TPE 2023 – Case Study Sample Solution

Erskine

Solution to Erskine

To: Brian Branch
From: Andy
Date: 31 October Yr 45
Subject: Erskine Electronics Limited – Due diligence review

Dear Brian,

Please find attached the documents you requested regarding Erskine Electronics Ltd:

- Valuation of 35% shareholding for attention of Colin Dunn; and
- Briefing document for Colin Dunn on improving profit levels.

I would like to bring to your attention some areas of concern following the due diligence work carried out by Frances.

Personal expenditure
The directors, Dave and Pete Erskine, appear to draw no distinction between the company funds and their own funds. This attitude of the directors is not something that we should necessarily wish to be involved with. This could be considered as fraud and there may be other areas of fraud which we have not uncovered.

A series of payments for personal expenditure has taken place and is included in the draft statement of profit or loss as follows:

- The company pays for purchases for Pete Erskine's wife's business. These have been charged to cost of sales and the balance of stock is included in inventories in the balance sheet.

  Additionally, it appears that VAT on these purchases might have been claimed. This is not business expenditure and as a result, VAT is not recoverable by Erskine. This should be the subject of a voluntary disclosure to HMRC in order to minimise any penalties. Repayment will be required and will include interest. The distributions will result in Pete and Dave having personal income tax to pay to HMRC.

- Dave's alimony to his former wife (£2,000) was charged to insurance expenditure.

- Repairs and renewals were charged with £100,000 for renovation to properties belonging to Pete's other company and as a result there is misrepresentation within the financial statements.

Directors' loans
Overall, it appears that the directors are not taking any dividends from the business but both directors' loan accounts (totalling £412k) have been written off during the year. These should be assessed as distributions on the directors and Erskine cannot take any deduction for these in its corporation tax computation.

Poor internal controls
Our due diligence review indicates overall poor controls within Erskine.

Assets are not secure which resulted in a recent theft of copper wire. Differences in bank reconciliations are not investigated which may mean that any theft from the company's funds is not found.

Credit balances on customer accounts are not returned to customers but instead have been recognised in the statement of profit or loss (£120,000).

Email received from Pete Erskine
Pete Erskine sent us an email stating that he suspects Mary, Erskine's bookkeeper, is involved in the stealing of copper wire. His suspicion is based on her having a boyfriend who is a scrap metal dealer and that she doesn't take holidays.

Money Laundering Reporting Officer ('MLRO')
The trade debtors credit balances being retained and the possible deliberate reclaim of VAT, which is not due to Erskine, raises suspicions that money laundering may be taking place. The risk of fraud is also heightened by poor staff morale.

Overall, we should report Erskine to our MLRO to comply with our responsibilities regarding fraud and money laundering reporting.

Our client
Colin Dunn, our client, on the other hand, appears not to receive any return on his investment and doesn't seem to be aware of any of these transactions and the attitude of Pete and Dave Erskine. Therefore, there is no need for us to consider whether we should stop acting for him.

Please let me know if you wish to discuss the content of this report further.

Kind regards,

Andy

Briefing note
For the attention of Colin Dunn
Title: Valuation of 35% shareholding in Erskine Electronics Ltd

Valuation

We valued Dave's 35% shareholding in Erskine Electronics at around £1.4m using the earnings valuation method. See appendix 1 for calculations. This is above the minimum amount which Dave is looking to receive. It is significantly above the value of the assets in the business and so it is highly dependent on future profitability.

This valuation is based on unaudited accounts which include information which was lost during the year and had to be recreated as there were no backups. Therefore, we cannot rely on these figures until further verification is carried out at the year-end audit.

Recommendation

Overall, we recommend that you do not purchase the shares until audited accounts are available and the matters referred to below have been resolved.

Method of valuation

The earnings method provides a good valuation of Erskine Electronics as a whole. It can also be used for valuing significant minority shareholdings after applying a discount for lack of overall control of the company.

The earning valuation is calculated by applying a multiple to the estimated future maintainable earnings of a business. This multiple (called P/E ratio) can be calculated by using a similar ratio from a company listed on the stock exchange and adjusting it to suit the size and circumstances of the business being valued. Typically, the ratio is adjusted for any restrictions in share transferability specified in the Articles of Association and lower marketability of unlisted shares.

This method can also be adjusted for any negative aspects, such as lack of controls, and positive aspects such as the WSI contract, which both affect Erskine Electronics' maintainable earnings. As you will obtain control of the company by purchasing this additional shareholding, this factor may also be taken account of in the multiple used.

