TPE 2023 – Case Study Part 1

Hutden

History

TPE examination, May 2020. Pass rate 91%. 2½ hrs in the morning and 3 hrs in the afternoon.

Technical Content

FA 2021

BACKGROUND NOTES

It is one morning in early January Yr20 and you are sitting opposite Walter and Zena, the current chief executive officer ("CEO") and chief operating officer ("COO") respectively of Hutden plc ("Hutden"). Hutden is an unlisted construction company operating mainly in North West England specialising in building domestic dwellings.

You are Bobbie, a recently qualified chartered accountant employed by one of the medium-tier firms of UK Chartered Accountants and Auditors at their Manchester Office. Your usual work is within the firm's audit department. However, yesterday your manager, Ali Low, assigned you to a six-month secondment to Hutden, one of the firm's audit clients, starting from today.

Ali had explained that time spent on a non-audit assignment would be good for your career within the firm as it would bring different challenges. She said that it was important to remember that you represent the firm and that you were expected to report back to the firm's ethics partner on any ethical matters you encountered during your assignment. She had received comments that you had got on well with the client during your time as part of the audit team for each of the last two years.

"Good morning, Bobbie," says Walter. "I'm pleased your firm was able to spare you for a six-month secondment. If everything works out well then there may be an offer of a job for you at the end of the assignment, but let's stick with the present. I know you are already aware of the historical financial position of the group to 31 March Yr19 from your audit work but here is a brief summary of the group's current personnel and history, although there has been little change since March Yr19." Walter hands you the summary (Section 1).

"Although that's true internally," interrupts Zena, "the housing market has changed noticeably over the last 24 months and it is not as predictable as it used to be. New regulations are being introduced almost monthly and our potential customers seem to be concerned about the economic uncertainty and the impact it will have on the movement of house prices and the security of their employment. These, and other factors such as the movement in the interest and exchange rates, are putting downward pressure on new house prices in our catchment area as well as affecting the demand for new houses."

"Unfortunately for us that's definitely the case," says Walter. "Bobbie, to get you started in your new role I would like you to produce a briefing paper for me on a few issues that I can take to the board. Make sure it is easy to follow and understand since although I have a good grasp of numbers I can't claim to be an accountant, unlike you and Zena."

"Sure, what would you like me to include in the briefing paper?" you enquire.

"You will remember a company called Weeco Ltd ("Weeco"). It is the sole supplier of our Eco-friendly houses ("eco-houses") which we sell through EcoFries Ltd ("EcoFries"), one of our wholly-

owned subsidiaries. You may recall the business model is very simple. When a customer wants an eco-house built on their land we pass on the work to Weeco. They do all the work, invoice us and then we charge a small mark-up. Although the turnover is relatively small, it is growing steadily in line with the seeming increase in awareness of environmental issues amongst the public.

“That business model has worked well whilst we established whether there is a demand for this type of dwelling. However, for a while I have been very much of the opinion that the time has come for us to cut out the middle-person and to actively market and construct the eco-houses ourselves. If this is the future of construction in UK we want to be at the forefront of it and have a ‘first-mover-advantage’. Unfortunately not all of the board agree with me and we have been debating this for some time.

“One option the board considered was to purchase Weeco. Last month the advisor acting on behalf of the shareholders of Weeco wrote to Weeco’s customers asking if they would be interested in submitting an offer for the shares of the company. Seemingly the current shareholders have interests elsewhere and want to divest themselves of the company. After receiving an email from myself stating we may be interested, their advisor released some basic information about the company’s trading and operating activities (Section 2). After consideration of the information the board unanimously decided against making an offer and no further action was taken.”

Zena interrupts, “That suited me nicely. Just to let you know, I was recently engaged to a son of one of the owners, but it ended acrimoniously over the festive period. He works for Weeco and I didn’t relish the thought of having to keep meeting him.”

“Be that as it may,” continues Walter, “there is the option for us to start the business of constructing and marketing the eco-houses ourselves from scratch. Later this afternoon there is a full board meeting and the main point on the agenda is to reach a final decision as to whether or not we should proceed with this option.

“I want you to provide an independent view on this matter by evaluating the issues we should consider before coming to our decision. Clearly, I am very much in favour of constructing the eco-houses ourselves so I would expect you to recommend appropriately. This is an important decision for the group so make your evaluation comprehensive.”

“Yes, it definitely is,” says Zena. “It may also have the added bonus of causing financial difficulties for Weeco if we remove our business and become a competitor, not that I hold a grudge, you understand.”

