TPE 2023 – Guide to Answer

Erskine – November 2012

The Test of Professional Expertise multi-discipline case study is designed to encourage you to provide alternative creative answers and there is no “right answer” at TPE level. This Guide to Answer illustrates the structure and the depth of analysis and explanation the examiners were seeking.

In assessing scripts, credit is always given for appropriate answers even if not contained in this published guide.

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Morning Paper

The case study centres round Erskine Electronics Ltd ('Erskine'), a company established in Yr 18 by two brothers, Pete and Dave Erskine. The company has been successful over the years, but there is a risk that the evolution of the industry into cloud-based areas will leave Erskine behind, and the directors have tended to treat it as their own personal bank account. Ten years ago, a business angel, Colin Dunn, purchased 30% of the share capital and has remained as a director, but has not been involved in the day-to-day operation of the company. Dave Erskine wants to sell his shares and concentrate on other business options.

In the morning, candidates were asked to indicate how much they would recommend that Colin pay to acquire Dave's 35% holding in Erskine. Advice is also sought in the morning on improvements which the company could implement in order to improve efficiency and profitability. The final item in the morning is a brief confidential memo providing professional opinion of matters in the company.

Afternoon Paper

The scenario changes in the afternoon. Initially you are given some information in relation to your manager, Brian Branch and his relationship with the former wife of one of the directors.

Commercially, the largest trade debtor of Erskine's aged debtors ledger has gone into liquidation and your client has gathered evidence that there may be more customers in trouble because of this. The implications of the winding up coupled with an unfavourable valuation of one of its factory premises calls the going concern of Erskine into question. Colin Dunn also wishes you to prepare some content and speaker notes, to allow Colin to present to Pete and Dave about the implications of the liquidation for Erskine.

You are provided with a summary of the financial position of the company in the form of a Statement of Affairs which indicates the company is more than likely doomed. The main requirement of the afternoon then follows as you must prepare a report to Colin outlining the options he has in order to continue the Erskine business. Finally, ethics features by asking you to prepare a note for the compliance partner of any other issues which are relevant.

The case study tests candidates' awareness of valuations and contrasts how different a valuation can be when the circumstances of the company alter. The afternoon paper seeks to demonstrate the relative values and options for investing in a company when the going concern consideration changes.

Morning Paper Requirements

Requirement: Prepare the valuation and related information in relation to Colin acquiring Dave's shareholding.

"...Colin has asked us (C&S) to perform due diligence work to enable us to carry out a valuation on his behalf..."

*"...**an idea of how much** Colin should be prepared to pay to acquire the shares currently held by Dave."*

*"**Include the calculation** in your valuation document along with an explanation of your workings....."*

"...provide further information on other criteria which will affect his decision......."

The paper states that an asset valuation is of no use to Colin as he likes to value the trade. There is clearly insufficient information given in the scenario to carry out a discounted cash flow or dividend valuation. The only valuation option available to use is earnings.

1. Valuation of Dave's 35% shareholding

1.1 FME Changes, Assumptions and Explanations

Issue	Adjustment	Explanation
	£'000	
Loss before tax	(88)	
Directors Loan Accounts	412	Directors' loans have been written off to administrative expenses during the year. There are various tax implications of this transaction, however for the purposes of establishing maintainable earnings they should be added back.
Green Trees Fun	270 (25)	GTF accounts for the sales and Erskine pays for the purchases. This is depressing profit at Erskine and should be added back into earnings. Adjustment required for stock still held.
Dave's alimony	2	Although immaterial it would still affect the profit.
Arran Isle Holiday Breaks Ltd	100	Costs of refurbishing a cottage on Arran are not business expenses of Erskine and should be added back to reflect maintainable earnings of Erskine.
Dave's salary	133	As Dave will no longer be a director he will not be drawing a salary. Colin may want to take a salary or maybe dividend. Adding back Dave's salary increases profit which increases the valuation.
Customer overpayments	(120)	Overpayments from customers have been posted to revenue. Erskine should be reporting these to customers and repaying the amounts. This amount has been added back as it does not belong to Erskine.

