



TPE 2023 – Mock 3

Quaerum – Case Study Part 2

Comprehensive Case Study
Case Study Description and Question

You have **3 hours** to complete this paper

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This mock exam is taking place remotely.

ICAS would remind you to continue to be ethical and observe the exam conditions applicable to the TPE exam.

CASE STUDY

It has been three months since you prepared the briefing note for Emma. She selected information from the notes you prepared to inform her presentation to the board and focussed on the potential short-term financial gains in Blackstuff. The board decided to add Blackstuff to the Energy Fund and All Commodities Fund (replacing the Asian Energy 25% holding). Both funds have performed well, with the latter making it into the ‘top ten ones to watch’ in last month’s ‘Invest Today’ magazine. Emma is delighted: she is due to receive a bonus for the improvement in the funds’ performance and she has also recommended you for a bonus. The bonus decisions will be made by the remuneration committee next week. You are in equal parts pleased and relieved that things have worked out so well. The bonus will let you replace your car.

Over breakfast, you read ‘CA News’ on your phone (Appendix 1) and it mentions that the auditors of Blackstuff have resigned. There seems to be an issue to do with the valuation of oil reserves going back many years. You rush to your desk to log on and make a video call to Emma.

“Good morning, Taylor,” says Emma, “You’re online early. What can I do for you?”

You feel nervous and unsure how to broach the subject. You notice a new ‘Angelo Dimitri’ bag on Emma’s desk. Your sister has a fake one that she bought on holiday in Lanzarote but you doubt if Emma would own a fake designer handbag, even if it did cost a month’s salary. Without thinking, you blurt out, “Nice bag!”

Looking slightly surprised, Emma says, “Thanks, my brother bought it for me as a thank you present. Now what do you want to talk to me about?”

“It’s Blackstuff,” you say nervously. “There is a news report today that their auditors have resigned and there is speculation that it’s to do with the valuation of oil reserves. This could affect Blackstuff’s share price and our All Commodities Fund and Energy Fund.”

“No doubt about it,” snaps Emma, looking cross. “But let’s not overreact. The bonus decisions are next week and they’ll be based on performance to the end of last quarter. The next quarterly performance report is not due to go to the board until the end of next month. Just keep the news to yourself for now. I’ve already spent that bonus and I’m not losing it now. Anyway, I thought you looked at the audited accounts. Doesn’t look like Blackstuff’s auditors have been doing their job properly, does it?”

Stung by Emma’s response, you try to compose yourself to respond, but just then Emma’s phone rings and she says, ‘It’s Tom, I’d better take this’.

Emma mutes her microphone and talks to Tom Lawson, chief executive officer. After a couple of minutes, she puts down her phone and unmutes herself. She looks even crosser than before and says, “Can you forward the meeting link to Tom please, Taylor. He wants to talk to us about an oil spill. Just when I thought this day couldn’t get any worse!”

You email the link to Tom and he joins straight away saying, “Good morning! One good thing about home-working is that you always know where people are. We have a problem and I need to get you both involved in handling it”.

“Yes, it’s very unusual for auditors to do this,” you say.

Tom looks surprised and says, “Why would the auditors have anything to do with an oil spill?”

Before you can reply, Emma interrupts and says, “Oh, we’re at cross purposes here Tom. Taylor hasn’t heard the important Blackstuff news yet. Taylor, Tom wants to speak to us about a serious oil spill. We can talk about that other matter later.”

Feeling confused, you decide to listen and stay quiet, expecting Emma to explain what’s going on later.

Tom says, “Okay, I’ll be brief. There’s been a major oil spill in the Gulf of Guinea off the coast of West Africa overnight and it’s happened at one of Blackstuff’s rigs (Appendix 2). It could take years to clean up and it will mean big changes to the way energy companies operate there, adding significant sums to their operating costs. Our analysts are saying any oil company operating in the area will lose around 50% of its market value over the next few weeks.

“It looks as if our exposure to the energy sector in West Africa has been too high and we are simply unable to keep the Energy Fund open. Investors have started to sell their holdings already and it looks unlikely that we will be able to cope with all requests to sell. In fact, it could get worse: the situation could affect our flagship All Commodities Fund as well. The stock exchange has already suspended trading in Blackstuff and we’ve had to suspend our Energy Fund this morning due to a lack of liquidity to meet investor withdrawals. All Commodities Fund is still open but it’s under a bit of pressure from investors selling too. We’ll need to move fast.

“I need an urgent report to the board informing them about the Blackstuff situation, the impact on the All Commodities Fund and Energy Fund, the ongoing viability of the funds and the implications for QI’s investors.

“I’m planning to ask internal audit to review our decision-making about Blackstuff to try and see what we can learn from this situation – did we get our risk assessment right? There’s no need for you to go into that area today, but I do wonder if there is something we missed. There’s a lot of useful information in integrated reports these days and my gut feeling is that we should be using this to support our investment decisions, instead of just the extracts from the annual report our analysts provide. In the draft report, briefly set out the added value we could obtain from using an integrated report.

