Wednesday 12 March 2014 **(4 hours including reading time)**

ICAN CASE STUDY PILOT PAPER 1

CANDIDATE NUMBER

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

1. When instructed:

   a. check that your question paper contains all the required pages. The Institute's consecutive page numbering may be found under the base line at the foot of each page;

   b. enter your candidate number in the box provided above.

2. Number each page of your answer consecutively using the space provided at the top right of each sheet.

3. After the instruction to stop writing at the end of the paper, you will be given five minutes to assemble your answer in this folder. Fasten your complete script inside this folder using the hole in the back page and the tag provided.

4. Answer folders and examination stationery, used or unused, must **not** be removed from the Examination Hall. <u>Question papers may, however, be retained by candidates</u>.

ICAN Case Study

Pilot Paper 1

Requirement

You are Austin Peterson, a final year trainee in the firm of Moses Oku Chartered Accountants. You are to prepare a draft report to Philip Jasper, the Managing Director of a client company, Clear Grow Limited, as set out in the memo **(Exhibit 1)** from Stella Weaving, one of the directors of the business advisory arm of the firm Moses Oku.

The following overall time allocation is suggested:

Reading	1 hour
Planning and calculations	1 hour
Drafting report	2 hours

LIST OF EXHIBITS

Exhibit	Description
1	Email from Stella Weaving, partner in Moses Oku Chartered Accountants to you, Austin Peterson
2	Email from Philip Jasper, Managing Director of Clear Grow Limited (CG Ltd), your client, to Stella Weaving
3	3-year summarized financial statements Clear Grow Limited to 31 December 2013
4	Explanatory notes to the Clear Grow Limited financial statements
5	Letter from of Prizeman plc outlining their bid proposal for acquiring Clear Grow Limited
6	Prizeman plc financial statements for the 2-years ended 31 December 2013
7	Explanatory notes to the Prizeman plc financial statements

EXHIBIT 1

Moses Oku

Email

From: Stella Weaving
To: Austin Peterson
Re: Clear Grow Limited
Date: 12 March 2014

We have received an email from Philip Jasper, the Managing Director of one of our clients, Clear Grow Ltd (CG), a software development business, which I have attached to this email (**Exhibit 2)** together with all the attachments which he sent to me (**Exhibits 3-7**).

The attachments include a summary set of CG financial statements for the three years ended 31st December 2013 (**Exhibit 3**) together with explanatory notes relating to the summary financial statements (**Exhibit 4**).

As Philip Jasper states CG has been approached by Prizeman plc (Prizeman) who are willing to make a bid to buy the whole of the CG business – the details of the Prizeman proposal are shown in **Exhibit 5**. Prizeman has also sent a set of summary financial statements for the year ended 31 December 2013 together with the comparative figures for 2012 **(Exhibit 6).** Prizeman has also provided a set of explanatory notes relating to their financial statements (**Exhibit 7**).

I have spoken to Philip today and confirmed that CG would like us to provide a report identifying the key financial strengths and any weaknesses as shown in Prizeman's financial statements and explanatory notes, in comparison with the strengths and weaknesses as identified in the information supplied by CG.

Required

Using the attached information prepare a draft report to Philip Jasper. Your report should comprise
Either

1. **A**. An analysis of the key business, operational and financial, strengths and weaknesses as shown in the Prizeman information and financial statements.

Or

1. **B.** An analysis of the key business, operational and financial strengths and weaknesses as shown in the Clear Grow information and financial statements.

In the analysis of either company your report should only concentrate on the key figures and issues, and should provide a clear explanatory commentary together with your judgement and conclusions on the key items which you identify.

2. A calculation of the potential valuation of Clear Grow using the Prizeman criteria (**Exhibit 5**) and an evaluation and commentary on that valuation and the criteria which Prizeman has proposed, from Clear Grow's perspective.

EXHIBIT 2

CLEAR GROW LIMITED

Email

From: Philip Jasper
To: Stella Weaving
Re: Bid for Clear Grow Limited
Date: 10 March 2014

Dear Stella,

Please find attached a summary set of Clear Grow's financial statements for the three years ended 31 December 2013 together with a set of explanatory notes. The figures in these financial statements are in agreement with the audited financial statements for each of those years. This information will provide you with a comprehensive financial picture of the financial history of our business.

Clear Grow Limited future strategy

CG will continue with its robust development of significant new software for personnel analysis and accounting – in line with market demand. The next product is almost complete and it is anticipated to go "full to market" during 2014. This will have a significant impact on software revenues. Other areas of revenue should also increase in line with or ahead of past trends.

