The Institute of
Chartered Accountants
of Pakistan

Multi Subject Assessment Stage

5 December 2023
4 hours and 15 minutes – 100 marks

Management Professional Competence

CRN:

Name: ________________________________

INSTRUCTIONS

Please carefully read the following instructions:

1. You are required to access your answer working area by using your Student ID and Password as mentioned on your Admit Card.
2. The overall duration of the exam is 4 hours and 15 minutes, which includes the reading time and an extra 30 minutes of time that has been allocated due to the introduction of computer-based examinations, for the Winter 2023 examinations only.
3. All questions are compulsory.
4. Questions can be attempted in any sequence.
5. There is no specific time allocated for individual questions.
6. An auto-save function runs every minute. Further, your answers are saved automatically when you navigate between questions or click on the > **(NEXT)** or < **(BACK)** symbols.
7. Each question provides an answer area with a Rich Text Format (RTF) editor for writing your answers. Additionally, below the RTF editor, a spreadsheet is provided to facilitate examinees in doing rough calculations or other workings. **However, please note that any work performed in the spreadsheet will not be considered for marking. To ensure your work is considered, you must copy and paste it from the spreadsheet to the RTF editor.**
8. Work done in the spreadsheet of one question can also be copied into the RTF editor of the same or another question.
9. You may use Microsoft Office applications such as MS Word or MS Excel for rough working. However, please remember that any work performed in these applications cannot be copied into the examination software, and vice versa. Furthermore, any such work will not be uploaded with your exam for marking.
10. You may use pen and paper for rough work, but please note that pen and paper work should only be done on the last two pages of the question paper that are specifically allocated for this purpose. Remember that any rough work done on these pages will not be uploaded with your exam for marking.
11. In accordance with the open book policy of this paper, you are allowed to have a maximum of **FIVE** original books duly bound. Please ensure that the books or notes you bring are permissible under the open book policy. Keeping a book or notes are not permissible and will be considered a violation of the use of unfair means policy.
12. An external calculator can be used, provided it is included in the list of permissible calculators issued by ICAP.
13. During the exam, access to any website other than Assessment Master is strictly prohibited. Engaging in such activities will be considered a violation of the use of unfair means policy, leading to disciplinary action.

QUESTION 1

Today is 1 February 2023.

Indus Valley Silk (IVS) is located near Sukkur, in Sindh province. It is a well-established, family-owned business which buys raw silk in bulk, spins it into thread, then weaves it into yarn. This is sold to clothing manufacturers, mainly in Pakistan.

For many years, the majority of the silk was purchased from a trusted local supplier. Unfortunately, this supplier's silkworms suffered from a serious disease recently, meaning the whole plantation had to be destroyed at short notice. The supplier is unfortunately not intending to restart their business. This has left IVS unexpectedly short of supplies of raw silk in the face of a large order book from its customers. IVS has struggled to source silk from elsewhere, resulting in many customers cancelling orders at short notice, with some successfully prosecuting IVS for breach of contract. As a consequence, IVS is struggling to pay its bills in the short term and, for the first time in its history, the family is seriously concerned as to whether the business will survive.

The operations director, Paatav Khanna, is determined to turn the business around, and has outlined plans for IVS to invest in a new mulberry plantation and produce its own raw silk, reducing its cost base significantly compared to purchasing the raw silk externally as previously. It is also anticipated that if IVS produces more than the amount of silk required for its own purposes, the excess can be sold to other manufacturers. The investment in the mulberry plantation would create some change management issues as some staff would need to reskill to work in the mulberry plantation and harvest the raw silk, and some work would be more seasonal than currently. However, Paatav feels these issues are far from insurmountable. The business plan set out by Paatav also includes plans to expand the IVS customer base by actively promoting itself online. To do this, an online brand would need to be developed – either alone or in partnership with an existing online business.

Paatav shared his forecasts should the plans proceed as expected **(see Appendix 1)** with the board. The basic ideas and forecast were well received at a recent board meeting; however, a major issue was pointed out by Raahithya Khanna (the finance director) with reference to the latest statement of financial position **(see Appendix 2)**. Raahithya said that 'unfortunately, the family business does not have sufficient funds to pay its current bills, let alone having sufficient funds to invest in a mulberry plantation! New debt is not an option with our reputation at the moment.'