“Above all, we have to restore investor confidence in QI and update the market with some positive news as soon as we can. We must do all we can to restore our reputation with investors. There has been some immediate communication of course to make relevant people aware of the situation but we need a clear and consistent approach. Make sure you include recommendations about how we should handle communications, externally and internally, as I want staff to be reassured that their jobs are not at risk.

“I’ll send you a link to some relevant information shortly (Appendix 2) and you might find it useful to look again at some of the information you used for the Blackstuff investment appraisal. Use the information and your own business acumen to produce a draft report to the board from me.

“One more thing: I need to share some very sensitive information with you and it must go no further,” says Tom in a grave tone.

“Of course,” Emma responds. “You can trust us.” You nod in agreement, wondering what he is going to say next.

“Good,” says Tom. “Iona is thinking of standing down as chair and retiring from business life. She wants to sell some or all of her shareholding in QI and as the majority shareholder, she has asked me to consider the implications for investors, the board and staff of selling QI to one of our competitor companies: Lavender House.”

Tom begins to look agitated and he says, “To be honest, I don’t think she is the only board member thinking of retiring. After the year I’ve had trying to deal with the implications of the pandemic as well as the mess the previous director of investments left behind, retirement is beginning to sound pretty attractive to me too. You wouldn’t believe the effort I had to put in to make sure the customer data leak didn’t get known outside the company. It could have been the end of everything I’ve worked for!”

Taking a deep breath and sitting back in his seat, Tom relaxes and says, “That’s all in the past now; it’s the future of QI that we need to focus on. Iona always has the best interests of staff at heart and making sure that they are looked after will be at the top of her agenda. Please include your appraisal of the sale of QI in the report you are drafting. I’ll send you through some background information on Lavender (Appendix 3).”

Glancing at his watch, Tom continues, “I’ll need to leave this with you, I have a meeting with the incident management team now. Let me have the report by the end of the day.”

“That’s clear,” says Emma with a big smile. “You can rely on us Tom.

“Well, well, well,” says Emma, her smile fading as Tom’s screen disappears. “This is a tricky situation, but let’s keep calm. There’s the immediate response to the Blackstuff crisis to consider: we need to give the board information and analysis about the Blackstuff situation, the impact on the All Commodities Fund and Energy Fund, the ongoing viability of the funds and the implications for QI’s investors. Don’t forget to include your views on the added value of using integrated reports and make recommendations for how QI should handle external and internal communications. There’s also the longer-term issue of Iona’s retirement.

“I’ll call our head of communications and let you know what she advises about Blackstuff (Appendix 4). You draft the report this afternoon and I’ll finalise it before it goes to Tom. If we handle this properly, everything will be fine. There could be some good opportunities for both of us in a new company. Any questions?”

“No, I think I’ve got all that,” you say, so taken aback by the situation that you feel unable to say more. You have a lot of thinking to do.

Before you can end the meeting, Emma stares unblinkingly at the screen, “Remember, don’t speak to anyone about this Blackstuff auditor business. The oil spill is much more important.”

Shortly after the meeting with Emma, you receive a phone call from an ICAS friend who wants to arrange an online birthday party for a mutual friend. During the course of the conversation, your friend mentions that he knows Emma's brother, Donald Reid, and had actually met him on his last skiing holiday. You recognise the brother's name as the director of upstream operations at Blackstuff. Feeling uncomfortable, but certain that you need to do something, you resolve to jot down some notes about your ethical concerns to help you decide what to do.

At your desk you start to make a note of issues when your phone pings. Your friend has sent you a photo from his Yr21 skiing holiday; in the background is a group of people wearing hoodies with the Blackstuff logo on them, and right in the middle is Emma Reid.

Required:

- Prepare the draft report to the board about the Blackstuff situation;
- Include in the report an analysis of the implications for investors, the board and staff if QI is sold to Lavender House;
- Prepare notes of the ethical issues you have identified and the action you will take.

APPENDIX 1

Online article in 'Auditing Essentials' featured in 'CA News' 18 May, Yr22

The external auditors of Blackstuff plc resigned yesterday following the announcement that a material figure for 'Probable Reserves' has been incorrectly stated in Blackstuff plc's Annual Report and Accounts for each of the last five years. The company has issued a statement to say that two key figures were transposed each year, with the 'Probable Reserves' and 'Exploration Reserves' being reversed in the accounts. It is not yet known how this happened.

The external auditor has not commented on the reason for their resignation. The regulator has said that they are aware of the situation and will be taking appropriate action in due course.

APPENDIX 2

Online article in 'Commodity News' – '*Blackstuff takes double hit*', 18 May Yr22

Shock news overnight from the Gulf of Guinea as drilling is suspended on Blackstuff's 'Wand' drilling rig due to a fractured borehole. Further investigation will be needed to ascertain the root cause of the breach. A major oil spill is now affecting marine and birdlife in the area and there is no sign that it can be brought under control quickly. Other companies in the area have been ordered to suspend drilling operations and they are likely to seek compensation for financial loss.

