Professional Examinations

Strategic Level

March 2015

Case Study

FAMILIARISATION AND PRACTICE WORKBOOK
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Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.
Chapter 1

INTRODUCTION

1 INTRODUCTION TO CASE STUDY EXAMS

The Case Study Exam is an attempt to simulate workplace problem solving, and allows examiners to move one step closer to the assessment of competence than is possible with objective test questions.

The Case Study is assessed by way of a three hour computer based examination. You cannot take the examination until you have successfully completed all the Objective Test Examinations for the relevant level. The exam comprises a series of requirements which aim to integrate and apply the technical knowledge tested in the Objective Test Examinations.

The exam is based on:

- pre-seen material issued in advance of the exam day, supplemented by
- additional, previously unseen material given to you in the exam room.

There will be several requirements, comprising:

(a) Triggers – information and updates regarding situations in which the company finds itself

(b) Tasks – work you will need to carry out based on the trigger

2 ESSENTIAL SKILLS

The CIMA syllabus is based on a series of four generic competencies which underpin the skills required of a management accountant. These skills are Technical, Business, People and Leadership. More detail on the skills and the competency framework can be found in the Official CIMA Case Study Textbooks.

In order to demonstrate these competencies in an exam setting you will need to develop and apply certain techniques in preparation for the exam as well as for the exam day itself. Broadly speaking you will need to ensure you have properly prepared the pre-seen information in advance of the exam and also be comfortable with how to react to the unseen information provided in the exam.

We have split the preparation into these two broad areas – familiarisation with the pre-seen and practice for the unseen and have included exercises and tasks for each of the three technical papers at this level. Depending on your chosen method of study, you may also have the opportunity to practice the integration of all technical areas when you attempt mock exams.
3 HOW TO USE THIS WORKBOOK

It is essential that, before you begin the exercises and tasks provided here, you have worked through the Official CIMA Case Study Textbook and read the relevant pre-seen information at least twice. You can then work through the Familiarisation Exercises for a particular technical subject (the ‘E’ papers often give a good overview and introduction into the Case Study) before attempting the Practice Tasks from the same subject. This will help you to identify any last minute knowledge gaps as you prepare. Alternatively you can complete all of the familiarisation sections before you begin the Practice Tasks.

It is strongly recommended that when working through the Practice Tasks, you plan and write your own answer prior to reviewing the suggested solutions. This is an important part of the learning process.
## Chapter 2

### FAMILIARISATION QUIZ

#### INTRODUCTION

Attempt this quiz after you have read the pre-seen at least twice. Try not to refer to the pre-seen material when answering the questions unless you really can’t remember.

However it is better to look for the answers in the pre-seen if necessary rather than turning straight to the quiz solutions.

<table>
<thead>
<tr>
<th>Question</th>
<th>Your response</th>
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</thead>
<tbody>
<tr>
<td>When was the company founded?</td>
<td></td>
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<tr>
<td>How do Look’s founder shares differ from the ordinary shares?</td>
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<tr>
<td>What physical locations does Look have?</td>
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<tr>
<td>How does the search engine generate revenue?</td>
<td></td>
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<tr>
<td>What share of the search market does Look have?</td>
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<tr>
<td>How many devices use Look OS?</td>
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<tr>
<td>Which divisions does the Head of Mobile Services look after?</td>
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<tr>
<td>Does Look have a central HR function?</td>
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<tr>
<td>How many employees does Look have in total and which are the largest two divisions?</td>
<td></td>
</tr>
<tr>
<td>Question</td>
<td>Your response</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------</td>
<td>---------------</td>
</tr>
<tr>
<td>What is Look’s share price?</td>
<td></td>
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<tr>
<td>What is Look’s unofficial mission statement?</td>
<td></td>
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<tr>
<td>What is the Chairman’s background?</td>
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<tr>
<td>How has the company’s operating margin changed in the last year?</td>
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<tr>
<td>After cost of sales which is the biggest operating cost?</td>
<td></td>
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<tr>
<td>What is the effective tax rate?</td>
<td></td>
</tr>
<tr>
<td>Do Look capitalise software development?</td>
<td></td>
</tr>
<tr>
<td>Look Search represents 70% of revenue. Which is the next largest revenue stream?</td>
<td></td>
</tr>
<tr>
<td>What company did Look purchase during the year (which gave rise to goodwill)?</td>
<td></td>
</tr>
<tr>
<td>How much did Look spend on funding renewable energy projects in 2014?</td>
<td></td>
</tr>
<tr>
<td>It has reported that Vijay may be thinking of leaving Look. What is his role?</td>
<td></td>
</tr>
<tr>
<td>What was Friendtime’s annual revenue growth?</td>
<td></td>
</tr>
</tbody>
</table>
Chapter 3

LOOK FAMILIARISATION

1 INTRODUCTION

It is absolutely crucial that you completely familiarise yourself with the pre-seen information prior to attempting the Case Study exam. Merely reading through the materials is unlikely to be sufficient and it is also important that you consider which aspects of the three technical subjects may be useful and relevant for the Case Study.

The exercises in the following three chapters will help you to gain a thorough understanding of the Case Study scenario and ensure you are fully prepared to attempt the Practice Tasks later in this Workbook.

Solutions to these exercises are provided but are not exhaustive. It is important that you attempt the exercises yourself and makes notes of your answers before reviewing the solutions.

2 OVERVIEW OF PRE-SEEN

The pre-seen information concerns a company called Look, a technology company based in a European city with worldwide operations. Look started as a web search company and is now listed with a range of connected products.

Look search engine makes money through sponsored links and so needs to make these useful to ensure ‘click through’ revenue. To make the links relevant the engine gathers information about the users e.g. location from the device as well as past browsing history. Whilst 70% of Look revenue is from the search engine the remaining business incorporates:

Look Space – a similar concept to Google Earth which also earns revenue through advertising.
Look OS - an open source operating system.
Look Apps - which is an online store selling apps.
Look Phone - manufactures handsets using the Look OS.
Look Lens - the contact lens version of Google glasses.
Look Media - live media streaming.
Look Cloud – cloud data storage.
Look prides itself on good working conditions and is also very strong on staff development. Look’s Mission Statement is ‘Connecting People to the World’ but also has an unofficial statement ‘Do only good’ which reflects its strong social responsibility position. The company’s data centres are managed in order to reduce energy consumption and have been carbon neutral since 2005. The company has also funded renewable energy research projects totalling $1.1bn in 2014.

Look’s Strategy is to maintain market dominance and so economies of scale and therefore market share are crucial to success. Look has achieved about 25% revenue growth over the last year although a much bigger increase in cost of sales has had a negative impact on profit for the period. The company’s share price has been steadily rising over the last three years.

The company has highly technical, well-educated founders and other well qualified directors although the skills and independence of Mara Reynolds as a non-executive director seem doubtful.

There are rumours that Vijay, one of the founders, may be thinking of stepping down from the board as he is bored with corporate life. This could cause serious issues in terms of corporate governance and innovation of new products.

All of Look’s divisions operate in highly competitive markets and must ensure innovation, quality and volume of users to achieve continued success. For products such as Look Cloud, trust and integrity are also important and the security of the company systems is crucial. The divisions are also highly dependent on each other and so problems in one area are likely to be difficult to contain.
Chapter 4

STRATEGIC MANAGEMENT (E3) FAMILIARISATION

1 PRODUCT PORTFOLIO

Look has a range of complementary products. Portfolio analysis will help us to understand the strategic importance of each part of the business.

EXERCISE 1

Prepare a Boston Consulting Group (BCG) analysis of Look.

2 EXTERNAL ANALYSIS

Consideration of the external environment will help to appreciate the issues Look may face in the future. Several models are available to assist with this analysis. We have chosen to apply the two most popular – PEST and Porter’s Five Forces

EXERCISE 2(a) – PEST

Prepare a PEST analysis for Look

EXERCISE 2(b) – FIVE FORCES

Prepare a Five Forces analysis for Look

3 CRITICAL SUCCESS FACTORS

An awareness of the Critical Success Factors relevant to the company will help to assess potential future strategies for the company. Key Performance Indicators must be linked to these CSFs to ensure the company can achieve competitive advantage.

EXERCISE 3 – CRITICAL SUCCESS FACTORS AND KEY PERFORMANCE INDICATORS

Using the headings from the Balanced Scorecard, identify the likely Critical Success Factors for Look and determine suitable KPIs for each.
4 INFORMATION SYSTEMS

It is important to consider the role of information systems in organisational strategy. One particular relevant aspect of information systems is the concept of Big Data, which represents a significant development in the use of the internet for competitive advantage.

EXERCISE 4

What is meant by Big Data, and how is it relevant to Look?
Chapter 5

RISK MANAGEMENT (P3)
FAMILIARISATION

1 CORPORATE GOVERNANCE

Look is a listed company and therefore should be paying close attention to ensuring adequate corporate governance.

EXERCISE 1

Evaluate the Corporate Governance arrangements at Look. (Assume Look is located in a country where Corporate Governance is “principles based”).

2 RISK MANAGEMENT

A risk analysis for Look is provided in the pre-seen materials on page 20.

EXERCISE 2A

With reference to the TARA risk management framework, discuss risk management strategies already employed by Look and suggest further mitigations.

EXERCISE 2B

All business units are being asked to analyse the risks in their area. Look Media have asked you for some help in identifying and evaluating its risks.

3 CURRENCY RISK

Look is a global company although based in a European city. This suggests exposure to a range of different risks including currency risk.
EXERCISE 3

Let’s assume that its main currency is the US $ (the pre-seen just says the dollar)
Based on the information provided in the pre-seen, discuss the currency risk Look may be exposed to.

4  MANAGEMENT CONTROL SYSTEMS

Management control is defined as “the process of guiding organisations into viable patterns of activity in a changing environment”. Look employs about 20,000 employees worldwide across 12 business units and functional areas and prides itself on being an excellent employer with a low turnover rate.

EXERCISE 4

How might the managers at Look use management controls to ensure staff work to achieve Look’s objectives?
Chapter 6

FINANCIAL STRATEGY (F3)
FAMILIARISATION

1 FINANCING

EXERCISE 1
Analyze Look’s long term financing arrangements.

2 BUSINESS VALUATIONS

Look wishes to acquire a mobile phone technology company called MobilTronics (MT). The company develops new technology for the mobile phone industry which it patents and then sells to various mobile phone manufacturers.

EXERCISE 2
Amanda Wilson, the Director of Finance, wishes to start compiling some valuations of MT but is unsure of how to do this. She has asked you to prepare some briefing notes for her which includes the following:

- A brief description of the various methods of valuation
- Their strengths and weaknesses
- An indication of their suitability towards valuing MT
3 FINANCIAL ANALYSIS

EXERCISE 3
Analyze the profitability of Look Group year on year. Use any ratios you consider suitable.

4 INTEGRATED REPORTING

Traditional financial reporting has long been seen as insufficient to allow users to fully understand the organisation. There has been increasing pressure therefore for entities to provide more information in their annual reports beyond the financial statements since non-financial information can also be important to users’ decisions.

For example, the Global Reporting Initiative (GRI) has produced guidelines that propose additional disclosures in addition to the standard disclosures required in the financial statements. In particular, the GRI guidelines suggest that entities should disclose economic, environmental and social performance indicators.

Alternatively, the International Integrated Reporting Council (IIRC) has produced a revolutionary framework known as the Integrated Reporting Framework (IR) framework.

EXERCISE 4
Prepare a board paper explaining the main objectives of integrated reporting as well as the fundamental concepts that underpin it.

Also, comment on the relevance of integrated reporting and its benefits to the Look Group.
Chapter 7

LOOK PRACTICE TASKS

1 EXAM PRACTICE

Now you have thoroughly worked through the pre-seen materials and are familiar with the key issues it is time to think more about the exam environment and your strategy for three very important hours. Before you attempt any full mock exams it is necessary to consider the skills needed to approach each individual task.

2 IMPORTANCE OF TIME MANAGEMENT

Someone once referred to case study exams as "the race against time" and it's difficult to imagine a more accurate description. Being able to do what the examiner is wanting is only half of the battle; being able to deliver it in the time available is another matter altogether.

For this reason, time management is a key skill required to pass the Case Study Examination.

Successful time management requires two things:
- A tailored time plan – one that plays to your personal strengths and weaknesses; and
- Discipline in order to stick to it!

The first part of each task must be spent actively reading, processing the information and considering the impact on the organisation, how the issues link together and what could be done to resolve them. You will not have time to have a second detailed read and so these thoughts must be captured first time around.

You will be writing your answer in software with some similarities to Microsoft Word however the only functions available are:
- Cut
- Copy
- Paste
- Undo
- Redo
- Bold
- Italic
- Underline

The temptation to make various words bold or italics or underlined, is very hard to resist. But, resist you must! There are very few marks available for having a response that is well presented, and these finer details will be worth nothing at all.
As we've said earlier, not finishing your answer is a key reason for failing the Case Study Examination. One of the main reasons why students fail to finish their report is a lack of discipline when writing about an issue. They feel they have to get all of their points down rather than selecting the better points and moving on. If a task requires you to discuss three different areas it is vital that you cover all parts adequately.

Often students can reread paragraphs three or more times before they move on to writing the next part of their report. Instead, try to leave the read through until the final few minutes of the task and try to correct as many obvious errors as possible. The CIMA marker will be reading and marking your script on screen and it is harder to read and understand the points you are making if there are many typing errors.

3 ASSIMILATION OF INFORMATION

One of the most challenging things to deal with in a case study examination is the volume of information which you have available. This is particularly difficult when you have both pre-seen and unseen information to manage and draw from. It is important that you refer to relevant pre-seen information in your responses as well as incorporating the unseen information. The key things that you need to do to assimilate the information effectively and efficiently are:

- Read about and identify each event
- Consider what the issue is
- Evaluate the impact of the issue. Who is affected, by how much are they affected and what would happen if no action was taken?
- Determine the most useful and relevant exhibits from the pre-seen

Capturing all of your thoughts and ideas at this stage can be difficult and time consuming. The chapter in the CIMA Official Case Study Textbook on planning your answer will show you how to do this effectively without wasting time or effort but we have given some simple guidance below.

4 PLANNING YOUR ANSWERS

To make sure the time spent now is of use to you throughout the task, you will need consider carefully how best to document your thoughts. You will be provided with an on-screen notes page (‘scratchpad’) as well as a wipe-clean laminated notes page and marker pen. Any method you adopt to plan must be concise whilst still allowing you to capture all of your ideas and see the bigger picture in terms of how the issues interrelate with one another (see additional guidance below). Furthermore, the method must suit you! Everyone is different and what might work for one person could be a disaster for another. For example, some people prefer to work with lists, other with mind maps.

Most people find that some form of central planning sheet (to enable the bigger picture to be seen) is best. How you prepare the central planning sheet is a matter of personal preference and we've given illustrations of two different methods below. Practise each one to find out which you prefer and then tailor it further to settle on something that works for you.
Method 1 – The ordered list
This process is ideally suited to people who prefer lists and structure.

- Step 1:
  
  Begin by reading everything in the task exhibit. Ensure you have identified all aspects of the task and then write this on the left hand side of your planning sheet.

- Step 2:
  
  Read everything in the trigger exhibit, making notes next to the relevant task.

- Step 3:
  
  Review your list to identify any linkages to information provided in the pre-seen and note next to the task on your planning sheet.

- Step 4:
  
  Brainstorm any technical knowledge you can use in responding to the task and note this on your planning sheet.

Method 2 – The extended mind map
This process is ideally suited to those who prefer pictures and diagrams to trigger their thoughts.

- Step 1:
  
  Read the unseen information and identify the key tasks required.
  
  As you read, write each task in a "bubble" on your planning sheet.

- Step 2:
  
  Keep adding each new part of the task you identify to your sheet. At the end you should have a page with a number of bubbles dotted about.

- Step 3:
  
  Review your bubbles to identify any linkages to the trigger information or pre-seen exhibits. Add any relevant information to your planning sheet in a bubble attached to the appropriate part of the task.

- Step 4:
  
  Review the task bubbles and brainstorm any relevant knowledge which you can use in responding to the task. Add this to bubbles attached to the task.

  With detailed information provided in the exam it would be very likely that your brain would think of a wide range of ideas which, if left uncaptured, would be forgotten as quickly as you thought of them. This is where mind mapping comes in handy.
5 WRITING STYLE

Introduction

Writing style is something that develops over time. It is influenced by your education and experiences. To some it comes easily, they enjoy words – but remember, you are not looking to win any prizes in literature. It’s about putting facts, ideas and opinions in a clear, concise, logical fashion. Some students get very worried about their writing styles. As a general rule you should try to write as you would talk.

Logical flow

A typical point starts with a statement of fact, either given in the case or derived from analysis – ‘what?’

This can then be followed by an interpretation – ‘so what?’ followed by ‘now what?’ or ‘what next?’

For example:

(1) What? – The NPV is positive.

(2) So what? – Suggesting we should go ahead with the project.

(3) Now what? – Arrange board meeting to discuss strategic implications.

A similar structure can be obtained using the Socratic approach – what, why, how?

- So what?
- Why should we use it?
- How does it work?

