The Institute of
Chartered Accountants
of Pakistan

Multi Subject Assessment Stage Examination

3 December 2019
3 hours and 30 minutes – 100 marks
Additional reading time – 15 minutes

Management Professional Competence

CRN:

Name: ____

INSTRUCTIONS

Read the instructions carefully:

1. Answer all **THREE** questions.

2. Write your Name and CRN on the front page of the **MAIN ANSWER SCRIPT** and CRN on the front page of the **SUPPLEMENTARY SCRIPT.** Do not write your Name, CRN or any other identification mark on any other portion of the main or supplementary answer script.

3. Answer 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 scripts.

4. Answer in black pen only.

5. You are allowed to write notes/comments on the question paper. However, you must write your CRN and name on the question paper at the space provided above before starting to write any notes/comments.

6. The questions in this paper have been prepared on the assumption that examinees do not have a detailed knowledge of the types of organisations to which they relate. No additional mark will be given to examinees displaying such knowledge.

7. Only **FIVE** original books duly bound are allowed.

QUESTION 1

Perfect Building & Plumbing Supplies Limited (PBPS) is a leading distributor and retailer of plumbing, heating and building materials, employing over 800 people. PBPS quickly became a household name following a period of rapid growth in the retail sector after it was founded over 20 years ago. PBPS was listed on the Pakistan stock exchange over 10 years ago.

PBPS operates two independently operated divisions: a building materials division and a plumbing supplies division. Each division operates its own warehousing and distribution network, and chain of retail outlets.

Each division sells directly to the general public from its retail outlets, as well as to building and plumbing contractors and merchants. Each division can also deliver directly to the corporate customer premises. The demand for new housing and commercial buildings in Pakistan's major towns and cities has increased the demand for building and plumbing supplies which has resulted in PBPS's growth and profitability. The board of directors would like to understand the company's divisional performance, and determine if there is a need to improve existing management accounting and reporting systems.

The directors are also looking to introduce e-commerce and new product development to sustain growth. Recently, there has been some negative reporting of poor supplier practices in the media, which is in conflict with PBPS's corporate social responsibility objectives.

Strategic and corporate social responsibility objectives
The following strategic and corporate social responsibility objectives are published on PBPS's website:

- To be a leader in customer service and continuously improve the breadth and quality of its product range.
- To adopt fair business practices in all its dealings with its suppliers and promote cultural and social diversity in its workforce, and also expecting its suppliers to do so.
- To provide excellent customer service and responsiveness to changing customer needs
- To provide high levels of staff training and development, with a particular focus on health and safety.
- To hold suppliers to the highest ethical standards, with new suppliers having to pass an ethical supplier test.
- To minimise environmental damage by reducing CO_2 emissions, improving waste management, reducing use of single-use plastic and improving product recycling. These are managed using environmental performance measures applied by head office.
- To promote product safety through selling only safe and reliable products that meet required regulatory standards.

Strategic developments
PBPS aims to increase its market share by increasing sales to its existing corporate customers and footfall into its retail stores and showrooms. It also intends to launch a new marketing campaign, which PBPS hopes will attract new retail and corporate customers.

The company recognises that to maintain its high level of customer service, it requires investment in customer relationship management systems. Currently, customers are managed locally by individual stores and showrooms. PBPS currently does not provide an online sales option. However, the directors are aware that some competitors provide e-commerce from their website, allowing their customers to order products online, which are then delivered directly to their homes or commercial premises.

Business operations
PBPS's head office and two main distribution warehouses (one warehouse for each division) are located 20 miles outside of Karachi, close to the port and international airport. The head office function consists of the senior board, treasury function, human resources, data processing and IT services and inventory management.

The building and plumbing divisions sell and distribute supplier branded products as well as their own brand product ranges, as follows:

Division	Products stocked and distributed by PBPS
Building Division	Concrete, cement, bricks, tiles, plaster board, timber, roofing, flooring, internal and external doors and windows, and relevant power tools.
Plumbing Division	Toilets, sinks, baths, shower screens, taps and shower fittings, gas and electric boilers, radiators, all general pipes and plumbing fittings, waste systems, and relevant tools.

