



TPE 2020 – Case Study Part 1

W L Fitness

History

Examination November 2019. 2½ hrs am, 3 hrs pm. Pass rate 80.2%

FA 2019

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Background Notes

It is **mid-October 2019**, you are **Sam Tate** and you work for **Brackens LLP ('Brackens')** a large international firm of chartered accountants and business advisors. You have recently completed your training contract and have now qualified as a chartered accountant.

You work in the audit department at the Canary Wharf office, one of the five London offices. There has recently been an organisational change within the firm and, as a result of this, you have been transferred to **Dougie Harrison's team**. Dougie, a new audit partner, has recently joined Brackens. Previously he was a partner at another firm, Woods Accountants LLP ('Woods'). **Woods is a smaller, five-partner firm.**

You briefly met Dougie a few weeks ago when he was introduced to the team. You have not yet worked directly with Dougie and hope that you will be able to develop a good working relationship. Given your newly qualified status, you are looking to further your career and identify yourself as a suitable candidate for Brackens' Talent Programme, consequently you are keen to make a good impression.

Your firm has recently been appointed the auditor of W L Fitness Plc ('W L Fitness'), a company listed on the **AIM market**. Dougie was instrumental in winning this client as W L Fitness was previously a client of Woods.

Normal due diligence for a new client has been completed, except that there has been no response from Woods to the normal professional etiquette letter, despite contacting them several weeks ago and sending a reminder.

Dougie has asked you to join him for an assignment briefing and you are excited to find out what this will entail.

"Good morning, great to see you again, I'm looking forward to working with you. Please take a seat." Dougie gestures towards the nearest chair.

"Hi, likewise, how are you settling in?" you reply as you sit down.

"It's going well thank you. Brackens is a great firm and I've settled in really quickly. It's refreshing to have access to such a broad range of clients. Now let me tell you about some interesting work I'd like you to do. **I think you will like it, as it's a bit different to the usual audit work that you are familiar with.**"

"Tell me more, that sounds intriguing."

"Well, as you know, we have recently acquired a new audit client, W L Fitness. As it happens, I am familiar with the client as they were previously with Woods when I was there. I wasn't the audit partner but knew of them. Now, in order to clinch the deal and win their business, **I agreed that we would carry out a free business review for them.** That is what I would like you to prepare for me."

Liking the opportunity, you cheerfully reply, "The gym chain? Sounds great, please could you elaborate with some more details?"

"Yes, that's right, you've heard of them then. **The thing is, we won't be able to bill them for this, so** I don't want you to log much time on it. **If necessary, charge it to the audit code for the client.** You should prepare the business review in the form of a **briefing note** to the board which I can pass on to the client.

"By way of background information, Pascal, who is the co-founder and the operations director, has mentioned that he is aware **that AIM listed companies are meant to have non-executive directors now,** but he has done nothing about this. **He is worried about the cost of maintaining a non-executive board.** From his point of view this is just an unnecessary cost with no benefit, only a tick-box exercise to satisfy UK regulations. He'd much rather spend the money on operations or higher dividends. I think he is hoping that if we agree with him, he can turn a blind eye to the regulations. **To be clear, I don't want to get into a disagreement with him over this.**

"He also mentioned, and I can corroborate this, that relations with the previous auditors were a bit strained as there was **disagreement about income recognition.** Woods did accept the treatment in the end after several, shall we say, 'discussions.' Pascal mentioned that, because of this, he hadn't authorised payment for the latest

fee invoice. He said something like “I’ll pay them when I’m good and ready to, let them wait for it”. I’m thinking this might explain why we haven’t heard from Woods, as we sent the courtesy letter several weeks ago, so don’t worry that you don’t see that in the files. I am sure we will get it eventually once the bill is paid.

“Anyhow, I assured Pascal that he’d have no such problems with us, and I was sure we’d be happy with whatever policy they have chosen to follow. As long as we disclose the approach in the accounts, we’ll be fine.

“Getting back to the business review, I’ve pulled together some useful information and added this to the file notes. There is some background information using my previous knowledge of the client, recent financial statements, extracts from the management accounts and information regarding the capital employed in the company (Sections 1 – 4).

“I’d like you to analyse the financial performance and position of the business as a whole. Focus on the key areas in the financial accounts: profitability, liquidity and gearing. Some key ratios have already been calculated and are in the file notes (Section 2). Concentrate on explaining things, there is no need to calculate any additional ratios for this section.

“I’d also like an evaluation of the individual divisions. You will see from the file notes (Sections 1 and 3) that there are two divisions, Zone Ten and Edge. Evaluate each division’s performance and identify any areas for the board to address. I would expect you to include some key management ratios here.

“Finally, there are a few specifics that I’m about to tell you about.