Daughter's wedding	25	The full cost of the wedding should not be charged to marketing, so to be prudent the amount should be added back.
Adjusted profit	709	
Corporation Tax	(135)	Told to assume tax at 19%
Adjusted Profit	574	

No adjustment required for the following items:

- OEM – There is no add back required as the downsizing has taken place in Yr 44. There is nothing to indicate these sales have been replaced with any other business.
- Plasmotrobe – This is an unorthodox situation. Other than this invoice the Plasmotrobe account is up to date, which might tend to indicate that it will eventually be paid. However, it relies on incredible supplier goodwill from Erskine. Erskine may not be in a position to continue to be so generous.
- RachWeb – This represents a suspicious transaction pattern which needs further investigation. However, it does not involve an adjustment to maintainable earnings at present. There is potential that this transaction is significant as it may be the cover up of directors' loans in RachWeb. There is no implication for Erskine, but it may be an indication of the 'ethics' of Erskine's management and shareholder Dave Erskine.
- Start-up company – The writing down of this investment would be a one-off adjustment and has therefore been excluded from the valuation calculation.

1.2 Explanation of Valuation Method and Consideration of Multiplier

'...and consequently, an asset valuation will be of no use to him...'

The earnings basis for valuation is often used for simplicity on the basis that earnings should reflect profit after tax. The valuation is calculated as the future maintainable earnings multiples and appropriate price earnings multiple.

The first step is to calculate the recurring profits which an investor could expect to be achieved in the ongoing business. Analysis of past profits are used to provide a useful tool in estimating the company's future prospects.

Adjustments are often required to past profit in order to determine the maintainable level. The types of issue which may need adjustment include:

a) Dependency on customers or suppliers. In the case of Erskine, we are told that a major OEM has downsized its operations and affected sales in Erskine by 19%.
b) Extraordinary items. In the case of Erskine excessive write offs such as the directors' loan accounts.
c) Profits or losses on the sale of assets.
d) Non arms-length trading with related parties. In this case, for example, the dealings with Arran Holidays and GTF as well as RachWeb would require to be examined for potential adjustment.

e) Items relating to the personal expenditure of the directors. In the case of Erskine, this is reflected through the directors' loan accounts.

It is possible, as is the case with Erskine, that a loss situation will be reversed into one of profitability.

A profit multiple (P/E ratio) is applied to the maintainable earnings figure in order to arrive at a valuation for the company. A multiple would normally come from analysis of quoted companies operating in the same market or sector as Erskine. Ideally, they would also be of similar size.

The case study provides a typical price earnings ratio range between 8 and 12. As a starting point a P/E multiple of 10 could be used and discounted by up to 20% for a lack of marketability. There are considerable problems with the sustainability of this business model so a further discount could be applied, 20% would be prudent. On the other hand, the exclusive deal with Winchester Spires is a good opportunity for Erskine, which may add 10%. The earnings method supposes control so there is no need for a further adjustment.

P/E ratio of similar company	10
Lack of marketability – 20%	(2)
Sustainability of the company – 20%	(2)
WSL deal – 10%	1
Adjusted P/E ratio	7

Therefore, a P/E multiple of 7 might be appropriate for Erskine.

1.3 Credible Valuations Presented

	£'000
Adjusted profit	574
P/E multiple	7
Company valuation	4,018
Shares in Circulation	100,000
Price per share	£40.18
Dave's shareholding	£1,406k

The maximum Colin should be prepared to pay for Dave's 35,000 shares is £1,406,000.

From Dave's point of view, he might take less as it is a minority shareholding. However, from Colin's point of view he might pay more to gain a controlling interest.

1.4 Other Criteria which will Affect the Proposal

'...further information on other criteria which will affect his decision...'

You were expected to make pertinent comments in relation to Colin's decision on whether to invest or not. Examples could include:

1. IT trends

   Some of the products which Erskine is providing are reaching the end of their lifecycle. Retail customer preferences are moving to cloud based services and to mobile and tablet devices. They are no longer favouring desktop computers. Erskine's turnover may not be sustainable because of this. Does Colin really want to invest further in a company that the industry is beginning to leave behind? Are there any plans to expand the product range offered? If not, the valuation could be lowered, even allowing for the adjustment made to the P/E ratio already.

2. The minimum price that Dave will accept

   This is critical, because unless Dave is willing to accept the price offered for his shareholding, no sale will go ahead. The minimum Dave is likely to be willing to accept is £1million as that is what he needs for his new investment.

3. The likelihood of the bank funding being renewed

   If the bank funding cannot be secured, then the business would be in jeopardy. Also, the covenants of the existing bank overdraft should be reviewed to assess whether or not a change in ownership of the business would result in the loan being recalled immediately.

