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

Diploma in Financial Management

Module A

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.

ACCA

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

You are a business analyst with EVC, a venture capital company. Your company has been approached by Cala D'eau Nian, a privately owned limited liability company selling bottled Scottish water. The company has asked for funding to allow it to expand into the European market.

It is EVC's policy to take an active role in the management of clients in which an investment has been made. EVC's specific competences are in human resource management and performance management.

You have been asked to prepare an interim report to the lending executive dealing with Cala D'eau Nian to assist in the decision-making process. Your report is described as an interim report as it is required in a short time scale. If it is favourable, EVC will have an opportunity to obtain additional information from Cala D'eau Nian, and to conduct detailed discussions with the directors and shareholders.

The following information has been made available to you to assist you in preparing your interim report:

Company History

The company was founded in the early 1990s by a consortium of Scottish business people. Several years earlier, the consortium had acquired an estate in the Scottish highlands, with a view to creating a high quality conference venue. This had proved to be successful and, in 1990, one of the investors suggested that tests should be carried out on the water from a source on the estate. She had noticed that there was no obvious external source for the water and, therefore, it was likely that there was a well. This proved to be the case, and the tests showed that the water was of very good quality and high in nutrients.

The consortium decided to bottle the water and serve it in the restaurant at conferences, and in the estate shop. The water proved popular and a separate company, Cala D'eau Nian, was formed. Cala D'eau Nian agreed a 199 year lease with the conference company for exclusive use of the well which supplies the water. No new share capital has been issued since the company was established.

The company enjoyed steady growth during its first ten years of operation and, in late 2003, a contract to supply a range of 'own label' products to one of the leading supermarkets for a period of three years was negotiated, together with an opportunity to place branded products in a nationwide chain of healthfood stores. This led to significant increases in both turnover and profit in the year to 30 April 2004. The increase in the volume of activity was funded wholly through borrowings.

Since then, additional growth in the UK market has been difficult to achieve, and there has been consistent downward pressure on prices from the supermarket. When the contract was renewed in 2006, the company sought to obtain price increases in excess of inflation, but this was unsuccessful. The new prices negotiated under the renewed contract included a clause under which the supermarket would be eligible for rebates, provided sales exceeded certain levels. The company also had to accept lower prices. The supermarket contract runs until 2009. The directors expect that it is likely that there will be pressure to reduce prices further and that improved rebates will be sought by the supermarket when the contract is renegotiated.

Accordingly, the directors believe that the key to achieving further growth is to enter new geographical markets, as to date almost all sales have been confined to the UK. Trials have been carried out in several countries in mainland Europe, and these have indicated a high level of acceptance of the products.

Market Information

In Europe, the market for bottled water has shown consistent growth in recent years. It is estimated that by 2010 the market volume will be in excess of 50 billion litres, with a retail value of almost $40 billion. This growth is driven by a greater focus on health issues as consumers seek to reduce or eliminate caffeine and tannins from their fluid intake. A further factor is the increased awareness of the associated benefits of water, particularly if it has an appropriate blend of nutrients and minerals. This greater awareness will be leveraged as the average age of the European population rises, thereby increasing the need to maintain a healthy lifestyle.

The market is divided into four key sectors: still unflavoured, still flavoured, carbonated unflavoured and carbonated flavoured. The carbonated sector is further subdivided between low-carbonated and standard carbonated. The overall growth noted above is not evenly distributed across the sectors, with higher growth expected in the carbonated sectors (particularly low-carbonated) than the still sectors. Indeed, there is emerging evidence that opportunities for growth in the market for still products may be slowing considerably, and may even be non-existent.

A summary of the market share in each segment is shown at Appendix 1.

A relatively new trend is the emergence of 'functional' products. These are aimed at specific niche markets and their appeal is based on several key market propositions , such as 'energy' or 'sport'. These products usually have vitamins or herbal extracts added, and are often lightly flavoured. The target customer base is between 24 and 35 years old.

Germany is regarded as a key European market, representing almost $^{1}/_{3}$ of European sales, although consumption per capita is lower than other countries. For example, consumption per capita in Austria is around five times that of Germany. The scope for growth in the German market is such that it is expected that although the proportion of the European market represented by Germany will fall to just over $^{1}/_{4}$ by 2010, the growth in the German market will be almost 30%, compared to around 20% in Europe as a whole. An analysis of sales volumes in key countries is shown at Appendix 2.

