendations	• We are supposed to advise Ken Kato on what to do with the firm he has just joined

7.7 Analyse the unseen material

Because the unseen material essentially updates the pre-seen material, you should focus on incorporating it into your pre-seen analysis. Pay particular attention to:

- where the unseen information confirms trends or factors identified in your analysis of the pre-seen material and hence confirms your impression of the situation;
- where the unseen information changes or contradicts the conclusions of your analysis of the pre-seen material;
- where the unseen material provides data that sheds light on the requirement.

The following steps should be taken.

1. Update your analysis of the position of the firm(s) in the case in your rough workings:

- calculate ratios for profitability, liquidity and investor;
- update organization chart if necessary;
- sketch down updated SWOT analysis.

2. Conduct preliminary rough analysis on any proposals in the unseen material. The sorts of things this could involve include:

- evaluation of proposed project or acquisition;
- feasibility of a business plan;
- consideration of a recommendation for restructuring.

3. Perform any necessary calculations in a presentable form, clearly identifying the figures used, as appendices to the report. Try to avoid performing calculations in rough workings, and then rewriting them. Remember that it will be necessary to refer to the results of these calculations and explain their significance in the main report.

7.8 Analysis of the unseen material for November 2005 Domusco case

7.8.1 Notes on the unseen material

We will now look at the unseen material (which is included in Chapter 5). Read the unseen material and make some notes on each of the issues throughout the 5 pages of the unseen material. When you have made your notes compare them to the notes below:

Page	*Main information*	*Significance*	*Priority*
1	• Domusco acquisition of KLT	• Acquired competitor • Increased market share • Access to KLT's European infrastructure • Access to KLT's large land bank, mainly in Europe	No – KLT already acquired
	• Martyn Lite not in favour of acquisition of KLT • KLT valued at Z$550 million	• Market analysts did not approve of Domusco's acquisition of KLT and Domusco's share price fell by 12% to Z$12.16	
	• KLT acquisition paid Z$400 million in cash and Z$150 million in shares • New loan of Z$300 million taken out to finance part of the cash	• Instead of financing the acquisition by the exchange of shares, a significant proportion of the price paid was in cash, leaving Domusco short of cash for working capital	Yes – Cash used for acquiring KLT
1	• Changes in interest rates	• Increase in interest rates in Zee will lead to a slow down in the economy • Result in lower sales of houses due to increased cost of borrowing • Lower sales of offices as companies decide to defer office move until interest rates fall	Yes – reduction in sales
	• Effect on exchange rates	• Changes in exchange rates will affect Domusco's overseas loans that should be revalued	Yes – effect on overseas loans

2	• European sports stadium contract	• Awarded due to bribery • This could affect Domusco's international reputation and could have a long-term effect on the company's ability to win other international contracts • Decide whether contract should be accepted or refused	Yes – reputational risk
3	• Low sales in Hadsi	• Phase 1 only started and only 920 out of 3000 housing units sold (31%) • Only 2 out of 12 office buildings sold • Should Domusco invest in more marketing • Zee government not spent much of the agreed Z$20 million Hadsi promotional budget • Should construction continue	Yes – low sales – urgent action required
		• How to finance Hadsi with low sales levels leading to a drain in Domusco's cash resources	Yes – HIGH PRIORITY – CASH
		• Write down in value of remaining unsold Hadsi land to Z$30 million	Yes – Effect on 2005 profits
4	• Organisational change	• Close down Office Building subsidiary or merge with Major Construction Projects • Re-organise Project Planning department	No – not a priority
4	• Share price	• Domusco share price down to Z$7.50 • One investor threatening to sell its shares • Investor awareness and concerns of cash shortage due to low sales	Yes – low share price and unhappy investors – Priority
4	• Finance Director resigns	• Martyn Lite resigns over conflict of not being allowed to issue a profits warning • Low forecast profits for 2005 at Z$535 million (compared to 2004 actual of Z$686 million and plan for 2005 of Z$783) • No FD at end October 2005	YES – TOP PRIORITY A company in trouble needs a strong FD
5	• Cash flow forecast	• Table showing quarterly cash flow forecast for the 4 quarters, including current quarter	YES – High Priority Low or negative cash flows could lead to sever liquidity problems or even bankruptcy
		• Dividends have not yet been decided • Table of figures show a huge cash deficit forecast for current quarter and quarter1 of 2006 • Major cash flow issues	

5	• Appointment of consultant	• You have been appointed to advise Domusco • Feel free to criticise what you want to but you must make achievable recommendations on how to overcome the main issues

7.8.2 Preparation of issues for prioritisation

From the notes above you should now list the issues and prioritise them. You should select about 5 or 6 issues that are the top priorities and then list the other issues as being outside of the top 5 or 6 priorities. Within the top 5 or 6 priorities you MUST prioritise the issues as TOP PRIORITY, second priority etc.

There are 10 marks available in the assessment matrix for prioritisation. Up to 5 marks is awarded for prioritisation of the issues and more marks, up to the maximum of 10 marks are available for justification of the priorities.

From the analysis above you can see that the issues should be prioritised as follows:

Cash shortage – the main priority

There are a number of issues facing Domusco, but the main priority and the most overriding issue is the short-term cash situation. If the company does not address this urgently and take harsh actions, the company could go into liquidation. The company is profitable, albeit at reduced levels, but has cash flow problems.

The banks will wish to discuss with Domusco's management how the company can survive the forecast cash shortfall, and agree what plans are being put in place for the company's recovery. The banks will want to take an active interest in the action plan that needs to be drawn up, as they will not want to see Domusco's share price and investors' confidence fall any further.

The second priority is to recruit and appoint a new Finance Director and strengthen the Domusco Board, possibly with more non-executive Directors. This should give market analysts and shareholders more confidence in the company's ability to manage its recovery. The Finance Director selected should have a proven track record of improving companies in difficulties, and should therefore be well respected in the financial community.

The third priority is to prepare a clear achievable plan for the future, which then needs to be communicated to Domusco's shareholders to restore confidence.

The fourth priority is to address the possible breach of the loan covenants and to arrange additional debt financing if this is possible. Domusco must not lose the confidence of the loan finance providers, or breach the covenants without agreement, as Domusco could find that the loans are called in. This would almost definitely lead to bankruptcy and it is in nobody's interest for this to happen, including the loan finance providers. Therefore an amicable arrangement needs to be agreed upon.

Other priorities are:

- To address the issues which have led to the fall in Domusco's share price and improve the financial markets' view of Domusco's management team. This will necessitate some changes and possible resignations

- Improve Domusco's share price and confidence in Domusco's management team, so that Domusco is not the target of a hostile take-over. Its shares are undervalued at present, due to reduced profitability and cash flow problems, but the company still has valuable assets, including a large land bank, which a predator company may wish to acquire.

The Board and management issues have to be tackled urgently as the banks will wish to discuss with Domusco's management how the company can survive the current cash shortfall and also to put plans in place for the future recovery. Domusco's management must be committed to the painful choice of reducing the assets employed by the company.

7.8.3 Preparation of a SWOT analysis

There are marks available for the display of Technical Knowledge and also for the Application of technical knowledge, and a useful and helpful way to earn marks is the preparation of a SWOT analysis.

However, for the SWOT to earn reasonable marks, it MUST include all of the new data and updated issues included in the unseen material. Therefore all of your top 5 or 6 priorities MUST be in the SWOT.

The SWOT should also be prepared for the company in the question. Sounds obvious! However, in the May 2005 TOPCIMA exam, the unseen material introduced Shard and many students prepared SWOT analyses for ReuseR and NOW, but not for Shard. As these were largely irrelevant, they earned low marks.

From the unseen material and the notes above, you should now prepare a SWOT for Domusco. Prepare it yourself first, and then compare it to the case writer's SWOT, which is shown below.

SWOT analysis for Domusco

Strengths	Weaknesses
• Established large international construction company with profitable businesses in all construction segments • Major company in its own country of Zee • Experienced and stable Board of Directors • Good reputation for quality work • Profitable construction businesses in many countries	• Over extended company which has major cash flow problems • Stock of unsold houses and offices, some finished and some only part complete • Profit margins in office building segment are decreasing despite a planned increase in turnover • Poor cash forecasting, which has resulted in current situation • Badly over extended financially following the acquisition of KLT which involved a high level of loans, and which should have been made with a greater proportion of equity • Vacancy for a Finance Director following Martyn Lite's resignation • Domusco's management are used to success; there is little evidence that they can cope easily with the inevitable more difficult circumstances • An increased risk profile from larger scale developments, such as Hadsi, and very large foreign major construction projects • Some projects and developments inevitably go wrong; Domusco has undertaken some which are very large in relation to the size of the company
Opportunities • Improvement in Domusco's share price from its current low level of Z$7.50 • Domusco is already diversified geographically, and there is scope to undertake housing developments in a number of countries where economic conditions are not as problematical as in Zee • Scope to compete internationally for Major Construction Projects, subject to availability of working capital, and management resources • Strengthen and improve Domusco Board and management team • Improved project planning following proposed reorganisation • Improved profitability and control in the office buildings subsidiary if it is reorganised	**Threats** • Acute cash shortage; the company will be very near to breaking loan covenants, and will have to sell assets • Banks could dictate changes in the Board, and dictate which assets have to be sold • European sports stadium contract appears to have been gained by bribery. The required negotiations to resolve this situation could have unpredictable consequences • Greater exchange rate risks as more of Domusco's work is undertaken outside of Zee • Continued shortage of skilled experienced manpower to work on and manage contracts for construction • Loss of management skills in Domusco's office building subsidiary if Tan Lee left the company, following the proposed reorganisation

7.8.4 Preparation of a PEST analysis

Now that we have prepared a SWOT, a further useful analysis tool is a PEST analysis. Again you should try to prepare your own PEST before you read and check your own analysis against the PEST analysis shown below.

PEST analysis

Political

- good government connections in Zee, but Zee government not currently commissioning much construction
- limited government connections in other countries in which Domusco trades. Poor political connections with the Wye Government, which did not give any compensation for massive cost over-runs following poor weather
- Domusco will need a political ally to assist it, following the European sports stadium bribery issue, which could damage Domusco's ability to win other contracts in the future.

Economic

- following the exchange rate realignment and increase in interest rates in Zee, construction will be depressed for some time; there will be limited demand for houses and office blocks in Zee
- Land banks will be difficult to sell, even to other developers and competitors in Zee due to current economic downturn in Zee
- Land banks may need to be re-valued downwards, which would have a negative effect on Domusco's profits
- in current conditions other developers in Zee will face similar problems, even if not as stretched financially, and may not wish to acquire more land for their land banks.

Social

- good record on health and safety and corporate social responsibility
- high risk of extremely bad publicity if bribery issue with European sports stadium cannot be defused quietly, and becomes public knowledge
- plans to expand the number of direct employees to replace sub-contractors will have to be on hold in view of limited home demand and financial difficulties
- risk of need to make some of Domusco's employees redundant.

Technological

- cost of state of the art construction machinery has depressed ROCE and increased fixed costs when volumes are low
- office buildings are innovative, but demand appears to be low
- with the cash flow problems and low profitability forecast, Domusco will be unable to invest in new technologies and its R & D expenditure is likely to be severely restricted.

7.8.5 Answer planning for Domusco

Now that we have discussed the main issues and prioritised them, it is important to plan your answer. From reading and marking scripts for the November 2005 exam, it was apparent that too many candidates identified that Domusco was short of cash and made the following suggestions:

- Take on additional loans
- Have a rights issue to raise cash, and many calculated the number of shares required to raise Z$2,500 million
- Take on an overdraft.

The students then based their answer around these initial ideas and failed the exam. What they should have done instead is to sit back and think about the commercial feasibility of these 3 ideas.

Do you think that the banks introduced a loan covenant restricting loans to 40% of shareholders equity plus loans for a reason? Yes. They want to limit the level of gearing that Domusco take on and to reduce the risk of the loans not being paid back. The case material stated that the company was nearing the limit of the loan covenant, which really spelt out to students that more loans was NOT an option. Students could have calculated the forecast loan covenant at the end of 2005 and could have identified that Domusco had a small amount of "headroom" to take on additional loan finance, but this was only Z$158 million, which is no where near the Z$2,500 million needed.

Therefore, more loans was not an option. So what about the suggestion of a rights issue. Do you think this would be successful? Consider the information in the case:

- The share price has dropped by 46% to Z$7.50 a share
- The investors are not happy
- Some investors are considering selling their shares.

Yes – that's right – now is not a good time to ask the investors to stump up a further Z$2,500 million. In practice, a rights issue simply would not be successful at this time.

Now the last ridiculous suggestion was to arrange an overdraft! Do you think any sensible bank manager will lend Domusco Z$2,500 million? A bank would not allow an overdraft of the size required, for it to be used to carry on with the planned construction work of more unsold houses and offices.