Who is reading the response?

Failure to pitch the level correctly will inevitably result in failure to communicate your ideas effectively, since the reader will either be swamped with complexity, or bored with blandness.

The recipients of the report should also dictate the level of tact required.

<table>
<thead>
<tr>
<th>Tactless</th>
<th>Tactful</th>
</tr>
</thead>
<tbody>
<tr>
<td>The directors have clearly made errors</td>
<td>There were other options open to the board that, with hindsight, would have been beneficial</td>
</tr>
<tr>
<td>The marketing director is responsible for this disastrous change in strategy</td>
<td>The board should consider where this went wrong? It would appear that the marketing department may have made some mistakes</td>
</tr>
</tbody>
</table>
6 ATTEMPTING THE PRACTICE TASKS

In the following chapters, practice exercises are provided which will help you prepare for different scenarios arising in the exam. This will also give you an opportunity to revise some key aspects of the syllabus and consider how they may be applied to the scenario. It is crucial that you go through this process to fully prepare yourself for the exam. Be careful – this is NOT an exercise in question spotting. We are aiming to revise the knowledge required and practise the skills needed to perform well in any exam rather than guess what may come up.

Each task begins with a small scenario (or trigger) to introduce the topic and set the scene. You should be using the skills developed so far to work through these tasks. These tasks are discrete i.e. they do not follow on from each other but stand alone as sample exercises.

It is very important that you attempt these tasks yourself before reviewing the suggested solutions. Practising writing out full solutions is a key part of developing the required skills for the case study exams.
Chapter 8

STRATEGIC MANAGEMENT (E3)
PRACTICE TASKS

EXERCISE 1

TRIGGER

Press Release (embargoed until 8am 16 February 2015)

The Look Group (“Look”) announce today that Vijay Chatterjee, Look’s Director of Innovation, is leaving the Group with immediate effect.

Vijay is one of the founders of Look, and has served on the Board since the company’s inception. He is leaving to pursue alternative interests, and will have no further involvement in the management of Look. He has no plans to dispose of any of his holding in the Group.

The Board would like to place on record its gratitude to Vijay for his contribution over the last 17 years. Without his vision and commitment, Look would not be the global success story that it is today.

TASK

<table>
<thead>
<tr>
<th>To: Senior Manager, Look</th>
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</thead>
<tbody>
<tr>
<td>From: Head of Research and Development</td>
</tr>
<tr>
<td>Date: 16 January 2015</td>
</tr>
<tr>
<td>Subject: Look Lens</td>
</tr>
</tbody>
</table>

You will no doubt have heard by now that Vijay has decided to leave Look. Whilst this might have come as a shock to many, I feel that it has been likely for some time; privately, Vijay was very disappointed with the market’s reaction to Look Lens, and has been feeling disenchanted for some time. He has decided to train for and participate in the Around the World yacht race next year, and wants to focus entirely on that.

I feel that this presents the perfect opportunity to revisit the concept of Look Lens. In my mind, the idea is brilliant as it allows users more of exactly what they want i.e. access to information at all times with the minimum of effort. However, the actual product of a contact lens does not seem to appeal to those users not experienced in the whole process of inserting, removing and
cleaning lenses. This naturally reduces the potential market quite considerably.

Vijay seemed unwilling to accept this point, but now that he has left I want to present an alternative product to the Board. I feel that the same technology can easily be adopted in a pair of glasses, which opens the market to any user. People wear glasses for a variety of reasons (poor eyesight, protection from the sun, fashion etc.) - it is a natural extension of the Look Lens concept to enable users to access email, social media, text messages etc. simply by wearing a pair of glasses that is linked to their mobile phone.

I am confident that the technology is not a problem, but what I would like from you is to help me prepare an analysis of how this opportunity should be exploited. Should Look develop its own range of glasses entirely on its own (organic growth), or consider acquiring an existing manufacturer? Or is some sort of collaboration with a manufacturer the most suitable approach?

I would like you to prepare a brief report covering each of the options mentioned above, together with your recommendation. I am due to present to the Board in 10 days’ time, so would welcome your ideas well before then.

Prepare the report requested by the Head of R&D

(Time allocation: 45 minutes)

EXERCISE 2

TRIGGER

To: Head of Mobile Devices
From: Vincent Chang
Date: Today
Subject: Map Your Tracks app

Hi

It was very good of you to take the time to see me earlier today; I hope you found our meeting as interesting and rewarding as I did!

The proposal that I put to Look is the purchase of a revolutionary new app which I have developed, Map Your Tracks. As I explained, this is a unique app aimed at anybody interested in knowing more about the journey that they have just undertaken.

The app has been designed with smart phones in mind, and makes use of the GPS technology now present in all such phones. At the start of any journey, the user activates the app, and can then monitor their progress - distance travelled, time so far, average speed etc. More advanced uses are geographic direction (via a built-in compass), elevation (height above sea level), and points of interest that are close by, such as historic buildings, restaurants and cafes, petrol stations, and so on. Not only will the app record any current journey being undertaken, it can also store and keep details of routes
travelled in the past.

I feel that this app will be of interest to any smart phone owner who needs to travel - walkers, motorists, horse riders etc. - but it is likely to appeal in particular to cyclists and skiers. The recording of historic information means that such sports enthusiasts will be able to see whether they are beating their personal best on favoured routes.

As well as the information mentioned above, the app will be able to tell you what your top speed was during your travels, always of interest to thrill seekers who like to challenge themselves going down hills and mountains!

Whilst there are other products on the market that are similar, no other app delivers such a wealth of information or such accuracy as Map Your Tracks. Users will find that this completely changes their travel experience and, I am confident, will be quite happy to pay my suggested price of $9.99 to download it.

I feel that this is a truly unique opportunity for businesses that market Apps, such as Look, and will help to drive sales in other areas, such as Look Phones and Look OS. I am looking to sell the entire rights to it for $5m. I feel that it is only fair to remind you that I am scheduled to meet with two of your competitors during the next week to discuss the same proposal.

Again, many thanks for your time, and I look forward to hearing from you.

Kind regards

Vincent

Task

To: Senior Manager  
From: Head of Mobile Devices  
Date: 23 February 2015  
Subject: Map Your Tracks App

Hi

Please see the message above which is fairly self-explanatory. I am due to go into the regular weekly meeting of Divisional Heads at 11.00, and would like to raise the possibility of buying the Map Your Tracks app - as you can see from Vincent’s email, we need to move quickly if we decide to go ahead.
Could you please prepare some briefing notes for me. I want to put forward a persuasive argument, whatever our decision should be, so I suggest you structure your notes using a suitable framework for evaluating proposals.

Many thanks

Prepare the briefing notes as requested.  

(Time allocation: 45 minutes)

EXERCISE 3

TRIGGER

Article in The London telegraph January 2015

RIP OFF BRITAIN? RIPPED OFF BRITAIN THESE DAYS!

Remember the phrase “Rip Off Britain?” Popular during the late 80s and early 90s, when everything in Britain was supposedly so much more expensive in the UK than could be bought elsewhere - food, power, cars, you name it, we were paying more for it in the UK than our neighbours in Europe. Well, those days are thankfully over with the establishment of the European Union, but a new scourge has raised it’s ugly head - the ability of the global business to make mega-profits in the UK, but pay negligible tax.

It is common practice today for extremely large businesses to use clever tax planning to minimise their overall tax liability. This is done by moving profits from one country to another, usually by means such as transfer pricing or management recharges. All you need to do is create the right organisational structure, and hey presto - no tax bill!

Confused? Well, let’s look at an example. Say you are a global business, operating in all parts of the world. For each country in which you have a presence, you set up a new subsidiary. So, the Global Group is actually made up of Global UK Ltd., Global Spain SA, Global Australia PTY etc.

Then you look at where tax rates are high. You don’t want to report profit there, so you move it around. For example, UK corporation tax is 21%, much higher than Luxembourg. So Global Group wants to report profit in Luxembourg rather than the UK. This is done by Global Luxembourg charging Global UK a management charge roughly equal to (you guessed it) Global UK’s profits. Easy!

Take the example of the internet giant, Look. For the year to 30 September 2014, Look reported global revenue of just under $62.5bn, but its tax liability was less than $3.5bn - an effective rate of tax on its profits of just 16%.

Look isn’t the only company that is showing sharp tax practices; almost all global businesses take
advantage of their size and geographic diversity in the same way. Furthermore, there is nothing illegal, at least not under current UK tax legislation.

So perhaps it is time for the legislation to change. The UK power brokers could introduce new laws to crack down on such operators, and ensure that the big players contribute their fair share to the exchequer. For let’s face it, whilst it is not illegal, it certainly feels as though it is immoral. And, in Look’s case, it makes their unofficial mission of “Do Only Good” seem laughable!

**TASK**

<table>
<thead>
<tr>
<th>To:</th>
<th>Senior Manager</th>
</tr>
</thead>
<tbody>
<tr>
<td>From:</td>
<td>Jay Bride, CEO</td>
</tr>
<tr>
<td>Date:</td>
<td>23 January 2015, 11.00</td>
</tr>
<tr>
<td>Subject:</td>
<td>Press article</td>
</tr>
</tbody>
</table>

Please see the attached press article, which appeared in London, England earlier this month. I don’t like to see criticism of our company in any form, particularly one that questions our moral integrity.

I have a meeting with some important analysts in 1 hour’s time. Could you please brief me on the different ethical stances that a business like ours can adopt - I vaguely remember phrases such as “shaper of society” but my memory is hazy.

Could you also give me some ideas on how we can counter this criticism - just some brief points will do.

Many thanks

Respond to the email from Jay Bride  

(Time allocation: 45 minutes)
Chapter 9

RISK MANAGEMENT (P3) PRACTICE TASKS

EXERCISE 1

TRIGGER

A fraud has been uncovered in one of Look’s business units. Despite the fact that Internal Audit had visited the business unit in the last month, it was a whistle-blower from the HR department who brought the fraud to the Audit Committee’s attention.

The HR manager had been able to create false, “ghost” employees over a period of 3 years. The manager had access to the payroll and HR records and as a result she was able to create new employees and set up their wages to be paid into her own bank account.

The fraud came to light when the division was considering a staff restructure. An operational manager requested a staff list and did not recognise some of the names. They approached a member of the HR team, Mrs W, who began to investigate the issue. Mrs W had heard that Internal Audit (IA) were due to visit and so was expecting to be able to speak to IA and explain what she had discovered. However, after a risk assessment, it was decided IA would not be auditing the HR function. As a result, Mrs W investigated the matter further and later went to the Audit Committee (AC) with her findings.

The fraud was very small - 5 “ghost” employees from over 15,000. They were on the lowest wage therefore the value of the fraud was low. Initial investigations have begun into how IA missed the fraud although it is acknowledged that the size would have made it very difficult to find.

TASK

You arrive at work to the following email:

To: You  
From: Chief Internal Auditor  
Re: Meeting preparation

In the light of this fraud, the way my team carry out their work has been questioned by the Head of the Business Unit, in particular our use of risk based auditing. I need to give him a balanced evaluation of risk based auditing in light of the fraud in his area. Can you make some notes for my meeting with him?
I’ve also received an email from the Chairman which says:

“It has long concerned me that our Internal Auditors are either IT or Finance trained. I noted that the 2 auditors who missed the HR fraud had an IT background. We should look into whether it is time to formally split IA into two sections: one unit which checks IT compliance and the other which checks all other controls including Finance. Both aspects of the business are important in their own right and separating the disciplines would only serve to strengthen them”

Can you pull together some pros and cons regarding the Chairman’s suggestion for me please.

I’ll be back in 45 minutes - we can talk through your thoughts then.

Thanks

Prepare an email addressing the Chief Internal auditor’s points.  

(Time allocation: 45 minutes)

EXERCISE 2

TRIGGER

You have just received the following meeting minutes

Look Finance Meeting Minutes
Date: 16th Feb 2015
Next meeting: 16th Mar 1015

Interest rate risk
After many years of low interest rates in Europe, there is a strong possibility that the interest rate may increase by the end of the year. This poses risks for Look:

1. Our long term loan is for 15 years with 10 years left to go. The interest rate is a variable rate of 1.5% + Libor. Higher interest rates would therefore increase our payments.
2. We are expecting to acquire a new office building in Europe by the end of September 2015. An existing property will be sold to fund the new premises. A buyer has been found and contracts have been drawn up for the property to be sold in December. It has been decided that Look will have to retain ownership of the existing premises for 3 months (from September to December) while equipment and staff are moved over in a phased manner to the new building. This means that Look will need a short term loan to cover the purchase of the new building. The loan will be for 3 months only. There is a risk that by September, loan rates will be significantly higher. Interest rates are currently 1%.
TASK

You have received the following email from your line manager:

To: You  
From: Senior Finance Manager  
Date: Today  
Subject: Interest rates

Hi,

I left some minutes on your desk from the latest group finance meeting. There are some concerns about interest rates at the moment as you can see.

I need to present our options for interest risk management at the next meeting. Can you draft a briefing note for me which covers the points identified below? Your notes will form the basis of the presentation.

The merchant bank we use to help us hedge foreign currency risk has already said they can help arrange an interest rate swap with a counterparty. Look has not used this form of hedging before and we need to present how the how swaps work, as well as advantages and disadvantages, at the next Finance meeting.

Re the short term loan, Forward Rate Agreements (FRAs) and Interest Rate Guarantees (IRGS) seem to be the most likely options. The same merchant bank is offering a FRA for the period we need at 2% and an IRG at 2.5%. Please explain how these both might work and as above, the pros & cons.

I’ll be around this afternoon so it would be great if you can make a start on this as soon as possible so we can get some slides prepared.

Thanks.

Respond to your line manager’s request.  

(Time allocation: 45 minutes)

EXERCISE 3

TRIGGER

Look Phone does not have any manufacturing capacity. The phones are manufactured by 2 large subcontractors who specialise in making electronic devices.

Look Phones develops the phones to tie in with changes in the Look operating system. The market is fast moving and competitive. Look has a reputation for developing products that set the trend
for the market as a whole. The R&D facility that specializes in phone innovation is in Europe. The two manufacturers are in China located close to one another. They are both large facilities of about the same size.

Getting a phone produced and out to market is complex due to the supply chain. Each phone requires well over 100 parts, resulting in relationships with approximately 100 global suppliers. The suppliers deliver direct to the manufacturers in China. Some parts are standard and easily available, while others are unique to a supplier. In order to ensure the process runs smoothly, Look remains in control of the purchasing process. It will order the necessary parts from suppliers, who then deliver to the manufacturers. The finished goods then go straight to the retail outlets and customers.

The process of manufacturing is comparatively straightforward. The work is not complicated and does not require highly skilled staff, although it is time consuming.

The purchasing of supplies is based on the use of information systems. They inform the purchasing team of when new orders need to be placed based on programmed lead times and stock information at the manufacturing sites.

In the past 6 months there have been increasing difficulties with the manufacturing process. Unique parts were unavailable slowing down the launch of a new phone. A minor fire at one of the manufacturing plants caused supply issues. Production schedules were not affected but the quality of the product suffered. Problems were spotted before goods were despatched to customers but supply was affected.

Look wishes to develop this business unit further by applying the same operating system to tablet computers and laptops. This would require Look to double its manufacturing capacity. Existing sites may be able to increase capacity but new sites will also have to be sought. The parts and manufacturing process are very similar to those for mobile phones.

**TASK**

You have received this email:

```
To: You
From: Chairman
Date: Today
Subject: Risk

Risks in Look Phone

You may have heard that Look phone is going to expand it’s products to include tablets and computers. At the last audit committee meeting we discussed reviewing the main risks in Look Phone in light of recent events and the proposed expansion.

We view the main risks of this division as:
```
- the unique parts required
- the IT systems that generate the parts orders
- the complexity of the supply chain
- current reliance on two manufacturers

We are requesting help from a diverse range of people across the company to give their opinions on how these risks can be mitigated. The risks will increase in terms of probability and impact if the business expands, so we believe this discussion is critical now so action can be taken.

Can you draft me some notes on this for tomorrow please.

Thanks

Prepare the notes requested by the Chairman. (Time allocation: 45 minutes)
Chapter 10

FINANCIAL STRATEGY (F3)

PRACTICE TASKS

EXERCISE 1

TRIGGER

You are called into a meeting with Amanda Wilson and Amanda tells you the following:

“Thank you for your paper regarding the financing of the company.

Following its discussion at the last board meeting, the Board have decided that we need to restructure our finances to increase the gearing level and take advantage of tax benefit more.

The plan is likely to involve a share buyback of around $10,000 million which is to be financed by new debt. There are no firm plans as yet but two suggestions have been made:

Option 1: An issue of 10 year bonds.

Our investment bank has advised us that typical required bond yield would be about 8.5% for bonds of this risk with interest paid annually. The bonds would be redeemed at par. Some covenants would be required and security would be needed by use of a floating charge.

Option 2: A 10 year bank loan.

