TPE 2023 – Guide to Answer

Greentree

The Test of Professional Expertise multi-discipline case study is designed to encourage students 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 are seeking.

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

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MORNING PAPER

The morning session asks for a briefing paper and memo requested by Paul for Susan, the managing director of Greentree Spirits Limited (‘Greentree’).

1 Industry Analysis

“…. give some context to your product comparison …. prepare a brief industry analysis …. ensure that the analysis is relevant to the circumstances of Greentree….”

1.1 Market and competition

The premium spirit market is still growing in the UK. However, this boom is leading to many new entrants entering the marketplace, and the existing large distilleries starting to produce new premium spirits. Therefore, it is important to produce a quality product with a unique selling point to capture market share. Greentree will have to articulate the unique selling point through brand building and marketing as this will be the factor that makes it possible to charge a premium.

Greentree is one of an ever-growing number of small players within the market and this may eventually result in the market becoming saturated. However, Greentree’s sales are currently growing at around 10% per annum which is very positive. Given the number of market competitors, there is a risk that customers may substitute another craft spirit, or a cheaper spirit for the Greentree product.

Craft products are usually sold in specialist retailers or upmarket supermarkets. Although they have introduced some craft product lines, a wide range of craft products are less likely to be sold in discount supermarkets such as Aldi or Lidl. Unless a greater range is stocked in discount supermarkets, it is likely that the growth in the market will slow and then stagnate.

1.2 Distribution and marketing

For the year to 30 June Yr57, Greentree sold 70,690 units. 43,990 units, or 62% of total sales, were wholesale to distributors with the remaining 38% being direct sales. However, the direct sales provide 73% (£341k/£467k) of gross profit. On this initial analysis, there is a possibility that it would be worthwhile concentrating marketing effort on growing direct sales.

The craft spirit industry has little access to the major retailers due to the pressure on margins, so sales are made through distributors. It is therefore vital to form a positive relationship with a leading distributor, particularly as they are responsible for marketing the product to retailers.

Greentree has a strong level of direct sales, which indicates that internal marketing through social media and word of mouth is working well. Advice could be sought from a social media marketing expert to reach a wider market through use of targeted advertising, promoted tweets etc.

1.3 Environmental issues

Repeated flooding in recent years has had a significant impact on potato farming, increasing soil acidity which reduces crop yield. 25% of the Lawrence farmland has been affected by flooding, so the farm business will incur additional costs in order to rebalance the acidity levels which are likely to be passed on to the customer i.e. Greentree.

At present, approximately 30% of potato stock is purchased from other farms, but as production capacity increases, this percentage will also increase. Greentree must keep the strategy of growing potatoes for spirit production under review. Unless the brand needs home grown potatoes to be part of the marketing story, the decision to grow potatoes is unconnected to the spirit business. 100% of potatoes could be bought-in if the flooding fields could be used for a more profitable farming activity. Due to the flooding issues, potato prices are generally likely to increase, which could have an impact on margin, unless the price increases were transferred to the customer.

1.4 Minimum unit pricing

Each Greentree bottle has 14 (50ml) servings, each of which is 2 alcohol units, so there are therefore 28 units per bottle. If the minimum pricing per unit was 50p, that would lead to a minimum retail price of £14 per bottle. This should not have an impact on Greentree whose retail prices are £22.50 for vodka and £26.50 for gin. The minimum pricing may be beneficial to Greentree's business as the size of the craft premium would be reduced and consumers may perceive craft products as relatively more attractive.

1.5 Health Awareness

The public are in general, consuming less alcohol. However, they are often choosing higher quality products when they do. The craft trend has continued for a number of years now, but at some point, growth will slow. Greentree must remain alert to social trends and plan its strategy accordingly.

2 New Product Assessment

"….. prepare a comparison between them looking at both financial and non-financial aspects and make a recommendation as to which product to introduce…."

Due to the current low levels of inflation, it has not been factored into the new product forecasts below. It has also been assumed that all goods produced during the year are sold i.e. there is no opening or closing stock.