After a quick glance at the information on Weeco you reply, “Of course not, but it may do more than that, it may put them out of business. In any event my evaluation should be balanced to provide an accurate picture for the board.”

“Bobbie, you have a lot to learn if you want to stay ahead in business,” advises Walter. “I’m not saying produce an inaccurate picture for the board but to merely state the facts in a manner that accentuates the positive, if you know what I mean?”

“I think so,” you tentatively reply. “The information from Weeco will prove to be useful for my evaluation and I’ll recommend appropriately based on my assessment, although my instinct is telling me it will be a good thing to do.”

"Very good, Bobbie, I can see you are a fast learner," replies Walter. "Yesterday our finance department produced a summary of a number of key performance indicators ("KPIs") for our main trading subsidiary, Qdwell Ltd ("Qdwell"), including those from the latest financial forecasts for the year ending 31 March Yr20 based on management accounts to December Yr19. This means these figures will be close to the final reported figures due to the traditional slowdown of sales in the March quarter each year. This year, they have also included forecast KPIs for Qdwell for the year ending 31 March Yr21 based on their knowledge of the market and their view on any potential changes to it. They have also produced a profit forecast for the Hutden group (Section 3). They have been under a lot of time pressure this year and so have done well to produce these in such a short time scale. Needless to say, you are the first person to see these figures outside of the finance department.

"I'm keen to know whether the changes in the KPIs mean we should be looking at fine-tuning our strategy and whether or not the profit forecast reflects the change in the forecast KPIs. I therefore would like you to interpret and evaluate the KPIs in light of the general market conditions and to comment on the reasonableness of the profit forecast; a sense check if you like.

"I'm interested in what is happening now, and in the future, and would appreciate your ideas on this. Remember to include suggestions you may have about our strategy or product offering, even if only in general terms within your commentary.

"I would like to have your comments on the KPIs and profit forecast included in the briefing paper together with your evaluation of the issues we should consider regarding commencing the construction and marketing of the eco-houses ourselves. If you can produce this by lunchtime, it will give me sufficient time to read it before I disseminate the information to the board members in advance of this afternoon's meeting."

At that point Walter answers his mobile, so you leave to start preparing the briefing paper.

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 briefing paper requested by Walter that he can take to the board.

SECTION 1

Personnel and History of Hutden (January Yr20)

Personnel

- Walter Hutcheson, CEO, age 63 – joined the company forty-five years ago and owns 50% of the share capital, which he inherited from his parents.

- Zena Hutcheson (daughter of Walter), COO and director, age 28 – after gaining two years post-qualification experience as an accountant she joined the company in Yr17 and was appointed director in Yr19.

- Xandra Ferguson, finance director, age 61 – joined the company over forty years ago, and appointed director nearly thirty years ago.

- Yazmin Smith, sales and marketing director, age 60 – joined the company after completing a masters degree specialising in marketing and appointed director in shortly after Xandra.

- Board of five Non-Executive directors, average age 43.

The experience and contacts of the directors are key to enable the group to operate successfully. Walter, Xandra and Yazmin each receive a basic salary of £1 million and a bonus of up to 300% of basic salary if the principal bank covenant condition is met, after the bonuses (if borderline, the bonuses are restricted so the covenant is not breached). The principal bank covenant is that the profit before tax should be a minimum of four times the par value of the issued share capital, which is currently £10 million. During each of the last five years all the targets have been met and the bonuses have been paid out in full.

All other employees receive salaries and benefits that are at or just above market rate. The company contributes to a defined contribution pension scheme at the same rate as the company contribution rate as required by auto-enrolment.