After much discussion, it was concluded that a scheme of financial reconstruction would be required in order to overcome the immediate cashflow issue and provide funding for investment in the mulberry plantation. Subsequently, Raahithya drafted a proposed scheme for the board to consider **(see Appendix 3)**.

Requirements

(a) Calculate what each provider of finance would receive if IVS were forced into liquidation. **(06 marks)**

(b) Estimate the value of all IVS ordinary shares if the reconstruction proceeds. **(04 marks)**

(c) Evaluate whether the reconstruction is likely to be acceptable to each class of finance provider. **(12 marks)**

(d) Evaluate the likely causes of resistance from workers being moved to the mulberry plantation, and recommend how this resistance could be addressed. **(10 marks)**

(e) Describe four options for developing an online brand and recommend, with justification, how this should be done. **(08 marks)**

(f) Discuss the income tax and sales tax implications if the board approves the investment in the new mulberry plantation. Also, discuss the tax implications of the financial restructuring scheme with Sahiwal Bank and Faisalabad Bank if the shares were issued to them at Rs. 18,000 per share. **(10 marks)**

Total: 50 marks

APPENDIX 1 – FORECAST IF THE INVESTMENT IN THE MULBERRY PLANTATION PROCEEDS

FOR BOARD DISCUSSION
Prepared by Paatav Khanna
23 December 2022

Forecast financial performance should the investment in a mulberry plantation proceed

Assuming the plantation is available from 1 January 2023, I forecast the following for 2023:

- Revenues of Rs. 10,000 million
- Gross margin of 30% of revenues
- Operating expenses of Rs. 1,400 million
- Taxation of 29% of profit before tax
- A price-earnings ratio of 10 is applicable. This is consistent with industry averages, adjusted for IVS specific circumstances

APPENDIX 2 – SUMMARY STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2022

	Rs. in million
Non-current assets **(Note 1)**	7,185
Current assets:	
Inventory	1
Receivables **(Note 2)**	200
Current liabilities:	
Trade payables – unsecured	(475)
Other payables (excluding overdraft) – unsecured	(1,525)
Overdraft **(Note 3)**	(1,270)
Net-working capital	(3,069)
Total assets less current liabilities	**4,116**
Equity:	
Share capital **(Note 4)**	100
Retained earnings	(184)
Total equity	(84)
Non-current liabilities:	
Bank loan – Sahiwal Bank **(Note 5)**	2,500
Bank loan – Faisalabad Bank **(Note 6)**	1,700
	4,116

Notes:

1. Non-current assets consist of Rs. 3,200 million of property (market value also Rs. 3,200 million), with the remainder being plant and equipment, worth approximately 25% of its net book value if it were to be sold.
2. Approximately 70% of receivables are expected to be recoverable. The other 30% are under dispute given recent supply issues.
3. A Rs. 1,300 million maximum overdraft facility is provided by Sahiwal bank. This is secured by way of a floating charge over all the assets of the business.
4. Each share has a nominal value of Rs. 1,000 with all shares owned by members of the Khanna family.
5. The Sahiwal bank loan is repayable in full in 2027. The interest rate applicable to the loan is 10%, and it is secured by a first fixed charge over property.
6. The Faisalabad bank loan is repayable in full in 2032. The interest rate applicable on this loan is 12%. This is secured by a second fixed charge over property, and a floating charge over all the assets of the business.

APPENDIX 3 – TERMS OF PROPOSED RECONSTRUCTION SCHEME

EMAIL

To: The Board, IVS
From: Raahithya Khanna
Subject: Proposed reconstruction scheme
Date: 17 January 2023

Dear fellow board members,

Further to the recent board meeting, the finance team have drafted a proposed reconstruction scheme for the board's consideration. No providers of finance or creditors have been approached as yet. As this scheme is voluntary, each class of creditor would need to agree to the proposal before it can proceed.

The proposed terms of the reconstruction scheme are as follows:

- The Khanna family contribute a further Rs. 2,000 million in return for 100,000 shares.
- The Sahiwal bank loan and overdraft is converted into a Rs. 2,250 million 15% loan repayable in 2030 with a first fixed charge over property, and 75,000 ordinary shares.
- The Faisalabad bank loan is converted into a Rs. 1,000 million 15% loan repayable in 2030, secured with a floating charge over all the assets, and 30,000 ordinary shares.

I suggest we meet to discuss this in detail later this week. Any questions in the meantime, please ask.

Best wishes,

Raahithya

QUESTION 2

Assume that it is currently 1 December 2023.

