# TPE 2023 – Case Study Sample Solution

## Greentree

## Email to Paul

**To: Paul**

**From: Anna**

**Date: December Yr57**

**Subject: Greentree engagement**

Good afternoon Paul,

Please see attached the following pieces of work for your review:

1. Briefing paper on drinks industry and analysis of new product options
2. Memo for Susan on key areas of concern for the bank
3. Slides and speaker notes regarding potato futures
4. Letter to Thomas regarding Marian's shares; and
5. Report to the board regarding the bank meeting and SBS offer

Please let me know if you would like to discuss any of the above.

Kind regards, Anna

## Email to Ethics Partner

**To: Ethics partner**

**From: Anna**

**Date: December Yr57**

**Subject: Greentree engagement**

Good afternoon,

I am currently working on the Greentree Spirits Limited engagement and have come across a number of ethical concerns, as set out below.

**Going concern**

The company is experiencing significant cashflow problems and will be unable to pay back their term loan or overdraft if recalled. The term loan is due to be repaid in January Yr58 and therefore will cause significant going concern issues if this cannot be renegotiated with the bank. In addition, the company has breached its covenants and reporting deadlines, heightening this risk.

We should ensure that we review this situation carefully and consider our involvement. We should at the very least ensure that the directors are aware of their responsibilities to creditors in the event of liquidation and the penalties associated with continuing to trade if the company is insolvent.

We should also monitor the situation to ensure that we are confident that the client can continue to pay our fees.

**Potential bribery**

Greentree has indicated that one of its agents has been paying bribes to local bureaucrats to ‘smooth the way’ for the saffron supply. This falls under the Bribery Act 2010.  We should report this to the MLRO immediately.

Whilst care must be taken not to tip off the client or the agent, the client should be advised that the practise is illegal, and directors have a responsibility under the bribery Act.  They should be made aware of this.

**SBS offer**

There has been an offer to buy Greentree by a client of SBS. Whilst the offer is not in itself an ethical issue, there are a number of indicators that something unusual may be involved. The client is remaining anonymous, which may not be an issue, however they also wish to proceed with the deal within a few weeks. This speed is unusual as due diligence would normally be required.

Should the shareholders wish to proceed with this deal, we should ensure that we advise them to understand the circumstances surrounding the deal before proceeding.

I hope that my explanations on these matters are clear, but please do not hesitate to get in touch if you have any further queries.

Kind regards,

Anna

## Briefing paper

**For: Paul**

**Subject: Greentree Industry Analysis and New Product Assessment**

### Industry analysis

In analysing the current state of the industry, a suitable model such as PEST analysis can be employed. This groups factors into political, economic, social and technological influences. A PEST analysis has been prepared for the drinks industry as follows.

**Political**

There has already been a ban on selling alcohol below cost. Greentree must be careful to monitor their selling prices to ensure that they do not sell below cost. This will include careful analysis of how to allocate overheads as the cost of the inventory will include a proportion of these. Any breach of these rules may result in fines and negative press resulting in a damage to reputation.

The introduction of a minimum price of 50p per unit should not have an impact on Greentree as the prices; £22.50 for vodka and £26.50 for gin; are above the minimum price of £14 (14 servings with 2 unit of alcohol each).

In addition, the sugar tax has been extended to include fruit-based alcopops, which will affect the plans for the new drink discussed below. Whilst this is not thought to be likely to significantly reduce sales, the impact will not be fully understood until more research is performed, and the effects of this new tax are fully understood.

**Economic**

The demand for premium spirits is increasing, with a trend towards people drinking alcohol less often, but spending more on premium products when they do. The major brands have launched new UK products in the last few months however reviews have been mixed. This shows that the market is expanding and Greentree are in a good place to capitalise on this by introducing new products, as discussed below.

Vodka is the most popular spirit in the UK with a market share of 30.1%, however Gin also holds a large market share at 22.3%. This may factor into the decision discussed below as to which new drink to proceed with, however Greentree should also consider that there are likely to be more competitors in the vodka market due to the increased market share and therefore attractiveness of the market.

**Social**

Recent research has suggested that the public are more interested in the provenance, ingredients and stories behind products and brands than previously. Greentree could use this to their advantage as they are a family run business that has been operating for 20 years, and the public may respond positively to a well targeted marketing campaign that uses this back story. A positive public response is likely to generate more sales in the future.

