

Paper DA2 – Incorporating subject areas:  
– Interpretation of Financial Statements  
– Performance Management

# Diploma in Financial Management

All questions are compulsory and **MUST** be answered.

The project **MUST** be written in English.

The maximum word count (including appendices and tables but excluding table of contents, references and bibliography) is 5,000.

The project **MUST** be TYPED in black ink, one-sided, double-spaced, using a minimum 12-point font size and a 1-inch margin at each side. **HANDWRITTEN SUBMISSIONS WILL NOT BE ACCEPTED.** The project must be submitted by post, electronic submissions are not acceptable.

The project should be submitted on A4 paper with your student number, project name, date and page number at the top of each page.

A project submission form **MUST** be completed for each project submitted and attached to the front of the project.

**The Association of Chartered Certified Accountants**



# Module A

## **Section 1 – Incorporating subject areas: Interpretation of Financial Statements and Performance Management.**

**This ONE question is compulsory and MUST be attempted**

### **1 Introduction**

Duplex is a quoted company which has successfully followed a strategy of growth by acquisition. The company's divisionalised structure is seen as a key aspect of the successful management of the expanding business. When a company is acquired, it is absorbed into one of the existing divisions of Duplex.

When the acquisitions department of Duplex identifies a potential investment, the published financial statements are reviewed and meetings are arranged with the management of the potential investee. The purpose of these meetings is to obtain more detailed information than is available from the published financial statements. If these investigations support the case for acquisition, the corporate finance department will place a value on the potential investee and conduct the negotiations for the purchase of the investee.

Duplex's approach to the management of acquired companies is to retain the existing management, who will have responsibility for increasing shareholder value. Progress towards this objective is monitored through the provision of a management information package.

You are employed in the acquisitions department of Duplex. Your responsibilities include the appraisal of possible investments and specifying the content, format and timing of the management information package which Duplex will use to manage the investee. You have recently been asked to respond to an enquiry from a newly appointed director.

This director has questioned whether the approach to acquisitions needs to be revised, for example, by making use of analytical techniques such as shareholder value analysis and the balanced scorecard. The board has agreed to undertake a critical appraisal of the approach to acquisitions, based on the potential acquisitions outlined below.

Your brief is to provide an outline of the decision-making process with regard to investments, based on the potential acquisitions. In that context, you have been asked to explain the usefulness and limitations of published financial statements in the acquisition decision, how the financial statements are used in the decision-making process, and how Duplex can exercise control over the acquired companies.

#### **Potential acquisitions**

Two companies have been identified as potential acquisitions. If acquired, these companies would become part of the technology division of Duplex, which currently comprises five companies.

The two companies are Softconsult Co and Harcon Co. Summarised financial statements for both companies are provided at Appendices 1 and 2, and additional information on each company is provided at Appendices 3 and 4.

It is Duplex's view that the performance of both companies can be improved due to the ability to offer customers integrated solutions, combining the software skills of Softconsult and the hardware manufactured by Harcon.

**Required:**

**Prepare a report to the directors of Duplex which:**

- (a) **Discusses the usefulness and limitations of the published financial statements of a potential investee for the purpose of making an acquisition.** (8 marks)
  - (b) **Identifies those ratios and other measures which are of most relevance in deciding whether to acquire that particular company; and clearly explains the relevance of each ratio or measure you have identified for each of the potential acquisitions.** (16 marks)
  - (c) **Assesses the suitability of each company as a potential acquisition using the ratios and measures you have identified in (b) above.** (24 marks)
  - (d) **Discusses the suitability of measures of shareholder value and the balanced scorecard as techniques for managing the businesses, assuming that both of the companies are acquired.**  
Note: you are NOT required to design balanced scorecards for the companies (8 marks)
  - (e) **Discusses the problems which are likely to arise in merging the existing and acquired businesses into one coherent business unit, and explains how these problems may be overcome.** (18 marks)
  - (f) **Identifies and justifies measures of performance to be used to manage the two companies following the proposed acquisitions.** (22 marks)
- Marks awarded for overall quality of the report. (4 marks)

**(100 marks)**

## Summarised financial statements for Softconsult Co

	2007 \$000	2006 \$000
<b>Balance Sheets as at 31 October 2007 and 31 October 2006</b>		
<b>Assets</b>		
<b>Non-current assets</b>		
Property, plant and equipment	7,302	6,935
	<u>7,302</u>	<u>6,935</u>
<b>Current assets</b>		
Inventories	–	–
Trade receivables	12,543	6,533
Other current assets	2,884	1,275
Cash and cash equivalents	6,694	–
	<u>22,121</u>	<u>7,808</u>
<b>Total assets</b>	<b><u>29,423</u></b>	<b><u>14,743</u></b>
<b>Equity and Liabilities</b>		
Share capital	7,000	4,000
Share premium	3,000	1,000
Retained earnings	(7,499)	(13,847)
<b>Total equity</b>	<b><u>2,501</u></b>	<b><u>(8,847)</u></b>
<b>Non-current liabilities</b>		
Long-term borrowings	1,135	1,885
<b>Total non-current liabilities</b>	<b><u>1,135</u></b>	<b><u>1,885</u></b>
<b>Current liabilities</b>		
Trade and other payables	2,885	3,622
Customer deposits and payments in advance	18,441	10,932
Short-term borrowings	1,228	2,741
Bank overdraft	–	1,438
Current tax payable	595	–
Other current liabilities	2,638	2,972
<b>Total current liabilities</b>	<b><u>25,787</u></b>	<b><u>21,705</u></b>
<b>Total liabilities</b>	<b><u>26,922</u></b>	<b><u>23,590</u></b>
<b>Total equity and liabilities</b>	<b><u>29,423</u></b>	<b><u>14,743</u></b>
<b>Income statements for the years ended 31 October 2007 and 31 October 2006</b>		
	2007 \$000	2006 \$000
<b>Revenue</b>	98,543	58,155
Cost of sales	(21,665)	(16,102)
Gross profit	<u>76,878</u>	<u>42,053</u>
Other income	632	241
Operating expenses	(70,402)	(61,362)
Finance costs	(165)	(380)
<b>Profit/(Loss) before tax</b>	<b><u>6,943</u></b>	<b><u>(19,448)</u></b>
Income tax expense	(595)	(122)
<b>Profit/(Loss) for the period</b>	<b><u>6,348</u></b>	<b><u>(19,570)</u></b>

