



P10 – Test of Professional Competence in Management Accounting

24 November 2005 – Thursday Afternoon Session

Instructions to candidates

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| You are allowed three hours to answer this question paper. |
| You are allowed 20 minutes reading time before the examination begins during which you should read the question paper and, if you wish, make annotations on the question paper. However, you will not be allowed, under any circumstances , to begin to write your answer, or to use your calculator during this reading time |
| This booklet contains the examination question and both the pre-seen and unseen elements of the case material. |
| Answer the question on page 19, which is detachable for ease of reference. |
| The TOPCIMA Assessment Matrix, which your script will be marked against, is included in this booklet on page 20. |
| Maths Tables and Formulae are provided on pages 27 to 29. |
| Write your full examination number, paper number and the examination subject title in the spaces provided on the front of the examination answer book. Also write your contact ID and name in the space provided in the right hand margin and seal to close. |

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TURN OVER

Domusco

Background

Domusco was formed 42 years ago, and became a listed company 30 years ago, in its home country of Zee, a fictitious country in Southern Europe. Zee is not in the European Union (EU).

The Domusco group structure comprises a number of wholly-owned subsidiary companies operating in different construction business segments. The three construction business segments that Domusco has are:

- Major construction projects;
- Office building construction;
- House building.

Domusco's group structure, together with its key personnel, are shown in **Appendix 1** (on page 14).

Domusco's major construction project subsidiary company is structured around the type of project undertaken. The Domusco Office building subsidiary company manages all office construction work from its Head Office based in Zee, for all office construction work in Zee, other areas of Europe and the Middle East. Domusco's house building subsidiary company is structured differently, as it has separate subsidiary companies for geographic areas. It has house building subsidiary companies based in Zee, another European country as well as a subsidiary in the USA, to enable management to be closer to the markets in which they operate.

The Domusco group has been involved in residential house building since the company was formed. It entered the major construction projects segment over thirty years ago and then expanded into the office building construction segment twelve years ago. Domusco has established itself as a builder of high quality housing and apartments at the top and middle segment of the market. The Domusco group has been able to command premium prices, because of its good designs and quality specifications. Domusco has not been involved in any low cost or social housing projects to date.

Domusco has recently been awarded two contracts in a European country in which it has not previously operated. One is for the construction of a large office building. The other is for the construction of five blocks of high-rise apartments. Both projects commenced in early 2005 and are planned to last for three years. The latter project generated much international publicity because of Domusco's innovative designs and high technology features that have been incorporated into each apartment. The Board is hopeful that these latest contracts will lead to other contracts being awarded to Domusco.

Domusco personnel

The following Directors are on the main Board of Domusco and their career histories and functional responsibilities follow:

Tom Micol – Chairman

Tom Micol, now 63, has been Chairman of Domusco for the past six years and previously was one of its non-executive directors. He is currently working part-time, following a recent spell of ill health. Tom Micol has worked in the construction industry all of his life and is proud of Domusco's recent expansion. He wants to see the company grow even stronger before he plans to retire in three years' time. Tom Micol is a close ally of Peter Kaye, and believes that Peter Kaye has brought in a huge amount of the new business since he joined.

Will Umm – Chief Executive

Will Umm, now 49, joined the company fourteen years ago when the previous Chief Executive retired. Will Umm has seen the company's revenue grow at over 15% per annum for most of the last ten years. He has personally been the driving force behind many of the large construction projects that Domusco has been awarded over the last few years. He qualified as a civil engineer in Asia and has lived and worked in several countries.

Will Umm has good government connections and has always found time to deal with many personnel matters. He often visits sites and speaks to workers to hear what thoughts they have. He is considered to be fair in his business dealings and has been able to maintain Domusco's reputation as being scrupulously fair in its contract negotiations. He is very much in touch with his workforce and is well liked and respected by most of the Domusco Board as well. It is only the Finance Director, Martyn Lite, with whom he has not established a good rapport. This is primarily because Martyn Lite often argues that what Will Umm wants to do is not in the shareholders' interests. Martyn Lite often states that a project that appears to be profitable can be too risky, or that Domusco has taken on too much construction work and has insufficient management resources. On most occasions, Will Umm has over-ruled him, and although he respects Martyn Lite, he considers him to be too conservative.

Martyn Lite – Finance Director

Martyn Lite, now 52 years old, qualified as an accountant in his twenties while working for a major construction company in Europe. He moved to Zee and worked his way up in the finance department of a small construction company to become Finance Director. Within two years he transferred into a general management position, but decided that he missed the finance side of the role. He then reassessed his career and joined Domusco when its previous Finance Director retired in 1996.

He has now been with Domusco for over nine years and still has some challenging tasks ahead. He has been involved in much IT development and has tried to introduce the concept of shareholder value into Domusco. While the Domusco Board has accepted the principle, the ability to cascade down the identification of value on individual projects has been difficult. In the meantime, he has put more emphasis on growth in EPS and has had several boardroom clashes with the Chief Executive. He finds Will Umm too visionary with little understanding of financial matters. However, even Will Umm would admit that their joint skills have contributed towards the growth achieved over the last decade.

Peter Kaye – Director of Major Construction Projects

Peter Kaye, now 48, is an American citizen who joined Domusco five years ago when Domusco acquired a house building company in the USA, where he had held the role of Chief Executive. After successfully merging the US house building company into Domusco's group structure, he was appointed as Director of Major Construction Projects.