The building and plumbing divisions are structured in the same way, with a single, large distribution warehouse, which supplies its retail stores and showrooms. Each division also fulfils direct sales orders to commercial building and plumbing contractors.

The network of retail stores for the Building Division has been built up over the past 20 years. The retail stores are located in out-of-town retail or industrial parks. The Plumbing Division operates through an established chain of smaller showrooms, which displays its range of bathrooms, plumbing products and tools.

The Building Division retail stores and Plumbing Division showrooms operate under 'Better Building' and 'Perfect Plumbing' brands respectively.

Each year, PBPS sells to over 600,000 retail customers and to over 20,000 corporate customers, which are made up of construction companies and small building and plumbing companies. Some larger corporate customers purchase through trade accounts with agreed terms of credit, offering a 60-day settlement period.

Each division operates its own logistics and distribution network, with their own fleet of road haulage vehicles to distribute products from its distribution warehouse to its retail stores and showrooms.

To serve its customer base with an ever-changing inventory of products, PBPS has over 25,000 domestic and internationally based suppliers. PBPS uses rail, sea and air transport to receive supplies inward to its warehouses.

PBPS expects each division to operate an efficient supply chain by maintaining good relationships with a wide range of suppliers, both large and small. It offers preferred supplier status to suppliers who agree to advantageous credit terms.

Whilst some centralised operations are provided by head office, each division is run as an independent commercial operation with its own management team.

Requirements

(a) Using information in Appendix 1 and Appendix 2, compare divisional performance for the years 31 December 20X9 and 20X8, and recommend **four** matters for the board and divisional management to address. **(15 marks)**

(b) Evaluate the advantages offered to PBPS by offering a single e-business platform and discuss the e-marketing opportunities that this would create. **(09 marks)**

(c) Outline the benefits to PBPS of using benchmarking to improve product integrity and staff turnover. **(06 marks)**

(d) For the potential new product outlined in Appendix 4:

(i) Calculate the expected net profit margin that could be achieved for each year over a five-year period for the new product, and explain your reservations with any of the assumptions made by the directors. **(06 marks)**

(ii) Recommend whether PBPS should proceed with the new product development proposal, using the Suitable, Acceptable, Feasible framework to support your evaluation. **(06 marks)**

(e) Discuss the factors that the board of directors would need to consider in order to successfully implement a new Code of Conduct for its suppliers. **(08 marks)**

Total: 50 marks

APPENDIX 1 – RECENT COMPANY PERFORMANCE

Statement of profit or loss for the year ended 31 December 20X9

	20X9	20X8
	--------- Rs. in million ---------	
Revenue	14,736.8	13,876.8
Cost of sales	(10,856.8)	(10,128.0)
Gross profit	3,880.0	3,748.8
Operating costs	(3,552.0)	(3,304.0)
Operating profit	328.0	444.8
Finance cost	(68.0)	(68.0)
Profit before tax	260.0	376.8
Tax	(96.8)	(112.8)
Profit for the year	163.2	264.0
Dividend	(60.0)	(50.0)
Retained profit	**103.2**	**214.0**

Statement of financial position as at 31 December 20X9

	20X9	20X8
	--------- Rs. in million ---------	
ASSETS		
Non-current assets		
Property, plant and equipment	3,031.4	3,113.6
Current assets		
Inventories	1,682.6	1,784.0
Trade and other receivables	2,274.4	2,126.4
Cash and bank balances	213.2	393.6
	4,170.2	4,304.0
Total assets	**7,201.6**	**7,417.6**
EQUITY AND LIABILITIES		
Equity		
Share capital	50.0	50.0
Share premium	50.0	50.0
Retained earnings	3,316.8	3,213.6
	3,416.8	3,313.6
Non-current liabilities		
Bank loans	800.0	1,000.0
Current liabilities		
Trade and other payables	2,867.0	2,904.0
Bank loans and overdrafts	117.8	200.0
	2,984.8	3,104.0
Total equity and liabilities	**7,201.6**	**7,417.6**