“Firstly, the board wants our comments on the actions and recommendations proposed by Dominique. Dominique Woodford is the new finance director and, shortly after joining the company, she carried out an operational review and, on the back of this, she has proposed some changes. Pascal has provided me with an outline of the proposals, called ‘Focus 2020’ (Section 5). He has asked for an independent and objective appraisal by us for the board to consider.

“I have also included a recent article on ‘The Only Gym’ (Section 6) as background information.”

You were just about to raise some questions when Dougie is distracted by a message that popped up on his phone. He quickly reads the message.

“Hmm, now that’s interesting. That was an email from Kat, who is the CEO at W L Fitness. She has just asked me to squeeze in a conference call tomorrow with herself and Dominique to run through W L Fitness’s options for financing an investment of around £30 million. I wonder what they are up to? I’ve got back-to-back meetings for most of today, so although I can always make time for a call with a client, especially if there is any chance of squeezing some more cash from them, I am not going to have time to prepare for this. Would you mind preparing some notes for me as a separate matter? If you can get something to me for lunchtime, I’ll review it this afternoon.”

“Sure,” you say, “are there any particular areas you think I should look at with regards to the additional finance?”

Dougie thinks for a few moments and then says, “Kat mentioned sale and leaseback, so look at that, plus other sensible suggestions. Comment on the practicalities of each one.”

He adds as an afterthought, “You should probably check the file notes too, to see if there are any existing covenants and, if so, what the implications might be.

“Ensure that you recommend a practical solution, but hopefully one where we can advise and generate some more fee income!

“In summary then, I need you to prepare a briefing note for me to pass to the board, it should cover:

- the initial business review; and
- “Focus 2020”.

“In addition, I need separate notes to me, as required for my call with Kat and Dominique.

“I am sure that I don’t need to say this, but you will be aware, of course, of our standard policy that you should report any ethical concerns that arise during work in an email to our ethics partner. I trust there won’t be any problems. That reminds me, did I mention that I’ve been asked to nominate candidates for the Talent Programme?”

After checking that you had everything you needed, he left for a client meeting off site.

You head back to your desk making a cup of coffee on the way. You have a lot to do!

In preparation for answering the case study question this afternoon, you will find it useful to undertake the following tasks during the morning session:

- read all the information carefully and note down any points you feel are significant;
- prepare the briefing note for Dougie to pass onto the board; and
- prepare the notes for Dougie’s call with Kat and Dominique.

Section 1

Summary of the background information held by Brackens on W L Fitness Plc

History

W L Fitness Plc is an established company operating in the health, sport and leisure industry. The company was incorporated 28 years ago by Kat Willows and her university friend Pascal Laroche. Pascal was originally from France but chose to remain in the UK to work with Kat on their business concept culminating in the creation and success of W L Fitness. Expansion has been funded through retained earnings, borrowing and an injection of equity a couple of years ago when the company obtained an AIM listing.

Under the Zone Ten brand, the company runs 44 health clubs based primarily in the south of England with 15 centres located in Greater London. In addition, the company owns an exclusive leisure club situated in London's financial district which trades under the brand name of Edge. W L Fitness do not offer any corporate memberships.

- **Zone Ten**

Each Zone Ten site is a family-orientated club providing a range of activities including gym facilities, fitness classes, tennis, swimming and spa, although swimming and spa are not available at all the clubs.

- **Edge**

This is an exclusive club offering a premium service 24/7. The club provides complementary one-to-one personal fitness coaching, a premium spa including complementary treatments and a laundry service, all in addition to a high-spec gymnasium. The Edge clientele comprise professionals working in London's financial district.

W L Fitness's history includes expansion by both organic growth and acquisition including the acquisition of the trade and assets of Edge four years ago.

Corporate Mission and Objectives

Mission

- Helping families stay fit for life, making fitness fun.

Objectives

- Provide an inclusive high quality space for families.
- Provide the latest cutting-edge gym equipment.
- To offer an innovative and comprehensive range of exercise classes.
- To offer fun classes for children.
- Net growth in each division's membership of 3% per year.
- Profit growth in each division of at least 5% per year.

Governance

Details of the current board of directors are shown below:

Executive directors	Position	Length of service
Kat Willows	Chair and CEO	28 years
Pascal Laroche	Operations Director	28 years
Dominique Woodford (CA)	Finance Director	0.5 years
Varun Varma	Human Resources Director	7 years
Tim Fordham	Edge Director	4 years
Melanie West	Zone Ten Director	12 years

Overall, the board is experienced and well balanced however there is disagreement regarding the future strategic direction of the company. Tim is keen to expand the Edge division to other UK cities; this view is not shared by the other directors.