Whilst the amount required is large, our bank has identified a number of partners who may be willing to enter into a syndicate arrangement for the loan. The interest rate would typically be 8% nominal but interest payments would need to be made on a quarterly basis rather than annually (not sure how this affects cost if at all?). Covenants are likely to be quite extensive and security would be a mixture of fixed and floating charge (not sure of the difference and how it affects our choice)”
TASK

From: Amanda Wilson  
To: You  
Date: Today  
Subject: Financing options

Hi there

Thanks for the meeting earlier.

I need you to put together a briefing document which provides a fully justified recommendation to the Board on which financing option to choose and how it should be progressed.

Some of the terminology may confuse the rest of the Board so make sure you explain the technical terms to them.

Thank you

Respond to Amanda’s email by preparing a briefing paper  
(Time allocation 45 minutes)

EXERCISE TWO

Note: This task requires some detailed calculations which are unlikely to be required in the case study exam. We have included this task to give you a full working example of HOW to value a business – crucial if you are going to need to comment on other peoples’ calculations – a more likely scenario. If the key valuations were provided as reference material in the exam the time allowed for this task would be reduced to 45 minutes.

COMBINED TRIGGER AND TASK

You receive the following email from Amanda Wilson.

To: Senior Manager  
From: Amanda Wilson  
Subject: Project Sheldon  
Date: Today

Hi

I’m currently with the Board at a remote location to discuss the feasibility of a potential major acquisition of another company in our industry. This is EXTREMELY confidential at present, hence
why we have met at my home to discuss it. I can not tell you the name of the company at present so the acquisition is simply called project Sheldon.

As part of our discussions, the question of how much we are prepared to offer for Sheldon has come up and I need you to prepare some information for me. I need you to do the following:

- Determine a minimum and maximum value for Sheldon using the information I’ve attached to this email. Attachment 1 is some financial information on Sheldon, attachment 2 is some basic working assumptions.
- Determine an initial offer.
- Impact on our share price following acquisition.
- Your thoughts and recommendation regarding the offer - don’t worry about the strategic implications, just the financial ones, particularly from our shareholders point of view.

You will see from attachment 2 that if this does proceed it is likely to be a share for share exchange as we do not want to have to raise external finance for this.

Again, let me emphasise the confidential nature of this so do not discuss this with anyone else.

I need the requested information emailing to me by 11:00 am this morning - sorry for the rush.

Regards

Amanda Wilson

Attachment 1

**CONFIDENTIAL**

Project Sheldon - Financial information

Statement of profit or loss

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>31,025</td>
</tr>
<tr>
<td>Costs of revenues</td>
<td>(11,248)</td>
</tr>
<tr>
<td>Overheads</td>
<td>(8,542)</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>11,235</td>
</tr>
</tbody>
</table>
Finance charges \((158)\)
Taxation \((2,215)\)
Profit after tax \(8,862\)

Statement of financial position extract

As at 30 September 2014

$ million

<table>
<thead>
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<th>Equity:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital ($1) (8,000)</td>
</tr>
<tr>
<td>Share premium (2,500)</td>
</tr>
<tr>
<td>Reserves (23,584)</td>
</tr>
<tr>
<td>Total equity (34,084)</td>
</tr>
</tbody>
</table>

Stock market information as at 21st January 2015

<table>
<thead>
<tr>
<th>Share Price</th>
<th>P/E Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Look Group</td>
<td>$7.91</td>
</tr>
<tr>
<td>Sheldon</td>
<td>$8.75</td>
</tr>
</tbody>
</table>

Attachment 2:

**CONFIDENTIAL**

Project Sheldon - Working Assumptions

Expected operating costs savings in Sheldon following acquisition - 20%

Method of acquisition funding - share for share exchange

Expected required premium over share price - 25%
EXERCISE THREE

COMBINED TRIGGER AND TASK

You receive the following email:

To: sfm@lookgroup.net
From: Amanda.wilson@lookgroup.net
Subject: Leasing decision
Date: Today

Hi

Look Group is having to undertake a major equipment replacement exercise, total cost is $2,000 million. The two options are either leasing or buying the equipment ourselves.

The lease will be a 5 year finance lease with annual payments of around $501 million at an interest rate of 8%. We will be able to claim tax relief on the accounting depreciation if we lease. Tax as you know is 20% paid one year in arrears.

If purchased, the finance is likely to be 5 year bank loan(s) also at an average rate of 8% and tax writing down allowance will be available on a straight line basis.

In your absence last week I got one of the accountants in your department to put a lease versus buy appraisal together which I have attached. It does not look right to me.

I need you to do the following:

Firstly, have a quick look at the attached appraisal and see if you can see what’s wrong with it. I’ve checked all the arithmetic in the spreadsheet and that’s fine so it must be something more fundamental - the two results can not possibly be that far apart! I can not understand why 6.4 % has been used as a discount rate and why the loan cashflows have not been shown in the buying appraisal so please could you explain this to me? Do not worry about doing the corrections, I can do that myself but I need the detail of the errors.

I’m also a bit rusty on these things so how do we choose between the two options given the results are negative?
Secondly, could you explain the differences, if any, in the accounting treatment between the two options. Again, just an explanation, don’t worry about doing any calculations on this.

Finally, any other factors you think we should be considering in the decision.

Thanks

ATTACHMENT

<table>
<thead>
<tr>
<th>Leasing Evaluation</th>
<th>Year&gt;</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Lease payment</td>
<td></td>
<td>(500,913)</td>
<td>(500,913)</td>
<td>(500,913)</td>
<td>(500,913)</td>
<td>(500,913)</td>
<td>(500,913)</td>
<td>(500,913)</td>
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<tr>
<td>Interest</td>
<td></td>
<td>(160,000)</td>
<td>(107,127)</td>
<td>(58,484)</td>
<td>(13,732)</td>
<td>27,440</td>
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<tr>
<td>Tax relief on interest</td>
<td>20%</td>
<td>(32,000)</td>
<td>(21,425)</td>
<td>(11,697)</td>
<td>(2,746)</td>
<td>5,488</td>
<td></td>
<td></td>
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<tr>
<td>Tax relief on depreciation</td>
<td>20%</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Net cashflow</td>
<td></td>
<td>(660,913)</td>
<td>(560,040)</td>
<td>(500,822)</td>
<td>(446,342)</td>
<td>(396,220)</td>
<td>(85,488)</td>
<td></td>
</tr>
<tr>
<td>Discount factors</td>
<td>6.40%</td>
<td>1.0000</td>
<td>0.9398</td>
<td>0.8833</td>
<td>0.8302</td>
<td>0.7802</td>
<td>0.7333</td>
<td>0.6892</td>
</tr>
<tr>
<td>Present Value</td>
<td></td>
<td>(621,159)</td>
<td>(494,693)</td>
<td>(415,775)</td>
<td>(348,258)</td>
<td>(290,555)</td>
<td>(58,919)</td>
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<tr>
<td>Total Leasing PV</td>
<td>=</td>
<td>(2,111,521)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Buying Evaluation</th>
<th>Year&gt;</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Asset purchase</td>
<td></td>
<td>(2,000,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td>(400,000)</td>
<td>(400,000)</td>
<td>(400,000)</td>
<td>(400,000)</td>
<td>(400,000)</td>
<td>(400,000)</td>
<td>(400,000)</td>
</tr>
<tr>
<td>Tax relief on depreciation</td>
<td></td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Net cashflow</td>
<td></td>
<td>(2,000,000)</td>
<td>(400,000)</td>
<td>(320,000)</td>
<td>(320,000)</td>
<td>(320,000)</td>
<td>(320,000)</td>
<td>(320,000)</td>
</tr>
<tr>
<td>Discount factors</td>
<td>6.40%</td>
<td>1.0000</td>
<td>0.9398</td>
<td>0.8833</td>
<td>0.8302</td>
<td>0.7802</td>
<td>0.7333</td>
<td>0.6892</td>
</tr>
<tr>
<td>Present Value</td>
<td></td>
<td>(2,000,000)</td>
<td>(375,940)</td>
<td>(282,662)</td>
<td>(265,659)</td>
<td>(249,680)</td>
<td>(234,661)</td>
<td>(55,137)</td>
</tr>
<tr>
<td>Total Leasing PV</td>
<td>=</td>
<td>(3,353,465)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Respond to the email

(Time allocation 45 minutes)
### Chapter Two

#### Question | Response | Reference
--- | --- | ---
When was the company founded? | 1998 | p.2
How do Look’s founder shares differ from the ordinary shares? | The dividend is the same but there are 20 votes per share (and presumably just one for ordinary shares) | p.2
What physical locations does Look have? | Two programming centres Two R&D facilities Three data storage facilities | p.2
How does the search engine generate revenue? | Each click on a ‘sponsored link’ earns a few cents in revenue from the sponsor | p.3
What share of the search market does Look have? | 60% of searches are via Look’s engine (this doesn’t mean they have 60% of the advertising revenue though) | p.3
How many devices use Look OS? | 900 million | p.3
Which divisions does the Head of Mobile Services look after? | Look OS Look apps Look Phone Look Lens | p.5
Does Look have a central HR function? | No - HR is dealt with at divisional level | p.5
How many employees does Look have in total and which are the largest two divisions? | 20,252 Look Search - 5,083 Look OS - 3,480 | p.6
What is Look’s share price? | Almost $8 | p.8
What is Look’s unofficial mission statement? | ‘Do only good’ | p.9
What is the Chairman’s background? | Chief Executive of multi-national | p.12
<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>How has the company’s operating margin changed in the last year?</td>
<td>Reduced from 37.9% to 34.1%</td>
<td>p.14</td>
</tr>
<tr>
<td>After cost of sales which is the biggest operating cost?</td>
<td>Research and development</td>
<td>p.14</td>
</tr>
<tr>
<td>What is the effective tax rate?</td>
<td>16% (reduced from 19%)</td>
<td>p.14</td>
</tr>
<tr>
<td>Do Look capitalise software development?</td>
<td>No - these costs are expensed ‘before feasibility is determined’</td>
<td>p.16</td>
</tr>
<tr>
<td>Look Search represents 70% of revenue. Which is the next largest revenue stream?</td>
<td>Look Space</td>
<td>p.17</td>
</tr>
<tr>
<td>What company did Look purchase during the year (which gave rise to goodwill)?</td>
<td>Memory games</td>
<td>p.18</td>
</tr>
<tr>
<td>How much did Look spend on funding renewable energy projects in 2014?</td>
<td>$1.1bn</td>
<td>p.22</td>
</tr>
<tr>
<td>It has reported that Vijay may be thinking of leaving Look. What is his role?</td>
<td>Head of Innovation</td>
<td>p.26</td>
</tr>
<tr>
<td>What was Friendtime’s annual revenue growth?</td>
<td>41%</td>
<td>p.29</td>
</tr>
</tbody>
</table>

**CHAPTER FOUR**

**EXERCISE 1 – PRODUCT PORTFOLIO**

The BCG matrix was originally formed in the 1970s to assist managers in identifying cash flow requirements of different businesses in a portfolio, and to help to decide how each of those different businesses should be managed. There are 4 main steps to conducting such analysis:

- Divide the company into Strategic Business Units (SBUs)
- Allocate each SBU into the matrix
- Assess the prospects of each SBU and compare against others in the matrix
- Develop strategic objectives for each SBU

The matrix measures 2 variables for each SBU: market share (where the SBU sits relative to competitors); and market growth (the growth of the market as a whole). Both can be considered as high or low.
For Look, the SBUs will be:

- Look search engine
- LookSpace
- Look OS
- Look Apps
- Look Phone
- Look Lens
- Look Media
- Look Cloud

Each will be assessed in turn.

**Look Search Engine**

With its engine being used for 60% of all internet searches, the Look Search Engine is clearly the market leader, and thus has **high market share**.

Although the volume of searches performed each year is huge, the rate of growth has declined significantly as usage has reached saturation point. There is therefore **low market growth**.

In BCG terminology, the Look Search Engine SBU would therefore be classed as a **cash cow**. Conventional theory would suggest that little investment is required in such a SBU as the market leader enjoys significant advantage over competitors, will benefit from economies of scale, and new entrants will be deterred from joining the market by the existing operators’ power and the lack of growth potential.

A cash cow should therefore generate significant cash flows to allow for investment elsewhere in the business.

However, in a market such as this, where change is constant, failure to invest can quickly lead to loss of advantage. Look should avoid complacency and continue to innovate to stay ahead of its competitors.

**LookSpace/ LookOS/ LookApps/ Look Media**

Little information is given about Look’s position in each of these markets, but it is likely that Look is not the market leader. It is also likely that there is high growth in each market, particularly when looking on a global level and considering demand in emerging economies. BCG analysis would categorise any SBU with **high growth** but **low share** as a **problem child**.

Theory would suggest that there is a decision to be made with regards to problem children; invest in such an SBU in order to try to increase market share; or accept that the SBU has no long term future in the portfolio.
The returns in Look Space and Look Media are already impressive, given that they generate a gross margin of 40% and 54% respectively. Look Apps is lower at 10%, and Look OS a loss-maker, given that the system is effectively given away for free. It would be tempting therefore to suggest that more emphasis should be given to growing Look Space and Look Media.

However, this would ignore the joint nature of the SBUs. The attractiveness of Look OS has increased demand for the other SBUs, so each should not be considered in isolation; rather, they should be considered as a portfolio within a portfolio.

Investment should continue across all 4 SBUs to try to grow market share.

**Look Phone**

As the fourth largest manufacturer in terms of number of handsets sold, Look Phone would be seen as having low market share. Furthermore, the global market for handsets is unlikely to be increasing at double digit rates, and so there is low market growth. Conventional BCG analysis would classify this SBU therefore as a dog and, as such, Look should seek to withdraw from this market.

However, this would again be simplistic. Look Phone delivers $1.1bn of gross profit at a healthy margin of 35%, and should be seen as a complement to Look OS and Look Apps. Withdrawing from Phones would doubtless have a negative effect on other SBUs.

The company should therefore maintain its presence in the phone market, and invest to grow its market share.

**Look Cloud**

It is difficult to categorise Look Cloud in BCG terms, as little is known about either market share or market growth. Also, whilst it generates nearly $1.9bn of revenue, it records a gross loss of $600m. Whether it will become a profitable SBU in the future is uncertain, and probably not worth considering further at this point; it’s value to Look is in cementing the brand in the minds of IT users.

**Look Lens**

This SBU is the exception in the portfolio, as it seems to be an innovative product that stands alone, but for which demand is uncertain. It has yet to generate any revenues.

The product is unique; there seems to be no competition. This gives Look first mover advantage, and therefore there should be high market share. However, it is uncertain whether the product will appeal to consumers, so the key variable is market growth. If demand is high, Look will have a star; if not, the product has no value.

Further research needs to be conducted to assess market demand before significant additional investment is made.

**Conclusion**
Look has a balanced portfolio in BCG terms. The significant cashflows generated by its cash cow, the search engine, can be used to fund development and growth in other areas of its portfolio.

EXERCISE 2 – EXTERNAL ANALYSIS

Exercise 2(a) – PEST

Political

• Possible Government intervention where companies are considered too dominant in a particular market, such as happened to Microsoft when the US authorities tried to force it to become 2 different entities
• Restrictions on search engine operating practices in some countries e.g. China wanting censorship
• Possible Government action on global companies who use transfer pricing to reduce their tax liabilities

Economic

• Global spend on advertising will depend on health of world economy
• Strength of US dollar compared to other currencies will impact Look’s reported performance
• Internet technologies are global, therefore no reliance on any particular part of the world’s economy
• Interest rates will affect the returns on cash balances

Social

• Increased demand for access to social media, particularly in developing nations
• Demand for innovation from consumers
• Increased use by older consumers (“silver surfers”)

Technological

• Development of new devices and platforms for accessing the internet e.g. smart TVs, iWatch
• Higher broadband speeds and mobile speeds (4G) likely to increase use of the internet
• Opportunities to move into new areas of technology e.g. driverless cars

Environmental

• Ongoing focus on reducing carbon footprint throughout entire supply chain
• Pressure to make batteries for mobile phones more environmentally friendly on disposal

Legal

• Data security requirement for all data, notably on Look Cloud
• Need to have adequate patent protection on all new technological developments
• Differences in employment legislation in all countries where Look has a physical presence
• Copyright issues associated with stored content
Exercise 2(b) – Five Forces

Barriers to Entry/Threat of New Entrants

- Need for significant capital to enter market, both to establish a brand but also to set up a high number of servers across the world
- Look and existing competitors have well-established brand names and market share
- Need for skilled employees with imagination and flair
- Relationships required with manufacturers of hardware (compatibility etc)

Conclusion: barriers to entry are high, making the threat of new entrants to the market low

Threat of Substitutes

- No modern equivalent to search engines. Traditional means of accessing information (encyclopaedia, brochures etc) seen as too slow in modern era
- Similarly, Look Cloud is the modern storage method for information, replacing disks, pen drives, photo albums etc
- For other Look products, main threat is not from substitute products, more from similar products made by competitors.

Conclusion: the threat of substitutes is low

Customer Power

- Customers for search engine activity will be those who buy advertising space. Little switching costs for such customers to place their business elsewhere e.g. Friendtime
- However, each customer is likely to make up only a small proportion of Look’s overall revenue, thereby reducing power.
- For other products, customers are likely to be individual consumers with little bargaining power other than which brand they choose.