It is Peter Kaye's subsidiary company within the Domusco group that is responsible for contract negotiations for all of Domusco's major construction projects. These projects involve construction work that will be undertaken by the Major Construction Projects subsidiary company or by other subsidiary companies within the Domusco group. For example, if Domusco bids for a major construction project involving the construction of office buildings and motorway access, the relevant companies within the Domusco group are involved in costing and resource planning, but it is Peter Kaye's team which negotiates and signs contracts on behalf of Domusco. After contract signing, budgets will be allocated to the appropriate Domusco group companies and each company within the group will have operational authority for delivering to the agreed contract terms. Therefore, although Peter Kaye is bringing business into the company and negotiating delivery dates and pricing, it will be other areas of Domusco that will be responsible for delivery of the contracted construction work. There is much cross company liaison and involvement in all major projects at an early stage, prior to signing of contracts.

Peter Kaye has worked for several international companies, but has only been involved in the construction industry for sixteen years. He has helped Domusco to win several major construction projects in the last four years, some of which have been joint venture projects, and he has established a good reputation for bringing in business to Domusco. However, Peter Kaye has had many clashes with Martyn Lite. Martyn Lite finds Peter Kaye to be too outspoken, egotistic, and not very financially astute.

Tan Lee – Director of Office Building Construction

Tan Lee, now 54, joined Domusco over twenty years ago and has worked his way up in the company from structural surveyor. When the office building construction subsidiary company was formed twelve years ago, he was appointed as a main Board director responsible for this business segment that was new to Domusco. He is technically excellent and has good business and financial awareness. He usually supports Martyn Lite in any Board disagreements as he feels that the company has been expanding too fast in the last few years. He is a sound manager who has a proven track record of delivering the construction projects under his control on time and to budget. However, with the demands of international competition and the innovative features that Domusco now incorporates into its office buildings as standard, far exceeding legal requirements, margins have decreased from the levels achieved a decade ago.

Marma Winge – Director of House Building

Marma Winge, now aged 39, has progressed rapidly in his career with Domusco. He started as an architect and he has won awards for both innovative designs and the use of high technology to reduce energy consumption. His energy efficient house designs have been built extensively in Zee, as well as in many of the European countries that Domusco has expanded into. He was appointed as Director of House Building in 1997, and has overall responsibility for the three house building subsidiary companies (in Zee, other areas of Europe and the USA). He established a good working relationship with Peter Kaye during the acquisition of the USA based house building company in 2000, and they have mutual respect for each other's abilities.

Piers Moore – Director of Sales and Marketing

Piers Moore, now aged 42, joined Domusco twelve years ago from a large international house building company where he had held the role of Sales Manager. He brought with him the mix of skills needed to complement Domusco's other directors' skills. He established a small corporate marketing department that supports the sales and marketing teams that are in place within each subsidiary company of Domusco.

In each of Domusco's subsidiary companies, the staff numbers in the sales and marketing departments vary greatly. Most of the construction work undertaken by the Major Construction Projects and Office Building subsidiary companies is specifically commissioned and these Domusco group companies have only a small sales and marketing support team.

Within the last five years, Domusco has been involved in the construction of many smaller office buildings which had not been specifically designed and built for a company prior to commencement of construction, but were instead sold during the construction period. The construction of these smaller edge-of-town office buildings has increased the working capital requirements of Domusco's office building construction subsidiary, but has improved the office building construction subsidiary's sales revenue and profitability.

Each of the house building subsidiary companies requires a large sales and marketing team to secure sales and ensure that all properties are sold before completion of construction work, or shortly after all work has been completed. Domusco has seen the type of house building change in the last decade, with a higher percentage of lower priced houses and apartments being built and fewer larger houses being constructed. House building companies also attempt to sell some of the planned properties "off-plan" as soon as building plans have been approved. Off-plan purchase of houses or flats is defined as a customer committing to purchase the housing unit and paying a deposit prior to any construction work commencing on the housing unit. During the last decade, Domusco has seen a change in the timing of when customers purchase their

houses or apartments, and they are making their decisions later in the construction process and the level of off-plan sales has fallen. All of these factors have adversely affected cash flows within Domusco's house building subsidiary, although profitability has increased year-on-year within the house building subsidiary.

Jackie Paul – Human Resources Director

Jackie Paul, now 46, has been involved in the construction industry all of her working life and her father managed a small construction company in the Far East where she grew up. She knows and understands the industry, which has helped her to reach her current position. She joined Domusco nine years ago as Human Resources Director, and has been involved in numerous changes, not least the doubling of the company's workforce, to make it less dependent on sub-contractors and due to growth in the volume of its construction work. She has been dominant in introducing performance related pay for most levels of staff. She has also been heavily involved with some other Board members in the development, implementation and target setting for Domusco's corporate social responsibility reporting. She has been instrumental in establishing the Advisory Committee, which reports to the main Domusco Board.

An extract from Domusco's Corporate Social Report is shown in **Appendix 2** (on page 15).

Desmond Luna – Director of Health and Safety

Desmond Luna, now 50, was injured in a construction accident when he was in his twenties and has worked very hard to reach his current role. He works tirelessly and often turns up on site unannounced to see for himself what is happening and the types of problems that are being experienced. Despite a good track record on safety in the last ten years, Domusco had two accidents involving the deaths of several construction workers, in Zee and in the Middle East, last year. Desmond Luna is working on improving site safety awareness and accident prevention, so that the events that led up to these accidents do not recur.

Carlos Freer – Director of Business Planning

Carlos Freer, now 47, joined Domusco eight years ago and has seen the company grow rapidly. He works closely with Martyn Lite, who he respects enormously, but finds the planning role frustrating at times due to the uncertain nature of the industry. It is difficult to plan when the company is usually only successful in being awarded contracts for around 25% of the projects that the company has bid for. Furthermore, some major construction projects are awarded to the company with a very short time span between contract signing and start of the construction work. This makes manpower planning, as well as financial planning, difficult.

Non-executive directors

Domusco has three non-executive directors who are well experienced in industry and commerce.