Therefore, we have ruled out raising finance from external sources – which leaves 3 options, which were:

- Selling parts of the company – some of its land banks or even one of the subsidiaries.
- Slowing down expenditure, especially on construction in Hadsi. In real life, if one phase of a development is not sold, then the next phase will be delayed until demand picks up.
- Taking actions to boost sales, through a series of sales initiatives and reduced prices.

A further issue that was important with the cash issue in this case was the URGENCY of the problem. If Domusco was to carry on how it planned to, it would have a cash shortfall of Z$2,500 million within 6 months. Clearly this is unacceptable and the quickest way to cut this deficit is to cut back on construction work, but even that takes some time, as sub-contractors and employees have a notice period. A recommendation to sell parts of Domusco was acceptable but comments about the time that selling a subsidiary could take should have been discussed.

7.9 Analysis of Homejay unseen material

Homejay – Unseen material provided on examination day

Additional (unseen) information relating to the case is given below. Read all of the additional material before you answer the question.

ANSWER THE QUESTION – 100 MARKS

You are the independent management consultant appointed by the new Chairman, Ken Kato.

Prepare, for the Chairman, a review of the issues facing Homejay. Your review should discuss and evaluate each of the four strategic options that have been identified. Your report should conclude with recommendations.

Notes: Ignore taxation.

Homejay – Unseen material provided on examination day

Read this information before you answer the question

Ralph Black retires early

After Homejay announced its full years result for the year ended February 2003, at the end of May 2003, Ralph Black was criticized by both the financial media and the market analysts. He realized that his position was becoming untenable and he announced that he was retiring earlier than planned, and would leave the company at the end of September 2003.

Most of the senior employees of Homejay, and many market analysts, had expected Andy Mottram to succeed Ralph Black as Chairman, and felt that he been preparing for the role for the last two years. However, Ralph Black considered that Andy Mottram was not suitable for the role and the Homejay Board agreed that the role should be filled by someone from outside of the company with more vision and better retailing skills.

A suitable candidate was quickly identified and the appointment was approved at a Board meeting. The new Homejay Chairman was Ken Kato, an entrepreneurial Japanese businessman who lived in the USA. He joined Homejay in early October 2003.

Homejay's new Chairman

Ken Kato had previously held the role of Chairman of a company which manufactured and retailed clothing and toys globally with a turnover equivalent to around $6 billion (1 billion equals 1,000 million). In the five years that he had been Chairman there, he had seen an increase in staff morale and staff loyalty. During that time the company's productivity had increased (measured by sales per employee) by over 150%. The company's share price had grown by over 45% in the last three years, despite the global recession.

Andy Mottram was disappointed that the Board did not have sufficient confidence in his abilities to take on the role of Chairman and was considering resigning.

Ken Kato met with Andy Mottram in early October to discuss how saw the business developing, and the need to change the focus of the company. Ken Kato discussed with Andy Mottram the management skills required to make changes and his knowledge of Homejay's business. Ken Kato asked Andy Mottram to stay with the company to help implement the changes that he considered were required. However, Andy Mottram was reluctant to give a firm commitment to Ken Kato. Ken Kato is still deciding whether or not he wishes to retain Andy Mottram on a longer-term basis.

The new Chairman spent most of October and early November visiting some of Homejay's manufacturing plants and some of its retail outlets in the USA and Europe and learnt much from Andy Mottram of historical events within each business unit.

Funding limitations

In Maxine Gill's opinion, Homejay is more highly geared than it should be. She wants to reduce the current loans, but is unable to achieve this from operating cash flows. Furthermore, Maxine Gill does not consider a right offer would be successful at the current time.

In the past, Homejay's business units have been able to obtain funding for capital projects that have been approved by the business unit's general manager up to a limit of $10 million per project. Up to now there has been little direct control from the Head Office finance department or from the Homejay Board, except for larger capital projects.

The Homejay Board agreed with Maxine Gill's recommendation to limit capital expenditure on all projects across the company to $50 million in 2004/05. It is anticipated that this policy of limiting capital expenditure to $50 million per annum would continue for the next few years. This would necessitate each business unit referring any project over $1 million to the Head Office finance department for approval.

The Homejay Board agreed that no further loan financing would be obtained, irrespective of the NPV on any proposed project or acquisition. Furthermore, the agreed company-wide capital expenditure limit of $50 million for the next financial year would have to cover all planned projects unless funds could be generated by divesting some areas of Homejay's businesses.

Planning review meeting

At the planning review meeting held on 3 November 2003, Ken Kato stated that Homejay had not recognized that a key objective of the company should be the creation of value for shareholders. He stated that he considered that it would be necessary for some major strategic changes to be made.

Ken Kato announced that he had appointed an independent management consultant to undertake a strategic review of Homejay. The management consultant was present at the planning meeting and was introduced to the general manager of each business unit. During the planning review meeting, the consultant merely observed and made notes on areas for further investigation.

Ken Kato had been liaising closely with Maxine Gill and Paul Simpson whose departments were working on Homejay's business plans for the next financial year and beyond. Ken Kato was concerned that even if all of the business units actually achieved the forecast increased sales and profitability, the company's earnings per share would grow very little. He was also very concerned that historical the company had failed to achieve its financial plans.

Paul Simpson's department had received forecast financial data from each business unit for the next three years and a further estimate for later years. The forecast flow data from each business unit were discussed at the planning review meeting. Maxine Gill was concerned that these forecasts did not address all of the problems that the business units were experiencing, particularly in respect of quality control in Electryco. Paul Simpson also wanted to review more closely the underlying forecast increases in sales volumes, as he felt that some of the forecasts had not addressed the competitive nature of the markets in which the businesses operate. Therefore, overall, it was considered that the forecasts might be overly optimistic.

Paul Simpson was also concerned that the capital expenditure required for the refurbishment programmed of 25 Fixitco stores had *not* been included in the plan for 2004/05. Instead, Barry Milo had planned that this would be deferred a further year and not take place until 2005/06. In his plan for 2005/06 he had included capital expenditure of $45 million and an additional cost of around $8 million for increased marketing spend to relaunch the refitted stores. There was some discussion at the meeting as to whether the sales targets were too high in these 25 stores (which recently had seen sales declining further), if the refurbishment programme was deferred for at least another 15 months.

The level of communication between corporate Head Office and each of the business units' general managers is not very effective at present and there is a lack of corporate identity.

The level of corporate Head Office costs was also discussed. Joseph Logan was very critical of the high level of corporate Head Office costs that were allocated to business units, over which each general manager had no control. Andy Mottram stated that he had been looking at several ways to reduce the corporate Head Office costs, which were forecast for 2004/05 to be over $330 million.

Andy Mottram stated that one way of reducing corporate Head Office costs that was under consideration was the relocation of the Homejay Head Office. The proposal was for Homejay to relocate from the current site in a prestigious American city center, to a lower cost, regional location. This would be expected to save $40 million each year. However, it is estimated that only 50% of head office staff would elect to stay with Homejay. In the short term, the proposed move could incur around $15 million on redundancy, recruitment and relocation expenses.

A further corporate Head Office cost that was planned for 2004/05, in addition to the $330 millions corporate Head Office costs, was Mark West's corporate marketing campaign (*as detailed in the pre-seen material*). Mark West stated that he considered the time was right to publicise the Homejay brands to make the company more visible in the public eye and to enhance its profile. He was highly confident that the planned campaign would generate additional sales. These additional sales would increase the forecast gross margin in 2004/05 by between $100 and $110 million, over all five business units.

Maxine Gill was concerned at the high level of management bonuses that had been paid in recent years, particularly since earnings per share had not grown. She informed the general managers of the business units that Catherine Barnes was planning to change the basis for calculating managers' performance-related pay. The current system is based around achieving a target ROCE for senior managers and individual performance bonus scheme so that bonuses are linked either to Homejay's share price or to the company's earnings per share.

Ken Kato concluded the meeting by thanking the business unit general managers for their input into the business plans. He undertook to advise all of the business unit general managers of any proposed strategic changes for the company after had had further discussions with the management consultant.

Review of Homejay's strategies

A week after the planning review meeting, Ken Kato met with the management consultant on his own to discuss ideas for change. A number of alternative strategies were identified at this meeting. Ken Kato considered that Homejay should concentrate on its core competencies, which were the Fixitco and Woodyco businesses only.

Ken Kato briefed the management consultant about the early discussions that Andy Mottram had held with a number of companies that Homejay could acquire. At this stage only one company looked like a promising acquisition. It was another company in the DIY business that would be complementary to Fixitco, called Makeitco. Ken Kato asked the management consultant to review this proposed acquisition (see *Option D* below).

The Cosmetco business unit was discussed and Ken Kato commented that the forecast cash flow data for the Cosmetco business unit looked attractive. He was also very impressed by the recent growth in Cosmetco's sales and profitability. Furthermore, he liked the management style of its general manager, Jayne Reed. Both Ken Kato and the management consultant agreed that Homejay should retain Cosmetco in the short term and that this business unit should be reviewed in 18 months.

After much discussion, Ken Kato and the management consultant agreed that Homejay has four strategic options at present (which are not necessarily mutually exclusive). These are:

Option A:	improve profitability within the existing business units
Option B:	divest the Electryco business unit
Option C:	divest the Cardco business unit
Option D:	acquire Makeitco.

Option A – improve profitability within the existing business units

Ken Kato has asked the management consultant to consider ways in which the company could improve its profitability. He had requested the management consultant to undertake strategic review of each of the existing business units and to consider any changes that would help to improve profitability throughout the company.

Option B – divest Electryco

Electryco has reviewed its pricing policy and product ranges and has decided not to make substantial changes to its range of products and their features, nor to alter many of the current prices materially, although some individual products have been reduced in price to remain competitive with similar product offered by competitors. It is expected that any sales volume increase achieved would be eroded by reduced prices to remain competitive.

A competing electrical appliance manufacturer, Kitbeco, which is planning to expand its manufacturing capacity, has expressed its interest in acquiring Electryco. It plans to use some of Electryco's manufacturing capacity to build its own brand products and also to continue to manufacture selected ranges of Electryco's more successful products.

Kitbeco has had a series of detailed meetings with Homejay's senior management and has expressed a firm commitment to acquire Electryco. However, Kitbeco has stated that it would not require around 20% of the current workforce of Electryco.

The forecast net operating cash flows for Electryco (in nominal terms) are as follows:

	Year 1 2004/05 *\$ million*	*Year 2 2005/06* *\$ million*	*Year 3 2006/07* *\$ million*	*Year 4 and annually thereafter* *\$ million*
Electryco	39	40	41	42

Kitbeco has now made a cash offer to Homejay of \$310 million. However, this offer excludes the potential cost of future warranty claims on current year sales.

Option C – divest Cardco

Some enquiries have been made to companies competing with Cardco and it has been established that Cardco would be a particularly attractive acquisition, as the business owns or leases valuable retail sites in high streets that are difficult for other companies to obtain. Initial enquiries have found two companies that are interested. They have indicated that they would offer around \$160 million.

The forecast net operating cash flows for Cardco (in nominal terms) are as follows:

	Year 1 2004/05 *\$ million*	*Year 2 2005/06* *\$ million*	*Year 3 2006/07* *\$ million*	*Year 4 and annually thereafter* *\$ million*
Cardco	16	18	20	20

Option D – acquire Makeitco

Barry Milo has identified a chain of DIY stores in the USA named Makeitco which he considers would be a good acquisition of Homejay. If it were to be acquired, it would allow the company to expand Fixitco's geographic coverage. It would also provide further retail outlets for Woodyco's products.

The founding family members own the majority of shares in Makeitco. They have agreed that they want to enjoy the benefits of the success of Makeitco and to sell the company for cash. If Makeitco were to be acquired, it would be a friendly take-over and at present no other companies are competing to acquire Makeitco. Makeitco is a listed company and is currently valued at \$350 million.

Makeitco has made available to Homejay its future plans and forecast of net operation cash flows (in nominal terms). These are as follows:

	Year 1 2004/05 *\$ million*	*Year 2 2005/06* *\$ million*	*Year 3 2006/07* *\$ million*	*Year 4 and annually thereafter* *\$ million*
Makeitco forecast cashflows	33	34	35	36

It is expected that there would be synergy benefits of a further \$5 million per year. There would also be a one-off re-branding cost of approximately \$10 million.

Maxine Gill's initial reaction was that as the cost of acquiring Makeitco exceeded the agreed funding limitation, it could not proceed. However, Ken Kato is keen to build upon Homejay's core business competencies and in principle, is in favour of the acquisition. Maxine Gill considered that this business was very similar to Fixitco's business and should be assessed using Fixitco's discount rate of 10%.

For the purposes of evaluating all of the net operating cash flow data, taxation should be ignored.

Discount rates

Homejay has assessed the betas for each business unit based on suitable proxy companies. Maxine Gill has assessed the following discount rates as being suitable for each business unit, taking into account both business risk factors and exchange rate risks.

