The Institute of Chartered Accountants of Pakistan

Multi Subject Assessment Stage

8 December 2020
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 candidates do 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 are allowed.

QUESTION 1

Farid Textiles Ltd (FT) is a manufacturer of clothing based in Lahore. The company was started by Farid Farooqi twenty years ago with just one sewing machine. Over the years, Farid has taken on additional employees, expanded the factory and gained some prestigious customers throughout the world. The company is still privately owned by Farid and members of his family. Farid is an ambitious man who is prepared to take risks where necessary in order to expand the business.

FT's customers are fashion retailers. They provide FT with designs for the clothing that they require. FT makes the clothing, dyeing the materials to the required colour, sewing the clothes and embroidering the customer's brand name onto them. Typically, the work is performed in batches and stored in FT's warehouses until the customer requests delivery.

FT employs 50 staff members. Factory staff include loom operators, sewers, maintenance and warehouse staff. In the office, the company has a sales department, an accounting department, an export department (which deals with the paperwork associated with sending products abroad), a procurement department and a small IT department that deals with the maintenance of FT's office computers.

The sales director has suggested that the company should set up an online store to sell clothing directly to customers. He points out the high profit margins that FT's customers enjoy, often selling clothing for more than twice the wholesale price that they pay to FT. He has suggested that if FT can sell directly to end customers then it could enjoy the benefit of these higher margins. Farid is excited by this idea and is keen to investigate further.

The online store would require an initial investment of approximately Rs. 110 million. The Farooqi family do not have additional capital to invest, and Farid does not wish to take on debt. Instead, he is considering listing FT on the Pakistan Stock Exchange in order to raise the finance. The shares to be issued would represent 20% of the share capital of FT. Extracts from a business plan, along with a forecast NPV for the online business, are included as Appendix 2.

Textile companies already listed on the Pakistan Stock Exchange trade at a price earnings ratio of six on average. A comparable listed company to FT has an ungeared cost of equity of 15%. The free cash flows to equity from the existing business operations (not including the proposed online retail business) are expected to remain at the same level as for the year ended 30 September 2020 in perpetuity.

Requirements

(a) (i) Evaluate the net present value calculations for the online business in Appendix 2. **(08 marks)**

(ii) Evaluate the proposed strategy of diversifying into online retail and recommend whether FT should go ahead with the investment. **(10 marks)**

(b) Calculate a fair value for the new shares that will be issued on the Pakistan Stock Exchange using the price earnings ratio and free cash flow to equity methods, and briefly evaluate each method in this case. **(09 marks)**

(c) Explain how big data could be used to improve the competitiveness of FT. **(06 marks)**

(d) (i) Discuss the ethical stance of Arish Clothes based on the newspaper article about the documentary 'Ghost workers in Pakistan's Textiles industry' described in Appendix 3, and discuss the impact that this stance may have on its future performance. **(06 marks)**

(ii) Recommend two actions that FT should take in the light of the documentary 'Ghost workers in Pakistan's Textile industry.' **(06 marks)**

(e) Discuss the sales tax implications on FTL if it decides to set up an online store. **(05 marks)**

Total: 50 marks

APPENDIX 1 – FINANCIAL INFORMATION OF FARID TEXTILES LTD

Statement of profit and loss for the year ended 30 September 2020

	2020	2019
	------ Rs. in million ------	
Sales	1,605	1,364
Cost of sales	(1,452)	(1,240)
Gross profit	**153**	**124**
Admin expenses	(27)	(25)
Distribution costs	(22)	(21)
Operating profit	**104**	**78**
Tax at 29%	(30)	(23)
Profit after tax	**74**	**55**

Note: Included in cost of sales is depreciation of Rs. 139 million.