4. The ability to pay creditors on time, to prevent insolvency

   At the moment, Erskine is not meeting its suppliers' credit terms. This means that there is a risk of a creditor filing for insolvency.

5. Exit route

   Usually, a business angel will not commit to an investment in a company unless there is a clear exit route and the likelihood of a good return on their investment. At the moment it is very uncertain as to whether these will be achievable.

6. Pete Erskine's management of the company

   Colin will need to consider whether he could work with Pete on a day-to-day basis. In addition, he would need to consider how he might manage his workload in terms of looking after Erskine and any other companies in which he may have an investment.

   Consideration should also be given regarding how Pete might react to Colin being the majority shareholder and taking a much more hands on role.

7. Directors' salaries

   Dave is currently drawing a salary however this will not be the case when he leaves. Consideration should be given as to whether the salaries being taken are excessive. If so, a saving could be made.

Colin may want to draw a salary however he may not need to receive the same as Dave and so there could still be a saving in directors' salaries.

Colin will be looking for some sort of return. So, if not salary, he may well be looking at dividends.

8. Possible tax compliance issues

   The current tax situation may not be able to be relied upon considering all the problems which Frances has discovered within Erskine. This could give rise to a tax investigation which could lead to further tax liabilities and penalties for Erskine.

Requirement: Short briefing document setting out your recommendations in order to achieve improved profit levels.

*"a **short briefing document** to Colin setting out recommendations in order to achieve improved profit levels."*

*"**Derive** your recommendations from an assessment of business risks and corresponding mitigations."*

2. Risks, Mitigations and Profitability

2.1 Business Risks and Corresponding Mitigations and Profit Improvements

It was expected that candidates would carry out an assessment of business risks and the mitigation of these. From this analysis, candidates were expected to highlight areas of profit improvement.

Business Risks	**Mitigation**
Change in technology Changes are resulting in declining demand for products and reduced sales for Erskine.	Review product mix and offer different products/services to keep up with changes in the market. Research the market and where Erskine could fit. Formulate a long-term strategy for Erskine that will maintain its relevance in a changing market. This involves reviewing market research/competitor and product research to identify what IT area the business should move into. Analyse profitability from existing products and change focus of business. E.g. WSI products are helping sales however need to assess the margins these products make.
Going Concern The bank overdraft is currently at its limit and is up for renewal. If the bank does not renew the overdraft it may mean the company is no longer a going concern. Trade payable days have increased to 60 days (credit terms are 30 days) which indicates Erskine is	Cash flow projections/profitability analysis on key products. KPI review for cash management and working capital management. KPI to manage performance in the balance sheet.

having difficulties paying suppliers. One of the suppliers may put Erskine into liquidation if they cannot pay their debt.	
Non business expenses Arts and crafts business costs are posted through Erskine and products held in inventory (£25k at year end). This is not part of Erskine's business and should not be going through the company's books. Also, Erskine should not be paying for expenses that are not theirs. Substantial director loans have been written off during the year which has impacted the profitability of the company. This causes cash flow problems for Erskine which currently needs its cash.	Only Erskine's expenses should be met by the company and not family business costs. Define policies for payments to directors. Enforce these. No more directors' loan write-offs.
Diversification Erskine has tried to diversify its products – but investing in the wrong products can impact on sales and profits, particularly when failed products need to be written off. This is particularly an issue when the company is tight for cash.	Proper analysis of new products and sign off by all directors to show agreement of direction being taken.
Reliance on Pete Erskine Although Dave is a director he has little involvement in the company and Pete makes all strategic decisions. There is no-one to question Pete's decisions.	Appointment of a non-executive or executive director to the board to maintain a balance with no one director being dominant.
Lack of focus Too many 'other' interests of directors – takes focus away from success of Erskine.	Review effectiveness of directors; look at governance and ongoing leadership of the company.
Customers in financial difficulty There is one customer mentioned in the due diligence report, however there may be others. This will cause cash flow difficulties for Erskine if they do not enforce credit terms with customers. Erskine needs to go to their own bank for additional financing now. The customer's credit is still being offered which is increasing the bad debt issue.	Enforce the credit control policy. Where customers can't pay Erskine should arrange a payment plan to reduce their existing debt and not continue to provide further credit. Either require payment in advance or stop trading with the company. Review all existing balances in the aged debtors ledger for those long outstanding and chase up payment with customer.
Lack of financing This may impact on their ability to follow the strategy of buying more of WSI range.	Renegotiate terms with the bank to extend the funding or look for external finance to enable the business to grow. Also look at working capital management, stock levels and credit control.
Circumvented controls Payment to RachelWeb authorised by Dave. Manipulation of accounts at year end – possible fraud. Also, posting through cost of sales is wrongly	Review internal controls and make improvements.