Business unit	*Discount rate*
Fixitco	10%
Woodyco	11%
Electryco	13%
Cosmetco	10%
Cardco	16%

The company's current weighted average cost of capital is 11%.

7.9.1 Analysis of unseen material for Homejay Incorporated

The key points to notice from each page are as follows:

Page	*Main information*	*Significance*
19	• Resignation of Ralph Black in September 2003 following poor results • Appointment of Ken Kato, excellent turnaround record, as Chairman in October 2003 • Andy Mottram (CEO) passed-over as Chairman & considering leaving • Maxine Gill wants rights issue	• Kato has free hand and is powerful because shareholders want him to turn Homejay around • Will need to make recommendation on approach to take with Mottram • Financing of options needs considering in recommendations. Shareholders will want clear strategy before they supports rights issue
20	• $50 m cap on capex during 2004/05 and all must come from equity • EPS unlikely to rise without new projects • Forecasts over-optimistic • Refurbishment expenditure at Fixitco not included in forecast and now deferred 15 months • HQ costs forecast at $330 m and allocated arbitrarily	• All options must be evaluated in terms of ability to increase EPS or shareholder wealth against baseline forecast of no improvement • Head office costs likely to stay if divisions sold. Factor HQ costs into new profit forecasts
21	• New relocation option being considered • Corporate marketing campaign still needs approval • Proposal to change bonus system • Ken Kito favours retaining only Fixitco and Woodyco • Ken Kato likes management style of Jayne Reed (GM Cosmetco) • Cosmetco retained due to good cash flows and management • Four strategic options to consider of which three change scope of Homejay	• Evaluate viability and timing of relocation • Evaluate marketing campaign • Comment on bonus system • Chairman's personal preference should be borne in mind when recommending options • All above are secondary issues, which require decision on main options concerning size and scope of Homejay to be taken first
22	• Option A is to increase profitability • Option B is divest Electryco. Partial cash flow forecast given against backdrop of nil growth and offer of $310 m • Option C is divest Cardco for $160	This is the start of the main work in this case • Absence of data for A means this requires you to suggest ideas based on Pre-seen and perhaps indicate profit impact of cost reductions • Assess offer for Electryco against PV of future free cash flow and comment on need to allow for termination costs • C is as Electryco but without termination costs
23	• Option D is to acquire Makeitco • Breach of funding limit an issue • Different costs of capital provided for each part of Homejay and compared to group WACC of 11%	• D should be evaluated as a PV with annuity after year 4 but comments made on problems of acquiring family firms • Comment on how funding cost could be reduced (e.g. staged buy-out)

Page	*Main information*	*Significance*
		• Need to use relevant discount rates for each calculation above • Shows that value of Homejay could go up if Cardco and Electryco were sold because group WACC would fall • Different rates could imply a 'sum of the parts' valuation for Homejay needed

7.9.2 Perform rough calculations

These are essential if you are to come to a consistent view on what you will recommend.

Divest Electryco

	2004/05	*2005/06*	*2006/07*	*2007 on*
Net cash flow	39	40	41	42
Disc @ 13%	0.885	0.783	0.693	1/0.13 (0.693)
PV	34.5	31.3	28.4	223.9
Total PV	318.1			

So offer of \$310m is insufficient even before bearing termination costs. Reject and hold out for better offer.

Divest Cardco

	2004/05	*2005/06*	*2006/07*	*2007 on*
Net cash flow	16	18	20	20
Disc @ 16%	0.862	0.743	0.641	1/0.16 (0.641)
PV	13.8	13.4	12.8	80.1
Total PV	120.1			

Proposed cash offer of \$160m is favourable.

Purchase Makeitco

	Year 0 *2003/04*	*Year 1* *2004/05*	*Year 2* *2005/06*	*Year 3* *2006/07*	*Year 4* *on*
Net cash flow	(350) + (10)	33 + 5	34 + 5	35 + 5	36 + 5
	(360)	38	39	40	41
Disc @ 10%	1	0.909	0.826	0.751	1/0.1 × 0.751
PV	(360)	34.5	32.2	30.0	307.9
Total NPV	404.6 − 360 = \$44.6m				

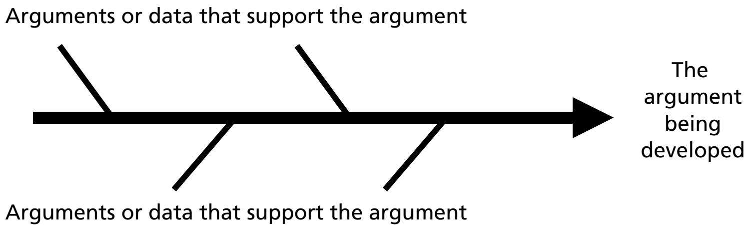
Acceptable providing forecasts are right and capex can be afforded. Will reduce 2003/4 profit due to \$10 m re-branding.

7.9.3 Decide basic argument of report

The requirements set in the TOPCIMA exam must be met before you start branching off to discuss other issues you think relevant.

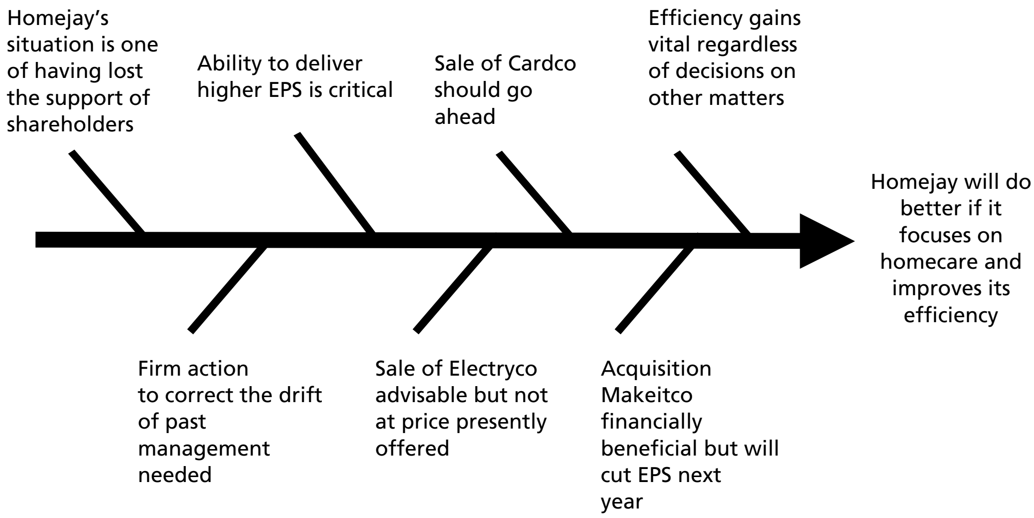
Candidates report that having a clear idea of what they want to say is the hardest part of passing an exam like this.

Some candidates have found *fishbone diagrams* a good way to plan their development sections.



You should draw the fishbone(s) in the rough workings section of your answer books. Using pencil helps you to shift ideas about, although sometimes it's just as quick to redraw them if a better sequence of ideas comes to mind.

- write the argument at the point of the fishbone;
- put each separate piece of data analysis or evaluation that lead to the conclusion of the argument as spines;
- ensure that each spine is essential to supporting the argument;
- ensure the spines are in the best sequence for leading the reader through your argument.



The spines are the main steps in the argument and build up left to right.

7.9.4 Start developing a skeleton plan

You will be given two answer books at the start of the TOPCIMA exam. We recommend you to use them as follows:

- the larger one should be set aside for the written section of your final report;
- the first half of the second book (up to the double page containing the staples) should be reserved for presenting any appendices to your final report;
- the double page spread following the staples can be used for your skeleton plan;
- the remainder of the second book is for rough working.

Here is the first stage of a skeleton plan to answer the requirements for Homejay Inc.

Homejay Incorporated CONFIDENTIAL REPORT – Issues and future strategic options To: Ken Kato: Chairman From: A Consultant Date: 20th November 2003 Content 1. **Introduction**	5. **Evaluation of Option to Divest Cardco** 6. **Evaluation of Option to Purchase Makeitco**
2. **Current Strategic Issues facing Homejay**	7. **Other issues**
3. **Evaluation of Option to Improve Profitability**	8. **Conclusions**
4. **Evaluation of Option to Divest Electryco**	9. **Recommendations** **Appendices**

7.9.5 Adding content to your report

The next step is to decide what you wish to write under each section of your skeleton plan.

From your analysis of the pre-seen you should already have a pretty good idea or what you think of the current situation of Homejay and the issues it faces.

For example:

- it has lost the support of shareholders due to the failures of previous senior management (but note Black has gone);
- its performance evaluation and bonus systems are a contributory factor to this (but note this is going to be changed);
- it has acquired businesses that have little synergy with the core business of Homejay and should be rationalised if the price is right (this is the main part of the unseen);
- it needs to sort out it duplication of factories in Woodyco;
- it should improve its stock management.

The last two can be discussed as part of the section on improving efficiency.

Therefore be ready to write a SWOT as an appendix and draw these key conclusions out and put them in Section 2.

More difficult is evaluating the other aspects of the case. From rough calculations you could conclude as follows:

- sell Cosmetco,
- reject offer for Electryco,
- acquire Makeitco,
- press ahead with efficiency gains.

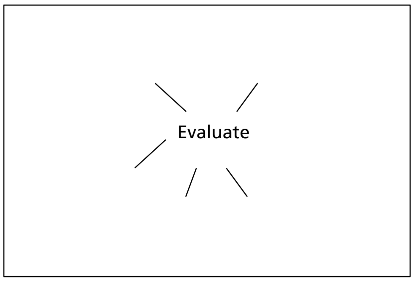
The remaining aspects of the unseen also need to be addressed but they seem to be secondary to the issues above. You were not specifically asked to address them and so only do them if you have time

- shall Homejay relocate to cheaper HQ?
- shall the corporate branding go ahead?
- what shall be done with Mottram?
- shall bonus system be re-based?

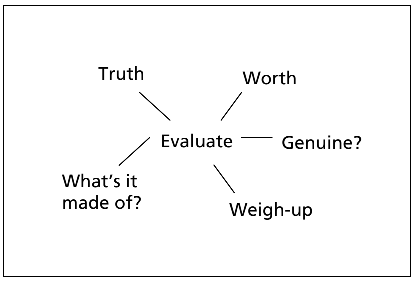
Finding enough to write can be a problem for some candidates. A technique that can help here is *word association*.

Write a key word or phrase in the middle of a sheet in the rough workings section of your second answer booklet (tip: put the sheet on its side) and then draw 4 or 5 rays from it.

For example, for Homejay 'evaluate the options'. Taking the sale of Electryco as an example:

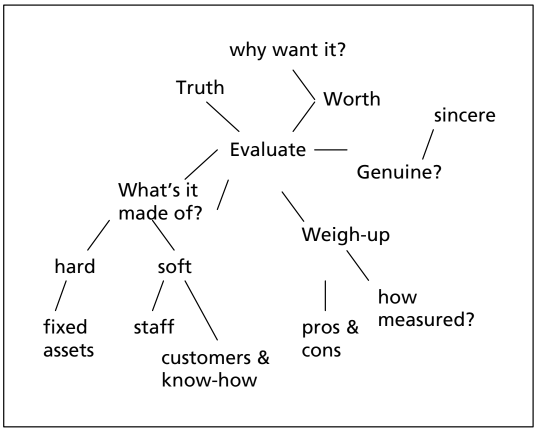


At the end of each ray write a word or phrase that comes to your mind as being connected with the central word. The important thing here is to suspend your critical filter. Rely on word association and do not worry if the words you write down seem silly or out of context. The fact you thought of them means that somewhere in your mind there is a connection between them.



A quick consideration of some of the words on this map may help us to realise that our report should discuss business valuation ('worth'), the future earnings, assets, management and technologies of Electryco ('what's it made of?), the reliability of information we have been given by Maxine Gill ('genuine', 'truth').

If you still have a problem getting ideas then repeat the exercise with the more promising words on the original rays, and so on:



These further associations have reminded us to consider the validity of the accounting information ('how measured'); to itemise the benefits and risks clearly in our report ('pros and cons'); to check on the assets and protections available ('hard and soft') and also to consider the strategic logic to Homejay selling it ('why want it?').

Reviewing the key word and word association exercises gives us a promising list of things to talk about in our report:

- question why they are selling,
- what will be the termination costs of 80% of its workforce,
- what will be the warranty costs in the future and who will deal with the problems if Electryco is sold,
- how the cash might be used,
- what is right price for Electryco,
- impact on morale of Homejay staff if early decision of Kato leads to 80% of Electryco staff losing their jobs,
- whether Suzie Green can or should be retained within Homejay as a manager.