The future earnings to which the multiplier is applied is usually determined from the forecasts prepared by that company.

Other factors to consider

Erskine is an established company with a good reputation and, after excluding personal and non-business expenditure as explained in appendix 1, it appears to be profitable. It also has plans to expand and has secured a ten-year exclusive supply contract from a reputable supplier. Despite the current economic climate, the IT industry has a good outlook and if better controls are introduced you can expect profits to be maintained or increased.

Bank overdraft

The company is currently close to its overdraft limit and we understand that it is looking to expand. This would require a significant increase in the overdraft facility. The bank will need to be contacted to assess whether this will be possible. Currently Erskine's creditors are not being paid within their agreed terms which suggest there may be liquidity problems within Erskine.

Investment

You indicated that you would not normally invest in such a large shareholding in one company. Purchasing 35% from Dave Erskine would give you overall control of the company, owning 65% of the shares. This may deliver high returns, however there are also significant risks you need to be aware of.

You are not currently involved with the daily running of the company. Pete runs the company and he may not run it the way you want. You might find it difficult to assert controls over his personal expenditure and operation of the business. If you decide to purchase the additional shares you should become more involved with the company's affairs.

You should also consider the return on your investment. Currently Erskine does not pay you any dividends or salary. Therefore, any return on your shares will only be realised when you eventually sell them. Dave and Pete receive high salaries and also have been benefiting from the use of director's loan accounts, substantial balances from which were written off this year. Before you commit any more money, a clear dividends and remuneration policy should be agreed. You will no longer have to pay a salary to Dave, but you may wish to take some form of remuneration instead.

Exit strategy

You should agree an exit strategy with Pete. It may be that in a few years Erskine could be prepared for floating on the Alternative Investment Market (AIM). This strategy may be attractive to Pete as, considering his age, by the time the exclusive contract comes to an end, he could be looking to retire and may welcome an opportunity to adopt an exit strategy. You should also discuss with Pete how the company has been managed. He may not adapt well to having a majority shareholder.

Personal transactions

We noticed several irregularities in the treatment of personal expenses and there are also very poor controls over assets of the company. This may result in a tax investigation in future with sizeable penalties and interest that may be payable.

Appendix 1 – Valuation

Earnings Method of Valuation

Value of the company	=	P/E Ratio x Future Maintainable Earnings (FME)	=	4,020,030
Value of 35%				1,407,011

	Note		
P/e ratio used:	**Note**		
P/E of CQC (estimated)		10	Industry ratios are between 8 and 12 – 10 used as average
Adjust for:			
Lack of marketability (20%)		(2)	
Restrictions on transferability (20%)		(2)	
WSI contract		2	
Poor controls		(1)	
		7	
FME:			
Loss per accounts		(88,000)	
Add back: directors loan accounts written off	1	412,000	
Add back: Green purchases	2	270,000	
Less – in stock	2	(25,000)	
Add back:			
Dave’s alimony	3	2,000	
Arran renovation	3	100,000	
Add back:			
Wedding costs	4	25,000	
Directors remuneration	5	133,000	
Customer overpayments	6	(120,000)	
		709,000	
Corporation tax at 19%		(134,710)	
Future maintainable earnings		574,290	

Note 1
Directors loan accounts were written off during the year. The valuation should reflect profits which are maintainable therefore £412k has been added back.

Note 2
The company paid for purchases related to Theresa Green's business - this does not represent Erskine's expenditure and needs to be added back.

Note 3
Director personal expenditure is added back as not business related. This includes Dave's alimony and renovation costs for Arran Isle Holiday breaks.

Note 4
£25k of memory sticks was provided at Dave Erskine's daughter's wedding. These costs should not be reflected through the company. They have been added back.

Note 5
Directors remuneration appears excessive and will be reduced if Dave leaves. An estimate of £133k to reflect what level of profits you can expect from the business has been added back.

Note 6
£120k of customer money has been included within the Income Statement as revenue. This money does not belong to Erskine so has been deducted.

Briefing Note

For the attention of Colin Dunn
Title: Recommendations to achieve improved profit levels

Business risks and mitigation factors were considered to help derive improved profitability.