Statement of financial position as at 30 September 2020

	2020	2019
	------------- Rs. in million -------------	
Land and buildings	450	499
Plant & machinery	320	321
Office equipment	40	38
Total non-current assets	**810**	**858**
Inventories	289	246
Trade receivables	230	205
Cash	50	22
Current assets	**569**	**473**
Total assets	**1,379**	**1,331**
Share capital (Rs. 1,000 each)	100	100
Retained profits	1,137	1,100
Total equity	**1,237**	**1,200**
Trade payables	112	95
Tax payable	30	36
Total current liabilities	**142**	**131**
Total liabilities & equity	**1,379**	**1,331**

Note: Rs. 91 million was spent on acquisition of property, plant and equipment to maintain the existing operating capacity of the company.

APPENDIX 2 – EXTRACTS FROM THE BUSINESS PLAN RELATING TO THE ONLINE RETAIL PROJECT

The online retail project would require the setting up of a new warehouse where inventories of finished goods would be held for despatch to customers. IT infrastructure would also need to be developed, with a website offering the products for sale, and supporting databases that can receive orders from customers, take payments via credit cards or other payment methods, and monitor stock levels. Existing IT staff have no experience of e-commerce systems, so additional IT staff would be required to set up the new systems.

The following is a forecast of the net present value of the project:

	At year ending 30 September					
	2021	2022	2023	2024	2025	2026
	---------- Rs. in million ----------					
Sales		50.0	75.0	112.5	123.8	130.0
Cost of sales		(20.0)	(30.0)	(45.0)	(49.5)	(52.0)
Gross profit		**30.0**	**45.0**	**67.5**	**74.3**	**78.0**
Expenses						
Marketing		(1.5)	(1.5)	(1.0)	(1.0)	(1.0)
Rental		(4.0)	(4.4)	(4.8)	(5.3)	(5.8)
Staff costs		(7.6)	(11.2)	(13.3)	(14.0)	(14.7)
Other costs		(0.8)	(1.2)	(1.9)	(2.0)	(2.1)
Pre-tax cash flows		**16.1**	**26.7**	**46.5**	**52.0**	**54.4**
Tax at 29%		(4.7)	(7.7)	(13.5)	(15.1)	(15.8)
Investments						
New IT equipment	(75.0)	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)
Machinery	(30.0)		(2.1)	(2.2)	(0.3)	(2.7)
Working capital	(5.0)	(2.5)	(3.8)	(1.1)	(0.6)	0.0
Total cash flows	**(110.0)**	**8.4**	**12.6**	**29.2**	**35.5**	**35.4**
Discount factor at 15%	1.000	0.870	0.756	0.658	0.572	3.813
PV	(110.0)	7.3	9.5	19.2	20.3	135.0
NPV	**81.3**					

The investment would take place on 30 September 2021. It has been assumed that total cash flows from the year ended 30 September 2026 would be Rs. 35.4 in perpetuity. Staff costs relate to additional marketing staff who would decide on the product offerings and prices, and keep the website updated. Also included is a small number of warehouse staff, who would manage the inventories and package the goods for delivery to the customers. FT would use third party delivery companies to deliver the products and customers would pay the costs of delivery.

The sales manager has pointed out the possibility of analysing big data to help predict trends in the industry. This data would include new data obtained about the buying habits of customers who use the new online business.

The finance director of FT has determined that an appropriate cost of equity for the project would be 15% per annum based on the cost of equity for similar companies.

Free cash flow to equity for the existing business would be unaffected by the decision of whether or not to proceed with the direct sales project.

APPENDIX 3 – NEWSPAPER ARTICLE

The Pakistan textiles industry has been receiving international attention following an undercover documentary made by a UK broadcaster into employment practices at a well-known textiles company, Arish Clothes.

The documentary 'Ghost Workers in Pakistan's Textiles industry' highlighted practices at Arish Clothes' factory in Lahore, which uses contract workers rather than employing staff directly. The workers are contracted on one-month contracts. Usually the workers are contracted again at the start of the following month. This practice avoids the legal requirement that staff who work for more than three months are automatically considered by the law to be employees.

