Section 1 – Financial Strategy

1 (a) Funding requirements

If there is an immediate issue of debenture stock, there should be sufficient funds to pay for the costs of expansion based on those estimates currently available. When calculating the funds required, it is prudent to assume the minimum level of sales mentioned in the case study. The following calculations show the funding gap.

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 onwards
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Sales	264·7	272·1	280·6	290·1	300·7	309·6	316·4	321·0	325·0	327·8	327·8
Gross profit	150·9	156·5	162·7	169·7	177·4	184·2	189·8	194·2	198·3	201·6	201·6
Operating expenses	(131·6)	(133·2)	(134·9)	(136·9)	(139·1)	(140·9)	(142·3)	(143·3)	(144·2)	(144·8)	(144·8)
Operating profit	19·3	23·3	27·8	32·8	38·3	43·3	47·5	50·9	54·1	56·8	56·8
Add Depr'n*	8·3	9·4	9·9	10·4	11·1	11·1	11·1	11·1	11·1	11·1	11·1
Operating cash flows	27·6	32·7	37·7	43·2	49·4	54·4	58·6	62·0	65·2	67·9	67·9
Interest	(7·5)	(7·5)	(7·5)	(7·5)	(7·5)	(7·5)	(7·5)	(7·5)	(7·5)	(7·5)	(7·5)
Dividends*	(5·9)	(7·9)	(10·2)	(12·7)	(15·4)	(17·9)	(20·0)	(21·7)	(23·3)	(24·7)	(24·7)
Additional FCI	(40·4)	(27·5)	(12·3)	(12·9)	(18·0)						
Additional WCI	(1·0)	(0·7)	(0·9)	(1·0)	(1·1)	(0·9)	(0·7)	(0·5)	(0·4)	(0·3)	
Funding surplus/(gap)	(27·2)	(10·9)	6·8	9·1	7·4	28·1	30·4	32·3	34·0	35·4	35·7

* The dividend payment is slighter higher than the dividend that is likely to be paid. This is because the dividend payout ratio (50%) applied does not take account of the additional interest payments on new loan finance that must be paid and which will reduce profits available for dividend. The higher dividend payment will have the effect of producing a more conservative funding requirement.

The depreciation charges are calculated as follows:

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 onwards
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Depr'n existing fixed assets	6·7	6·7	6·7	6·7	6·7	6·7	6·7	6·7	6·7	6·7	6·7
Acquisition											
2004	1·6	1·6	1·6	1·6	1·6	1·6	1·6	1·6	1·6	1·6	1·6
2005		1·1	1·1	1·1	1·1	1·1	1·1	1·1	1·1	1·1	1·1
2006			0·5	0·5	0·5	0·5	0·5	0·5	0·5	0·5	0·5
2007				0·5	0·5	0·5	0·5	0·5	0·5	0·5	0·5
2008					0·7	0·7	0·7	0·7	0·7	0·7	0.7
Total	8·3	9·4	9·9	10·4	11·1	11·1	11·1	11·1	11·1	11·1	11·1

The funding deficit in the first two years is (£27·2m + £10·9m) = £38·1m. Cash flows are positive from 2006 onwards but before this year, the company will have to borrow sufficient funds to cover the expansion costs and to pay the interest payments that fall due. Interest on the debenture stock is payable at the rate of 7% per annum.

Thus, it will be necessary to borrow approximately £44·3m as this will result in:

	£m
Annual interest charges in the first two years (£44·3m x 7%) x 2	6·2
Funding gap in first two years	38·1
Total funding required	44·3

This calculation assumes that any funds that are temporarily surplus to requirements cannot be invested and thereby generate returns. If surplus funds can be invested, any returns generated will reduce the borrowing requirement.