Economic growth in Zee

The country has been a democracy for over 50 years and is experiencing a period of growth in consumer spending. Annual inflation has remained at a little over 4% per year for the last few years and the GNP is forecast to grow at 4% per year over the next few years. The country is a net importer, marginally, and its principal export market is the EU. The country's currency is the Zee dollar (Z\$) and the exchange rate at 30 June 2005 is Z\$3.25 to US\$1 and Z\$2.55 to €1.

Competitor analysis

In Domusco's home country of Zee, there are eight large construction companies, some of which only operate within Zee, whereas Domusco and three other companies are involved in construction work internationally. Domusco is one of three leading house builders in Zee, and during 2004, Domusco completed 6,924 housing units (one unit is equal to one house or one

apartment) in Zee. On the basis of completed units, it constructed a little less than 12% of all new units during 2004 in Zee. Its operations in some European countries and in part of the USA are very small compared to other international companies and Domusco is likely to build less than 1% of all new housing units in these countries.

Domusco's international office building construction work is very small compared to many other international companies. However, Domusco has a substantial market share in the office construction market in its home country of Zee. However, the volume of new office construction in Zee has fallen in the last five years, but Domusco has achieved around 20% of new office buildings in Zee during the last three years.

The Major Construction Projects subsidiary companies of Domusco have been awarded more contracts within the last three years than they had undertaken in the decade prior to that. This has necessitated Domusco's Major Construction Projects subsidiary company recruiting over two hundred more employees in several countries, as well as them using a high proportion of sub-contractors, to enable them to meet contract deadlines. Peter Kaye is the driving force for much of this new business and he is confident that he can grow this high margin business much further.

Domusco shareholding and share prices

Domusco has 441.6 million shares of Z\$0.50 each in issue and has a total of 800 million authorised shares. Its share price at 30 June 2005 is Z\$13.82, which is at an all-time high for the company, due partly to its good 2004 results. Institutional shareholders own over 80% of its shares, with no single large shareholder. Domusco's directors, staff and general public own the rest of Domusco's shares.

Major construction projects currently under construction

The Major Construction Projects subsidiary company within Domusco, headed up by Peter Kaye, had five main contracts under construction during 2004. These were:

- the construction of a sports stadium in the Middle East (in a country where it has undertaken many projects before), which is due for completion in February 2007. The total profitability on this project is forecast to be Z\$78 million over four years.
- the construction of motorways and bridges in the neighbouring European country of Wye. More details on this project are shown later.
- the construction of a motorway in a different country in the Middle East, which is due for completion in September 2005. The overall updated forecast profitability on this project is Z\$380 million over 2.4 years.
- road and motorway construction and road improvements in Zee. The project spans two years and is due to be completed by mid-2005 and the forecast profitability is Z\$220 million.
- construction work on a new marina in Zee. Work commenced in August 2004 and is due for completion in November 2005. The total project profitability is forecast to be Z\$270 million.

Domusco has not yet signed contracts for any other major construction projects. However, Domusco has bid for several other major construction projects. It is also currently negotiating a major construction project in the USA. If the USA contract were to be awarded to Domusco, it would be its first major construction project in the USA. Domusco currently has house building operations in the USA, but has no other construction work there to date.

Motorway construction project in Wye

Domusco has been involved in several motorway construction projects previously and it was selected from a shortlist of four international companies, for a particularly difficult motorway construction project in a neighbouring country of Wye, because of its experience of building roads in difficult terrain. The motorway project commenced in Spring 2004 and was due for completion by the end of 2006. However, the project is currently behind schedule, on account of unforeseen extra construction work that will be required, because of the exceptionally heavy rainfall during late 2004, which caused some of the completed sections of the motorway and other foundation and bridgework to be partially washed away, or damaged. Some areas of the motorway will require totally new, stronger foundations to be constructed.

Peter Kaye and one of his managers, Weng Zen, the Head of Motorway Construction in Domusco, are currently trying to renegotiate the budget for the project with the Wye government. Peter Kaye has put forward the case to Wye's government that the entire cost of 14 lost weeks and the additional construction costs should be met by Wye's government's road building budget, due to the exceptionally heavy rains, which were unforeseen. Wye's government minister for transport has publicly stated that the agreed budget cannot be exceeded and that Domusco should have ensured that the quality of the foundations were stronger, to have withstood the heavy rainfall. However, in private it is understood that Wye's government were surprised at the devastation caused in many areas of the country by the high rainfall. Peter Kaye has put forward the case to Wye's government that all of the completed foundations had been fully inspected and approved by Wye's government department, prior to the heavy rainfalls that damaged or destroyed them. He therefore stated that the re-building costs should be borne entirely by the Wye government road-building budget. The Wye government has strongly disagreed with any claims and has refused to pay any compensation for the delays or any rebuilding work.

Peter Kaye reported to the May 2005 Domusco Board meeting that he did not want to harm the delicate relationship with the Wye government at this early stage of this project, particularly with possible future major construction projects in Wye that Domusco is planning to bid for in the next few years. Peter Kaye advised the Domusco Board that the motorway project had a planned profitability of Z\$105 million. However, it is now forecast to make an overall loss of Z\$35 million, unless the Wye government changes its mind on any compensation payments.

At the May 2005 Board meeting, Martyn Lite stated that Peter Kaye should not allow the possibility of future projects to adversely affect Domusco's negotiations with the Wye government concerning payment for the delays and rebuilding costs. The Chief Executive, Will Umm, over-ruled Martyn Lite and stated that this was the first of many projects in Wye and that long-term profitability was more important than one single project. Martyn Lite disagreed and in a heated discussion stated that the Wye government must assume the company's management is weak. Martyn Lite also stated that it would be more difficult to negotiate prices in the future if Domusco did not pursue compensation for the delays on this motorway construction project.

