TPE 2023 – Case Study Part 1

Erskine

History

Original TPE exam November 2012. 2½ hrs morning 3 hrs afternoon. Pass mark 85.2%

Background Notes

It is October Yr 45 and you are Andy, a recently qualified CA working in the Glasgow office of Charleston & Sylvester ('C&S'), a national CA practice with offices throughout the UK.

After qualifying, you moved to the Corporate Finance department and have been enjoying working on a number of projects. You are finding it very different from the audit department, in which you spent most of your training contract.

Your manager, Brian Branch ('Brian'), has appointed you in the lead role on a piece of client advisory work for Colin Dunn ('Colin') – a long-standing client of C&S and a director of Erskine Electronics Ltd ('Erskine'). You have been called to a meeting with Brian and all that you know is that he wants you to review Erskine's finances and activities. Another member of staff from C&S, Frances Galdamez ('Frances'), has already visited Erskine and carried out a due diligence review, before moving on to another project.

You arrive at Brian's office and he looks up, nods to you, points to a chair and launches into explaining your task further:

"Erskine was founded by two brothers, Pete and Dave Erskine, in Yr 18. Each brother owns 35% of the issued share capital. Pete is the managing director, works full time in the business and is the principal driving force behind its operations. On the other hand, Dave, a director, is involved in the decision making of the company. Dave tends to spend most of his time playing golf, normally in Scotland but increasingly in Spain. The third shareholder is our client, Colin Dunn. Colin is a business angel who invested in Erskine ten years ago, allowing the business to expand at a time when the market for the IT industry was highly profitable. Colin holds a 30% shareholding and is not involved in the daily operations of the company.

"As an Original Equipment Manufacturer ('OEM'), Erskine has a good reputation within the IT industry for the reliability of its assembled products and for meeting its customers' delivery requirements. Erskine's customer base is primarily well-known wholesale and retail companies, and the industry has been largely unaffected by the recent COVID-19 pandemic.

"The main business activities of Erskine can be split into:

- 'box building' – assembling other manufacturers' parts and other branded products for resale;
- testing of assembled products; and
- resale of bought-in manufactured components.

"Erskine's substantial experience in box building allows it to source and supply consumers with desktop computers, laptops, servers and related products. It also offers exhaustive testing to detailed customer specifications to ensure the product reaches the end user in fully working condition.

"Based in a 4,000 m^2 facility at Port Glasgow, Erskine has immediate access to the motorway network and are able to offer a national and international distribution service ensuring that customers receive the materials they need quickly and efficiently.

“In Yr 44, Erskine entered into a new ten-year exclusive contract with Winchester Spires Inc (‘WSI’) to distribute its products in the UK. WSI is world famous for quality electrical components and has been the UK’s market-leading brand and the choice of all major wholesalers and end users for many decades.

“Over the past 20 years, Erskine has diversified into other business areas which were often not related to its core business. Sometimes these were successful but, more often than not, these ventures have been spectacular failures, leading to tension between Pete and Dave.

“The bank overdraft is at its limit of £1,200,000 and is up for renegotiation. Pete wants to extend the WSI range and, to do this, he requires to double the stock of WSI components, and he wants the bank to extend the overdraft by £250,000.

“Meanwhile, Dave has announced that he wants out of the business. He says he is tired and longs for a change of direction. Together with five of his golfing associates, he has identified a tract of land currently used for farming, situated on the west coast of Scotland. The group wish to purchase it as a consortium with the intention of opening a golf academy. The land is within easy driving distance of many famous championship golf courses and the market is there for attracting foreign golfing holiday participants from Europe and the USA. Dave will be a junior partner in the venture, he says he needs £1million to allow him to obtain a 10% stake.

“Dave considers Erskine to be very successful and by selling his shares he should easily realise the funds which he needs for the investment in the golf academy. Pete is not so sure. He is worried that things don’t seem to have been going well for them recently and he thinks they may have more debts than they have assets.