The skeleton plan can be further filled out:

Homejay Incorporated

CONFIDENTIAL REPORT – Issues and future strategic options

To: Ken Kato: Chairman
From: A Consultant
Date: 20th November 2003

Content

1. **Introduction**
2. **Current Strategic Issues facing Homejay**
   - lost the support of shareholders due to previous senior management
   - acquired businesses with little synergy with the core business (note WACC inflated by Cardco and Electryco)
   - it has efficiency problems: duplication of factories in Woodyco: poor stock management.
   - its performance evaluation and bonus systems are dysfunctional
3. **Evaluation of Option to Improve Profitability**
   - essential to improvement of EPS
   - low risk strategy
   - efficiency gains to be made by rationalising Woodyco factories and supply chain/stock
   - head office relocation not advisable due to effect on short-term earnings
4. **Evaluation of Option to Divest Electryco**
   - Electryco does not build on core competences of firm and is at variance with Kato's vision for Homejay
   - Offer from Kitbeco not sufficient to compensate for loss of free cash flows
5. **Evaluation of Option to Divest Cardco**
   - essential in refocusing business
   - offer acceptable
   - may be possible to get better offer if rival firms can be encouraged to bid too
   - no employment or morale effects if buyer takes over staff too
6. **Evaluation of Option to Purchase Makeitco**
   - consistent with core business vision
   - offer price is acceptable (show maximum price in case bid war starts)
   - point out problems of anti-trust regulations and managing a family owned firm
   - recommend subject to finance being available and fall in next year's profits acceptable. Could suggest earn-out for management to spread costs of acquisition
7. **Other issues**
   - allow Mottram to leave as he is tarnished with past failure Suggest interview other divisional managers to replace him
   - base bonus scheme on share movement e.g. by share options
   - suspend branding exercise to save cash flow and await final decisions on disposals and acquisitions
8. **Conclusions**
   - more focused group will be more valuable
   - taking action will restore investor confidence
   - cash released by disposals will help pay for Makeitco
9. **Recommendations**
   - institute rationalisation and efficiency programme to increase profits
   - seek replacement for Mottram
   - invite more offers for Cardco
   - enter second stage negotiations with owners of Makeitco
   - seek replacement for Mottram
   - postpone branding campaign for 2 years
   - introduce new incentives and performance evaluation system

Appendices

A. SWOT Analysis for Homejay Inc.

B. Evaluation of sale of Electryco

C. Evaluation of sale of Cardco

D. Evaluation of purchase of Makeitco

7.9.6 Writing the introduction to your report

Remember that great thriller writers keep their readers in suspense until the last chapter or page to find out what happens. Sometimes there is a twist and the ending is the opposite of what the reader had been anticipating.

Your TOPCIMA report should be the **complete opposite** of a novel:

- the reader should be clear from the start what the conclusion of your report will be;
- the report should show the reader how you arrived at this conclusion in a way that builds the argument and shows how one point leads on to the next and makes your conclusion inevitable;
- it should end with a clear recommendation on what management should do next.

This opening paragraph has power and compels attention.

A useful discipline is to ensure the first sentence of your Introduction begins with one of the following phrases:

- 'This report will argue that . . .';
- 'This report will present the case for . . . (a given course of action or decision)';
- 'The central conclusion of this report is its recommendation that . . .';
- 'This report will demonstrate that . . . (the following situation is the case or certain actions are essential'.

This only works if this sentence is the first thing you actually write in your skeleton plan and final report. Do not cheat by leaving a space and inserting the sentence once you have finished your report and finally decided what you think.

7.10 The Case Writer's Answer to Homejay Inc.

This chapter concludes with the published answer to Homejay. You will note that it differs from the skeleton plan above. This is for two reasons:

- the published answer is likely to be far longer than a student's script. Its purpose is to indicate the sorts of analysis and arguments that would have gained marks;
- it illustrates that it is quite permissible to have your own opinion of what to recommend, providing you justify your recommendations.

Case Writer's Answer for Management Accounting – Case Study

REPORT

20 November 2003

To: Homejay's Chairman From: Management consultant

Review of Homejay that discusses the four strategic options identified and makes recommendations for changes

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Appendix 2 Homejay draft budget for 2004/05 and EPS calculations
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1.0 Introduction

Homejay has been in business for over 100 years but for the last 9 years, since 1994, it has seen earnings decline and shareholders are dissatisfied with the company's lack of growth in its earnings per share. It is operating in competitive markets and, despite a number of management initiatives, has maintained a turnover of over $4,000 million for the last two years but margins have declined.

The company's Chairman has recently retired and the new Chairman, Ken Kato, is proposing a number of strategic changes, involving possible divestment of some of the business units. The Finance Director has also introduced a funding limitation of $50 million per year for capital expenditure across all of Homejay's business units.

An opportunity has also arisen to acquire a complementary business, Makeitco, which is being evaluated.

2.0 Terms of reference

I have been appointed as a management consultant, to undertake a review of the issues facing Homejay. This review also discusses and evaluates each of the four strategic options that have been identified and the report includes recommendations of changes that would enable Homejay to achieve longer-term growth in its earnings per share.

3.0 Review of the issues facing Homejay

The overriding key to success in these customer-orientated manufacturing and retail industries is having the right product available at the right time at the right price and marketed in such a manner to appeal to potential customers. It also involves close cost control to ensure margins are not eroded.

While there are a lot of ways in which Homejay can improve its profitability, it should be noted that it is continuing to be successful in achieving over $4,000 million worth of sales worldwide each year and profitability is still over $200 million each year. Many other businesses in the retail market have seen earnings fall far more drastically. Furthermore, many companies in the furniture industry have declined into loss-making situations, so Homejay has been relatively successful compared to some of its competitors. One of the global furniture retailers, Courts, has decided to refocus the company on its core business of retailing furniture and has ceased retailing all electrical products.

The last two years' actual results have seen the return on sales slip from 5.1% to 5.0% in 2002/03. The latest forecast for 2003/04 shows a further slippage of 0.1% to 4.9% return on sales assuming the forecast net profit before interest and tax is achieved. All figures are based on earnings before interest and tax as a percentage of turnover.

Homejay has been capable of producing growth in sales, which has historically been the focus, but it now needs to address growth in profitability so that shareholders can see growth in earnings per share. Additionally, this strategic review will look at whether or not retaining or divesting two of its business units will contribute towards improving shareholder value. This review also considers the proposed acquisition of Makeitco.

A much greater level of control is required in Homejay's planning process. From historical evidence it is clear that financial plans have been prepared, approved and communicated to the market, which had been over-optimistic and unachievable. Maxine Gill and Paul Simpson need to address the planning issues and control procedures much more closely.

It seems that Homejay has been able to achieve turnover targets but at the expense of profitability, presumably due either to poor cost control or selling surplus stock off at cost or little margin. More flexibility is required from suppliers and also Homejay's own manufacturing units to achieve maximum sales.

Homejay has not expanded its geographical coverage at all, or even the number of its retail outlets, over the past few years. Many of the other global furniture retailers, such as *IKEA* and *Courts*, have continued to expand into new and developing markets. Homejay needs to look for new markets for its products, or it will be facing increased competition from larger global retailers in its existing markets.

The company appears to be a little 'stale' and has not been proactive or very innovative in its retailing. It has relied on bringing in repeat business from many of its Woodyco customers and the Fixitco stores have been allowed to fall behind those of its competitors in terms of attractiveness to its customers. If this downward spiral is allowed to continue, the company could find that it loses some of its market share to its competitors in a very short space of time and it would be difficult to redress.

The Homejay situation could be compared to the *Marks and Spencer* business that failed to spot changing market trends and saw a rapid decline in sales and its share price a few years ago. *Marks and Spencer* made a number of strategic changes and sold off some stores and improved its appeal to segments of the market that it had lost in the past, and this has resulted in improved turnover and share price.

The *Kingfisher* group has recently reviewed its core businesses and has used IT solutions to enable it to improve cost control in its *B&Q* DIY stores.

Fixitco and Woodyco should be more pro-active in their stores' design and layout to attract customers and to boost sales. They should not be competing on price alone, but should be trying to create a good sales environment and to build upon existing strong brand names.

The company's management performance bonus was paid to over 85% of its managers in the last financial year to February 2003. During this period, the company's EPS improved slightly from $0.21 to $0.22 per share. It is necessary for the managers' performance bonus to be realigned with shareholders' interests and this is discussed below, in Section 4.0 of this report.

4.0 Review of Homejay: Option A – improve profitability

The strengths, weaknesses, opportunities and threats to Homejay are shown in *Appendix 1*. Homejay needs to make a number of strategic decisions and should use the opportunity of this review to divest itself of two of its business units and acquire the complementary business in the DIY market in the USA. These proposed divestments and acquisition are discussed in depth in Sections 5.0, 6.0 and 7.0 below.

Each of the five Homejay businesses needs to be thoroughly reviewed so that Homejay's profitability can be improved.

Each of the Homejay business units should review its products and use the BCG matrix to confirm whether the products are worth retaining or should be withdrawn. It would also help to focus attention on which products are 'cash cows' and which products need more marketing to improve their level of sales. The company also needs to identify which products need to be changed or modified to improve their marketability. Each of the business unit general managers should re-examine the target market that its products are aimed at and ensure that its prices reflect whether it is operating as a low price cost leader or whether it is able to charge premiums for products that are differentiated from those of its competitors. Homejay needs to become more outward-looking and not just continue in the same way as it has always done. It needs to be more proactive, rather than reactive, to its chosen markets. New senior managers should be recruited who can improve Homejay's responsiveness to customers' needs.

The retailing markets are all much more competitive and fast-moving than they have ever been before, with consumers being more selective and aware of alternative suppliers and prices. Customer loyalty is a luxury that Homejay has had the privilege of for many years but it must not sit back and expect this to continue. Clearly Homejay is doing a lot to meet customers' requirements with the high levels of sales that it has been able to generate, but with more careful management of its customer base and targeting of new customers, sales could be much greater. The company needs to concentrate on controlling its costs so that net margins can be increased.

The company needs to review how innovative it is with introducing new products. Is Homejay always following its competitors or is it a market leader? In the Woodyco business, it has a target percentage of 15% of its turnover to be generated by new products each year. Is this achievable and are all of the new products successful? Should it increase or decrease this innovation target? Another way for the company to be innovative could be the way sales are made, perhaps by retailing via its website or by offering its customers new choices. Again, for the Woodyco business, a choice could be offered to its customers, whether they want flat-packed furniture, or ready-assembled furniture (at a higher price). Are customers offered the choices they are seeking? More market research is needed in the DIY and furniture businesses to identify how Homejay could be more innovative and appeal to a wider market.

The business units appear not to have been closely managed in the past, and general managers have not been held accountable for shortfalls from their forecasts. Homejay needs to identify the underlying reasons for not meeting planned objectives and financial forecasts. Until the difference and the reasons can be identified, it is difficult for forecasts to hold much credibility. More effective use of IT solutions is needed so that the company can react quickly to changing levels of demand, and so that forecasts can be updated to reflect actual events.

There is a need for improved cost control and management of margins across products, across all business units. This can only be achieved with good IT systems and better management control. A 1% reduction in its cost base (across all costs, including staff costs) could generate over \$40 million to the company's bottom line.

There should be more emphasis on Homejay's procurement policy since it has a large cost base and it clearly needs to have better control over its supply chain. It is recommended that a new post of Procurement Director be approved and a suitably qualified and experienced person recruited into this key post. The post holder should be responsible for all procurement issues across all business units and should liaise with and advise each of the business unit's procurement staff on best practice and help with re-negotiation of contracts where necessary. The company also needs to improve its distribution service and logistics, so that it can meet customers' expectations.

Corporate Head Office costs and possible relocation

The level of corporate head office functions and their associated costs also need critical review so that only value-adding services are retained. As each of the businesses is acting as an autonomous decentralised business unit, there should *not* be a need for vast levels of staff at Corporate Head Office. As much work as possible that is currently undertaken at Corporate Head Office should be reallocated back to each business unit and any duplication of tasks should be eliminated. More control by each business unit general manager is required.

It should be possible to reduce costs and headcount in Corporate Head Office departments by rationalisation and outsourcing. *Appendix 2*, which shows the draft budget for 2004/05, includes a target reduction of 10%, that is, \$33 million for 2004/05. There should be scope for larger reductions in future years, and if two of the business units are divested, it is likely that some of the Head Office support teams should be reduced accordingly.

In respect of the possible relocation of Head Office that Andy Mottram stated was being considered, it is not recommended that this proceeds while the company is undergoing a strategic review of it businesses and with a new Chairman in place. At present, the Head Office is in a different USA city to that of each of the three business units that are based in the USA. Therefore, it would make logistical sense to defer moving Head Office, simply for the sake of finding a cheaper location that may cause further loss of communication between Head Office and Homejay's business units. Furthermore, until a decision is taken on the proposed divestment of Electryco, the move should be deferred.

