

Forge Group Ltd Case Study (B)

Director Duties, Management Compensation and Ownership, Risk, and Ethics

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THE FORGE STORY

Forge Group Ltd (FGL) was a successful engineering and construction company based in Australia, listed on the Australia Stock Exchange with 2,000 employees and operating across eight countries. On March 6, 2013, its share price peaked at \$6.98. (All monetary amounts discussed herein are in Australian dollars. To convert to another currency, visit www.x-rates.com.) It was on a growth path and had \$1.5 billion in forward orders on its books. Within 12 months, it was out of business. Voluntary administrators and receivers were appointed in February 2014.

THE ENGINEERING AND CONSTRUCTION INDUSTRY

The engineering and construction sector provides significant economic activity in many countries. The industry is typically seen as high risk due to the nature and size of the contracts. The contracts typically span long periods of time, which adds tremendous uncertainty given the forecasting required and large amounts of capital involved. Joint ventures and public/private partnerships are common in the industry to reduce the risk of large-scale projects and to ensure adequate capital and expertise. Major contracts generally involve a number of different companies with primary contractor and sub-contractor status,

all tendering and quoting on various stages of work in a project. This makes the industry highly competitive, and the value of appropriate costing and project management expertise is vital.

After the Global Financial Crisis (GFC), large-scale mining and construction projects had been the driving force for some economies, especially in Australia. But recently there has been a decrease in activity in this area because a number of projects were completed and moved to production phase. In Australia in 2013-2014, the engineering and construction spend was \$128 billion, dropping \$1 billion from the previous year. This decline increases competition in the sector and therefore demand for lower-priced contracts and shorter completion times. The market value of a company is based partly on its future secured order book. The sector is risky, and many companies have suffered as a result of stalled projects, poor costing, and mismanaged cash flow.

THE FORGE GROUP LTD STORY

The company was formed from a private construction company called AiConstruction and listed on the Australian Stock Exchange at \$0.56 on June 26, 2007. The company's path was one of acquisitions and organic growth since it survived the GFC and leveraged the mining and construction boom. In April 2010, another construction company called Clough bought 13% (10.5 million shares) of the FGL ordinary shares, thus becoming the largest shareholder. This sent a confident message to the

investment community in FGL's future. Clough continued to purchase shares until it divested its total holding of 35% in March 2013. Clough management explained its divestment by indicating that expectations of joint ventures between the two companies did not eventuate and therefore the equity holding was cashed in to allow the pursuit of other objectives.

In January 2012 FGL undertook a major acquisition by purchasing CTEC Pty Ltd. In essence, the acquisition meant the takeover of two major projects: The Diamantina Power Station (DPS) Project in Queensland, Australia, and the West Angelas Power Station (WAPS) Project in the Pilbara region of Western Australia. It was expected that these major projects would add \$7.5 million and \$10.8 million to EBITDA in 2012 and 2013, respectively. The purchase price was \$16 million up-front with further payments due on the meeting of specified performance targets (total paid was \$32.26 million). This increased FGL's contract book significantly, and its share price rose in response. In June 2013, FGL acquired Taggart Global for \$43 million. This purchase meant that FGL was now diversifying into asset management and into other economies.

COMPANY STRUCTURE

The company's legal structure is shown in Figure 1, but it essentially had four key divisions. They were Power, Construction, Asset Management, and Minerals and Resources. Since listing, the company raised more than \$99 million in equity from shareholders and as of June 30, 2013, had a market capitalization of \$356 million with net profit after tax of \$63 million on revenue of \$1 billion. The order

book showed more than \$1.5 billion in secure orders to be delivered over the next few years. For engineering and construction companies, the security of its future orders is the lifeblood of the business. Given such a great record and a future that seemed secure what went wrong?

ISSUED SHARES AND SHARE PRICE

The number of issued shares and the share price are shown in Table 1.