The cash flows generated from 2006 to the maturity of the debenture stock in 2010 will be sufficient to pay the interest and to repay the principal sum:

	£m
Surplus cash flows from 2006–2010 will be: (6·8 + 9·1 + 7·4 + 28·1 + 30·4)	81·8
Annual interest charges in the last five years of debenture (£44·3m x 7%) x 5	(15·5)
	66·3
Debenture repayment	44·3
Remaining surplus	22·0

(b) If a debenture issue is made immediately, and sales are the minimum expected, the forecast profits for the first five years of the expansion programme and the interest cover ratio for each of these years will be as follows:

	Profit and loss accounts for the years ended 31 May				
	2004	2005	2006	2007	2008
Operating profit (see above)	19·3	23·3	27·8	32·8	38·3
Interest payable	(10·6)	(10·6)	(10·6)	(10·6)	(10·6)
Interest cover ratio	1·8	2·2	2·6	3·1	3·6

It can be seen that the restrictive covenant concerning the interest cover ratio cannot be complied with until 2008.

Further issues that may have been discussed include:
– the relatively high balance sheet gearing of the company, following the issue of the debentures.
– the lack of clarity concerning available security (at least in the early years before sufficient new premises are acquired)

(c) An alternative approach would be to delay the borrowing until the funds are needed rather than to borrow the funds immediately. The advantage of this approach is that it may not be necessary to borrow as much. At the beginning of the expansion programme it is prudent to plan on the basis of the minimum level of sales being achieved. This will identify the maximum level of funding required. However, this may prove to be too pessimistic and, as time progresses, higher sales (and profits) may be achieved. Thus, by delaying, the amount borrowed may be adjusted according to circumstances. This approach should also overcome any difficulties concerning security for the amount borrowed, as the premises acquired should offer sufficient security.

Although John Kerria has expressed a preference for a debenture issue, this may not be possible if the funding is relatively small and required on a piecemeal basis over time. However, it may be possible to obtain bank credit for an agreed maximum amount and to draw down amounts as and when required. A series of term loans may also be considered. However, this latter approach carries the risk that at some future point a term loan will be denied and so the expansion programme will be undermined, (although there is no evidence to suggest this is likely).

Leasing may also be considered in answering this part of the case study.

(d) The profitability of the expansion plan can be calculated as follows:

Year ended 31 May	Additional gross profit based on minimum sales	Additional operating expenses (exc. depr'n)	Additional fixed asset investment	Additional working capital	Net cash flows	Discount rate	Present value
	£m	£m	£m	£m	£m	10%	£m
2004	7·3	(1·2)	(40·4)	(1·1)	(35·4)	0·909	(32·2)
2005	12·9	(1·7)	(27·5)	(0·7)	(17·0)	0·826	(14·0)
2006	19·1	(2·9)	(12·3)	(0·9)	3·0	0·751	2·3
2007	26·1	(4·4)	(12·9)	(1·0)	7·8	0·683	5·3
2008	33·8	(5·9)	(18·0)	(1·1)	8·8	0·621	5·5
2009	40·6	(7·7)		(0·9)	32·0	0·564	18·0
2010	46·2	(9·1)		(0·7)	36·4	0·513	18·7
2011	50·6	(10·1)		(0·5)	40·0	0·467	18·7
2012	54·7	(11·0)		(0·4)	43·3	0·424	18·4
2013	58·0	(11·6)		(0·3)	46·1	0·386	17·8
2014–18	58·0	(11·6)			46·4	1·461	67·8
Net present value of expansion programme							126·3

The expansion programme seems to be very profitable, based on the information provided. Similar calculations can be carried out to calculate the NPV based on the maximum expected sales.

(e) The validity of the assumptions and forecast can be checked by examining:

- Forecasts for the economy as a whole
- Industry forecasts
- Past trends within the business

In relation to the last item, the following trends over the past five years should be examined:

Gross profit This shows a declining gross profit margin despite an increase in the proportion of high price carpets sold. This contrasts with the assumption made concerning the profitability of the future strategy. This is a key issue that casts some doubt on the strategic direction of the business and requires further investigation.

