Diploma in Financial Management

Module A

PROJECT DA2, INCORPORATING SUBJECT AREAS
– INTERPRETATION OF FINANCIAL STATEMENTS
– PERFORMANCE 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

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

This ONE question is compulsory and MUST be attempted

1 Background

Cleenup is a family owned limited liability company based in the UK. The company was formed by two brothers and their cousin in the 1970s to manufacture a number of domestic cleaning products. The initial investment by the owners was £70,000, and the company was established with the assistance of £200,000 of local development agency grants. It quickly established a reputation for providing good quality products at a competitive price, and generated strong profits growth during the 1980s. The owners have regularly capitalised retained profits as a demonstration of their continued commitment to the company, and the balance sheet is forecast to report shareholders' funds totalling £12·7 million at 31 May 2007. The company's reputation and profitability has been achieved through a focus on the manufacturing process, accompanied by rigorous cost control.

The financial statements for the year to 31 May 2007 are forecast to report revenue of almost £30 million and retained profits for the year of £2·1 million. Financial results and ratios for the years to 31 May 2005 and 2006, together with industry averages, are provided at Appendix 1.

When the company was founded, all of the members of the senior management team were shareholders, although not all shareholders were involved in the day to day running of the company. As the company has expanded, the founders and their families have mainly withdrawn from the management roles, although the present chairman, who is now aged 66, is one of the founders. The managing director is the daughter of another of the founders. None of the other directors and managers has any family connections with the founders. The company operates a share-based incentive scheme for directors and managers. A schedule of share ownership is set out at Appendix 2.

The directors have a participative management style, and firmly believe that this has created a culture in which staff at all levels feel committed to the success of the company. A key element in this is the coherence provided by what is internally referred to as 'the Cleenup Credo' – 'We will succeed if we continually strive to deliver what our customers want at as low a price as possible'. This statement is prominently displayed throughout the company's premises and is used as a reference point for all decision-making.

The customer base is multiple retail chains throughout the EU, with Cleenup manufacturing products for the chains' own label ranges. New products have been a result of negotiations with customers, usually based on the customer's objective of competing with proprietary brands.

Over the last few years, the company has maintained a steady market share of around 12%, but the directors believe that this will come under threat in the future, as customers will become increasingly demanding, seeking both an improvement in quality and a reduction in costs.

Against that background, the directors sought to exploit the opportunity provided by an idea developed by the production director. This idea arose from his analysis of the attributes of existing products. From this analysis, he began to consider the possibility of developing a new compound which would reduce the amount of physical input required for the task of cleaning surfaces. His basic idea was that it may be possible to formulate a compound that, when sprayed onto the surface, would combine the tasks of removing dirt from surfaces and providing a protective film so that the surface would stay clean for longer. He argued that if such a compound could be developed it would remove the need for surfaces to be cleaned, polished and waxed and that this would be an attractive product for Cleenup's customers. As the director investigated the feasibility of his idea, it became apparent that, while it is likely that the product which would eventually be developed would have a potential for sales in the domestic market, the main potential is in the industrial market. It is anticipated that the product would be attractive to facilities maintenance providers who sub-contract the cleaning of large buildings such as apartment blocks, office blocks and hotels.

Initial research which was carried out at a cost of £350,000 and written off to the income statement in the year to 31 May 2006 seemed to support the directors' belief that such a compound could be successfully developed and the company registered a patent. This led to increased expenditure of £625,000 in the year to 31 May 2007. By March 2007, it was clear that the idea had some prospect of success, and the directors are now considering the next step, and how to account for the development expenditure in the current year.

At a recent brainstorming session, several proposals were agreed for further consideration. The directors have no set position on any of the proposals and have asked you to advise them on the most appropriate action. From your initial enquiries, you have formed the view that there is a growing feeling among the directors and senior managers that Cleenup should carry the development through to a final product which should be manufactured and sold by the company.

The choices for the company have been identified as:

Sell the patent

The directors have engaged an agent to carry out confidential discussions with other manufacturers. These discussions have indicated that the patent rights could be sold, with the purchaser continuing the project by further development with a view to achieving a marketable product. The most obvious benefit of this option is that as well as providing royalty income when the product is brought to market, it would allow Cleenup to regain its focus on manufacturing products with a relatively guaranteed market, without any need for further investment.

Develop the product and then sell

It has also been suggested that the project be continued to the point at which the product has been fully developed, and then sold to a manufacturer of industrial cleaning products. At that point it is likely that there will be a greater return to Cleenup as the purchaser will be acquiring a fully developed product. Under this option, the company would be able to negotiate an arrangement to receive royalties based on the volume of sales. The royalty income in this case would be higher than that obtained if the patent is sold.