Analysts agree that craft distillers are increasing their share by expanding the category offering rather than stealing share of bigger competitors. This may include more specialised and premium products, or by diversifying into related products such as liqueurs. This may be an important factor in deciding which product option to choose, as discussed below.

**Technological**

The recent flooding problems that have been affecting the potato crops are expected to continue, and therefore potato price rises may remain. Research by Somerset University has suggested that the best way for farmers to tackle this will be to invest in rebalancing the acidity of the soil through limiting methods. Greentree may need to consider whether to invest in this technology soon to ensure the continuing success of the business. Greentree currently produces 70% of their own potatoes and failing to invest in this technology may result in further outsourcing being required, thus increasing prices and decreasing margins.

## Review of products

**Flavoured Vodka**

Figures calculated in Appendix 1 show that this product would generate a margin of £20,650 in year one and £24,610 in years two and three. This assumes that a full bottle of vodka costing £3.06 (excl. excise duty) to make is used for each bottle and excise duty of £7.44 per bottle is not added on top of the sales price but is included in cost of sales. This relates to a margin of 16.3% for wholesale sales and 50.9% for direct sales.

The standard wholesale price for Greentree vodka is £13.10, compared to the £13.50 price for the flavoured vodka. Therefore, the additional 40p wholesale sales price seems to be low considering the additional costs of 80p per bottle. Greentree should consider increasing the wholesale price to make a profit on this revenue stream if this product is chosen, considering the price that the wholesalers are willing to pay and can sell on to a retailer for.

The choice of elderflowers as an ingredient may limit production, as the expected demand is greater than the expected 3,000 bottles that can be produced at 4,200 in year 1 and 6,000 in year 2. Limiting production to 3,000 bottles would reduce the amount of sales that could be made. However, a price increase may be possible given that the product could be made ‘limited edition’.

The elderflowers also need to be ‘handpicked’ which may increase labour/ raw material costs above what has been predicted and they must also be used immediately which will restrict production to the three months that elderflowers are available for. Importing elderflowers may be a possible alternative, as they may be growing in other climates whilst not growing in the UK, however this may be expensive, and it may not be possible to transport the flowers without diminishing the flavour.

**Flavoured gin liqueur**

Figures calculated in Appendix 2 show that the total margin would be £20,868. This is under the assumption that half a bottle of gin is used equating to a cost of £2.08 (excluding excise duty), and excise duty is included in cost of sales. This relates to a margin of 24.8% for wholesale and 49.8% for direct sales.

In addition, as the drink uses only half of a bottle of gin per bottle, (as opposed to a full bottle of vodka for option 1) the expected price increases in potatoes are likely to have less of an impact on margin than for option 1 in the future.

The product appears to be versatile as it can be used alone, with a mixer or in a cocktail. This will expand the market that the product may appeal to and therefore increase sales. Susan has stated that Greentree do not want to dilute their market share, however other premium brands are likely to expand their offerings, as shown by the PEST analysis, and it is better for Greentree to take advantage of the expanding market than to let a competitor produce a similar product first. The industry analysis also suggested that diversifying offerings is likely to be the way forward for smaller craft players such as Greentree.

The production time of seven extra days for this product seems excessively long, and therefore the production capacity of the plant must be carefully considered. Year one demand is expected to be 5,000 units and may grow as the brand develops so Greentree should ensure that they expect to be able to meet this demand in the future without compromising the production of their other products.

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.

**Vodka based alcopop**

As shown in Appendix 3, the expected margin for this product is £2,857 in year one increasing to £4,571 in years two and three. However, Greentree has no experience in this area and therefore these figures may not be accurate.

The product is an alcopop and is not a premium product, therefore breaking away from the experience and expertise of the company. The product does not fit well with the Greentree brand and does not capitalise on the boom in the premium drinks market.

Greentree would need to consider whether the current production facilities would be suitable to make this drink and would need to consider employing salespeople or manufacturing staff that have experience in the alcopop industry.

The wholesale sales price of £5.30 per case (excluding VAT) is above the average supermarket price of £4.00 - £5.00 per case, and as this is a budget product, customers are unlikely to be willing or able to pay a premium for this product.