Operating expenses This shows a much higher percentage of operating expenses to sales ratio than is being forecast for the expansion plan.

Working capital needs This is currently lower than the forecast figure of 10% of additional sales.

Sales The minimum predicted increase in sales over the next ten years is less than the increase in sales achieved over the past five years. The maximum predicted increase in sales is also less than the increase in sales achieved over the past five years.

The main concern seems to be the assumptions regarding gross profit and operating expenses, which may require further examination.

Section 2 – Risk Management

2 The case study can be approached in a number of different ways and so the outline solution below should only be regarded as indicative.

(a) Possible elements and sub-elements for an appraisal framework that might be considered are set out below.

Board structure and roles
- Are the roles and responsibilities of the board clearly defined?
- Does the board carry out these roles and responsibilities effectively?
- Is the structure of the board and its relationship to the various board committees clear and logical?
- Are the roles and composition of the nomination, remuneration and audit committees of the board appropriate and clearly defined?

Mission and strategy
- Has the board developed a clear mission and strategy for the business?
- Do all board members have a clear understanding of the mission and strategic objectives of the business?
- Do board decisions reflect the mission and strategic objectives developed?
- Does the board regularly assess progress towards the achievement of the mission and objectives of the business?

Board development
- Is there is a policy for providing appropriate training and development opportunities for board members?
- Do new board members undergo an induction process?
- Is there is a succession policy for key members of the board?

Meetings
- Does the board meet on a regular and frequent basis?
- Do board meetings have a written agenda and is relevant material relating to decisions to be taken at a meeting distributed to board members in good time?
- Is there an attendance policy and what is the attendance record for board members?
- Do board meetings focus on all important matters relating to the progress of the business?
- Is there a system for dealing with urgent matters arising between board meetings and how are these reported to the board?

Board composition
- Does the board possess the appropriate balance of skills and experience?
- Is there a separation between the roles of chairman and chief executive?
- Is there an appropriate balance between executive and non-executive directors?
- Is the age profile of the directors balanced?
- Does the tenure of the board members reflect both continuity and change?

Board discussions and decisions
- Does each board member feel that there has been sufficient time to discuss matters as well as the opportunity to contribute towards board discussions?
- Do all board members contribute towards problem solving and strategic development?
- Does the board work together as an effective team?
- Do the independent, non-executive directors fulfil their roles at board meetings?
- Do board discussions lead to clear outcomes and decisions?

Board communication

- Are key decisions and strategies communicated effectively to employees, customers, shareholders and other interested parties?
- Does the board communicate to shareholders all relevant matters relating to compliance with the Combined Code?
- Does the board maintain a constructive dialogue with institutional investors?
- Does the board maintain communication with private shareholders through the AGM and other means?

A brief rationale for each element that is identified is required.

The evidential base for the various elements identified may include:

- Board documents setting out mission, strategies, plans and policies
- Documents setting out the board organisation and structure
- Board operations manual
- Minutes of board meetings
- Annual reports and accounts to shareholders
- Directors' CV's.
- Interviews with directors
- Questionnaires to directors, institutional shareholders, employees and private shareholders
- Observation of board meetings by external consultants
- Performance reports (e.g. budget reports and sales reports) sent to the board
- Records of the AGM and meetings with institutional shareholders

(b) Information from the annual report and accounts, that may be used to answer this part include the following.

Board structure and roles

A statement of directors' responsibilities in the annual report sets out:

- It is the duty of the directors to prepare financial statements and to safeguard the assets of the business.

The auditors report reveals that:

- the directors have carried out their duties concerning the preparation of the financial statements

The responsibility of the directors in safeguarding the assets of the company may be an issue. The financial review reveals the parlous state of the company as at 31 March 2002 by stating that:

- although the accounts of the company have been prepared on a going concern basis, this will be invalidated if negotiations with creditors concerning financial restructuring fail.