When the Homejay review is complete and any proposed acquisitions and divestments are agreed, the Head Office should relocate to one of the cities in which Homejay already has management, such as the city that either Woodyco or Cosmetco is already in.

Furthermore, the possible loss of 50% of Head Office staff could lead to severe loss of knowledge and could damage Homejay's short and medium-term success. The relocation is not recommended at present.

Review of managers' performance-related bonuses

Homejay needs to change the company's culture and also the managers' performance-related bonuses to align them with the shareholders' interests.

Shareholders want to see an increase in the value of the company, which can be measured in many ways. One way is an increase in the future cash flows of the businesses, but this is difficult to monitor and to measure. Another way is an increase in earnings per share, which is easy to monitor. Also, targets in the past have been short-term, annual ROCE targets. For senior managers, particularly business unit general managers, targets should be over a longer time frame, to enable the effects of decisions to come to fruition. Therefore, longer-term targets linked to earnings achieved by the business unit, with a capital constraint, should focus each business unit to achieve improved bottom-line results.

At the planning review meeting, Maxine Gill stated that Catherine Barnes was considering linking the performance bonuses to either Homejay's share price or EPS. As the fluctuation in the company's share price is subject to market conditions which are outside the direct control of its managers, it is recommended that performance bonuses should be linked to EPS, but not on an annual target. Perhaps it could be over a rolling three-year period to allow the results of decisions to flow through to positive results. This would stop the current short-termism approach that seems to have been adopted by Homejay's managers.

Senior managers could also be given share options over a longer time frame, perhaps 5 to 10 years, to encourage long-term growth in the company's share price.

Other human resource issues

Staff morale within Homejay needs to be maintained during the strategic review, and redundancies handled fairly. If two of the business units are divested, the Homejay staff should be given the opportunity to transfer to another business unit within Homejay, if possible, if they wish to.

Review of Fixitco

Fixitco has not expanded the number of retail stores in recent years and with the current limit on capital expenditure, this would not be possible at present unless expansion could be financed in a different way, such as leased property or franchising of the Fixitco name.

The supply chain needs to be improved with shorter lead times for delivery to Fixitco stores, so that stores can react more quickly to market trends and customer demand. It is unacceptable for Fixitco to run out of stock on fast-moving products and its IT systems should be able to identify these products and ensure that supply is available by having on-line ordering with its key suppliers. Tighter contracts may be required with suppliers so that the time delay between ordering and delivery of key product lines is minimised.

The recommended improvement in Homejay's procurement policies should improve its ability to ensure that supply keeps up with customer demand.

In respect of the refurbishment of 25 Fixitco stores, Barry Milo stated at the planning review meeting on 3 November 2003 that he was planning to defer this expenditure until 2005/06. The standard and attractiveness of the Fixitco stores are key to maintaining and increasing customer loyalty and maintaining sales. Although this represents a large part of the overall funding limitation of $50 million during 2004/05, it is recommended that the capital cost of $45 million for this refurbishment project be incurred during 2004/05, as shown in *Appendix 5*. It should not be deferred until 2005/06.

As managers' performance-related pay has, in the past, been linked to ROCE, perhaps many capital projects of this nature have been postponed, as they would have adversely affected results in the short term. It is important to maintain the appeal of Fixitco stores and to increase sales, which is key to long-term profitability. The refurbishment project of 25 Fixitco stores is recommended, and it is proposed that this should take place in early 2004/05.

Review of Woodyco

The business should prepare a detailed product profitability analysis, and review the effectiveness of retailing low-profitability product lines. Some products may need to be redesigned or marketed more effectively to produce higher sales.

The Woodyco management should review whether it could outsource the manufacture for some product lines, as it may not be cost-effective to manufacture all furniture items in-house. Furthermore, a review of the manufacturing capacity in Woodyco's business should be undertaken to rationalise the nine manufacturing plants and reduce its in-house capacity. Any duplication in manufacturing of product lines should be eliminated, to ensure manufacturing capacity is used most effectively. Quality control needs to be maintained and improved so that customer satisfaction remains high. This is particularly important if some products are outsource so that quality standards are maintained.

Woodyco's manufacturing capacity should be reviewed, but if there is the possibility of rationalisation and closure of some sites, this should not happen until a decision on the Makeitco acquisition is agreed. Consideration needs to be given to the possible extra demand for Woodyco products if Makeitco stores in the USA were to be acquired, as this would provide new sales outlets for Woodyco products.

New design staff should be recruited into Woodyco to ensure that the company's products are successful in the longer term.

MFI and *IKEA* are two large international furniture manufacturers and retailers which have increased their sales by continuing to launch new product ranges and innovative ways to sell them, including comprehensive computerised planning services for customers. Both of these companies have used IT solutions to improve their control of their manufacturing and logistics, to speed up lead times and to control costs. Woodyco has much to learn from competitors such as these. Woodyco also needs to improve its ability to focus on its customer requirements.

Electryco

If the Electryco business unit were to be retained there would be a need to improved quality control.

There should be more focus on what the customer wants. There has been too much emphasis on producing goods and spending large sums on marketing to promote them. The company needs to identify customer requirements and meet or exceed them at a price to be competitive. At present, Electryco appears to be selling products with features that do not appeal to customers and many of the products are not competitively priced. Perhaps these additional features cost too much to manufacture and are not considered value for money by customers. If the products were redesigned, their manufacturing costs may reduce allowing a lower retail price without eroding margins.

Cosmetco

The Cosmetco business is not being reviewed at present but close monitoring is required to ensure that it continues to grow without the need for the high product development costs that have already occurred. The nature of this business is very fickle and subject to changes in fashion and consumer taste.

Marketing is very important and data provided infers that much of the success recently is related to the actress who promotes the products. Careful negotiations are required to ensure contract obligations are fulfilled, or careful consideration to what the effect on the business would be if the actress disassociated herself from the company. It is recommended that Cosmetco commences discussions with another model or actress who could step in if necessary, if the currently contracted actress fails to complete her contract. Additionally, the cost of contract renewal could be significant. It is not unusual in this industry for $5 to $10 million to be paid in fees alone.

The business unit needs to continue to carefully monitor the markets it operates in and should consider extending its geographical sales to other European countries after thorough market research.

Proposed corporate marketing campaign

If the forecast effects of the proposed corporate marketing campaign are correct, this could result in increased gross margins across all five business units of between \$100 and \$110 million in 2004/05. After the cost of the marketing campaign of \$80 million, this could result in a favourable effect of between \$20 and \$30 million. However, if the estimates of volume increases are incorrect (and past forecasts appear over-optimistic), then the marketing campaign may cost more than the gross margin that it could generate. Additionally, until the strategic review is completed and the future of the five business units is decided, the time is wrong to undertake such a large corporate marketing campaign. If the effect on the Cosmetco business is incorrect and volumes increase by only 5%, then most of the favourable effect of the campaign would disappear.

Additionally, would the marketing spend have a better effect in each of the businesses, rather than promoting the Homejay corporate name? The effect on Homejay's bottom line would be disastrous if the \$80 million was spent and very little increase in the volume of business was generated. Furthermore, if some of the business units are divested, then this would reduce the forecast effect on Homejay's overall margin. Therefore the marketing campaign is *not* recommended at present.

Other organisational changes recommended: Business Development Director

The company appears not to have expanded its sales outlets in recent years. This was possibly due to business unit general managers not wishing to increase the capital employed, which would have had a negative effect on performance bonuses.

It is recommended that a Business Development Director be appointed. This post holder would be responsible for identifying areas that the existing Homejay business could expand into. This could be in one of two ways, first by increasing the number of Fixitco and Woodyco sales outlets (in countries that it currently operates in or in new countries) and secondly by selling Fixitco and Woodyco products through other sales channels. For example, Woodyco products could be sold on a franchising arrangement or through other furniture or kitchen shops.

Information provided shows states that Homejay currently does not have many interests in the Far East. Most multinational furniture manufacturers have shops/outlets globally in all continents. Therefore there is room for Woodyco to expand geographically. The Caribbean market and the Far East are growing fast and there is a high demand for 'Western' products.

Operations Director

It is recommended that an Operations Director be appointed to oversee all of the ongoing operations in Homejay's business units. This post holder would have direct control of the business units and would replace the role of Chief Executive.

It appears that each business unit general manager has been kept busy just keeping each business operating at the same level, and very little has been done to examine business operating methods and capacity. It is recommended that the Operations Director reviews the current manufacturing capacity of Woodyco. This should result in some rationalisation and perhaps closure of some of the smaller factories. Alternatively, if excess manufacturing capacity is identified, this could be used to manufacture furniture to be sold to new markets/new sales outlets identified by the new Development Director.

Chief Executive

It is not recommended that Ken Kato retain Andy Mottram.

Andy Mottram has failed to manage the five business units in order for them to deliver the planned levels of profitability over the last 11 years since he joined in 1992. While he has extensive knowledge of the business, this may not be sufficient reason to retain him, as the Homejay Board clearly does not have confidence in him and his management skills to improve the business results. While EPS have decreased over the last nine years, he has not initiated any major organisational or staff changes, and he is not well respected by the business unit general managers.

Realistically, Andy Mottram may have difficulties securing another senior position elsewhere (which could explain why he has not already left Homejay) as his track record and his professional reputation is not impressive. It is suggested that Ken Kato retains him in the very short term, for the next few months, while some of the changes are being made, and that he is then asked to leave. Depending on his contract terms, it may be appropriate for Homejay to make a payment to him when he is asked to leave.

IT Director

As IT is so crucial to Homejay's future success, both in capturing data at point of sale and in helping management to identify sales trends and control costs, a main board director should manage the IT function. At present, all of the recent IT initiatives have been made by Maxine Gill, the Finance Director, but it is not entirely clear who is officially responsible for IT. It is proposed that a new IT department is established, outside of each business unit general manager's control, which provides this specialist service to all business units.

Procurement Director

The Homejay businesses do not have any one person who is responsible for procurement. With such a large cost base, this important role is key to establishing cost control and prompt service from Homejay's suppliers. It is recommended that a main board director should be appointed, who would be responsible for the company's procurement policy and maintaining best practice across all business units. The person appointed should be a specialist in procurement in the industry of fast-moving consumer goods, and also experienced in logistics.

Head of Corporate Planning

It is recommended that the current Head of Corporate Planning, Paul Simpson, be replaced with a more experienced planning manager who will help to ensure the integrity of Homejay's business plans. Paul Simpson has allowed over-ambitious plans to be repeatedly prepared and communicated to market analysts over the last nine years and has not helped Homejay's business unit managers to monitor their actual results to plans. It is also recommended that the planning department moves to be under the direct control of the Finance Director.

Summary of the review of Homejay

With improved IT systems and a stronger, more focused management team which is working towards one goal of increased EPS in the medium term, rather than always looking at one-year targets, the company should be able to become more profitable.

Appendix 2 shows how the draft budget for Homejay for 2004/05 could achieve a growth in EPS to \$0.34 if Homejay were able to achieve the budgeted growth in sales of 17% and growth in profitability of 19%, that is, increase margins by 2% across the entire company. This could only be achieved if costs were controlled better than they have been in the past, as retail prices could not be increased without affecting Homejay's competitiveness. The only other change that has been incorporated in *Appendix 2* is reduction in Corporate Head Office costs by 10% in 2004/05.

However, the resultant EPS of \$0.34 looks very optimistic and a more reasonable EPS that could be released to market analysts would be around \$0.28, which is between the current actual EPS of \$0.22 and this optimistic budget of \$0.34. Even EPS of \$0.28 would be challenging to deliver.

5.0 Review of Homejay: Option B – divest Electryco

The Electryco business is currently profitable (even after its allocation of Corporate Head Office costs), and the business unit is forecast to produce a return on capital employed of 8.6% in 2003/04. However, the business unit seems to be a 'problem child' business, in terms of the BCG matrix.

To examine whether the business should be divested, it is necessary to consider its future forecast cash flows, discounted at the appropriate discount rate (to reflect the risk of the business) and these should be compared to any possible price that could be obtained if it were to be divested now. The evaluation of the future cash flows for Electryco is shown in *Appendix 3*.

Appendix 3 shows that the future forecast cash flows produce an NPV of \$318.1 million, assuming year 4 cash flows continue into perpetuity. This is \$8.1 million higher than the proposed divestment price to Kitbeco of \$310 million. Therefore, on a simple choice based on numbers, Electryco should be retained. However, due to the funding limitations imposed by the Homejay Board, there are other issues that must be considered.

As part of the bigger corporate picture, Homejay could only finance the acquisition of Makeitco if both Electryco and Cardco were to be divested. Therefore, the strategic nature of these proposed divestments should be considered also.

