Final Admitting Examination

Chartered Accountants Ireland

PAPER 3 ADVANCED PERFORMANCE MANAGEMENT

SUMMER 2016 Friday 19th August 2016: 10.00 am - 2.30 pm

INSTRUCTIONS TO CANDIDATES

1. The first 30 minutes of this examination is dedicated to reading time.

During this time, candidates may make notes on this examination paper or on their own paper and refer to their materials.

Candidates are **NOT** permitted to open their answer books until instructed to do so.

2. Answer **BOTH** Simulations.

3. Candidates should indicate clearly in their ANSWER BOOKLET whether they are answering the paper in accordance with the law and practice of Northern Ireland or the Republic of Ireland.

4. Candidates should deem each monetary amount shown with the €/£ symbol to be stated in their relevant currency.

5. All workings should be shown.

6. **Simulation 1** begins on page 2 overleaf.

Appendices for SIM 1 & SIM 2 are included within this paper.

SIM 1: GOURMET GOODIES

(Suggested time: 120 minutes)

You are Jennifer Carroll, accountant, responsible for analysis of projects and investment opportunities at Gourmet Goodies plc ("GG"). You are working with the chief executive Martin Stuart on a number of projects.

GG is an Irish company that manufactures a range of luxury food brands, which are distributed throughout Europe, primarily through upmarket food stores and delicatessen outlets.

The company has managed to survive several years of recession through a combination of reduction in manufacturing capacity (including associated staff reductions), re-pricing of certain product ranges and aggressive marketing efforts in order to maintain their share of a shrinking European market.

Martin has decided to pursue a number of potential growth opportunities both within and outside Europe and is particularly keen to explore the potential for GG in the United States.

One morning, Martin pays you a visit at your desk and asks you to prepare a paper for him and the board outlining what methods they might employ to do business in the U.S. In particular, Martin is keen to understand the relative merits and issues of each method considered and how distribution might be established for each method.

Option 1

Martin has identified a potential acquisition target, Happy Hamperz Inc. ("HH"). HH is a Boston-based manufacturer of high-end food hampers, focusing on seasonal markets, such as Thanksgiving and Christmas.

Martin feels that HH might be a good fit for GG as a way of breaking into the US market. He has commissioned an analysis firm, Munchie Numbers ("MN"), who specialise in this industry segment, to produce a report on HH, including an indicative business valuation (see **Appendix I**).

Option 2

Martin has also sourced and paid for an independent analysis of the setup costs of establishing GG directly in the United States, including the lease of a manufacturing facility (see **Appendix II**). You can assume this option will generate the same cash flows as those used in the 5 year forecast for HH.

Martin would like an analysis of the two investment options over a 5-year timeline and a recommendation based on the analysis. Martin states that this analysis can be completed in US dollars without the need to convert the analysis back into local currency. GG's standard weighted average costs of capital (W.A.C.C.) is 10%.

The C.F.O. of GG, Don Cooper, has been eager to caution Martin that doing business in the USA could be fraught with financial risk, particularly in the areas of interest rates and exchange rates and for these reasons is reluctant to support any expansion of GG outside the EU. He has prepared a summary of the relevant interest and foreign exchange rate movements, which shows significant movements in recent years. (see **Appendix III**) Martin asks for a brief outline of the relationship between interest rates and foreign exchange and how the GG might mitigate its potential exposure in the context of capital investment outside the EU, such as the potential acquisition of HH.

"On a separate but related matter", says Martin, "There has been a lot of international consolidation in the consumer foods sector. I wonder should we be considering the potential to invite investment in GG from large multi-national groups with interests in the consumer foods business sector. Without any detailed consideration of what form that investment might take, could you put together a paper on what might be the rationale for such a group to do business in Ireland with a business like GG?"

APPENDIX I: REPORT – INDICATIVE BUSINESS VALUATION OF HAPPY HAMPERZ INC.