The directors' statement on internal control states that:

- the forecasting process failed to predict changes in the environment
- the ability of the company to forecast accurately is a continuing risk

The corporate governance section of the annual report and accounts reveals that:

- the audit, remuneration and nomination committees are made up entirely of non-executive directors

Mission and strategy

The annual report indicates that the strategy of the business appears to have been blown off course and the financial performance of the business was very poor. This is supported by the following key points from the Chairman's statement:

- A 34% decline in sales
- A significant operating loss before exceptional items and amortisation for the year (£463 million)
- Acquisitions totalling £5,492 million during the past four years have performed well below expectations
- Exceptional write offs and provisions of £5,216 million for the year (a large proportion of this amount relating to a goodwill write off of acquisitions)
- The need for financial restructuring that is likely to lead to a dilution of value for existing shareholders
- The development of a revised business plan

Further evidence from the chief executive's review include the following:

- The stated need to reduce the huge burden of debt (£4·3 billion as at 31 August 2001)
- The stated need to reduce the operating costs by £400 million per year
- The company' s attempt to regain a sense of direction by commissioning an independent firm of consultants to undertake an extensive strategic review of the business.

Board composition

Various issues relating to the balance, and continuity of the board could be mentioned.

Key points from the Chairman's statement are:

- the company is searching for new board members to achieve a more appropriate balance of skills and experience
- 3 directors resigned during the year.
- an interim chairman has been appointed

Key points from the directors' report are that:

- 2 new directors were appointed to the board during the year
- the chief executive officer and chief operating officer were appointed mid-way through the year

The Directors section of the annual reports reveals:

- a very small team comprising five non-executive directors (including the interim chairman) and only three executive directors.
- a balance of ages ranging from 41 to 64 years of age.

The corporate governance section states that:

- all non-executive directors are considered to be independent
- there is a clear division of responsibility between the chairman and the chief executive

Board meetings

The corporate governance section states that:

- directors receive sufficient relevant information on financial, business and corporate matters to enable them to participate effectively in board decisions.
- the board meets eight times per year but holds additional meeting when circumstances require
- between meetings there is frequent contact to progress the affairs of the company

Board development

The corporate governance section states:

- directors receive appropriate training on appointment and then as necessary
- the directors undergo an induction programme

Board communication

The corporate governance section states that:

- communication with shareholders is a high priority
- the announcement of interim and final results offers the opportunity for institutional shareholders to ask questions.
- there is regular dialogue with institutional shareholders
- quarterly trading updates are provided to all shareholders
- there is a company website that provides information about the company for shareholders and other interested parties
- the AGM offers the opportunity for shareholders to meet formally and informally with the directors
- the company complied with the provisions of Section 1 of the Combined Code throughout the year.

The directors' report states that:

- individual employees and their representatives are kept informed of current business issues through various means including intranet website, briefing groups and newspapers.

Diploma in Financial Management – Module B
Project DB2 incorporating Subject Areas:
Financial Strategy
Risk Management

Marking Scheme Project
Issue date August 2003

			Marks
1	**(a)**	12 marks, annual funding surplus/gap, 1 mark interest adjustment, 2 marks repayment calculation	15
	(b)	2 marks covenant calculations, 1 mark discussion, 2 marks gearing, 2 marks security	7
	(c)	1 mark alternative, 4 marks discussion	5
	(d)	2 marks gross profit, 2 marks op. expenses, 2 marks FAI, 2 marks WCI, 2 marks NCF, 1 marks discounting, 4 marks for calculations using alternative sales figure (Min/max.)	15
	(e)	4 marks identification of validity tests, 4 marks calculations	8
			50

2	**(a)**	Flexibility will be required by markers but, as a guide, the following breakdown is suggested:	
		Rationale for each element	7
		Evidential base for each element	14
		Identification of significant elements (not already identified in case study)	4
		Identification of key sub-elements	25
			50
	(b)	Appraisal of board performance for each element (max. 4 marks per element)	32
		Use of relevant information in annual report to support evaluation (max. 2 marks per element)	16
		Markers discretion	2
			50