Homejay's management needs to reassess the projected cash flows to ensure that they are achievable and realistic. In particular, the forecast cash flows need to address Electryco's pricing policy and whether it can compete effectively at the forecast prices. Furthermore, the quality problems that Electryco is currently experiencing need to be rectified. Any impact on prices and volumes and any increased production costs required to improve quality control need to be built into the forecast cash flows. Has this been done and are the forecast costs of manufacture realistic and achievable?

Another issue to be considered is that the \$310 million divestment price is fairly certain, whereas the \$318.1 million forecast future cash flows are rather uncertain. Additionally, Electryco seems to have a brand image and the Homejay Board should consider the risk of retaining this business unit and the possibility of the bad image from faulty goods affecting the rest of the company.

The Electryco business unit has recently undertaken a pricing review and has not made major changes to its pricing structure. Since there are a number of indications that its products are not priced competitively, this must cast some doubt on whether the forecast cash flows could be achieved.

Another consideration in the proposed divestment of Electryco is that the business unit has a forecast level of capital employed of $350 million at the end of February 2004. If the business unit were to be divested for $310 million, there would be a one-off impact on the company's EPS arising from the write off of $40 million of capital employed. However, it is likely that the capital employed for the Corporate Head Office would, in the short term, simply be reallocated to the remaining business units, with little, or no, effect on EPS.

To sum up, the uncertainty of the future profitability and reliability of the forecast cash flows should be sufficient evidence to persuade the Homejay Board to divest Electryco now. Homejay has a possible buyer and Kitbeco has expressed a firm commitment to acquire Electryco for a realistic price. If this offer is not accepted and the Electryco business were to suffer further declines in sales and profitability, it could make a divestment harder at a later date, and probably at a much reduced price.

Since Kitbeco has offered a price of $310 million for the business, which currently has capital employed of $350 million in the latest forecast, it obviously considers that it can achieve higher future cash flows than Electryco.

It should also be noted that the forecast cash flows for Electryco (and Cardco) are after their respective allocation of corporate Head Office costs. The level of allocated corporate Head Office costs charged to each business unit has not been stated. Homejay would need to put in place a process to manage divestment, so that the overall level of corporate Head Office costs should reduce with the divestment of Electryco (and Cardco). It could be that some corporate costs, such as the company secretary office, would not reduce and would simply be reallocated to the three remaining business units. However, with the divestment of two of the five business units, there should be ample scope to reduce the overall level of corporate Head Office costs. Possibly, Kitbeco has a lower level of corporate costs and can operate this business more profitably.

At the strategic level, Homejay would need to divest Electryco in order to finance the acquisition of Makeitco, which is forecast to generate $44.6 million of value for shareholders. This is larger than the possible gain of $8.1 million that could be made by retaining Electryco.

Homejay would still have to bear the burden of warranty costs for Electryco's products sold, although this could be insured against. Alternatively, Electryco could come to some arrangement for Kitbeco to undertake repairs or replacement products. Assuming a higher than normal failure rate of, say, 5% then this could possibly cost Homejay $34 million in replacement products.

It is recommended that Homejay divests Electryco and uses the sale proceeds of $310 million to be put towards the acquisition cost of Makeitco. However, it should be noted that the amount of $310 million would be insufficient to acquire Makeitco, without the additional divestment of Cardco.

6.0 Review of Homejay: Option C – divest Cardco

Cardco's forecast cash flows are expected to grow at over 10% each year for the next two years. It should be questioned whether this forecast growth in cash flows is realistic and achievable. Even if the cash flow forecasts are correct, the business is not growing in the dynamic way that Ken Kato wants to achieve for Homejay.

The discounted cash flows for Cardco produce an NPV of $120.1 million, as shown in *Appendix 3*. The possible divestment of Cardco at around $160 million, because of its valuable high-street sites, therefore looks very attractive. If this business were to be divested, then the company would gain $39.9 million over the future discounted cash flows.

The card retailing business has not been growing rapidly over recent years and it is not a core business. Homejay has retailing skills and is best known for its DIY and furniture businesses and it is recommended that this minor business be divested now for around $160 million. The material states that two companies are interested in acquiring Cardco and perhaps if they are both keen to acquire Cardco's valuable high-street sites, the actual price obtained could be even higher than the $160 million currently indicated. They must have business plans that could achieve higher cash flows than Cardco has forecast that it could produce if they are willing to pay this price.

Additionally, the $160 million selling price is $70 million in excess of the forecast capital employed for the business. This would help to contra the adverse $40 million difference in the Electryco sale price to its capital employed, should both businesses be divested.

It is recommended that the proposed divestment of Cardco should be pursued.

The $160 million raised by the sale of Cardco could be used to finance other areas of the Homejay business, such as the proposed acquisition of Makeitco, or to repay debt.

7.0 Review of Homejay: Option D – proposed acquisition of Makeitco

Barry Milo has identified a DIY chain in the USA called Makeitco, which is looking for a cash buyer and, at present, no other companies are competing to acquire it. It also would be considered a friendly acquisition and, with the absence of other buyers, it is likely that Homejay could acquire the company for around the current valuation price of $350 million.

The evaluation of the future cash flows for Makeitco is shown in *Appendix 4*. At an acquisition price of $350 million, and re-branding costs of $10 million, Homejay could achieve a positive NPV on this acquisition of $44.6 million, if it is able to achieve synergy benefits of $5 million per year (discounted at 10%). However, the acquisition has a long payback period of around 9 years (undiscounted), which is to be expected in a business of this nature.

Perhaps a small premium would be necessary to acquire the company, which would erode some of the positive NPV of $44.6 million based on cash flow forecasts supplied by Makeitco's management. Subject to these forecast cash flows being verified by Homejay's management or its advisers, this looks to be a promising acquisition.

In strategic terms, the acquisition of Makeitco makes sense, as it is an acquisition of a company in the same retail field as one of Homejay's existing businesses, that is, DIY stores. It would also give Homejay access to the growing DIY trade in the USA. At the same time, it also provides further retail outlets in the USA for Woodyco's products. The DIY industry is growing globally and this acquisition would enable Homejay to be a global leader in this industry and would allow it to gain advantage from economies of scale and other synergy benefits.

Therefore, if Homejay feels that this acquisition is a good strategic fit to its other DIY business, Fixitco, then the acquisition should be made. However, this positive NPV could be eroded by any premium that may be required to acquire Makeitco. If the premium over the current valuation is only 10%, then the premium would be $35 million and the NPV would reduce to only $9.6 million. If the premium were greater, then this would cast doubt over the financial viability of the acquisition.

Other points to consider on the financials is whether Homejay should re-brand Makeitco stores, presumably to the brand Fixitco, and whether $10 million is sufficient to do this.

The calculations also include synergy benefits of $5 million per year. It needs to be established how these synergy benefits have been calculated and operational plans would need to be put in place to ensure these benefits do accrue. Often after an acquisition, synergy benefits fail to materialise as the company finds it difficult to merge the two businesses. A further cost that Homejay may incur may be the one-off cost of merging Makeitco's stores into Homejay's portfolio, or any IT-related costs required to ensure that IT systems are compatible.

Additionally, if the price of Makeitco were to rise above $350 million, which could happen if other companies are interested in acquiring Makeitco, then the maximum that should be paid is $394.4 million, which includes the identified synergy benefits.

In summary, it is recommended that Homejay does acquire Makeitco, but at a price not exceeding $390 million. However, due to funding limitations, this could not be financed by further loans and the owners of Makeitco have indicated that they do not want shares (even though they could sell Homejay shares on the open market) and are looking for a cash buyer. Therefore, the acquisition could proceed only if both Cardco and Electryco were to be divested.

If Electryco and Cardco were to both to be divested, then these two businesses would generate $470 million ($310 million plus $160 million). This would be more than sufficient to purchase Makeitco at around $350 million. It would also allow Homejay to undertake all of the other identified capital projects, as well as repay some of Homejay's debt. This is detailed in *Appendix 5*.

8.0 Recommendations for changes

The time is right for Homejay to make a number of strategic changes. The actual process of making these changes will signal to market analysts that Homejay is tackling its problems, which have resulted in stagnant EPS and falling share prices in recent years.

The process of re-examining its portfolio of businesses and divesting two businesses which it considers to be non-core and the acquisition of a USA-based DIY company, Makeitco, would probably be greeted with enthusiasm by market analysts. This would have a positive effect on the confidence of the market in Homejay. This should result in an increase in Homejay's share price in the short term, as the market would view that its medium-term to longer-term prospects look brighter. However, until increases in the company's EPS actually appear, the market analysts may remain cautious. Continued close liaison between Maxine Gill, and also Ken Kato, and the market analysts, is recommended to build confidence and to inform the latter of its outline plans.

It is recommended that Electryco is divested for $310 million, even though this is lower than the value of forecast future discounted cash flows of $318.1 million (but there is doubt over the reliability of the future cash flows because of pricing and quality issues). The funds generated could be put to better use to generate wealth for shareholders by acquiring Makeitco.

It is recommended that Cardco be also divested for $160 million, as this is in excess of future expected cash flows for the business.

It is recommended that Homejay acquires Makeitco for a price around $350 million. Cash raised by the sales of both Electryco and Cardco could be used to fund the cash acquisition of this company.

It is also recommended that the refurbishment programme in Fixitco be undertaken during 2004/05 at a capital cost of $45 million, and *not* deferred any longer.

Appendix 5 shows a summary of the financial effects of these recommended changes for 2004/05. This table shows that the net effect for 2004/05 is a net cash inflow of $75 million, which could be used towards other capital projects or to repay debt. The acquisition of Makeitco is broadly financed by the divestment of both Electryco and Cardco, and the capital expenditure required to refurbish the 25 Fixitco stores is available with $75 million remaining. This could be used on improving the company's IT systems or indeed for expansion of sales outlets.

The $75 million remaining for capital projects does not include the costs associated with the acquisition and divestments, nor any of the operational costs of the recommended staff changes.

While all of these changes are occurring, it is considered the wrong time to undertake the proposed corporate marketing campaign. It is recommended that each business unit's marketing budget and planned marketing activities should be reviewed, so that each business continues to market its own brands to build upon its already established brand awareness.

There are a number of organisational changes recommended. The Homejay Board needs to agree on a number of senior posts. After the posts are agreed, Catherine Barnes would need to ensure that the selection and appointment of suitably qualified and experienced personnel are made at the earliest opportunity. It is vital that these crucial new posts are filled by people with a proven track record of delivering results in their field of expertise. The organisational changes that are recommended are detailed above in Section 4.0 of this report. The new posts and organisational changes that are recommended are summarised as follows:

- Business Development Director – responsible for expanding the core businesses into different geographical areas and establishing new sales outlets for existing products;
- Operations Director – responsible for monitoring on-going operations within the business units. The business unit general managers would report to the Operations Director (instead of to the Chief Executive);
- Remove the role of Chief Executive;
- Andy Mottram, the current Chief executive, should have his contract terminated;
- IT Director – responsible for all of Homejay's IT requirements;
- Procurement Director – responsible for Homejay's procurement policy and maintaining best practice across all business units;
- A more experienced planning manager should replace the current Head of Corporate Planning Department, Paul Simpson. It is also recommended that Corporate Planning should move under the direct control of the Finance Director.

With the recruitment of an IT Director, more emphasis should be placed on improving the company's IT systems. Improved communication between businesses, and also within business units, is necessary, so that there are no more surprises at each financial year end. Improved financial forecasting systems are required so that actual results are closely tracked to internal budget, and updated forecasts and reasons for variances understood in a timely manner so that corrective action can be taken to ensure that financial targets are met or exceeded.

While much change is occurring within Homejay, it is not recommended that the company should relocate its Head Office. However, as part of the review of Corporate Head Office functions, perhaps as departments are thinned down, a logical time to move may be when the two business units (Electryco and Cardco) have been divested and Makeitco has been acquired. This move should be deferred by about two years and it would be logical to minimise the number of geographical locations that the company is operating in. Therefore, if the Head Office is to relocate, it is recommended that this could be to one of the US cities in which Homejay already operates (that is, to one of the cities where Woodyco, Cosmetco or Makeitco already has offices).

It is recommended that Homejay changes the criteria used for managers' performance-related bonus scheme, so that it is aligned with shareholders' interests. Of the two proposals made by Catherine Barnes to link it to either the company's share price or to the company's EPS, the latter is recommended. This should encourage all managers to work towards one goal, which would be to improve the company's EPS. This should, in turn, lead to increases in its share price.

It is also recommended that Head Office costs are thoroughly reviewed and that many Head Office functions are cut back or put under the direct control of each of the respective business unit general managers. The Homejay Head Office costs appear far too large for an organisation such as this with highly devolved business units. These costs need radical trimming. Targets for cost reduction should be set for the next few years.