To: Martin Stuart, C.E.O., Gourmet Goodies plc
From: Chad Kroeger, analyst, Munchie Numbers Inc.
Cc: Don Cooper, C.F.O., Gourmet Goodies plc

Having considered the assets, revenues, profits and potential future growth of Happy Hamperz Inc., along with the current and future direction of the economic environment in which the firm operates, we value Happy Hamperz Inc. between $ 18m to $ 22m.

5 Year Forecast Cash-flows for Happy Hamperz:

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Sales (inflows)	$ 12m	$ 16m	$ 18m	$ 18m	$ 20m
Costs (outflows)	$ 7m	$ 10m	$ 9m	$ 8m	$ 8m

These forecasts assume benefit of synergies with Gourmet Goodies plc.

APPENDIX II: INDICATIVE SET-UP & OPERATING COSTS FOR GOURMET GOODIES PLC IN THE US

Lease of manufacturing facility (payable in advance starting “Year Zero”)	$ 4.5m per year for 5 years
Initial factory fit-out and commissioning	$ 3m
Initial recruitment costs	$ 2m
Research of potential acquisition target costs and fees	$0.5m
Initial regulatory and admin costs	$ 2m
Distribution and marketing costs	$ 2m per year for 5 years

APPENDIX III: US FED & EURIBOR/LIBOR INTEREST & FOREIGN EXCHANGE RATES OVER THE LAST 5 YEARS

Year	Euribor/Libor Interest Rate	US Fed Interest Rate	1 USD = €/£ FX rate
0 (Current year)	0.40%	0.10%	1.067
-1	0.75%	0.10%	1.276
-2	1.00%	0.15%	1.277
-3	1.50%	0.20%	1.236
-4	2.00%	0.25%	1.337

END OF SIM 1

SIM 2: DUNROAMIN' PLC
(Suggested time: 120 minutes)

It is August 19th 2016 and you are Grace Jones, a chartered accountant and you recently joined Dunroamin' plc ("DR"). DR is an Irish spirit manufacturer and has a number of distilleries based in Ireland. The company is listed and is lowly geared.

DR is well-known, boasting several flagship spirit brands; however DR has seen very rapid international expansion of its key branded whiskey called "Gravelle™". Gravelle™ whiskey is a unique pale, highly distilled whiskey. The distillation and ageing process gives Gravelle™ a very smooth finish and it is seen as the perfect introductory whiskey. Gravelle™ has won the gold medal every year for the past 3 years at the world whiskies awards and this has attracted the attention of the Chinese consumer markets.

Potential opportunity
The board met in April 2016 in response to phenomenal overseas demand that is putting a strain on the supply chain of DR. At that meeting the board tentatively agreed to acquire Zedroo ("ZED"), a private family owned distilling, bottling and distribution facility south of the industrial district of Shenzhen on the Hong Kong side of the border with China. Zed is established and has long supplied into China. The facility qualifies under the special administrative region of Hong Kong which allows for foreign companies to acquire an overseas subsidiary without having to enter joint venture arrangements. A number of issues surrounding the potential acquisition were discussed and clarity has been sought on a number of matters. These will be brought up at the next board meeting and hopefully pave the way for the deal to be concluded in December 2016.

Finance director, Jim Kerr calls you into his office for a discussion. "Grace, as you know the board are very excited at the prospect of establishing an operation overseas. However there are a number of issues that I would like you to examine and outline in a report that I will present to the board at the end of the month."

"I have attached a couple of notes for you to review. Firstly, I have sent you the investment appraisal that was used in the provisional approval of the project (see **Appendix I**). Secondly, I have been tracking currency movements and I have attached the movement of rates for 2016 (see **Appendix II**). Finally I have attached some economic data relevant to the project (see **Appendix III**). What worries me Grace is the fact that there has been some volatility with the Hong Kong Dollar. The region has been performing so strongly so I am wondering why the volatility exists. Can you outline for the board the main economic factors that are relevant to DR investing in a location like this?"

