Multi Subject Assessment Stage

The Institute of
Chartered Accountants
of Pakistan

11 June 2024
4 hours and 15 minutes – 100 marks

Management Professional Competence

CRN:						

Name: ______________________________

INSTRUCTIONS

Please carefully read the following instructions:

1. You are required to access your answer working area by using your Student ID and Password as mentioned on your Admit Card.
2. The overall duration of the exam is 4 hours and 15 minutes, which includes the reading time and an extra 30 minutes of time that has been allocated due to the introduction of computer-based examinations.
3. All questions are compulsory.
4. Questions can be attempted in any sequence.
5. There is no specific time allocated for individual questions.
6. An auto-save function runs every minute. Further, your answers are saved automatically when you navigate between questions or click on the > **(NEXT)** or < **(BACK)** symbols.
7. Each question provides an answer area with a Rich Text Format (RTF) editor for writing your answers. Additionally, below the RTF editor, a spreadsheet is provided to facilitate examinees in doing rough calculations or other workings. **However, please note that any work performed in the spreadsheet will not be considered for marking. To ensure your work is considered, you must copy and paste it from the spreadsheet to the RTF editor.**
8. Work done in the spreadsheet of one question can also be copied into the RTF editor of the same or another question.
9. You may use Microsoft Office applications such as MS Word or MS Excel for rough working. However, please remember that any work performed in these applications cannot be copied into the examination software, and vice versa. Furthermore, any such work will not be uploaded with your exam for marking.
10. You may use pen and paper for rough work, but please note that pen and paper work should only be done on the last two pages of the question paper that are specifically allocated for this purpose. Remember that any rough work done on these pages will not be uploaded with your exam for marking.
11. In accordance with the open book policy of this paper, you are allowed to have a maximum of **FIVE** original books duly bound. Please ensure that the books or notes you bring are permissible under the open book policy. Keeping a book or notes that are not permissible will be considered a violation under the policy on the use of unfair means.
12. An external calculator can be used, provided it is included in the list of permissible calculators issued by ICAP.
13. During the exam, access to any website other than Assessment Master is strictly prohibited. Engaging in such activities will be considered a violation under the policy on the use of unfair means, leading to disciplinary action.

QUESTION 1

Karachi Organix (KO) is a successful, all-equity financed, family-owned organic skin care product and moisturiser business based in Karachi. KO has high corporate social responsibility (CSR) credentials, including not testing on animal. It manufactures an exclusive range of products in a small factory in the Bin Qasim industrial zone in Karachi, made from ingredients supplied by carefully selected Pakistan-based suppliers. It sells exclusively to the Pakistan market, and has been reluctant to sell overseas as the family feel they know the Pakistan market much better than anywhere else.

The eldest sibling, Pervaiz Larik, is moving to a reasonably small island state in the South Pacific, where his wife's family is from. The island is a developing nation whose small population has a low income per capita. Economic activity currently consists largely of subsistence farming. Poverty is widespread, and the newly elected government is keen to attract foreign investors to help develop the economy. The island is ideal for growing oil palms, the fruit of which is used in the manufacture of palm oil. Palm oil can be used as an ingredient in cosmetics, food production, cleaning products or as a biofuel.

Pervaiz is keen for KO to invest in palm oil production in his new home, and the CEO and wider board have approved the idea in principle. The new business, 'Pacific Palm', will initially aim to supply the mass-produced food market. Palm oil from the island is expected to be average to below average quality for the first few years of production. In the long term, Pervaiz aspires to improve the quality and move more into cosmetics, but it will take time to refine the manufacturing process to produce palm oil of a sufficient quality.

The government of the island state is offering tax incentives for KO to invest, provided it commits in the next month but, if KO accepts the incentive package, it will face certain conditions and restrictions imposed in return. KO can opt to reject the government's offer and continue to invest as normal, if it so wishes. The head of finance – Daanish Larik – is considering the advantages and disadvantages of the offer before deciding whether or not to accept (**Appendix 1**).

Employment law is weak in the island state. Partly due to this, and partly due to the state of the economy, labour costs are low. Pervaiz intends to take advantage of the low costs to produce a competitive product – in his view, the potential volume of sales will help to build the brand internationally and secure employment for citizens of the island state for years to come.

The current organisational structure of KO is functional in nature (**Appendix 2**). The board is concerned that the new palm oil business will not be well served by the current structure, but is keen to utilise the skills of the current functional teams in the new venture wherever possible.

A marketing plan will be needed to launch the new product internationally. The existing marketing function in KO has been given responsibility for the plan, but it requires assistance.

The island state uses US dollars as its currency, so Pervaiz does not see the need to spend money on managing foreign exchange risk, given how stable the US dollar tends to be. Daanish explained to Pervaiz that this was not true, and outlined some alternatives to help manage foreign exchange risk for him to consider (**Appendix 3**).

