

Paper DB2 – Incorporating subject areas:

- Financial Strategy
- Risk 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 B

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

**Section 1 – Incorporating subject areas: Financial Strategy and Risk Management.**  
**This ONE question is compulsory and MUST be attempted**

**1 Kolyo Ficheto EAD**

Kolyo Ficheto EAD is a property development company based in Bulgaria. Its core activity is building holiday apartments and hotels and, to date, the company has built in various Bulgarian Black Sea resorts. However, it is now keen to extend its reach to Bulgarian ski resorts.

A summarised statement of financial position of the company as at 31 December 2007 is shown below.

**Statement of financial position as at 31 December 2007**

	<b>Bulgarian leva (BGN millions)</b>
Non-current assets	256
Current assets	96
<b>Total assets</b>	<u>352</u>
<b>Equity</b>	
Ordinary shares	65
Retained earnings	180
	<u>245</u>
Current liabilities	107
<b>Total equity and liabilities</b>	<u>352</u>

**Borovets**

The directors of Kolyo Ficheto EAD believe that Borovets, a ski resort which nestles among pine forests in the Rila mountains, may provide a good starting point for their ambitions. The resort is located 1,350m above sea level where snow cover is a minimum of 120 days a year and where the ski season stretches from late December until the end of March. The resort has 24 runs totalling more than 40 km in length with the highest point at 2,550m above sea level. Although Borovets has twice hosted World Cup competitions, its facilities and infrastructure are less well developed than in other Bulgarian ski resorts. Recent investment in the main Bulgarian ski resorts of Bansko and Pomporovo has left Borovets a poor neighbour. However, things are set to change.

Since Bulgaria joined the EU, low-budget airlines have been flying to the nearby airports of Sofia and Plovdiv and have brought skiers to Borovets in much greater numbers. This has greatly increased demand for good quality accommodation and made the resort an attractive prospect for property developers. Moreover, the Bulgarian government plans to invest heavily in the infrastructure of Borovets in the near future in order to boost the prospects of Bulgaria hosting the 2014 Winter Olympics.

Borovets is located within a designated conservation area, which means that opportunities to build within the resort are severely limited. Thus plans for the development of new apartments and hotels are largely centred on the nearby town of Samokov, where new ski lifts will be installed to carry skiers to and from the mountains. There are, however, a few plots of building land available within Borovets and the Bulgarian government, which owns the land, intends to hold an auction for these plots in the near future.

**Snezhinka Apartments**

The directors of Kolyo Ficheto EAD have decided to bid at the auction for one of the plots located in Borovets. The most attractive plot for the company is in a prime site situated very close to the main gondola lift station. Swiss architects were recently commissioned by the company to design an apartment complex to be built on the land in the event of a successful bid. The plan, produced at a cost of 900,000 BGN, envisages 148 apartments arranged into four identical blocks with each block situated on a corner of the rectangular plot of land. In the centre of the plot will be communal facilities including a gymnasium, spa, swimming pool, restaurant and bar. The Snezhinka Apartments (Snowflake Apartments), as they will be called, will consist of the following:

Apartment type	Number to be built	Apartment average size (sq.m)
Studio	60	45
One-bedroom	64	65
Two-bedroom	24	75

Each block will consist of 37 apartments and will have a large reception area on the ground floor. The mix of apartments within each block will be as follows:

Floor	Apartment type			Total
	Studio	One-bedroom	Two-bedroom	
Ground	5	4	–	9
First	5	4	1	10
Second	5	4	1	10
Third	–	4	4	8

The directors of Kolyo Ficheto EAD believe that Western European and Russian investors are the most likely buyers for the apartments and market research suggests that the following selling prices could be achieved.

