**The Institute of**
**Chartered Accountants**
**of Pakistan**

**Multi Subject Assessment Stage**

6 June 2017
3 hours and 30 minutes
100 marks

# Strategic Management – Professional Competence

**CENTRALISED REGISTRATION NUMBER (CRN)**

| | | | | | |
|---|---|---|---|---|---|
| | | | | | |

## INSTRUCTIONS

Read the instructions carefully before answering the question:

1. Answer all **THREE** questions.
2. Write your Name and Roll Number on the top perforated portion of the **MAIN ANSWER SCRIPT ONLY.** Do not write your Name, Roll Number or any other identification mark on any other portion of the main or supplementary answer script.
3. Answers to each question must begin on a new page and must be clearly numbered. Use both sides of the paper in your main and supplementary answer script.
4. Answer each question in black pen only.
5. Do not write anything on the question paper except CRN.
6. The questions in this paper have been prepared on the assumption that candidates will not have a detailed knowledge of the types of organisations to which they relate. No additional mark will be given to candidates displaying such knowledge.
7. Only **FIVE** original books duly bound shall be allowed.
8. Mathematical tables will be supplied on request.

# QUESTION 1

TNS Textiles (TNS), which was incorporated over 50 years ago, is listed on the Pakistan Stock Exchange. It manufactures textile products and sells them in Pakistan (25%) and internationally (75%), with customers in Asia, Europe and the US. This includes home textile products such as bed linen as well as a wide range of clothes, to companies which then sell the goods under their own brand names around the world. TNS is one of the largest textile companies in the country and has steadily accumulated a significant cash balance, but has been losing market share for several years. Growth in the industry has also slowed, leading to declining revenue, to the extent that TNS is in a breakeven situation. Some major shareholders in TNS have been critical of management, demanding that they formulate a strategy to restore growth.

The board of TNS is now considering two options to achieve this growth, both of which could be financed from cash reserves:

(1) Launch an aggressive marketing campaign to grow organically, particularly in export markets. This would be underpinned by a new, more efficient production process as TNS will replace its existing machines, some of which are outdated, with modern, innovative machines purchased from Germany. These can be operated by fewer staff which will allow for reductions in cost, and lower, more competitive pricing.

(2) Acquire an established competitor, Premium Fabrics, which is also based in Pakistan and exports 95% of its production.

The board members believe that they must choose between these options as they do not have the management capability or financial resources to undertake both of these.

TNS has made a number of acquisitions in the past, always integrating the acquired company into its existing operations. All acquisitions have been significantly smaller than Premium Fabrics. In all cases the business and assets of the acquired companies were transferred to TNS and the newly acquired subsidiaries were either left dormant or wound up. Success has been mixed. The most recent acquisition, International Fashions, was acquired in 20X2 and the management of the acquired business were vocal in criticising the TNS board following the acquisition, feeling that they were being undermined. Eventually, most of the management left the company and the operations were integrated into TNS's existing operations, but the dispute and loss of expertise meant that the planned benefits resulting from the acquisition were realised two years later than the original forecast.

**Potential acquisition of Premium Fabrics**

Premium Fabrics is a privately owned company operating from five production facilities in different parts of Pakistan. It was founded 40 years ago by Mr Ashar Ahmad, who remains the Chairman and Chief Executive. The shareholdings are (ordinary shares of Rs. 10/each):

| | |
|---|---|
| Ashar Ahmad | 7 million |
| Rafqat Memon (Finance Director) | 4 million |
| Mst. Ghazala Khan (Operations Director) | 3 million |
| Managers and other employees | 6 million |

The shareholders of Premium Fabrics have indicated that they are willing to sell the company if an appropriate offer was made and the board would be willing to make some limited, non-public information available to TNS in order to enable an initial bid to be made.

**Report required**
You are an assistant to the group accountant of TNS, Reema Malik. Premium Fabrics has provided financial statement data (Appendix 1) and some accompanying notes (Appendix 2). Reema has also provided some additional notes to guide you based on a recent meeting with the TNS board, together with some post-acquisition performance assumptions made by Reema (Appendix 3). One of the other members of the finance department has also supplied some foreign exchange data (Appendix 4). Reema has asked you to prepare a draft report which addresses each of the following requests:

(a) Estimate the amount we should offer as an initial bid for Premium Fabrics, based on the information we have. As a minimum, please provide estimates using free cash flow and net asset valuation and an explanation of the pros and cons for each valuation method. Assume a WACC of 15%. **(14 marks)**