Overall CG's market is seen as strong. CG's clients are loyal and the company anticipates further growth from within its client base and by way of new market developments.

CG has an employment and management strategy which will allow it to achieve real anticipated growth. CG invests strongly in its skilled workforce and recruits ahead of time offering good remuneration and training packages. It has a collegiate philosophy and operates its employment policies with transparent incentives and good opportunities for advancement within the business. These practices help to ensure its success. Outsourcing is not considered to be an option.

CG will continue to invest heavily but appropriately in new IT facilities according to the availability of finance and in anticipation of market needs. CG also has a firm commitment to stick to its core business. The company will not seek external finance

Clear Grow as a target for other companies

CG is becoming of interest to other businesses seeking to acquire it. CG is new to this situation and the board of directors are aware that although it is flattering to be the subject of this attention they do not have any prior experience in either valuing the CG business or in critically appraising the bids which might come in from other organisations.

As a result at recent board meetings there has been an on-going discussion concerning the process which might develop including what strategies might be open to CG to "present the company in the best possible light to any bidder". CG has never previously "window dressed" its financial results although it is aware that other companies do adapt such an approach.

Coincidentally Clear Grow Limited has recently received a bid proposal from Prizeman plc. Please find attached Prizeman's bid letter (**Exhibit 5**); a set of Prizeman 2013 and 2012 financial statements (**Exhibit 6**) together with explanatory notes (**Exhibit 7**) for your analysis.

Prizeman Group plc (Prizeman)

From our initial enquiries CG have established the following facts concerning Prizeman:

- Prizeman is a software development business providing software to the legal profession for house purchasing and planning purposes.

- Prizeman was formed in 2006 after a number of smaller businesses merged. Prizeman was listed on the stock exchange more than five years ago, following the takeover of a company named Dataland Limited. The takeover of another company, ARP, occurred in 2012. These actions identify that Prizeman has "actively pursued a policy of expansion by acquisition and merger … [believing] that growth by acquisition enables the group to achieve its targets in an accelerated timeframe".

- Prizeman seeks enterprise based organisations where owners are also managers. It requires its targets to meet certain basic financial and other key criteria: a constant pattern of growth over the past five years; positive cash flow; balance sheet showing a position of positive net assets.

- Prizeman's two recent takeovers have been valued on a multiple of adjusted net earnings, the purchase consideration comprising cash and Prizeman shares.

- According to the limited financial information provided in **Exhibit 6**, Prizeman's gross revenue at ₦21,461million indicates that Prizeman generates substantially more revenue than CG and having total assets of ₦19,832million compared with CG's N4,418million, Prizeman appears to be a much bigger business.

- Prizeman operates in a related industry. Prizeman's method of valuing its targets, by a multiple of adjusted net earnings is one method of valuing CG but it needs to be critically evaluated.

Instructions

The Board of Clear Grow Limited would like to instruct Moses Oku to:

1. perform a critical analysis of the strengths and weaknesses of the financial statements and operations of Prizeman plc in comparison with the financial statements and operations of CG

2. use the Prizeman criteria to calculate the potential valuation of CG and provide an evaluation and commentary on that valuation and the criteria which Prizeman has proposed, from CG's perspective.

I look forward to receiving your report in the near future.

Yours sincerely

Philip Jasper

Managing Director Clear Grow Limited

Clear Grow Limited 3 year financial summary (to 31 December 2013)

Clear Grow Limited
Extracts from summary financial statements for the 3 years ended 31 December 2013
(Updated 7 March 2014)

Statement of profit and loss

Year ended 31 December	**Notes**	**2013 ₦'million**	**2012 ₦'million**	**2011 ₦'million**
Revenue	1	**12,583**	**11,354**	**9,079**
Cost of sales	2	(454)	(428)	(340)
Gross Profit		**12,129**	**10,926**	**8,339**
Administrative expenses	3	(10,709)	(9,557)	(7,208)
Earnings before interest, tax, depreciation		**1,420**	**1,369**	**1,131**
Depreciation and amortisation	4	(337)	(527)	(516)
Profit (Loss) on disposals	4	(6)	(10)	(13)
Operating profit		**1,077**	**832**	**602**
Finance income		101	80	54
Profit before tax		**1,178**	**912**	**656**
Taxation		(294)	(228)	(164)
Profit after tax		**884**	**684**	**492**
Dividend		(350)	(300)	(250)
Profit for the period		**534**	**384**	**242**

