

ADVANCED LEVEL CASE STUDY EXAMINATION

WEDNESDAY 7 NOVEMBER 2018

(4 HOURS)



CASE STUDY

CANDIDATE NUMBER

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DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

- When instructed to begin the paper:
 - check that your question paper contains all the required pages. The ICAEW's consecutive page numbering may be found under the base line at the foot of each page;
 - enter your candidate number in the box provided above.
- Number each page of your answer consecutively** using the space provided at the top right of each sheet. Ensure that you write your candidate number on each page of your answer. You must do this **before** you are told to stop writing.
- Answer folders and examination stationery, used or unused, must **not** be removed from the Examination Hall. Question papers may, however, be retained by candidates.
- Your answer must be submitted on the paper provided by the ICAEW in the Examination Hall. Any pre-prepared papers, or papers comprising annotated exhibits from the case material, included in your answer **WILL NOT** be marked by the examiners.
- After the instruction to stop writing at the end of the paper, you will be given five minutes to assemble your answer in this folder. You **may not** number pages during this time. Fasten your complete script inside this folder using the hole in the back page and the tag provided. Do **not** include your question paper in the folder. When the assessment is declared closed, you must stop writing immediately. If you continue to write (even completing your candidate details), it will be classed as misconduct.

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November 2018 Case Study: Bespoke Monogramming Limited (BM)

List of exhibits

The following exhibits were included in the material provided as Advance Information:

- 1 About you, Afon Crabbe; your employer, Borax Beadle ICAEW Chartered Accountants (BB); and your client, Bespoke Monogramming Limited (BM)
- 2 The design and related production industry
- 3 BM: history and overview
- 4 Email from Ffion Deans to Penny Price: BM financial and operational history and review of management accounts for the three years ended 30 September 2017
- 5 BM: management accounts for the three years ended 30 September 2017
- 6 Email from Ffion Deans to Penny Price: review of BM business operations for the year ended 30 September 2017
- 7 BM: purchasing and inventory
- 8 BM: computer aided design and production (CADP)
- 9 BM: customer evaluation and making sales
- 10 BM: evaluating suppliers and contracting for supplies
- 11 Email from Gayle Harries to BM board cc Penny Price: review of management accounts, corporate responsibility, commercial review
- 12 Email from Shelly Drapes to BM board cc Penny Price: customer review for the year ended 30 September 2017
- 13 Email from Viv Baines to BM board cc Penny Price: supplier review for the year ended 30 September 2017
- 14 Media articles

These items are newly provided:

- 15 Email from Penny Price to Afon Crabbe, 7 November 2018: BM
- 16 BM: draft management accounts for the year ended 30 September 2018
- 17 Email from Ffion Deans to Penny Price, 7 November 2018: BM operations and financial performance for the year ended 30 September 2018
- 18a Email from Viv Baines to Penny Price, 5 November 2018: new supplier contract
- 18b Recent media articles
- 19a Email from Shelly Drapes to Penny Price, 2 November 2018: new customer contract
- 19b Recent media articles

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Bespoke Monogramming Limited (BM): Case Study requirement

You are Afon Crabbe, a final-year trainee ICAEW Chartered Accountant working in the business advisory unit of Borax Beadle (BB), a firm of ICAEW Chartered Accountants. One of your clients is Bespoke Monogramming Limited (BM), a company which designs and produces bespoke monogrammed bathrobes and towels for supply to businesses in the luxury hotel and related hospitality industry. You report to Penny Price, a partner in Borax Beadle.

Requirement

You are required to prepare a draft report for the BM board, as set out in the email dated 7 November 2018 from Penny Price to you (**Exhibit 15**). Your report should comprise the following four elements:

- An executive summary
- Your responses to the three detailed requirements set out in **Exhibit 15**, including financial appendices (as required).

State clearly any assumptions that you make. All workings should be attached to your answer. Your report should be balanced across the three detailed requirements, and the following time allocation is suggested:

Reading and planning	1 hour
Performing calculations and financial analysis	1 hour
Drafting report	2 hours

Marks allocation

All of the marks in the Case Study are awarded for the demonstration of professional skills, allocated broadly as follows:

Applied to the four elements of your report (as described above)

• Assimilating and using information	20%
• Structuring problems and solutions	25%
• Applying judgement	25%
• Drawing conclusions and making recommendations	<u>20%</u>
	90%

Applied to your report as a whole

• Demonstrating integrative and multidisciplinary skills	5%
• Presenting appropriate appendices	<u>5%</u>
	<u>100%</u>

Of the total marks available, 15% are awarded for the executive summary and approximately 10% for the relevant discussion of ethical issues within your answer to the requirements.