Competition

The European market is highly competitive, with a small number of large companies holding the highest market shares. The largest share (just over $^{1}/_{4}$) is held by Nestlé. A further three companies (Group Danone, Acqua Minerale San Benedetto SpA and Gerolsteiner Brunnen) account for a proportion of the market which is slightly less than that of Nestlé. This leaves just over half of the market to be supplied by all other suppliers. Almost 40% of sales are through supermarkets and hypermarkets.

An interesting feature of the market is that, while growth has been driven by increasing awareness of health and wellbeing, there is evidence that taste and image are important.

Examples of this are:

(i) Importance of advertising – commentators have noted that the brands which consistently achieve the strongest advance in sales are also those which incur the highest levels of advertising expenditure. Television advertising is seen as particularly important in achieving increased sales.

(ii) Even within the price-conscious supermarket sector, some brands command premium prices. For example, one of Nestlé's premium brands retails for almost twice the price of a key competitor.

Although forecasts indicate that the most significant growth in sales will be in the flavoured sectors, such products are often not as healthy as unflavoured, as the additives used to provide the flavour add sugar to the product.

There are indications that the dominant position of the four main companies may lead to some of the smaller companies disappearing. The directors of Cala D'eau Nian have noted this observation, and have expressed the view that the success of their planned expansion will be based on achieving high sales volumes, while maintaining margins. They intend to achieve this by positioning the product range as premium products. This will involve promoting the products as part of a healthy, but refined, lifestyle. A key part of this strategy is to occupy market niches which will become available due to the expected move towards the growing sectors of the market. They point out that with four companies accounting for around 50% of the market, and the projected size of the market, success can be achieved by obtaining a very small proportion of the total market, potentially through capturing customers who wish to move away from what might be perceived as 'mass appeal' products towards niche products with a premium image. Their argument is that it will only be necessary to achieve a small shift in customer preferences to create a high level of sales.

Regulatory environment

While the normal requirements of health and safety and product quality obviously apply to all food products within the EU, there are currently differences in the requirements in specific countries. For example, in Germany, it is a legal requirement that mineral water should be bottled at source, and usage of the term 'natürliches Mineralwasser' (natural mineral water) is subject to legal protection. The directors of Cala D'eau Nian expect that the trend for increasing central control of food labelling will mean that regulations such as these will become a standard requirement of the European market. They believe that this will provide Cala D'eau Nian with a competitive advantage. The company's products are totally natural, and the unflavoured products have no added ingredients. The directors are confident that this will allow them to carry the designation 'natural mineral water' – both in the short term in Germany and in the longer term throughout Europe. It also intended to use the image of the Scottish highlands as a source of natural products which are beneficial to healthy living as a key element in product promotion.

Accounting information
Key ratios from the financial statements for the last five years are provided at Appendix 2.

The company was an early adopter of IFRS, with effect from the year to 30 April 2004. There is a strong culture of internal control, and the auditors have always issued an unqualified audit opinion.

The lease on the well is reported on the balance sheet at cost, although a recent valuation has indicated that the company's success means that its value has increased by approximately £2 million. The valuers have noted that, if the company is successful in increasing sales volumes, current market conditions mean that the value could rise by a further £4 million over the next three years.

Production capacity
The company has consistently invested in the production facilities, with capital expenditure regularly exceeding the depreciation charge. The plant is modern, well maintained and meets or exceeds all relevant health and safety regulations. Current production levels are around 85% of capacity. The directors have stated that they are confident of achieving an increase in sales of around 30% in the first two years of the expansion. They intend to invest in increased production facilities in that period and, based on mid-term sales forecasts, intend to increase production capacity by a factor of 3 over three years.