Clear Grow Limited
Statement of financial position
As at 31 December

	Notes	2013	2012	2011
		₦'million	**₦'million**	**₦'million**
Non-current assets				
Intangible assets	4	200	220	240
Tangible assets	4	511	556	595
		711	776	835
Current assets				
Inventories	5	77	67	62
Accounts receivable	6	2,175	1,713	1,088
Cash and cash equivalents		1,455	1,151	1,087
		3,707	2,931	2,237
Total assets		**4,418**	**3,707**	**3,072**
Shareholders' equity				
Ordinary share capital	7	50	50	50
Retained earnings		2,596	2,062	1,678
Total shareholders' equity		2,646	2,112	1,728
Current liabilities				
Accounts payable	8	623	631	533
Taxes payable		334	258	224
Contract payments received in advance	9	815	706	587
Total current liabilities		1772	1595	1344
Total shareholder's equity and liabilities		**4,418**	**3,707**	**3,072**

Clear Grow Limited
Statement of cash flow

Year ended 31 December	2013	2012	2011
	₦'million	₦'million	₦'million
Cash flows from operating activities			
Profit before tax	1,178	912	656
Adjustments for:			
Depreciation and amortisation	337	527	516
Other operating income (profit on disposals)	6	10	13
Finance income	(101)	(80)	(54)
Change in accounts receivables	(462)	(625)	(389)
Change in inventories	(10)	(5)	(26)
Change in accounts payable (trade)	(8)	98	42
Cash generated from operations	**940**	**837**	**758**
Interest received	101	80	54
Income taxes paid	(218)	(194)	(131)
Contract payments received in advance	109	119	112
Net cash from operating activities	**932**	**842**	**793**
Investing activities			
Proceeds from disposal of plant and equipment	2	6	8
Purchase of property, plant and equipment	(280)	(484)	(437)
Net cash used in investing activities	**(278)**	**(478)**	**(429)**
Financing activities			
Dividends paid	(350)	(300)	(250)
Net cash (used in)/from financing activities	**(350)**	**(300)**	**(250)**
Net change in cash and cash equivalents	**304**	**64**	**114**
Cash and cash equivalents at start of year	**1,151**	**1,087**	**973**
Cash and cash equivalents at end of year	**1,455**	**1,151**	**1,087**

EXHIBIT 4

Notes to the Clear Grow financial statements for the three years ended 31 December 2013

Note 1 Revenue

	2013	2012	2011
	₦'million	₦'million	₦'million
Sales of software and software installation	9,282	8,764	6,904
Training courses income	989	817	776
Support services under contract	2,116	1,591	1,231
Other	196	182	168
	12,583	**11,354**	**9,079**

Sales of software increased significantly in 2011 & 2012 caused by a new product sales push. This has been followed by a smaller increase in sales in 2013, which has been a significant year for major new product development.

Support services under contact represents fees earned by selling support services contracts to those clients who buy CG products. These are annual contracts which are renewable by negotiation.

Support service contracts are taken out by clients when they initially purchase CG software packages. In 2013 these were taken out by the majority of all new clients. A smaller proportion of these clients renew their service contracts for subsequent years.

An appropriate proportion of the support service receipts is carried forward in the balance sheet as contract payments received in advance (**Note 9**).

There has been a continued steady increase in training course income.

Note 2 Cost of sales

Cost of sales are royalty payments made to the original suppliers of the software for sales made by CG. All subsequent product development has been based on this software.

Note 3 Administrative expenses

	2013	2012	2011
	₦'million	₦'million	₦'million
Staff salaries	6,597	5,804	3,957
Staff bonus	597	487	285
Directors' emoluments	1,950	1,825	1,685
Marketing	843	758	776
Other	722	683	505
	10,709	**9,557**	**7,208**
The directors emoluments comprised:			
Victor Grow	525	500	460
Abigail Grow	650	600	550
Philip Jasper	775	725	675
Total	**1950**	**1825**	**1685**

Note 4 Non-current assets

Intangible assets

Cost: Software distribution rights were purchased from Victor and Abigail Grow in January 2009 for ₦ 300million.

Amortisation of the purchase price of those software distribution rights is on a straight line basis over 15 years = ₦ 20million per annum.

Tangible assets
The company's policy on depreciation is to write down the value of all assets over their commercial useful life on a straight line basis, pro-rated monthly: computer equipment 33.33%; office furniture 15%; motor vehicles 25%.