Manufacture and sale by Cleenup

As the company has already spent a considerable sum on bringing the project this far, and the fact that the eventual manufacturing technology will be compatible with Cleenup's current processes, it may be possible to maximise the long term return by Cleenup manufacturing and marketing the product itself. This option would require a totally new customer base to be developed in the industrial market.

You are employed by a business consultancy firm. Your firm has provided services to Cleenup for several years. The directors have asked you to prepare a report which will assist them in deciding which of the above options to choose, and will identify a range of appropriate performance measures.

From your research, you have gathered the following data.

Domestic Products

This market is dominated by a small number of major brands. The branded products are sold through the large retail chains, both under brand names and as own label products. The branded products are also sold in independent shops. In each case, the products are sold at a premium which provides a higher margin than Cleenup is able to obtain. Cleenup has concentrated on selling to retail chains which are small in comparison to the customers of the major brands. In most cases, Cleenup's customers offer the consumer a low cost alternative to the major brands. The directors of Cleenup believe that the trend over the last number of years which has seen retailing becoming concentrated in a decreasing number of very large chains will continue. This will inevitably lead to considerable pressure to reduce selling prices. As the company is already operating on low margins, the directors' conclusion is that the focus on cost control must continue. There is concern that, as consumers in the markets within the EU become more affluent, they will move from the products offered by low cost retailers to the perceived higher quality of the major brands.

Industrial Products

Customers within this market tend to be more technically aware than those within the market for domestic products. In the main, these customers are large providers of contract cleaning and facilities maintenance services. While they could be described as cost conscious, product performance and the likelihood that the product will reduce the overall costs of a contract by minimising the time taken to complete the task is seen as having more importance than product cost. In particular, in the premium sector of the market, high quality performance is a key element in the success of a product.

Costings and returns

Develop the product and then sell

You have estimated that the additional development to achieve a marketable product will take a further 18 months, at an estimated cost of £2·6 million. The development would be undertaken in cooperation with a University in the UK. You have ascertained that there are three possible buyers of the final product, and that the eventual selling price will depend on the extent of the competition between them. If interest between all three can be generated, it is expected that the selling price could be close to £8 million. However, if only one is interested, the price is likely to fall to £4 million.

Manufacture and sale by Cleenup

Investigations have indicated a willingness from potential customers to consider adopting the product. The European market for the product is mature and is estimated to be equivalent to £65 million per annum at current exchange rates. You estimate that as this is a new market for Cleenup, the initial market share will be low, but that once the product's reputation becomes established this is likely to grow to between 6% and 8% over five years.

As the product is not yet fully developed, firm costings have not been established, but there is strong evidence to suggest that the likely operating profit will be between 8% and 10% of revenue.

While the production process will be similar to Cleenup's current processes, the company is currently operating at 93% of capacity, so an additional investment of £3 million will be required to create the required capacity. This investment must be undertaken in advance of production commencing.

Funding

The shareholders and directors are aware that if the option to manufacture and sell the product is chosen, there will be a need for additional funding. The family shareholders have stated that their prime consideration is that they do not wish to lose control of the company. They have specifically asked you to provide guidance on how their ability to retain control of the company will be affected by the issue of share capital and/or the raising of loans.

Current Structure

The company is organised on a functional basis, with each function being the responsibility of a specific director. An organisation chart is attached at Appendix 3. To date, the development of the new product has been the responsibility of a project team. This team is led by the managing director, and is made up of senior staff from each functional area.

Required:

Prepare a report to the directors of Cleenup which:

(a) Indicates the extent to which each of the options under consideration is likely to result in a cohesive mission and strategy for Cleenup; (14 marks)

(b) Considers the implications of selecting the option to manufacture and sell the product, by:

(i) proposing objectives which could be used to assess the company's performance; (10 marks)

(ii) identifying six ratios or other measures derived from the company's published financial statements which could be used by either current or future investors to assess the company's future performance, and clearly explaining the relevance of each of these in light of the objectives you have proposed in (i) above;

Note: You may refer to the ratios and measures included in Appendix 1, or any other ratios or measures that you believe are relevant. (18 marks)

(iii) discussing how any decisions which the directors must make regarding the choice of accounting policies will affect the outcome of your chosen measures; (8 marks)

(iv) examining the suitability of equity funding and borrowings as possible methods of funding the completion of the project and the development of the business to manufacture and sell the product, and discussing how the measures identified in (ii) above would be affected by each type of funding; (20 marks)

(v) discussing the extent to which Cleenup's current organisation structure will be suitable for the new activity; (12 marks)

(vi) identifying and, in the context of the objectives you have proposed in (i) above, justifying a range of non-financial performance indicators which the directors should use to monitor the company's performance. (18 marks)

(100 marks)

Data from Cleenup's Financial Statements for the years to 31 May:

		2006	2005
Net cash flow from operating activities	£	241,000	310,000
Capital expenditure in/(out) flow	£	(70,000)	(150,000)
Increase/(decrease) in cash	£	65,900	(23,500)
Current ratio		2·4	2·3
Acid test ratio		1·5	1·5
Asset cover	times	4·7	5·2
Gearing (debt/equity)	%	114	95
Non-current assets per employee	£	69,000	58,700
Turnover per employee	£	170,200	162,163
Working capital per employee	£	18,300	15,100
Gross profit margin	%	31·1	31·7
Net profit margin	%	11·1	13·5
Return on capital employed	%	12·7	13·6
Interest cover	times	4·1	11·4
Inventory turnover	times	7·2	8·0
Receivables collection period	days	58·2	50·8
Suppliers payment period	days	30·8	28·6
Net asset turnover	times	1·6	1·8
Non-current asset turnover	times	2·4	3·0
EBITDA margin	%	14·4	12·1

Industry Averages for:

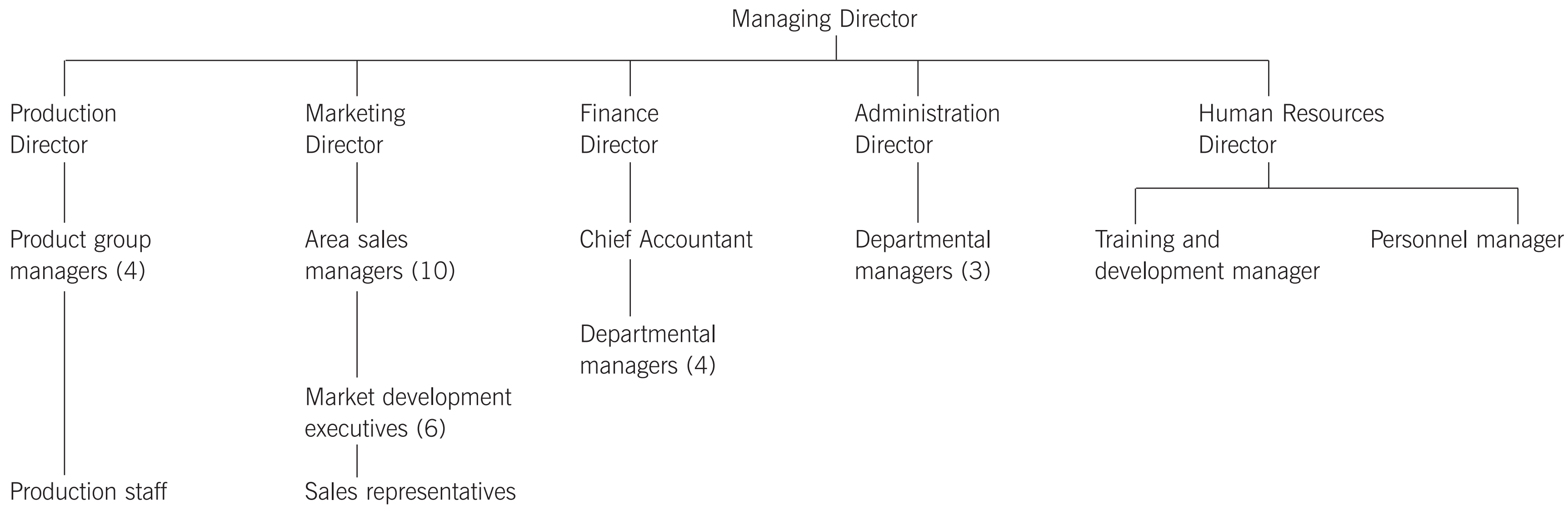
		2006	2005
Current ratio		2·1	2·1
Acid test ratio		1·8	1·9
Asset cover	times	5·3	5·8
Gearing (debt/equity)	%	89	78
Non-current assets per employee	£	155,000	148,700
Turnover per employee	£	230,400	214,300
Working capital per employee	£	22,600	21,750
Gross profit margin	%	29·3	28·9
Net profit margin	%	9·7	10·2
Return on capital employed	%	11·6	11·1
Interest cover	times	5·3	7·4
Inventory turnover	times	5·8	5·9
Receivables collection period	days	45·6	47·3
Suppliers payment period	days	32·4	33·6
Net asset turnover	times	1·9	1·7
Non-current asset turnover	times	2·3	2·9
EBITDA margin	%	15·2	14·5

Breakdown of share ownership in Cleenup Ltd

Name/Role	**% held**
Original founders:	
Jim Matthews (current Chairman)	22
John Matthews	16
Alice Green	14
Other family members	12
Production director	7
Marketing director	7
Finance director	8
Administration director	6
Human resources director	5
Members of management team	3

Appendix 3

Organisation structure of Cleenup Ltd



End of Project