Office building construction

The sales revenue for Domusco's Office Building construction subsidiary company has risen from Z\$732 million in 2003 to Z\$768 million in 2004 and is forecast to be around Z\$1,248 million in 2005, but profitability on some buildings has fallen.

Up until five years ago, all construction work of office buildings were bespoke projects commissioned by organisations. Recently, Domusco has constructed office buildings, both in Zee and in two European countries, where the office buildings have not been sold until part way through the construction process, or after completion of the building. Domusco has been involved in several office buildings construction projects in edge-of-town locations, where several construction companies have each constructed a range of buildings. These edge-of-town office developments have proved profitable and have enabled Domusco to expand its range and size of office building designs.

Tan Lee was pleased to see the revenues generated from his company grow, although it is the smallest of Domusco's three main subsidiary companies, with sales revenue in 2004 only a little over 12% of the total Domusco Group sales. In 2004 profitability fell significantly for two reasons. Firstly, one office building that remained unsold for over one year after completion of construction was sold at a reduced price and resulted in an overall loss. Secondly, there have been some cost over-runs on two large office construction projects in Europe that were specifically commissioned by Domusco.

House building construction

Domusco's house building subsidiary company is split geographically, into three companies. One is responsible for all house building in Zee, another for house building in other European countries and the third for house building in the USA.

Domusco had acquired a small house building construction company based in the USA in 2000 for several reasons. Primarily it was to acquire its innovative designs and have access to its high profitability, which was due to its relatively low construction costs. It has managed to apply the principles learned from this acquisition and Domusco's house building subsidiary has used them in other countries to improve operating margins. Some cost savings have been due to a change in building techniques, which have removed some of the build stages in the construction process. This allows some construction processes to take place at the same time, resulting in labour savings and a reduction in the costs associated with late alterations. Peter Kaye, who is now Director of Major Construction Projects, joined Domusco from this USA based house building company.

Traditionally in the construction industry, profitability and success has been measured by the company's return on capital employed (ROCE). However, Marma Winge found this measure misleading when comparing ROCE for the three subsidiaries. This is because the ROCE in one subsidiary has been depressed by the purchase of some state-of-the-art construction machinery. A summary of the return on capital employed achieved by geographic region for Domusco's house building subsidiary companies for the past two years is as follows:

| | | Zee | Other European countries | USA | Total house building |
|-----------------------------------|-------------|------------|---|------------|-------------------------------------|
| Operating profit – 2004 | Z\$ million | 193 | 165 | 91 | 449 |
| Operating profit – 2003 | Z\$ million | 183 | 150 | 82 | 415 |
| ROCE – 2004 | | 23.1% | 25.0% | 27.4% | 24.0% |
| ROCE – 2003 | | 21.0% | 22.5% | 26.1% | 21.7% |
| Number of completed housing units | | | | | |
| 2004 | | 6,924 | 4,463 | 2,811 | 14,198 |
| 2003 | | 6,700 | 4,607 | 2,695 | 14,002 |

There are also two other influences on the return on capital employed that is achieved. One is the size of the housing development. Generally, smaller developments achieve lower returns than a larger quantity of housing units that are constructed at the same site. Secondly, the type of housing influences returns achieved. Large apartment blocks generally achieve a higher ROCE than medium priced houses. However, some of Domusco's new housing developments in Europe have been achieving exceptionally high returns, as Domusco had purchased the land plots at a low price a few years ago, compared to current land purchase prices, which have risen considerably.

Domusco's staffing levels and sub-contractors

Most companies operating in the construction industry use a mix of their own employees and sub-contractors. The mix varies by country and also by construction segment. In the house building segment, Domusco employs its own staff for site surveying and site management, as well as for a proportion of the house building construction work. Specialised sub-contractors

undertake the rest of the house building construction work. Domusco also directly employs all of the sales and marketing teams and administrative support for Domusco's house building subsidiary companies. The majority of the sub-contractors that Domusco uses have worked closely with Domusco for several years.

In major construction projects, particularly motorway construction, specialised sub-contractors undertake the majority of the construction work. The location and the level of staffing required varies enormously with each major project and Domusco does not wish to employ large numbers of staff that may be located in the wrong area or with unsuitable skills. The use of sub-contractors gives Domusco flexibility.

Peter Kaye's operational management has experienced problems with the use of some sub-contractors. Although Domusco has repeatedly used the same sub-contracting companies as on previous occasions, the make-up of the teams used on projects that undertake the work change far too often. Despite supervision by the sub-contractors' management and subsequent inspections by Domusco's project management, there are large numbers of unskilled workers who are not capable of completing certain stages of construction to the required standard, which causes delays while the extent of the faulty work is identified and rectified. In Zee and some other European countries, there is currently an increase in the amount of construction work being undertaken, and many sub-contractors are employing workers who have entered into this industry with little or no training and are both inexperienced and unskilled, which inevitably leads to quality issues. Additionally, as sub-contractors are paid a fixed fee for various stages of construction, they want to complete the job in the least possible time, so that their employees can move onto the next job. This leads to jobs being rushed and not thoroughly or professionally completed.

In the office building construction subsidiary of Domusco, Tan Lee has recruited a strong team of experienced staff and is less dependent on sub-contractors than the other subsidiaries of Domusco.

Domusco always uses its own staff for project management and surveys and inspections. One of the recent reports that Marma Winge's operational management is currently reviewing is whether Domusco's house building companies should increase their staffing levels, so that their dependence on sub-contractors would reduce. This would have a number of benefits including reducing costs, as sub-contractors cost more and secondly, the quality of work is usually higher with their own staff. Domusco has had a number of incidents where sub-contractors have employed workers who were less skilled than usual which has resulted in delays and the need for rectification work. Marma Winge is particularly keen to increase the staffing levels that are employed in the house building subsidiary companies in Zee and other European countries and to reduce their dependence on some sub-contractors and has presented a paper at the May 2005 Domusco Board meeting with a proposal to increase staffing levels.