recognising the transaction. Business risk as money can be misappropriated.	
Poor inventory controls and systems This provides opportunity for theft of stock. High value items are insufficiently secured. The copper held is also tradable and has a ready market so is very susceptible to theft.	Improve stock control systems. Ensure all high risk/value stock is securely stored away and access restricted to authorised personnel.
Insufficient security and back up of accounting software There is no back up. This can impact on service to customers if records have to be recreated. Particularly as Erskine's strengths are on meeting customer delivery requirements. Not having this information may impact on the business. Also, if accounting records cannot be recreated this means that they are not complying with the Companies Act in maintaining proper books and records.	Need to do a risk assessment of existing systems to determine what system is required for the business needs. If there is a factor that impacts the success of the business the resources should be designed to enable that to be met. Cost/benefit analysis should be carried out of back up options to design back up plans. Take regular backups, store securely, and test regularly to ensure records can be restored adequately..
Hardware security poor The loss of the server could also impact on the ability to trade with customers.	Introduce physical security – access to the server, conditions of office (heating, air conditioning, sprinkler system) as well as making sure there is a backup server and equipment to run restored data on in the event of a failure. The need for replacement hardware and how easily it can be sourced, how long it can be down for should be considered in defining a suitable disaster recovery plan.
Not fully utilising existing assets Other factory building is empty and not being used to generate revenue or income.	There should be a regular review of assets to identify any underutilised or obsolete assets. This is to ensure that assets are being utilised in the best way to maximise profits for Erskine.
Holding onto overpayments from customers This opens the company and the directors up to legal proceedings as the money should be returned to the customers. This will also affect Erskine's reputation with those customers and future business.	Any customers with credit balances should be investigated to identify reasons for the balance. If it relates to overpayment the customer should be contacted and efforts made to return the overpayment.
Investments being made unrelated to the business of the company Erskine has invested in a start-up company, it does not appear that the investment was subject to due diligence before being made or is being monitored for performance. This can lose the company money that could offer a better return if invested elsewhere.	All investments should be supported by some due diligence and risk assessment. They should also be considered in line with the long-term strategy of the business and support those long-term goals. All transactions should be properly documented.

High staff turnover/ poor staff morale Staff may not work as hard/may be more willing to cut corners/steal from the company. To replace staff regularly Erskine will be incurring recruitment costs/training costs as well as a period of lower productivity while new staff learn about the business. Understaffing by this level can impact on the quality of service provided. With a shortage of 9 in production this may have a big impact on Erskine delivering the quality of service that they are known for. A vicious cycle of poor morale may have resulted in the staff shortage and the staff shortage may have resulted in poor morale. It's possible that further staff may leave if this is not addressed.	Regularly review staffing requirements and plan to replace staff. Review internal operations to understand why staff morale is low and why so many have left. Need to fundamentally address this in the longer term. Monitor staff turnover on an ongoing basis to assess whether the issue remains. In the short term, review the contract terms and recruitment strategy to fill the positions/hire temporary staff to make sure existing staff are not making up the shortfall and therefore having an impact on morale.

Areas of Profit Improvement Derived from the above:

Private Expenditure

The directors are currently using the business to cover a number of areas of private expenditure. This should be stopped and will have an immediate effect on increasing the profit levels.

Working Capital Management

The improvement of credit control and the more efficient control of stock levels would lead to reduced bank borrowing and would reduce overdraft interest that needed to be paid. This will reduce expenses and help to improve profit.

Stock Losses through Pilferage

High value stock should be kept in a secure area with limited access by staff. This would improve the profit as there would be no need to write off stock losses and the stock can be sold to generate revenue for Erskine.

Management control

Scrutiny of management accounts and use of key performance indicators with any variances being closely investigated would improve the overall performance of the business. This will help the directors to focus on improving profit levels through better performance and efficiencies being introduced.

Unused factory

Currently the business has a factory which is not generating income. This should either be let out or sold to generate cash. This would either bring in rental income to the business or reduce the overdraft and therefore reduce bank interest.