Bannu Furniture (BF) is a listed all-equity financed bedroom and kitchen furniture business. Some recent market research with the existing customer base concluded that BF is seen as a high-quality, desirable brand. Many of the customers surveyed used BF for both their bedroom and kitchen furniture, and expressed a preference to have a whole 'BF' house, with lounge furniture being the first choice by customers for a new range.

The board are keen to expand in principle but are concerned about finance. As a listed business, the company has a high dividend payout ratio, leaving little internally to fund significant expansion at the moment.

The board is unsure whether to use debt or equity finance, as some directors think equity is cheaper (a dividend does not have to be paid), but others are attracted to the tax deductibility of interest associated with the debt option. The finance director – Tariq Patel – noted that the average gearing in the industry is 25% debt/(debt + equity) by market values, so before any financing decisions can be made, an understanding is needed as to how the source of finance will affect gearing ratios in the eyes of investors. Key to comprehend this is in understanding the amount of finance required **(see Appendix 1)**.

Two types of debt are being considered: a bank loan or convertible debentures. The cost and relative merits of these would need to be considered if debt finance is to be used. Tariq has circulated an email comparing the two for consideration **(see Appendix 2)**.

Interest rates are increasing globally and are somewhat erratic, so the board is concerned that, if debt is chosen, interest costs could spiral alarmingly and might increase before obtaining the loan. Tariq said he has included in his email an analysis showing how this risk could be managed using forward rate agreements, or purchasing an option to enter into an interest rate swap **(see Appendix 2)**.

Requirements

(a) Calculate how much finance is required for the expansion plan and, with reference to appropriate theory, explain whether debt or equity is recommended. **(07 marks)**

(b) Calculate the after-tax cost of each proposed type of debt finance, and recommend with justification which is preferable if debt were to be the chosen finance method. **(10 marks)**

(c) Recommend, with supporting calculations and justification, which hedging instrument should be chosen (if either) to manage interest rate risk on the bank loan if it were to be chosen. **(08 marks)**

Total: 25 marks

APPENDIX 1 – PLAN FOR EXPANSION

To: Tariq Patel
From: Zahid Hussain, financial controller
Subject: BF expansion into lounge furniture
Date: 17 November 2023

Dear Tariq,

In order to assist with the financing decision for a potential expansion into lounge furniture, my team have assembled the following analysis:

- Current share price: Rs. 950 per ordinary share, five million in issue
- 2023 sales were Rs. 1,450 million. This would be set to rise by 30% immediately in 2024, if we launch the new range of furniture and maintain that higher level indefinitely.
- The sales-to-working capital ratio of BF is 10:1. This ratio would be maintained with the expansion.
- Incremental non-current asset investment would need to be 250% of any increase in sales, payable immediately.
- An initial marketing campaign would be required, costing 15% of any new revenues from the new range, payable at the start of 2024.

Please let me know if there is any further information you require at this stage.

Best wishes,

Zahid

APPENDIX 2 – DEBT AND HEDGING ALTERNATIVES

To: The Board
From: Tariq Patel
Subject: Debt finance alternatives and interest rate hedging
Date: 20 November 2023

Dear Board,

BF is currently proposing to arrange new debt finance on 1 January 2024.

Whereas I fully appreciate that the board are still considering funding options, should debt be the preferred route, then research indicates two alternatives may be available:

- A 20% fixed rate, five-year bank loan, secured on BF properties with a fixed charge; or
- Rs. 10,000, 15% fixed, five-year secured convertible debentures, convertible into 12 ordinary shares at the investor's option or redeemable at par in five years' time. Our share price is predicted to grow by 4% per year over the next five years.

BF pays tax at a rate of 30%. The base rate of interest is currently 14%. To manage the interest cost, the following alternatives are available on the bank loan:

- A five-year forward rate agreement with a guaranteed base rate of 16% for borrowing; and
- An option on a variable-for-fixed interest rate swap for an upfront premium of Rs. 40 million, exercisable at any time over the next 12 months.

Any questions, please ask.

Kind regards,

Tariq

QUESTION 3

Mirani Steel Mill (MSM) is located outside Karachi and produces specialist steel, the main ingredient of which is iron ore. It is known for having efficient production processes and associated low prices. The production process is labour intensive, uses a large amount of energy and produces a significant amount of carbon-based pollution. Unfortunately, MSM has a less than perfect health and safety record. In recent years, there have been several deaths and serious accidents on site; for example, recently a worker fell off a gantry into a steel vat. This is being investigated by the Pakistan Safety Council, with an initial assessment due soon.