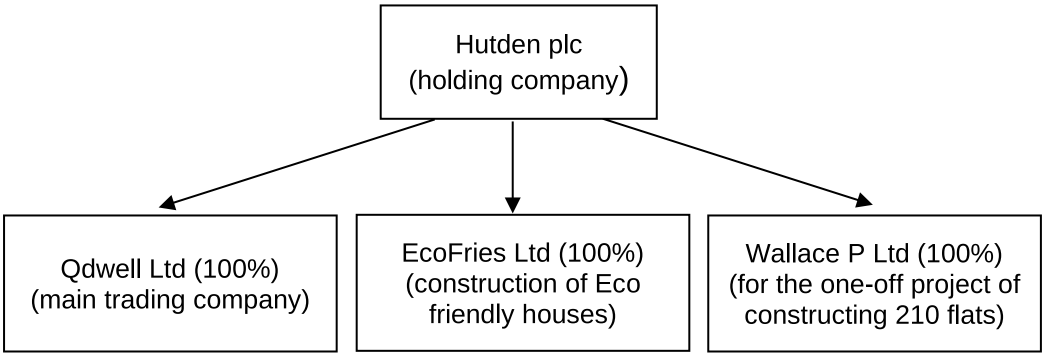
History

Hutden is an unlisted construction company that specialises in the construction and selling of high-quality residential accommodation in and around the Liverpool and Manchester areas of North West England. The company was incorporated in 1950 when Walter's father and his business partner, Harry Muffleden, started the company with each owning 50% of the share capital.

In the early years the company expanded using retained earnings and a low level of bank borrowings to fund the growth. However, during a period of rapid expansion, the banks refused to lend the company large sums due to the low level of share capital and so the company made a bonus issue out of retained earnings to increase the share capital to £10 million, which is the value of the present share capital.

Twenty years ago the original founders of the business retired. Within a year of retiring, both founders died with Walter receiving 50% of the shares and the Muffleden family receiving the other 50% split between four siblings.

The current group structure is:



The group vision is "to maximise shareholder returns by acquiring and developing land in the most cost effective and efficient manner possible".

The group has bank borrowings, which are secured by a fixed and floating charge over the assets of the holding company and all the subsidiaries. A number of bank covenants are in place, which are reviewed from year to year. The principal covenant in place for Yr20 and Yr21 is that the profit before tax should be a minimum of four times the par value of the issued share capital, which is currently £10 million.

Qdwell Ltd

Essentially all of the main construction work undertaken by the group is via the wholly-owned subsidiary, Qdwell. One of the company's areas of expertise is its detailed local knowledge of the market and the extensive market research undertaken before purchasing a development site, which can range from a small plot for one or two executive houses to a larger development site covering many acres. The houses are priced at the premium end of the market i.e. above the typical house price for the area and are aimed at attracting professionals working in Liverpool and Manchester.

Over the years Walter has built up an excellent reputation and has an extensive network of contacts. This enables the company to often obtain a verbal indication as to whether or not planning permission (authorisation from the local council to build the houses) will be granted prior to purchasing any land. The company has an estimated land bank (land which it owns but has not yet been used for construction) of five years. However, the older, cheaper land purchased towards the end of the investment phase of the business cycle has now largely been built upon.

Although Qdwell has its own specialist core-workforce it does make extensive use of subcontractors. Assuming no restriction on the availability of suitable subcontractors, this enables it to construct as many houses as the demand dictates. Whenever possible it has a policy of using UK suppliers. The company has a reasonable health and safety record with accident rates only slightly above the industry average. The accident rate amongst the subcontractors is nearly twice that of the company's workforce.

Historically the majority of the houses are sold in advance of construction commencing (forward selling or off-plan selling). Potential buyers review a 3D computer-generated plan of the site and houses and place a 5% deposit against the plot they wish to purchase. This guarantees the purchase price of the house and gives the purchaser some degree of choice over the fixtures and fittings and decoration of the property. It also assists Qdwell with cash flow. When sufficient plots have been sold the construction of the houses begins. Many of the purchasers of the houses are speculators who have no intention of moving into the house once built but plan to sell it immediately and make a large profit from any increase in the market value of the house.

In addition to local owner-occupiers (people who purchase a house to live in, usually with a mortgage) other purchasers of the houses are Buy-to-Let investors from both UK and overseas. This group of purchasers is interested in the investment potential of the houses and usually let them out to tenants with the intention of making a profit from a combination of the rental income and capital gain.

EcoFries Ltd

In Yr15 Hutden started to offer the service of constructing eco-houses via a separate wholly-owned subsidiary called EcoFries. The operating model is very straight forward. A customer approaches the Hutden group with a request to construct an eco-house on their own land. The group, via EcoFries, then passes the request to Weeco, which produces a quote to construct the finished house built to the customer's specifications. EcoFries applies a small mark-up to the quote to achieve a gross margin of 10%. The quote is then sent to the customer who either accepts or declines the price. Any changes to the contract (unders and overs) are handled in exactly the same way, with the same mark-up being applied to all costs. Although the turnover is relatively small it is increasing over the years and is effectively profit for doing very little work. Any minor administration costs are met by Qdwell.