In planning your report, you should be aware that not attempting one of the requirements will have a significantly detrimental effect on your chances of success, as will not submitting an executive summary. In addition, as indicated above, all four skills areas will be assessed under each of the four elements of your report. Accordingly, not demonstrating your judgement or failing to include appropriate conclusions and/or recommendations in each element of your report will affect your chances of success.

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EMAIL

From: Penny Price
To: Afon Crabbe
Subject: BM
Date: 7 November 2018

BM has produced its draft management accounts for the year ended 30 September 2018. BM's board has asked Borax Beadle to help with assessing BM's financial performance for the year ended 30 September 2018. The board has also asked for advice on some specific financial matters and broader strategic and operational issues. I am attaching the following:

- BM's draft management accounts for the year ended 30 September 2018 (**Exhibit 16**)
- An email from Ffion Deans providing additional information about the management accounts and board discussion notes concerning trade receivables (**Exhibit 17**)
- An email from Viv Baines about a new supplier proposal (**Exhibit 18a**) and related media articles (**Exhibit 18b**)
- An email from Shelly Drapes concerning a new customer (**Exhibit 19a**), together with media articles (**Exhibit 19b**).

Please draft for my review a report addressed to the BM board. The report should comprise the following.

1. A review of BM's draft management accounts for the year ended 30 September 2018 in comparison with the year ended 30 September 2017.

Your review should be based on the draft management accounts as set out in **Exhibit 16**. It should cover revenue; each element of cost of sales; gross profit; and operating profit. In your review you should refer to the additional information provided in **Exhibit 17** relating to the draft management accounts. You should also answer the questions raised by the non-accounting members of the BM board in relation to trade receivables (**Exhibit 17**).

2. An evaluation of the proposal to use Wisher as a supplier of base products (as detailed in **Exhibit 18a**).

Using the assumptions in **Exhibit 18a**, calculate BM's cost of sales, gross profit and operating profit, for each of the years to 30 September 2019 and 2020, if BM decides to use Wisher base products. You should evaluate (a) the adequacy of the assumptions and (b) the information about Wisher, referring where possible to BM's supplier criteria (**Exhibit 10**). You should include any business trust and ethical issues, taking account of the media articles in **Exhibit 18b**. Provide a clearly justified recommendation as to whether BM should use Wisher as a supplier for its base products.

3. An evaluation of the potential financial contribution and the issues surrounding the request to supply a new customer, MEC, with BM monogrammed products (**Exhibit 19a**), referring also to the matters identified in **Exhibit 19b**.

You should evaluate the financial, operational and strategic factors against BM's customer criteria (**Exhibit 9**). Include any business trust and ethical issues. You should provide appropriate calculations and commentary to support your evaluation.

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Bespoke Monogramming Limited
Draft management accounts

Statement of profit or loss
Year ended 30 September

		2018
		£000s
	Notes	
Revenue		8,493
Cost of sales	1	<u>(6,941)</u>
Gross profit		1,552
Other operating costs	2	<u>(1,416)</u>
Operating profit		136
Interest charges		<u>(13)</u>
Profit before taxation		123
Taxation		<u>(25)</u>
Profit after taxation		<u>98</u>

Statement of financial position
As at 30 September

		2018
		£000s
	Notes	
Non-current assets		
Property, plant and equipment	3	<u>594</u>
		<u>594</u>
Current assets		
Inventory	4	326
Trade and other receivables	5	<u>1,441</u>
		<u>1,767</u>
		<u>1,767</u>
Total assets		<u>2,361</u>
Shareholders' equity		
Ordinary share capital		200
Retained earnings		<u>556</u>
Total shareholders' equity		<u>756</u>
Current liabilities		
Trade and other payables	6	1,447
Bank overdraft		<u>158</u>
		<u>1,605</u>
		<u>1,605</u>
Total equity and liabilities		<u>2,361</u>

Statement of cash flows	2018
Year ended 30 September	£000s
Profit before tax	123
Adjustments for:	
Depreciation & loss on disposals	159
Interest charges	13
	295
Change in inventory	(31)
Change in trade and other receivables	(354)
Change in trade and other payables	390
Cash generated from operations	300
Taxation paid	(29)
Interest charges	(13)
Net cash from operating activities	258
Investing activities	
Purchase of PPE	(364)
Proceeds from disposal of PPE	12
Net cash used in investing activities	(352)
Net change in cash and cash equivalents	(94)
Cash and cash equivalents at start of year	(64)
Cash and cash equivalents at end of year	(158)