Conclusion: customer power is medium with regards to search engine activity, low for other revenue streams

Supplier Power

- Suppliers consist principally of suppliers of hardware (e.g. mobile phone manufacturers) and Look staff
- Due to its size and market share, Look will be in strong negotiating positions with suppliers of hardware, thereby reducing supplier power
- Volume ordered by Look will be significant, making a contract with the company lucrative for suppliers
- Look’s commitment to ethical trading practices will further increase the value of supplying Look

Conclusion: supplier power is likely to be low with regards to suppliers of hardware

- Look is dependent to a large extent on the skills of its employees (ability to innovate, technological expertise, commitment to quality etc.)
• With competition in all of Look’s revenue streams, employees can switch employer or be persuaded to move to a competitor. This increases the power of employees.
• To counter this, Look can point to its reputation as a quality employer (low staff turnover, large number of applications per post, commitment to staff development etc.) to convince employees that Look should be the position of choice.

Conclusion: supplier power is likely to be low/medium with regards to employees

Competitive Rivalry

• Degree of rivalry will be different for each revenue stream
• For the main stream of search engine services, Look has dominant market share of 60%, indicating that it is the provider of choice in most user’s minds, therefore has greatest brand strength for those conducting general searches.
• Slowing rate of growth in online searches each year means the brand advantage enjoyed by Look reduces competitive rivalry
• For other revenue streams, Look has more powerful competitors in most areas e.g. Look Space - TomTom, Garmin, Apple Maps; Look OS - Microsoft, Apple; Look Apps - Apple iTunes store; Look Phone - Apple, Samsung, LG, Amazon; Look Media - Netflix, Amazon Prime
• Most of the companies mentioned above enjoy the same strengths as Look i.e. brand awareness, cash position, technological skills etc.
• There will therefore be significant rivalry between operators all hungry for share of lucrative markets

Conclusion: competitive rivalry will be medium in the search engine market, high in all other markets.

Overall conclusion

The main forces that Look needs to focus on are competitive rivalry and customer power. The ability to innovate and deliver to customer expectations are critical in hi-tech industries such as those that Look works in.

EXERCISE 3 – CRITICAL SUCCESS FACTORS

This shall be considered using a balanced scorecard approach:

Customer Perspective

<table>
<thead>
<tr>
<th>CSF</th>
<th>KPI</th>
</tr>
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<tbody>
<tr>
<td>Advertising success</td>
<td>Number of hits per advert per customer</td>
</tr>
<tr>
<td>Customer satisfaction</td>
<td>% of revenue derived from repeat business</td>
</tr>
<tr>
<td>Product functionality</td>
<td>Average review received for new products from journalists/customers</td>
</tr>
<tr>
<td></td>
<td>Number of glitches reported in software</td>
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</table>
### Innovation and Learning

<table>
<thead>
<tr>
<th>CSF</th>
<th>KPI</th>
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</thead>
<tbody>
<tr>
<td>Product development</td>
<td>Number of new research projects started each year</td>
</tr>
<tr>
<td></td>
<td>Number of new products successfully launched</td>
</tr>
<tr>
<td></td>
<td>% of revenue derived from products launched within last 12 months</td>
</tr>
<tr>
<td>Staff development</td>
<td>% of vacancies filled by existing employees</td>
</tr>
<tr>
<td></td>
<td>Average number of hours spent on training courses per employee pa</td>
</tr>
</tbody>
</table>

### Internal Business Process

<table>
<thead>
<tr>
<th>CSF</th>
<th>KPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Data security</td>
<td>Number of reported incidents of breaches in security pa</td>
</tr>
<tr>
<td>Staff retention</td>
<td>Staff turnover %</td>
</tr>
<tr>
<td>Winning business</td>
<td>Number of new clients buying advertising space from Look each year</td>
</tr>
</tbody>
</table>

### Financial

<table>
<thead>
<tr>
<th>CSF</th>
<th>KPI</th>
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<tbody>
<tr>
<td>Increasing shareholder wealth</td>
<td>Revenue growth pa</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Growth in share price</td>
</tr>
<tr>
<td></td>
<td>Change in cash position during the period</td>
</tr>
<tr>
<td></td>
<td>Level of financial gearing at year end (%)</td>
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</table>
EXERCISE 4 – INFORMATION SYSTEMS

Meaning of Big Data

There are several definitions of Big Data, the most commonly used referring to large volumes of data beyond the normal processing, storage and analysis capacity of typical database application tools. Although Big Data does not refer to any specific quantity, the term is often used when speaking about petabytes and exabytes of data (a petabyte is 1m gigabytes, and an exabyte is 1,000 petabytes!).

The definition can be extended to incorporate the types of data involved. Big Data will often include much more than simply financial information and can involve other organisational data which is operational in nature, along with other internal and external data which is often in an unstructured format.

One of the key challenges of dealing with Big Data is to identify repeatable business patterns in this unstructured data, significant quantities of which can be in text format. Successfully managing such data can lead to significant business benefits, such as greater competitive advantage, improved productivity and increasing levels of innovation.

The defining characteristics of Big Data can be summarised by the three V’s:

Velocity

This is the speed at which data is being created. Sources of data such as social media sites mean that data is streaming at a virtually constant rate, and current processing servers are unable to cope with this flow and generate meaningful real-time analysis.

Volume

The increased sources combined with the amount of data that exists in the digital age combine to increase the overall volume of data to a potentially unmanageable level.

Variety

Traditionally data was structured and in similar and consistent formats such as Excel spreadsheets and standard databases. Data can now be generated and collected in a huge range of formats including rich text, audio, and GPS data amongst others.

Another V which is sometimes added by organisations to the above list is Veracity, or truthfulness. It is vital that organisations gather data that is accurate; any failure to do so will make analysis meaningless.

Examples of data that inputs into Big Data systems can include:

- social network traffic
- web server logs
- traffic flow information
• satellite imagery
• streamed audio content
• banking transactions
• web page histories and content
• government documentation
• GPS tracking
• telemetry from vehicles
• financial market data

How is Big Data relevant to Look?

Look’s main revenue stream is based on the ability to match appropriate websites with an internet user’s needs. When the user types key words into the search engine, it is only a worthwhile process if the algorithm that Look employs finds web pages that the user will want to look at, otherwise the search adds no benefit and the user will be put off using it again.

Furthermore, the value to Look from a user’s search comes from the search activity putting the user in front of advertising that is also appropriate to that user’s possible profile. Those businesses that spend on advertising will only continue to do so if it helps to increase their own revenues.

For example, if a user types “new Ford Focus” into the Look search engine, not only does the search need to result in details of how to buy a new Ford Focus, it also needs to be relevant to the location of the user. Should the user live in Bristol in the South West of the UK, they are unlikely to be interested in details of cars available for sale in Edinburgh in Scotland, nor for that matter in any other parts of the world.

Accordingly, Look’s technology needs to be able to sift through millions of websites and petabytes of data to give appropriate responses within milliseconds. Whilst there may be many pages of possible response to an internet search, the user will not browse through all of them, therefore those responses likely to be most relevant must feature first.

It is only if the user is pointed to relevant pages that he/she will continue to use Look, and only if he/she is using relevant pages that advertisers might gain benefit for their advertising expenditure.

Another aspect of Look’s business that will depend on correct analysis of Big Data will include Look Space. If users make use of this software for satellite navigation purposes, the software will need to be able to show the most appropriate route in real time ie taking into consideration traffic news as it is happening.

In conclusion, the concept of Big Data is highly relevant to Look, and the company will need to continuously adapt its systems and processes in this area. Many open-source platforms have been created to help organisations make sense of Big Data (such as Hadoop and Cassandra); Look will need to be at the forefront of such development if it is to retain its competitive advantage.

As Big Data is by nature a rapidly changing force, Look will also need to ensure that it develops the right skills and recruits appropriate talent, as there is undoubtedly a shortage of skills and support in this area.
CHAPTER FIVE

EXERCISE 1

Board balance

There are 5 executive directors and 4 non-executive directors (NEDs). Ideally there ought to be a balance of 50:50 between executive and non-executive directors. The current structure allows the execs to overrule any non-executive challenge.

This may be particularly concerning at Look as three of the execs formed the company and have been influential in the direction it has taken. Between them they represent the business operation almost entirely. We are told the founders of the company “focus on the matters that interest them”. This may not always be in the interests of the shareholders. However, the NEDs ability to actively represent the needs of the shareholders may be hampered due to their numbers.

Conversely, it could be argued that the founders are major shareholders and therefore would not jeopardise its success. Indeed they claim their vision sustains the company (and therefore may not harm shareholder interests). Executive directors are often accused of being too far removed from the businesses they run, whereas the 3 founder directors are still generating ideas that create income at Look.

Whether executive director dominance is an issue or not is unknown. However, too few NEDS may also impact the ability to effectively run the committees required for good corporate governance (see below)

Board composition

Board members are usually required to have a fixed term of office and for there to be a shareholder vote at the end of this term on whether the post can be filled by the same person. The executive Board members have all served at least 4 years. Information on fixed terms or shareholder votes has not been mentioned. However, the longest serving NED joined the Board in 2010 which may point to NEDs being changed more often.

Regarding experience, all Board members (including NEDs) have relevant experience either in the area of the business they are working in or IT. Almost all are also educated to degree level and have professional qualifications. In addition, the chairman came from a major multinational retailer. Such experience outside the IT industry may help provide a diverse perspective which is useful on the Board.

NEDs are meant to be independent so that they can act without bias when representing the shareholders. It is not clear whether those who came from outside Look had dealings with the company (such as suppliers or customers). However, Mara Reynold’s position as a NED may be questioned. She previously worked for Martin Hong and has been awarded the NED position as a reward. Such connection to the company may jeopardise her independence.
Committees

There is an Audit committee and Remunerations committee, both manned by the NEDs as would be recommended. However there is no Nominations committee.

Nominations committee - its role is to oversee the process for board appointments and make recommendations to the Board. The majority of committee members should be independent NEDs. The committee also reviews succession planning with regard to Board membership. This may be particular may be important given the news article about Vijay’s potential departure. The lack of Nominations committee may explain how Mara Reynolds became a NED.

The Audit Committee (AC) includes the Chairman and 2 other NEDs. At least one member of the AC is recommended to have financial experience and all three do. Some also have IT experience which will also help evaluate the effectiveness of Internal Audit.

Remuneration Committee - comprised of the same independent NEDs as the AC. This committed should ensure that no executive can decide their own pay (although it may be possible for the execs to overrule the NEDs as mentioned above).

The existence of two committees does not automatically ensure corporate governance at Look is “good”. With no other information (such as minutes, Director remuneration reports, records of how often the committee met etc.) such judgement cannot be made.

Further information requirements

In order to fully evaluate the effectiveness of the corporate governance arrangements at Look, it would be useful to get further information, such as

- How often the Board meet
- Records of board review and performance management
- Records of AGMs and meetings the investors
- Disclosure statements from the annual report
- Details of remuneration
- The role of risk management
**EXERCISE 2A**

<table>
<thead>
<tr>
<th></th>
<th>Competition</th>
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<tbody>
<tr>
<td>1</td>
<td>By diversifying the products, Look is already reducing its risk by not focusing in one area where market share may be eroded. One of the founding board members, Vijay Chatterjee, is Director of Innovation and has a track record of creating new products. Look also has a specific policy encouraging staff to research and develop their own ideas which may result in commercial opportunities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>In addition, Look’s products have synergies and “mutually support” each other e.g. Look Apps and Look OS. Positive reputation across the products reduces competition risk: Once someone has bought one Look product they are more likely to buy another.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Look may consider buying competitors in order to reduce this risk.</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Investment in new businesses - Though positive in terms of generating potential ideas, the constant need for development can be disruptive.</td>
<td>A balance may need to be struck between ensuring ongoing business activities are not ignored over developing new ideas. Financial and non-financial targets via a balanced scorecard may help communicate and focus activity. For instance, ensuring income is maintained from old products may be in the financial quadrant, while no. of new products in development may come under innovation and learning.</td>
</tr>
<tr>
<td></td>
<td>Updating and developing existing products may be essential but disruptive. However, as staff are encouraged through HR policies to develop themselves and keep to date with IT changes, the need to embrace change becomes part of the culture rather than demotivating.</td>
<td></td>
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<tr>
<td></td>
<td>Controls in particular management controls over staff may help to organise staff and communicate new innovations.</td>
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<tr>
<td></td>
<td>Should organic development of new lines prove too disruptive, Look could buy companies that have innovated new products. However, this form of growth can also be disruptive.</td>
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**SUGGESTED SOLUTIONS**

**1 Competition**

- By diversifying the products, Look is already reducing its risk by not focusing in one area where market share may be eroded. One of the founding board members, Vijay Chatterjee, is Director of Innovation and has a track record of creating new products. Look also has a specific policy encouraging staff to research and develop their own ideas which may result in commercial opportunities.

- In addition, Look’s products have synergies and “mutually support” each other e.g. Look Apps and Look OS. Positive reputation across the products reduces competition risk: Once someone has bought one Look product they are more likely to buy another.

- Look may consider buying competitors in order to reduce this risk.

**2 Investment in new businesses**

- A balance may need to be struck between ensuring ongoing business activities are not ignored over developing new ideas. Financial and non-financial targets via a balanced scorecard may help communicate and focus activity. For instance, ensuring income is maintained from old products may be in the financial quadrant, while no. of new products in development may come under innovation and learning.

- Updating and developing existing products may be essential but disruptive. However, as staff are encouraged through HR policies to develop themselves and keep to date with IT changes, the need to embrace change becomes part of the culture rather than demotivating.

- Controls in particular management controls over staff may help to organise staff and communicate new innovations.

- Should organic development of new lines prove too disruptive, Look could buy companies that have innovated new products. However, this form of growth can also be disruptive.
| 3 | New Technologies | New technologies/devices/platforms may result in current Look products being incompatible or undesirable. This risk cannot be transferred, avoided or simply accepted. Look must try to reduce this risk by monitoring the innovations to the way the internet is used. This is already being done via some of the measure mentioned in 1 and 2 above. |
| 4 | Advertising revenue | The impact of negative economic conditions can be reduced through making Look’s products more inelastic: advertiser may then use Look no matter what the price. This can be achieved through having a strong brand and through the effectiveness of its search engine. For instance, through the use of controls, Looks search engine can provide the most relevant and tailored results. Look will have the ability to see which “clicks” end up with a purchase. The more accurate the search result, the more likely the customer is to purchase. During hard economic times, advertising is most likely to continue where it is most effective. Look’s brand is also strengthened by its range of mutually supportive products. |
| 5 | Regulations and scrutiny | The political, regulatory and legal risks cannot be avoided or transferred to another party. Neither would it be possible to simply accept these risk and do nothing, due to the reputational and financial damage it may cause. However, managing these risks is not straightforward. Look can work with political governments and their regulatory bodies to ensure existing laws are not broken and new laws are not onerous. Look may also consider working with its peers eg Friendtime when lobbying governments to increase its power and influence. Staff with relevant expertise may be hired to advise and work in different countries and legal systems. Each country and situation may require a different approach in order to mitigate the risk accordingly. As Look as already diversified its operation globally, adverse Government action towards Look, may be limited to that country (although it may be a significant market and create a precedent for other parts of the world). Specifically regarding the legal claims, Look’s legal team can develop terms and conditions for users to agree to, which may reduce the risk of legal claims. There ought to be a clear complaints procedure for |
| 6 | Political motives | |
| 7 | Legal liability | |
user. Look has an unofficial mission of “Do only good” which should help guide staff on how to resolve issues in an efficient and ethical manner, therefore potentially reducing the no of legal claims.

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<tbody>
<tr>
<td>8</td>
<td>Joint liability</td>
<td>Having (partially in some cases) transferred the risk associated with manufacturing and service provision, Look need to reduce the risk of 3rd party failure through contracts, service level agreement and inspections. It may also consider buying the manufacturer to maintain more control over production.</td>
</tr>
<tr>
<td>9</td>
<td>Manufacturing and supply chain</td>
<td>Look ought to have plans in place for resilience in its services such as backup plans, business continuity procedures and incident management capability. These ought to be reviewed and tested frequently.</td>
</tr>
<tr>
<td>10</td>
<td>Security &amp; quality of service</td>
<td>Look may monitor non-financial information that may help reduce this risk of losing key staff, such as staff turnover. In addition, through staff surveys and exit interviews, Look may find out what motivates staff to stay so that Look can take required action. The 3 founder/directors remain a “Key man” risk. A succession plan ought to be developed for a smooth exit and transition.</td>
</tr>
<tr>
<td>12</td>
<td>Key personnel</td>
<td>As the bulk of income come from advertising on the search engine, Look need to monitor this risk closely. Continued system controls and improvements may lead to search engine service provision that is so accurate, customers see less unnecessary/inapplicable advertising, reducing the need for ad blocking. Look may consider other ways of making money from new products that are not dependent on advertising e.g. monthly subscription fees like with Look Media. Look may also be able to develop ways to circumvent ad blocking when users are using Look OS services.</td>
</tr>
<tr>
<td>13</td>
<td>Ad blocking</td>
<td></td>
</tr>
</tbody>
</table>

**EXERCISE 2B**

**Competitor risk**
Look has many competitors in this area - it is a “relatively crowded market”. Potential customers may not choose Look Media for streaming TV and films.