Floor on which apartment located	Selling price per sq.m (BGN)
Ground	2,700
First	2,900
Second	3,100
Third	3,400

Whilst these prices compare favourably with prices offered in other major ski resorts in Bulgaria, the directors of Kolyo Ficheto EAD believe that overseas buyers may need some incentive to invest in the Snezhinka Apartments. This is because the apartments, which are aimed at buyers wishing to generate a rental income, may prove difficult to rent in the short-term. Various problems conspire to make the short-term rental prospects uncertain, including the following:

1. Although the resort is becoming increasingly well known, it is still much less well known than other Bulgarian ski resorts.
2. The facilities and infrastructure are below international standards and will remain so for the next year or two.
3. Most tour operators enter into rental agreements with owners well in advance of a new ski season. The proposed completion date of the apartment complex, however, makes it likely that in the first season following completion, there will be some difficulty in arranging rental agreements and so occupancy rates will be below normal levels.

To 'sweeten the deal', the company therefore intends to offer a guaranteed rental income of 10%, during the first year of ownership, based on the value of each property purchased. This 10% guaranteed income will be paid to clients without any deduction of costs incurred.

The auction for the plots of land in Borovets takes place on 1 February 2008 and, if the company is successful, the bid price must be paid to the Bulgarian government immediately. However, construction work in Borovets is only permitted outside the ski season and the earliest point at which work can commence on the apartment complex is 1 April 2008. Furthermore, all building work must finish on 30 November each year, in time for the beginning of the new ski seasons. With these points in mind, the operations director has estimated that construction of the apartment complex will comply with the following schedule:

Stage	Work done	Completion date	Estimated cost (BGN 000)
1.	Clearing site and laying foundations	1 July 2008	1,840
2.	Exterior working including building walls	30 November 2008	10,260
3.	Buildings roofs	1 August 2009	3,140
4.	Putting in windows and completing interiors	30 November 2009	6,550

There is, however, a risk that there will be delays in acquiring the necessary planning permission and building licenses. If this occurs, work is unlikely to begin until 1 July 2008. This will mean that the above schedule will be revised as follows:

Stage	Work done	Completion date	Estimated cost (BGN 000)
1.	Clearing site and laying foundations	1 October 2008	1,840
2.	Exterior working including building walls	1 July 2009	10,260
3.	Buildings roofs	1 November 2009	3,140
4.	Putting in windows and completing interiors	1 July 2010	6,980

The cost of all work done is expected to accrue evenly over the period during which the work is carried out. Under the revised schedule of work, the expected increase in costs at Stage 4 arises because the company will lose the opportunity to purchase bathroom and kitchen fittings from a cheap source. The operations director believes that there is a 70% chance that the construction work will begin on 1 April 2008 and completed in accordance with the original schedule. There is a 30% chance, however, that construction will be delayed until 1 July 2008 and then completed in accordance with the revised schedule.

The apartments will be sold 'off plan', that is, from the date that the plans are finalised, by appointed agents in the UK, Ireland and Russia. Agents' fees have been agreed at 3% of the sale price of the apartments and will be paid as soon as the full selling price of an apartment has been received. The terms of sale are that each buyer will pay:

1. An initial instalment of 20% of the value of the apartment in order to reserve it.
2. A further instalment of 30% of the value of the apartment when the roofs of all the apartment blocks have been completed.
3. A final instalment of 50% of the value of the apartment when all construction work is completed.

It is expected that all apartments will be sold 'off plan' within six months of the commencement of the building work.

#### Rental division

The directors of Kolyo Ficheto EAD have decided to set up a separate division to rent the apartments during the first year following their completion. It will be a condition of the guaranteed 10% return that apartment owners agree to to this division renting the apartment on their behalf and all owners are expected to agree to this. Alexander Petrov, who will head this division, has considerable experience in this kind of work. This was gained when employed by another company during the building boom in the Bulgarian ski resort of Bansko.

Although Borovets is primarily a ski resort, it attracts holiday makers throughout the year. In particular, hikers are attracted to the resort during the summer months. Petrov believes that skilful marketing of the apartments could help to generate further income from outside the ski season. Assuming that the company can complete the apartment complex in line with the original estimate, he has estimated the following rental rates for each type of apartment for the year from 1 December 2009 to 30 November 2010.