2.1 Flavoured vodka

The revised cost per 70cl bottle is as follows:

	£	£	
Current vodka production cost		11.11	
Additional raw materials	0.45		
Additional labour	0.25		
Additional overhead	0.10		
Spirit duty saving	-0.60		3% x £28.74 x 0.7litres
		0.20	
Revised cost		11.31	

Based on selling prices of £13.50 wholesale (16% margin) and £23.00 for direct sales (51% margin), sales and cost of sales can be calculated as follows:

Apple and elderflower vodka		**Sales**	**Cost of Sales**	**Gross Profit**
		£	£	£
	Year 1			
Wholesale	250 bottles monthly = 3,000 per year	40,500	33,930	6,570
Direct	100 bottles monthly = 1,200 per year	27,600	13,572	14,028
	TOTAL	68,100	47,502	20,598
	Years 2 & 3			
Wholesale	400 bottles monthly = 4,800 per year	64,800	54,288	10,512
Direct	100 bottles monthly = 1,200 per year	27,600	13,572	14,028
	TOTAL	92,400	67,860	24,540

The flavoured vodka would be produced at a slightly higher cost than your current premium vodka (£11.31 compared to £11.11 per bottle). You are predicting that you will be able to pass on that cost with slightly higher sales prices and are therefore able to maintain similar margins:

	Wholesale margin	**Direct sales margin**
Premium vodka	15%	51%
Flavoured vodka	16%	51%

Clearly proceeding with this product at this time would only be worthwhile if the market for Premium vodka is fully exploited. Launching this new vodka product will need management, marketing and administration effort. The margins are similar to Premium vodka making the need for a clear strategic advantage essential.

The manufacturing process requires an additional three days but is otherwise similar and you have indicated that you should be able to source the apples locally and get the elderflowers on the farm.

Elderflower harvest

The use of elderflower as a flavour adds a number of issues. Elderflowers have a short harvest season from late May to mid-June and can't be stored without an impact on the flavour. The result of this is that the full year production would have to take place at harvest season.

Assuming annual sales are roughly equal to production, you sell around 33,650 bottles of vodka and 37,040 bottles of gin a year, so monthly production is approximately 5,900 bottles per month. You would need to focus solely on producing the flavoured vodka around harvest time and spread production of other products over the rest of the year. As production would be just before the year end, this would lead to a much higher closing stock figure than in previous years. It must also be ensured that Greentree has enough storage space to store this level of stock. There would also be an impact on cash flow by producing a large amount of product up front which would then generate cash slowly over the following year.

You would need to store the product and distribute it over the course of the year. The product only has a shelf-life of two years, so there is a risk that bottles sold toward the end of that time will have a shorter shelf life for the distributor.

The flowers can only be handpicked which means you will need additional staff at harvest time. It is unclear whether this has been factored into the additional labour cost you provided. Care would be required to implement and consistently undertake checks on identity. The availability of seasonal staff may have reduced compared to recent years due to the UK leaving the EU.

As you have indicated that you would only be able to obtain enough elderflowers for 3,000 bottles from the farm, you would have to obtain the remainder from elsewhere, within the tight harvest timescale. We would recommend that you enter into a contract with a supplier for a guaranteed supply, with stringent penalties for failure as this would have a critical impact on your ability to meet your orders.

You will need to be aware of the seasonality of your raw materials and plan accordingly to ensure sufficient stock to meet your distribution contracts. We have based our direct sales figures on 100 bottles per month for all three years, when in fact this would be likely to increase if the product was successful. The margin on direct sales is 51% so any increase in sales will have an impact on profit.

2.2 *Flavoured gin liqueur*

The revised cost per 70cl bottle of 20% ABV gin liqueur is as follows:

	£	£	
Current gin production cost (70cl)		12.41	
Less: spirit duty		(8.25)	(new calculation needed)
		4.16	
Cost of 35ml gin (excluding spirit duty)		2.08	50% x £4.16 (½ gin: ½ liqueur)
Additional raw materials	2.68		
Additional labour	0.15		
Additional overhead	0.10		
		2.93	
Spirit duty:70cl bottle with 20% ABV		4.02	20% x £28.74 x 0.7l (bottle)
Revised cost		9.03	

Based on selling prices of £12 wholesale (25% margin) and £18 for direct sales (50% margin), sales and cost of sales can be calculated as follows:

Blackberry gin liqueur			**Sales** £	**Cost of Sales** £	**Gross Profit** £
Wholesale	4,000 units per year		48,000	36,120	11,880
Direct	1,000 units per year		18,000	9,030	8,970
		TOTAL	66,000	45,150	20,850

You are only predicting sales of 5,000 bottles of the blackberry liqueur. As it has a much lower alcohol content of 20%, compared to the premium gin at 41%, the cost per unit is much lower than the premium gin at £9.03 per bottle.

The profit margins are similar to the flavoured vodka at 25% (£11,880/£48,000) margin on wholesale sales and 50% (£8,970/£18,000) on direct sales. However, the annual gross profit of £20,850 is less than the £24,540 predicted for the flavoured vodka in years 2 and 3, a shortfall of £3,690. At this time, the rise of interest in craft gin has considerable momentum. An argument could be made that this shortfall could be made up by selling an additional 400 units direct (£8.97 gross profit per bottle) as a consequence of consumers' interest in craft gin continuing to rise.