Retention of staff and vacancies, poor staff morale

The recruitment of staff and settling in of new staff is a significant cost to the business. The poor staff morale should be investigated, and management should endeavour to improve it, thus reducing costs of recruitment and improving efficiency and productivity both of which would improve the profit levels.

Requirement: Short confidential memo to Brian to give your professional opinion on concerns arising from the results of the firm's due diligence review of the company.

*"….a **brief confidential memo** to Brian consisting of your assessment and professional opinion on matters in this company."*

Confidential Memo – Professional Opinion

Concerns

On the surface Erskine looks to be reasonably successful, but this is hiding underlying problems.

Attitude of directors

The directors are not behaving in the best manner in relation to the company. They may be the dominant shareholders, but they are using the company for their own private purposes and this is demonstrated through the directors' loan accounts. It is also clear that they are happier focussing on outside interests and the private projects in which they have been involved.

Loan write off as a distribution

The directors' loan accounts have been written off during the year. The Companies Act permits this as long as all of the shareholders have approved it. We need to check whether Colin was involved or aware of this.

The loans will not be tax deductible for corporation tax purposes. In fact, they will be subject to a 32.5% notional tax which is payable by Erskine. This would only be repaid to Erskine if Pete and Dave repay the loans or the loans are written off. As the loans have been written off, the notional tax will be repaid to Erskine.

Credit balances on the aged debtor's ledger

It appears that customer overpayments have been kept by Erskine and charged as revenue in the Statement of profit or loss. It is not clear if the directors have intentionally not given the money back to customers.

Erskine are required to notify customers of overpayments and how this overpayment should be used. We should find out if the customers have been contacted and the actions Erskine have taken. If the customer has not been contacted, this would be considered money laundering and we would need to make a report.

If there is any suspicion of deliberately holding onto this money within Erskine we need to be careful not to tip off. However, Colin should be made aware of this as he is not involved.

Email about Mary

A memo was received from Pete regarding the bookkeeper of Erskine, Mary. Pete has concerns that Mary is committing fraud in Erskine. Copper wire has went missing and Pete suspects Mary may be involved. He also has concerns over her handling of the petty cash.

Although there is no proof the suspicion is enough to raise concerns. This should be investigated further within Erskine by Pete.

Report to MLRO

The directors' loans written off, the customer credit balances which have been retained and the suspicion of the director of fraud, could suggest that there are offences being committed within the company which should be reported to NCA. Therefore, we should make a report to our firm's MLRO detailing our suspicions.

Colin's role

Our client is Colin Dunn, the third director. From our due diligence work, it seems that Colin Dunn is not involved in the various discoveries and that he was unaware, despite his shareholding and his directorship, of these transactions.

Other tax/VAT issues

Pete and Dave will be deemed to have received a dividend equal to the amount of the directors' loans written off which will be subject to income tax.

VAT might have been reclaimed on the purchases made for Green Trees, a completely separate business. This VAT should not have been reclaimed. A voluntary disclosure will have to be made in respect of the VAT inappropriately claimed.

Requirement: Create the draft content and speaker notes for a brief presentation suitable for Colin to deliver to Pete and Dave, covering the specific implications for Erskine of KVT going into liquidation.

"....I have received a letter from Claire Minnow & Co stating that one of Erskine's customers, KVT, is in creditors voluntary liquidation, and that unsecured creditors are unlikely to receive a payout"

"What would be really useful is if you can summarise the impact of all this on Erskine in a couple of slides so that I can present them to Pete and Dave."

3. Presentation – impact of KVT liquidation on Erskine

Slide 1 content:

- KVT is in a creditors voluntary liquidation
- KVT currently owe Erskine £486k
- The £486k debt will need to be written off
- Future turnover likely to fall

Speaker notes - Information to discuss:

- KVT is in a creditors voluntary liquidation. Erskine is an unsecured creditor of KVT, and unsecured creditors are unlikely to receive a payout, as per the letter received by Colin.
- Claims by unsecured creditors such as Erskine are paid on a pari passu basis i.e. without preference. Erskine may receive a dividend paid pro rata at the end of the liquidation. It may be that the dividend to unsecured creditors will be just a few pence in the pound, or it may be nothing at all. It has been stated that it is unlikely that a dividend will be paid to unsecured creditors.
- Erskine will need to submit details of their claim which will consist of proof that the debt is owed, such as copies of the unpaid invoices to the liquidator along with proof of the debt.
- Erskine should write off the KVT balance of £486k and assess the implications for cash flow going forward.
- The future turnover of the business will likely fall, because KVT will no longer exist post-liquidation, and KVT is a substantial customer.