The development of the Hadsji area of Zee

For the last few years the government of Zee has been planning to sell for development a large amount of land in the area of Hadsji. There has been much speculation as to which construction company would buy the land and what type of development would be built on it. Media speculation in Zee feared that it would become another tourist area and this would not help local companies and local people with their housing needs. Despite expanding urbanisation of some cities in Zee, the large site in the Hadsji area of Zee, is still mainly empty and undeveloped. The Hadsji area is 40 kilometres east of the city of Prine. The Zee government has launched an initiative to move people out of crowded cities to better housing. The government also wants to attract companies in the IT industries to relocate to the Hadsji area. All office buildings are to be built with the latest high tech equipment to support "intelligent buildings". The Zee government will be funding the transport infrastructure, which will mainly be the construction of all roads in the Hadsji area.

The Zee government currently owns the land and wants to sell the entire area to one construction company. The Zee government would prefer that the construction company that purchases the entire Hadsi area should then sell plots of land onto other construction companies. In this way, the development of Hadsi could be completed in a shorter period of time, possibly within four years, than if only one construction company were to be involved. Tom Micol and Will Umm had been invited to several meetings with Zee government ministers regarding the future development of the Hadsi area and they reported back to the Domusco Board in Summer 2003 that it was likely that the Hadsi land would be used for residential housing. In addition, a commercial centre is planned, as several international companies had expressed interest to the Zee government and had indicated that they would establish offices in Hadsi. The government ministers had also informed Tom Micol that the Zee government planned to commission some community buildings, including schools, sports and recreational facilities. The media in Zee soon picked up this information, possibly leaked by the Zee government, and the general reaction in Zee was positive, with much interest in this development project.

September 2003 Domusco Board meeting

The Chief Executive, Will Umm, reported back to the Board on the discussions held with the Zee government about the proposed development of the Hadsi area. Will Umm surprised the Board when he reported in total confidence that his government connections had reliably informed him that the Zee government had decided that its first choice to sell the entire Hadsi land to was Domusco. The Zee government envisages that over 23,000 housing units could be built on this land, together with schools and sports buildings and a large commercial centre. Will Umm stated that he felt strongly that Domusco should be involved in this major construction project in its home country and the other Board members agreed.

Will Umm advised the Board that the cost of the entire Hadsi land that the Zee government was offering to sell would be around Z\$900 million. Some of this cost would be recouped in a short period of time when plots of land were sold onto other construction companies. Will Umm completed his presentation to the Domusco Board by stating that this could be the single largest project the company had ever undertaken, and that his government contacts had confirmed that it was Domusco's to take, if it wanted it. After much heated discussion, the Domusco Board agreed by a majority vote that Domusco should seize this opportunity and acquire the Hadsi land if it were to be offered to it by the Zee government. The Board requested Martyn Lite to arrange loan finance to cover this land purchase and Carlos Freer was requested to prepare financial forecasts for construction costs on the area of land that Domusco planned to develop itself. In deference to Martyn Lite's concerns about risk and Domusco stretching its financial and manpower resources too thinly, the Domusco Board agreed that Domusco would only undertake construction work on no more than 40% of the Hadsi land area. The other 60% of the Hadsi land would be sold off to other construction companies.

Acquisition of the Hadsi land

The Zee government finalised the sale of the Hadsi land to Domusco during January 2004 at a final price of Z\$830 million, a reduction of Z\$70 million from the estimated price. The reduction had been negotiated by Peter Kaye, to enable Domusco to undertake the necessary land surveying and other environmental studies, prior to the start of development and the sale of plots of land to other construction companies. Martyn Lite was also able to negotiate with the Zee government that only one half of the price would be paid on signing contracts in January 2004, and the balance would be paid in December 2005.

As part of the contract for the purchase of the Hadsi land, the Zee government also undertook to spend Z\$20 million over two years on promotional and marketing costs to help support the marketing programme that Piers Moore felt would be necessary in order to generate public interest and sales of houses and commercial property in the Hadsi area. It was agreed with the Zee government that any construction company involved with buildings in Hadsi would also market its own construction work to the general public, so that the early sales of offices and housing could reduce the amount of working capital required to finance this major development.

Domusco's construction plans in Hadsi

In January 2004, the Domusco Board requested Marma Winge to prepare outline plans for the housing development and to recommend what size plots of land Domusco should retain for its own planned construction work, and not, therefore, sell to other developers.

In March 2004, the Domusco Board agreed to construct 12,000 housing units over three years, which will significantly increase the volume of its house building in Zee. This will result in significantly higher revenues and profits for Domusco's house building company over the next few years and will create many new jobs. In addition to housing construction, the Domusco Board agreed to construct a total of fifty commercial office buildings. In addition, the Domusco Board agreed to bid for a contract to construct some roads and motorways connecting the Hadsi area to the nearby city of Prine, which are to be financed by the Zee government. The Domusco Board had previously agreed in September 2003 that the total area of the Hadsi land that Domusco would use for construction work would not exceed 40% of the total area being developed, which the above planned construction work conforms to.

Sale of some of the Hadsi land to other construction companies

The Zee government sold the entire Hadsi plot of land to Domusco in January 2004 for Z\$830 million and it envisages that the entire development of the area would be completed in about three to four years. The Zee government has given outline planning permission for Domusco's plans for the entire Hadsi area, but formal Zee government approval will still be required prior to the start of any specific construction work by Domusco or any company to which Domusco may sell plots of land.

