Chapter 6 Management and cost accounting information

Questions

1. Pinfold and Patel Limited is a discount trading company which is still run by its founder directors, Peter Pinfold and Usman Patel. The business has been successful over the years, supplying a wide range of imported goods to retailers and wholesalers.

   An opportunity has arisen to acquire a retail outlet and the directors are considering the expansion of their operations. They need to decide in principle: (a) whether or not to make the acquisition; and (b) how the acquisition could be financed. The asking price of the retail outlet is £1.1million and the business has spare cash resources of only £200 000.

   What items of information, both financial and non-financial, are likely to be useful to the directors in making these decisions?

2. Shelby Garden Designs Limited is a company with a successful record in selling garden ornaments (gnomes and so on) to retail outlets. However, the market for its products has declined in recent years; the availability of cheaper ranges of goods imported from outside the UK has had a detrimental effect on the company's market share. The production facilities have been scaled back several times, and they now occupy only about 60% of the space available in the factory. The factory, which is owned outright, occupies a potentially very valuable piece of land near to the centre of a town with a housing shortage.

   Shelby's production director, Esmond, has written a report for his fellow directors in which he discusses possible future uses for the spare capacity. The conclusion to the report advocates investment in new machinery which would produce garden netting of various strengths. Esmond thinks that, with new machinery, the company could produce netting very efficiently and would be able to compete on price with the existing market leaders.

   As one of Esmond's fellow directors, you are required to jot down the principal questions which you would want to put to Esmond at the next meeting of the board.

Answers

1. Pinfold & Patel Limited

(a) Deciding whether or not to make the acquisition

This acquisition would represent a major strategic development for the company and its directors. Pinfold and Patel is a discount trading company which makes money by selling goods to retailers and wholesalers. If the company acquires a retail outlet of its own it enters a different kind of business. If the acquisition were to be successful the company would be able to channel some of its goods through the retailer, selling directly to the public. This could achieve significant economies and would allow the company to benefit from a greater proportion of the profit. The directors should be looking at the following types of information:

- Information about the current levels of profitability of the retail outlet. This would be obtainable from recent sets of accounts.
- Projected turnover and profit levels for the retail outlet. This information would not normally be available to interested parties outside the company, but Pinfold and Patel, as prospective purchasers, should be able to obtain some of the management accounting information which would normally be confidential.
- Details of existing managers and staff employed. Would key members of staff be likely to stay? What incentives might they require to make them stay? (this is particularly important for Pinfold and Patel who do not, it seems, have any experience of running a retail outlet).
- Information about the type of products stocked. The company makes money by selling goods at a discount. If the retail outlet is a high class, full margin type of business, there is likely to be a poor match with Pinfold and Patel's existing business.

[There are many other valid points that could be mentioned here]

(b) Deciding how to finance the acquisition

In order to obtain finance from external sources, the directors will need to produce a business expansion plan. In the plan, they will have to explain their strategy, setting out the reasons for the alteration to the company's strategic direction. They will use some of the information noted in part (a) above to produce financial forecasts to support the application for finance.

The directors are not in a position to finance the acquisition through the existing resources of the company, and so they will have to examine the range of available external sources of finance. These include:

- *Commercial borrowing*. The directors need to investigate possible commercial lenders in order to identify the best financing deal. Rate of interest, repayment schedules and terms and conditions of lending will all form part of the information which feeds into the decision.
- *Venture capital*. The situation described in the question is one where venture capital financing might well be appropriate. A venture capital firm would probably require an equity stake (i.e. a shareholding) in the company and at least one seat on the board of directors. The advantage to Pinfold and Patel of this arrangement is that the venture capital firm would probably be able to provide them with a retail specialist as a director. Pinfold and Patel, however, need to be clear on the extent to which they are prepared to accept outside help. If they are inclined to see it as meddling interference, the venture capital route might not be appropriate.

2. Shelby Garden Designs Limited

Questions for Esmond:

1. What problems are likely to arise if the company attempts to break into the garden netting market? (The existing market leaders will not abandon their market share without a fight. They are more experienced in the market than Shelby and may be better able to compete because of factors such as reputation for reliability, good sales contacts and so on).
2. How robust are the financial projections which have been prepared by Esmond? What assumptions has he used to estimate future sales and costs?
3. The new machinery could well be able to produce garden netting very efficiently, but is it safe to assume that competitors will be less efficient? How much information does Esmond have about the production capacity of the competitors in this market?
4. Has Esmond considered the possible alternative use for the land on which the factory is built? If planning permission could be obtained for a change in use from industrial to residential, the company could make a lot of money by

selling its factory (which is too large) and moving elsewhere to production facilities of a more suitable size.

5. What are the other possible uses for the spare capacity in the factory? Have thorough financial projections been prepared for them, so that the directors can weigh up the various options?