As part of the recommendation to move Corporate Planning under the direct control of the Finance Director, there is a need to improve the control of Homejay's planning process. The current planning process appears not to link with what is actually happening within each business. Improved communication and modeling based on historical trends is required so that plans prepared are more realistic. It is also recommended that the Head of Business Planning be replaced with a more able manager. The current Head of Business Planning, Paul Simpson, has a poor track record of producing achievable forecasts. These poor forecasts that have been communicated to market analysts have led to a lack of confidence in Homejay's ability to deliver results. As recommended above, Business Planning should move to be under the control of the Finance Director, Maxine Gill.

Once all of these recommendations have been actioned, and the two business units have been divested and Makeitco has been acquired, Homejay will become a much stronger player in its chosen markets. It will be able to start to reap the rewards of becoming a global player and could expand its furniture, DIY and cosmetics businesses into new geographical areas to improve its growth prospects.

Appendix 1

SWOT analysis for Homejay

Strengths

- Profitable business units
- Established sales channels
- Established brand names
- Repeat business from customers
- Good quality record generally (except some recent problems with some Electryco products)
- Experienced staff
- Valuable High Street sites of Cardco retail outlets
- New Chairman, Ken Kato, and his retail experience
- Control of its own manufacturing plants for the Woodyco business
- Cosmetco's profitability is growing fast

Weaknesses

- Weak management
- Slow to innovate
- Market led, rather than driving the market
- Poor planning and control systems
- Poor cost control
- Slow to react to changes in demand
- Organisation slow to change to meet the changing tastes of consumers
- Head Office corporate costs very high
- High fault level in new Electryco products
- Homejay management performance bonus scheme not aligned with shareholders' interests
- Some Electryco products not competitively priced

Opportunities

- Expansion through new sales outlets of existing brands
- Expansion geographically
- Improved IT systems should improve cost control
- Improved IT systems should identify fast-moving stock more quickly to maximise sales
- Opportunity to acquire Makeitco to enable Homejay to own retail DIY stores in USA
- Opportunity for new sales outlets for Woodyco products if Makeitco is acquired
- Opportunities to divest Electryco and Cardco
- Opportunity to rationalise Woodyco manufacturing plants

Threats

- Existing competitors (and new competitors) gaining market share from Homejay, resulting in falling sales
- Competitors with lower prices (particularly in Electryco's business)
- Competitors introducing new products more quickly than Homejay
- Electryco's quality problems could affect entire businesses if not managed promptly, which could lead to major loss of market share
- Loss of confidence in Homejay by shareholders and market analysts if Homejay is unable to increase EPS, which could lead to a downward spiral in its share price
- Could be the subject of a takeover
- Proposed corporate marketing campaign may not be a success, and high cost of campaign could erode Homejay's profitability

Appendix 2

Homejay draft budget for 2004/05 and EPS calculations

	Actual forecast 2002/03 \$ million	*Latest changes 2003/04 \$ million*	*Budget*	*Draft budget 2004/05 \$ million*	*Less:Head Office savings 10% × \$330 \$ million*	*Revised budget 2004/05 \$ million*
Turnover	4,290	4,510	17%	5,277		5,277
Operating costs	4,076	4,287		5,012	(33)	4,979
NPBIT	214	223	19%	265		298
Interest	64	64		64		64
Net profit after interest	150	159		201		234
Tax at 30%	45	48		60		70
Net profit after tax	**105**	**111**		**141**		**164**
Number of shares	480	480		480		480
EPS	**0.22**	**0.23**		**0.29**		**0.34**

Notes:
1. This assumes that all five business units continue.
2. Assumes that loan interest remains at \$64 million per year.
3. Assumes that the corporate marketing campaign does not proceed and that Head Office is not relocated but that savings of 10% on Head Office costs could be achieved.
4. This assumes that Homejay is capable of producing growth of 17% in its turnover and 19% growth in its net margin and that the latest forecast for 2003/04 is accurate.

Overall, the resultant EPS of \$0.34 looks very optimistic and a more reasonable EPS for release to market analysts would be between the current actual of \$0.22 and this optimistic budget of \$0.34, that is, around \$0.28. Even EPS of \$0.28 would be challenging to deliver.

Appendix 3

Evaluation of the proposed divestment of the Electryco and Cardco business units

	Year 1 2004/05 \$ million	*Year 2 2005/06 \$ million*	*Year 3 2006/07 \$ million*	*Year 4 onwards 2007 onwards \$ million*
Electryco				
Net cash flows	39.0	40.0	41.0	42.0
Year 4 cash flows in perpetuity				42.0/0.13
Year 4 cash flows in perpetuity				323.1
Discount rate @ 13%	0.885	0.783	0.693	0.693
DCF	34.5	31.3	28.4	223.9
Cumulative DCF	34.5	65.8	94.2	318.1
Total NPV				318.1
Potential divestment price for Electryco				310.0
Decrease over future expected cash flows				(8.1)
Cardco				
Net cash flows	16.0	18.0	20.0	20.0
Year 4 cash flows in perpetuity				20.0/0.16
Year 4 cash flows in perpetuity				125.0
Discount rate @ 16%	0.862	0.743	0.641	0.641
DCF	13.8	13.4	12.8	80.1
Cumulative DCF	13.8	27.2	40.0	120.1
Total NPV				120.1
Potential divestment price for Cardco				160.0
Increase over future expected cash flows				39.9

Appendix 4

Evaluation of forecast cash flows for the proposed acquisition of Makeitco

	Year 0 2003/04	*Year 1 2004/05*	*Year 2 2005/06*	*Year 3 2006/07*	*Year 4 and annually thereafter*
	\$ million	*\$ million*	*\$ million*	*\$ million \$*	*\$ million*
Makeitco					
Net cash flows	(350.0)	33.0	34.0	35.0	36.0
Synergy benefits		5.0	5.0	5.0	5.0
Year 4 cash flows in perpetuity					41.0/0.10
Year 4 cash flows in perpetuity					410.0
Rebranding costs	(10.0)				
Total cash flows	(360.0)	38.0	39.0	40.0	410.0
Discount rate @ 10%	1	0.909	0.826	0.751	0.751
DCF	(360.0)	34.5	32.2	30.0	307.9
Cumulative DCF	(360.0)	(325.5)	(293.3)	(263.3)	44.6
Total NPV	44.6				
Payback (undiscounted)	9 years				

Appendix 5

Summary of the financial effects of the recommended changes for 2004/05

	Financial effect of changes in 2004/05
	\$ million
Refurbishment of 25 Fixitco stores	(45)
Divestment of Electryco	310
Divestment of Cardco	160
Acquisition of Makeitco	(350)
Net cash inflow for 2004/05 towards other capital projects or to repay debt	75

Notes:

1. The cost of the acquisition of Makeitco could be greater than \$350 million if a bid premium is paid, which would reduce the net cash inflow for 2004/05.
2. This does not include the costs associated with the acquisition and divestments, nor any of the operational costs of the recommended staff changes.

Final Tips and Advice for your TOPCIMA Exam

8

8.1 Introduction

By now you will have worked your way through this CIMA Learning System. You have the 3 full TOPCIMA cases in Chapter 5 and also 2 other cases, Homejay and Sparkle, which have been analysed for you in Chapters 6 and 7.

Hopefully, you will have spent time writing your answers and comparing them to the case writer's answers. For each case that you have worked through, I hope that you have improved your skills, and these will also help you in your future life as an ACMA – when you have passed TOPCIMA.

All that remains to do in this brief chapter is to remind you what you need to do when the pre-seen material is available for the case that you are planning to sit, and to remind you of what you need to remember to do on the exam day.

Remember the key to passing TOPCIMA is good preparation.

8.2 Advice for preparation using the pre-seen material

When you can access the pre-seen material on the CIMA website for the TOPCIMA exam that you are planning to sit, remember to work through the material page by page, like we did in Chapter 6. Remember to refer back to the Skills Toolkit and also the Technical toolkit in Chapters 3 and 4.

The solutions to the TOPCIMA cases in Chapter 5 demonstrate that an understanding of the real world context of the industry will gain you marks in TOPCIMA (Figure 8.1) by:

- providing examples of actions and strategies that companies operating in the real world would follow which could be used by the company in the case study material;
- demonstrating to the reader of your TOPCIMA report (the CIMA examiner), that you understand the industry and its opportunities and challenges, and therefore your advice is reliable and realistic;

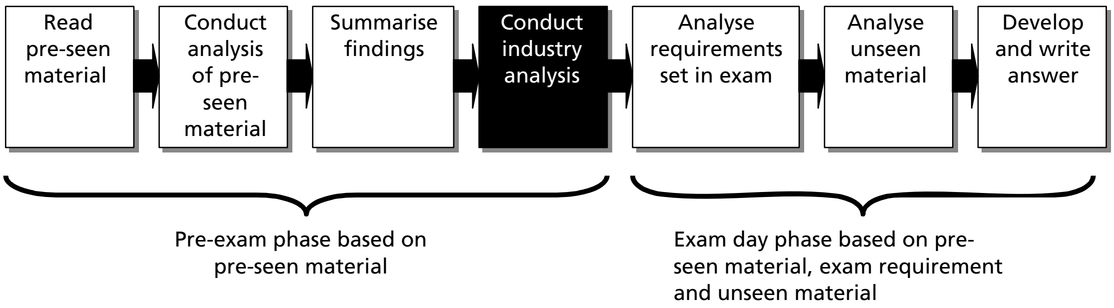

Figure 8.1 Diagram of TOPCIMA process

- helping your report to look professional by avoiding suggestions of unrealistic ideas that could make your report look ridiculous and cast doubt on your competence as a management accountant.

As part of your preparation, it would be useful to go back to Chapter 2 and re-read the 3 Post Exam Guidance reports that were prepared after each of the 3 TOPCIMA exams held in 2005. Learn from others mistakes and learn from what they did right – and do NOT repeat the same mistakes again!

8.3 Advice for researching the industry setting

To give you a deeper understanding of the problems and challenges facing the company in the case that you are sitting, it is vital to research the industry setting.

Therefore many of the factors you should look for can be summarised using the Industry Analysis section of the Technical Toolkit in Chapter 4:

1. identify industry lifecycle stage and the factors driving it;
2. identify whether any of the five forces are strong or strengthening and the forces causing this;
3. consider the competitive strategies being followed by companies operating in the real world and how they are achieved (e.g. special technologies, use of brands) and whether they could be adopted by the company in the pre-seen;
4. identify real-world issues against the PEST framework (This may involve some basic research into the laws and technologies of the industry.);
5. consider the impact of globalisation on the future of the industry and on the firm in the pre-seen;
6. consider the problems and challenges facing companies in the real world and to be aware of topical news stories on the issues facing them and how they deal with them.

An additional factor to consider is the state of the investment markets, which will affect costs of capital and share prices.

The easiest two ways of conducting industry research are:

- Reading the financial pages of a good newspaper several times each week.
- Setting up an internet news alert using one of the search engines, such as a "Google alert".

Read widely, as your knowledge of how industry and commerce work can help you to make realistic and achievable recommendations in your report. Get wise – read and revise the industry!

8.4 Advice on what to do on exam day and analysing the unseen material

It is vital that you read, and re-read, the unseen material on the exam day, and analyse the key issues in the way that we have done in Chapter 7. You must take some of the 3-hour exam time to simply analyse, plan and think about your answer. It is vital that much consideration goes into deciding which the key issues are and what the priorities are, as an error or oversight can lead to the report not covering some of the crucial issues.

You MUST USE the new material and the information in the unseen material that is given to you on the exam day. It is imperative to your success in the TOPCIMA exam that you read and analyse the unseen material carefully and take note of the changed circumstances that the company in the case may be in. You may come into the exam with some pre-prepared ideas and a plan for your SWOT or PEST analysis (all in your head of course as no papers are allowed into the exam hall) – but when you have read the unseen material – and you now get an additional 20 minutes reading time – you need to have the confidence to decide whether some of the ideas and information and plans that you have prepared and planned to write are now relevant. You need to have the confidence to discard ideas if they are no longer relevant to the unseen material.

The unseen material will give you a whole draft of important and some not so important issues and factors that affect the company. It is your job on the exam day to:

- Identify these new issues.
- Decide which are important (prioritising the main issues).
- Discuss each of the issues (main issues as well as some of the less important issues).
- Then reach well thought out and justified recommendations.

It may be helpful to use the following report format for your answer, which should provide a check that all areas of the TOPCIMA assessment matrix has been covered, especially prioritisation and ethical issues. A recommended report format is:

- Contents page.
- Introduction (brief 5 to 10 lines of background on the company).
- Terms of reference (brief 5 to 10 lines to set the scene of who you are – e.g. a consultant, and to state who the report was commissioned by, and who it is aimed at).
- Identify and prioritise the main issues facing the company, showing the top 5 items in priority order. This area of the report should also include discussion on your position audit or SWOT analysis.
- The main body of your report should discuss in depth all of the issues you have identified above and should be supported by numerical evaluation of the proposals, which should be shown in appendices. Note: all numbers and data given in appendices should also be discussed within the body of the report.
- Separate paragraph on Ethical issues, covering at least 3 ethical issues and offering advice on how the issues could be handled.
- Recommendations and conclusions. The most important part of the report and should pick up on each of the issues discussed earlier. Each recommendation should be clear and well justified as to why you are recommended a particular course of action. Do NOT recommend that more information needs to be collected before a recommendation can be made.