Representatives from Domusco held several meetings with other Zee based and international construction companies about this specific high profile construction project in early 2004. These companies ranged from small and medium sized construction companies based in Zee to international construction companies who were keen to take a part of this major development. Peter Kaye, Tan Lee and Marma Winge met with these companies and selected five companies to which Domusco contracted to sell plots of land on the Hadsi site. The five companies who have purchased land on the Hadsi site from Domusco will be involved with the construction of housing, public buildings, including schools and government funded sport facilities and office buildings. The five companies will also be involved in bidding for road and transport infrastructure construction work.

Contract negotiations on the sale of land plots to these five companies continued throughout 2004 and the sale to all five companies occurred in early 2005. In the first half of 2005, Domusco received payments totalling Z\$428 million for the sale of plots of land from the five other construction companies. The total volume of land sold was just over 51% over the total land. The Domusco Board has agreed that Domusco would retain a maximum of 40%, which still left 9% to be sold, which is located in the commercial area of Hadsi. However, by the end May 2005, Domusco had still not identified a construction company that was interested in acquiring some or all of this area of land for the construction of office buildings, until firm buyers for office space had been identified. Therefore this plot of land remained within Domusco's land bank and reported as inventory, together with other plots of land that Domusco owns worldwide.

Financing plans for the Hadsi development

At this early stage of the project, the forecast total construction costs for Domusco's planned construction work will be around Z\$5,000 million in total over the four years ending 2007, as shown in the table below. The construction costs shown below do not include Domusco's share of the cost of the Hadsi land.

| | | 2004 | 2005 | 2006 | 2007 | Total |
|------------------------------|-------------|-------------|--------------|--------------|--------------|--------------|
| Housing units (completed) | | 0 | 3,000 | 4,000 | 5,000 | 12,000 |
| Office buildings (completed) | | 0 | 12 | 16 | 22 | 50 |
| Forecast construction costs: | | | | | | |
| Housing | Z\$ million | 300 | 700 | 900 | 1,100 | 3,000 |
| Office buildings | Z\$ million | <u>300</u> | <u>500</u> | <u>600</u> | <u>600</u> | <u>2,000</u> |
| Total construction costs | Z\$ million | <u>600</u> | <u>1,200</u> | <u>1,500</u> | <u>1,700</u> | <u>5,000</u> |

Martyn Lite has negotiated loans with two international banks for the equivalent of Z\$900 million. The loan finance is for a five-year period at 9% interest per annum, payable quarterly. The loan is forecast to cover working capital requirements for the start of the construction work.

The initial payment for the cost of the Hadsi land was paid from cash generated by the Domusco group's operations. Subsequently, payments have been received from other construction companies for the sale of plots of land in the Hadsi area.

It is planned that the balance of the required payment to the Zee government for the land, due in December 2005, would be financed by the sales of housing and offices that will be under construction. The amount of working capital cannot be forecast exactly as it is unknown what proportion of the housing will be sold "off-plan" (sold in advance of construction commencing) but a conservative amount has been forecast. The two international banks, ALT and BRG, have confirmed that they are interested in providing Domusco with additional financing if required during the course of construction work.

Domusco's existing loans, to Zee based banks, totaling Z\$1,020 million are denominated in Zee dollars. The details of Domusco's new loans with ALT and BRG, denominated in US dollars and Euros, for the equivalent of approximately Z\$900 million as detailed below:

| | <i>Currency of loan</i> | <i>Loan value (million)</i> | <i>Exchange rate (as at loan date of 30 June 2004)</i> | <i>Z\$ million</i> |
|-----------------|-------------------------|-----------------------------|--|--------------------|
| Bank ALT | US\$ | 200 | 3.18 | 636 |
| Bank BRG | Euros | 105 | 2.51 | <u>264</u> |
| Total new loans | | | | <u>900</u> |

Bad publicity for the Hadsi development

There has been a growing amount of adverse publicity concerning the Hadsi development, generated by lobbyists who are concerned that the Hadsi area will become another concrete area. The Hadsi area currently has a few endangered species of small wildlife animals, which are dependent on the existing habitat. While every effort has been made to preserve as many trees as possible, which enhances the appeal of the completed development, it was planned that there would be the need to clear a large area of forest where some of the housing and the commercial office buildings area would be constructed.

The adverse publicity about the removal of trees in parts of the wooded areas in Hadsi, and the changes to the local habitat that this has caused, has been growing. The management at

Domusco has asked the Zee government to support it, and the other construction companies, and to increase the amount of marketing it should undertake about the benefits of the completed Hadsi development, in order to counteract the level of adverse media publicity.

Sports stadium contract awarded to Domusco

At the Domusco Board meeting held in June 2005, Peter Kaye announced that after negotiations lasting several years, Domusco had been awarded the contract for the construction of a large national sports stadium in a European country. He stated that he had understood that Domusco had been eliminated from the short list some months ago in favour of the leading construction company in that European country. It had come as a surprise when government officials from the European country had contacted him to confirm that Domusco had been awarded the contract. Contracts are due to be signed within the next month.