If workers are not officially employed, the company saves costs such as holiday pay, sick pay, social security, and pensions contributions. One worker who was interviewed in the documentary reported that he had been injured during an accident at work and had to take a month off to recover. He asked the company for sick pay but was told that since he was not an employee, he was not entitled to it. Another worker was fired, allegedly because his supervisor did not like him. When he tried to appeal to an employment tribunal, he was told that the court could not hear his case because he was not an employee.

The documentary has attracted considerable interest in the UK. The British interest in the case relates to the fact that some well-known British retailers, such as Trendy Fashions, buy clothing from Arish Clothes. After the documentary was aired, Trendy Fashions issued a press release stating that they had been unaware of such practices, but they would be reviewing their contract with the company as a result of the practices uncovered by the documentary. Another British retailer, which buys clothing from factories around the world, stated on the documentary that it requires all its suppliers to adhere to its corporate code of conduct. This code of conduct includes provisions relating to the fair treatment of employees and requires all employees to have a fair contract of employment.

The documentary could harm the reputation of all textiles companies in Pakistan, as retailers may assume that these practices are common. It is important that the industry in Pakistan reacts to the criticisms made collectively, rather than seeking to brush these issues under the carpet.

QUESTION 2

Today is 1 January 20X1.

Faisalabad Surgical Supplies Limited (FSSL) is a manufacturer of high quality surgical tools that listed on the Pakistan Stock Exchange six years ago. FSSL has one main manufacturing site in Faisalabad. The main head office is located on the same site as the factory, with a second office in Islamabad used primarily for meetings. FSSL sells surgical tools all over the world, with 90% of items being exported, and invoiced in the customer's domestic currency. FSSL has a world class reputation for the quality of its surgical tools, commanding a 30% premium over the market average as a result.

The board are reviewing their formal risk management processes, and have identified some new risks, but a course of action to address this is currently outstanding. The draft risk register containing these new risks may be found in Appendix 3.

The company has historically favoured a 'hollowed out' structure, where many aspects of operations have been outsourced – including outbound logistics. FSSL has a strategic partnership with a global logistics business that transports inventory from the factory in Faisalabad to the customers' premises on a just-in-time basis. There have been several complaints in recent months from customers about slow deliveries. An internal investigation by FSSL revealed that to manage their costs, the logistics service provider has been holding FSSL inventory until sufficient deliveries could be gathered from elsewhere to justify the cost of delivery vans and plane freight costs. Given the premium FSSL charges their customers, FSSL has decided to investigate bringing logistics in-house to ensure tight control over delivery times.

Despite higher than average sales prices, FSSL has relatively low margins due to the high quality manufacturing process it uses. In a bid to improve margins, the board is considering outsourcing manufacture of most of its product range to a reputable manufacturer in Myanmar. The Myanmar provider will be required to invest in machinery and training, but FSSL have agreed in principle to lend them the money (Rs. 500 million) to enable them to invest. Further details of the proposed outsourcing arrangement are provided in Appendix 1.

A significant amount of funding will be required for both the in-house logistics and outsource manufacturing proposals – approximately Rs. 950 million in total. FSSL intends to borrow the funds from a bank, repayable over a ten-year term at an annualised rate of 7.042% per annum. The directors are concerned about the impact this increase in gearing could have on their cost of capital. Details of current finances are provided in Appendix 2.

Requirements

(a) Assess the risks identified in the draft risk register and recommend and justify a suitable response to those risks. No calculations are required. **(05 marks)**

(b) (i) Calculate the weighted average cost of capital now and after the proposed increase in borrowing. Explain the assumptions implicit in calculating the impact of the borrowing on the WACC. **(09 marks)**

(ii) Recommend a hedging strategy for the regular amounts payable to / receivable from the Myanmar outsource partner. No calculations are required. **(04 marks)**

(c) Identify and explain the key change management issues FSSL face as a result of the decision to outsource some manufacturing to Myanmar. Recommend and justify key aspects of a change management programme in response. **(04 marks)**

(d) Briefly discuss the income tax implications of outsourcing the products to the manufacturer in Myanmar. **(03 marks)**

Total: 25 marks

APPENDIX 1 – MYANMAR OUTSOURCE PROPOSAL (KEY FACTS)

Potential provider	Myanmar Precision Engineering
Scope	75% of current product range by value
Initial term	Five years
Notice period	1 year after initial term, either party.
Start date	1 January 20X2
Set up	FSSL to lend Rs. 500 million, 8% per annum interest, capital repayable in monthly equal installments over three years.
FSSL headcount impact	60% of Faisalabad factory workers to be made redundant, with the option for 5-10% of those at risk of redundancy to relocate to Myanmar for the initial five-year contract.