(b) Provide an analysis of the two strategic options the board is considering, including the strategic and foreign exchange risks involved in each. Recommend, with reasons, which you think would be a better strategic fit for TNS. **(8 marks)**

(c) Discuss the key implementation challenges we can expect to see if we choose either option, with brief recommendations on how we can overcome them. **(10 marks)**

(d) Explain how we could manage the exchange risk arising if we go ahead with the purchase of machinery from Germany, and the expected outcome if we use forward contracts, assuming the actual rate on 30 June 20X7 for 1 Euro is Rs. 116.21/Rs. 116.45. Discuss any other ways we could manage this risk. **(4 marks)**

(e) Examine the taxation implications of the two options followed by a brief conclusion. (Actual calculations are not required) **(14 marks)**

Reema has indicated that she does not require any executive summary, contents page, etc. She just wants you to prepare the above sections of the report.

**Requirement**
Prepare the sections of the report requested by the group accountant, Reema Malik. Assume the current date is November 20X6.

**Total: 50 marks**

## APPENDIX 1 – FINANCIAL INFORMATION PROVIDED BY PREMIUM FABRICS

### Statement of profit or loss and other comprehensive income for the years ending 31 December

| | 20X6 | 20X5 |
|---|---|---|
| | Forecast | Actual |
| | ------- Rs. in million ------- | |
| Revenue | 15,764 | 13,843 |
| Cost of sales | (14,114) | (12,108) |
| Gross profit | 1,650 | 1,735 |
| Operating expenses | (702) | (561) |
| Profit from operations | 948 | 1,174 |
| Finance costs - loans | (23) | (30) |
| Finance costs - finance leases | (5) | (5) |
| Profit before tax | 920 | 1,139 |
| Tax | (285) | (353) |
| Profit for the year | 635 | 786 |

### Statement of financial position at 31 December

| | Notes | 20X6 | 20X5 |
|---|---|---|---|
| | | Forecast | Actual |
| | Notes | ------- Rs. in million ------- | |
| *Non-current assets* | | | |
| Property, plant and equipment | 1 | 4,673 | 5,588 |
| | | | |
| Current assets | 2 | 4,755 | 3,965 |
| Total assets | | 9,428 | 9,553 |
| | | | |
| *Capital and reserves* | | | |
| Issued capital | | 200 | 200 |
| Retained earnings | | 2,724 | 2,089 |
| Equity | | 2,924 | 2,289 |
| *Non-current liabilities* | | | |
| Loans | | 1,855 | 2,372 |
| Finance leases | | 45 | 71 |
| | | | |
| Current liabilities | | 4,604 | 4,821 |
| Total equity and liabilities | | 9,428 | 9,553 |

**Notes**

1 Non-current assets consist of land and buildings, plant and machinery and office equipment. Some plant and machinery and office equipment are held under finance leases. All non-current assets are held at historic cost less accumulated depreciation.

| | ***Owned land and buildings*** | ***Owned plant and machinery*** | ***Assets held under finance leases*** | ***Office equipment*** | ***Total*** |
|---|---|---|---|---|---|
| | **------------------------- Rs. in million -------------------------** | | | | |
| Cost | | | | | |
| at 1/1/X6 | 2,359 | 4,372 | 196 | 768 | 7,695 |
| Additions | | 91 | 26 | 95 | 212 |
| Disposals | | (4) | | (20) | (24) |
| at 31/12/X6 (forecast) | 2,359 | 4,459 | 222 | 843 | 7,883 |
| | | | | | |
| Accumulated depreciation | | | | | |
| at 1/1/X6 | 308 | 1,472 | 90 | 237 | 2,107 |
| On disposals | | (3) | | (15) | (18) |
| Charge for the year | 41 | 874 | 59 | 147 | 1,121 |
| at 31/12/X6 | 349 | 2,343 | 149 | 369 | 3,210 |
| Carrying value as at 31/12/X6 (forecast) | 2,010 | 2,116 | 73 | 474 | 4,673 |

2 Current assets break down as follows:

| | ***31/12/X6*** | ***31/12/X5*** |
|---|---|---|
| | **-------- Rs. in million --------** | |
| Stock | 3,311 | 2,570 |
| Trade receivables | 761 | 846 |
| Other receivables | 300 | 282 |
| Cash and bank balances | 383 | 267 |
| Total | 4,755 | 3,965 |

3 The company has not paid any dividend.

## APPENDIX 2 – ACCOMPANYING NOTES PROVIDED BY PREMIUM FABRICS

Ashar Ahmad, the founder, Chairman and Chief Executive, is now 65 and looking to sell his shareholding and retire. The other directors do not have sufficient funds to buy him out. They are willing to sell their shares in principle, but have indicated that they would like to remain in post following the company's sale.