You are suggesting that the packaging for the gin liqueur should be similar to the current premium gin. We would recommend that you consider distinguishing the products as their usage and alcohol content are significantly different.

As with the vodka there is additional manufacturing time and you must be conscious of the seasonality of blackberries in this country and ensure that you have an adequate supply for production. Sourcing blackberries may not be entirely similar to sourcing potatoes and further research may be of value to be clear about the benefits of using fresh fruit over concentrated flavourings.

The distributor you have been in contact with to market and sell this product is not one that you have worked with previously, so you must ensure that any contract you make has been reviewed by your company lawyer and that you have satisfied yourself of the credibility of the distributor.

The impact of the Covid 19 virus on certain sectors of economy particularly the hospitality industry may mean that the demand in this sector could be subdued for some time. It is uncertain when this industry will get back to full operation but hopefully the roll out of the vaccine will enable demand to bounce back quickly.

2.3 Vodka alcopop

The cost price per 275ml bottle of alcopop is £1.12. However, the extension of the sugar tax to cover fruit-based alcopops will increase the cost per bottle to £1.20 (rounded for ease of numbers).

The wholesale sales price margin will be 10% - 20%. A 10% margin would result in a sales price of £1.33 per bottle (£1.20 / 90%).

Sales and cost of sales would be as follows:

Vodka and apple alcopop - 10% margin		**Sales**	**Cost of Sales**	**Gross Profit**
		£	£	£
	Year 1			
Wholesale	500 cases monthly = 24k bottles per year	31,920	28,800	3,120
	Years 2 & 3			
Wholesale	800 cases monthly = 38.4k bottles per year	51,072	46,080	4,992

* £1.33 used as sale price – rounding can be used

A 20% margin would mean a sales price of £1.50 per bottle (£1.20 / 80%) which would give the following results (rounded for ease of numbers).:

Vodka and apple alcopop - 20% margin		**Sales**	**Cost of Sales**	**Gross Profit**
		£	£	£
Wholesale	Year 1 500 cases monthly = 24k bottles per year	36,000	28,800	7,200
Wholesale	Years 2 & 3 800 cases monthly = 38.4k bottles per year	57,600	46,080	11,520

You estimate costs to be £1.20 per bottle. Currently bottles of alcopop can sell for less than £1 in supermarkets, including VAT. Your wholesale price would be £1.33 at a 10% margin and £1.50 at a 20% margin and so your product is unlikely to be attractive to larger retailers. Alcopops are usually consumed by younger drinkers with less disposable income who are less likely to pay for a premium, or craft product. There is also a reputational issue as some people believe that alcopops encourage irresponsible drinking amongst younger drinkers.

We have included the extra cost per unit for sugar tax (7p has been added and total rounded) in the unit cost and have assumed you will try to recover this through the pricing.

Note: a valid assumption would also be for the sugar tax not to be recovered, which will have a negative effect on the margins on these products.

Alcopops are produced by most of the large distilleries, which can produce them at a significantly lower cost per unit and can therefore make a much bigger margin, at a similar retail point.

Alcopops are sold in 275ml bottles, as opposed to the other products which are sold in 700ml bottles. It is unclear whether your current bottling process could deal with different bottle size, and a carbonated product. Obviously, a separate bottling process would result in further costs.

2.4 Recommendation

Based on your predicted sales, the results of the three options are as follows:

Gross profit based on forecast sales	**Year 1**	**Year 2**	**Year 3**
	£	£	£
Flavoured vodka	20,598	24,540	24,540
Flavoured gin liqueur	20,850	20,850	20,850
Vodka alcopop – 10% margin	3,120	4,992	4,992
Vodka alcopop – 20% margin	7,200	11,520	11,520

We recommend that you do not proceed with the alcopop due to the comparatively poor financial results. A less premium product may also damage the Greentree brand.

The apple and elderflower vodka produces the best gross profit from year 2 onwards but there isn't a significant difference in gross profit between this and the gin liqueur.

Expected production levels of vodka rise to 6,000 bottles in year 2 onwards and 5,000 bottles for the gin liqueur. As you currently produce over 70,000 bottles of your premium vodka and gin, neither of these products would have a major impact on your existing production, particularly if you are increasing capacity by purchasing another still.

As discussed in section 2.1, the inability to store elderflower would necessitate the production of the flavoured vodka in June, to coincide with the elderflower harvest. There would be a lack of flexibility to increase sales, as production levels for the year would be fixed. In addition, there would be additional storage costs to hold this product until sale.