Employment
The company currently employs 85 people. The majority of the employees are lifelong inhabitants of the area in which the spring is located. This has provided a sense of community and cohesion and has resulted in a highly motivated workforce, who are extremely proud of the company's success, and their part in that success. As the local community is small, the company's success is viewed with great pride locally, and the company is seen as an important ambassador, both for the immediate area, and for Scotland as a whole. The directors are aware that their expansion plans will lead to a considerable expansion of the workforce, and have identified EVC's proven track record in human resource management as a key reason for seeking support from your organisation. They have specifically asked that assistance should be given in manpower planning and implementing incentive schemes to maintain and enhance motivation. They are also aware that as the geographical market expands, another key decision will centre on the extent to which support activities, such as distribution and logistics will be carried out in-house or outsourced.

Required:

Prepare a formal report covering the issues in (a) to (i) below. Your report should include recommendations as appropriate, and should also:

(a) include an Executive Summary (of between 300 and 400 words) which highlights the key findings in your report; (4 marks)

(b) provide an assessment of the performance of Cala D'eau Nian from the perspective of EVC, based on the information provided in the scenario and appendix 2; (12 marks)

(c) explain the significance of each of the measures you have used in your assessment in (b); (10 marks)

(d) identify, and explain the significance of, any additional information that you would request from the management of Cala D'eau Nian; (16 marks)

(e) based on the assumption that EVC decides to invest in Cala D'eau Nian, discuss whether any investment should be by way of equity or a loan; (8 marks)

(f) propose suitable objectives and an appropriate mission statement for Cala D'eau Nian, assuming that further analysis leads to EVC investing in Cala D'eau Nian; (8 marks)

(g) identify the key results that should be monitored to ensure the expansion and investment are successful, based on the objectives and mission statement proposed in (f);

Note: you should both explain the significance of the results you have identified and specify how these will be measured. (20 marks)

(h) discuss how the expanded workforce should be managed so that the current high level of motivation can be maintained; and (10 marks)

(i) explain how the company's plans are likely to be affected by influences which have not been significant to date. (12 marks)

(100 marks)

Appendix 1

Estimated European market segments – 2008

By product range		%
Unflavoured	carbonated	48·5
	still	45·3
Flavoured	carbonated	4·7
	still	1·5
		100·0

By country	%
Germany	32·3
Italy	22·7
France	10·8
UK and Ireland	7·9
Rest of Europe	26·3
	100·0

Appendix 2

Key financial data and ratios extracted from the financial statements of Cala D'eau Nian for the years to 30 April:

		2008	2007	2006	2005	2004
Revenue	£000	9,922·12	9,337·50	9,225·19	7,986·15	6,233·27
GP margin	%	48·64	50·23	55·43	54·47	53·11
Net profit margin	%	6·27	8·71	10·15	7·82	4·47
Current ratio		1·10	1·17	0·96	1·43	1·55
Liquidity ratio		0·95	1·02	0·83	1·30	1·28
Gearing ratio (debt/equity)	%	126·90	54·71	54·75	48·07	51·72
Inventory turnover	days	13·01	13·16	14·30	11·83	18·32
Receivables collection period	days	53·62	61·81	59·61	57·80	63·84
Payables period	days	30·24	32·05	35·95	32·56	20·80
Net assets turnover	times	2·40	1·97	2·36	1·96	1·50
Non-current assets turnover	times	2·54	2·14	2·30	2·46	1·77
EBITDA	%	13·76	16·74	16·23	15·29	13·10
ROCE	%	15·05	17·14	23·97	15·29	6·71
Gross profit	£000	4,826·54	4,690·38	5,113·65	4,350·00	3,310·38
Operating profit	£000	704·42	880·00	962·69	683·46	362·50
Administrative expenses	£000	4,122·12	3,810·38	4,152·88	3,666·54	2,947·88
Profit before tax	£000	621·73	813·65	935·96	624·23	278·46
Profit after tax	£000	404·81	600·19	665·58	426·92	244·23
Non-current assets	£000	3,902·88	4,362·69	4,012·69	3,240·96	3,505·58
Current assets	£000	2,596·35	2,705·58	2,707·88	2,784·62	1,784·42
Current liabilities	£000	2,369·42	2,320·58	2,816·35	1,945·58	1,152·12
Non-current liabilities	£000	2,065·96	1,280·77	728·08	1,048·65	1,178·08
Inventory	£000	353·65	336·54	361·35	258·85	312·88
Interest cover	times	6·31	9·06	15·03	8·15	3·94

End of Project