## Summarised financial statements for Harcon Co

	2007 \$000	2006 \$000
<b>Balance Sheets as at 31 October 2007 and 31 October 2006</b>		
<b>Assets</b>		
<b>Non-current assets</b>		
Property, plant and equipment	15,883	15,169
	<u>15,883</u>	<u>15,169</u>
<b>Current assets</b>		
Inventories	18,237	17,558
Trade receivables	47,655	49,521
Other current assets	11,274	6,129
Cash and cash equivalents	1,338	986
	<u>78,504</u>	<u>74,194</u>
<b>Total assets</b>	<b><u>94,387</u></b>	<b><u>89,363</u></b>
<b>Equity and Liabilities</b>		
Share capital	12,400	9,200
Share premium	2,910	958
Retained earnings	1,940	437
<b>Total equity</b>	<b><u>17,250</u></b>	<b><u>10,595</u></b>
<b>Non-current liabilities</b>		
Long-term borrowings	17,381	22,685
<b>Total non-current liabilities</b>	<b><u>17,381</u></b>	<b><u>22,685</u></b>
<b>Current liabilities</b>		
Trade and other payables	48,496	43,606
Short-term borrowings	1,286	1,154
Bank overdraft	9,835	11,236
Current tax payable	139	87
<b>Total current liabilities</b>	<b><u>59,756</u></b>	<b><u>56,083</u></b>
<b>Total liabilities</b>	<b><u>77,137</u></b>	<b><u>78,768</u></b>
<b>Total equity and liabilities</b>	<b><u>94,387</u></b>	<b><u>89,363</u></b>

## Income statements for the years ended 31 October 2007 and 31 October 2006

	2007 \$000	2006 \$000
<b>Revenue</b>	204,533	206,673
Cost of sales	(201,178)	(205,442)
Gross profit	3,355	1,231
Other income	2,175	533
Operating expenses	(2,155)	(1,885)
Finance costs	(1,664)	(1,914)
<b>Profit/(Loss) before tax</b>	<b>1,711</b>	<b>(2,035)</b>
Income tax expense	(208)	(144)
<b>Profit/(Loss) for the period</b>	<b><u>1,503</u></b>	<b><u>(2,179)</u></b>

### Softconsult Co Company overview

Softconsult was founded six years ago when two students completed their PhDs. It is based in Asia, and specialises in developing software by building a platform to support complex systems.

Although the company has only recently moved into profit, it has a good reputation for delivering quality solutions in a relatively short timeframe.

This is achieved through the combination of a focus on leading edge technology and recruitment of the most able graduates and post-doctoral students worldwide. The culture is informal with an emphasis on enjoying the challenge of using and developing the capabilities of the design and production team through harnessing technology. The research carried out by Duplex has shown that staff are highly motivated and see themselves as being change agents – not just in the sense of meeting customers' needs, but in changing the way technology affects society.

Customers are drawn from an eclectic range of industries. When Duplex expressed the view that it may be more effective to focus attention on key customer groups, the founders' response was that 'the diversity is both the strength of the company, and the source of the fun'.

While the company uses very powerful computers to develop the products, it is recognised that the innovative, adaptable and motivated workforce is the key element for success. Staff at all levels are encouraged to seek new ways of operating, and to suggest solutions to problems and new services which might be offered to customers.

### Harcon Co Company overview

The company is UK based, with manufacturing plants in a number of locations. It manufactures products which are designed to provide complete solutions to customer needs. The company has been trading for over 10 years and has developed a global customer base. It has a reputation for delivering reliable solutions to complex problems. Customers are in a range of industries including communications infrastructure, healthcare, defence and aerospace.

The strengths of the company are its ability to provide a comprehensive solution to customer problems and a strong customer focus. It is also recognised as an innovator, and turnover expanded by almost 60% in 2006.

The directors of Harcon have identified the need to build strong ongoing relationships with customers as the key to future development. They plan to do this by creating what they have termed a 'global reach' so that a customer in any market can feel confident that their needs will be met, irrespective of which manufacturing location provides the product. This will be achieved by continuing to focus on world-class manufacturing and customer service.

The growth achieved in 2006 created some difficulties, and the directors have stated that they believe that the company is well placed to achieve its targets, as it has been restructured and operations throughout all locations have been realigned.

In all locations, the production process is highly automated, using the most up to date equipment.

**End of Project**