## Recommendation

| | Year 1 margin | Year 2/3 margin | Wholesale GM% | Direct GM% |
|---|---|---|---|---|
| ***Option 1*** | *£ 20,650* | *£24,610* | *16.3%* | *50.9%* |
| ***Option 2*** | *£ 20,868* | *£20,868* | *24.8%* | *49.8%* |
| ***Option 3*** | *£ 2,857* | *£ 4,571* | *9.6%* | *n.a.* |

Table 1: Summary of financial results

Option 2 is recommended as the raw materials and ingredients are readily available and the product fits well with the current Greentree brand. The margins produced are positive and not subject to any limiting factors. However, careful consideration should be given to the production capacity of the plant, to ensure that it is sufficient to facilitate such a lengthy process.

Although option 1 is forecast to generate a greater margin than option 2, this does not take into account the limiting factor of the elderflower. Given that this will allow only 50% of forecast production in years 2 and 3, this option is not viable. In addition, whilst vodka has the largest market share, there are likely to be numerous competitors in this market.

The alcopop market is a new industry for Greentree with little experience and limited market research. The figures produced can therefore not be relied upon and the product does not fit in with the Greentree brand. Therefore, this option is not recommended.

## Appendix 1: Option 1 calculation

| **Margin** | **Wholesale** | **Wholesale** | |
|---|---|---|---|
| | **Yr1** | **Yr2-3** | **Direct** |
| Sales price | £ 13.50 | £ 13.50 | £ 23.00 |
| Number of sales | 3,000 | 4,800 | 1,200 |
| *Costs per bottle* | | | |
| Raw materials | £ 0.45 | £ 0.45 | £ 0.45 |
| Labour | £ 0.25 | £ 0.25 | £ 0.25 |
| Overheads | £ 0.10 | £ 0.10 | £ 0.10 |
| Cost of vodka (excl. duty) | £ 3.06 | £ 3.06 | £ 3.06 |
| Total | £ 3.86 | £ 3.86 | £ 3.86 |
| | | | |
| Excise duty per bottle | £ 7.44 | £ 7.44 | £ 7.44 |
| | | | |
| Margin | £ 2.20 | £ 2.20 | £ 11.70 |
| Margin % | 16.3% | 16.3% | 50.9% |
| **Total sales** | **£ 40,500** | **£ 64,800** | **£ 27,600** |
| **Total margin** | **£ 6,602** | **£ 10,562** | **£ 14,048** |
| | | | |
| **Yr 1** | **£ 20,650** | | |
| **Yr 2-3** | **£ 24,610** | | |

## Appendix 2: Option 2 calculations

| **Margin** | | |
|---|---|---|
| | **Wholesale** | **Direct** |
| Sales price | £ 12.00 | £ 18.00 |
| Number of sales | 4,000 | 1,000 |
| *Costs per bottle* | | |
| Raw materials | £ 2.68 | £ 2.68 |
| Labour | £ 0.15 | £ 0.15 |
| Overheads | £ 0.10 | £ 0.10 |
| Cost of gin (excl. duty) | £ 2.08 | £ 2.08 |
| Total | £ 5.01 | £ 5.01 |
| | | |
| Excise duty per bottle | £ 4.02 | £ 4.02 |
| | | |
| **Margin** | **£ 2.97** | **£ 8.97** |
| Margin % | 24.8% | 49.8% |
| **Total sales** | **£ 48,000** | **£ 18,000** |
| **Total margin** | **£ 11,904** | **£ 8,964** |
| | | |
| **Yr 1-3** | **£ 20,868** | |

## Appendix 3: Option 3 calculations

| **Margin** | **Yr 1** | **Yr 2-3** |
|---|---|---|
| | **Wholesale** | **Wholesale** |
| Sales price | £ 4.96 | £ 4.96 |
| Number of sales | 6,000 | 9,600 |
| Total costs (inc excise duty) | £ 4.48 | £ 4.48 |
| **Margin** | **£ 0.48** | **£ 0.48** |
| Margin % | 9.6% | 9.6% |
| Total sales | £ 29,760 | £ 47,616 |
| **Total margin** | **£ 2,857** | **£ 4,571** |
| | | |
| **Yr 1** | **£ 2,857** | |
| **Yr 2-3** | **£ 4,571** | |

## Memorandum

**To: Susan**

**From: Anna**

**Date: November Yr57**

**Subject: Preparation for meeting with the bank**

Susan,

Please see below the key areas that the bank are likely to be concerned with.