APPENDIX 2 – RECENT DIVISIONAL PERFORMANCE

Year to 31 December	Building Division 20X9	Building Division 20X8	Plumbing Division 20X9	Plumbing Division 20X8
	Rs. in million			
Revenue	8,565.3	8,048.0	6,171.5	5,828.8
Cost of sales	(6,459.4)	(6,076.7)	(4,397.4)	(4,051.3)
Gross profit	2,105.9	1,971.3	1,774.1	1,777.5
Operating expenditure	(1,878.1)	(1,751.2)	(1,673.9)	(1,552.8)
Operating profit	**227.8**	**220.1**	**100.2**	**224.7**

Year to 31 December	Building Division 20X9	Building Division 20X8	Plumbing Division 20X9	Plumbing Division 20X8
	Rs. in million			
Property, plant and equipment	1,837.2	1,887.2	1,194.2	1,226.4
Current assets				
Inventories	782.3	928.0	900.3	856.0
Trade and other receivables	1,444.3	1,382.4	830.1	744.0
Cash and bank balances	149.2	216.8	64.0	176.8
Current liabilities				
Trade and other payables	(1,578.0)	(1,585.2)	(1,289.0)	(1,318.8)
Total assets less current liabilities	**2,635.0**	**2,829.2**	**1,699.6**	**1,684.4**

Performance targets
The board set the following 20X9 targets for both divisions:

- A 10% increase in revenue driven by increased sales volumes
- A 10% reduction in receivable days achieved by improved credit control with corporate customers
- A reduction in payable days to a 90-day maximum, to maintain good relations with suppliers

Both divisional managers have provided management accounting reports, which confirm that sale volume growth in 20X9 has exceeded 10%.

Additionally, cost saving initiatives were introduced which has improved the operating margin in both divisions. This was achieved by identifying efficiencies in the supply chain and reducing the current product range, particularly in the Plumbing Division.

APPENDIX 3 – CORPORATE SOCIAL RESPONSIBILITY, HUMAN RESOURCES AND CODE OF ETHICS

The promotion of product safety, and trading fairly with suppliers and customers are PBPS corporate objectives. There are also commercial benefits, such as enhanced customer confidence which boost product appeal and reduce wastage rates, which will help PBPS to continue to grow revenues and improve margins. PBPS customers expect products to be safe to use, comply with relevant standards and originate from a verifiable source.

A significant challenge to PBPS is the management of a highly-fragmented supplier base with over 25,000 supplier relationships to manage. Recent studies have made PBPS's management aware that there are significant variations in the approaches taken to assess supplier's quality and performance. In some cases, supplier performance is not assessed.

Occasionally, products are found to be unfit for purpose and are recalled and returned to the supplier. Whilst PBPS is unaware of any serious product integrity issues, it has become apparent that the absence of common procurement processes across all suppliers creates significant risks of litigation and disruption if certain products are suddenly withdrawn from sale.

Staff turnover
PBPS is under continuing pressure to improve margins and attain market leadership in the regions in which it operates.

In a recent interview discussing difficult trading conditions, PBPS's finance director said that some retail stores with higher levels of staff turnover were in an advantageous position, as they found it easier to trim costs by implementing a recruitment freeze. However, this is at odds with PBPS's strategic objective to retain existing customers as well as win new ones, which depends on customers receiving best-in-class customer service.

Freezes on recruitment also appear contrary to PBPS's increasingly extensive investment in staff training and development, which assumes staff will remain with PBPS for a sufficient amount of time to justify the investment in training made. In fact, PBPS's management are aware of companies who have enjoyed success in growing their customer base largely because their staff possess a high level of product knowledge which adds real value to the customer throughout the buying experience. This is particularly important in building and plumbing retail, as customers often require informed advice to select the best product from those available.