Probability: Low: Look has high brand recognition. It has user other services, to which Look Media is simply an extension rather than a totally new product. Furthermore, this brand strength may enable Look to negotiate exclusive rights to certain TV or films.
Impact: High - high volume is key to the negotiating lower royalty payments or exclusive rights, therefore impacting significantly Look Media’s financial viability

Operational risk
There is a risk that certain day to day processes critical the operation of Look Media do not work.

Media purchasing processes do not trigger a royalty payment
Probability - Difficult to tell without more information on the testing and monitoring of the royalty payment processes.
Impact - High. If the TV and film producers cannot be assured that they will be paid, they may withdraw the Look’s rights to sell the films

Media purchasing processes do not collect payment from customer
Probability - low. Look is experienced in collecting money from customers in all its other ventures. The likelihood of this not being set up correctly at Look Media is low.
Impact - low. So long as records as available of the rental or purchases, Look may be able to retrospectively charge customers (whether these are subscription charges or individual purchases outside of the subscription) Terms and conditions customers enter into when renting/viewing could make it clear that payment could be sought for up to a year after viewing for instance. Although cash-flow may be affected, the money may eventually be received.
If however, no records of purchase are available the impact due to financial losses would be high.

IT risk
There is a risk that the service does not work due to IT failure.
Probability - as Look Media will use Look’s own storage services, the probability of service failure is low. The storage processes and contingency plans, if there is a failure, are within Look’s control and the business units are meant to be “mutually supportive”.
Impact - high, although it would depend on the frequency and severity of the system failure. Users expect to be able to watch their chosen show “on demand”. Regular service interruption may result in a cancellation of subscription. Any interruption may have a negative impact on Look’s reputation (and affect the whole brand).

There is a risk that the service does not work due to compatibility issues with hardware
Probability - High. New technology advances are occurring rapidly. New hardware developments may not work with Look Media. New mobile and tablet devices may only with competitors media streaming services. Furthermore, although Look is developing Look Lens for which compatibility may be assured, competitor products such as Google Glass may not be. The technical updates required may need to be very frequent and Look may not be able to keep up.

Impact - High. Compatibility issues will result in lower subscriptions which may result in higher royalty payments, therefore jeopardizing financial success.

Security risk

There is a risk of theft through hacking and downloading media without paying
Probability - will depend on the security Look has. Given that it has very experienced staff and other internet based businesses, the probability of a hacker being able to use Look’s media services may be low.
Impact - low if one individual is able to watch TV/movies for free. Should the security breach allow many users to watch for free, the impact would be much greater in terms of finances and reputation.

There is a risk that a hacker (someone external to Look) steals customer information
Probability - as above re security risk
Impact - high*. Such breaches in security may cause customers to cancel subscriptions to all of Look’s services, impacting on the revenues from other business units like Look Cloud.

There is a risk that staff internal to Look, steal customer information
Probability - low. This will depend on the policies and procedures Look has surrounding its customer data security. As mentioned above however, Look as experience in this area. It also appears to have experienced and motivated staff, with a low staff turnover rate. Staff would presumable have contracts explaining what is expected of them and what the disciplinary procedures are. Presupposing such controls exist, the risk is minimised.
Impact - as above *

NB You may have come up with other risk and your evaluations. This is not a definitive list.

EXERCISE 3

Translation risk:

Currency risk of holding foreign assets or liabilities.
We are told Look has various operating centres:
two programming centres, one in India and the other in Eastern Europe. These premises may be leased or owned

- two major research and development centres, one in Europe and the other in the USA. These premises may be leased or owned

- three major storage facilities at unknown locations which Look owns.

If any of these buildings are a foreign asset, their local currency value will have to be translated back into US$ to be included in Looks accounts. If the exchange rate changes, the value of the property may fluctuate when reported.

**Transaction risk**

This is the risk of buying and selling on credit in foreign currency.

Look may be purchasing equipment from Europe that will be paid for in € in three months time.

The value of the purchase in € will not change. However, the equivalent value of the purchase in US$ may change between now and when the payment is made, due to currency movements. There is a risk that Look will end up paying more in US$ in 3 months than they are expected.

**Economic risk**

Whereas with transaction risk, the invoice amount for payment/receipt is known, economic risk covers the long term currency exposure Look may have due to its global presence.

For instance, let’s say that one of the programming centres is in Bulgaria. Look is happy with its location and staff and believes it will stay there for the long term. The lease has to be paid in Bulgarian Levs and lease payments are likely to be increased in 2016. Look knows that it will have to exchange US$ into Levs, however, it does not know what the long term currency movement may be (is the Lev likely to appreciate/depreciate). Nor does it know exactly what the amount may be from 2016 onwards (which makes it difficult to hedge). This risk is economic risk.

Economic risk can also affect Look in another way. For instance, Look may have guaranteed prices for Cloud services at €10 per month until the end of 2015 to subscribers. In January, this price may seem reasonable in the market and at the current exchange rate of 2US$: 1€, the income is equivalent to US$20. But as the exchange rate changes during the year the amount of income Look may get as a $ equivalent will vary.

In addition, later in the year, a foreign competitor based in the UK “1Sky” is able to offer a product similar to Look. Because the exchange rate for “1Sky” between £:€ is more favourable than Look’s US$:€ rate, they can charge a lower price than €10 per month. Look’s product now looks expensive and customers leave, reducing sales. This is another way economic risk can affect Look.

In summary, global currency movements can affect Look’s costs and income in the long run.
affecting future profits. In addition, currency movements can also affect its competitiveness vs global prices, also affecting profits.

EXERCISE 4

Organisational structure

Unclear or complex organisational structures can lead to poor communication, missing performance targets and even fraud (in the case of Nick Leeson for instance). They are a key control for managing staff.

An organisational structure has been supplied showing how the business units and functional areas fit into together a Look. Such structures charts provide staff with a view of who has authority and responsibility. It would be expected that this chart would be broken down further to show the staff within each business unit for instance, especially as each unit also looks after its on human resources and health & safety.

Policies and procedures

Formal policies and procedures guide staff on how to perform certain day to day tasks. Given the speed with which products change and develop at Look, it may be difficult to keep policies and procedures up to date. However, such circumstances make up-to-date guidelines even more imperative.

There may be a tendency in such an innovative environment to think of policies and procedures as too bureaucratic. However, they are essential to keep control of the innovative ideas, projects and the development, whether it is simply to track progress or to ensure legal requirements are met such as data security.

The case mentions their policies may not change as frequently. For instance Look’s HR policies: “Look has a clear policy of treating staff with respect and of providing them with opportunities to grow and develop”. This includes an internal formal training scheme for all staff as well as encouraging staff to participate in external training courses (which are paid for by Look).

Such policies ensure that professional skills are maintained and extended which is key to Look’s need to innovate.

There is an ethics policy also which helps underpin the mission of “only do good”

Job contracts

It would be expected that staff will be given employment contracts which will include such details as job role specification, hours, place of work, job term, salary and title. The job description may form the basis on which the staff are later appraised therefore guiding their behaviour at work.

Feedback and appraisal

Regular feedback and communication is a key aspect of management control. In a very changeable and innovative environment as at Look, communication between staff at the same level and within a hierarchy will be even more important. All staff will need to be aware of changes to products, timings or performance expectations so that company objectives can be met.
Formal, regular appraisals help to encourage good behaviour and highlight poor performance so that it can be addressed and improved. This will also help drive employee behaviour in the desired direction.

**Reward and discipline**

Little is mentioned regarding pay and bonuses at Look. They have benefits such as training, childcare etc mentioned which may encourage staff to be committed to Look. However, Look may also have bonus schemes based on meeting performance targets which may motivate staff. Staff may also be entitled to a proportion of sales if they invent/develop a new product.

On the flipside it would expected that Look have disciplinary procedures to act as a deterrent and set an example of what behaviour will not be tolerated. This ought to be explained when a staff when joins.
CHAPTER SIX

EXERCISE 1

The Look Group is financing its activities through a mixture of debt and equity. Debt is a mixture of both long term and short term although there is no additional information to analyse the debt further. We can assume that given the current liability classification of the short term debt that this will be repaid within a year.

Gearing level

The gearing calculations have been performed using book values of debt and equity as there are no market values available. Given Look’s success, we can assume that the market value of the equity will be higher than its book value and therefore any market value gearing calculations would show lower gearing than those using the book values.

Gearing ratios (book value):

<table>
<thead>
<tr>
<th></th>
<th>2014 $ million</th>
<th>2013 $ million</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Look:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long term debt</td>
<td>4,800</td>
<td>4,800</td>
</tr>
<tr>
<td>Short term debt</td>
<td>2,897</td>
<td>3,874</td>
</tr>
<tr>
<td>Total debt</td>
<td>7,697</td>
<td>8,674</td>
</tr>
<tr>
<td>Total equity</td>
<td>74,967</td>
<td>65,839</td>
</tr>
<tr>
<td><strong>Friendtime:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long term debt</td>
<td>4,400</td>
<td>3,800</td>
</tr>
<tr>
<td>Short term debt</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Total debt</td>
<td>5,400</td>
<td>4,800</td>
</tr>
<tr>
<td>Total equity</td>
<td>10,652</td>
<td>11,997</td>
</tr>
</tbody>
</table>

Gearing (debt/(debt + equity)):

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Look</td>
<td>9.3%</td>
<td>11.6%</td>
</tr>
<tr>
<td>Friendtime</td>
<td>33.6%</td>
<td>28.6%</td>
</tr>
</tbody>
</table>

As can be seen from the above, Look appears to have a very low level of gearing at 9.3% and their gearing has reduced slightly on 2013 when it was 11.6%
By comparison, Friendtime had gearing of 28.6% in 2013, increasing to 33.6% in 2014. This highlights the very low level of debt that Look is utilising in financing its activities. This brings both advantages and disadvantages.

**Advantages of low gearing**

The first advantage of Look’s low gearing will be a lower annual interest obligation, which will keep the financial risk to Look’s shareholders low. Consequently, a downturn in Look’s operating result will not be amplified by the financial gearing, resulting in a greater reduction in the profits available for distribution.

Secondly, there will be a lower required rate of return by Look’s shareholders compared with Friendtime’s shareholders, as Look’s shareholders are exposed to less risk to their earnings.

Finally, the low level of debt and consequent low level of financial risk is likely to mean that there will be relatively few covenants imposed on Look by its debt-holders. This will result in greater freedom for Look in its financial decision making.

**Tax Shield**

Despite the advantages however, the main problem with low gearing is that Look will not be taking advantage of the tax benefits of debt as much as it could be. Debt will attract tax relief on the interest payments and therefore increasing the level of debt in the capital structure would reduce Look’s tax liability.

According to Modigliani and Miller’s capital structure theory with corporate taxes, increasing the gearing in a company will increase the company’s value due to the effects of tax shield, the tax saving on interest payments.

We do not have the tax rate applicable to Look but their tax charge in 2014 was around 16% of the profit before tax figure (3468/21542=16%). If Look was to increase its level of gearing to 30%, say, that would be an increase of 20.7% in gearing (30% - 9.3%) which would equate to an increase in the level of debt of $15,518 million (20.7% x $74,967 million). If this was a permanent increase in the level of debt, the tax shield and subsequent increase in the market value of the company would be around $2,483 million (16% x $15,518 million).

**Weighted average cost of capital**
Look's low gearing would also impact upon their cost of capital as their dependence upon equity means they are relying on expensive finance. Debt is cheaper to use than equity, primarily due to its lower risk, as well as the tax shield benefits already described.

Greater use of debt in the structure would reduce their weighted average cost of capital, increasing the value of the company. There would be a limit on this of course as too high a level of gearing would increase the risk to a level whereby the benefits of cheaper finance are outweighed by the distress costs caused by the high financial risk (Traditional Capital Structure Theory).

**Debt Capacity**

Although Look's gearing appears low, their ability to raise further debt would depend upon their debt capacity, particularly its asset strength for providing security/collateral for the debts. Without any security the cost of unsecured debt borrowing is likely to be high.

According to the Statement of Financial Position, while Look has just over $36 billion of non-current assets, only $14.5 billion of this is tangible, the remainder consisting of intangibles such as patents and consolidated goodwill. Whether the patents have any open market value and could be realised would be a key determinant in whether these could be used as security for new debt. The goodwill is unlikely to suitable unless its value could be easily realised by lenders.

The tangible non-current assets consist of property as well as plant and equipment. The plant and equipment is likely to be mainly the IT infrastructure at its data centres which are unlikely to be suitable for security purposes due to their rapid loss in value.

Raising an additional $15,518 million of debt could therefore be a problem for Look as it is likely to exceed their current debt capacity according to the financial statements.

On the positive side however, any lenders seeking security would be more interested in the open market/realisable value of the property rather than the book value. It is likely therefore that the debt capacity could be higher than the financial statements indicate.

**EXERCISE 2**

**Methods**

There are a number of valuation methods available to value MT. They are:

- Assets based
- Calculated Intangible Value (CIV)
I will describe each in turn, along with their respective strengths and weakness.

**Asset Based**

In its simplest form, an asset based valuation would involve taking the book value of MT’s equity from its statement of financial position.

**Strengths:**
- simplicity - easy to understand
- information is readily available

**Weaknesses:**
- ignores the earning potential of the assets
- ignores intangibles such as goodwill, intellectual assets etc
- book value of assets is usually a depreciated, historic value and therefore gives an out-of-date value

An improvement on the book value method would be to use realisable or replacement values for the assets.

**Strengths:**
- more up-to-date/relevant than the book value
- use of realisable values gives an indication of minimum/break-up value which can be useful for negotiation purposes
- use of replacement cost can be useful for a maximum value as it indicates the cost of setting up the business from scratch
- replacement costs can give a proxy for value in use, i.e. earning potential of the assets

**Weaknesses:**
- earning potential still ignored if realisable values are used
- realisable values can be subjective and unreliable
- intangibles are still ignored

**Calculated Intangible Value (CIV)**

The CIV approach is a development of the assets based approach where a value is placed on the intangibles as a separate asset and added to the basic asset value of the company.

The CIV is calculated by working out the amount of profit generated from intangibles. This requires an industry average rate of return from tangible assets to work out the tangible profit first - any excess being from intangibles, or the “value spread”.
The value spread is then discounted into perpetuity at the WACC in order to give a present value of all of the intangible profit/cash flow and hence the CIV.

Strengths:
- incorporates the intangible assets of the company as well as the tangible assets

Weaknesses:
- obtaining an industry return on tangible assets can be difficult and judgemental
- assumes the value spread will continue into perpetuity
- assumes no change in the WACC into perpetuity

P/E Ratio

The price earnings ratio (P/E ratio) method involves obtaining a P/E ratio of a similar listed company to MT and multiplying MT’s earnings by the proxy P/E ratio to get an equity value. MT is not a listed company and will not have its own P/E ratio, hence why a proxy P/E ratio must be obtained.

Strengths:
- relatively simple to do (P/E ratio x Profit after tax)
- P/E ratios are readily obtainable in the financial press
- gives a better indication of the market value of the company as P/E ratios are based on market value information

Weaknesses
- MT’s annual earnings need to be stable/sustainable or else the value obtained can vary considerable year on year
- the value obtained is based on profit, not cash and is therefore subject to manipulation and accounting policy
- a suitable proxy can be difficult to obtain (an exact match will be impossible as P/E ratios are unique to each individual company)
- the value obtained for MT is likely to require adjustment as MT is not a listed company and consequently its shares are not as marketable. Any adjustment will be very subjective

Dividend Valuation Model (DVM)

As its name suggests, DVM uses the dividend stream to value the equity. DVM is based on the principle that the value of the equity is equal to the present value of the future dividends. The valuation therefore requires three key pieces of information:

The dividend payable
Dividend growth rate
Equity holder’s required rate of return (Ke)

Strengths:
• cash based, using the dividends, rather than profit which can be manipulated
• time value of money is considered as it is a discounting method
• shareholders require return is considered which will have an impact on value

Weaknesses:
• only dividends are considered rather than the total cash-flow of the business
• growth in cash earnings which could be different to dividend growth, is ignored
• forecast growth in dividends is an estimate
• the required rate of return could be difficult to estimate
• not suitable for controlling interests
• cannot be used if the company does not pay dividends

Cash Based

The two main cash based methods are free cash-flow (FCF) and free cash-flow to equity (FCFE). Both methods involve forecasting the future cash-flows of the business and discounting them using a suitable discount rate to get the present value of the future cash-flows. The discount rate may be either the WACC or cost of equity, depending upon the cash-flows used.

FCF would require the net cash-flows of the business pre-interest to be discounted at the WACC. This would give the value of the firm, being debt plus equity. Deducting the value of debt from this value would then give the value of equity.

FCFE uses the net cash-flows post-interest and would be discounted using the Ke to derive a value for the equity directly.