Notes to draft management accounts

Note 1 Cost of sales

	2018
	£000s
Base products	3,982
Monogramming materials	1,925
Production labour	433
Production overheads	601
	6,941

Note 2 Other operating costs

	2018
	£000s
Administrative staff and overheads	879
Marketing and distribution	373
Allowance for impairment of trade receivables	86
Trade receivables written off	78
	1,416

Note 3 Property, plant and equipment (PPE)

	Leasehold Improvements	IT & Machinery	Vehicles	Total
Cost	£000s	£000s	£000s	£000s
At 1 October 2017	114	706	290	1,110
Additions	-	188	176	364
Disposals	-	-	(52)	(52)
At 30 September 2018	114	894	414	1,422
Depreciation				
At 1 October 2017	86	461	162	709
On disposals	-	-	(26)	(26)
Charge for the year	11	82	52	145
At 30 September 2018	97	543	188	828
Carrying amount at 30 September 2018	17	351	226	594

Note 4 Inventory

	2018 £000s
Base products	217
Monogramming materials	109
	<u>326</u>

Note 5 Trade and other receivables

	2018 £000s
Trade receivables	1,328
Other receivables	113
	<u>1,441</u>

Note 6 Trade and other payables

	2018 £000s
Trade payables (see Note 6a below)	1,269
Other payables	178
	<u>1,447</u>

Note 6a Purchases and suppliers

	Annual Purchases £000s	Year-end Payable £000s
Cassio (monogramming materials)	958	143
Fomenta (base products)	1,765	342
Hardy (base products)	1,864	295
Prospectus (monogramming materials)	977	183
Tooley (base products)	374	72
Other suppliers (not products)	-	234
	<u>5,938</u>	<u>1,269</u>

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EMAIL

From: Ffion Deans
To: Penny Price
Subject: BM operations and financial performance for the year ended September 2018
Date: 7 November 2018

Additional information relating to the draft management accounts

- a BM benefited from the Royal Wedding in May 2018, which created £750k of additional one-off revenue from established and new customers.
- b Boreal Spas' expansion enabled BM to increase its revenue from Boreal by 40% this year.
- c The predicted increase in BM revenue from Cosset Hotels also occurred.
- d Deep Wave Cruises (DWC) stopped buying BM products temporarily in March 2018 because of difficulties in BM's delivery of orders. The issue was resolved, and trading was later restored. Revenue from DWC was up overall by just 1% in the year.
- e Both Cassio's and Fomenta's prices increased by an average of 10% by comparison with the previous year. Hardy, Prospectus and Tooley held their prices at the previous year's levels.
- f BM recruited new employees whose training costs are being reimbursed under the UK government apprenticeship scheme. This training subsidy, which amounted to £50k in the year to 30 September 2018, is netted against production labour costs.
- g The investment in new IT and monogramming machines for the CADP system has enhanced the range and complexity of design possibilities and increased production capacity and speed. This resulted in an increase in efficiency in the CADP system.
- h The trade receivables write-off, which occurred in December 2017, relates to Titanic Cruises. After an outbreak of serious illness amongst passengers on a cruise, there was adverse publicity on social media and Titanic suffered mass cancellations. Subsequently, it went into liquidation, owing BM its trade receivable balance as at 30 September 2017.

Trade receivables

In the context of the trade receivables write-off, the following questions were raised by the non-accounting members of BM board:

- BM makes an allowance of 20% of its year-end trade receivables balance. Is this too prudent given all our other controls?
- With the large allowance for impaired trade receivables, could we not use that instead of writing off the actual trade receivable as a separate expense? It is all making our operating profit look much worse.
- Because it is clearly impossible to anticipate which of our customers are going to fail financially, should we not just deal with each problem as it happens, rather than create a problem where none exists?
- It appears that the reason BM cannot get rid of its continuing overdraft is that we have set aside a lot of our funds in the allowance for impaired trade receivables. Can we not just transfer some of that back into the bank account and save the interest payments?

Please answer these questions raised by the non-accounting members of the board. (Do not perform any additional financial statement analysis.)

EMAIL

From: Viv Baines
To: Penny Price **cc:** BM board
Subject: New supplier contract
Date: 5 November 2018

In September 2018, BM was approached by Wisher Limited, a UK company created in January 2017, based near Cardiff. Wisher specialises in producing the items BM uses as its base products, from re-shredded cotton. Wisher is seeking to become an established BM supplier from 1 January 2019. If BM decides to go ahead with Wisher, it would replace some existing base product supplies with those supplied by Wisher.

