

## QUESTION BANK

### SECTION A

# ROLE AND RESPONSIBILITY TOWARDS STAKEHOLDERS

# A

### 1. Strategic, financial and ethical issues

The chairman of your company has become concerned about the accumulation of cash in hand and in the deposit accounts shown in the company's statement of financial position. The company is in the manufacturing sector, supplying aerospace components to the civil aviation markets in the UK and Europe. For the last 20 years the company has grown predominantly by acquisition and has not invested significantly in research and development on its own account. The acquisitions have given the company the technology that it has required and have all tended to be small, relative to the company's total market capitalisation. The company has a healthy current asset ratio of 1.3, although its working capital cycle has an average of 24 unfunded days.

The company has not systematically embraced new manufacturing technologies nor has it sought to reduce costs as a way of rebuilding profitability. Managerial and structural problems within divisions have led to a number of substantial projects overrunning and losses being incurred as a result, it has also proven difficult to ensure the accountability of managers promoting projects – many of which have not subsequently earned the cash flows originally promised. At the corporate level, much of the company's accounting is on a contracts basis and over the years it has tended to be cautious in its revenue recognition practices. This has meant that earnings growth has lagged behind cash flow.

Over the last 12 months the company has come under strong competitive pressure on the dominant defence side of its business which, coupled with the slow-down in spending in this area across the major western economies, has slowed the rate of growth of its earnings. The company's gearing ratio is very low at 12% of total market capitalisation and borrowing has invariably been obtained in the European fixed interest market and used to support capital investment in its European production facility. In the current year, investment plans are at the lowest they have been in real terms since the company was founded in the 1930s.

In discussion, the chairman comments upon the poor nature of the company's buildings and its poor levels of pay which could, in his view, be improved to reflect standards across the industry. Directors' pay, he reminds you, is some 15% below industry benchmarks and there is very little equity participation by the board of directors. He also points out that the company's environmental performance has not been good. Last year the company was fined for an untreated discharge into a local river. There are, he says, many useful things the company could do with the money to help improve the long-term health of the business. However, he does admit some pessimism that business opportunities will ever again be the same as in previous years and he would like a free and frank discussion at the next board meeting about the options for the company. The company has a very open culture where ideas are encouraged and freely debated.

The chairman asks if you, as the newly appointed chief financial officer, would lead the discussion at the next board.

#### Required:

- (a) In preparation for a board paper entitled 'Agenda for Change', write brief notes which identify the strategic financial issues the company faces and the alternatives it might pursue.

(10 marks)

- (b) Identify and discuss any ethical issues you believe are in the above case and how the various alternatives you have identified in (a) may lead to their resolution.

(10 marks)

**(20 marks)**

**(P4 December 2007)**

## 2: Role and Responsibility Towards Stakeholders

### 2. Strategic, financial and ethical issues - Solar Supermarkets

Solar Supermarkets, a listed company, is reviewing the approach that it should take to remunerating its executive directors and other senior managers. Over the years, the company's share price has performed well although there is now concern that price and cost competition from overseas entrants into the domestic market will have a significant impact on the firm's profitability. As a result, the directors believe that large investment in new technologies and markets will be required over the next five years. Traditionally, management has been rewarded by salary, a generous system of benefits, and a bonus scheme that has taken up to 4% of turnover. The directors are considering introducing a generous share option scheme with a five year vesting period.

There is also a view, expressed by some of the company's principal equity investors, that the company should consider returning cash to them through the sale of its property holdings. The company has over 200 stores nationally and 15 overseas, of which all except five are owned by the company. In the domestic economy, growth in the value of commercial property has averaged 8% per annum in recent years whilst retail growth has remained static at 5.5%. A sale and leaseback, or the flotation of a separate property company that would rent the stores to Solar Supermarkets at commercial rates, are two suggestions that have been made at investor meetings. Either approach, it is suggested, would return value to investors and create a supply of capital for further expansion. There have been press rumours, possibly fed from sources within the investor community, that the company may be a target for a private equity acquisition. However, no formal approach has been made to the company.