“Pete and Dave have approached Colin to ask if he would acquire Dave’s 35% stake in the company. Colin has indicated that he would be willing to consider buying the shares from Dave. He is unsure if that is what he really wants. As a business angel, he normally maintains a lower percentage investment and looks for an exit route when the company’s fortunes are favourable. Colin generally avoids placing reliance on the statements of financial position of his investments when valuing them and, consequently, an asset valuation will be of no use to him. His view is that he likes to value the trade instead.

“As Colin is not involved in the day-to-day running of the business, he has asked us to perform a due diligence review to enable us to carry out a valuation on his behalf. The notes prepared by Frances are in Sections 1, 2 and 3. She spent several days at the company and interviewed the directors and members of staff in addition to carrying out a high-level review of the finances and activities. Colin has seen these notes and wants us to use them to come up with some ideas for how to improve profits at Erskine.

“Section 4 contains an extract from the financial statements, provided by Pete. We believe these are in the final draft stage before audit.

"I require you to prepare three pieces of work this morning. Firstly, we need an idea of how much Colin should be prepared to pay to acquire the shares currently held by Dave. Include as part of your valuation the calculation and your detailed assumptions and workings along with an explanation of your valuation method – this will form the basis of any negotiations between Colin and Dave. You should also provide further information on other criteria which will affect Colin's decision.

"Secondly, provide a short briefing document to Colin setting out recommendations on how to achieve improved profit levels. Derive your recommendations from an assessment of business risks and corresponding mitigations.

"Thirdly, provide a short confidential memo – addressed to me – giving your professional opinion of concerns arising from the results of your work and our firm's due diligence review of the company.

"I don't think that should take you all day."

At that, you realise Brian has moved on to his next email and you get up and leave his office.

In preparation for answering the case study question this afternoon, you will find it useful to undertake the following tasks during the morning session:

- read all the information carefully and note down any points you feel are significant;
- prepare the valuation and further information in relation to Colin acquiring Dave's shareholding;
- draft the short briefing document to Colin; and
- prepare the short confidential memo to Brian.

Section 1

Notes on due diligence review of Erskine, prepared by Frances in September Yr 45

Industry

The IT industry generally continues to find trading conditions difficult. OEMs such as Erskine have also suffered from the rise in cloud computing services (accessing software and services on remote hardware) as this has meant less money being spent on on-site server procurement by IT departments. It has also suffered from the rapid move away from desktop computer solutions to mobile and tablet technology. So even though the industry was largely unaffected by the COVID-19 pandemic, it is fair to say things were already on the decline.

The diversification by Erskine into the sale of components through the arrangements with WSI is helping to lessen the downward pressure on sales.

Customers still require their hardware delivered in a fast and efficient manner and with the factory located near the motorway network, Erskine continues to offer a strong and competitive service.

The typical Price/Earnings ratios reported for companies similar to Erskine range from 8 to 12.

People

Pete Erskine

- Managing Director of Erskine.
- Owns 35% of the shares.
- Arrives at work before 7.30am and is always available, rarely on holiday and clearly devoted to the company.
- He is currently married to his second wife. The first, whom he divorced in Yr 10 prior to the founding of Erskine, has never had any involvement with the company. His current wife, Theresa Green, runs an arts and crafts business.
- Pete has a 30-year-old son from his first marriage who lives in the USA and works for a large software development company.

Dave Erskine

- Director of Erskine.
- Owns 35% of the shares.
- Much less regular attendee at the company offices than his brother. Was out of the office ‘networking’ for three out of the four days of my visit to the company.
- Divorced his only wife in May Yr 45. This was, by all accounts, very acrimonious and he has weighty alimony payments to make.
- He has two daughters, Vivienne (aged 24) and Rachel (aged 22). Neither is employed by Erskine.

Colin Dunn

- Director of Erskine.
- Owns 30% of the shares.
- Business angel.
- Our client.

Detailed notes on review of financial information and discussion with directors and staff

1. In May Yr 44, a major customer announced that it was downsizing its UK operations immediately. This was a significant contributing factor to the large fall in Erskine's sales by 19% to £10,063,000 in the accounts for the year ended 30 June Yr 45.

2. Normal credit terms allowed to Erskine by suppliers are 30 days. Current trade payable days for Erskine are 60 days. This has deteriorated from 46 days at 30 June Yr 44.