Although financial returns have been good historically, two major institutional investors have recently reviewed their own corporate social responsibility (CSR) policies and have requested that MSM issues reports in accordance with integrated reporting principles laid out by the International Integrated Reporting Council, using the six capitals as a framework, being:

- Financial capital
- Intellectual capital
- Social and relationship capital
- Human capital
- Manufacturing capital
- Natural capital

The board of directors is concerned that aspects of the report will paint MSM in a poor light. The suggestion has been made by the CEO that any negative aspects can easily be 'softened', given there are no detailed reporting standards for integrated reports, and they are not audited.

As a basis for discussion, the finance department has produced some draft information to assist in the production of the integrated report **(see Appendix 1)**. The financial controller has been vocal about the extremely large amount of manual effort that was involved in producing the numbers, given information systems currently do not exist to produce the required data easily. To support the production of future integrated reports, the IT director proposes investing in an enterprise resource planning system, to replace the current department-specific systems used by MSM.

MSM has a small number of extremely large, reputable international customers and, with its manufacturing scheduling, typically focuses on one large order at a time. A significant order was completed three months ago, but the customer has yet to pay their invoice. This is creating cashflow difficulties. Unfortunately, this issue is not a rare occurrence. The head of finance is keen to take steps to protect MSM from these short-term liquidity risks, and is considering various options **(see Appendix 2)**.

Requirements

(a) Insofar as the information permits, evaluate the performance of MSM using **THREE** of the six capitals of integrated reporting as a framework, including financial capital. **(08 marks)**

(b) Evaluate the case for investing in an enterprise resource planning system to assist with integrated reporting at MSM. **(07 marks)**

(c) Evaluate whether adjusting the presentation of the integrated report to make it appear more favourable is unethical. **(05 marks)**

(d) Recommend, with justification, which method of managing working capital would be most appropriate to manage short-term cashflows. **(05 marks)**

Total: 25 marks

APPENDIX 1 – MSM PERFORMANCE DATA

DRAFT

Compiled by Hashim Iqbal, the financial controller

Financial performance:			
Financial periods	**2023**	**2022**	**2021**
	-------- Rs. in billion --------		
Sales revenue	7.90	7.40	6.80
Gross profit	2.88	2.78	2.55
Overhead expenses	1.48	1.41	1.41
Profit before tax and finance costs	1.40	1.37	1.14
Profit for the year	0.65	0.58	0.52

Other information			
Current ratio	0.96	0.98	1.10
Number of employees	125	136	150
Staff turnover (%)	9%	6%	4%
% of orders delivered late	10%	8%	7%
Forward contract order book (tonnes of steel on order)	4,287	4,745	5,484
Customer complaints as a percentage of total orders and existing contracts	3.4%	2.4%	2.2%
Accidents reported	124	12	154
Deaths or serious injury	4	4	5
Investment in non-current manufacturing equipment as a percentage of sales revenue	7%	8%	9%
R&D expenditure as a percentage of sales revenue	0.5%	1%	2%
Carbon emissions in tonnes per tonne of steel	2.15	2.1	2.1
Energy consumption (million BTU's per tonne of steel)	12	13	16

APPENDIX 2 – OPTIONS FOR MANAGING RECEIVABLES

From: Pervaiz Kharal, Head of Finance
To: Hashim Iqbal, Financial Controller
Subject: Receivables management
Date: 3 October 2023

Dear Hashim,

I hope you and your family are well. Given our recent panic about liquidity caused by ISM paying us late, I would like to focus on improving management of our receivables. I fully appreciate our credit collection team do all they can to ensure payment is made on time, so it's clear we need to consider additional measures.

I am considering one of the following to help manage our receivables:

- Paying suppliers late: If our customers pay late, we delay paying our suppliers. We source our iron from two large companies as you know, and we have known them for many years.
- Offer an early settlement discount to customers who pay on time, may be increasing this discount if they pay before the due date.
- Factor receivables: We receive funding from a debt factor at the point of sale to a customer, on a 'without recourse' basis, to be repaid when customers pay us.

Before we get into the financials of each option, I wanted your thoughts on each approach in principle, please.

I look forward to hearing from you.

Regards,

Pervaiz

(THE END)