Strengths:
• Conceptually sound method as it uses present values of cash-flows
• time value is incorporated
• required rate of return is incorporated
• provides the maximum value of the business providing synergies have been incorporated
• suitable for valuing controlling interests as it based on the whole cash-flow

Weaknesses:
• forecasting future cash-flow will be extremely subjective, particularly the growth assumptions
• discount rate can be difficult to estimate
• the cash-flow information required will hard to obtain, if at all

Suitability of methods

Given that MT is likely to have significant intangible value due to its research and development activities as well as the value of its staff’s experience, creativity and technical expertise, an asset based valuation is very unlikely to give a sensible valuation for MT.
While the CIV method will incorporate intangibles, its suitability will depend upon our ability to obtain a suitable average return on assets for the industry. Further information would be required on this.

DVM is unlikely to give a suitable value as we do intend to purchase 100% of MT’s equity and therefore control the company. In such circumstances, the current dividend policy is irrelevant as this can be changed.

Suitability of the P/E ratio approach will depend upon whether there are any similar, listed companies to MT. Given that MT are very “specialised” in what they do, a proxy company could be difficult to find, undermining the suitability of the method.

The most suitable method is likely to be a FCF/FCE approach given our intention to obtain control of MT and its cash-flow. Reasonable estimates of cash-flows, growth and a suitable discount rate will be the main problem however and further information would be required to determine these.
EXERCISE 3

See appendix for detailed ratio calculations.

Note; Figures in brackets relate to 2013

Look achieved a profit after tax of $18,074m in 2014 ($15,762m) which represents an increase of 14.7%, a healthy increase on first sight but significantly behind Friendtime’s growth rate of 77%.

Revenue & Gross Margin

Revenue increased to $62,488m ($50,615m) an increase of 23.5%. Again, this was lower than Friendtime’s rate of revenue growth of 41%. This may indicate that Look could be losing market share and not keeping up with competition.

Revenue generation has improved with asset turnover improving to 0.76 (0.68) highlighting that Look is generating greater revenue per $ invested.

Cost of revenues has worsened to 36% of revenue (32%). The 4% increase in revenue costs has cost Look $2,500m in gross profit and the reasons for the increase need investigating as Look’s business should be about economies of scale and it would arguably be expected for the % cost to revenue to reduce following growth in sales.

In addition, given the nature of Look’s business, a very high proportion of its costs would be assumed to be fixed and consequently the high operational gearing should have resulted in a higher rate of profit growth than sales growth, not the decrease observed. There could however be increases in fixed costs which have contributed to the reduced growth in profit but detailed cost breakdowns are not available.

If we analyse the gross margin in detail we can see that Look’s original product, Search, accounts for the bulk of Look’s business with Search representing 68% of the revenue and 91% of the gross margin.

Space and Media in comparison are providing a much smaller proportion of revenue at 15% and 7% respectively but they both have healthy gross margins of 40% and 53.7% respectively. Together, they account for a further 15% of Look’s gross margin.

In total, Search, Space and Media are accounting for 90% of Look’s revenues and providing a total gross margin of $42,293m.

The other products are less profitable however.

Cloud is currently generating a gross loss of $600m on revenue of only $1,875m.

Similarly, OS, Apps and Phone are also loss making. In 2014 a loss of $351m was made on revenue of $4,372m.
Unfortunately, comparatives are not available to ascertain whether the problem is revenue or cost related.

Lens is not achieving any revenue at present but this division cost Look $1,350m in 2014. Lens is undoubtedly a very risky and speculative venture at present and is in its initial phase but Look needs to decide if Lens will start to achieve sales and cover its costs.

**Overheads**

Overhead costs have all seen increases, the greatest being in R&D and Sales & Marketing with increases of 27.4% and 25% respectively. Both are necessary expenditures and we would expect a correlation between increased expenditure on these areas and an increase in revenue which we have indeed seen, but these increase are likely to be unsustainable and could highlight inefficiency.

**Operating Profit**

At operating profit level we can see the effect of the increase in costs with only an 11% increase in operating profit compared with the 23.5% increase in revenue. Similarly, the operating profit margin has slipped from 37.9% to 34.1%. Further detail on the cost lines would be required to analyse this further.

The decrease in operating margin and increase in asset turnover have negated one another to produce a static return on capital employed of 25.8% (25.7%).

**Taxation**

The effective rate of tax decreased by 4% in 2014 to 16% of profit before tax (20%). This could be due to efficient tax planning or R&D tax incentives which may have been introduced but without further information, this cannot be determined. Given Look’s unofficial mission to “do only good” and to respect external regulation, hopefully the reduction in tax is not due to tax-avoidance schemes that may have been entered into which could harm Look’s image and reputation.

**Appendix**

<table>
<thead>
<tr>
<th>1 - Summary Analysis of profit or Loss</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>62,488</td>
<td>50,615</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>21,286</td>
<td>19,185</td>
</tr>
<tr>
<td>Short term debt</td>
<td>2,897</td>
<td>3,874</td>
</tr>
<tr>
<td>Long term debt</td>
<td>4,800</td>
<td>4,800</td>
</tr>
<tr>
<td>Equity</td>
<td>74,967</td>
<td>65,839</td>
</tr>
<tr>
<td>Total Capital Employed</td>
<td>82,664</td>
<td>74,513</td>
</tr>
</tbody>
</table>
## Asset Turnover (revenue/capital employed)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>0.76</th>
<th></th>
<th>0.68</th>
</tr>
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</table>

## Operating Margin (operating profit/revenue)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>34.1%</th>
<th></th>
<th>37.9%</th>
</tr>
</thead>
</table>

## ROCE (operating profit/capital employed)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>25.8%</th>
<th></th>
<th>25.7%</th>
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</thead>
</table>

## 2 - Detailed Analysis of Profit or Loss

<table>
<thead>
<tr>
<th>Year on Year Change</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>$m</td>
<td>%</td>
</tr>
<tr>
<td>Revenues</td>
<td>23.5%</td>
<td>11,873</td>
</tr>
<tr>
<td>Cost of revenues</td>
<td>38.9%</td>
<td>(6,299)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>16.2%</td>
<td>5,574</td>
</tr>
<tr>
<td>R &amp; D</td>
<td>27.4%</td>
<td>(1,859)</td>
</tr>
<tr>
<td>Sales &amp; marketing</td>
<td>25.0%</td>
<td>(1,306)</td>
</tr>
<tr>
<td>General &amp; admin</td>
<td>9.6%</td>
<td>(308)</td>
</tr>
<tr>
<td>Overheads</td>
<td>22.8%</td>
<td>(3,473)</td>
</tr>
<tr>
<td>Operating profit</td>
<td>11.0%</td>
<td>2,101</td>
</tr>
<tr>
<td>Interest net</td>
<td>(196)</td>
<td>256</td>
</tr>
<tr>
<td>Profit before tax</td>
<td></td>
<td>21,542</td>
</tr>
<tr>
<td>Tax</td>
<td>(407)</td>
<td>(3,468)</td>
</tr>
<tr>
<td>Profit for year</td>
<td>14.7%</td>
<td>2,312</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## 3 - Business units revenues & profitability - 2014

<table>
<thead>
<tr>
<th></th>
<th>Revenue</th>
<th>Costs</th>
<th>Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>$m</td>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td>Search</td>
<td>68.0%</td>
<td>42,492</td>
<td>(6,297)</td>
</tr>
<tr>
<td>Space</td>
<td>15.0%</td>
<td>9,373</td>
<td>(5,624)</td>
</tr>
<tr>
<td>Media</td>
<td>7.0%</td>
<td>4,374</td>
<td>(2,025)</td>
</tr>
<tr>
<td></td>
<td>90.0%</td>
<td>56,239</td>
<td>(13,946)</td>
</tr>
<tr>
<td>Cloud</td>
<td>3.0%</td>
<td>1,875</td>
<td>(2,475)</td>
</tr>
<tr>
<td>OS, Apps, &amp; Phone</td>
<td>7.0%</td>
<td>4,374</td>
<td>(4,725)</td>
</tr>
<tr>
<td>Lens</td>
<td>0.0%</td>
<td>0</td>
<td>(1,350)</td>
</tr>
<tr>
<td>TOTAL</td>
<td>100.0%</td>
<td>62,488</td>
<td>(36,442)</td>
</tr>
</tbody>
</table>
EXERCISE 4

Aim, purpose and objectives of <IR>

Integrated reporting is seen by the IIRC as the basis for a fundamental change in the way in which entities are managed and report to stakeholders.

The objective of integrated reporting is to try to create a more holistic and balanced view of the company being reported upon, bringing together material aspects such as strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates.

Sustainability reporting is an intrinsic element of integrated reporting.

The <IR> framework sets out the purpose of an integrated report as follows:

“The primary purpose of an integrated report is to explain to providers of financial capital how an entity creates value over time. An integrated report benefits all stakeholders interested in an entity’s ability to create value over time, including employees, customers, suppliers, business partners, local communities, legislators, regulators and policy-makers.”

The objectives for integrated reporting include:

- To improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital.
- To provide a more cohesive and efficient approach to corporate reporting that draws on different reporting strands and communicates the full range of factors that materially affect the ability of an organisation to create value over time.
- To enhance accountability and stewardship for the broad base of capitals (financial, manufactured, intellectual, human, social and relationship, and natural) and promote understanding of their interdependencies.
- To support integrated thinking, decision-making and actions that focus on the creation of value over the short, medium and long term.

Fundamental Concepts

There are three fundamental concepts underpinning integrated reporting:

- Value creation for the organisation and for others
- The capitals
- The value creation process

1 - Value creation for the organisation and others

An organisation’s activities, its interactions and relationships, its outputs and the outcomes for the various capitals it uses and effects, influence its ability to continue to draw on these capitals in a continuous cycle.
Value created by an organisation over time manifests itself in increases, decreases or transformations of the capitals caused by the organisation’s business activities or outputs.

2 - The capitals

The capitals are the resources and the relationships used and affected by the organisation, which are identified in the <IR> Framework as:

- Financial - the pool of funds available to an organisation, obtained through financing such as debt or equity.
- Manufactured - manufactured physical objects, which are available to an organisation for use in the production of goods or provision of services, eg buildings and equipment. Manufactured capital is often created by other organisations.
- Intellectual - organisational, knowledge based intangibles including patents, software, knowledge and systems.
- Human - people’s competencies, capabilities and their motivations to innovate.
- Social and relationship - the institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective well-being.
- Natural - all renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current or future prosperity of an organisation, such as air, water, land and minerals.

However, these categories of capital are not required to be adopted in preparing an entity’s integrated report, and an integrated report may not cover all capitals - the focus is on capitals that are relevant to the entity.

3 - The value creation process

At the core of the value creation process is an entity’s business model, which draws on various capitals and inputs, and by using the entity’s business activities, creates outputs (products, services, by-products, waste) and outcomes (internal and external consequences for the capitals).

Relevance and benefits to Look Group

Look Group already pride themselves on their corporate social responsibility (CSR), evidenced by its motto to “do only good”, particularly the minimisation of environmental impact. Adopting integrated reporting could have the following benefits to Look:

Potentially strengthen Look’s commitment to CSR and its relationships with key stakeholders.

The report would provide an insight into the nature and quality of Look’s relationships with its key stakeholders. Value is not created by the organisation alone but through relationships with others.

The report would provide an insight into Look’s strategy and it’s ability to create value.

By promoting more integrated thinking in Look’s activities, the more naturally will the connectivity of information flow into management reporting, analysis and decision making.
An integrated report will enhance transparency and accountability - essential in building trust with key stakeholders.

CHAPTER EIGHT

EXERCISE ONE

Report

To: Head of Research and Development
From: Senior Manager, Look
Date: 19th February 2015
Subject: Look Lens glasses proposal

Introduction

The purpose of this document is to consider the different means of developing the Look lens product from contact lenses to a pair of glasses. Specifically, the options considered are to develop the new product without any reference to another business (Organic growth), to buy an organisation already experienced in making glasses (Acquisition), or to work together with an existing glasses manufacturer (Collaboration).

Each option will be considered separately, and then a preliminary conclusion reached.

Organic Growth

This option would entail Look working entirely by itself to bring the new product to market. Specifically, Look would develop, manufacture and market the product without the input of any other organisation.

There are a number of advantages to such a strategic option:

- Look can keep complete control over the product. It will not have to work to another organisation’s deadlines etc.
- Intellectual property will be protected. With other forms of growth, there can be a need to share privileged information with another business, thereby risking the loss of a source of competitive advantage
- Consumers will see that there is a distinctive Look “feel” to the product. It will result from Look skills, processes, and the culture of the company, without outside influences
- Capital can be applied as and when it is needed - there will be no need to find significant sums at the outset
• Look is already a considerable way towards completing the end product, having developed the lens. To incorporate this into a frame for a pair of glasses is merely one extra (probably straightforward) step.

However, there are a number of disadvantages too:

• Look will need to decide how manufacturing will occur. If it decides to make the glasses itself, this will require significant capital to establish a factory and production line, recruit people with the rights skills, and then establish appropriate distribution channels.
• Look has no reputation in either the world of fashion or in making prescription lenses. Both of these will be critical in creating an attractive product to consumers.
• Look will need to establish appropriate sales channels from scratch, as it is unlikely that existing retail routes will be suitable. For example, sunglasses are sold by department stores, specialist retailers or dedicated online sites. Look does not currently sell through these channels.

Acquisition

This route would mean that Look identifies a suitable organisation currently involved in manufacturing glasses, agrees a value with the owners and then incorporates that business into the Look Group.

The advantages of this option are:

• It is a quick means to bringing the Look glasses product to market. The manufacturing facilities, skills and retail channels will already be present
• It would lead to further diversification of the Look Group; as well as making the Look glasses, the acquired business would continue in its current product areas. This increased diversification reduces risk for Look shareholders
• It should be a lower risk option than the organic route above. This is because Look would be buying a business with a track record, reputation, and established customer base.
• Acquisition can get around certain barriers to entry. For example, some countries will not allow foreign-owned businesses access to state owned distribution channels such as railways and ports. Acquiring a business in that country removes that barrier.

The disadvantages are as follows:

• A large capital outlay will be involved if the deal is for cash. Look could avoid this by partly offering equity in the Look Group via a share for share exchange, but this would have the effect of diluting existing shareholders’ investments.
• A value would need to be determined for the target company. If a quoted business is bought, the current market capitalisation acts as a starting point, but then a premium above that value would need to be offered - the question becomes, how large a premium? If the target business is not quoted, the valuation becomes much more subjective. It can take time to agree a deal, and it is generally accepted that in as much of 80% of takeovers, the buyer pays too much.
• There can be clashes of culture. The Look culture is distinctive, and not likely to be replicated widely in the business world. Trying to bring about changes in culture following a deal can be time-consuming and damaging.

• There can be problems in integrating systems and processes. Look would need to ensure, after the deal has been finalised, that its existing management information systems become compatible with those of the target to be able to monitor properly the performance of the new subsidiary.

**Collaboration**

There are a number of ways in which a collaborative approach to strategy can occur e.g. franchising, strategic alliance etc. This document will only look at those that are most relevant, being a joint venture, licencing or outsourcing. Each will be considered in turn.

**Joint venture**

This would mean identifying a suitable partner with which to do business (in this instance a manufacturer of glasses), and entering a formal arrangement whereby a 3rd entity is created to make the Look Lens glasses. Each party takes a stake in the new entity and provides capital, know how, staff etc. Resultant profits are then shared according to the equity stake each party has.

The main benefits of such an arrangement for Look are that risk is shared and the other party brings its own expertise.

The main problem is one of shared management - in effect, there are 2 decision-makers with regards to the joint venture, and there can be risk of disagreement.

**Licencing**

Under a licence arrangement, Look would perfect the technology, and then allow another business to make and market the product; Look would have no involvement in the manufacturing or retail of the Look Lens, rather they would simply receive a licencing fee for each unit.

The main advantage of this is that, assuming the product is a success, Look will not need to do anything once the product is launched other than receive regular cash payments.

The disadvantage is that Look will only receive a proportion of the product’s overall profits; the manufacturer will keep the rest.

**Outsourcing**

This is the approach adopted so far by Look with regards to Look Phone. Manufacturing is done by a chosen supplier or suppliers, but all responsibility for marketing the product, its brand and distribution remains with Look. The supplier is simply paid a fixed price per unit made, and all profits are kept by Look. This also gives the greatest degree of flexibility; whilst contracts for supply tend to be agreed for a fixed period, it is possible to change supplier should that prove desirable.
Conclusion

The most appropriate means of exploiting the revised Look Lens proposal would be to outsource manufacturing. This has worked very successfully in the past, and should result in the greatest return for Look whilst also making use of other party’s expertise.

Look should identify a suitable outsource partner in the glasses industry, and start preliminary negotiations. However, it is very important to ensure that production does not commence before the new Look Lens has been perfected; the company still has the market to itself, and can afford to take its time in bringing the new product to market.