The profits and losses on vehicle disposal occur largely as a result of regular changes and upgrades in the vehicles which are used by CG consultants to travel to CG's clients located throughout the country.

Any IT and office equipment disposal is normally donated to charitable organisations or local schools at ₦nil proceeds (after the removal of all software in the case of IT equipment).

Note 5 Inventories
Inventories represent items of office and computer supplies held in the normal course of trade.

Note 6 Accounts receivable
The accounts receivable balance represents the balance of all items invoiced to clients which remain outstanding at the year end. The balance of outstanding accounts receivable has grown in recent years but the company has traditionally experienced a very small level of bad debts.

Note 7 Share capital
The shares are held by the three directors: Victor Grow 40%; Abigail Grow 30%; Philip Jasper 30%

Note 8 Contract payments received in advance
This represents the advance proportion of the amounts received from customers concerning their annual support services contracts which remain to be delivered.

EXHIBIT 5

PRIZEMAN GROUP PLC

The Board of Directors
Clear Grow Limited

Dear Sirs/Madam,

Re: Prizeman Group plc investment in Clear Grow Limited [Subject to contract]

Following previous correspondence and various telephone calls Clear Grow Limited (CG) is asked to consider the following offer, on behalf of Prizeman Group plc (Prizeman), to purchase the whole of Clear Grow Limited as a going concern – subject to shareholder approval and subject to contract.

Prizeman would be willing to purchase the entire share capital of CG for a multiple of CG's adjusted net profit after tax.

- Prizeman will use as the basis for a valuation the CG accounts to 31 December 2013.
- Prizeman proposes that the multiple should be 6 times the adjusted net profit after tax.
- The adjustments Prizeman suggests to be made would be to increase the 2013 net profit after tax, by adding back to profit any directors' emoluments for the three key shareholders in excess of ₦600million in total.
- The purchase price would comprise ₦2,000million in cash (raised either by debenture or by a rights issue), payable as soon as the purchase is complete, together with the balance in Prizeman Group plc shares at market price (currently quoted at ₦15 per share).

In our opinion, these adjustments would bring Clear Grow's accounting and remuneration policies into line with Prizeman's policies and make any comparisons of those policies easy. It would also provide a higher profit figure on which the multiple would be applied.

We would also like to offer the Clear Grow Managing Director a place on the Prizeman Group plc board as well as requesting that all the current Clear Grow directors be contracted to remain within Clear Grow in their working roles for a period of 36 months at a remuneration figure to be mutually agreed, but not exceeding ₦200million per annum each.

This letter should be read as the first step in the negotiation process but should provide Clear Grow with a clear indication of Prizeman's serious acquisition intentions.

Please find below extracts from Prizeman Group plc's latest accounts – for the year to 31 December 2013 – together with a commentary on the key figures which should substantiate the opinion of the Prizeman board of directors that Prizeman Group plc is a group moving in the right direction. Please note that although Prizeman Group plc has not declared a dividend in the past it is its intention to pay dividends in the future.

Yours faithfully

George Adams

CEO Prizeman plc (on behalf of Prizeman plc Board)

Prizeman Group plc

(Extracts from group accounts)

Consolidated Income Statement

Year ended 31 December 2013

	Commentary	2013 N'million	2012 N'million
Revenue	1	21,461	15,766
Cost of sales	2	(7,403)	(5,572)
Gross profit		**14,058**	**10,194**
Administrative expenses	3	(9,218)	(7,527)
Earnings before interest, taxation, depreciation and impairment (EBITDI)		**4,840**	**2,667**
Impairment	4	(550)	(468)
Depreciation	5	(594)	(403)
Loss on disposal		(198)	(146)
Operating profit		**3,498**	**1,650**
Finance costs		(363)	(179)
Profit before tax		**3,135**	**1,471**
Taxation		(783)	(368)
Profit for the period		**2,352**	**1,103**

Prizeman Group plc

(Extracts from group accounts)

Consolidated statement of financial position

As at 31 December 2013

	Commentary	2013 N'million	2012 N'million
Non-current assets			
Intangible assets	4	9,157	9,707
Tangible assets	5	2,116	961
		11,273	10,668
Current assets			
Inventories - Work in Progress	6	4,301	2,552
Accounts receivable		4,136	2,761
Cash and cash equivalents		122	238
		8,559	5,551
Total assets		**19,832**	**16,219**
Shareholders' equity			
Ordinary share capital	7	8,540	8,540
Retained earnings		4,090	1,738
Total shareholders' equity		12,630	10,278
Non-current liabilities			
Loan	8	4,000	4,000
Total non-current liabilities		4,000	4,000
Current liabilities			
Accounts payable		2,408	1,529
Taxes payable		794	412
Total current liabilities		3202	1941
Total shareholder's equity and liabilities		**19,832**	**16,219**