Dominique has many years' experience of working for a listed company but is new to the sport and leisure industry. Since joining W L Fitness, Dominique has carried out an internal review and consequently launched the Focus 2020 programme to improve operational efficiency. This has caused some internal tension between Pascal and Dominique. However, the board has agreed to Dominique's proposals for measures to improve profit, recognising the importance of short-term performance for the institutional investors.

Other directors have experience of the industry but not a listed company and consequently found the transition to a listed company challenging, especially the demands of publicising regular financial and non-financial information. Kat and Pascal, in particular, whilst appreciative of the access to capital resent the additional costs of being an AIM listed company.

Industry Market Report: Health and Fitness

The fitness industry is competitive with an estimated 10 million gym users in the UK attending one of the 7,000 fitness centres. This equates to approximately one in every seven people being a member of a gym.

The market is split between public gyms run by local government (57%) and private gyms run through limited companies (43%). The latest statistics suggest that 35% of the private gym market are budget gyms.

The statistics can be misleading regarding the health of the nation as typically only 18% of members are regular users of the facilities, with many clubs relying on this to manage their operational capacity.

There are two broad categories: budget and premium gyms.

Budget gyms, like The Only Gym and 2TheGym, tend to offer a reduced level of facilities focusing on gym and exercise classes but not offering spa facilities, swimming and racket sports. Budget clubs also tend to focus towards the needs of adult members rather than those of children.

Budget gyms tend to offer flexible memberships with no joining fee and freedom to leave at any time with no further commitment.

Premium gyms, such as Zone Ten and Bailey's Gym, offer a wide range of services to satisfy the needs of both adult and junior members. The membership fee includes access to classes with no additional charges. Additional facilities such as a café and spa are also often included as part of the membership. These gyms often charge a joining fee and typically sign members up for a minimum number of months of membership with no refunds for early termination.

Budget gyms are seeing growth from increases in market share and also by growth in this part of the industry as the UK market penetration rate increases, currently around 15%.

Section 2

Extracts from W L Fitness Plc Financial Statements:

Statement of financial position as at 30 June

	2019 £'million	2018 £'million
Assets		
<u>Non-current assets</u>		
Goodwill	10	10
Property, plant and equipment	67	69
	<u>77</u>	<u>79</u>
<u>Current assets</u>		
Inventories	1	1
Trade and other receivables	2	2
Cash and cash equivalents	20	19
	<u>23</u>	<u>22</u>
Total assets	<u>100</u>	<u>101</u>
 Equity and liabilities		
<u>Equity attributable to equity holders</u>		
Share capital and premium	30	30
Retained earnings	20	18
Total equity	<u>50</u>	<u>48</u>
 <u>Non-current liabilities</u>		
Bank loan	37	37
 <u>Current liabilities</u>		
Trade and other payables	12	12
Tax payable	1	4
	<u>13</u>	<u>16</u>
Total liabilities	<u>50</u>	<u>53</u>
Total equity and liabilities	<u>100</u>	<u>101</u>

Statement of profit or loss for the year ended 30 June

	2019	2018
	£'million	£'million
Revenue	112	132
Cost of sales	(68)	(67)
Gross profit	44	65
Selling and administration expenses	(33)	(35)
Operating profit	11	30
Net finance costs	(5)	(5)
Profit before tax	6	25
Tax expense	(1)	(4)
Profit for the period	5	21

2. Accounting policies (*Extract from the financial statements*)

Revenue: The company income relates to:

- Health and fitness club joining fees
- Health and fitness club subscriptions
- Food and beverage.

Income in respect of the non-refundable annual subscriptions and joining fees is recognised when received.

Key ratios

Summary of key profitability ratios	2019	2018
ROCE	13%	35%
Return on equity	10%	44%
Gross margin	39%	49%
Operating profit margin	10%	23%
Asset turnover	1.3	1.6
 Summary of key liquidity ratios	 2019	 2018
Current ratio	1.8	1.4
Trade receivables days	7	6
Trade payables days	64	65
 Summary of key financial risk ratios	 2019	 2018
Gearing ratio (D/D+E)	43%	44%
Debt ratio	37%	37%
Interest cover	2	6

Section 3

Management information

Management accounts year ended 30 June 2019

<i>(Extract)</i>	Zone Ten £'million	Edge £'million	Total £'million
Revenue	107.1	4.9	112
Cost of sales:			
Property costs	17.5	1.3	18.8
Staff costs	24.8	1.9	26.7
Food and beverage	10.7	0.5	11.2
Depreciation	8.6	0.4	9.0
Other	2.0	0.3	2.3
	63.6	4.4	68
Gross profit	43.5	0.5	44