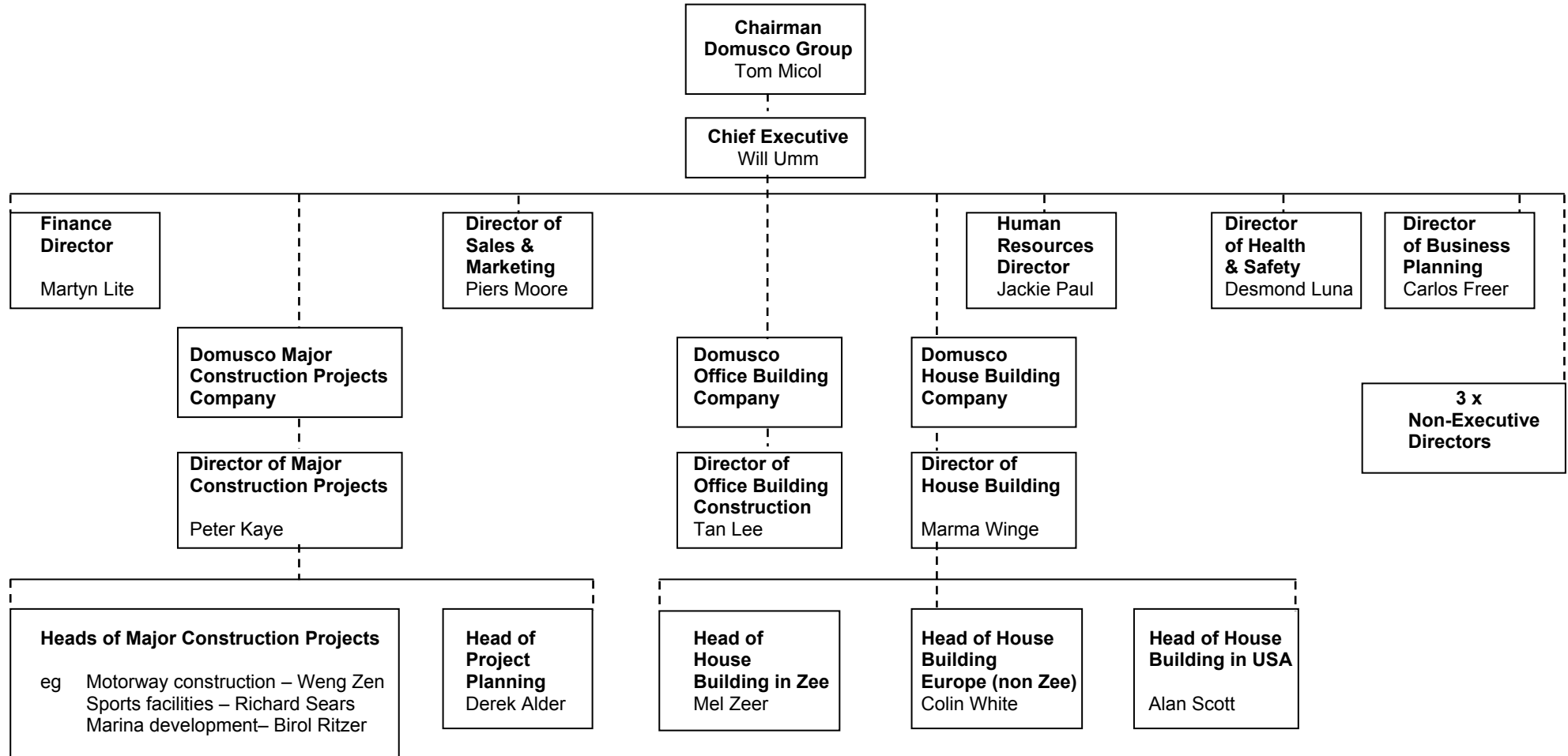
The sports stadium contract is for €180 million (approximately Z\$459 million) and all payments to Domusco are to be made in Euros. The forecast profitability for this contract, which will span 18 months and must be completed by April 2007, is the equivalent of almost Z\$83 million. However, if the contractual terms are not met, and the stadium is not completed on time, the final stage payment will be reduced by approximately Z\$31 million.

Whilst Peter Kaye is pleased that Domusco has been awarded the contract, he is concerned at Domusco's available manpower and the very tight construction timetable, upon which the final stage payment would be made. Peter Kaye stated that he would not have accepted the same proportion of the Hadsi development proposal if he had believed that Domusco would have been awarded this contract. The contractual terms state that work has to be commenced no later than December 2005 and completed by end of April 2007. For a stadium of this size, the construction period could be as long as five years, and therefore the high price reflects the extra amount of manpower needed on this large project.

The Board discussed the problems of taking on this project, but agreed that it would not want to damage its reputation by not accepting it, which could put at risk its ability to win any future contracts of this type.

Organisation chart for Domusco

Appendix 1



Extract from Domusco's Corporate Social report for 2004

| | <i>Key achievements in 2004</i> | <i>Major targets for 2005 and beyond</i> |
|---|---|---|
| Social Responsibility | Established an Advisory Committee, which meets quarterly and reports to the Domusco main Board. | Continue to clarify Domusco's responsibility to its shareholders, its suppliers and its customers. Improve the supply chain. |
| | Improved internal controls and risk awareness | Continue to improve risk awareness among all managerial levels and train senior staff in risk management techniques. |
| Health & Safety (H & S) issues | 100% of staff trained in H & S issues | Targets set for reduced number of incidents. |
| | 90% of our contractors inducted in H & S procedures. Reduction of accident levels for both serious incidents and moderate incidents, although the company had fatal accidents in 2004. | Tighter safety procedures in place to prevent the types of accidents that caused fatalities in 2004. |
| Environment | Trained 90% of site management in environmental management. | Survey of suppliers' environmental policies. |
| | Established a site specific environmental action plan. | Increased use of technology to reduce energy waste during construction. |
| | Trained 60% of sub-contractors on environmental issues. | Train 100% of site management in environmental management. Continue to train sub-contractors. |
| | Improved the amount of site materials that are recycled. | Increased recycling targets set. |
| Employees | Results of third employee survey published and action plan to address issues drawn up. | A fourth employee survey, in an updated format, will be undertaken. |
| | Introduced new HR strategy, concerning working hours and performance related pay. | Increased management training and more emphasis on supporting staff to gain relevant qualifications for their job. |
| | Increase of 18% in training hours per employee | New training programme planned |