PBPS's directors would like to replicate this product expertise across all their retail outlets and are considering how they might benchmark against other companies that are known for offering excellent customer service and product expertise.

New ethical code for suppliers
The director of procurement has received a letter alleging fraud at one of PBPS's large suppliers. Volumes of inventory have apparently been stolen: bribes have been paid to staff for 'turning a blind eye' to the theft; stolen inventory has been incorrectly classified as 'damaged in transit' before being written off in the supplier's stock management system. There is no suggestion of any wrongdoing by PBPS.

The impact on PBPS is that goods on order do not arrive on schedule, leaving empty shelves, and these delays are resulting in lost sales. Customer confidence is also eroded as staff in PBPS's retail stores are unable to tell customers when new stock will be received.

The chief executive has recommended that PBPS should demonstrate its commitment to ethical supplier relationships by introducing a new Code of Conduct for suppliers to clarify what is expected from a continuing supplier relationship with PBPS.

APPENDIX 4 – E-COMMERCE AND PRODUCT DEVELOPMENT

Introduction of e-commerce
As part of a strategic review and a drive to standardise processes and embed common practices, the directors of PBPS have determined it is now time to consider an online sales option to attract new customers and support future revenue growth. PBPS's vision is to invest in a single, shared online platform across both divisions, which the directors believe will offer significant advantages to customers and suppliers. Of particular interest is the ability to collect and share unified customer data across the whole group. The directors are optimistic that enhanced customer insight and e-marketing will allow PBPS to better understand its customer needs and enable PBPS to make significant improvements to customer service, which the board has identified as a critical success factor for future sustainable growth.

New product development
The directors have decided not to explore market development and have instead decided to focus on a strategy of new product development. Having screened out a number of unsuitable options, PBPS is now undertaking a more detailed investigation of the option to set up a range of sustainable building and plumbing products, supported by an enhanced employee training programme.

Having consulted with many existing suppliers throughout the supply chain, it is apparent that very few of PBPS's current suppliers possess the required core competences to develop and supply the necessary sustainable and ecological products which the market is now demanding. In fact, only five suppliers have been identified as potentially being able to deliver the required expertise to develop the products specified.

Alternatively, PBPS is aware of several suppliers outside its current supply chain that have already completed the research and development (R&D) phase and are supplying products to the market. However, each of these suppliers operates on a far smaller scale than PBPS requires to service its retail network.

Despite uncertainties concerning the sourcing solution, the finance director has pulled together some initial financial information, in order to gain an estimate for a new range of sustainable building and plumbing products. These new products are expected to have a five-year product life-cycle in financial terms.

Initially, PBPS would need to invest approximately Rs. 8 million in R&D in year 1. Further to PBPS's customer service objective, it is deemed essential that any new venture is fully supported by knowledgeable staff. It is therefore probable that initial training in the first year will cost Rs. 4 million, with ongoing expenditure of Rs. 1 million in the subsequent four years. The current plan is to sell the new products alongside PBPS's current ranges. However, in order to create a distinct product identity, it would be necessary to devote a section of each store exclusively to the new range, and it is estimated the necessary store re-fit costs would result in a one-off initial expenditure of Rs. 6 million in year 1. The store re-fits would result in some loss of floor space for PBPS's current product lines, resulting in a fall in revenue of Rs. 8 million per annum for each of the five years at the 20X9 gross profit margin.

The marketing director has advised that year 1 sales are forecasted to be Rs. 40 million, and earn a gross margin of 1.25 times the total PBPS 20X9 gross profit margin, as it is believed customers will pay a premium for environmentally less damaging products. Sales are expected to grow at 20% per year thereafter for the subsequent four years.

QUESTION 2

Floormagic Carpet Weavers Limited (FCW) are based in Lahore and make high quality hand-knitted carpets. FCW listed on the Pakistan Stock Exchange five years ago. A summary of their latest statement of financial position can be seen in Appendix 1.

FCW export to many countries via distributors and directly to some large overseas retailers. FCW operate out of a large factory site in Lahore, which is close to machine capacity, and the board is considering the options for increasing volume capacity.