Requirements

(a) Evaluate the current plan for KO to invest overseas in palm oil production using the criteria of suitability, acceptability and feasibility. ***(No calculations are required in this part)*** **(08 marks)**

(b) Recommend and justify a new organisational structure for KO should it invest in the new palm oil business, and discuss whether it would be worthwhile for KO to take the tax incentives from the island state's government. Provide supporting calculations. **(16 marks)**

(c) Prepare and justify an outline marketing plan for the new product, using the headings of Product, Price, Promotion, and Place. **(06 marks)**

(d) Recommend and justify a foreign exchange risk management strategy for the new palm oil business. **(05 marks)**

(e) Discuss the ethical issues surrounding the plan to take advantage of low labour costs and poor working conditions. Recommend how KO should proceed in relation to this matter. **(05 marks)**

(f) Identify the possible ways of repatriating the profit to Pakistan in a legal manner and discuss the tax implications for KO of each of the possible ways. **(10 marks)**

Total: 50 marks

APPENDIX 1 – INVESTMENT INCENTIVE PACKAGE

EMAIL

To: Pervaiz Larik
From: Daanish Larik
Subject: Pacific Palm government incentives
Date: 12 May 2024

Dear Pervaiz,

I hope you are well. Further to the discussion held at the board meeting last week, I would urge caution in respect of the incentive package offered by the island's government in relation to the Pacific Palm investment. I fully appreciate that the incentive package means you will not have to pay corporation tax for the first three years but, please bear in mind, this generous incentive comes at a cost:

- No repatriation allowed of dividends for the first five years. I would ideally be seeking to repatriate 80% of profits at the end of each year. Under the incentive scheme, we'll bring 80% of cumulative profits after tax back at the end of Year 5.
- A requirement to operate below the legislated pollution restriction for the first five years. This will significantly increase our operating costs – by up to 7% of sales a year for the first five years.

Also, bear in mind the following:

- Revenue equivalent of PKR 500 million expected in the first year of production, doubling annually for the first five years
- Operating margin of 50% annually
- Profit before tax of 20% of sales each year
- Tax at a rate of 35% locally

Even if we assume a constant USD:PKR exchange rate, I'm not at all convinced it is worth taking the incentive package. I will revert with suitable calculations. As mentioned, I believe a cost of capital of 10% is applicable to the cashflows of, and the dividends remitted by, Pacific Palm. I will be basing my recommendations on the net present value impact of the incentive package, although I appreciate there are also wider considerations.

Let us both consider this matter further, and meet next week to discuss in more detail.

Best wishes,

Daanish

APPENDIX 2 – EXTRACT FROM BOARD MEETING MINUTES

Board meeting: Karachi Organix

Date: 7 May 2024

Apologies: None

Organisational structure of Karachi Organix

Jasrah Larik, the head of human resources, explained the current structure of the group as a basis for further discussion on how Pacific Palm could be integrated into the group:

'We have a traditional functional structure which has served us well. We currently serve one industry in one country, so our functional structure allows functional specialists to focus on their 'part' of our one plan. Our departments include:

- Finance
- Human resources
- Sales and marketing
- Production and distribution
- Procurement
- Information technology (IT)

I am concerned that the inclusion of Pacific Palm into the group structure will defocus the business and cause confusion, however I am reluctant to create separate new functions as the skill sets in the current KO functions are exceptional and work together well.'

Jasrah agreed to circulate her proposal for a revised structure in the coming week.

… end of extract.

APPENDIX 3 – FOREIGN EXCHANGE RISK MANAGEMENT

Memorandum

To: Pervaiz Larik
From: Daanish Larik
Subject: Pacific Palm foreign exchange hedging
Date: 15 May 2024

Dear Pervaiz,

I hope you're well. Whereas I fully appreciate your comment at the last board meeting that the US dollar used locally on the island you are moving to is relatively stable, we must be mindful that many of the sales we make will be in other currencies, and the PKR:USD exchange rate is not necessarily very predictable. This is new territory for us given our wholly domestic operations to date!

The alternatives I suggest we explore further include:

- Invoicing all Pacific Palm customers in US dollars;
- Financing the operation with a US dollar loan, perhaps sourced from the island state itself; and
- Using forward contracts to hedge Pacific Palm sales income, and also to hedge repatriations to Pakistan.

We need to be practical in the early days while we become accustomed to managing overseas operations. I'm sure you'd agree.

Can you please let me know your thoughts?

Thanks and regards

Daanish

QUESTION 2

Peshawar Gym Equipment (PGE) is a listed manufacturing business that designs and builds hi-tech gym equipment such as running and cycling machines.