Average staff headcount per club

	Zone Ten	Edge
Manager	1	1
Assistant manager	1	4
Food and beverage	7	18
Reception	7	10
Spa	2	12
Housekeeping and maintenance	2	4
Gym coach	5	15
Swim coach	2	3
Tennis coach	5	0
Average staff headcount per club	32	67

Number of clubs

Zone Ten	Edge
44	1

Membership information

	2019		2018	
Average members per club	Zone Ten	Edge	Zone Ten	Edge
Adults	2,000	750	2,400	735
Children	950	0	990	0
	2,950	750	3,390	735
Average annual membership fees				
Adult	£900	£5,300	£820	£5,000
Child	£180	NA	£164	NA

Section 4

W L Fitness Plc Capital Structure

Equity

	No of Shares `000
Kat Willows	3,000
Pascal Laroche	3,000
Nicole Willows (Kat's civil partner)	1,500
Fleur Laroche (Pascal's wife)	1,500
The Willows Family Trust	500
The Laroche Family Trust	500
Institutional investors	6,000
Total	<u>16,000</u>

W L Fitness Plc	All time high	All time low	1 November 2019
Share Price	£18.72	£9.89	£10.04

Debt

	Amount	Charge	Redeemable	Interest
GLB Bank (syndicate)	£37 million	Secured #	31 December 2030	13%

Security is provided by non-current assets

Extract of debt covenant from GLB Bank

2.1 Financial covenants

1. The Company shall maintain the following ratios during the term of the loan:

- I. Gearing ratio (calculated in accordance with 2.2.I below) shall not exceed 50%.
- II. Current ratio (calculated in accordance with 2.2.II below) shall not fall below 1.0.

2.2 Definition of financial ratios:

- I. Gearing calculated as the book value of debt repayable in more than one year divided by the sum of debt repayable in more than one year and total equity.
- II. Current ratio is defined as the ratio of current assets divided by the current liabilities.

Section 5

Information supplied by Pascal Laroche

Focus 2020

Dominique Woodford joined W L Fitness in the spring of 2019 and immediately commenced a thorough review of the Zone Ten operations. The review included benchmarking against a number of competitors including 2TheGym.

The review revealed that there are opportunities to improve operational efficiency, so a programme of phased improvement was introduced which will be implemented in the first half of 2020. The planned improvements are projected to increase operational profit by £16 million. The first two stages of the programme, named internally as Focus 2020, have already been communicated to staff and customers.

The following changes are planned:

Opening hours

Zone Ten clubs currently open from 5am through to midnight seven days a week. Analysis of the member usage suggests that only a small number of members use the facilities prior to 6am or after 10.30pm. Dominique has estimated that changing the opening hours to 6am to 10.30pm will reduce costs by 13% and so generate additional profit of £13 million.

Redundancy

A benchmarking analysis comparing clubs identified that the staffing ratios in some Zone Ten clubs were significantly higher than the competitor clubs. Further investigation confirmed that this was the case and, consequently, a redundancy programme has been announced affecting 27 of the 44 clubs. The staff affected are currently being consulted, with around 200 jobs at risk. The new structure means that there will only be 100 positions available for those staff, with all 200 having to reapply for the now reduced number of new roles within the business.

The revised job description has lower requirements for experience and qualifications, as Dominique concluded that staff were often overqualified for their role and, consequently, paid a higher than necessary salary. Dominique has estimated that this will reduce ongoing operational costs by approximately £3 million.

The staff areas affected by this are reception, food and beverage, gym and pool staff.

Section 6

Business Magazine Editorial

Business Investor

OCTOBER 2019

Companies to watch in 2020

The Only Gym

It is always refreshing to see growth from old industries revitalised by a new perspective, and this is certainly the case for the so called budget gyms which have been shaking up the fitness industry. The growth in this industry continues and these low cost, no frills clubs now represent around 15% of the UK market in an industry estimated to be worth around £5 billion.

These new gyms are investing in the latest high-tech equipment and continuing to provide flexibility for the user, no binding contracts, no hefty joining fee and low membership fees. Historically, the low cost gyms offered a budget alternative to the long established premium gyms, but this is changing with companies like The Only Gym offering a high quality experience without the premium fees and obligations. Their strap line that it's the "only gym you need" could be right.

Their approach certainly seems to be working reflected by yet another year of outstanding results. The June 2019 financial results have just been released causing the share price to rise to an all-time high with market capitalisation of £273 million on earnings of £7 million.

Eilis Evans, the company's founder and CEO, explained that customers needed to come first and this was the driver behind their successful strategy. Put simply, it means focus on the needs of customers and deliver this to a high standard. The company is leading this gym revolution winning market share from both budget and premium clubs.

The company plans to open additional outlets during 2020 as part of its expansion plan.

For more details go to www.TheOnlyGym/Investor.com

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