EXERCISE TWO

<table>
<thead>
<tr>
<th>Briefing Note</th>
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<tr>
<td>To: Head of Mobile Devices</td>
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<tr>
<td>From: Senior Manager</td>
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<td>Date: Today</td>
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<tr>
<td>Subject: Evaluation of opportunity to purchase Map Your Tracks app</td>
</tr>
</tbody>
</table>

Introduction

The purpose of this briefing note is to evaluate the possible acquisition of the Map Your Tracks app from Vincent Chang. This will be done by using the Johnson, Scholes and Whittington framework of Suitability/Feasibility/Acceptability, and a preliminary conclusion then reached.

Suitability

Suitability is concerned with whether the proposal addresses the circumstances in which an organisation is operating - its strategic position.

Acquiring a popular app would certainly be in line with Look’s strategic direction. Assuming that it as well-received in the market as Vincent Chang claims, it will generate revenue for Look Apps each time the app is bought. Furthermore, if it can be made unique to a particular platform e.g. consumers can only use this app on their Look phone or in tandem with Look OS, a truly popular app can help to grow sales in these other divisions too (to my knowledge, the question of whether the app can be made unique to the Look platforms has not been addressed.)

Look Apps, Look Phone and Look OS are all integral parts of the Look Group with a long-term future in the Group, and therefore any proposal that helps to grow these parts of
the business is in line with the company’s strategy.

The proposal is therefore suitable.

Feasibility

Feasibility is concerned with whether the proposal can be made to work in practice and as such looks at more detailed practicalities of strategic capability.

Buying the Map Your Tracks app and then making it work will certainly be within the existing skill set of the organisation, as Look has an established Apps division already up and running. Indeed, with over 2,500 employees, the question of human resource is not a problem.

It is assumed that the app is fully developed and ready to be launched. If this is not the case, it would be worth ensuring that Vincent Chang remains involved in finalising the product, as he is the one with the vision of what it should ultimately look like. Given the sum that he is requesting for the sale of the app, this should also be feasible - he has great personal incentive to make disposal of his technology a success.

In addition, Look would have no problem in raising the necessary $5m, given that it had $874m of cash and cash equivalents at the last year end.

The proposal is therefore feasible.

Acceptability

Acceptability is concerned with the expected performance outcomes (such as return or risk) of a strategy and the extent to which these would be in line with the expectations of shareholders.

In terms of return, the acceptability of this app needs to be seriously questioned. At a cost of $5m and sales of $9.99, the app would need to be bought over half a million times before any return would be seen; this is before factoring any additional costs to Look, such as launch costs and any further development costs (making it compatible with updated versions of operating systems etc.). It is difficult to see how the app can be made attractive to any users other than cyclists and skiers (despite Vincent Chang’s claims), and therefore the market is restricted.

Furthermore, research shows that there are lots of competing products on the market. A quick search on the Apps Store for Apple brought up 3 products, all of which were free to download, when searching using the words “ski tracker”. There is therefore a high degree of risk that the app will fail to break even, let alone generate profit.

This risk is further enhanced by the fact that new products are constantly being brought to market; what might seem revolutionary today can be made obsolete by new developments within a short space of time.
It is likely, therefore, that the app will fail to deliver a return in line with shareholder expectations.

One further issue to consider is the ethical question. Vincent Chang would seem to suggest in his email that part of the appeal of the app is to make skiers and cyclists challenge themselves, to beat their personal bests. It could be argued that selling such an app is unethical as it promotes irresponsible behaviour. Both skiers and cyclists may be tempted to travel faster than is deemed safe, leading to possible personal injury and even death. The website Strava has been sued on more than one occasion by relatives who have made this very claim, that their loved-ones were lead to act recklessly by the site.

The proposal to buy Map Your Tracks is not acceptable.

**Conclusion**

Look should not agree to buy this app at its current sales price. As Vincent Chang claims to have two possible alternative buyers lined up, Look should not continue negotiations any further.

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**EXERCISE THREE**

**Briefing Notes**

To: Jay Bride, CEO  
From: Senior Manager  
Date: 23 January 2015, 11.50  
Subject: Response to press article

**Introduction**

The purpose of these briefing notes is to highlight the different ethical stances that an organisation can adopt, and then to present some points that can be used to counter recent criticism of Look’s position with regards to tax planning.

**Ethical stances**

According to the respected theorists Johnson, Scholes and Whittington, there are 4 ethical stances that an organisation can adopt. An ethical stance can be defined as “the extent to which an organisation will exceed its minimum obligations to stakeholders”.

The 4 stances are:

*Short term shareholder interest (STSI)*
This ethical stance has a short-term focus in that it aims to maximise profits in any financial year. Organisations with this ethical stance believe that it is the role of governments to set the legal minimum standard, and anything delivered above this would be to the detriment of the organisation’s principal stakeholders.

For example, the organisation pays the minimum wage to its unskilled labour, as determined by local legislation. Paying more is unnecessarily eating into profits.

It would seem from the newspaper article that Look is being accused of adopting this stance.

*Longer term shareholder interest (LTSI)*

This ethical stance takes broadly the same approach as that above, except that it takes a longer term view. Hence it may be appropriate to incur additional cost now so as to achieve higher returns in the future.

So, to continue with the example above, an organisation may decide deliberately to pay unskilled labour more than the minimum wage, in order to achieve employee loyalty and prevent high staff turnover (which might incur greater costs in the long run). Investment in staff training and development might also feature, again at a cost today.

Not only is this helping to increase profits over the longer term, it is also helping to develop staff in their skill set and perhaps career progression. It is therefore argued that this ethical stance takes into consideration a wider body of stakeholders - here, not just the shareholders, but also the employees.

*Multiple stakeholder obligations (MSO)*

This ethical stance accepts that the organisation exists for more than simply making a profit, or providing services at a minimal cost. It takes the view that all organisations have a role to play in society and so they must take account of all the stakeholders’ interests.

For example, a training organisation in the private sector accepts that it has a responsibility to generate returns for its owners, but also sees its role of delivering education as fundamental to why it exists. Education helps to improve society, to help people make better choices, to improve standards of living etc. Such an organisation may well take steps that reduce its profitability because it believes doing so is the right thing e.g. offering free scholarships to the disadvantaged.

*Shaper of society*

This ethical stance is ideologically driven and sees its vision as being the focus for all its actions. Financial and other stakeholders’ interests are secondary to the overriding purpose of the organisation.

For example, charitable organisations whose employees work for little or no pay could be said to be shapers of society. The aim is to do as much good work as possible, bearing in mind the limited financial resources at the charity’s disposal.
Points to counter the recent criticism

As mentioned, the focus of the accusation in the article is that Look has adopted an ethical stance of STSI. I feel it is important that this is a blinkered view, and that Look demonstrates aspects of other stances, as follows:

Look prides itself on being an excellent employer, offering a great working environment and high rates of pay. Whilst this helps Look maintain its skill set and therefore preserve competitive advantage, it also results in a benefit to the wider economy. More income tax is received by governments, standards of living increase meaning more expenditure on other aspects of the economy, leading to greater profits for other businesses, thereby enabling expansion and more corporation tax receipts.

Look pays for staff to earn qualifications that will be of no commercial benefit immediately to Look. Again, the immediate beneficiaries are staff and the wider economy.

Look has established programming centres in India and Eastern Europe, historically locations that have suffered lower standards of living than established Western economies. Creation of a significant number of jobs in both locations has helped to improve local conditions and also attracted other investors to the same areas.

Look sponsors many programmes in the communities of which it is a part, and staff are given significant time off from work to give training in programming and information systems to local schools. This is much more in line with the MSO ethical stance mentioned above.

Look provides services free of charge to a number of charities.

Look is quick to step in and help out when any natural disaster occurs.

Look funds research into the development of renewable energy resources ($1.1bn in 2014), thereby underpinning its own commitment to being carbon neutral and helping to preserve the world’s resources for future generations.

All of the above show that the criticism contained in the newspaper article is only looking at one narrow aspect of what Look is about. The Group could change its stance with regards to tax and pay a much larger rate, but this would inevitably lead to cutbacks in so many other areas in which Look benefits society.
CHAPTER NINE

EXERCISE ONE

To: Chief Internal auditor  
From: Me  
Date: Today  
Subject: Fraud and Internal Audit

Hi

Please see notes below as requested

Risk based auditing

Meeting company objectives

Risk based auditing allows the Internal Audit (IA) department to focus on the areas of the business that are most at risk of control failures and areas where control failures would have the greatest impact on the organisation. In this case, it was decided that the risks in the HR department were not high enough - the probability of something occurring that would have a high impact on the company was regarded as low.

High risk areas may need to be visited more frequently, especially as the environment and technology changes rapidly at Look. If IA were to visit and conduct testing in all areas, the highest risk areas would not get monitored often enough. This may have serious consequences for running the business and meeting objectives.

Audit efficiency

Although Look have an IA function based in every site from which the group operates, it only has 234 employees out of a total workforce of 20,252. If Look were to monitor and check every risk and control, the IA workforce would have to be increased significantly. Audit departments are a cost to the organisation and so must be scrutinised in terms of the value they deliver compared to the costs they incur. Prioritising work (through risk analysis), however big the department, would always be necessary.

Effectiveness of risk analysis

Risk based auditing as a concept itself may not be responsible for this fraud not being identified sooner. The risk assessment process that leads to creating the audit plan (the timetable of audits over the year) and accuracy of the risk analysis on individual audits may require review.
The company’s major risks are assessed and form the basis of the audit plan. Corporate Governance guidelines often suggest the audit plan is created by the Audit Committee. At a minimum, the Audit Committee need to be satisfied that significant risks across the business are monitored. Currently, it would seem that audits focus on security and privacy of data. However, audit plans are fluid documents and if new concerns over the business become apparent, the Audit Committee can change the audit plan. Audit is itself a control overLook’s controls and needs to develop and adapt to meet changes in the business environment. This will determine how often a business unit is audited.

The entire business unit may be too big to audit and areas within it are prioritised through further risk assessment. How this occurred within the business unit where the fraud occurred may be questioned. Although there may be significant risks regarding, let’s say, IT security, that were of significant importance to the business unit, there were risks in HR that were not investigated. For instance, there was no segregation of duties in the HR Manager role. Other key compensating controls do not appear to have been in place such as a manager reviewing each department’s payroll report.

Although the fraud would have been difficult due to its size, the lack of controls meant the risk of fraud was significant and the likelihood of it being a large fraud was high. The risk based decision to not audit the HR department requires further review.

Changing the structure of the IA department

Presumably, other than this fraud, the department’s performance has been good to date. Changes in structure may be disruptive and lead to audits not being performed correctly while new processes are learnt.

There are synergies and hence cost savings in the current structure. For instance a new IT project could be analysed from a finance angle and IT angle by one individual rather than two. Having one department may help reduce duplication of activity.

Having two departments creates bureaucracy and the need for agreement over common areas. For instance, it would need to be determined which department would do a post investment audit into a system development.

It is important for the two disciplines to have an appreciation of what is right; IT ought to understand the implications of costs and the importance of controls. The Finance function ought to understand the product fully to be able to understand the controls required. The business units may find audits more disruptive. Instead of 1 audit a year they get two separate ones.

Lack of specialist knowledge may not be critical. A “fresh pair of eyes” may be useful when questioning controls and compliance.

Both the disciplines are specialist and may not be able to learn from each other as easily as suggested. There is a risk that control issues do not get spotted by a non-specialist.

Having staff who are highly knowledgeable gives a department status and credibility
which will help when auditing and suggesting recommendations. Having two separate departments will aide this.

IT is critical to the company’s success overall. It would follow that a specialist IT compliance department would be needed. The business has grown and maybe a new approach is needed to ensure all risks are managed.

EXERCISE TWO

To: Senior Finance Manager
From: Me
Date: Today
Subject: RE: Interest rates

Hi

I have made some notes as you requested. Let me know if I can do anything else!

Swaps

An interest rate swap will convert the variable interest rate into a fixed one. The fixed rate would then protect Look from interest rate rises. The merchant bank would find another company or bank that Look could swap with. This “counterparty” would currently have a fixed rate and want to swap to a variable rate. The parties exchange their interest rate commitments with each other but retain their obligations to the original lenders.

Interest rate swaps are a common form of hedging for long term interest rate risk like the 10 year remaining loan that Look has. They can be customised to meet Looks specific requirements regarding length of the loan and its amount.

The advantages are as follows:

Look can obtain a fixed interest rate it wants and often one that may be lower than it could get from a bank.

Swaps are easy to arrange and transaction costs are usually low, depending on what the merchant bank charges for setting up the arrangement.

They provide a way of managing Look’s interest rate risk without changing the underlying loan. Look would not have to pay any potential penalty charges for ending the loan early nor expensive loan arrangement fees to set up a new fixed rate loan for the remaining 10 years with another bank.
The main risk of swaps is counterparty risk. If the counterparty defaults on the interest payments, Look will still have to pay a variable rate loan with their own bank (until a potential new swap arrangement can be made). Merchant banks may be able to offer due diligence checks on the counterparty so this risk can be assessed.

A further risk is that Look enters into the swap and interest rates do not rise. Fixed interest rates are likely to be higher than the low variable rates Look has now. Let’s say that Look can arrange a swap at a fixed rate of 2.5%. This is 1% higher than rates now. Rates may go up as predicted over the next 10 years, but only exceed 2.5% in the final three years of the term. The fixed interest will give Look certainty over its cash-flow but in terms of overall interest payments, Look would have been better not entering into the swap.

**Short term loan**

A FRA would allow Look to fix the interest rate payable on the short term loan from September to December. The loan itself would be with a bank, but the FRA would be with a merchant bank as suggested.

On the 1st of September one of two things may occur:

- The prevailing interest rate is higher than the FRA rate of 2%. Let’s say it is 3%. Look would take out a loan with a (retail) bank at 3%. The merchant bank would pay Look the difference between the FRA rate and the loan rate i.e. 1%. Therefore Look is paying a loan rate that is 2% (net). In this way, it has fixed its rate at 2% for the 3 month loan.

- The prevailing interest rate is lower than the FRA rate of 2%. Let’s say its 1.75%. Look would take out a loan with (retail) bank at 1.75%. However, Look would have entered into an FRA that means it will pay 2%. Look would pay the merchant bank the difference between the FRA rate and the loan rate i.e. 0.25%. Therefore Look is paying a loan rate that is 2% (net) as arranged through the FRA. It cannot take advantage of the lower than expected rate.

Therefore although an FRA would give Look certainty regarding payments and take away the downside risk it also takes away any upside risk with respect to interest rates movement.

IRGs offer Look a maximum interest rate so that, unlike with FRAs Look would be able to participate in the upside risk of a rate decrease. In this case, Look would have a maximum rate of 2.5%. Like with FRAs, the loan itself would be with a bank, but the IRG would be with a merchant bank. The merchant bank would also charge a non-refundable premium, which is a downside to this method of hedging. The premiums can be expensive.

The IRG transaction may look something like this:

On February 11th 2015, Look takes out an IRG with its merchant bank and pays a premium cost. On September 1st when Look needs a three month loan to start, 1 of 2 things may happen:

- If the prevailing interest rate is 3%, therefore higher than the IRG rate of 2.5%: Look would take out a loan with a (retail) bank at 3%. The merchant bank would pay Look the difference between the IRG rate and the loan rate ie 0.5%. Therefore Look is paying a loan rate that is 2.5% (net). In this way, it has not paid over the maximum rate of 2.5% for the 3 month loan agreed through the
IRG (excluding the premium).
If the prevailing interest rate 1.75% therefore lower than the IRG rate of 2.5%: Look would take out a loan with (retail) bank at 1.75%. It can take advantage of this rate and does not need to make any further payments to the merchant bank that arranged the IRG.

With both the FRAs and the IRGs, Look needs to decide whether the hedging methods are necessary. Rates are currently 1%. Does the Finance Team believe that rates will go above 2% (in the case of a FRA) or 2.5% (in the case of a IRG) in the space of 7 months? If the rates increase is expected to be minimal, the most cost effective strategy may be to do nothing.

I hope this answers your queries.

Kind regards

**EXERCISE THREE**

**To:** The Chairman  
**From:** Me  
**Date:** Today  
**Subject:** Risks for Look Phone

Dear Sir

Please find the notes you requested below

**Unique parts**

This has posed a problem in recent months and requires addressing even if expansion does not go ahead. Contracts with these unique suppliers may impose penalties if orders are not met. However this does mitigate the lost sales and idle time at the manufacturing sites. Therefore other mitigations need consideration.

**R&D:** Look’s expertise is in research and development. The staff may be able to reverse engineer or create parts similar to those required. Another option would be for staff to redevelop the phone design so that these specialist parts are no longer required. This would reduce or eliminate the reliance on these suppliers.

**Licenses:** Look may be able to negotiate with the supplier to be produce the part themselves (or outsource the manufacture) under a license agreement. This would allow them to have more control over the quality, location and volume of production.

**Purchase the supplier:** Look has cash reserves that enable it to purchase the producer of the unique parts. This would give them control as above.

**NB.** Whether licensing or purchasing the supplier, Look must be aware that its core skill is
not in manufacturing. Such risk mitigation strategies create new risks due to lack of experience in this area.

**Inventory:** In order to protect itself from a loss in supply, Look could build up buffer stocks.

**IT risk**

This has not been an issue in the past however the impact of IT failure in the purchasing system would be severe.