	Daily rental rate (BGN)											
	2009 Dec	2010 Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov
Studio	100	120	120	100	80	70	70	80	90	80	70	70
1-bed	120	140	140	120	100	80	80	90	100	100	80	80
2-bed	150	180	180	150	120	100	100	110	130	130	100	100

Petrov has also estimated occupancy rates for each type of apartment for the year from 1 December 2009 to 30 November 2010:

	Occupancy (Number of days)											
	2009 Dec	2010 Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov
Studio	10	21	22	20	12	0	10	14	20	10	0	0
1-bed	10	20	25	20	14	5	10	15	22	14	5	0
2-bed	8	20	25	18	10	0	8	10	15	10	0	0

The following additional information and forecasts are available concerning the rental of the apartments:

1. Rents are due to be received in full in the month before the month of occupancy.
2. 75% of the rent received will be paid over to the apartment owners in the month following the month of occupancy as a contribution towards their guaranteed rental income. The remainder will be retained to help pay for operating expenses of the rental division.
3. The balance due to the owners under the guaranteed rental income agreement will be paid in the final month of the division's operations.
4. Cleaning of the apartments will be contracted to an outside contractor. The charges, which are based on each day of occupancy, are expected to be as follows:
  - Studio apartments – 20 BGN per day
  - 1-bedroom apartments – 25 BGN per day
  - 2-bedroom apartments – 30 BGN per dayThe cleaning contractor will be paid in the month following the cleaning of the apartments.
5. The rental division will commence operations on 1 September 2009 and will start to incur operating expenses at that point. The division will cease operations on 31 December 2010.
6. Staff salaries of the rental division will be 8,000 BGN per month payable at the end of each month.
7. Office equipment will be leased at a lease rental of 2,000 BGN per month and payable in the month incurred.
8. The rental division will rent an office in a shopping arcade in the centre of Borovets. The rent will be 12,000 BGN per quarter, or part of a quarter, and it is payable in advance.
9. All heating and lighting costs of the apartments will be borne by the apartment owners and will not be taken into account when calculating the guaranteed rental income.
10. Kolyo Ficheto EAD has an obligation to make good any damage done to the apartments and to maintain the apartments in good order during the rental period. The cost of maintenance and repairs for all the apartments is expected to be 10,000 BGN per month during the four peak months from December 2009 through to March 2010 and 5,000 BGN per month thereafter. These costs will be paid in the month incurred.
11. The company will not provide any direct financing to the rental division. Instead, it has arranged an overdraft facility with an international bank to meet the division's financing requirements.

In the event that the building work is delayed and completion occurs in line with the revised estimate, Petrov believes that the above assumptions and forecasts would still apply, except that everything would be exactly one year later than stated above. Thus, the apartments would be rented for the first time during the ski season commencing 1 December 2010.

### **Corporate governance**

Kolyo Ficheto EAD has grown rapidly in recent years as a result of the building boom in Bulgaria. The board of directors is keen to maintain this rate of growth, partly through involvement in projects outside Bulgaria. The board believes that the company should obtain a listing on a recognised stock exchange to gain access to the funds that it will need to sustain this growth. It is considering an application for a listing on the London Stock Exchange and is putting in place appropriate corporate governance procedures prior to making a formal application for listing. There are, however, two areas that concern the board of directors of the company.

The first is the relationship between the company and institutional shareholders. At present, the company has no institutional shareholders but, following the listing, this is likely to change. The board is aware of the potential power of institutional shareholders and of the anecdotal evidence which suggests that they are increasingly prepared to exert this power in order to protect their investments. The board is, therefore, anxious to cultivate a good working relationship with its prospective institutional shareholders, although it is not clear what this will entail or how it should proceed. The board is also not clear as to how institutional shareholders may seek to influence the board where they disagree with the decisions or policies that it seeks to implement.