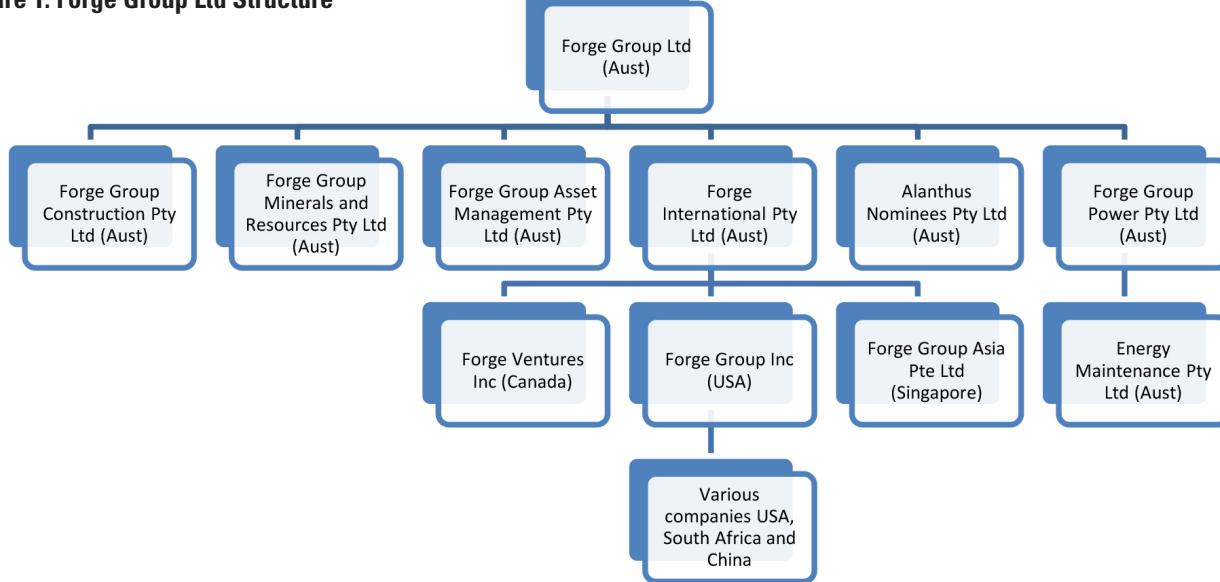
Table 1: The Number of Issued Shares and the Share Price

	2010	2011	2012	2013	2014
No. of Shares	70,699,487	81,541,569	86,169,014	86,169,014	86,169,014
Share Price	\$2.66	\$5.46	\$4.37	\$4.20	

CTEC PTY LTD PURCHASE

In the wash up of the demise of FGL, the attention was paid to two main contracts: The Diamantina Power Station (DPS) Project in Queensland, Australia, and the West Angelas Power Station (WAPS) Project in the Pilbara region of Western Australia. Both projects were acquired under the takeover of the company CTEC Pty Ltd on January 13, 2012. The purchase of CTEC Pty Ltd was to change the business model by bringing work in-house with the intended consequence of taking out the "middle man" and thereby increasing earnings (by negating sub-contractor margins). The CTEC purchase payment terms required an up-front payment of \$16 million with subsequent payments

Figure 1: Forge Group Ltd Structure



conditional on meeting performance criteria (possible further payment of \$40 million in total). CTEC's prior year (June 30, 2011) EBIT was \$2 million, with expected EBITDA at year-end 2012 and 2013 to be \$18.4 million and \$24.8 million, respectively. The DPS and WAPS projects were to increase this expected EBITDA by \$7.5 million in 2012 and \$10.8 million in 2013.

Yet the projects' revised 2013 estimates showed a \$61 million project margin loss for the DPS project and a \$41.7 million project margin loss on the WAPS project. The cost overruns on these two projects led to the profit downgrade and contributed to the resulting shortage of cash.