Business Risks	Mitigation and profit suggestions
Non-business-related expenses Charging personal expenses and non-business-related expenses through Erskine's Statement of profit or loss reduces profits for the company and also impacts on the company's cash flow.	Only Erskine expenses should be met by the company and director loans should not be allowed to build up and be written off without approval by all shareholders. This will instantly improve profitability and allow a more accurate picture of Erskine's performance to be viewed.
Going Concern Erskine is currently at its overdraft limit. If the bank does not renew the overdraft or Erskine cannot generate more cash, it may result in the company no longer being a going concern. Erskine is struggling to bring in cash from debtors on time. There is evidence that a customer (Plasmotrobe) is in financial difficulty yet Erskine are continuing to provide them with credit. Also, Erskine is not paying their creditors within the 30 day set credit terms. They are taking 60 days to pay.	Working capital should be managed better. If customers are chased to pay quicker this will bring cash into the company. This will help to reduce the overdraft balance which in turn will reduce any interest charges being incurred which will lead to improved profitability. Erskine should monitor their payment of suppliers to ensure that they continue to receive credit from them in order to trade effectively.
Change in technology The industry that Erskine operates in is fast changing. Box building is becoming obsolete and cloud computing is becoming more popular. This change will result in declining demand for products and reduced sales for Erskine.	Review product mix and offer different products/ services to keep up with changes in the market. Research the market and where the company could fit. In the long-term diversifying into more popular and customer demanding products will increase profitability for Erskine however in the short-term funding will be required to do this. In addition, changes will be on-going, and Erskine will need to keep on top of this.
Management There is a lack of management focus within Erskine due to the directors' 'other' business and personal interests. This takes the focus away from the success of Erskine.	Review the effectiveness of directors and on-going leadership of the company. With Dave wanting to leave and more involvement from Colin this will help to bring more focus which will lead to more success and increased profitability.

Poor inventory controls Poor inventory controls and systems have resulted in continuous theft of some stock items. High value items are insufficiently secured. The copper wire has a ready-made market so is very susceptible to theft.	Improve stock controls. Ensure high risk stock is securely locked away, the locks work properly, and access is restricted to authorised personnel. If stock is secured it can be sold by Erskine and generate profit in the company.
Unused second factory The second factory building owned by Erskine is not generating any income for the company. It is currently unused and potentially incurring costs.	Assets owned by the company should be reviewed to assess whether they are being used to generate profit for the business It may be possible to rent out the factory to bring in some income to help improve profit. Alternatively, it could be sold to generate cash for the business which would help the overdraft position and reduce interest costs which in turn will help with profitability.
Poor staff morale Erskine has high staff turnover and poor staff morale. This may result in staff not working as hard as they could be. Erskine will be incurring high staff costs for replacing and training staff on a regular basis. This is likely to have an adverse effect on the quality of service provided by Erskine.	The directors should review the recruitment strategy to address the key issues. It may be that the terms and conditions of employment need to be reviewed or staff need to be motivated better by management. If staff are motivated to perform a good job it will increase productivity which can lead to improved profitability for Erskine.

Slides detailing the impact of KVT liquidation on Erskine

Slide 1 content:

- KVT is in a creditor's voluntary liquidation
- KVT currently owe Erskine £486k
- The £486k debt will need to be written off
- Future turnover likely to fall

Speaker notes - Information to discuss:

- KVT is in a creditor's voluntary liquidation. Erskine is an unsecured creditor of KVT, unsecured creditors are unlikely to receive a payout.
- Claims by unsecured creditors such as Erskine are paid on a pari passu basis i.e. without preference. Erskine may receive a dividend paid pro rata at the end of the liquidation. It may be that the dividend to unsecured creditors will be just a few pence in the pound, or it may be nothing at all. It has been stated that it is unlikely that a dividend will be paid to unsecured creditors.
- Erskine will need to submit details of their claim which will consist of proof that the debt is owed, such as copies of the unpaid invoices to the Liquidator along with proof of the debt.
- Erskine should write off the KVT balance of £486k and assess the implications for cash flow going forward.
- The future turnover of the business will likely fall, because KVT will no longer exist post-liquidation, and KVT is a substantial customer.

Slide 2 content:

- Other Erskine customers are also exposed to KVT
  i) Immediate cash flow impact - Allander Components (£143k impact)
  ii) Long term cash flow impact - Blane Peripherals (KVT accounts for 20% of their turnover)
  iii) Uncertainties - Finglen (£75k impact)

Speaker notes - Information to discuss:

- Worryingly, a number of other customers are also exposed to KVT. This will likely have a triple impact on Erskine.
  i) Firstly, some of Erskine's current debtors might struggle to pay Erskine on time or at all, because they in turn are not being paid by KVT. Allander Components currently owe Erskine £143k. Allander Components have stated that they have a large exposure to KVT and that they might not be able to continue. The current debt of £143k should be provided for in full and the situation monitored. All other debtors with exposure to KVT should also be monitored, and debts recovered as soon as possible.
  ii) Secondly, some of Erskine's customers might struggle to continue in the future, or reduce orders in the future, due to the loss of custom of KVT. In particular, Blane Peripherals, where KVT accounts for 20% of their turnover.

iii) Finally, there are a number of uncertainties still to be quantified. In particular efforts should be made to contact Finglen (current outstanding Erskine debt of £75k) to establish their KVT exposure.