From a capacity perspective the same suppliers will be used but the production will double. Look must review whether the system itself can cope with such increase in usage. The system may require upgrading.

The IT system will be relied upon even more so if production is doubled. Therefore back up plans to ensure the business is resilient to disasters require review.

The IT system requires installation and correct use at all suppliers and manufacturing sites. As the same suppliers are likely to be used, new installation and training is not required here, which is an upside. However, the process by which items are tracked and entered into the system may need review in order to ensure the operational side can cope with the increased volume at existing manufacturing sites. The human interaction with the system is crucial for it to give accurate information from which to place orders. New manufacturing sites will need training.

**Suppliers**

Look could reduce the number of suppliers. They currently have approximately 100 suppliers providing parts for one phone. It may be very difficult therefore to build up long term close relationships with the suppliers due to the scale of this task. By reducing the number of suppliers, Look would be able to better control the supply through better communication on issues such a timing of production, quality control and so on. (A greater volume purchased from one supplier may decrease prices also).

However the upside of this reduced complexity needs to be balanced against the risk of increased reliance. Look may need to create contingency plans for alternative supply.

Suppliers are global which increases the risk of transportation problems. Although suppliers may be able to dispatch items on time, they may be delayed in transportation and customs, disrupting the manufacture of Look’s products. Choosing suppliers that are close to the manufacturing site, even if they are more expensive, may help to limit this risk. Alternatively, as Look requires a new manufacturing site, this may be chosen to be close to key suppliers.

**Reliance on two outsourced manufacturers**
Having two manufacturers close to each other must reduce the complexity of the distributing parts required for production. One plant may also be able to act as a back-up if the other cannot produce (so long as there is spare capacity). However, there are concerns with this set up, which require mitigation.

Look could diversify the location of manufacturers. Both manufacturers are located in the same country, near to each other. Should there be a natural disaster, both sites ie 100% of production may be affected. Similarly, Look maybe subject to political risk from the Chinese Gov. Although the site is a local company, its production for a Western company may not be looked on favourably. The facility may be ordered to stop production or items seized.

The opportunity to begin manufacturing in a completely new location due to the increase in production, will help to mitigate this risk. Diversification of production will reduce the political risk and environmental risk, if increasing operational risk due to increasing complexity in distribution.

As stated above, there are benefits to having two sites located close together. However, it may be decided that when looking at sites to expand too, Look take the opportunity to also move production from one of the Chinese sites also, to spread the risk.

Look could increase the number of outsourced manufacturers. By having many suppliers across the world, Look will not be reliant on simply 3 or 4. This would reduce the impact of any manufacturing disruption. However, this would again add to the complexity of the purchasing and distribution of parts. In addition, Look may not be able to build up as strong relationships with its manufacturers, which in turn may lead to production problems.

CHAPTER TEN

EXERCISE ONE

*Note - the task is about the two forms of financing, NOT the issues surrounding the share buy-back itself.*

**Briefing Paper**

**Subject - Financing Recommendation for proposed share buy-back**

**Overview**

Two options to finance the $10,000 buy-back are proposed:

(i) 10 year bonds  
(ii) 10 year syndicated bank loan
While both will provide the necessary financing there are a number of factors which will affect our choice.

**Availability**

Neither sources of finance are guaranteed at present.

The bonds will need to be placed among financial institutions. We will need to ensure the bonds are attractive to investors or else the issue could fail.

Bond investors are looking for an 8.5% annual return (yield) on their investment so it would make sense for this to be the rate of interest on the bonds which would then reduce the risk of the bonds being an unattractive investment.

Any difference in the rate set would mean we would have to issue the bonds at a different price to $100, resulting in either a fewer or greater number of bonds being issued.

Underwriting the issue (insurance against the issue failing) will reduce the risk of failure but we will be charged high underwriting fees if success of the issue looks uncertain.

The bank loan is also uncertain. The bank has stated that it’s consortium partners “may be willing” to enter into a syndicated arrangement. I think we need to establish how certain this option is before we incur too much cost pursuing this.

In both cases, our reputation and size should help to reduce the risk of unavailability of the finance.

**Interest rates**

The 12 monthly nominal rate on the bank loan is 8%. If the rate on the bonds is set at 8.5% then the bond appears more expensive than the loan.

The bank loan, however, requires quarterly payments of interest rather than the annual payment with the bond. This results in a cash-flow disadvantage with the bank loan as it will require more frequent payments than the bond.

The increased frequency of payments with the bank loan also means that the effective annual rate on the bank loan is actually 8.24% (8% / 4 = 2% per quarter, annual rate = 1.02^4 - 1 = 0.0824). In other words, if the bank only required their interest to be paid annually, they would have to increase the nominal rate on it to 8.24% to ensure that they we no worse off than receiving 2% every quarter and re-investing for the rest of the year.

This rate of 8.24% is comparable with the annual bond yield of 8.5% and thus, even at the rate of 8.24%, the bank loan is still cheaper than the bond. The difference of 0.26% would equate to a saving of $26 million in interest payments a year.
Issue costs

Both the loan and the bonds will incur arrangement or issue costs. The bank loan is likely to be a simple agreed arrangement fee that the bank will notify us of up front.

Given the syndication arrangement however, the arrangement fee for this type of bank loan is likely to be more than a straight-forward bank loan due to the extra administration involved by our bank.

The bond issue costs are likely to be more complex as it involves an issue of securities on the market. There will be costs of the issuing house, advisors and underwriting fees which are likely to be more than the bank arrangement fee. Even at 1%, the issue costs on the bonds would be $100 million although this would be tax allowable.

Security

The bonds will require a floating charge as collateral which involves using current assets such as inventories as security for the debt.

A floating charge will allow us freedom to trade in those underlying current assets as it is not a specific asset being used and charged, unlike a fixed charge such as a mortgage, but we will probably need to maintain a minimum level in accordance with the bond agreement. Given our level of current assets, I do not think this should produce any problems.

The bank loan will also require some fixed charge as additional security. This will involve using specific non-current assets as collateral for part of the debt and it will place restrictions on the asset used.

We need to ensure we have that sufficient level of non-current assets for this as it is likely that they will only consider land and property for this purpose.

Covenants

Both forms of debt will require covenants, i.e. restrictions on what we can do. You have not informed me of the detail of these but they will typically be:

- maintenance of key financial ratios
- dividend per share restriction
- restrictions on raising further debt
- provision of management accounts

Lenders will require these covenants to protect their investment but there will then be an impact upon our shareholders, particularly if we are restricted on the level of dividend paid.
Given that the bank loan will require “extensive” covenants, that could be a problem but we need to know the detail of them.

**Recommendation**

Firstly we should obtain the details of the covenants for both the bank loan and the bonds as these are going to be critical to our decision.

Secondly, the issue costs and arrangement fee with the bank loan need determining.

If the bank loan covenants are too restrictive then we should look at the bond issue, despite the slightly higher cost involved but I think it likely that the issue costs will be high compared with the bank loan.

If the bank loan covenants are acceptable to us then the bank loan would be a good choice as it would simplify the administration of the debt and is lower cost.

**EXERCISE TWO**

1 - **Values based upon working assumptions:**

**MINIMUM**  $70,000 million  ($8.75 per share)

**MAXIMUM**  $105,200 million  ($13.15 per share)

**Minimum:**
Sheldon’s current share price is $8.75. This represents the minimum value for Sheldon as shareholders will not accept less than current market value.

Sheldon has 8,000 million shares in issue giving a total value of $70,000 million.

**Maximum:**
For the maximum value of Sheldon I have determined what I consider to be it’s value to Look Group based upon the working assumptions, particularly in relation to the synergies achievable from cost savings.

**Calculation:**

<table>
<thead>
<tr>
<th></th>
<th>Earnings $ million</th>
<th>P/E</th>
<th>Value $ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Look Group</td>
<td>18,074</td>
<td>8.75</td>
<td>158,200</td>
</tr>
<tr>
<td>Sheldon</td>
<td>8,862</td>
<td>7.90</td>
<td>70,000</td>
</tr>
<tr>
<td>Synergy (i)</td>
<td>3,166</td>
<td></td>
<td>35,200</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>30,102</strong></td>
<td><strong>8.75</strong></td>
<td><strong>263,400</strong></td>
</tr>
</tbody>
</table>

(i) - Annual synergy has been calculated as follows:
Cost savings in Sheldon = 20% x (8,542+11,248) = $3,958 million
After tax (assuming tax @ 20%) = 3,958 x (1-20%) = $3,166 million

As the above calculation shows, the acquisition should add approximately $35,200 million in total to the combined company value. This makes the maximum value of Sheldon to the Look Group $105,200 being their current market value plus the additional value created by synergy (70,000 + 35,200).

Per share this is $13.15 \{105,200 / 8,000\}.

2 - Initial Offer: $10.94 per share

The valuations in part 1 will result in an initial offer falling somewhere between $8.75 and $13.15 per share.

Sheldon’s existing shareholders will be looking for a premium over the current share price or else the bid will be rejected. The working assumptions state 25% as a possible level of premium although I question the acceptability of this (see below).

25% premium will give an initial bid of $10.94 per share \{$8.75 x 1.25\} or $87,520m in total on the 8,000 million shares in issue.

3 - Impact on share price

Based on Look Group’s current share price of $7.91 this consideration of $87,520 will require 11,064 million shares to be issued to the Sheldon shareholders in exchange \{$87,520 / $7.91\}.

Following the acquisition, the Look Group share price would then be expected to rise to $8.48 based upon Look Group’s new total value of $263,400 million and the 31,064 million shares now in issue.

Overall, an increase of 57c in the share price (7% rise).

4 - Thoughts on bid value

The initial proposed bid of $10.94 is approximately in the middle of the range of values calculated in part 1.

Also, the post acquisition share price should have moved to $8.48 which is an increase of 7%.

Whilst this appears acceptable at first glance, on closer inspection, there are problems.

Firstly, if we offer $10.94 for Sheldon’s shares, in total this is a bid of $87,520 million. Compared with Sheldon’s current value of $70,000 million it means that Sheldon’s shareholders will be receiving a premium of $17,520 \{$87,520 - $70,000\}.

This will mean that the synergy value appears to be being split as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Look Group</td>
<td>$17,680</td>
</tr>
<tr>
<td>Sheldon</td>
<td>$17,520</td>
</tr>
<tr>
<td>Total</td>
<td>$35,200</td>
</tr>
</tbody>
</table>
Given that Look Group is just over twice the size of Sheldon, this appears an unfair sharing of the gains and our existing shareholders are unlikely to be pleased with this division and consequently shareholder approval is doubtful. However, the sharing of the synergy is even more unbalanced than this.

Given the proposed share for share consideration, further gain will go to Sheldon’s shareholders as their current share price is higher than Look Group’s at present. Consequently, they will receive 11,064 million Look Group shares for the 8,000 million shares in Sheldon they currently own.

This will further shift gain away from Look Group’s shareholders to Sheldon’s. The actual sharing of the value gains between the two groups of shareholders will be as follows (post acquisition values based upon the share price calculated of $8.48):

<table>
<thead>
<tr>
<th></th>
<th>Number of shares</th>
<th>Pre-Acq value</th>
<th>Post-acq value</th>
<th>Gain value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Look Group</td>
<td>20,000 million</td>
<td>158,200 $ million</td>
<td>169,600 $ million</td>
<td>11,400 $ million</td>
</tr>
<tr>
<td>Sheldon</td>
<td>11,064 million</td>
<td>70,000 $ million</td>
<td>93,800 $ million</td>
<td>23,800 $ million</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>31,064 million</strong></td>
<td><strong>228,200 $ million</strong></td>
<td><strong>263,400 $ million</strong></td>
<td><strong>35,200 $ million</strong></td>
</tr>
</tbody>
</table>

As can be seen from above, Sheldon’s shareholders will obtain a total gain of $23,800 which represents 68% of the total gain - a wholly disproportionate share given the current values of the companies.

I think it should be our own shareholders receiving ⅔ of the gains given we are twice the size.

From our shareholders’ perspective, this proposal is too one-sided in favour of the Sheldon shareholders.

Rectifying this could be a problem however as in order to ensure our shareholders receive the larger share of the gain, fewer shares need to be issued. This means either lowering the bid or structuring the consideration in another way.

To ensure our own shareholders get approximately ⅔ of the gains would mean lowering the total bid by around $11,000 million to approximately $76,520 million. This would represent a bid of around $9.57 per share. Sheldon will see this as a premium of around 9% {(9.57-8.750)/8.75}.

In share for share exchanges, this level of premium is likely to be unacceptable. Typical share for share exchange premiums have been know to be anywhere between 20% to 40%. Even the current 25% used would be considered to be low and it is acceptability questionable.

An alternative to lowering the bid yet still allowing Sheldon to receive their premium could be to offer a mixed consideration, ie a mixture of cash and shares or bonds as well. This would reduce the number of shares being issued while still giving them the consideration they need to accept the bid. This could also be potentially more acceptable to our shareholders.

Another option could be a purely cash based offer which would then reduce the gain going to Sheldon resulting from any share price increase in Look Group post-acquisition. I know however that this is not being considered at present but I would advise discussing this.
Of course, if more synergy can be found, that could be another way of improving the gain for our shareholders. This can be dangerous however, as we may create synergies that are not justifiable or even feasible in an attempt to make the acquisition appear viable. We must be confident in the synergy.

My recommendation would be to abandon the current share for share offer and consider a mixed consideration or even a full cash bid.

Hope this helps

Regards

EXERCISE THREE

Errors

 Lease Interest cashflow

The interest on the lease has been incorrectly shown in the leasing appraisal as a separate cashflow. The interest element of a finance lease is tax allowable so the calculation is correct to show the tax relief on it as a cashflow but the interest itself is already part of the $501 million lease payment each year. The interest line therefore needs taking out of the leasing appraisal.

 Lease Interest Calculation

The calculation of the interest is also incorrect as in the working of interest at the bottom, it has been deducted from the outstanding capital brought forward. It should be added to the outstanding capital brought forward. This explains why at the end of 5 years the outstanding amount is negative instead of zero and why in year 5 we appear to be receiving interest.

Depreciation

The calculation of tax allowable depreciation is correct but it should not be shown as a separate cashflow in the buying appraisal as it is not even a cashflow. Only the tax relief on it should be shown, which it has. The depreciation line therefore needs removing from the buying appraisal.

 Net result

Having put those corrections through, the results should be closer as the buying PV will significantly reduce having taken the depreciation out.

Given the same interest rates of 8% and equal depreciation, they should certainly be very close to one another.
Non-errors

Discount rate - 6.4%

The use of 6.4% is correct. Although the interest rate on both the lease and loans would be 8% the cashflows need to include the tax effects and consequently the net cashflows are after tax. The discount rate therefore must also be after tax so given the tax rate of 20%, that is why 6.4% is being used \(8\% \times (1-0.2)\).

Exclusion of loan cashflows

It is correct to exclude the loan cashflows providing the post-tax cost of the loan (6.4%) has been used as a discount rate, which it has. If the loan cashflows were to be included along with their tax effects, the NPV of the loan cashflows when discounted at the post-tax cost of the loan would be zero. Therefore the cashflows can be left out as they do not affect the result.

Decision criteria

The resulting calculations will still result in two negative results as we are looking at financing an asset, i.e. we are looking at costs only. Therefore, whichever is the smallest negative would be the most financially advantageous.

I know the figures need correcting but looking at the two results at present, we would lease as $2,111,521 (PV of leasing) is less than $3,353,465 (PV of buying). The result may change of course once the calculation has been corrected.

Accounting Treatment

If purchased with a loan, the $2,000 million asset cost will need capitalising in the statements of financial position under plant and equipment and depreciated on an annual basis.

The loan would need showing as a liability, split between current and non-current if repayable in instalment as any capital repayments in the coming year would need showing as current liability.

Interest payments on the loan would go through the finance charges line of the income statement on an annual basis.

If a finance lease is adopted instead, there would not be any difference in the accounting treatment. Finance lease are treated in the same way as if the asset had been purchased by ourselves and financed with a loan. Therefore the above accounting treatment adopted for the loan is exactly the same for the finance lease.

Other Factors

Maintenance
Your email made no mention of maintenance. If we buy the equipment then we are responsible for the maintenance but the lease could be different. Having said that, finance leases usually require the lessee rather than the leasing company to maintain the asset but this should be investigated.

Residual Value

Nothing has been assumed for residual value in the appraisal. If there is significant residual value then this could favour buying the assets rather than leasing. If we were to lease, the rights to residual value would depend upon the terms of the lease and is another area to be investigated. Given the fact that it is a finance lease suggests that residual value will be low (less than 10% of original value).

Other finance options

Have we considered other ways of financing this investment. We do have significant retained cash and marketable securities at present ($47,944 million) so depending upon our cash requirements for the next 5 years, using our own cash could be an option in order to save interest cost.

Gearing

Both options will increase gearing but not significantly. Book value gearing is currently 9.3% but would increase to approximately 11.4% following the investment \( \frac{(4800+2897+2000)}{(4800+2897+2000+74967)} \). This is unlikely to have a significant effect on our investors’ perceived risk of the company.