Slide 2 content:

- Other Erskine customers are also exposed to KVT
  - i) Immediate cash flow impact - Allander Components (£143k impact)
  - ii) Long term cash flow impact - Blane Peripherals (KVT accounts for 20% of their turnover)
  - iii) Uncertainties - Finglen (£75k impact)

Speaker notes - Information to discuss:

- Worryingly, a number of other customers are also exposed to KVT. This will likely have a triple impact on Erskine.
  - i) Firstly, some of Erskine's current debtors might struggle to pay Erskine on time or at all, because they in turn are not being paid by KVT. Allander Components currently owe Erskine £143k. Allander Components have stated that they have a large exposure to KVT and that they might not be able to continue. The current debt of £143k should be provided for in full and the situation monitored. All other debtors with exposure to KVT should also be monitored, and debts recovered as soon as possible.
  - ii) Secondly, some of Erskine's customers might struggle to continue in the future, or reduce orders in the future, due to the loss of custom of KVT. In particular, Blane Peripherals, where KVT accounts for 20% of their turnover.

iii) Finally, there are a number of uncertainties still to be quantified. In particular efforts should be made to contact Finglen (current outstanding Erskine debt of £75k) to establish their KVT exposure.

Slide 3 content:

Immediate actions required:

- Assess if Erskine is still solvent.
- Contact the KVT liquidator.
- Contact Erskine's bank

Speaker notes - Information to discuss:

- It is vital that the directors assess the completed Statement of Affairs as soon as possible to assess the solvency of Erskine in light of the liquidation of KVT.
- In addition, Erskine should contact the KVT liquidator to request more information and submit a claim for the unsecured debt of £486k.
- Given that Erskine are already at the top overdraft limit, it is vital to contact the bank as soon as possible to discuss current developments.

Requirement: Draft the report to Colin outlining his options for the future of Erskine.

4. Estimated Statement of Affairs

4.1 Assessment of position

"…to have someone else in the team – Cerys Roberts – construct a Statement of Affairs for Erskine and provide it to you…"

"…you should be able to make appropriate conclusions from it based on your training. You should be able to use this Statement of Affairs, once drafted, as a key ingredient in writing the report requested by Colin…"

You were provided with an estimated Statement of Affairs for Erskine to drive the options to be considered by Erskine on a potential insolvency route.

This Statement of Affairs should have been provided in the report to Colin to allow him an accurate assessment of the situation Erskine is in. The report should then have made brief comment on the implications of the figures provided.

Estimated Statement of Affairs of Erskine Electronics Ltd.

	Estimated Realisable Value
Assets	**£**
Assets not specifically secured (List A)	2,008,300
Assets specifically secured (List B)	2,976
Estimated total assets available for preferential creditors, holders of floating charges and unsecured creditors	2,011,276
Liabilities	
Preferential Creditors (List C)	(55,000)
Estimated balance of assets available for holders of floating charges and unsecured creditors	1,956,276
Estimated prescribed part of Net Property	(394,255)
Holders of Floating Charges (List D)	(1,165,000)
Estimated surplus as regards holders of floating charges	397,021
Add: Estimated prescribed part of Net Property	394,255
Unsecured Creditors (List E)	(1,326,000)
Estimated deficiency as regards creditors	(534,724)
Issued and called up share capital	(100,000)
Estimated deficiency as regards members	(634,724)

Based on the figures provided by Cerys, with reasonable assumptions regarding recoverability, Erskine may well be insolvent.

As there is no mention of Erskine being unable to pay its debts as they fall due presently, the type of insolvency appears to be *absolute* insolvency rather than *practical* insolvency. That is, it is very likely that the liabilities of Erskine outweigh the assets, meaning the creditors cannot be paid from the available pool of assets.

The Statement of Affairs suggests that secured creditors, preferential creditors and floating charge holders can be repaid in full. However, a deficit arises when attempting to repay the unsecured creditors (List E). With £791,276 available for the unsecured creditors (being the prescribed part added to the surplus after paying back the floating charges), and debts amassing to £1,326,000, it would appear trade creditors would only receive around 60p in the £.