Appendix 3

Domusco Balance Sheet, Income Statement and Statement of changes in equity

Note: All data in this appendix are presented in international financial reporting format

| | <i>As at 31 December 2004</i> | | <i>As at 31 December 2003</i> | |
|--|--|--|--|--|
| | <i>Z\$ million</i> | <i>Z\$ million</i> | <i>Z\$ million</i> | <i>Z\$ million</i> |
| Domusco Balance Sheet | | | | |
| Non-current assets (net) | | 124.8 | | 120.3 |
| Current assets | | | | |
| Inventory (including land bank, work-in- progress and inventory of materials) | 5,339.6 | | 4,470.5 | |
| Trade receivables | 841.2 | | 727.1 | |
| Cash and short term investments | 501.6 | | 98.2 | |
| | | 6,682.4 | | 5,295.8 |
| Total assets | | 6,807.2 | | 5,416.1 |
| Equity and liabilities | | | | |
| Equity | | | | |
| Paid in share capital | 220.8 | | 220.8 | |
| Share premium reserve | 327.6 | | 327.6 | |
| Retained earnings | 2,880.8 | | 2,469.6 | |
| | | 3,429.2 | | 3,018.0 |
| Non-current liabilities | | | | |
| 9% Loan notes (redeemable in 2007) | | 324.0 | | 324.0 |
| 10% Loan notes (redeemable in 2008) | | 696.0 | | 696.0 |
| 9% Loan notes (redeemable in 2009) | | 900.0 | | - |
| Current liabilities | | | | |
| Trade payables | 747.4 | | 728.0 | |
| Tax | 296.6 | | 259.8 | |
| Accruals | 414.0 | | 390.3 | |
| | | 1,458.0 | | 1,378.1 |
| Total equity and liabilities | | 6,807.2 | | 5,416.1 |
| <i>Note: Paid in share capital represents 441.6 million shares of Z\$0.50 each</i> | | | | |
| Income statement | | <i>Year ended 31 December 2004</i> | | <i>Year ended 31 December 2003</i> |
| | | <i>Z\$ million</i> | | <i>Z\$ million</i> |
| Revenue | | 6,216.0 | | 5,810.8 |
| Total operating costs | | 5,104.8 | | 4,861.5 |
| Operating profit | | 1,111.2 | | 949.3 |
| Finance costs (net) | | -128.4 | | -98.1 |
| Tax expense | | -296.6 | | -259.8 |
| Profit for the period | | 686.2 | | 591.4 |
| Statement of changes in equity | | | | |
| | <i>Share capital Z\$ million</i> | <i>Share premium Z\$ million</i> | <i>Retained earnings Z\$ million</i> | <i>Total Z\$ million</i> |
| Balance at 31 December 2003 | 220.8 | 327.6 | 2,469.6 | 3,018.0 |
| Profit for the period | - | - | 686.2 | 686.2 |
| Dividends paid | - | - | -275.0 | -275.0 |
| Balance at 31 December 2004 | 220.8 | 327.6 | 2,880.8 | 3,429.2 |

Extracts for the next 5 years from Domusco's 10 year plan

| | <i>Actual</i> | <i>Plan</i> | | | | |
|--|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| | <i>2004</i> | <i>2005</i> | <i>2006</i> | <i>2007</i> | <i>2008</i> | <i>2009</i> |
| | <i>Z\$ million</i> | <i>Z\$ million</i> | <i>Z\$ million</i> | <i>Z\$ million</i> | <i>Z\$ million</i> | <i>Z\$ million</i> |
| Revenue | | | | | | |
| Major projects | 2,592.2 | 2,748 | 3,022 | 3,264 | 3,493 | 3,842 |
| Office building | 768.0 | 1,248 | 1,473 | 1,811 | 1,902 | 1,997 |
| House building | <u>2,855.8</u> | <u>3,541</u> | <u>3,896</u> | <u>4,246</u> | <u>4,671</u> | <u>5,231</u> |
| Total revenue | <u>6,216.0</u> | <u>7,537</u> | <u>8,391</u> | <u>9,321</u> | <u>10,066</u> | <u>11,070</u> |
| Pre-tax operating profit | | | | | | |
| Major projects | 576.0 | 616 | 684 | 746 | 805 | 894 |
| Office building | 86.1 | 138 | 158 | 195 | 205 | 215 |
| House building | <u>449.1</u> | <u>561</u> | <u>629</u> | <u>691</u> | <u>774</u> | <u>883</u> |
| Total pre-tax operating profit | <u>1,111.2</u> | <u>1,315</u> | <u>1,471</u> | <u>1,632</u> | <u>1,784</u> | <u>1,992</u> |
| Post tax profit for the period | <u>686.2</u> | <u>783</u> | <u>876</u> | <u>999</u> | <u>1,121</u> | <u>1,274</u> |
| Shareholder capital employed (Equity) | <u>3,429.2</u> | <u>3,900</u> | <u>4,424</u> | <u>5,023</u> | <u>5,696</u> | <u>6,460</u> |
| Loans (at end year) | <u>1,920.0</u> | <u>2,420</u> | <u>2,420</u> | <u>2,096</u> | <u>1,900</u> | <u>1,900</u> |
| Number of shares (million) | 441.6 | 441.6 | 441.6 | 441.6 | 441.6 | 441.6 |
| Earnings per share (EPS) Z\$ | 1.55 | 1.77 | 1.98 | 2.26 | 2.54 | 2.88 |

Note: Plan approved by Domusco Board in November 2004 and includes construction work for all contracts signed at that date (including Hadsji development)

End of Pre-seen Material