Diploma in Financial Management

Module B

PROJECT DB2, INCORPORATING SUBJECT AREAS
– FINANCIAL STRATEGY
– RISK 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 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 – Financial Strategy
This ONE question is compulsory and MUST be attempted

1 Kerria Carpets plc

John Kerria had been the Sales Director of the largest carpet retailer in the UK for more than ten years. Following the appointment of a new Chief Executive, however, he became disillusioned with the direction in which the company was being taken and so decided to start his own business. With the help of a consortium of venture capitalists he founded Kerria Carpets plc, which began trading in 1994. The company sells carpets, rugs, vinyls and wood-like laminate flooring to the public and now has outlets throughout the south of England, Wales and Northern Ireland. The company was floated on the London Stock Exchange in 1997 and, at that point, the venture capitalists realised their investment in the company. However, John Kerria retained a twenty-five per cent shareholding and is the largest shareholder in the company. He is also the chairman and the chief executive of the company.

Kerria Carpets plc operates through two trading formats:

– Carpet Park is a chain of out-of-town superstores that sells own-brand carpets to the lower and middle sectors of the market.
– Carpetier is a chain of high street stores that sells high quality, branded carpets to the upper sector of the market.

Both formats have traded profitably since the company was formed.

John Kerria started the company in 1994 when the market for floor coverings was far from buoyant. Sales volumes and prices for the industry had been static for some years and there was considerable overcapacity within the carpet manufacturing industry. Nevertheless, he believed that it was possible to grow a successful carpet retail business by aggressively acquiring a large market share. A very large proportion of total carpet sales within the UK are made through more than four thousand small, independent retailers and John Kerria believed that it was possible to obtain competitive advantage through the use of scale. From the outset, Kerria Carpets plc was a relatively large player in the market and was able to buy large quantities of carpets from beleaguered carpet manufacturers at competitive prices. These price benefits were then passed on to the customer.

John Kerria recognised that those customers seeking high-quality, branded carpets did not usually shop in out-of-town superstores and so the Carpetier chain of high street shops was created to cater for this end of the market. These shops provide a more personal service to customers within a showroom format. This had proved to be a successful strategy and sales for the highest-priced carpets have accounted for an increasing share of total sales of the company by volume (see below).

	Percentage of sales by volume for the year to 31 May				
	1999	**2000**	**2001**	**2002**	**2003**
Price per square metre (£)					
1–15	55	53	48	46	42
16–30	31	30	28	27	26
>30	14	17	24	27	32

Since its flotation, the company has been well regarded by investment analysts and investors and has a reputation for delivering solid earnings and sales figures. The profit and loss accounts for the company for the past five years are as follows:

	Profit and loss accounts for the years ended 31 May				
	1999	2000	2001	2002	2003
	£m	£m	£m	£m	£m
Turnover	190·5	205·8	212·9	226·8	254·2
Cost of sales	(79·1)	(86·5)	(90·6)	(97·6)	(110·6)
Gross profit	111·4	119·3	122·3	129·2	143·6
Distribution	(11·3)	(11·7)	(11·9)	(12·1)	(12·4)
Administration	(89·6)	(96·4)	(98·5)	(103·5)	(116·4)
Operating profit	10·5	11·2	11·9	13·6	14·8
Interest payable	(8·5)	(7·8)	(7·5)	(7·5)	(7·5)
Profit for the year	2·0	3·4	4·4	6·1	7·3
Dividends	(1·0)	(1·7)	(2·2)	(3·1)	(3·7)
Retained profit for the year	1·0	1·7	2·2	3·0	3·6

It can be seen that dividends have been paid for each of the past five years, although for the first few years all profits had been retained to strengthen the capital base of the company.

The balance sheet of the company as at 31 May 2003 is as follows:

	£m	£m	£m
Tangible fixed assets			
Cost			168·6
Less Accumulated depreciation			(40·0)
			128·6
Current assets			
Stock	43·2		
Debtors	7·8		
Cash	1·2	52·2	
Less: **Amounts due for repayment within one year**			
Trade creditors	(25·6)		
Other creditors	(10·8)	(36·4)	15·8
			144·4
Less **Amounts due for repayment after one year**			
Loan capital			(90·0)
			54·4
Capital and reserves			
Called-up share capital			30·0
Profit and loss account			24·4
			54·4

Since Kerria Carpets plc was first launched, sales for the carpet industry as a whole have remained static and there is little prospect of an upturn in demand in the foreseeable future. Nevertheless, John Kerria believes that company sales can continue to increase by seizing greater market share and that profit margins can also increase through greater concentration on the upper end of the market. To this end, John Kerria has developed an ambitious plan to double the number of high street shops over the next five years.

The plan will involve an expansion of high street stores in the north of England. To support these stores, a new warehouse with 8,000 square metres of storage space will be built in Yorkshire and will incorporate the latest machinery and cutting equipment. The cost of freehold premises and equipment arising from this expansion is estimated to be as follows:

Year to 31 May	2004	2005	2006	2007	2008
	£40·4m	£27·5m	£12·3m	£12·9m	£18·0m

Depreciation will be charged at an average figure of 4% per annum on the cost of the new fixed assets acquired. This is in line with the average depreciation charge for tangible fixed assets already held.