3. A customer, Plasmotrobe Ltd ('Plasmatrobe'), is listed on the aged debtors ledger with a balance owing to Erskine of £50,000. This is showing as having been outstanding for 24 months. Rather than going to their bank for extra funding, Plasmotrobe came to an agreement with certain creditors that they wouldn't be paid until the company's trading had improved. Erskine has continued to trade with Plasmotrobe and, other than this balance, their account shows no other debt past its due date. Dave Erskine insists that this debt will be paid and so no allowance has been made against it.

4. There are directors' loan account issues. These include the fact that Pete has been investing in a gastro pub and has taken £200,000 out of the company over the last two years and this has been charged to his director's loan account. Dave has had his annual golf subscription of £12,000 and his clubhouse repair levy of £50,000 to the exclusive Mull of Kintyre Golf Club paid by the company and these are included in the statement of profit or loss. He usually manages to play twice each year, normally himself and the same three customers. Directors' loans totalling £412,000 were written off during the year and there is no outstanding balance at 30 June Yr 45.

5. Theresa Green runs an arts and craft business called Green Trees Fun ('Green') and Erskine has paid for her purchases during the year. These have been charged to Erskine's cost of sales. £25,000 of paints, brushes and art equipment is included in Erskine's inventories at the year end. This is the first year that this has happened. All sales go through Green's accounts. Purchases paid for by Erskine in the year amounted to £270,000 excluding VAT.

6. Dave's alimony for his former wife, whom he divorced in the current year, is paid through the company and has been posted to 'Insurance costs'. The first monthly payment of £2,000 was made in the last month of the financial year.

7. Pete is also a director of Arran Isle Holiday Breaks Ltd. It owns a number of rental holiday properties on the Isle of Arran. During the year, one property was renovated through Erskine at a cost of £100,000. These costs are included in repairs and renewals.

8. Dave’s younger daughter, Rachel, owns a website design and hosting company – RachWeb Ltd (‘RW’). RW purchases hardware from Erskine and has a trade debtors account. A week before the year end, Erskine paid £50,000 to RW posted through trade debtors. Three weeks later the £50,000 was returned and the RW trade debtors was credited. On enquiry, we were told that there was no invoice or credit note raised and that Dave had personally authorised the initial payment.

9. Various inventory valuation and system problems have been noted during the year. There is quite a thick file of reports. Poor perpetual inventory results indicate ongoing theft of copper wire. High-value inventory is segregated in another room; however, the lock on the door was noted as being broken. A lock has been attached but, on the day of my visit, the padlock was missing and the door unsecured.

10. Accounting software crashed in February Yr 45 with no backup and so records had to be recreated. The server is in the corner of the bookkeeper’s room which is never locked and has no air conditioning. There is no backup system.

11. Accounting controls are very poor. Differences in bank reconciliations are not investigated. There are minor differences being carried forward on the bank reconciliation which in total are not material. Pete says he is too busy to worry about these.

12. A routine review of the aged debtors ledger revealed a number of credit balances arising during the year had been cleared to the statement of profit or loss. It would seem that Erskine is holding on to overpayments from customers and not reporting this to them. Three instances have been noted totalling £120,000. These have been recognised as revenue.

13. Erskine owns a second factory building, which has lain unused for some time, in a nearby industrial estate. According to Pete, it was purchased several years ago to enable them to expand and hold greater amounts of inventory. The factory is currently included in the accounts at its historical cost. Pete says that its current value will definitely be more than what they paid for it.

14. In Yr 40, Pete’s son persuaded Erskine to invest in a start-up company based in the USA. Erskine invested $100,000 to acquire 5,000 shares. This represented a 5% stake in the company. The capital value of the stock fluctuated in the range of $18 to $22 until July Yr 45, although no dividend was ever paid. The share price has dropped to $2 per share by September Yr 45. Pete thinks that they might have raised further capital in Yr 42 and that Erskine’s holding may have been diluted but he cannot remember, and no documentation has been kept.