### 1. Covenants

The bank has a number of covenants in place with Greentree covering the bank financing. Greentree must continue to comply with these to avoid any penalties and recall of facilities.

***Interest cover must be not less than three times***

The current interest cover of 8 times should not be of concern to the bank.

***Gearing should be a maximum of 85%***

Gearing is currently 76% which should be of no concern to the bank. There have been minimal movements between years in this ratio which may be of further comfort.

***Current ratio must not be less than 1***

Current ratio is currently 1.13, however it has been 1.01 and 0.91 in Yr56 and Yr55 respectively. This calculation also excludes the bank loan, which if included would give a current ratio of 0.49. This could be a breach of covenant as it is not clear if the bank wishes to include this loan in its calculation. If so, the bank may be within its rights to immediately recall the loan. You should study the loan documentation to understand how this calculation is defined.

### 2. Submission of quarterly accounts

The bank also requires submission of quarterly management accounts within one month of the quarter end. This deadline has now been missed and therefore you may be in breach of the terms and conditions of the loan. These accounts should be completed and submitted as soon as possible, and procedures put in place to ensure that this breach does not occur again. This may include employing another member of staff to support

Marian in preparing the accounts as she does not appear to have any financial qualifications to aid her in the preparation of accounts.

**3. Repayment of bank loan**

The bank loan is due to be repaid in January Yr58, however Greentree does not currently have sufficient funds to repay this, with current assets of only £172,000 compared to a loan of £200,000. This calls into question the going concern status of the company and should be addressed immediately.

Greentree should apply to the bank to have the loan extended, perhaps with annual repayments rather than a bullet repayment to minimise the risk of the same situation occurring in the future. To secure this funding Greentree will need to ensure that they can meet the bank's covenants in future, as discussed above, and have put procedures in place to ensure that they do not miss submission deadlines again.

**4. Overdraft**

The bank overdraft has been steadily increasing over the historical period. Overdrafts often have higher interest than term loans and are repayable on demand. If the overdraft were to be recalled Greentree would be unlikely to be able to repay it as they have no cash and limited current assets on the balance sheet. This situation would cause the going concern of the company to be put at risk and should be considered carefully.

One solution may be to apply for an additional amount to the term loan. Greentree may need to negotiate more lenient covenants to ensure that the additional loan does not breach these. For example, a further £100,000 loan would affect covenants in the following way (assuming an extension of the original loan is also agreed):

- Interest cover (assuming base rate of 1%): 5.09
- Gearing: 82.6%
- Current ratio: 3.26

As these ratios are all within current covenant limits the bank is likely to agree.

**5. General comments**

The bank may want to do a more general review of Greentree and its management to ensure that its lending risk criteria are still being met. Examples of areas they may wish to discuss are as follows:

- Reliance on distributors – two distributors account for 49.6% of turnover in Yr57. The bank may wish to discuss what plans are in place in the case that one of these distributors is lost.

- Accounting procedures – Marian does not appear to have relevant financial qualifications and the 'list of sales' does not appear to be integrated into the accounting system. The bank may wish to discuss accounting policies and procedures to ensure these are robust as they will be relying on the accounts produced by these.

I hope that this memo has provided you with some initial guidance on what the bank may be concerned with. Please do not hesitate to get in touch if you have any further questions.

Anna

## Slides on Potato Futures

**Slide 1: What is a future?**

- Defined price, quantity and time
- Open market
- Gains/losses are made by ‘closing out’

**Slide 1 speaker notes**

- Futures contracts represent an obligation to buy or sell a defined quantity of potatoes at a defined price and time
- Futures are traded on an open market and prices change regularly.
- Contracts must be ‘closed out’ on the transaction date by entering into an opposite contract

**Slide 2: Example**

- Step 1: Enter into futures contract on 1 November Yr57 to buy 1 tonne of potatoes on 1 December Yr57 for £100
- Step 2: On 1 December Yr57 go to spot market and buy one tonne of potatoes. This costs £125.
- Step 3: Close out futures contract by doing opposite of step 1. E.g. Sell potatoes future, selling potatoes for £125.
- Overall gain is £25 compared to what would have been achieved by only transacting in the spot market.