The only other area of controversy to emerge about the company which has concerned the directors followed an announcement about the company pension scheme. Although the scheme is well funded the directors took the decision to close the current final salary scheme to new employees and to replace it with a money purchase scheme. Current employees would not be affected.

#### Required:

Discuss the strategic, financial and ethical issues that this case presents and the merits of the proposed share option and sale and leaseback schemes.

(20 marks)  
(P4 December 2008)

### 3. Regulatory, financial and ethical issues - Saturn Systems

Mr Moon is the CEO of Saturn Systems, a very large listed company in the telecommunications business. The company is in a very strong financial position, having developed rapidly in recent years through a strategy based upon growth by acquisition. Currently, earnings and earnings growth are at all-time highs although the company's cash reserves are at a low level following a number of strategic investments in the last financial year. The previous evening Mr Moon gave a speech at a business dinner and during questions made some remarks that Pluto Limited was an attractive company with 'great assets' and that he would be a 'fool' if he did not consider the possibility 'like everyone else' of acquiring the company. Pluto is a long established supplier to Saturn Systems and if acquired would add substantially to the market capitalisation of the business.

Mr Moon's comments were widely reported in the following morning's financial newspapers and, by 10 am, the share price of Pluto had risen 15% in out-of-hours and early trading. The first that you, Saturn's chief financial officer, heard about the issue was when you received an urgent call from Mr Moon's office. You have just completed a background investigation of Pluto, along with three other potential targets instigated at Saturn's last board meeting in May. Following that investigation, you have now commenced a review of the steps required to raise the necessary debt finance for a bid and the procedure you would need to follow in setting up a due diligence investigation of each company.

On arriving at Mr Moon's office you are surprised to see the chairman of the board in attendance. Mr Moon has just put down the telephone and is clearly very agitated. They tell you about the remarks made by Mr Moon the previous evening and that the call just taken was from the Office of the Regulator for Public Companies. The regulator had wanted to know if a bid was to be made and what announcement the company intended to make. They had been very neutral in their response pending your advice but had promised to get back to the regulator within the hour. They knew that if they were forced to admit that a bid was imminent and then withdrew that they would not be able to bid again for another six months. Looking at you they ask as one: 'what do we do now?' After a short discussion you returned to your office and began to draft a memorandum with a recommendation about how to proceed.

**Required:**

- (a) Assess the regulatory, financial and ethical issues in this case. (15 marks)
- (b) Propose a course of action that the company should now pursue, including a draft of any announcement that should be made, given that the board of Saturn Systems wishes to hold open the option of making a bid in the near future. (5 marks)
- (20 marks)**  
**(P4 June 2008)**

**4. Listing and ethical issues - Martin Pickle**

You have been appointed as the chief financial officer of a multimedia company which is financed by private equity. There is considerable public interest in the company and it continues a very rapid rate of growth under the leadership of its dynamic founder and chief executive officer, Martin Pickle. Martin Pickle owns over 30 per cent of the company's equity and has also loaned the business substantial sums to sustain its overseas development. The balance of the other investors consist of some small shareholdings held by current and past employees and the remainder is in the hands of a private equity company which is represented by two directors on the board.

You enjoy a substantial salary and package of other benefits. Your role description gives you overall responsibility to the board for the financial direction of the company, the management of its financial resources, direction and oversight of its internal control systems and responsibility for its risk management. After two months in the job you are called to a meeting with Martin Pickle and the company's non-executive chairman. In that time you have made significant progress in improving the financial controls of the business and the current year end, which is three weeks away, looks very promising. The company's underlying earnings growth promises to be in excess of 20 per cent and its cash generation is strong. The CEO tells you that he would like you to put together a plan to take the company to full listing as a first step to him undertaking a substantial reduction in his financial stake in the business. He tells you that this discussion must be confidential, as he expects that the market would react adversely to the news. However, he would like to see what could be done to make sure that the year-end figures are as strong as possible. Given your performance, he also tells you that they would like to offer you a substantial incentive in the form of share options.