The shareholders would, unsurprisingly, receive nothing.

The figures presented here also likely do not take account of various costs associated with insolvency, or any fluctuation in figures in the coming days and weeks. It is also unclear whether the knock-on consequences of KVT's liquidation on others in the industry has been considered. Therefore it is very likely that the true position for Erskine is even worse than what is shown here.

The directors of Erskine should be left in no ambiguity: The company is insolvent and their responsibilities should change as a result.

5. Options for Continuing Erskine Business

*'Erskine is generally a sound business...However, I need some advice as to the current position...I am **still keen to consider a further investment** in the company.'*

*'...if Pete can be persuaded to stay on and drive through the ideas from your report for improving efficiency and profitability, **I think he and I could run the company very successfully....'***

The report on the options for Colin is one of the key aspects of the case study. In the morning, Colin was being told to consider paying a maximum of £1.4m for 35% of the shareholding, yet in the afternoon it appears as though the company may be insolvent and the shares worthless.

Colin has three principal options:

- Inject additional finance into the company personally in order to keep it solvent.
- Allow the company to fold and seek to acquire the assets and name from the liquidator at a cost in order to continue the trade.
- Start a new company carrying on the same trade, build up the business and seek to acquire the contracts which Erskine had.

A fourth option would be to allow the company to fold and for him to lose his investment.

5.1 Inject Additional Funds into the Company

Colin had been considering paying over a million pounds for Dave's shares. So, he must have free capital which he could use to inject into Erskine. He could do this by way of a loan, perhaps on commercial terms. If not, we need to consider his return for effectively saving the company from liquidation.

Buying Dave's shares would not be of help to the company as the funds would flow to Dave. Colin could acquire newly issued shares. This would effectively dilute the shareholdings of the other directors. However, as their shares may well be worthless without the help of Colin it is possible that a deal could be done.

Funds could be injected into Erskine from another source, possibly by the bank. Possibly other shareholders could be sought. It seems unlikely that Pete has any free cash to invest given the activities outlined in the morning part of the paper. Given the current climate and the potentially insolvent state of the company this seems an unlikely source of funds.

At the moment Colin already owns 30% of the shares, which without further intervention may well be worthless, so he has an incentive to keep the company alive.

The position with regard to the estimated deficiency is, of course, fluid. The deficiency may not turn out to be as large as estimated. It could, however, turn out to be greater. More up to date figures would, of course, help to clarify the position. But even if the current liquidity is not immediately off-putting for potential investors, Erskine is likely going to experience harder and harder times as its product range begins to look more and more outdated.

5.2 Acquire Business from Liquidator/Start New Company

Colin could allow the company to go bust, and then seek to acquire the business from the liquidator. One advantage of this is that the company's debts would remain in the liquidation. Erskine seems to have a good reputation within the industry and that could be nurtured to continue.

Colin could acquire the workforce and would have various responsibilities under the TUPE regulations to continue service terms and conditions.

Drawbacks with this option include the fact that his own original 30% shareholding in Erskine will have lost its entire value in the liquidation. He may have other investments and undertakings for which he was using the Erskine investment as leverage.

The liquidator may not deal with him. He is, after all, a director of the failed company and the liquidator may be reporting him under the Company Directors Disqualification Act 1986 (see below).

It is possible that any suppliers or other contacts that have lost money in the liquidation will not deal with him again – even though he was not involved in the day to day running of the company.

Colin will need to consider ways to raise the necessary finance. Banks may not be willing to lend to the players of a downward sloping industry, although on the estimated Statement of Affairs they are paid in full.

Colin would also need to consider whether he would want Pete to join him in the new venture.

Another option open to Colin and potentially Pete if he were to join him, would be to start a new company in the same trade. This is the least appetising of the options as it will involve probably the largest capital outlay, in that premises, contracts etc. will require to be sought and the business built up.

Some of the concerns raised above would also apply in this scenario such as:

- Colin losing his 30% shareholding in Erskine;
- The business needing to develop to keep up with changes in the industry;
- Supplier and customers may not be willing to deal with a new company; and
- Colin would need finance to fund the new company.

The liquidator of Erskine may well view such a new start company as a 'Phoenix Company' set up to commence trading without the debt of Erskine and with common directors. A director of an insolvent company is debarred from being a director of a company with the same or similar name. They may take no part in the promotion, formation or management of such a company. If Colin does this he is liable to imprisonment and/ or a fine. In addition, he could face potential personal liability for debts incurred by the new company if he contravenes the provisions.