Assumptions and information

Assumptions

1. BM expects to maintain its annual revenue at the same level as for the year ended 30 September 2018, and that this will accrue evenly within each year.
2. To maximise commercial efficiency in its trade with BM, Wisher would want to be supplying 50% of BM's base products.
3. For the 3-month period to 31 December 2018 BM is continuing to purchase all of its base products from its existing suppliers.
4. In the initial 9-month period to 30 September 2019, the average cost of the base products that BM purchases from Wisher will be 20% more than the average cost of the equivalent base products purchased by BM from other suppliers in the year ended 30 September 2018.
5. In the 12-month period to 30 September 2020, Wisher expects to achieve economies of scale. As a result, it should be able to supply its higher volume of base products for this 12-month period for the same total cost to BM as the total for the initial 9-month period to 30 September 2019. (Therefore, BM would save the cost of purchasing alternative base products for 3 months of this 12-month period.) Wisher's base product costs would remain at the same level after that.
6. Carl Morgan estimates that BM's ongoing testing of Wisher's re-shredded cotton products, to ensure continuing high product quality, might add a further overall 10% to total production overheads in the year ended 30 September 2019 (by comparison with the total production overheads in the year to 30 September 2018). Production overheads would then remain at that increased level after that.

Other information

- Wisher can supply a full range of BM base products (bathrobes and towels). Wisher's base products are all manufactured using re-shredded cotton from local UK sources.
- Given their sustainable source, these base products are created with a slightly off-white colour. This would be acceptable to most of our current clients.
- In the year to 30 September 2019, BM purchases could be approximately 40% of Wisher's total annual sales.
- BM will be responsible for collecting Wisher products and transporting them to its site.
- As a relatively new business trying to manage its cash flow, Wisher gives credit terms of 30 days from invoice date.
- Wisher is supported by Cardiff Local Government in its sustainability and local employment programme.

International Trader**September 2018****Expansion of cotton re-shredding gathers pace**

In what is claimed to be the biggest investment in re-shredding processing plants in Europe, the HT group has recently acquired and created two new processing operations. One is the takeover of Grindle manufacturing business just outside London. The other is located close to Berlin in Germany. Both locations give good access to enormous quantities of unwanted cotton clothes and related products, generated by local retailers, which these re-shredding processes require. HT, which has a major re-shredding site near Stockholm in Sweden, aims to open ten more sites over the next two years, near other major European cities.

HT claims that this new process of re-shredding cotton will become the dominant force in the manufacture of all cotton products within the next five years, and accordingly it is investing heavily in this sector. The process benefits enormously from economies of scale with the cost of re-shredded products predicted to fall sharply, as critical re-shredding levels are reached.

In a change of production process, Grindle's future aim is to draw most of its raw materials from London, which has a huge number of clothes retail outlets. It will also benefit from good access to the local and export markets which it will be serving. Dan O'Hare, the managing director of Cyril (a major clothes retailer in the centre of London), stated: "Having a re-shredding facility nearby will be a huge benefit to London clothes retailers. Getting rid of unfashionable and unwanted cotton clothes inventory is a major problem – in future, it will be collected and dealt with efficiently whenever needed."

Another recently established, independent, re-shredding operation is Wisher, located in the city of Cardiff. It is following a similar path in terms of its location near a major city with access to large quantities of raw materials and looking to achieve a similar pattern of growth.

Geographic Global**October 2018****Shredded fabric responsible for fire risk during manufacture and use**

In a little reported incident in its factory in India, Shredex (one of the new driving forces behind the innovation of shredding and re-compiling different natural fabric) has denied that the end-product of re-shredded cotton created a fire risk. In a statement issued to local press, Shredex has reiterated that the reason for a recent fire, which damaged the building and caused production to cease, was an electrical fault.

Although that may have been true, the relevant fact is that the fire spread rapidly, and it is believed that the newly-manufactured materials which caught fire so easily may have been responsible. As a result, the manufacturers of such products are going to have to provide clear evidence of rigorous fire safety tests before these new cotton-shreds can be stored and used in the manufacture of finished products.

The Shredex statement also states that its process is completely safe and that criticism of its safety standards and employment practices has come from rivals who do not want the re-shredding industry to succeed. What is not in dispute is the enormous political and historical importance of cotton production in India on small hand looms, made famous by Mahatma Gandhi, which helped India to gain its independence.