The turnover and number of eco-houses built is:

	Yr17	Yr18	Yr19	Yr20 (F)
Number of houses constructed	10	15	23	35
Turnover (£'000)	3,500	5,625	9,200	14,350

(F) = Forecast

Wallace P Ltd

Any project where the turnover is forecast to be in excess of £10.2 million, or the board considers it to be of an abnormally high level of risk, is undertaken by a separate 100% owned subsidiary. This subsidiary is dissolved upon completion of the project and any ongoing future risk is covered by an insurance policy. The only current project of this magnitude is the construction of 210 flats with a forecast turnover in excess of £30 million.

The project commenced in Yr19 although no flats were sold in the year to 31 March Yr19. The project is expected to be substantially completed by March Yr21. During the negotiation process to obtain the planning permission, the senior operations manager assigned to the project verbally agreed that the development would include 10 affordable accommodation flats (accommodation sold to the council at below market value so they can be made available, either by selling or renting, to relatively lower-paid key workers doing essential work e.g. nurses and firefighters). He agreed that these would all be available by December Yr20.

SECTION 2

Summary trading and operating activities of Weeco Ltd ("Weeco") as provided by Weeco's advisor

In response to your note of interest the following is a summary of the trading and operating activities of Weeco. More detailed financial information will be released should the note of interest develop into something more substantial.

Weeco was incorporated twenty years ago with a 31 March year end. It trades from rented premises in Glasgow, Scotland and has a good compliance and filing history with HMRC and Companies House.

Summary trading figures:

	Yr17	Yr18	Yr19	Yr20 (F)
Number of houses constructed	90	85	88	90
Turnover (£'000)	28,750	28,163	30,380	32,165
Gross margin (£'000)	5,750	5,069	5,165	4,825

(F) = Forecast

In order to attract skilled labourers all employees are paid approximately 20% over the market rate for their work. The pension scheme for all employees is a generous final salary scheme (defined benefit scheme). At the time of writing the pension scheme has a significant deficit, which the directors are acting upon and do not consider to be an issue.

For each of the last two years the company has introduced innovative construction processes and has submitted Research and Development ('R&D') tax claims. HMRC are currently seeking evidence to prove that the new processes fall within the definition applicable to an R&D claim. The directors are confident this evidence can be provided.

Summary of operational activities:

Unique selling proposition

Weeco follows the nine principles of the voluntary 'Code for Sustainable Homes' and ensures it obtains the highest possible rating in each of the nine sustainability criteria.

Weeco does not sell directly to the public and only deals with larger construction companies and their subsidiaries e.g. EcoFries. The construction company provides details to Weeco of potential customers who want to build an environmentally friendly house on their own property. On behalf of the construction company, Weeco, as a subcontractor, provides a full-service operation from an initial site audit through to the final completion of the house, all bespoke to the construction company's customer.

The initial legal contract to construct the house is between Weeco and the construction company. The construction company, in turn, enters into an identical contract with their customer. The price stated in the contract between the construction company and the customer will include a mark-up applied by the construction company on the price that they have agreed with Weeco.

Although the feel-good factor of owning an eco-friendly house is a major component of Weeco's selling strategy, a further incentive for the ultimate potential customers (the final owners of the houses once constructed) is the 20-year warranty that is given with each house. This is provided by Weeco to the construction company via the legal contract but one of the terms and conditions is that the construction company has to provide an identical 20-year warranty to those customers (the final owners of the houses). This is in addition to the industry-standard warranty of 10 years backed up by a third-party insurance company.

Operations

All of the workforce are full-time employees and have been fully trained in the unique construction processes adopted by the company. The training can take up to five years. They have all undertaken the initial induction courses on health and safety including fire safety, manual handling, control of substances hazardous to health and, where appropriate, site management. Most of the employees have been with the company for more than ten years. Feedback from customers purchasing eco-houses shows they prefer to deal with a company that uses its own employees rather than subcontractors.

All materials used are sourced from eco-friendly suppliers who can demonstrate their eco-friendly credentials. Most of the suppliers are from overseas and are only able to supply in relatively small quantities, thus ensuring a unique product bespoke to the customer. Any carbon footprint is offset by purchasing the equivalent carbon credit from a regulated specialist company. The difference in purchase price between eco-friendly and non eco-friendly materials used in the houses is about 20%, although for some of the more expensive bespoke temperature (solar gain and cooling) and rainwater systems, the difference can be as much as 300%. The inclusion of these bespoke systems is a unique selling point for some customers.

Many of the construction processes required to construct an eco-house efficiently have been developed 'in-house' and have either been granted a patent or are 'patent pending'.