In recent years, the company has invested successfully in artificial intelligence (AI) to improve the effectiveness of workouts offered by their equipment. On-board technology monitors the performance of individuals and tailors the difficulty and variety of programmes to suit their current fitness levels and goals. The AI is also potentially adaptable to all kinds of fitness activity. For example, the software designers have suggested the AI could reside on a smart watch and monitor performance when walking or running using the watch to monitor heart rate and blood oxygen levels. They are keen to develop an app to act as a 'hub' for all of a customer's fitness activities. PGE's AI is improving all the time, not just through software development but through the use of big data gathered from existing customers to tailor constantly improving suggested workouts.

The board of directors increasingly see their business as a software business as opposed to manufacturing, and they increasingly struggle to successfully manage both. Although the board is supportive of the software side of the business and can see its potential, the majority of the board members come from a manufacturing background. Two of the three large institutional investors in the company are increasingly concerned they do not understand the software side of the business well enough, as they initially invested in a manufacturing business. However, the third institutional investor thinks the company should exit manufacturing altogether and focus purely on fitness software development.

At a recent board meeting (**Appendix 1**), the board considered the possibility of demerging the two businesses to try and simplify management and to appease the shareholders.

Following the board meeting, the head of finance (Elmar Wazir) gathered some information to enable the finance team to prepare relevant calculations relating to the proposal (**Appendix 2**).

Requirements

(a) Evaluate the financial and non-financial value that is likely to be created by the demerger for the company and its investors. Provide supporting calculations. **(12 marks)**

(b) Explain how PGE could use the big data gathered so far to create and enhance competitive advantage. **(07 marks)**

(c) Recommend steps to increase the digital skillset of the board and employees of the software business. **(06 marks)**

Total: 25 marks

APPENDIX 1 – BOARD MEETING MINUTES EXTRACT

PGE Board meeting
8 April 2024

Chair: Darab Masud
Apologies: Zuhra Kundi, HR

Demerger proposal
The chair, Darab Masud, led a discussion concerning the ongoing coexistence of the software and manufacturing streams of the business. He tabled communications from three institutional shareholders (with a combined shareholding of 70%), which expressed concerns over the future direction of the business.

Two of the institutional shareholders were particularly long standing – they invested in PGE when it was first listed. They said that, although they appreciated the growth potential of the software side of the business, PGE was added to their portfolio as a manufacturing business, and they were concerned with the increasing systematic risk of the business being driven by the growing significance of the software side. Most of the board agreed with this sentiment and said they struggled with developing a vision and strategy for the software side of the business, given that software was not their specialism. There were two out of the ten board members present with an IT background who noted that they felt the same about the manufacturing side.

The third institutional investor felt that the manufacturing side of the business was holding back the software development side, and that the software business would benefit from being freed up to expand in any number of new directions.

Darab proposed to investigate the possibility of demerging the two sides of the business, by:

- Putting the software management, assets and trade into a new entity; and
- Issuing one new share in the new entity for each share currently held by the existing shareholders.

Elmar Wazir agreed to develop the formal business case for presentation at the next board meeting.

Digital skillset
The board agreed that their majority manufacturing background meant they did not have the knowledge or experience to manage the software business optimally, even though some management and staff would need to move to that side of the business in the event of a demerger. Addressing this issue was deferred until the next meeting, where Zuhra Kundi would be asked to present a plan to upskill the board and staff appropriately.

… end of extract.

APPENDIX 2 – DEMERGER PROPOSAL

To: Khaan Banuchi, Financial Controller
From: Elmar Wazir, Head of Finance
Subject: **CONFIDENTIAL: Demerger proposal**
Date: 10 April 2024

Hi Khaan,

I hope you and your family are well. As discussed, I need us to work on the business case to consider demerging the manufacturing and software sides of the business.

Here is a summary of the forecast Profit or Loss account for the year ending 30 June 2024 for PGE. Let's assume these are an accurate prediction for the year:

	Rs. in million
Revenue	24,950
Variable cost	(9,980)
Contribution	**14,970**
Fixed operating cost	(4,970)
Operating profit	**10,000**
10% interest payable	(2,000)
Profit before tax	**8,000**
Tax at 33%	(2,640)
Profit after tax	**5,360**

The following estimates and assumptions are also relevant to our calculations:

- 70% of revenue relates to manufacturing, which creates a contribution margin of 50%.
- 80% of fixed operating costs relate to manufacturing.
- The bank loan financed the new factory, and is secured on the property, plant and equipment of the factory where we manufacture equipment.
- Tax will be payable at 33% (29% + 4% supertax) for the foreseeable future.
- The equity beta relevant to manufacturing is 1 and, for software, is 3.
- The risk-free rate can be assumed to be 15%, and the market risk premium 5%.
- Software earnings are expected to grow at 17% per annum indefinitely, but manufacturing is only expected to grow at 8% going forwards.
- The current cost of equity is 25%, and our steadily growing earnings were PKR 4,027 million three years ago. I would expect the average annual rate to continue going forwards if we don't demerge.
- For our purposes, assume retained earning equal dividends paid each year.