Slide 3 content:

- Immediate actions required:
- Assess if Erskine is still solvent.
- Contact the KVT liquidator.
- Contact Erskine's bank

Speaker notes - Information to discuss:

- It is vital to assess the provided statement of affairs as soon as possible to assess the solvency of Erskine in light of the liquidation of KVT.
- In addition, Erskine should contact the KVT liquidator to request more information and submit a claim for the unsecured debt of £486k.
- Given that Erskine are already at the top overdraft limit, it is vital to contact the bank as soon as possible to discuss current developments.

PRIVATE AND CONFIDENTIAL

REPORT TO COLIN DUNN

A REVIEW OF COLIN'S OPTIONS FOR THE FUTURE OF ERSKINE ELECTRONICS LIMITED

Prepared by: Charleston and Sylvester
Date: 6 November Yr 45

Contents

1. Introduction

The purpose of this report is to discuss the current position of Erskine Electronics Ltd ('Erskine') and the options available to you regarding the future of the company.

This report has been prepared using the draft accounts for the year ended 30 June Yr 45 and further information that you have provided to us. We have not verified this information.

This report is for your sole use and should not be released to any third party without our prior written consent.

2. Executive Summary

- Erskine is insolvent with a deficit of assets in excess of £634,000.
- We recommend that you inject capital into Erskine rather than purchasing Dave's shareholding. In addition, we recommend that the bank funding is renegotiated. This method will prevent Erskine from going into administration or liquidation and protect your current investment.
- To enable Erskine to return to profitability there will have to be tight controls introduced to ensure the company trades profitably. You should also become more involved in the day to day running due to having a larger investment.

3. Current Position

We have assessed the current financial position of Erskine using a Statement of Affairs ('Statement'). The Statement takes each of Erskine's balance sheet asset categories (as at 30 June Yr 45) and estimates what they would be likely to realise in a winding up of the company. For the full Statement of Affairs please refer to Appendix 1.

The statement shows that the liabilities of the secured creditors, the preferential creditors and the floating charge holders are satisfied.

However, Erskine is insolvent. On a winding up of Erskine there would be a deficiency of assets over liabilities of approximately £634,000 and the unsecured creditors, i.e. you, would receive nothing.

If you continue incurring debts in Erskine whilst knowingly insolvent and Erskine subsequently goes into liquidation, all directors may be found guilty of wrongful trading and ordered to personally contribute to assets of the company. Once the company is insolvent, the directors' primary responsibility is to company's creditors and the only defence against future claims is that you acted in their best interest e.g. by following advice from a qualified insolvency practitioner.

4. Options for Future

4.1 Inject Additional Capital into Erskine

Last month you were considering paying over a million pounds for Dave's shares however by doing this it would not provide Erskine with additional finance as the funds would flow directly to Dave. It would be more beneficial for Erskine if you used this capital to inject funding into Erskine.

The best way to do this is to offer Erskine a loan on commercial terms. This would enable you to receive an income by way of interest and would help to save Erskine from liquidation. The loan could be repayable once Erskine is in a solvent position.

An alternative option might be to receive preference shares for your investment. This offers some protection should Erskine be unable to come out of the current insolvent position. Preference shares rank above existing ordinary shares for income and rights on a winding up should Erskine go into liquidation.

Erskine could issue more ordinary shares to you which would effectively dilute the shareholdings of the other directors. At the moment you already currently own 30% of the ordinary share which without further intervention may well be worthless, along with the ordinary shareholdings of the other directors. Receiving additional ordinary shares to keep the company going may be a big enough incentive to the other directors as it will help to protect their investment. However, you need to consider that losing your 30% investment may be relatively small compared to the cost of injecting further funds into Erskine to keep the company going.

If you do not wish to invest any further personal capital, funds could be injected from another source, possibly by the bank. You should, in any event, consult the bank on their position regarding Erskine. They are likely to be fully repaid if Erskine went into liquidation, but they may not wish any further involvement with this business.

The position with regard to the estimated deficiency could change. The deficiency may be more or less than the Statement currently shows. More up-to-date figures are required to help to clarify the position.