15. Of the 59 staff posts, there are currently three vacancies in the administration staff and nine vacancies on the production side. Turnover of staff is generally high in this industry, but these vacancies have been difficult to fill. Comments overheard from staff include “Morale is so low here, it can’t get any lower”, and “I can’t wait to get out as soon as I find another job”, and “I hate Neil”. I was never able to find out who this ‘Neil’ was.

16. I have had a look at the tax, and I understand this has yet to be calculated. Our tax department recommends that for valuation purposes we should assume a tax rate of 19%.

Section 2

Copy email found in file in finance department

To: Finance Dept
From: Dave Erskine
Subject: Wedding Costs – Vivienne Erskine
Date: 18th February Yr 45

I hope you all enjoyed the reception for my daughter's wedding at the weekend. It was a super day!

Wasn't it a great idea to give all the ladies a 'favour' of a memory stick, branded with 'Erskine Electronics' and loaded with photos of the ceremony? The carriage that they took from the ceremony to the reception had full Wi-Fi connection – I had it specially fitted.

Attached is the invoice from the wedding organiser and as Erskine will benefit from all that advertising, I thought the company should pay the bill. Please pay and post the full £25,000 to 'Marketing costs'.

Thanks.

Dave Erskine
Director

Section 3

Memo – Highly Confidential

From:	Pete Erskine
To:	Frances Galdamez, Charleston & Sylvester
Subject:	Finance Assistant & Bookkeeper – Mary Kilpatrick
Date:	September Yr 45

Frances,

Following your work on the due diligence, I am sending you this memo to outline some of my concerns about one of the members of staff. I am convinced that Mary Kilpatrick, the full-time Finance Assistant and Bookkeeper, is committing a fraud within the company – I just can't prove it.

She is always short of money and forever asking for advances on her wages. Anytime I have petty cash expenses to be reimbursed, she insists I leave the receipts with her and she brings me the cash later. I never see her with the petty cash tin.

I am convinced that a quantity of copper wire which went missing a few months back was taken by her. She gets picked up each night from work by her boyfriend in a big car with blacked out windows. When I asked her what he did for a living, she told me he was a scrap metal merchant.

She rarely takes any holidays. Last year she only took one week off. It was one of the weeks I was off too.

I am convinced she is up to something. Perhaps you could look specifically at the areas over which she has responsibility?

Pete

Section 4

Extracts from the annual report for year ended 30 June Yr 45

The directors present their report and financial statements for the year ended 30 June Yr 45.

Principal activity

The principal activity of the company during the year was the provision of services to the electronics industry and wholesalers. The year-end financial position is satisfactory and the outlook for the future is encouraging.

Trading performance

Revenue in the year ended 30 June Yr 45 fell to £10m. This was mainly as a result of a decline in orders from a large OEM. However, underlying trading performance is strong, with the outlook for the future very encouraging. The operating loss after one-off charges of £88,000 in the year disguises the fact that results are in line with the previous year.

During the year, the need to impair the balances on the outstanding directors' loan accounts was recognised and, accordingly, the balance has been written off. The charge to the statement of profit or loss of £412,000 is included in administrative expenses.

The directors have taken steps to diversify products and services and to widen the customer base. The company now offers an impressive skill set that also includes kitting, assembly, repair and debug and product refurbishment. In keeping with a fast-moving industry, we continue to develop new services which provide high-quality IT products and solutions to corporate customers.

The acquisition of the sole rights to distribute Winchester Spires Inc's ('WSI') products is, in the opinion of the directors, a major step in developing the company. WSI is the most famous name for tooling and cable accessories and has been the UK's market leading brand and the choice of all major wholesalers and end users for many decades. These products are targeted at electrical wholesale markets which demand the fast, efficient, reliable customer service for which Erskine is renowned.

The statement of financial position shows that the company's financial position remains strong.

Future outlook

The external commercial environment in which the company operates is expected to remain competitive. To broaden the base of its activities the company has continued to seek new markets and has recently started the distribution of cable ties and connectors to the electrical contracting sector and the 3D printing of computer keyboards. Continued review of operations has also resulted in the company ceasing the resale of computer peripherals. The company has continued to trade profitably through this period of changes and will seek to consolidate its position for the remainder of this year.