**Slide 2 speaker notes**

- Step 1 is to enter into a futures contract as soon as the risk is known. This would be immediately for Greentree as the potato price rises are already known about.
- Step 2 is on the transaction date to go to the spot market and complete the transaction. In Greentree’s case this would involve buying potatoes from a farmer at the current rate.
- On the same day, step 3 involves closing out the futures contract by entering into an opposite contract at the current rate. This would then be netted off against the original contract to give a gain or loss.
- Greentree should be aware that losses may also be made, and the gains/losses are usually in opposition to the market movements.

**Slide 3: Why should Greentree hedge?**

- 70% of potatoes from own farm
- 25% increases from one of main suppliers
- Industry analysis suggests prices going to continue to increase

**Slide 3 speaker notes**

- Although Greentree currently produce 70% of their own potatoes, the crops are also being affected by flooding and they are likely to require more and more potatoes from outside suppliers in the future.
- Although only one supplier has currently indicated that they will be increasing prices at the moment, industry analysis suggests that the flooding situation will not improve and therefore potato prices

are likely to continue to rise.

- Therefore, to mitigate this risk whilst the possibility of investing in technology to combat the pH issues in the soil is investigated, futures are a good option to help mitigate the possible price rises.
- Hedging is a complex issue and Greentree should seek further advice before making any firm decisions or entering into contracts.

## Letter to Thomas

**[Our address]**

**Thomas Lawrence**
**[Thomas' address]**

Dear Mr. Lawrence,

Re: Consequences of gifting shares to Susan

Thank you for your enquiry regarding the gifting of shares from Marian Lawrence to Susan Lawrence. I have provided some information below on the consequences of this transfer, with any calculations based on a nil consideration being paid. I have also included comments to explain the differences that would occur if a consideration is required to be paid in order for Marian to agree to relinquish her shares.

Given that Marian owns 20% of shares you will not be able to force her to relinquish her shares. Therefore, if she will not gift the shares you will need to consider making an offer to buy the shares. The valuation given in our report to the board may be useful as an indication, however a discount should be applied for the fact that 20% is still a minority shareholding.

As Susan currently owns 40% of the shares, the additional 20% would make her a majority shareholder and she would therefore have greater control over the company. This will allow her to pass ordinary resolutions without the support of other shareholders. If you are unwilling to give Susan this level of control then it may be worth considering whether Greentree could afford to buy back the shares from Marian, effectively leaving yourself and Susan with 50% control each.

The main financial concerns with regards to gifting the shares are as follows:

**Capital gains tax**

If Marian disposes of her shares as a gift or sells her shares she will be liable to capital gains tax at 10% (basic rate band) or 20% (higher and additional rate band) after deducting the cost (£2,000) and an annual exempt allowance of £12,000. The same rule will apply to Susan if she sells at a later date, however she may have a different base cost depending whether or not gift relief is applied.

**Gift relief**

If Susan and Marian jointly elect to apply gift relief, Marian will not pay capital gains tax. Instead, the shares will transfer to Susan at the base cost that was paid by Marian. If Susan then disposes of the shares at a later date, then the base cost paid by Marian will be used for these shares. Assuming that Marian bought these shares upon incorporation that would be £2,000. This election must be made in writing within 4 years of the end of the tax year of the gift. It is important to note that Susan would be liable for the full capital gains tax and she would need to understand this before agreeing to take the shares.

**Business Asset Disposal Relief (BADR)**

If Susan and Marian did not agree to jointly make a gift relief election, then it may be possible for Marian to claim BADR on the sale the shares, resulting in the gain being taxed at only 10%. However, as she has moved to Spain it is possible that she will not be treated as taking an active role in the business as an employee of the company and therefore this election would not be available.

**Inheritance tax**

The transfer of shares may be subject to inheritance tax as there would be a transfer of value. However, this is treated as a potentially exempt transfer (transfer from an individual to another individual). The transfer would only be chargeable if Marian does not survive seven years after making the transfer.