We recommend that you do further market research and have further discussions with your distributors about the other two products and choose the product which can sell the most units.

Note: Students could pick the flavoured vodka or the flavoured gin liqueur and earn credit, if justified

3 Financial position from a lender's perspective

"…. review the financial position of Greentree from the point of view of the bank…. base your review on the year to 30 June Yr57…. a preliminary memo to give Susan an idea of the sort of thing that the bank will be looking at…."

3.1 Profitability

Greentree is a business with good growth. Net profit has almost doubled from £46k to £90k for the year ended 30 June Yr57 and year-on-year sales have risen by 13%. This indicates that operating expenses have been held down as sales have grown. This appears to be a good result but should be checked against the budget expectations. For example, staff costs have grown by 3%. Does this mean that the same work is being required to deliver the increased gross profit or could it mean that the business is short staffed and potentially cutting corners?

The gross profit margin has remained steady at around 35% over the last three years which suggests sales prices and production costs are being managed. Net profit is 7% for the year ended 30 June Yr57, an increase from 4% the previous year. It may be worth sourcing some benchmark data. Given the boom in popularity of craft spirits, it may be that margins should have been better.

3.2 Cash and working capital

Greentree has a £100,000 overdraft facility and at 30 June Yr57, the bank overdraft was £99,000, an increase of £43,000 from the previous year.

The trade debtors' position has increased from £73,000 to £129,000. It is only wholesale sales which are made on credit and there are only two customers/distributors. The bank is likely to ask about how long the trade debtor balance has been outstanding, and, if it is not a current debt, what efforts are being made to chase the debt up. As there are currently only two distributors, it may be practical to collate evidence of the actions taken to reassure the bank that you are on top of the situation. If Greentree are to purchase a new pot still, this will require additional finance if the expected grant funding is not available.

Greentree is using the bank overdraft to fund the payment of dividends (Yr57: £59k, Yr56: 41k). The bank is likely to question this policy and may suggest suspending dividend payments until the company reduces its overdraft.

Stock has more than doubled from £20k at 30 June Yr57 to £43k at 30 June Yr56. Care must be taken to ensure that this balance doesn't continue to rise, tying up cash in stock.

The current ratio covenant is being met for the year ended 30 June Yr57, and the ratio is increasing, mainly as a result of the increase in stock and debtors.

3.3. Debt

Greentree is heavily geared due to the £200k bank loan. Greentree has good interest cover (at 7 times) which shows that it is generating sufficient profit to service the debt.

The covenants imposed by the bank required interest cover to be a minimum of 3 times and gearing to be a maximum of 85%. Greentree is meeting these covenants comfortably. This is in part because the bank overdraft is not being included as 'debt' in the gearing calculation. If it was included, the impact on gearing would be to increase the ratio to 83%. This is very close to the limit. The relationship with the bank is very important and it may be worthwhile discussing the covenant with the bank at the next opportunity. It is best to be clear that the bank is supportive of the financing arrangement. Given that the margin on the loan and the overdraft are the same and therefore the perceived risk to the bank similar, it is not immediately clear why the bank does not include the substantial overdraft in the gearing.

However, the loan is due for repayment on 31 January Yr58. Greentree do not have funds to repay this loan and must negotiate with the bank to renew/extend the loan. This negotiation to renew should be done in good time to avoid the position where the bank's terms must be accepted due to a lack of time to 'shop around'.

3.4. Security

Greentree has a solid fixed asset base, with buildings with a net book value of £269,000 in the financial statements. The bank would want to know the current market value of these assets, if they were to be used as security for future financing.

There is also a possibility that the bank will ask the directors to provide personal guarantees against any future borrowing.

AFTERNOON PAPER

Students are asked to prepare a number of documents in the afternoon session.

4 Quarterly accounts and draft business plan for the bank

"…. analyse the latest accounts …. identify which covenants we may have breached and what might have caused this"

"…how we are going to manage our financial position going forward…. bring a business plan to the meeting …. the plan should include sections on the finance required going forward, staffing of the finance function and the recording of and controls over financial information"

"…prepare a report to the board…. include the section of the business plan in the report…. prepared from the perspective of what the bank should be looking for…. include your analysis of the quarterly management accounts and the covenants, identifying the areas of concern…. review the notes that Susan has produced …. include the revised draft sections of the business plan for the bank …. any further information is needed, you should make this clear…"

4.1 Analysis of quarterly accounts and bank covenants

The bank will be pleased with the decrease in the overdraft from £99k at the year end to £41k at 30 September Yr57.