Added to that is the discovery that there was an early payment to the vendors of CTEC prior to the performance conditions being met. Further, the previous managing director, Peter Hutchinson, was paid a bonus of \$375,000 for a successful acquisition and integration. These payments are the subject of further investigations by the liquidator.

The Administrator's report shows that the actual work-in-progress income for the period was \$126 million below management's forecast; that labor costs were \$70 million over budget; material costs were \$55 million over budget; and work-in-progress overheads were \$22 million over budget.

KEY MANAGEMENT CHANGE

There was a major change in management during 2012. Next is a list of holders of substantive management positions in June 2012 and 2013.

As of June 30, 2012:		
Peter Hutchinson	Managing Director	(resigned July 9, 2012)
Andrew Ellison	Executive Director	(resigned July 31, 2012)
Gregory McRostie	Executive Director	(resigned November 30, 2012)
Marcello Cardaci	Non-executive Director	
David Craig	Non-executive Director	
Kevin Gallagher	Non-executive Director	(resigned March 28, 2013)
Neil Siford	Non-executive Director	(resigned March 28, 2013)
As of June 30, 2013:		
David Simpson	Managing Director and CEO	(appointed July 9, 2012)
Marcello Cardaci	Non-executive Director	
David Craig	Non-executive Director	
John O'Connor	Non-executive Director	(appointed November 29, 2012)
Greg Kempton	Non-executive Director	(appointed November 29, 2012)

Management Compensation and Ownership of Shares

There was very minor ownership of shares in FGL by directors. The ownership of ordinary shares held as of June 30, 2013, by the directors were as follows:

David Simpson, Managing Director	Nil – (653,396 performance rights held)
David Craig, Non-executive Chairman	6,000 shares
Marcello Cardaci, Non-executive Director	Nil
John O'Connor, Non-executive Director	Nil
Gregory Kempton, Non-executive Director	5,000 shares

The remuneration report shows that payments to the key executives combine both a base salary and performance incentive bonuses (see Table 2). The performance bonuses were predominately cash and based on earnings per share (EPS) targets. Performance rights (right to one ordinary share in FGL) were also conferred on key executive subject to the achievement of EPS increases over a five-year period.

Table 2: Remuneration Information

Personnel	Cash Salary and Fees	Sign-on/Retention Bonus	Performance-related Cash Bonus	Non-monetary Benefits	Total Short-term Benefits	Super Annuation	Termination Benefits	Equity	Options and Rights	Total Options	% as Options	Performance Related %
Executive Director												
D. Simpson	2013 \$958,112	\$750,000	\$800,000	\$69,309	\$2,577,421	\$16,470	—	—	\$312,107	\$2,905,998	11%	38%
Former Executive Directors												
P. Hutchinson	2013 27,792 2012 955,710	—	90,000	—	27,792 1,855,710	1,386 50,728	472,362	—	—	501,540 1,906,438	0% 0%	0% 47%
A. Ellison	2013 87,391 2012 848,157	500,000 —	450,000	—	587,391 1,298,157	—	—	—	—	754,827 1,349,471	0% 0%	0% 33%
G. McRostie	2013 431,250 2012 757,388	500,000 —	150,000	—	931,250 907,388	11,058 35,988	—	—	—	942,308 943,256	0% 0%	0% 16%
Non-Executive Directors												
D. Craig	2013 150,601 2012 77,409	—	—	—	150,601 77,409	13,554 6,967	—	—	—	164,155 84,376	0% 0%	0% 0%
M. Cardaci	2013 84,863 2012 77,409	—	—	—	84,863 77,409	7,638 6,967	—	—	—	92,501 84,376	0% 0%	0% 0%
J. O'Connor	2013 54,670	—	—	—	54,670	4,920	—	—	—	59,590	0%	0%
G. Kempton	2013 53,956	—	—	—	53,956	—	—	—	—	53,956	0%	0%
Former Non-Executive												
N. Siford	2013 69,375 2012 71,637	—	—	—	69,375 71,637	—	—	—	—	69,375 71,637	0% 0%	0% 0%
K. Gallagher	2013 69,375 2012 59,060	—	—	—	69,375 59,060	—	—	—	—	69,375 59,060	0% 0%	0% 0%
Senior Executives												
D. Montgomery	2013 368,029	50,000	159,000	—	577,029	12,353	—	—	31,077	620,459	5%	31%
B. Smith	2013 504,294	150,000	195,000	78,080	927,374	37,373	—	—	38,113	1,002,860	4%	23%
C. Ross	2013 113,338	—	45,342	—	158,680	4,118	—	—	22,957	185,755	12%	37%
M. Rankmore	2013 251,225	—	135,000	43,390	429,615	9,608	—	—	26,386	465,609	6%	35%
L. Arasu	2013 117,696	—	81,709	—	199,405	5,490	—	—	20,523	225,418	9%	45%
R. Mancini	2013 241,077	—	126,000	—	367,077	11,927	—	—	21,988	400,992	5%	37%
Former Senior Executives												
A. Bell	2013 97,482 2012 314,771	—	40,413 25,000	—	137,895 339,771	4,804 15,728	—	—	32,287	174,986 355,499	18% 0%	42% 7%
Grand Total	2013 \$3,680,526 2012 \$3,161,541	\$1,950,000 —	\$1,582,464 \$1,525,000	\$190,779 —	\$7,403,769 \$4,696,541	\$145,033 \$167,572	\$635,464 —	Options and Rights	\$305,438 —	\$8,689,704 \$4,854,113	—	—