I hope that this letter sets out the main concerns for you, but please do get in touch if you have any further queries.

Kind regards,

Anna

**STRICTLY PRIVATE & CONFIDENTIAL**

# REPORT TO BOARD OF GREENTREE
## Bank review, grant funding and SBS offer review

By: Anna
Date: December Yr57

## CONTENTS

## 1. Introduction

This report contains a review of the current management accounts, suggested wording for the business plan to present to the bank and a review of the offer for shares made by SBS.

This report is intended only for the purpose of providing information to you and does not constitute investment advice. This report should not be shown to, or relied upon, by any third party without our prior written consent.

## 2. Executive summary

- The current breaches in bank covenants and the capital repayment due in January Yr58 cause doubt over the going concern of the company. These matters should be discussed with the bank and an extension to the repayment date agreed as a matter of urgency.

- The interest cover ratio has decreased to 1.67 which is a breach of the covenant of 3 times. This is due to decreased profits as a result of high cost of sales and staff costs, which should be investigated, and measures put in place to control these costs.

- The management accounts state that nil stock is held at the quarter end. This is unlikely and calls into question the reliability of the accounts. These should be reviewed by a qualified external individual, in advance of the meeting with the bank, so that discussions can be held based on accurate figures.

- A new head of finance should be recruited immediately, bringing appropriate qualifications and experience to the role.

- Controls over the financial reporting processes at Greentree's need to be tightened. This will include segregation of duties, bank reconciliations, review and approval of large invoices. At the very least, the accounts should be reviewed and approved by the managing director and the board prior to submission to the bank.

- The offer by SBS should not be accepted at this time in its current form. The offer to buy the shares of the business for £700,000 is above the earnings valuation of £630,000. However, the terms and conditions suggest it is likely that only £350,000 may be received which is well below the valuation.

## 3. Review of quarterly management accounts in relation to covenants

A review of the quarterly management accounts in relation to the covenants imposed by the bank give rise to the following:

- ***Interest cover: 1.67***

  This is a significant decrease from the previous full year accounts and will be an area of concern for the bank. The decrease is due to reduced profit before interest and tax rather than increased finance costs, therefore the reasons for the decreased profitability should be investigated and addressed.

  An initial review of the accounts shows that gross margin has decreased from 36.2% in the year to June Yr57 to 23.8% in the three months to September Yr57. This is due to increased cost of sales. The reason for this increase should be investigated and controls put in place to reduce these.

  In addition, the PBIT margin has decreased from 6.9% to 1.2% in the same period, largely due to increased staff costs. Again, the reason for this should be investigated and controls put in place to mitigate.

  The bank requires an interest cover of three times and at present this is not being met, therefore this matter should be investigated as a matter of urgency.

- **Gearing: 75.5%**

  Gearing is within the bank's requirement of a maximum of 85% and has remained stable across the historical period. The bank is unlikely to be overly concerned with this area, particularly as the overdraft has now decreased and is unlikely to be required to be converted to a term loan.

- **Current ratio: 0.39 (incl. bank loan) , or 1.31 (excl. bank loan)**

  Current ratio has increased when excluding the bank loan, which is likely to be a positive sign in the eyes of the bank. However, the ratio is still close to their limit of 1, therefore further improvement may be required.

  The balance sheet shows nil stock as at 30 September Yr57. This is unlikely to be the case as there should be stock in production and ready for distribution in addition to raw materials. It is unlikely that there is nil stock as a company like Greentree in the drinks industry is likely to be stocking up in anticipation of the Christmas rush. An increase in stock would further increase the current ratio. The stock figure should be calculated, and the management accounts amended

  However, this omission calls into question the integrity of the rest of the management accounts, as other such errors may have been made. You should consider carrying out a review the of the accounts to ensure that the bank have the correct information to base their assessment on.

## 4. Finance required going forward

The 10-year bank loan of £200,000 is due for repayment on 31 January, however Greentree request that this repayment date is extended for a further five years. This will allow Greentree to continue trading profitably to repay the capital at the later date.