In recent years, there has been a noticeable and sustained increase in export orders from Myanmar to several national distributors in Yangon and Mandalay. Ahmed Mirza, the Sales Director at FCW is keen to operate closer to the Myanmar customers, and has suggested that having a production base in Myanmar would show local commitment and provide a local contact for these increasingly important customers. Hakim Sahu, Head of Human Resources, is also keen on the idea, noting the advantages of a lower labour and operating cost environment in Myanmar.

However, Kamran Yousafzai, Head of Finance, feels a little nervous about this suggestion. "We've never invested overseas – I'm not sure we know enough about Myanmar to do this without the risk of a serious mistake". Ahmed replied by saying "we don't have to set up from a zero base, I'm sure we could look to acquire or partner with an existing business over there. Surely that would reduce our risk".

The board has decided to investigate the expansion idea further in Myanmar, either by internal (organic) growth, by acquisition or by some sort of collaboration with an established Myanmar business.

Kamran has yet to find any suitable local businesses to work with or acquire, but he has compiled some information to assist with an appraisal of setting up the manufacturing base internally. This information is presented in Appendix 2.

Requirements

(a) Compare the different methods FCW could adopt to expand into Myanmar, and explain which you would recommend in this instance. **(05 marks)**

(b) Considering the option to expand by setting up a manufacturing site in Myanmar:

(i) Calculate the net present value and discuss any additional relevant considerations with this project. **(10 marks)**

(ii) Discuss and recommend whether the expansion should be financed by debt or equity. **(05 marks)**

(iii) Discuss and recommend a suitable hedging strategy for the quarterly dividend remittances back from Myanmar. **(05 marks)**

Total: 25 marks

APPENDIX 1 – LATEST SUMMARISED STATEMENT OF FINANCIAL POSITION

	Rs. in million
ASSETS	
Total non-current assets	**200**
Current assets	
Inventories	60
Trade receivables	48
Cash and cash equivalent	20
	128
Total assets	**328**
EQUITY AND LIABILITIES	
Equity	
Share capital (Note 1)	100
Retained earnings	90
	190
Non-current liabilities	
8% Bank loan (Note 2)	40
9% Irredeemable debentures (Note 3)	60
	100
Current liabilities	
Trade and other payables	30
Current tax payable	8
	38
Total equity and liabilities	**328**

Notes:

1. The ordinary shares have a nominal value of Rs. 100, and are currently traded on the Pakistan Stock Exchange at Rs. 125 per share. A dividend of Rs. 20 per share has just been paid. Dividends have historically grown at around 10% per annum.
2. The bank loan is secured on property, plant and equipment. It is repayable on 30 June 2025 in full. Interest is tax deductible.
3. The irredeemable debentures are unsecured and quoted on the Pakistan Stock Exchange at a price of Rs. 9,500 per Rs. 10,000 nominal value. Interest is about to be paid, and will be tax deductible for the company.
4. FCW pay income tax at a rate of 29%.

Further information

The industry average gearing level is 50% (measured as debt / (debt + equity) using market values).

APPENDIX 2 – FORECASTED CASH FLOWS FOR SETTING UP A NEW MANUFACTURING SITE IN MYANMAR

The initial appraisal should be for a four-year period only, after which the decision will be reassessed. The currency in Myanmar is the Kyat (K).

A suitable site in Myanmar can be purchased and built for Ks. 50 million, all of which is equipment and is eligible for capital allowances. The initial allowance would be 25% then 10% reducing balance in the first year and every year thereafter. Assume the equipment can be sold for its tax written down value at the end of year four.

Sales are already made in Myanmar. The nominal incremental operating cash inflows (before tax) of setting up a local operating base in Myanmar are expected to amount to Ks. 30 million in today's prices, increasing by 10% per year. The rate of income tax in Myanmar is 25%.

The current exchange rate is Ks. 9.5 : Re. 1. Inflation in Myanmar is estimated to be around 8% per year, and is around 6% a year in Pakistan. All the above figures are nominal amounts.