Principal risks and uncertainties

The management of the business and the execution of the company's strategy are subject to a number of risks. The key business risks affecting the company are considered to relate to competition from international suppliers, employee retention and product availability and price.

Key performance indicators

Given the straightforward nature of the business, the directors are of the opinion that analysis using KPIs is not necessary for an understanding of the development, performance or position of the business.

Directors

The Directors of the company during the year and up to the date of approval and signing of these financial statements are:

Mr P Erskine
Mr D Erskine
Mr C Dunn

By order of the Board

Director

Statement of profit or loss for the year ended 30 June Yr 45

	Notes	Yr 45	Yr 44
		£'000	£'000
Revenue		10,063	12,454
Cost of sales		(8,044)	(10,391)
Gross profit		2,019	2,063
Other income		-	3
Distribution costs		(108)	(79)
Administrative expenses	1	(1,900)	(1,547)
Finance income		6	5
Finance costs		(105)	(116)
(Loss)/ Profit before taxation		(88)	329
Taxation		-	(66)
(Loss)/ Profit for the year		(88)	263

All results relate to continuing operations.

Statement of financial position as at 30 June Yr 45

	Notes	Yr 45 £'000	Yr 44 £'000
Non-current assets			
Property, plant and equipment	2	465	508
Investments		67	67
		532	575
Current assets			
Inventories		1,017	419
Trade and other receivables	3	1,859	2,234
Cash and cash equivalents		15	10
		2,891	2,663
Total assets		3,423	3,238
Equity and liabilities			
Equity			
Share capital		100	100
Capital redemption reserve		20	20
Retained earnings		596	730
Total equity		716	850
Non-current liabilities			
Other payables		-	3
Current liabilities			
Trade and other payables	4	2,683	2,264
Current tax payable		-	55
Provisions		24	66
Total current liabilities		2,707	2,385
Total liabilities		2,707	2,388
Total equity and liabilities		3,423	3,238

The financial statements were approved by the board of directors on _______ and signed on its behalf by:

Director

Notes to the financial statements

1. Directors' emoluments

The aggregate emoluments, excluding pension contributions, paid to the directors were:

	Yr 45	Yr 44
	£'000	£'000
Aggregate emoluments	266	266

The emoluments of the highest paid director excluding pension contributions were £133,338 (Yr 44: £133,380)

2. Property, plant and equipment

	Land and buildings £'000	Property investments £'000	Plant, fixtures and fittings £'000	Motor vehicles £'000	Total £'000
Cost					
At 1 July Yr 44	246	300	453	61	1,060
Additions	-	-	-	-	-
Disposals	-	-	-	-	-
At 30 June Yr 45	246	300	453	61	1,060
Depreciation					
At 1 July Yr 44	49	192	267	44	552
Charge for the year	5	11	22	5	43
Disposals	-	-	-	-	-
At 30 June Yr 45	54	203	289	49	595
Carrying amount					
At 30 June Yr 45	192	97	164	12	465
At 30 June Yr 44	197	108	186	17	508

The carrying amount of property, plant and equipment includes an amount of £9,024 (Yr 44: £13,536) in respect of motor vehicles held under hire purchase agreements.

3. Trade and other receivables

	Yr 45	Yr 44
	£'000	£'000
Trade receivables	1,686	1,945
Directors' loans	-	180
Other receivables	77	4
Prepayments and accrued income	96	105
	1,859	2,234

Directors' loans

	Pete Erskine £	Dave Erskine £	Total £
Opening balance	89,973	89,974	179,947
Advanced in year	116,213	116,213	232,426
Repaid in year	-	-	-
Written off in year	(206,186)	(206,187)	(412,373)
Closing balance	-	-	-

4. Trade and other payables

	Yr 45 £'000	Yr 44 £'000
Bank overdraft	1,165	687
Trade payables	1,341	1,311
Obligations under hire-purchase agreements	9	4
Other tax and social security	32	112
Accruals	136	150
	2,683	2,264

The bank overdraft is secured by a floating charge over the assets of the company as at September Yr 44, and by personal guarantees from Dave Erskine and Pete Erskine as directors of £100,000 each.

END OF PAPER