The current forecasts do not include sales and profits of the new product, a blackberry flavoured gin liqueur. The current forecasts show expected sales growth continuing, along with profit before interest and tax. The blackberry flavoured gin is also forecast to produce sales growth of 5% in year one, with continued growth in sales and profits thereafter. As such, Greentree is expected to continue to run as a profitable business and therefore further reduce its overdraft over the coming periods.

## 5. Staffing of the finance function

The current management team have little financial experience; therefore, a new head of finance will need to be employed. This will involve recruiting a qualified accountant to run the finance department, along with a finance assistant who may be qualified or working towards qualifications.

This will allow sufficient time to process the management accounts on time to meet future deadlines, and with greater skill and accuracy than in previous periods. The inclusion of a second member of staff in the team will allow the finance function to continue in times of sickness or vacation on the part of the new head of finance.

Further review of the finance function will be taken annually, to ensure that the current staffing model is appropriate, and all outputs are being achieved in an accurate and timely manner.

## 6. Recording of and controls over financial information

The accounting system should be integrated, with sales, invoices, costs etc. all being handled by the same system. This will help to reduce the opportunity for human error and allow the system to link and cross check customers, orders, invoices etc.

Accounts should be reviewed and approved by the managing director and/or the board before being submitted to the bank. Therefore, accounts should be prepared and submitted to the managing director and board for review within three weeks of the quarter end, allowing one week for review and approval and submission to the bank.

Other appropriate controls include:

**Review of large sales invoices** – nearly 50% of sales are to two distributors, so these invoices should be checked by a second person before approval and distribution. As Susan is responsible for sales and marketing, the second person should be the new head of finance to segregate the duties.

**Review of expense invoices** – in addition to large expenses being reviewed and approved by Susan before ordering, the invoices received should be checked against the goods received note by finance staff before processing.

**Stock checks** – Stock checks should be performed at least quarterly to ensure that the stock recorded in the financial statements is accurate and up to date. This will also help to determine if stock is obsolete and needs to be written down, or if large discrepancies are found then they can be investigated.

**Bank reconciliations** – the bank balance should be reconciled to the accounts on a monthly basis and any discrepancies investigated. The head of finance should review the process. This will help to ensure that cash has been correctly recorded.

**New customers/suppliers** – identity checks should be performed and verified by both Susan and the new head of finance to ensure that fraudulent payments are not being made.

**General segregation of duties** – segregation of duties will help to reduce the opportunity for fraud and therefore reduce the risk of an error or mistake in the accounts. For example, having the head of finance set up new employees on the payroll but the finance assistant performs the monthly payroll run.

## 7. Evaluation of SBS offer

As SBS would be acquiring the entire shares and trade of Greentree, an earnings valuation would be appropriate to use as it takes account of future growth potential.

An earnings valuation, using a P/E ratio of 10 gives a value of £630,000 based on 30 June Yr57 earnings. The latest quarterly results have not been used as the figures have not been reviewed and doubts have been cast over their accuracy. This figure is below the offer given, and if Yr57 results are maintainable, the offer of £700,000 is reasonable.

A review of the terms of the offer poses the following concerns and questions:

- 50% of the consideration is deferred for three years, contingent on annual sales growth of 10% and margins of at least 15%. Given that the sales growth was 13.3% in Yr57 and 9.9% in Yr56, the sales targets may be achievable, however outside forces such as an economic downturn or government legislation could prevent this from happening. In addition, the letter does not state whether it wishes gross margin, PBIT margin or some other margin to remain at 15% so this is ambiguous.

- The current management team must remain at Greentree – this includes Marian, and the current personal situation is likely to cause some tension between management. This may in turn result in the business being run less effectively and targets not being met.

- Quick investment – the client wishes to invest quickly. Greentree should investigate why this is to ensure that the motives are legitimate and in line with their own objectives. It is unusual to invest such a large sum of money without thorough due diligence.

- Salary – there is no mention of the salaries that management will be paid for their three years' service. This should be discussed and agreed upon before further consideration is made.

As Management do not wish to sell the business at the moment, this offer should be rejected. The conditions imposed suggest that as little as £350,000 may be received, which is well below the minimum earnings valuation of £630,000. As each shareholder would receive only 20-40% of this, it is unlikely to be attractive to the shareholders. In addition, the conditions would put further strain on the management team as personal issues would not be able to be resolved by one family member exiting the company.