APPENDIX 2 – FAISALABAD SURGICAL SUPPLIES LIMITED ANALYST REPORT EXTRACTS

Balance sheet extract at 31 December 20X0:

	Note	Rs. in million
Non-current assets		1,245
Net current assets		330
		1,575
Share capital	1	250
Retained earnings		700
Total equity		950
5% TFCs	2	625
Total equity and long-term debt		**1,575**

Notes:

1. Share capital consists of shares with a nominal value of Rs. 100 and a market value of Rs. 375 cum div at close of business 31 December 20X0. A dividend of Rs. 25 per share is due to be paid on 3 January 20X1. Share price is expected to grow at the same rate as historical dividends.

2. The TFCs have a nominal value of Rs. 10,000 each, pay interest on 31 December each year and are irredeemable. They are currently priced at Rs. 7,100 per TFCs ex interest.

Other key facts:

Dividend per share history

Year	3 Jan W6	3 Jan W7	3 Jan W8	3 Jan W9*	3 Jan X0	3 Jan X1
Rs.	31	32	35	20	22	25

* There was a share split of 2 for 1 in early W9

- Industry average gearing level (debt/(debt plus equity)) = 30% by market values
- Debt beta = zero
- Corporate tax rate = 29%

APPENDIX 3 – DRAFT RISK REGISTER

Risk	Probability (high or low)	Impact (high or low)	Action
Being sued by a customer for faulty equipment supplied. This has not happened to date but has happened to our competitors' recently.			
The price of steel, which is a key raw material in our production process, fluctuates significantly.			
Myanmar operation may not work as expected. We have experience of outsourcing but we have not outsourced manufacturing specifically before.			

QUESTION 3

Today is 1 January 20X1.

Karachi Pharmaceuticals Limited (KPL) is a listed pharmaceuticals researcher and manufacturer. The board of directors is undertaking a strategic review as a result of recent concerns about cash flow. KPL's overdraft is reaching unsustainable levels while their competitors are paying large dividends and have significant cash reserves.

In order to prepare for a board meeting to discuss this crisis, you have been asked to examine the portfolio and benchmarked performance of KPL. More information to help this process is provided in Appendices 1, 2 and 3.

KPL has historically marketed its products by launching them at trade shows and press events, advertising in trade magazines and via the established network of face-to-face salespeople who visit hospitals and medical practices to speak to medical professionals directly. Often large intermediaries buy drugs in bulk for a discount, that they then sell on. The board is concerned that the company is not making the best use of technology through this traditional approach and is considering a more digitally-based approach to marketing and sales.

One of KPL's key products, tradename 'Pleuromol', is particularly effective in the treatment of otherwise often fatal respiratory illnesses. It is an expensive drug at Rs. 100,000 per day for a typical 14 day treatment. The marginal cost of manufacture is closer to Rs. 1,000 a day. Following a recent cybersecurity incident, this information has been leaked to the press. The class of diseases treated with Pleuromol is common in children in poorer, developing nations who cannot currently come close to affording the treatment. There is mounting pressure to make the drug available either free of charge or at a drastically reduced cost to these locations.

The marketing director is keen to make the drug available through a revised Corporate Social Responsibility Programme (Appendix 4). However, the finance director claims this would be a waste of shareholder's funds, neglecting the director's moral and fiduciary duty to the shareholders, and would reduce the funds available for future research.