**Financial reporting**
All land, buildings, plant and machinery are depreciated to a zero residual value over their estimated useful lives. This includes assets held under finance leases, as they will revert to the company's ownership at the end of the lease term. All depreciation is charged on straight line basis.

The owned land, buildings, plant and machinery have an estimated total fair value at 31 December 20X6 of Rs. 6.5 billion. It is estimated that the fair value of the finance lease assets at 31 December 20X6 would be Rs. 150 million.

Stock is held at the lower of cost and net realisable value.

The loans are secured by charges over the assets of the business and directors' guarantees.

## APPENDIX 3 – POST ACQUISITION PERFORMANCE ASSUMPTIONS

**From the meeting between Reema and the TNS board**

Assume that the acquisition would occur on 1 January 20X7.

*Operations*
The board of TNS believes that there is scope to reduce costs by integrating the operations of TNS and Premium Fabrics. They estimate that this will result in a reduction in cost of sales of Rs. 0.75 billion in 20X7, and a further Rs. 0.75 billion in 20X8. Due to the disruption of the integration, revenue is expected to be static in these years, but will grow by 20% in 20X9, as will cost of sales. Both are then expected to increase in line with forecast inflation of 3%.

Operating expenses are expected to reduce by 10% in 20X7 due to the integration and be static thereafter.

*Taxation*
Assume that future corporation tax rates will be 30%. Ignore final tax regime (FTR) and minimum tax.

The machinery at Premium Fabrics is considered to be quite antiquated and in need of renewal, so TNS plans to invest a total of Rs. 0.5 billion in capital expenditure in each year 20X7 and 20X8. Allowable initial and normal tax depreciation is 25% and 10% respectively. Tax depreciation on existing capital assets is forecast to be Rs. 150 million in 20X7 and Rs. 100 million in 20X8, while accounting depreciation will fall by 10% in each year.

Capital expenditure is forecast to be Rs. 0.3 billion in 20X9 which is approximately equivalent to total tax depreciation and total accounting depreciation in 20X9, which is then expected to increase by 3% per annum thereafter, in line with inflation.

From 20X9, no material difference is expected between accounting and tax depreciation.

## APPENDIX 4 – ADDITIONAL NOTES REPURCHASE OF EQUIPMENT FROM GERMANY

**Memo prepared by finance department**

If TNS goes ahead with purchasing the machinery from Germany, it will place the order on 1 January 20X7 and make the payment on 30 June. The machinery will then be delivered in September. The overall cost is expected to be EUR20 million. Forecast exchange rates as at 1 January 20X7 are:

| Spot (EUR/Rs.) | 112.18 – 112.44 |
|---|---|
| 3-month forward | 0.67 – 0.61 premium |
| 6-month forward | 1.15 – 1.08 premium |

# QUESTION 2

YSJ Chartered Accountants (YSJ) is a firm offering audit, tax and consulting services from two offices, based in Islamabad and Lahore. It was founded 20 years ago and has grown steadily in a very competitive market, based on a good reputation for client service. The Lahore office was opened ten years ago when a competitor in that city was acquired and rebranded, with the head of the competitor becoming the office's managing partner. It has grown rapidly, including by the acquisition of two smaller firms, which were integrated into the existing offices. The firm has 17 partners, 12 based in Islamabad and 5 in Lahore. The most recent partners were admitted five years ago. Each office is headed by a managing partner, and they report to the senior partner, who is based at head office in Islamabad.

The firm generally earns much higher margins on consulting work than audit and tax, but they tend to be one-off assignments, whereas audit and tax work recurs each year. The offices reflect the distinct business environments in their locations and have a great deal of autonomy. Staff tend to be loyal to their office and the managing partner, rather than the firm as a whole. Management information systems are different in the two offices, and use different technology.

The partners do not receive a salary, but divide profits between themselves on a broadly equal basis, with some adjustments for additional responsibilities. There has been increasing dissatisfaction with this system and the senior partner has proposed two alternative approaches for discussion (see Appendix 2).