The increase in sales and operating expenses (including depreciation) following implementation of the plan is estimated to be as follows:

	Estimated increase over previous year		
	Sales		Operating expenses
Year to 31 May	Minimum	Maximum	
	£m	£m	£m
2004	10·5	14·0	2·8
2005	7·4	12·1	1·6
2006	8·5	10·2	1·7
2007	9·5	12·4	2·0
2008	10·6	13·0	2·2
2009	8·9	10·6	1·8
2010	6·8	7·8	1·4
2011	4·6	5·8	1·0
2012	4·0	5·2	0·9
2013	2·8	3·5	0·6

For five years after 2013, it is anticipated that the total sales and operating expenses will remain at the 2013 figures. After this period, additional operating expenses are expected to rise to the point where the net benefits of the expansion programme will decline to zero. The increases in working capital necessary to sustain the expansion programme are expected to be 10% of sales growth. The gross profit margin is expected to increase by around 0·5% per year in each year over the first 10 years as a result of the increase in sales of higher priced carpets.

John Kerria does not wish to use equity finance to finance the expansion programme. He will not agree to an issue of new shares or any decrease in the dividend payout ratio by the company. He wishes to raise the necessary funds through borrowing and suggests that the company should issue debenture stock immediately at an interest rate of 7%. He has already had preliminary discussions with the company's financial advisors who believe that it may be possible to raise sufficient funds in this way in order to finance the expansion plan. However, the debenture deed is likely to impose certain restrictive covenants on the company and these include a requirement to maintain an interest cover ratio of 3·5 times. The debenture issue will also require adequate security and would have to be repaid on 31 May 2010.

The weighted average cost of capital of the company is 10%.

Required:

(a) Based on the information provided, produce an estimate of how much the company will have to raise in order to finance the expansion plan, assuming there was an immediate issue of debenture stock. (15 marks)

(b) Identify and discuss any issues that may arise as a result of funding the expansion plan by an issue of debenture stock. (7 marks)

(c) Suggest an approach to borrowing in order to finance the expansion plan that may be used instead of the one suggested by John Kerria and discuss the advantages and disadvantages of this approach. (5 marks)

(d) Evaluate the financial implications of the expansion strategy using the net present value method. (15 marks)

(e) Explain how the validity of the assumptions and forecasts provided in the case study may be tested. Where the information allows, provide suitable workings to support any points that you wish to make concerning the assumptions and forecasts made. (8 marks)

Notes:
1. In answering the case study all key workings and assumptions that you make must be clearly stated.
2. Workings should be in £ millions and should be made to one decimal place.
3. Ignore taxation.

(50 marks)

Section 2 – Risk Management
This ONE question is compulsory and MUST be attempted

2 Assessing the board of directors

Acacia Consultants Ltd offers a wide range of management consultancy services to large public companies in the UK. Recently, the company has found that an increasing number of clients has shown an interest in assessing the performance of its board of directors. The consulting company has found that, although each client has a system of annual appraisal in place for those managers below board level, these appraisal systems do not extend to the board of directors.

The Chief Operating Officer of Acacia Consultants Ltd believes that there is likely to be increasing pressure from institutional investors, investment analysts and others interested in corporate governance matters for some kind of system for appraising the performance of the board of directors on an annual basis. He sees this as an important market opportunity for consultancy companies and has therefore decided that the company should try to develop a general framework that can be used for appraising a board of directors. Once developed, the framework will be offered to clients as a means of improving the performance of the board of directors.

The Chief Operating Officer has no clear idea what the framework should contain. However, at a recent brainstorming meeting with key consultancy staff, it was suggested that an appraisal framework for the board of directors as a whole could cover the following elements:

– Board structure and roles
– Board composition
– Mission and strategy
– Board meetings

However, the outcome of this meeting was seen only as a first tentative step and that further development of the framework may result in adding to or subtracting from this list.

At the meeting, it was decided that each element for inclusion in the appraisal framework must have the following features clearly identified:

– a brief rationale
– the main sub-elements
– the evidential base for making an assessment

To ensure that the framework had a clear focus that would appeal to clients, it was felt that the framework should not be too elaborate. It was therefore agreed that it should cover 6–8 elements and that each element chosen should have 3–5 sub-elements only.

Required:

Assume that you are a leading consultant for Acacia Consultants Ltd, specialising in corporate governance matters.

(a) Prepare a report to the Chief Operating Officer that provides a framework for the annual appraisal of the board of directors of a listed public company. (25 marks)

(b) Use the framework that you have developed in order to appraise the performance of the board of directors of Marconi plc for the year ended 31 March 2002, insofar as the information provided in the annual report and accounts for the year allows (see Module B Supplement Booklet for the annual report and accounts). (25 marks)

Notes:

1. In answering part (a) of the question, you should take account of best practice as set out in various corporate governance reports. You should also take account of your own views concerning best practice.
2. In answering part (b) of the question, you should not use material that is sourced from outside the published financial report mentioned above.

(50 marks)

End of Project