The company owns all of the plant and equipment necessary to construct an eco-house. Approximately 70% of this plant has been modified by the company's in-house trained employees. As a result of the type of construction work undertaken, all of the plant and equipment is replaced and modified every three years. The average age of the plant and equipment is less than two years.

SECTION 3

KPIs for Qdwell and the Group Profit Forecast as produced by the finance department of Hutden plc.

KPIs of Qdwell

Set out below are the KPIs calculated for the five financial years based on actual figures for the years ended 31 March Yr17 to Yr19 and forecast (F) figures for the years ending 31 March Yr20 and 31 March Yr21. The Yr20 figures are likely to be close to actual due to the traditional low volume of sales that take place in the quarter ended 31 March. The forecast KPIs for Yr21 are based on our knowledge of the market and the changes that are anticipated over the period to March Yr21.

Inventories

An analysis of inventories split between the three main components is:

% by value	Yr17	Yr18	Yr19	Yr20 (F)	Yr21 (F)
	%	%	%	%	%
Land held	15	12	12	10	10
Work-in-progress	81	83	81	80	73
Finished properties	4	5	7	10	17

The number of days inventory has remained fairly constant at around 548 days over the same period and is forecast to do so in Yr21.

Revenue

The analysis of revenue as measured by the company's three main customer types is:

% by value	Yr17	Yr18	Yr19	Yr20 (F)	Yr21 (F)
	%	%	%	%	%
UK: owner-occupiers	53	53	52	53	48
Overseas investors	32	33	36	35	42
Buy-to-Let investors	15	14	12	12	10

The fall in the percentage of revenue generated from sales to UK: owner-occupiers has been attributed to the banks still only lending relatively low multiples of salaries and requiring a significant deposit before they consider offering a mortgage to purchase a property. Our research has indicated that the banks may tighten the lending criteria over the next 24 months. A review of the forward markets over the next 18 months indicate that the recent decline in the pound's value is likely to be reversed and it is forecast to strengthen against the major currencies over that period.

Margins

The trend in the gross margin is:

Margins (%)	Yr17	Yr18	Yr19	Yr20 (F)	Yr21 (F)
	%	%	%	%	%
Gross margin	27	26	25	22	22

Due to net operating expenses not being accurately allocated across each company e.g. directors' salaries and bonuses, an analysis of the trend in operating margin is not appropriate.

Hutden Group Profit Forecast

Profit forecast for the year ending 31 March

	Note	Forecast Yr20 £'000	Forecast Yr21 £'000
Revenue	1	617,750	767,620
Cost of sales	1	(483,695)	(601,774)
Gross profit	1	134,055	165,846
Net operating expenses	3	(88,100)	(97,400)
Operating profit		45,955	68,446
Net finance costs		(3,000)	(5,000)
Profit before tax		42,955	63,446
Income tax expense		(9,450)	(10,786)
Profit for the year		33,505	52,660

Notes to the Profit forecast

1. Revenue/Cost of sales/Gross profit

	Forecast for the year ended 31 March Yr20				Forecast for year ending 31 March Yr21			
	Qdwell Ltd	EcoFries Ltd	Wallace P Ltd	Total	Qdwell Ltd	EcoFries Ltd	Wallace P Ltd	Total
	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Revenue	597,000	14,350	6,400	617,750	722,370	21,250	24,000	767,620
Cost of Sales	(465,660)	(12,915)	(5,120)	(483,695)	(563,449)	(19,125)	(19,200)	(601,774)
Gross Profit	131,340	1,435	1,280	134,055	158,921	2,125	4,800	165,846

2. Analysis of Revenue (Qdwell Ltd)

	Forecast for year ending 31 March Yr20			Forecast for year ending 31 March Yr21		
	Small Dwellings	Large Dwellings	Total	Small Dwellings	Large Dwellings	Total
	£'000	£'000	£'000	£'000	£'000	£'000
Revenue	198,000	399,000	597,000	239,580	482,790	722,370
Avg Selling Price (£'000)	220	380		242	418	
Number sold	900	1,050		990	1,155	

3. Net operating expenses

	Forecast Yr20	Forecast Yr21
	£'000	£'000
Directors' salaries	3,100	3,200
Directors' bonuses	9,000	9,000
NED salaries	200	200
Head Office running costs	21,000	22,000
Advertising and selling	29,800	38,000
Other operating expenses	25,000	25,000
	88,100	97,400

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