- Conclusion (brief 5 to 10 lines for closing comments).
- Appendices. Note all data and numbers in all appendices should be referred to within your report.

A reminder concerning Ethical issues – you must state WHY you consider the issue to have an ethical dilemma and for higher marks, it is necessary to give advice and make recommendations as to how the ethical dilemmas could be overcome. You could include discussion of ethical issues in the body of your report and recommendations on ethical issues within the recommendations area. You will not get more marks for having a separate section.

8.5 Guidance notes from the TOPCIMA Examiner

Following the first 2 TOPCIMA exams in May and September 2005, the TOPCIMA examiner had identified a number of areas of concern where candidates had not earned marks or areas that had not been attempted well. This led to the preparation of some "Guidance notes" that were emailed to students sitting the November 2005 TOPCIMA exam.

It appears that these Guidance Notes were read widely and used by many students and there was a noticeable improvement in the quality and also the format and presentation of many scripts.

These Guidance notes do not contain any really new advice – much of it was in the Post Exam Guidance reports, which are in Chapter 2. However, the advice may help you to achieve higher marks in any (or all!) of the 9 assessment criteria, and is shown below:

TOPCIMA

Summary of Guidance notes following the first 2 TOPCIMA exams

1.0 TOPCIMA guidance notes

The guidance notes below are a summary of the advice given in the Post Exam Guidance reports prepared by the examiner after each TOPCIMA exam. It is hoped that these guidance notes will help candidates when they next sit the TOPCIMA exam. The guidance is of a general nature and is not related to any particular case.

This final exam is designed to test candidates' higher level skills and to test their ability to apply the knowledge they have already learned in previous CIMA exams and in their real life work experiences, and to use their judgement to solve multi-faceted problems given in the pre-seen and unseen material. The un-seen material always gives an unexpected twist to the case, so that candidates can be tested to see whether they can apply their knowledge to the case.

The key to passing TOPCIMA is candidates' ability to be able to apply their technical knowledge and understanding of the business setting in which the case is set. You should ensure that this knowledge and understanding is applied to the actual requirement set using the new data supplied in the unseen material on the exam day.

In summary, the TOPCIMA paper is trying to prepare you for the role of an ACMA. Part of this role is the ability to "think on your feet", which requires a sound understanding of a variety of business and financial techniques and commercial understanding, as well as the ability to apply this knowledge to new information presented to you. This final test of professional competence is testing just that – your ability to apply your knowledge to the case.

It is recommended that candidates undertake research into the business setting in which a case is set, and also that they have a good understanding and familiarity with the pre-seen material. However, in order to pass TOPCIMA you MUST discuss the relevant data given in the unseen material on the exam day and ensure that your answer relates to requirement that has been set. Despite the many practice answers you may have written using the pre-seen material before the exam, it is recommended that you come into the exam hall with an open mind and not a pre-prepared answer. Then, when you have read the unseen material and the requirement, you should ensure that your answer covers the relevant new issues raised in the unseen material and that your answer is tailored to the requirement that has been set.

2.0 TOPCIMA exams using pre-seen material that will cover two exam sittings

Candidates are reminded that there are now two exam sittings with two different sets of unseen material, both based on the same pre-seen material. You should remember that the two different sets of unseen material will deal with the organisation in the case in different ways. Therefore any familiarity or knowledge of the first unseen material has no bearing or influence whatsoever on the second sitting. Therefore **each** of the two unseen materials **follows directly on from the pre-seen material**, and NOT the previous unseen.

If you did sit the September 2005 exam and were unsuccessful, and you are sitting the November 2005 exam, you should re-familiarise yourself with the pre-seen material and forget about all of the new data that had been introduced in the unseen material in the earlier exam. The second sitting in November 2005 will totally ignore the data from the September 2005 exam and will follow on **only** from the pre-seen material.

3.0 Advice on the TOPCIMA assessment matrix

Familiarise yourself with the TOPCIMA assessment matrix, to ensure that your answer covers all nine of the criteria that your answer will be assessed against. Also, remember that the weighting of marks available for each of the nine criteria may change.

Technical

Candidates can earn marks for using techniques such as SWOT analyses, NPV calculations and discussion on relevant techniques and theories such as PEST analysis, Porter's Generic Strategies model, Ansoff's growth vector matrix, the BCG matrix, and so on.

Application

This criterion carries higher marks than Technical, as the examiner considers that it is the application of the knowledge to the case material that is important. Candidates should prepare accurate supporting calculations, such as NPV's, a range of company valuations where acquisitions or divestments are being considered and be able to prepare updated cash flow forecasts. It is also recommended that a detailed SWOT analysis, incorporating data from the unseen material is prepared together with other relevant techniques such as PEST, Balanced Scorecard, or Porter's Generic Strategies model.

As candidates can now only sit TOPCIMA when they have passed all of the Strategic Level papers, they should be familiar with all of these techniques. However, it is necessary to revise all of the business theories and techniques that you have learned in the Strategic Level subjects and to use them to solve some of the business problems facing the organisation in the case. A further area that is always helpful in understanding the case material is ratio analysis, including revenues, profitability, liquidity and gearing.

Diversity

Marks are available for demonstrating a breadth of technical knowledge and a range of views. It is recommended to read widely on the business setting in which the case is set to enable you to quote examples and to explain how real companies have overcome many of the problems facing the organisation in the case material.

Focus

The marks available for Focus are for discussion of relevant key data and issues. Generally, this criterion is well attempted. To ensure high marks here it is necessary to identify the relevant key data and issues in the case material (both the pre-seen and the unseen material) and to set up a "check list" of report headings to ensure that all of these have been discussed.

Prioritisation

The process of planning your answer, at the start of the exam, is to firstly identify the relevant key issues, then to prioritise them, and then to discuss each of them in depth. It is surprising, and disappointing, that this criterion continues to be so badly attempted, with the majority of candidates earning below pass marks. Many candidates earn low marks in this criterion for the identification of the main issues only. If the issues are not prioritised, then higher marks cannot be awarded. It is recommended that the opening paragraph (after an introduction and terms of reference) should identify the key issues facing the organisation and put them in a priority order. The key strategic issues should be clearly identified and discussed in a priority order, justifying your choice of priority, in order to earn high marks under this assessment criterion.

Judgement

This is an important criterion and is for the demonstration of alternative solutions and the display of professional judgement. It can also be considered as the "link" between the discussion of the issues and the recommendations. Marks are awarded on the basis of the level of the candidate's evaluation, comments and judgement that has been demonstrated in reaching their recommendations. Candidates need to be able to demonstrate a good commercial understanding of how the organisation in the case could enhance shareholder value. Candidates should demonstrate an understanding of this most important concept and how to apply it to the case material. In addition, other stakeholders' interests should also be considered here.

Integration

This criterion rewards candidates for their ability to discuss diverse areas of knowledge and skills and to integrate them effectively. It is necessary for the key data calculated or presented in appendices to the report to be further discussed in the main body of the report. Furthermore, marks are awarded if a candidate's report flows well and discusses all of the issues in a logical sequence culminating in clear, well justified recommendations.

Logic

This crucial criterion rewards candidates for preparing justified, well argued recomendations and for the clear presentation of their report. In any business report, the most important section is the recommendations section and how clearly and well justified the recommendations have been made. This criterion rewards candidates for doing just that.

The body of the report should be discussing all of the issues identified, and the recommendations section should be making clear justified recommendations on all of the issues identified earlier in the report and needs to follow on logically from what has been discussed earlier. Many candidates chose to end each paragraph, within the main body of their report, with a recommendations section. This is acceptable for full marks but generally it would be better if the recommendations are at the end of the report. This is because a recommendation cannot be made until all of the other issues are discussed and assessed, as many are competing for the same scarce resources, manpower and finance.

The areas that should be improved for candidates who were unsuccessful are:

- Preparing fully justified, well reasoned recommendations. Candidates should not simply state "recommend . . . " but instead should state "I recommend . . . . because . . . . ".
- Recommendations should cover all areas of the report. Each of the issues that have been identified and discussed elsewhere in the report should have a clear justified recommendation. It is necessary to make recommendations on all facets of the organisation, such as changes to the Board, use of IT, and other areas such as strengthening financial controls, and ways to improve the organisation's strategic planning process.
- It may be that some of your recommendations need to be only a few lines long (but certainly not only a few words) but your recommendations should cover every issue discussed elsewhere in your report. As above, you should have a "check list" of issues to be discussed, and you should use this same "check list" to ensure that a clear justified recommendation has been made for each issue.

Ethics

It is necessary to identify the ethical issues (and there are usually several of them) and then to briefly justify why the issue is considered to have an ethical dimension. Higher marks are then awarded for candidates who further offer realistic advice on how to resolve the ethical issues. To summarise, in order to earn pass marks in this criterion, it is necessary to identify, justify and recommend advice on how to overcome several of the ethical dilemmas included in the case material.

4.0 The requirement

Candidates are also reminded to ensure that the answer that they write does fully answer the requirement stated, and not the requirement that they expected or wanted it to be. The answer given should be focused to the actual requirement set, although the requirement is usually fairly open ended. It usually asks candidates to advise on the key issues. Therefore, in order to pass you need to identify what the key issues are. It is recommended that candidates prepare answer plans, or "check lists" to ensure that all areas are covered.

Additionally, candidates are reminded that they should ensure that their answer covers all nine criteria of the TOPCIMA assessment matrix, which is used to assess their answers.

5.0 Overall recommendations for candidates sitting TOPCIMA

Finally, it should be noted that candidates who prepare thoroughly for the TOPCIMA exam, and who are able to demonstrate their ability to apply their knowledge to the requirement in the question will put themselves in a far better position to be able to pass the TOPCIMA exam. Therefore, preparation and research are vital, but this is not enough to pass this exam. You must also have a thorough understanding of the required techniques and how to apply them to the case material.

Also, it may be helpful for candidates to use the following report format for their answers, which should provide a check that all areas have been covered, especially prioritisation and ethical issues. A recommended report format is:

- Contents page.
- Introduction (brief 5 to 10 lines of background on the organisation).
- Terms of reference (brief 5 to 10 lines to set the scene of who you are – e.g. a consultant, and to state who the report was commissioned by, and who it is aimed at).
- Identify and prioritise the main issues facing the organisation, showing the top five items in priority order. This area of the report should also include discussion on your position audit or SWOT analysis.
- The main body of your report should discuss in depth all of the issues you have identified above and should be supported by numerical evaluation of the proposals, which should be shown in appendices. Note: key data and analysis given in appendices should also be discussed within the body of the report.
- Separate section on Ethical issues, covering a number of ethical issues and offering advice on how these issues could be resolved.
- Recommendations. The most important part of the report and should pick up on each of the issues discussed earlier. Each recommendation should be clear and well justified as to why you are recommended a particular course of action. Do NOT recommend that more information needs to be collected before a recommendation can be made.
- Conclusion (brief 5 to 10 line lines for closing comments).
- Appendices. Note: key data and analysis given in appendices should also be discussed within the body of the report.

To summarise, the key tasks that will put you in a better position of passing TOPCIMA in the future are:

- Research thoroughly the business setting for the case that you will be sitting and familiarise yourself totally with the pre-seen material.
- Revise business strategies and techniques and be able to apply them to the case material.

- Ensure that your report covers the relevant key issues raised in the unseen material and that your answer relates to the exact requirement of the question.
- Familiarise yourself with the TOPCIMA assessment matrix, to ensure that your answer covers all nine of the criteria that your answer will be assessed against.

Remember – do your research and prepare for the exam – but on the day, ensure that you write a thorough, well reasoned answer that covers the relevant key issues raised in the unseen material and ensure that your answer covers all aspects of the requirement. If you do this, you **will** be successful.

8.6 Final advice

Remember it is good preparation and not good luck that is needed to pass this final test of professional competence. If you have WORKED through some (or all) of the cases in this CIMA Learning System, you will be well prepared for your TOPCIMA exam. However, if you have simply skimmed through or read the material, or read the unseen straight away after the pre-seen material – this WILL NOT help you to pass.

The other concern is for you to prepare and write answers and to check them yourself against the case writer's answers. If you have simply read the answers given and have not sat down for 3 hours to see how comprehensive an answer YOU could write in 3 hours, then you are NOT prepared for the exam.

The key to passing this exam, like many other exams and tests, is practice, practice and practice.

There is no short cut.

There is no easy answer.

There is no way to prepare without investing in hours of work using past papers and to work on them as if they are the real case that you are going to sit!

Now that you have prepared – go into the exam hall and answer the question with confidence.

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