Prizeman Group plc

(Extracts from group accounts)

Consolidated statement of cash flow

Year ended 31 December 2013

	Commentary	2013 N'million	2012 N'million
Cash flows from operating activities			
Profit before tax		3,135	1,471
Adjustments for:			
Finance costs		363	179
Impairment	4	550	468
Depreciation	5	594	403
Loss on disposals		198	146
Change in accounts receivables		(1,375)	(891)
Change in work in progress		(1,749)	(957)
Change in accounts payable		879	121
Cash generated from operations		**2,595**	**940**
Interest paid		(363)	(179)
Income taxes paid		(401)	(215)
Net cash from operating activities		**1,831**	**546**
Investing activities			
Proceeds from disposal of non-current assests		44	52
Purchase of non-current assets	4 & 5	(1,991)	(6,138)
Net cash used in investing activities		**(1,947)**	**(6,086)**
Financing activities			
Increase in long-term borrowings		-	4,000
Proceeds from the issue of shares		-	1,520
Net cash (used in)/from financing activities		-	**5,520**
Net change in cash and cash equivalents		**(116)**	**(20)**
Cash and cash equivalents at start of year		**238**	**258**
Cash and cash equivalents at end of year		**122**	**238**

Prizeman Group plc

As at 31 December 2013

Non-current assets

Intangible assets	**N'million**
Goodwill at cost at 1 January 2012	4,675
Additions in the year ended 31 December 2012	5,500
Impairment in the year ended 31 December 2012	(468)
Carrying value as 31 December 2012	**9,707**
Impairment in the year ended 31 December 2013	(550)
Carrying value as 31 December 2013	**9,157**

Tangible assets	**Total**
	N'million
Cost	
At 1 January 2012	2376
Additions	638
Disposals	(385)
At 31 December 2012	2,629
Depreciation	
At 1 January 2012	1,452
On disposals	(187)
Charge for the year	403
At 31 December 2012	1,668
Carry value 31 December 2012	**961**
Cost	
At 1 January 2013	2,629
Additions	1,991
Disposals	(671)
At 31 December 2013	3,949
Depreciation	
At 1 January 2013	1,668
On disposals	(429)
Charge for the year	594
At 31 December 2013	1,833
Carry value 31 December 2013	**2,116**

EXHIBIT 7

Explanatory commentary on the Prizeman financial statements

1. The increase in Prizeman Group plc's revenue in 2013 is due to ARP, acquired in the year to 31 December 2012, coming fully on stream in the year to 31 December 2013. The revenue of ARP prior to its acquisition was approximately ₦6,200 million per annum and its EBITDI was N2,448 million. The effect of Prizeman Group's acquisitions since 31 December 2010 is that revenue has virtually doubled in the past three years.

2. Cost of sales is mainly the salaries of the design engineers and attributable overheads.

3. Administrative expenses include all directors' remuneration: salaries, pensions and bonuses paid to our directors. The highest paid director earns remuneration of ₦250million. Pension contributions for all directors are up to a maximum of 20% of basic salary.

4. Impairment in 2013 is the writing down by ₦550million of the purchased goodwill of ₦5,500million created by the purchase of ARP to reflect changes in ARP's client base since the time of the acquisition. In 2012 the impairment related to the previously acquired Dataland purchased goodwill.

5. Tangible assets policies on depreciation are based on the expected economic lives, pro-rated monthly, of the various categories of assets: computer equipment 20% reducing balance; office furniture 10% straight line; motor vehicles 25% straight line. During the year to 31 December 2013 there has been a significant level of expenditure (₦1,320million) on refurbishing and upgrading the facilities at our head office, as well as investing in a new fleet of vehicles for our board members. Prizeman is proud that its offices and cars send a message of success to those who do business with the company.

6. Inventories – work in progress represents the cost of commissioned work being conducted on the development of bespoke software for certain legal practices and software for house-sellers.

7. Ordinary share capital comprises 74 million shares of ₦10 each. The number of shares in issue increased during the year to 31 December 2012 as part of the 100% acquisition of ARP during that year. Prizeman has no share options at this current time.

8. The loan is a 5 year 8% bank loan which was taken out during the year to 31 December 2012 to provide additional funds to finance expansion and create increased working capital.