EMAIL

From: Shelly Drapes
To: Penny Price
Subject: New customer contract
Date: 2 November 2018

cc: BM Board

BM has been approached by an intermediary on behalf of the owner of a private cruise ship. The owner, Anton Lewis, a European citizen, is the managing director of the Mediterranean Exploration Corporation (MEC), which is a recently-registered UK company.

This cruise ship, which includes 40 luxury suites on board as well as spa and pool facilities, is used on occasions by the company as a floating marketing location to entertain its wealthy business associates. It is mainly used as the personal asset of the managing director.

This ship is also hired out to other wealthy individuals who wish to charter it for special event cruises to exclusive locations in and around the islands of the Mediterranean and Atlantic.

MEC would like to enter into a contract with BM to purchase bathrobes and towels which incorporate its motif and the date and location for each cruise.

The company owns five other larger luxury cruise ships, all of which operate outside the UK.

Initial discussion details

- The first batch (1,200 items – the estimated minimum needed per cruise) must be ready for final inspection by 15 December 2018. The cruise would start on 1 January 2019.
- Two motif monogramming alternatives are proposed by MEC:
 - If BM uses its own base products (Option 1) in the monogramming process, a mark-up of 30% on its production costs would apply.
 - If MEC supplies base products from its own source (Option 2) for the BM monogramming process, MEC would be open to negotiating a price representing a mark-up of up to 50% on the total of other BM production costs.
- A different bespoke motif would be needed for different events and there could be up to ten motif changes in the year.
- Cruise locations can only be notified a short period before departure.
- BM is concerned that because of the relatively complex and changing design work in these motif changes, the design and production process could be longer than usual.
- BM would be responsible for the delivery of these orders to the specific cruise locations.
- If BM successfully delivers the contract according to the agreed terms, then it would have an opportunity to win other MEC contracts.
- It is believed that MEC's other luxury cruise ships can cater for more than 5,000 wealthy guests and their partners each year by way of different luxury cruises.
- MEC claims to generate revenue of more than £300 million a year globally.
- MEC has also indicated that it would want to pay BM in pounds sterling (£) using MEC's normal credit terms of 90 days through its bank based in Switzerland.

The need to manufacture, export and not report

Recently a noticeable new type of customer has been observed in the UK market for luxury goods – the billionaire oligarch, complete with private cruise ships. These are not so much sailing vessels as floating hotels. Equipped with everything including helicopter landing pads, they are display platforms for their owners to flaunt their wealth for guests and others whom they wish, or need, to impress. For those fortunate enough to satisfy these wealthy owners and make them their customers it is a case of almost too good to be true – supplying a customer in a world where money is no object.

Although money is not a problem for such customers, quality of service and quality of products most certainly are. These customers require everything from the menus served on board, to the pillows on which an important guest's head is to rest, to be very high class. From restaurants and bars serving the widest variety of menus and fine wines through to cinema screens showing the latest Oscar-nominated films – if money can buy it, then it will have been bought to impress others. Poolside facilities are second to none and steam rooms, spas and jacuzzis are all available to allow discreet, relaxed mingling for the rich and famous.

However, from the other side, discretion by suppliers is paramount – no trading organisation acting as a seller to these customers can ever advertise or claim that role. Although their demands may sometimes appear almost fanciful, in other ways these very wealthy customers tend to be extremely loyal to those they trust.

Suppliers who can match the demanding requests of these wealthy customers can expect to be paid appropriately for their service. More importantly, they will almost certainly be recommended to other similar customers in this exclusive circle – but only discreet suppliers should apply.

Expansion of MEC fleet

Those who study the movements of the many ships owned by the rich and famous will have seen that the cruise operator MEC appears to remain located for operational purposes outside the UK – despite having recently registered as a UK company. Its latest acquisition, the cruise liner Intrepid, was given its final interior fitting-out in a shipyard in the Bahamas. Prior to that, two of its other prestigious cruise liners were being given their major service overhaul in another Caribbean shipyard.

When asked why a UK operator such as MEC would choose to purchase these services based in other countries, a spokesperson for MEC stated: "Like all commercial operations, we are looking for the best value for money for any goods and services we purchase. We do not feel that we must support any local service provider who does not provide those services at what we consider to be the best possible price. If a better service provider can offer a better service at a lower price, we will always look to change to that provider."

For companies like MEC, which have an almost unlimited worldwide choice in selecting the suppliers that serve them best, physical location is no barrier to pursuing such a goal. Some would consider that these actions are demonstrating not only a position of strength but also an element of commercial opportunism and a lack of loyalty to suppliers.