Blackstuff's share price fell sharply this morning as a result of this news, dropping from 75p to 45p before market regulators suspended trading in the company's shares. This followed directly on from further bad news for the company as an allegation emerged that Blackstuff's reserves may have been overstated. A team of accountants is being brought in from a major firm to investigate and should report within a month. Investors are understandably nervous about prospects for the company despite it holding a healthy bank balance. Blackstuff plc has yet to comment.

Blackstuff has been popular with investment funds in recent years due to its long-held commitment to sustainability as well as its consistent returns for investors. One fund in particular likely to be affected is QI's Energy Fund, which is understood to have recently acquired a significant holding in Blackstuff.

One of the main shareholders in Blackstuff, Safecash Investment Fund, issued an official news release early this morning prior to trading in the company's shares being suspended:

'We have every confidence in the management team at Blackstuff. They have been through hard times before and have grown the business with a strong sustainability focus over recent years. We intend to support the company in whatever way we can through this unfortunate circumstance. Their young and skilled management team has the skills to turn the company around. Should further investment be required, we will give this our full consideration.'

We contacted spokespersons for both Safecash and QI following the suspension of trading in Blackstuff's shares. No further comment was made by either company.

Editor's note: The Wand rig is one of the oldest in Blackstuff's fleet and was due for its two-yearly maintenance refurbishment, which had been delayed for nine months due to poor weather, according to a company spokesperson.

APPENDIX 3

Information provided by QI's strategic analyst team about Lavender House

In the commodities investment market, QI competes with several rivals, all of whom are much larger companies with successful market-wide investment funds within their operations: none of these companies specialises in commodities in the way that QI does. All of these companies provide the latest technology to their investors.

Lavender House, one of QI's main competitors, was established in Glasgow 40 years ago as a family-owned business. It now operates with a board of 10, including three original family members who retain a significant stake in the business. It has consistently rejected takeover bids from larger investment companies over the last 10 years. Salaries on offer are slightly below the industry average.

It has always invested in higher risk/higher return sectors, mostly in developing areas of the world, leading to some short-term volatility in performance. There is a limit of 20% investment in any one country or company. It has grown organically over the last five years and also through acquiring a small number of carefully selected specialist asset management companies with a close cultural fit. It actively scours the market for acquisitions that fit its investment criteria, with most companies investigated being rejected on various grounds.

Table 1: Lavender House financial information (Yr21)

Description	Lavender
Commodities Fund size (£m) _____	920
Commodities Fund size growth % _____	11
Commodities Fund RoI % _____	12.5
Commodities management costs % of fund _____	1.0
Operating profit (£m) _____	30
Operating profit average annual growth last 5 years % _____	9.5
Dividend paid per share % _____	3.5
Debt/equity ratio % _____	22
Current available cash for acquisitions (£m) _____	140

Table 2: Lavender House organisational information (Yr21)

Description	Lavender	QI
Average middle manager salary £ _____	47,000	45,000
Staff turnover per annum % _____	5	6
Staff absence levels % _____	2.2	2.5
Staff % internally promoted to senior manager vacancies _____	60	75
Employee director on board? _____	Yes	No
Flexible hours/home working available _____	Yes	Yes
Wage ratio – chief executive officer to lowest paid worker _____	10:1	12:1
Accommodation – floor space per employee _____	5.5 sq mtrs	4.8 sq mtrs

APPENDIX 4

Transcript of telephone conversation between Emma Reid and Charlie Clarke, Head of Communications at QI

Charlie: Thanks for calling me back Emma. I just got out of the incident management team meeting with Tom and then Iona called. She was on the phone for over an hour talking about Blackstuff and wondering how we ever got involved with them. Iona wants QI to release a statement to the market by the end of the day. She didn't sound happy at all.

Emma: I can help you with the draft. Iona doesn't need to worry, it will all come good in the end; there's no way we could have foreseen what was going to happen.

Charlie: I'm not so optimistic. We contacted our major investors this morning and some of them are very unhappy. They don't think Blackstuff can survive this. They are saying that investor sentiment is rock bottom and unless we act quickly the All Commodities Fund and Energy Fund may both be at risk. We need to take a lead and reassure them. You know what investors are like – they all follow each other.

Emma: That's true, but we've made good returns for them over the last few years and we've built up a good reputation for sustainable investment.

Charlie: Yes, but you know better than I do how changeable market sentiment can be. The future matters more than the past. We put a holding statement on the website and said that there would be an update today. We need to come up with a more informative statement that shows we can still be trusted to look after investors' money. There's no way that we could have anticipated this disaster but it would be a nice gesture if the board could share some of the pain by foregoing bonuses this year. If you can give me the key points for a statement to the market, I'll develop it into a draft for Iona's approval.

Emma: That sounds like a good way forward. I have someone working on a report to the board right now and I'll ask them to include key points for an external communication to the market in the report. Tom wants the report to include key messages for internal communications too. I saw the earlier briefing to staff of course.

Charlie: Thanks, consistency is important. I'll let you know if anything else comes up but I think I need a coffee right now – it's going to be a long day.

Emma: Sounds like an excellent idea, I'll pass your comments on to Taylor. Bye for now.

Charlie: Bye.

END OF PAPER