The initial plan is to remit dividends back from the Myanmar operation on a quarterly basis, but for the purposes of the initial investment appraisal, it can be assumed that all operating cash flows arise at the end of the year to which they relate unless specified otherwise.

QUESTION 3

Karachi Cloud Ltd (KCL) offer cloud-based storage solutions with their main data centre based in Karachi. They have been listed on the Pakistan Stock Exchange for 10 years, and are looking to expand their current offering by moving into big data analytics.

KCL have found what they believe to be a suitable target for acquisition. Siddiq Global Intelligence Limited (SGIL), which despite having only started three years ago by Tariq Saigal, is quickly gaining a strong reputation nationally and internationally.

SGIL specialises in social media analysis for small and medium-sized companies, helping to inform their marketing and wider business strategies. SGIL provides a mix of ad-hoc work for a negotiated fee, and routine reporting for a regular monthly payment. SGIL is also based in Karachi.

The Finance Director of KCL, Waseem Mahmood, has commissioned some background research which is included in the Appendices 1 and 2.

KCL had only grown internally in the past, so Waseem is unsure how to value a start-up business with a short trading history and little in the way of tangible assets. Also, he is keen to preserve liquidity by suggesting payment should be made via a share-for-share exchange, but he would like to compare this to paying cash.

Additionally, Waseem is concerned about the integration and change management processes. He has worked for previous employers where post-integration issues have been ignored before the purchase takes place and has witnessed the potentially disastrous consequences this can create.

The owner of SGIL, Tariq Saigal, is keen to stay involved in growing the business, but would only be interested in selling if he can continue to participate in its success as he enjoys the day-to-day engagement he has with staff and customers alike. He is viewed as a technical visionary in the field of big data analytics and is often asked to speak at industry gatherings to present and discuss his views of the future.

Requirements

(a) Calculate a range of values of SGIL by applying **four** different methods of valuation. Recommend a bidding strategy for the board of KCL to adopt. **(13 marks)**

(b) Prepare a briefing paper for the board of directors of KCL outlining the group tax consequences of acquiring SGIL. **(05 marks)**

(c) Explain the risks associated with integrating SGIL into the KCL business and briefly outline a change management program to facilitate the integration process. **(07 marks)**

Total: 25 marks

APPENDIX 1 – EXTRACTS FROM THE FINANCIAL STATEMENTS FOR SIDDIQ GLOBAL INTELLIGENCE LIMITED

	20X9	**20X8**
	------- Rs. in million -------	
Revenue	1,000	500
Profit after tax	200	60
Dividends	100	35

	20X9	**20X8**
	------- Rs. in million -------	
Non-current assets	100	10
Current assets	31	16
Total assets	**131**	**26**
Share capital (Re. 1 per share)	1	1
Retained profit	50	(50)
Total equity	**51**	**(49)**
Non-current liabilities	60	60
Current liabilities	20	15
Total liabilities	**80**	**75**
Total equity and liabilities	**131**	**26**

Note:
The growth rate of SGIL is above the industry average – this warrants doubling SGIL's P/E ratio in comparison with industry average for the valuation purposes. SGIL has carried forward tax losses at the end of 20X9 of Rs. 11 million.

APPENDIX 2 – EMAIL

To: Waseem Mahmood, KCL
From Rizwan Abbasi
Date 3 September 2019
Subject: SGIL stats

Dear Mr Mahmood,

Further to our recent conversation, please find below the required data as requested. Please let me know if I can be of any further assistance.

Kind regards,

Rizwan Abbasi

Attachment: industry statistics

Industry P/E ratio	7	
Return on Pakistan Government bonds	2%	per annum
Sector average equity beta	2.3	
KSE 100 index return	9%	per annum
Sector growth rate	15%	per year
Sector average return on capital employed	50%	based on profit after tax
Pakistan corporate tax rate	29%	per annum
Terminal multiplier after 4 years	15	times operating cash flow for year 4

(THE END)