5.3 CVA/Administration/Liquidation

Administration

The directors might consider putting Erskine into administration. This would protect the directors against wrongful trading. Whilst under the control of the administrator this would enable the company to negotiate terms with its current creditors, while continuing to trade.

CVA

Erskine could enter into a creditors voluntary arrangement where it negotiates with its creditors to accept a reduced return on their debt, or a longer term to pay.

Liquidation

The directors could proceed to put the company into liquidation which would dissolve the company.

All of the above would damage Erskine's reputation and even if the directors were to buy the assets from the liquidator to start a new company, it might be difficult for them to obtain credit. They also might find that any of the above might put into jeopardy the exclusive supply contract they have negotiated.

5.4 Directors' Disqualification Act/Wrongful Trading

It is vitally important that the directors recognise their primary duty of care in an insolvency scenario shifts to the company's creditors, rather than the shareholders. Colin, Pete and Dave must be careful that decisions taken from this point are taken with a mind to improving the position for creditors, regardless of consequences to them as shareholders.

If Erskine is to continue trading, Colin and the other directors must carefully consider if this would constitute wrongful trading. If the court concludes that the directors knew or **ought to have concluded** that there was no reasonable prospect of the company avoiding liquidation, but continued to trade and incur credit, then it can make a declaration that the director is guilty of wrongful trading.

At this point it seems clear that the directors should be aware that there are solvency problems in the company. The only defence available to a director is that all possible steps to minimise any potential loss to the creditors were taken. The court will have regard to the level of skill/experience expected of someone acting in that director's capacity.

Therefore, Colin and the other directors need to be clear and careful about what course of action they choose to take. It should be recommended that they consult a licensed insolvency practitioner as they proceed with their plan.

5.5 Other Considerations

Another consideration at this point is that the bank, which holds a floating charge, may call up the overdraft or refuse to provide any additional funding. This could force the company into liquidation which would prevent

Colin moving his own plans forward. Indeed, Colin would be well advised to ensure that the bank is made fully aware of what his plans are as no doubt covenants will be affected.

The directors should also take professional advice from an insolvency practitioner at this point. It might be that placing the company into administration might be advantageous.

5.6 Conclusions and Recommendations

A succinct and articulate conclusion, together with recommendations, drawn from the analysis of the situation was required.

Requirement: Prepare a note of any other issues you consider to be relevant to your firm's compliance partner.

Professional Marks - Ethical Issues

Brian Branch Relationship

At the beginning of the afternoon paper there is mention of Brian's relationship with the former wife of Dave Erskine. No further mention of this is made and the appropriate action might be to draw this to the attention of the compliance partner in the firm.

It is fairly clear that it is the 'ex' wife as reference is made to alimony being paid in the morning paper. However, it does raise concerns regarding Brian's objectivity and independence on the Erskine assignment. This may be impaired due to the close relationship he has, and he may find himself in situations where these attributes are compromised. It may be best to remove Brian from any further involvement with Erskine in the future.

Other

Points raised with Brian

Some of the issues raised in the due diligence memo to Brian had ethical concerns attached to them such as fraud and money laundering. There may be concerns that these issues will not be passed onto the compliance partner by Brian due to his involvement with Dave's ex-wife. It may be an option to raise these matters again here in order to satisfy reporting requirements.

RachWeb

There is an issue with Dave's daughter's company 'RachWeb'. Dave's daughter may not be Patricia's daughter, but there is a closeness there which gives rise to a difficult ethical dilemma. Money was paid to RachWeb prior to the year end, and then returned post year end. There is no audit trail or paperwork to explain why this was done and it may be that there are issues with RachWeb which both Dave and Patricia would wish to cover up. Brian's closeness to Patricia, if he knows about difficulties at RachWeb, may compromise his integrity in dealing with this issue.

Act for Colin

Some of the ethical issues raised in the morning may also raise the question of whether we should continue to act if Colin remains as a director of Erskine and we do not receive satisfactory explanations of the issues.

Act for Erskine

The question of our role moving forward may also be raised. Currently we act for Colin, but depending on what happens to Erskine moving forward, there may be a continuing role for us in advising Colin, but there could be other opportunities to become more involved in Erskine. That then, raises the consideration of whether we want to be more involved or not.