The second concern is the threat of a takeover. Although there is no immediate threat to the company, once listed on the London Stock Exchange, the directors recognise that it could be an attractive target. The company has a valuable land bank, consisting of prime sites near the Black Sea resorts of Bourgas and Nessebar, which would be of interest to several property development companies. In addition, the company has a very good reputation for its building quality and has good working relationships with key government officials, land agents and architects in Bulgaria. The directors of Kolyo Ficheto wish to ensure that the company's procedures and practices enable it to identify any potential takeover bids at an early stage so as to allow the opportunity to take preventive action if necessary.

### Atlantis Builders plc

Recently, the board of directors of Kolyo Ficheto EAD identified another property development company that is currently listed on the London Stock Exchange and which has specialised in building holiday apartments in Black Sea resorts, particularly in Bulgaria. Atlantis Builders plc, a UK company, has been listed for several years and the summarised financial statements of the company for the year ended 31 December 2007 are shown below.

#### Income statement for the year ended 31 December 2007

	<b>£m</b>
Revenue	95
Cost of sales	(44)
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Gross profit	51
General and administration expenses	(16)
Selling expenses	(5)
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Operating profit	30
Interest charges	(2)
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Profit before taxation	28
Tax (25%)	(7)
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Profit for the year	21
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#### Statement of financial position as at 31 December 2007

	<b>£m</b>
Non-current assets	62
Current assets	59
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<b>Total assets</b>	<b>121</b>
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<b>Equity</b>	
£1 Ordinary shares	20
Retained earnings	34
	<hr/>
	54
Non-current liabilities	
5% Loan notes	40
Current liabilities	27
	<hr/>
<b>Total equity and liabilities</b>	<b>121</b>
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The ordinary shares of Atlantis Builders plc have a current market value of £8.20 per share and the equity beta is 1.45. Returns to the market are 9.7% and the risk-free rate is 3.9%. The loan capital is irredeemable and currently trading at £102.5 per £100 nominal value.

Kolyo Ficheto EAD has recently made large losses and is not expected to pay any tax for the foreseeable future.

**Required:**

**Assume it is now 1 February 2008.**

**Prepare a set of papers for the board of directors of Kolyo Ficheto EAD that deals with each of the matters set out below.**

- (a) **Assuming that work on the construction of Snezhinka Apartments begins on 1 April 2008 and is completed on time, prepare a monthly cash flow forecast for the rental division for the period from 1 September 2009 to 31 December 2010 and comment on any significant features revealed by this statement.** (18 marks)
- (b) **Assuming that work on the construction of the Snezhinka apartment complex begins either:**
- (i) **on 1 April 2008; or**
  - (ii) **on 1 July 2008**
- and is completed on time, suggest for each case the maximum price that Kolyo Ficheto EAD should be prepared to pay to acquire the plot of land in Borovets.** (21 marks)
- (c) **Identify the key operating risks relating to the proposed investment project and explain how these risks may be managed.** (21 marks)
- (d) **Bearing in mind all significant factors, suggest, with supporting reasons, the maximum price that the directors of Kolyo Ficheto EAD should be prepared to pay for the plot of land in Borovets at the forthcoming auction.** (5 marks)
- (e) **Explain:**
- (i) **the methods by which institutional shareholders may exert influence over the decisions and policies of the board;**
  - (ii) **the benefits to the company of maintaining close relationships with institutional shareholders;**
  - (iii) **the ways in which the board may seek to maintain close relationships with institutional shareholders.** (18 marks)
- (f) **Provide appropriate advice concerning:**
- (i) **the directors' duty when an unsolicited takeover bid is received and the ways in which the risks of receiving such a bid may be identified and assessed; and**
  - (ii) **what the directors should do to prepare for the possibility of receiving a hostile bid.** (17 marks)

**Notes:**

1. **Key workings should be shown and key assumptions must be clearly stated.**
2. **Workings in Bulgarian leva (BGN) should be in 000s and to one decimal place.**
3. **Percentages should be calculated to the nearest per cent.**

**(100 marks)**

**End of Project**