The bank covenants form part of the financing agreement with the bank. They are measures which must be complied with, or Greentree risks having its financing withdrawn immediately.

There are three financial covenants which have been put in place as follows:

	Quarter ended 30 September Yr57	**Year ended 30 June Yr57**	**Year ended 30 June Yr56**	**Bank requirement**
Interest cover (times)	$\boxed{1.7}$	8	5	Minimum 3 times
Current ratio (excluding bank loan)	1.31	1.13	1.01	Minimum 1.0
Gearing	75%	76%	77%	Maximum 85%

You can see from this that Greentree has breached the interest cover covenant in the quarter to 30 September Yr57.

Interest cover has dropped below three times, that is profit before interest and tax is less than three times the interest expense. The interest charge itself is in line with the prior year, at £3k for the quarter as opposed to £12k for the year to 30 June Yr57. It is profit before interest and tax which is much lower than expected at only £5k for the quarter compared to £90k for the full year to 30 June Yr57.

There is no entry for stock on the balance sheet as at 30 September Yr57, compared to a stock balance of £43k at 30 June Yr57. This will result in a much higher than expected cost of sales balance and consequently a lower profit. The stock balance as at 30 September Yr57 needs to be calculated and a correction made to the quarterly accounts. For illustrative purposes, we have used the stock holding at 30 June Yr57 of £43k as the closing stock balance at 30 September Yr57 and recalculated the ratios.

	£'000
PBIT for the quarter ended 30 September Yr57	5
Add: closing stock	43
	48
Interest cost	3
Revised interest cover (times)	16.0

The result is that Greentree would not actually breach the interest cover covenant. However, we stress that the actual stock balance as at 30 September Yr57 should be obtained or estimated and used to resubmit the management accounts to the bank. Care should be taken to provide good management accounts to the bank. If the bank sees indications of poor management therefore more risk, this could lead to higher interest rates.

In addition, Greentree have again missed the deadline to submit quarterly management accounts to the bank.

4.2 Finance required

The current financing structure is a £200,000 ten-year term loan paying interest at 3.5% over base plus a £100,000 overdraft. Greentree has been in overdraft at the year-end for the past three years, which suggests that this is actually a more permanent source of financing and should perhaps be rolled into the loan.

Sales have grown year on year, and our forecasts (to be provided later) show that we expect that growth to continue. Greentree intends to purchase a new pot still to meet the increased demand for the product. The cost of this still will be met from grant funding and will not require bank funding.

As discussed below, Greentree will need to obtain some bookkeeping support with the departure of Marian Lawrence. This part-time role will likely cost in the region of £15k per annum. W&M could provide a bookkeeping service in the interim and could help you with the recruitment process if required.

It is proposed that Greentree needs a five-year term loan of approximately £250,000 plus a £100,000 overdraft. The additional loan facility will be used to boost working capital as the business grows, but, with the improved controls outlined below, it is anticipated that a cash surplus could be reached over the next two to three years. Security over the loan could be over the buildings, or a floating charge over assets. Greentree would continue to provide quarterly accounts.

4.3 Staffing of the finance function

With the departure from the business of Marian Lawrence, some external financial support is needed, as there is no-one within the business who has the necessary financial experience. There are a number of finance functions which need to be performed:

- processing sales orders, invoicing wholesale distributors and recording cash received
- recording supplier invoices and paying suppliers
- running payroll
- submitting HMRC returns including VAT

Note: credit awarded for sensible suggestions

We propose to recruit an experienced bookkeeper to work in the business three days a week. As well as recording the financial information, this individual would prepare reconciliations for the directors to review (see sections 4.4). You will need a clear job description and clearly define the skills you are looking for. This can be as practical as knowledge of specific computer software. It would be too much to specify any knowledge of farming or the spirits industry, but you could state that these would be desirable. The candidate should have experience liaising with the bank regarding covenants and may also be involved in trading potato futures if you choose to go down that route.

4.4 Recording and controls over financial information

There are currently very few controls in place over the financial information. We intend to implement the following:

a) Prepare bank reconciliations each month. The reconciliation will be prepared by the bookkeeper and reviewed by Susan Lawrence. This control will ensure that all cash transactions are being correctly recorded through the financial statements of Greentree.
b) Sequential sales order forms will be introduced to ensure all sales are recorded. These forms will be used for direct and staff sales so that all sales are captured. The sales orders

will be filed sequentially, and any gaps will be investigated to ensure that all sales are recorded. Wholesale sales are based on the contract between the distributor and Greentree. Any variations to the contracted amounts by the distributor should also be noted on a sequential order form and an invoice generated.

c) A weekly payment run will be discussed between Susan and the bookkeeper before being authorised for payment to ensure invoices are being paid, but only when they fall due.
d) Susan will regularly review the debtors balance to ensure that any overdue debts with the distributors are chased.
e) Budgets will be prepared for the year ahead, broken down by quarter. The quarterly results will be compared to budget and variances will be investigated and documented.