QUESTION 3

Quetta Fruit Growers (QFG) is a successful family business. It has peach, plumb, apricot and apple orchards in Quetta, Balochistan. Its mission is to be the best environmentally friendly producer of organic fruit in Pakistan, for sale to high quality caterers and shops worldwide. It has won many awards for the consistency and flavour of its produce, and commands a premium price as a result.

It is looking to expand into the competitive melon farming business, and is considering the acquisition of Quetta Lotta Melon (QLM), a successful business owned by the Syed family, run by the charismatic eldest son – Gunjal. Gunjal is looking to retire and sell the business, having built it from nothing over four decades. The business is successful but very labour intensive. Many of Gunjal's customers and employees have been with the company over many decades, and are steadfast and loyal to Gunjal who maintains close relationships with all of them. Most customers are located in Pakistan.

As part of the due diligence work into the QLM business, QFG has drafted a balanced score card for the business to assist with assessing its future viability (**Appendix 1**).

The board have been discussing corporate social responsibility (CSR) policies that should be in place as QFG seeks to expand. The current policies are seen by some members of the board as being 'greenwashing', and these members want to push CSR more into the heart of the business (**Appendix 2**).

A new type of genetically modified (GM) melon is being considered for the new business, which can remain in storage for up to two years. The melon uses less water than the non-GM equivalent, but still uses significantly more than QFG's existing product range, which would make it necessary to import water from outside the plantation. Although useful for sales outside the growing season, the board is concerned about the impact the GM melon may have on their CSR credentials and also on their working capital.

Requirements

(a) Assess the current CSR policies of QFG and recommend changes that need to be made should the melon business be acquired and the new type of melon introduced. **(08 marks)**

(b) Assess both the performance and prospects of the potential acquisition from a financial as well as a non-financial perspective. **(08 marks)**

(c) Recommend how the human resources risk posed by the acquisition of QLM could be managed. **(04 marks)**

(d) Discuss the impact the new type of melon could have on working capital, and recommend how this could be managed. **(05 marks)**

Total: 25 marks

APPENDIX 1 – QLM BALANCED SCORECARD

DRAFT

Prepared by: Mane Magsi, 25 April 2024

	2023	2022
Customer		
Percentage of revenue from existing customers	98.5%	98.5%
Average length of existing customer relationship	18 years	17.8 years
Innovation and learning		
Staff training as a percentage of the standard working week	0.2%	0.5%
Staff turnover (percentage of staff who are replaced annually)	15%	10%
Percentage of revenue from new varieties introduced in the last five years	Nil	Nil
Internal business processes		
Gallons of water per square foot of ground per week	2.3	2.5
Percentage of fruit discarded by weight	18%	15%
Carbon footprint (kilogrammes of CO_2 per kilogramme of melon)	0.16	0.18
Financial		
Return on capital employed	27.2%	27.5%
Revenue growth percentage	–1.2%	0

APPENDIX 2 – BOARD DISCUSSION ABOUT CORPORATE SOCIAL RESPONSIBILITY (CSR)

Transcript – extract of video conference call between board members
Date: 14 January 2024

On the call:
CEO: Babu Magsi (BM)
Finance Director: Mane Magsi (MM)
Operations Director: Talha Magsi (TM)
Human Resources Director: Dawood Magsi (DM)
Marketing Director: Gulnar Magsi (GM)

… start of extract.

BM: 'OK, next on the agenda is our corporate social responsibility policies, or CSR. Gulnar, can you outline what our stated policies include?'

GM: 'Certainly. These are the policies we state:

- Reduce the carbon footprint per piece of fruit delivered to our customer each year
- Ensure all our fruit is natural and organically grown
- Source 75% of our energy from renewable sources
- Pay our employees and suppliers a fair price/wage
- Have an employee forum for staff to voice concerns over conditions
- Be self-sufficient for water'

TM: 'I'm concerned about how we work with these policies. For example, increasingly we encourage customers to arrange collection and say 'it's their carbon footprint not ours.' We hold the employee forum meeting only once a year, and rarely implement any suggestions. We say we source our energy from renewable sources, but all we do is purchase offset credits and use dirty energy anyway. It's a sham!'

GM: 'Steady on Talha! Technically we deliver on all our CSR promises. You can't deny it!'

BM: 'OK. I think Talha's concerns may be valid. Talha, can you and Gulnar have a rethink and refresh our CSR policies, especially as the purchase of Quetta Lotta Melon could impact on our CSR performance? I'd like you to report back at the next board meeting. Is that OK?'

… end of extract.

(THE END)