Before injecting capital, you should ensure that tighter controls are implemented within Erskine. We have already provided some suggestions regarding areas of risks within Erskine and ways to mitigate them which should lead to improved profitability. Please refer to the Briefing Note prepared for you dated October Yr 45.

In addition, you should consider becoming more involved in the day to day running of Erskine to aid the implementation of controls to help improve the financial position of Erskine. This will be beneficial to you, especially with a much larger investment in Erskine.

4.2 Allow the Company to be put into Liquidation

An option is to seek to have Erskine put into liquidation which would follow a similar process to what is currently happening with KVT. This would protect the directors. One advantage of this is that the company's debts would remain in the liquidation. However, it would result in the loss of your 30% investment as currently there would not be enough money, after realising the assets of Erskine, for unsecured creditors to receive any money, let alone the shareholders.

4.3 Start a New Company

If Erskine is liquidated there is the option for you to buy the assets from the liquidator. However, it is possible that the liquidator may not deal with you as a former director of Erskine.

The liquidator may also view this company as a 'Phoenix Company' set up to commence trading without the debt of Erskine and with common directors and could take action against you.

Erskine has a profitable business and the contract to supply components. Therefore, it is likely that the business could be successful. However, it may be that if the liquidation option was taken, the contract to supply components may end. This would need to be looked into by Erskine's lawyers.

Under this option you would need to consider whether you will be able to raise the finance necessary to implement setting up a new company and whether you would want Pete to join you to reform the company.

This is potentially the least attractive of the options as it will involve a large amount of capital investment. New premises and contracts would need to be sought and the company re-established.

It is also highly unlikely that any suppliers or other contacts that have lost money in the liquidation will deal with you again in a business capacity even though you were not personally involved in the day to day running of Erskine.

4.4 Take no Action

As explained earlier the directors could be accused of wrongful trading if they continue to trade whilst knowingly insolvent. Therefore, this is not an option we would recommend.

5. Directors' Disqualification Act

If the directors knew or ought to have known that Erskine could not avoid liquidation, but continued to trade and incur credit, then the directors could be found guilty of wrongful trading.

Based on the current position it appears Erskine has insolvency problems. The directors need to ensure that all possible steps are taken to minimise any potential loss to Erskine's creditors It is essential that you consult a licensed insolvency practitioner before proceeding with any attempt to reconstitute the business.

Appendix 1

Estimated Statement of Affairs of Erskine Electronics Ltd as at 6 November Yr 45

Estimated Statement of Affairs of Erskine Electronics Ltd.	
	Estimated Realisable Value
Assets	**£**
Assets not specifically secured (List A)	2,008,300
Assets specifically secured (List B)	2,976
Estimated total assets available for preferential creditors, holders of floating charges and unsecured creditors	2,011,276
Liabilities	
Preferential Creditors (List C)	(55,000)
Estimated balance of assets available for holders of floating charges and unsecured creditors	1,956,276
Estimated prescribed part of Net Property	(394,255)
Holders of Floating Charges (List D)	(1,165,000)
Estimated surplus as regards holders of floating charges	397,021
Add: Estimated prescribed part of Net Property	394,255
Unsecured Creditors (List E)	(1,326,000)
Estimated deficiency as regards creditors	(534,724)
Issued and called up share capital	(100,000)
Estimated deficiency as regards members	(634,724)

The estimates are subject to expenses of liquidation and to any surplus or deficiency on trading pending the realisation of the assets.

Note for Compliance Partner

To:	Compliance partner
From:	Andy
Subject:	Erskine Electronics Ltd

I would like to draw to your attention some issues I encountered whilst working on an assignment for Colin Dunn, Erskine Electronics Ltd.

Brian Branch
Brian Branch, manager on this assignment, appears to be involved in a personal relationship with the former wife of one of the directors of Erskine. I understand that the divorce was acrimonious however this does raise some ethical concerns. This may affect his objectivity and independence on the assignment. Therefore, it would be best if he was not involved on this assignment going forward as he might favour a view against the director, influenced by the former wife.

Money Laundering
Last month I reported to Brian several instances arising in Erskine which indicated the possibility of fraud and money laundering taking place. Due to the circumstances mentioned above I am concerned he may not have passed these on to you. In order to satisfy my reporting obligations please see attached a copy of the briefing note which was given to Brian.

Firm reputation
Although we are working for Colin, we are carrying out the work on Erskine. There are potentially serious implications to our reputation if we continue to be involved with a company that may be found to be involved in money laundering. We should consider the possibility of resigning from this assignment.

If you wish to discuss these matters in more detail please let me know.

Kind regards,

Andy