Note: This is a selection of possible controls that could be suggested. Marks awarded for reasonable suggestions, tailored to Greentree. The reasoning behind the control should be clear.

It is important that the board members can review the regular financial information that is prepared, including compliance with the bank covenants, and we therefore recommend that you obtain some basic financial training to be able to do this.

5 Offer from SBS

"…. received an offer from a company, to purchase Greentree, via a broker called Southern Business Solutions …. need to consider their offer…. evaluate the offer …."

"… prepare a valuation of Greentree to evaluate the offer… a P/E ratio of 10 would be appropriate…"

5.1 Who is the purchaser?

An offer has been received from a business broker, Southern Business Solutions ('SBS') to purchase Greentree. SBS is acting as the agent for an unknown purchaser who is willing to purchase Greentree through an intermediary with none of the usual due diligence. Irrespective of the terms of the offer, this would appear to be an unusual transaction.

We recommend that Greentree should seek to establish the identity of the purchaser from SBS to ensure it is a legitimate business. Once you have established the identity of the purchase, we advise you to do some research on the company – what is does, where it operates, who runs it etc., so that you have a better sense of who you are dealing with in these negotiations.

5.2 Outline of offer and valuation of Greentree

£700k has been offered to purchase 100% of the share capital of Greentree. This is to be paid £350k up front in cash, with the remaining £350k three years after the offer is accepted based on a number of conditions.

To determine whether this is a fair offer, we need to determine the valuation of Greentree. The earnings method of valuation is most appropriate here as it values the business as a whole, taking future growth potential into account. The earnings method is calculated by multiplying the future maintainable earnings (profit) by an earnings multiple. The earnings multiple is called the price/earnings ratio. The profit for the year to 30 June Yr57 was £63,000. We have no information about the possible cost savings from the purchaser's supplier network so have not adjusted this figure. The price/earnings ratio will need to be estimated. For a small company showing good growth, such as Greentree, a suitable profit/earnings ratio might be 10. These figures would give Greentree a valuation of £630,000.

On the basis of this valuation, the offer of £700,000 appears to be generous. However, if the offer conditions were not met, you would only receive £350k, which would not be a fair reflection of the value of the company.

5.3 Terms of the offer

The offer has 3 major conditions attached to the receipt of the additional £350k.

a) **Annual revenue growth of at least 10%**

Greentree's sales grew by 13% to 30 June Yr57 and the new still, new product and strong first quarter growth all suggest that this target could be met. However, you will want to understand the definition of revenue (would it include intercompany sales if you could make sales to other group companies?).

b) **Annual net profit margin of at least 15%**

Greentree had a net profit margin of only 7% for the year to 30 June Yr57. Significant costs would need to be cut to meet this target. SBS have stated in their offer that "the supplier network will aid you in achieving the net profit margins" but have provided no further detail. You would need to be clear about the definition of net profit margin and how the supplier network would be able to help you to meet this target.

c) **Management remain in post for at least 3 years**

You, your father and Bethany would all be required to stay at Greentree for three years. However, you would no longer control the business and would have to implement decisions made by the unknown purchaser. You must also consider whether you father will want to lessen his involvement in the business as he heads towards retirement age. The purchaser is unlikely to know that your mother does not intend to work for Greentree any longer and she might be included in their definition of management.

It is possible that you would not achieve all targets in all years and therefore fail to receive 50% of the consideration. For example, if you failed to meet the 15% net profit target in year 1, you would still be tied into the company for another 2 years, with no chance of receiving the other half of the £700k. You should look to negotiate the terms of the offer in your favour, clarifying the conditions and attempting to break down the requirements for the contingent consideration.

5.4 Practicalities of the offer

Were the deal to proceed, the purchaser would own 100% of the shares, so although you would still be a director, you would not be able to decide the strategic direction of the business.

The purchaser would be operating the Greentree business on the land of the Lawrence family farm, so this would also need to be negotiated carefully.

The mention of utilising the purchaser's supplier network to reduce margins means that the contracts you currently have in place with suppliers are likely to be amended or even cancelled.