Challenges
As you are taking notes, Jim continues the conversation. "Grace, it is equally important for us to understand what we are getting into 'on the ground', so to speak. I am very confident that the product will be distilled to our exacting standard; the net present value of the investment appraisal analysis is positive, however we will be faced with political, legal and cultural differences as well as the enormous operational and logistical challenges. I would like to get your views on these as well as how we may mitigate against them in your report."

"Also, the board will need clear guidance on how we are going to finance the acquisition. There were a number of widely held opinions as to whether we should raise further equity or incur debt to fund the expansion. I am conscious that the board agreed to pay for the acquisition in HK$ so could you consider how DR may appropriately fund the acquisition of ZED. Also, given the volatility in exchange rates the board are keen to minimise currency risk between now and the deal closing date, can you specifically look at what hedging techniques we might use? **Appendix II and III** should contain sufficient data to allow you to carry out some techniques".

Performance

As you start to leave the office Jim calls you back; "Grace, one final thought, we are sending over Charles Burchill, our vastly experienced operations manager. Charles and his team will oversee the running of the operation and as part of that Charles will implement our accounting systems, however the board feel it prudent at this time that we give some thought as to how we will measure performance of ZED. I have considered setting financial targets such as return on investment (ROI) or residual income (RI) as a means of incentivising the team; however I think the board would like to see a wider set of measures being proposed. Can you conclude your report with a section outlining what we should consider?"

You head back to your desk and start to prepare the report as required.

APPENDIX I: INVESTMENT APPRAISAL TO ASSESS THE ACQUISITION OF ZED

Prepared using exchange rate at April 2016	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
All values denoted in HK$	HK$ m	HK$ m	HK$ m	HK$ m	HK$ m	HK$ m
Sales Forecast		765.45	838.35	991.44	1,071.63	1,151.82
Less Manufacturing costs		(214.33)	(243.12)	(297.43)	(332.21)	(368.58)
Taxable cash-flows		551.12	595.23	694.01	739.42	783.24
Tax payable 15% in Hong Kong current year basis		(82.67)	(89.28)	(104.10)	(110.91)	(117.49)
Initial Investment	(1,275.54)					
Working capital	(1,020.43)					1,020.43
Net flows	(2,295.97)	468.46	505.94	589.91	628.51	1,686.18
Discount Factors 9%	1.00	0.92	0.84	0.77	0.71	0.65
Present Values	(2,295.97)	430.98	424.99	454.23	446.24	1,096.02
NPV HK$	556.49					

APPENDIX II: TABLE OF FOREIGN EXCHANGE RATES

Exchange Rates: Hong Kong $		
Date	**€ Euro**	**£ Stg**
	€ 1 = HK$	£ 1 = HK$
Apr-16	7.2888	9.3101
May-16	7.3926	9.4474
Jun-16	7.4145	9.4667
Jul-16	7.4317	9.4816
Aug-16	7.4869	9.5201
Sep-16*	7.5363	9.5567
Oct-16*	7.5916	9.5944
Nov-16*	7.6884	9.6732
Dec-16*	7.8126	9.7955

*Projected rates available from FX dealers

APPENDIX III: COMPARATIVE ECONOMIC INDICATORS

Economic indicators	Ireland	UK	Hong Kong	China
Population (million)	4.8	64.1	7.1	1,401
Gross Domestic Product (GDP) (US$ bn)	227	2,988	274	11,385
GDP per capita (US$)	48,900	41,787	38,123	8,300
GDP growth (last 12 months)	5.20%	2.20%	2.90%	6.90%
Inflation rate (last 12 months)	-0.30%	0.00%	2.50%	1.50%
Deposit rates (current)	0.45%	1.60%	2.00%	2.25%
Borrowing rates (current)	3.60%	2.80%	3.50%	3.75%
Corporation Tax Rate	12.50%	20%	15%	25%
Unemployment rate	8.60%	5.40%	3.30%	4.10%

END OF SIM 2

END OF PAPER