**Required:**

- (a) Prepare a board paper, describing the procedure for obtaining a listing on an international stock exchange such as the London or New York Stock Exchange. (6 marks)
- (b) Prepare a briefing note, itemising the advantages and disadvantages of such a step for a medium-sized company. (6 marks)  
(Including 2 professional marks)
- (c) Discuss any ethical considerations or concerns you may have concerning this proposed course of action. (8 marks)
- (20 marks)**  
**(P4 Pilot paper)**

**5. Financial performance review - International Enterprises**

You are the chief financial officer of International Enterprises, a multinational company with interests in Europe and the Far East. You are concerned about certain aspects of the company's financial management. The company has enjoyed a high rate of growth over the last three years as a result of a single product's development. This product has had a big impact in the fast moving mobile communications industry. However, the company does not have any new products in development and is relying on expanding its market share and developing upgraded versions of the current product.

As part of your preparation for the board meeting to discuss the 2007 draft accounts, you have prepared a projected income statement and statement of financial position for the year ending 31 December 2008. These projections are based upon a number of agreed assumptions taken from the company's strategic plan. As part of the agenda, the board will also consider its dividend target for the forthcoming year.

## International Enterprises

## Income statement for the year ended 31 December

	2008 (projected) \$m	2007 (draft) \$m	2006 (actual) \$m
Revenue	288.1	261.9	220.0
Cost of sales	143.2	132.6	104.0
Gross profit	144.9	129.3	116.0
Less other operating costs	36.1	27.0	24.0
Operating profit	108.8	102.3	92.0
Finance costs	1.8	2.3	2.3
Profit before tax	107.0	100.0	89.7
Income tax expense (at 30%)	32.1	30.0	26.9
Profit for the period	74.9	70.0	62.8

## Statement of Financial Position as at 31 December

	2008 (projected) \$m	2007 (draft) \$m	2006 (actual) \$m
<b>Non-current assets (see note)</b>			
Buildings, plant and machinery	168.0	116.0	96.0
<b>Current assets</b>			
Inventories	3.2	3.7	2.3
Receivables	25.6	29.1	19.6
Cash	151.8	155.8	121.7
<b>Total current assets</b>	<b>180.6</b>	<b>188.6</b>	<b>143.6</b>
<b>Total assets</b>	<b>348.6</b>	<b>304.6</b>	<b>239.6</b>
<b>Equity and liabilities</b>			
Paid up share capital			
Ordinary shares (25c)	25.0	25.0	20.0
Other reserves	12.0	12.0	10.0
Retained earnings	216.9	170.0	120.0
Less dividends payable	(0.0)	(28.0)	(20.0)
<b>Total equity</b>	<b>253.9</b>	<b>179.0</b>	<b>130.0</b>
<b>Current liabilities</b>			
Trade payables	8.8	7.7	6.4
Tax payable	28.5	25.6	23.3
Dividends payable	0.0	28.0	20.0
Interest payable	1.8	2.3	2.3
<b>Total current liabilities</b>	<b>39.1</b>	<b>63.6</b>	<b>52.0</b>
<b>Non-current liabilities</b>			
Loans	35.0	45.0	45.0
Provisions (deferred tax)	20.6	17.0	12.6
<b>Total non-current liabilities</b>	<b>55.6</b>	<b>62.0</b>	<b>57.6</b>
<b>Total liabilities</b>	<b>94.7</b>	<b>125.6</b>	<b>109.6</b>
<b>Total equity and liabilities</b>	<b>348.6</b>	<b>304.6</b>	<b>239.6</b>
<b>Note</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>
	<b>\$m</b>	<b>\$m</b>	<b>\$m</b>
Non-current assets	280.0	200.0	160.0
Less accumulated depreciation	112.0	84.0	64.0
Net book value of non-current assets	168.0	116.0	96.0

The projected figures assume:

- (i) \$10 million of the existing loans will be repaid during the year.
- (ii) Capital investment in plant and equipment of \$80 million will be undertaken.