There is a possibility that some shareholders may wish to take the offer up, but others may not. For example, your mother may see this as a way to extract money quickly from the company, or your father may see this as a way to fund his retirement. Should such a conflict arise, we would not be able to advise all parties.

If you sold your shares, you would become liable for capital gains tax, although you would be eligible to entrepreneurs' relief which should reduce the amount payable.

5.5 Conclusion

Based on a valuation of around £630k for Greentree, the offer of £700k, with half the payment in cash up front appears to be a generous offer. However, we would urge caution due to the unknown purchaser and the risk of failing to meet the targets and do not recommend that you sell based on the current offer. It is also unusual to wish to conclude a deal of this type within such a tight timescale.

6 Slides on potato futures

"….give a short presentation to the board"

"… prepare few slides, with speaker notes …"

"…a short, simple illustrative example would be useful…"

6.1 Describe futures

SLIDE 1 – What is a potato future?

- A future is a fixed obligation to buy or sell something on a future date at a specified price.
- Futures are traded on organised exchanges and have standard terms to facilitate trading.
- Using futures is a way of fixing future prices, but it may result in a profit or a loss.
- Futures are also used to speculate on price changes to make a profit.

Notes:

- In this case, Greentree would be entering into a future to buy a specified amount of potatoes at a set price on a set date. It is a fixed obligation, Greentree would be locked into the agreement.

- Greentree would still be required to actually buy potatoes at market rate. On the date that you buy the potatoes, you would also “close out” the future. Closing out would involve purchasing an equal and opposite future, i.e. a future to sell the same amount of potatoes on the same date. Doing so cancels out the original obligation to buy potatoes.

- As well as buying the potatoes at market rate, you would make a profit or loss on closing out the futures contract. If you make a profit (sell price > buy price) you receive the profit, but if you make a loss (buy price > sell price) you pay the loss amount.

- Although futures are used by banks and financial institutions to speculate and make money, they have a real use by producers, who can use them to insure against future changes to commodity prices.

6.2 Why would Greentree use them

SLIDE 2 – Greentree use

- Fix prices
- Reduce uncertainty
- More efficient budgeting

Notes:

- Greentree is unable to provide sufficient potatoes to meet current order levels so needs to purchase potatoes from external sources. As the distillery expands, an even greater level of potatoes will be required, and the price of potatoes is known to fluctuate leading to uncertain levels of expenditure.

- Buying futures is a way of providing more certainty over the price you pay in the future. If the market price of potatoes rises, you make a gain on your futures to offset the increased cost.

6.3 Example

> SLIDE 3 – Illustrative example
>
> It is now November, and a distillery expects to have to buy 10 tons of potatoes in February. The current cash price per ton of potatoes is £450/ton. The distillery is concerned prices are likely to rise, so it buys 10 February potato futures at £450/ton.
>
> *Example a)* The price of potatoes rises
>
> Market price in February - £500/ton
> Future price to sell potatoes in February - £500/ton
>
> Purchase potatoes: 10 x £500 = £5,000
> Profit on futures (sell price – buy price): 10 x (£500 - £450) = £500 profit
>
> Net cash outflow = (£5,000) + £500 = (£4,500)

Notes:

- Step 1: In November distillery buys 10 futures at £450 a ton
  Step 2: In February, distillery buys the potatoes in the spot market for £5,000
  Step 3: In February, the futures contract is closed out. As the information related to 'February futures' it is likely that the price of these is very close to the spot market price of £500/ton. In this case, assuming the £500/ton futures price, there is a profit of £50 per futures contract = £500.

Buying futures is a way of providing more certainty over the price you pay in the future. If prices in the spot market rise, you make a gain on your futures to offset the increased cost.

> SLIDE 4 – Illustrative example continued
>
> *Example b)* The price of potatoes falls
>
> - Market price in February - £425/ton
> - Future price to sell potatoes in February - £425/ton
>
> - Purchase potatoes: 10 x £425 = £4,250
> - Loss on futures (sell price – buy price): 10 x (£425 - £450) = (£250) Loss
>
> - Net cash outflow = (£4,250) + (£250) = (£4,500)

Notes:

- In this simple illustrative example, the net cash outflow is the same in both cases, irrespective in the actual price of the potatoes in February. If prices fall in the spot market, then rather than making a saving, you have to pay for the loss on the futures. Therefore, you would usually only take out a future if you expect prices to increase.

6.4 Recommendations

SLIDE 5 – Recommendations

- Greentree currently has to obtain 30% of potatoes from suppliers
- As the business grows, this percentage will increase
- Potato futures give a degree of certainty over future expenditure, which can allow for more efficient budgeting.