You are the Partnership Accountant at YSJ, and the financial controller has asked you to help her prepare this month's report to the partners by analysing the current financial position of the two offices. Extracts from the most recent management accounts are shown in Appendix 1. She would like you to prepare sections of the report which:

(a) Assess the recent performance of the two regional offices by interpreting the data given in Appendix 1. **(8 marks)**

(b) Briefly evaluate the likely impact of the current and proposed remuneration schemes on recruitment, motivation and behaviour of partners. **(8 marks)**

(c) Suggest two additional key performance indicators which YSJ could use to evaluate partners and why they are appropriate. **(4 marks)**

(d) Evaluate the potential benefits which introducing a new database and executive information system could have on performance management at YSJ, and practical issues connected with the introduction of the new system (see Appendix 3). **(5 marks)**

**Requirement**
Prepare the relevant extracts for the report to partners as requested by the financial controller.

**Total: 25 marks**

**APPENDIX 1 – MANAGEMENT ACCOUNTS FOR THE TWO OFFICES OF YSJ FOR THE YEARS ENDED 31 DECEMBER 20X5 AND 20X6**

| | *Islamabad* | | *Lahore* | |
|---|---|---|---|---|
| | *20X6* | *20X5* | *20X6* | *20X5* |
| | **Rs. in '000** | | | |
| Revenue | 730,136 | 725,364 | 436,044 | 361,917 |
| Staff costs | (380,337) | (372,730) | (227,469) | (204,722) |
| Other operating expenses | (159,790) | (154,996) | (76,570) | (69,679) |
| Operating profit | 190,009 | 197,638 | 132,005 | 87,516 |
| Allocated head office costs | (42,250) | (31,688) | (25,232) | (16,534) |
| Profit before interest and tax | 147,759 | 165,950 | 106,773 | 70,982 |
| | | | | |
| Current ratio | 2.8 | 2.7 | 1.6 | 1.8 |
| Receivable days | 139 | 137 | 188 | 154 |
| ROCE | 16% | 19% | 20% | 15% |
| Residual income | 56,502 | 79,256 | 52,274 | 23,567 |
| Capital employed | 912,577 | 866,948 | 544,995 | 474,146 |

**Notes**

1. Each set of office data is for the regional office only. It excludes any costs of the head office function based there other than the allocated costs listed.
2. Notional cost of capital at YSJ is 10%.

## APPENDIX 2 – EXTRACT FROM A MEMORANDUM SENT BY THE SENIOR PARTNER

Since its foundation, YSJ has operated on the basis that partners are paid equally, with adjustments for additional responsibility. This has helped to give everyone a shared stake in the business. However, now that we have two substantial offices, we should reconsider this policy. Two alternatives have been proposed:

(1) Starting in 20X7, we set a target for profit before interest and tax for each office, based on the 20X6 figures. If an office exceeds its target, partners will receive a 25% bonus on their standard profit share calculations.

(2) Partners are awarded 'points' based on their time served in the partnership, success in winning new business and additional responsibilities. Profits are then shared out among partners in proportion to the number of points they hold.

## APPENDIX 3 – NOTES FROM A MEETING WITH THE FINANCIAL CONTROLLER

The partners are considering making a change to the information systems at YSJ. Currently, each of the offices has its own systems and, within this, there are separate systems for time tracking, finance and human resources. The system in Lahore is based on the one used by the firm before it was acquired, and works in a different way to the one used by the Islamabad office. Reports are compiled and manually reconciled by the head office team in order to provide summary information for the partner information pack which forms YSJ's main strategic information system.

However, the partners are considering the implementation of a new system based on an integrated, single database that would be accessible via the web at both offices by all authorised staff. The company network would be upgraded to allow real-time input and updating of the database, although access rights will be restricted so that staff can only enter or amend data relating to their own function or site.

The database would support a management information system with more detail than is currently available and a high-level executive information system.

# QUESTION 3

You work for the advisory department of the firm Zaheer Khan & Company, Chartered Accountants (ZK). Chromium Mining Ltd (CML) is a key client of your department. Your manager has asked you to accompany her to a meeting with Husain, the Finance Director of CML.

CML is a long-established mining company which began mining chromite, but subsequently diversified and gradually its main business came to be copper mining. The price of copper has been in decline for some time and, although it has recently recovered, it has led to a poor financial performance for CML over a number of years, and now the company is facing liquidity issues. At the meeting, Husain explained that, in order to survive the next few months and provide a basis for its recovery plan, the company urgently needed to restructure its finances.

He went on to say, 'In the latest management accounts, the company has breached its loan covenants relating to profitability and current asset ratio and so our bank, TBL, has told us that our current borrowing is repayable in full, although we do not have the cash to do so. They have given us until the end of the year to come up with a viable plan. The bank may consider a refinancing package in the form of a loan, but if we cannot obtain this, or alternative financing, there is a significant risk of bankruptcy. This would be a tragedy as the board has a credible plan and we believe the company is viable.