QUESTIONS

1. Director's Duties, Corporate Governance, and Ethics

- a. Outline the key duties of directors.
- b. Outline the arguments for the directors of Forge Group Ltd that they carried out their duties.
- c. Outline the arguments for shareholders, creditors, and employees that the directors of Forge Group Ltd did not carry out their duties.
- d. Give your opinion, and justification, as to whether the directors of Forge Group Ltd carried out their duties.
- e. On February 18, 2014, journalist Paul Garvey from *The Australian* stated:

“A spokesman for Ferrier Hodgson said the group was aware of claims circulating on social media that allegedly detail expenses incurred ahead of the group’s slip into administration last week. The allegations suggest some senior managers cashed out their leave entitlements earlier this year and relocated to Sydney at the company’s cost...*The Australian* revealed on Saturday that senior Forge managers had been relocated to Sydney at significant expense in the months after Forge first revealed the power station contract issues that ultimately proved fatal...News of the spending and the rumours of the annual leave payout have angered some Forge shareholders whose holdings now appear worthless.”

Assume Paul Garvey’s allegations are founded, compare and contrast the concepts of utilitarianism and Kantianism by using the context of the allegations to illustrate your main arguments.

2. Risk

Reports suggest that the purchase of the CTEC group (and the major contracts assumed with the purchase) was a major element in the company’s demise.

- a. Outline general factors that company directors and management need to consider in relation to risk.
- b. Critically evaluate specific risk pertinent to Forge Group Ltd.

3. Management Compensation and Director Independence

- a. Examine the remuneration information of FGL’s board of directors and key management personnel. Using this information, draw some conclusions as to the actions of directors and key personnel.
- b. Explain director independence. In your view, appraise the independence of the FGL directors. Evaluate whether this was in FGL’s best interest.

REFERENCES

Forge Group Ltd 2013 Annual Report, www.fgl.com.au.

Forge Group Ltd 2011 Annual Report, www.fgl.com.au.

Martin Jones, Andrew Saker, and Ben Johnson, “Consolidated Group Report by Administrators pursuant to Section 439A(4)(a) of the Corporations Act 2001,” Ferrier Hodgson, March 10, 2014, www.ferrierhodgson.com/au/~media/Ferrier/Files/Documents/Corp%20Recovery%20Matters/Forge%20Group/439A%20Report%20Pack.pdf.

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