Notes:

- As Greentree continues to grow, you will need to obtain more and more potatoes from suppliers. Prices are on the increase, particularly after the repeated flooding over recent years. Futures would be something to consider in order to fix the price you need to pay. You should be aware that the price of a future is not always the same as market price (as it was in the example) and so the net cash position is not always fixed.

- You will need to be able to forecast the volume of potatoes that you intend to purchase to make futures work for your business. The example above has been simplified. In practice the gain/loss on a future is calculated daily and you are usually expected to provide an initial margin (similar to a deposit), and in addition you would have to pay more to the exchange to fund any daily losses.

7 Letter to Thomas

"…. suggest that she [Marian] gifts her shares to Susan with immediate effect …. write a letter …. explain what the consequences of this would be …"

7.1 Control of the company

Marian currently holds 20% of the shares, with you and Susan both holding 40%. If Susan receives Marian's shares, that will make her the majority shareholder with 60%.

7.2 Capital gains tax

On the gift of shares, Marian would be liable for CGT on the rise in value of the shares, comparing the market value on gift with the original cost. However, gift relief could apply, if both Marian and Susan jointly elect to claim it. This would mean that Susan would be liable for the full gain on the value of shares since the company was formed if she eventually sells them on. If Marian decides to gift the shares, she should discuss the tax position with Susan to decide who is going to be liable for the tax before the transfer happens. Whilst the joint election to apply gift relief can be made up to four years after the year of transfer, it is advisable to discuss this at the time. There is no guarantee that both parties would agree to the election at a later date.

An alternative to gift relief would be for Marian to claim Business Asset Disposal Relief (BADR) on the gain as she is disposing of unquoted trading company shares, of which we had held at least 5% and has been an officer of the company, all for at least two years prior to disposal. If BADR was claimed, any gain arising on the disposal of the shares would be taxable at only 10%. There is an argument that as she has moved to Spain that she no longer works for the company and as a result BADR would not be available.

7.3 Inheritance tax ('IHT')

The gifting of the shares would be a transfer of value, and therefore the gift would be subject to IHT. However, as Marian would be gifting the shares to an individual (Susan) it would be a Potentially Exempt Transfer. This means that it would only become chargeable to IHT if Marian does not survive for seven years following the gift.

However, it if did become chargeable, business property relief ('BPR') would apply as Marian held the shares for more than two years prior to the transfer to Susan. BPR would be available so long as Susan still retains ownership of the shares and the business is still an unlisted company.

Email to the ethics partner

"…if you have any ethical concerns about this engagement… alert the firm's ethics partner with an email…"

To: ethicspartner@walkermason.co.uk
From: anna@walkermason.co.uk
Re: Greentree ethical concerns
Date: November Yr57

I am currently working on the Greentree advisory engagement for Paul Mason, and I have a few concerns that I wanted to raise with you.

a) SBS offer (Integrity)

Southern Business Solutions have made an offer on behalf of an unknown purchaser to acquire 100% of the share capital of Greentree. There is no intention to carry out due diligence and the initial, up-front consideration of £350,000 is to be paid in cash. The offer seems highly unusual and I am concerned that this might be an attempt to launder money.

I plan to discuss this with Paul, but also wanted to fulfil my responsibilities by reporting it directly to you, as I believe that there may be a suspicion of money laundering, or other unethical practices and as such it may be necessary to make a report to the money laundering reporting officer.

b) Bribery (Integrity / Professional Behaviour)

It appears that the agent used to obtain saffron from Iran may be making facilitation payments on behalf of Greentree. This would be in contravention of the Bribery Act 2010.

It seems likely that the directors of Greentree are unaware of their responsibilities under the Bribery Act, but they ought to be and have a duty to be. We must act sensitively here. Is this the first time we have been aware of this situation and should we have been aware before? Have we told the advisory client about its duties under the Bribery Act? We must consider whether we can continue to act for this client, and whether we need to report out concerns.

c) Conflict of interest (Objectivity / Professional Behaviour)

Walker & Mason provides accounting, tax and advisory services for Greentree. We have also been approached by Thomas Lawrence (director and shareholder) to provide advice, should his estranged wife gift her shares to Susan Lawrence (his daughter, the managing director of the company and also a shareholder). It is not clear whether we have an engagement letter in place, or indeed whether we should be taking on this work given the amount of work we do for the company and the possible conflict of interest between the shareholders.

d) Withholding information of offer (Integrity)

It is unclear whether Thomas and Susan are attempting to keep knowledge of the SBS offer from Marion. Marion is looking to leave the business and may consider the SBS offer a way to realise her investment as opposed to just gifting her shares to Susan.