We need some cash flow forecasts to present to the bank in support of our refinancing. Owing to staff sickness I do not have anyone available in the team to do this, so please could you prepare a five-year forecast based on the information in my forecast (Appendix 1) and memorandum (Appendix 2) which sets out two additional options for refinancing. What I would also like from ZK is a report that compares the financing packages on offer, including their cost, and provides a clear recommendation regarding the best approach for CML to take, including the tax implications. Please could you also take account of a note which our CEO has sent me?' (Appendix 3)

Following the meeting, your manager asks you to draft a report in response to Husain's request, in two separate sections:

(a) Section 1: Five-year cash flow forecast to support the loan application **(5 marks)**

(b) Section 2: A comparison of the financing packages **(14 marks)**

(c) Husain would also like you to draft a brief note for him recommending how the firm should respond to the chief executive's memo. **(6 marks)**

**Requirement**
Respond to the instructions from the manager.

Assume the current date is 1 October 20X7. Ignore turnover tax implications. **Total: 25 marks**

## APPENDIX 1 – FORECAST INCOME STATEMENT FOR THE YEAR TO 31 DECEMBER 20X7

| | Rs. in million |
|---|---|
| Sales | 15,875 |
| Cost of sales | (11,310) |
| Gross profit | 4,565 |
| Other costs | (4,374) |
| Finance costs | (390) |
| Net loss before taxation | (199) |
| Taxation | 0 |
| Net loss after taxation | (199) |

CML is currently engaged in disposing of loss-making businesses, restructuring and development of new opportunities. This will require investment (net of cash receipts) of Rs. 800 million each year for the next 3 years, and Rs. 200 million per year thereafter. Turnover is forecast to reduce by 10% in 20X8, then increase by 5% each year for the next 4 years. Gross margin will improve by 1% for the first 3 years and then be stable thereafter and other costs will reduce by 10% in 20X8, then increase by 5% each year for the next 4 years.

Opening cash, apart from the refinancing, is an overdraft of Rs. 500 million. Depreciation is expected to be Rs. 350 million in 20X8 and remain constant. Any changes in working capital are not expected to be material. Assume that there is no material difference between tax depreciation and accounting depreciation. As at the end of 20X7, CML is forecast to have brought forward losses for tax purposes of Rs. 300 million.

## APPENDIX 2 – MEMORANDUM FROM HUSAIN

As we are now in breach of our covenants with TBL, it has indicated that it is not willing to continue our current overdraft at its interest rate of 12% beyond the end of this year. It is, however, willing to consider making a loan of Rs. 3 billion at a rate of 15%, starting on 1 January 20X8, subject to acceptable cash flow forecasts. The loan will be repaid in five equal annual instalments, at the same time as annual payments for interest. This loan would partially replace our current overdraft. Therefore, CML expects to pay Rs. 120 million in interest on remaining amount of current overdraft, over and above the interest on the new loan.

As an alternative, we have been in discussions with an investment house, Cosmopolitan. They have provisionally agreed the following financing package:

CML will issue Rs. 3 billion of 12% convertible Term Finance Certificates (TFCs) to Cosmopolitan at par on 1 January 20X8. Cosmopolitan would have the right to convert each Rs. 1,000 of convertible TFCs into 12 ordinary shares in CML on 31 December 20Y3. Issue costs payable to professional advisers would amount to Rs. 65 million. Under this agreement no dividends would be paid by CML before 20Y3. The investors' expectation is that the share price will increase by an average of 5% each year.

We have also had discussions with major shareholders who have provisionally indicated that they would be prepared to support a rights issue. Rs. 3 billion of new shares would be issued on a 1 for 2 basis and at a discount of 20% on market value.

**Note.** Assume CML's current debt:equity ratio is 0.4 and will drop to 0.1 if the rights issue goes ahead. The applicable tax rate is 30%, the risk-free rate is 6%, the market rate is 13% and CML's current equity beta is 1.7, with a market value of Rs. 85 per share.

**APPENDIX 3 – MEMO FROM ZOHAIB MALIK, CHIEF EXECUTIVE OFFICER**

**PRIVATE AND CONFIDENTIAL**

Husain,
As you know, the survival of the business could depend on securing one of the refinancing packages, and they in turn depend on the cash flow forecasts. Please can you make sure our advisers understand this, and that it is vital that the forecasts demonstrate we will be able to make all repayments. If need be, they should adjust growth assumptions to make this work. You are aware that I am currently negotiating with a major potential client in China and am very confident that we will win the deal, so I really don't think repayment will be a problem. You can share this with the advisers if you like but please don't circulate this any further. In particular, I am keen that we do not bring this to the Board for discussion until we have secured the financing.

Zohaib

**(THE END)**