Requirements

(a) Analyse the financial position and product portfolio of KPL in relation to its competitor and conclude on the position and prospects of KPL. **(13 marks)**

(b) Explain how the 'six Is' of e-marketing could be used to improve the current marketing mix. **(06 marks)**

(c) Respond to the claim that the proposed Corporate Social Responsibility Programme is potentially a waste of shareholders' funds. **(06 marks)**

Total: 25 marks

APPENDIX 1 – ANALYST REPORT EXTRACTS

Background on KPL's product portfolio, including industry growth and market share information

Pharmaceutical products are typically one of three types:

- Class 1 – Those under development. These are not yet saleable until fully developed and approved by regulators.
- Class 2 – Those being sold under patent. These enjoy a 20-year period of exclusivity.
- Class 3 – Those being sold out of patent and 'generics'. When a drug is outside its patent period, the drug is available to be made by any pharmaceutical companies. Often the original brand name still commands a premium due to customer familiarity with the name, but it is usual for there to be 'generics' – less expensive, essentially less branded versions of the product manufactured by others.

KPL's portfolio mix is as follows:

	Class 1	**Class 2**	**Class 3**
By number of products	174	15	40
By revenue (% of total revenue)	n/a	40	60
By gross margin (% of total gross margin)	n/a	65	35

The majority of the Class 2 and Class 3 products are in high-growth markets.

By definition, Class 2 products are effectively 100% market share. Of the Class 3 products, KPL is the largest provider by revenue for around 75% of the products in that class.

APPENDIX 2 – SUMMARISED FINANCIAL STATEMENTS OF KPL

Statement of profit or loss extracts

	20X0
	Rs. in billions
Revenue	200
Gross margin	**180**
Depreciation and amortisation	(80)
Other expenses	(30)
Operating profit	**70**
Finance charges	(50)
Profit for the year	**20**
Dividend	0
Retained profit for the year	**20**

Statement of financial position extracts

	20X0
	Rs. in billions
Tangible non-current assets	245
Intangible non-current assets	1,000
	1,245
Current assets	48
	1,293
Share capital	100
Retained earnings	653
Total equity	753
Long term borrowings	245
	998
Current liabilities excluding overdraft	40
Overdraft	255
	1,293

APPENDIX 3 – INFORMATION ABOUT MUMBAI PHARMACEUTICALS

KPL views Mumbai Pharmaceuticals Ltd (MPL) as a direct competitor of comparable size and with similar target markets. Using the same Class 1/2/3 as KPL use themselves, MPL's portfolio mix is as follows:

	Class 1	Class 2	Class 3
By number of products	40	30	50
By revenue (% of total revenue)	n/a	90	10
By gross margin (% of total gross margin)	n/a	95	5

The majority of the Class 2 and Class 3 products are in low growth, stable markets.

By definition, Class 2 products are effectively 100% market share. Of the Class 3 products, MPL is the largest provider by revenue for around 40% of the products in that class.

The following are financial statement summaries of MPL:

Statement of profit or loss extracts

	20X0 Rs. in billions
Revenue	220
Gross margin	**210**
Depreciation and amortisation	(40)
Other expenses	(30)
Operating profit	**140**
Finance charges	(30)
Profit for the year	**110**
Dividend	(110)
Retained profit for the year	**0**

Statement of financial position extracts

	20X0 Rs. in billions
Tangible non-current assets	199
Intangible non-current assets	350
	549
Current assets excluding cash	48
Cash	225
	822
Share capital	100
Retained earnings	447
Total equity	547
Long term borrowings	245
	792
Current liabilities	30
	822

APPENDIX 4 – PROPOSED CORPORATE SOCIAL RESPONSIBILITY PROGRAMME

The current corporate social responsibility programme extends to, for example:

- Sponsorship of key sporting events
- Supplier labour practices due diligence
- Local community support around our manufacturing facility
- University sponsorship and research fellowship support

However, the current programme does not extend to the charitable provision of products, as highlighted in the recent coverage concerning Pleuromol.

(THE END)