TPE 2023

Lorenso – Guide to Answer

The Test of Professional Expertise multi-discipline case study is designed to encourage students to provide alternative creative answers and there is no single “right answer” at TPE level. This Guide to Answer illustrates the structure and the depth of analysis and explanation the examiners are seeking.

In assessing candidates’ scripts, credit is always given for appropriate answers even if not contained in this published guide.

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MORNING PAPER

Briefing paper

1 Performance of the Lorenso Group analysed by revenue stream (26 marks)

1.1 Introduction (1 mark)

The Lorenso Group has five revenue streams:

- 3 Restaurants: Lorenso's, Table Romero and Bomerano
- Media
- Produce

Management accounts provide information on the operating performance of all streams, there are however additional head office costs that must be covered by the group before determining the overall performance.

Currently these costs are apportioned using a simple weighting of revenue, this approach is likely to be over simplistic and has been disregarded for the purposes of the evaluation. Instead, the briefing will consider the operating profit before head office costs, for each revenue stream.

1.2 Overall performance (1 mark)

Overall, 2023 was a very disappointing year for the Lorenso Group:

Total revenue has declined by 22%, gross profit by 49% and net profit by a substantial 81%, see Appendix 1.

The net result of this is an operating margin of just 3% which indicates that the group is close to operating on a break-even basis.

To understand the reasons behind the decline in performance each revenue stream must be considered separately.

1.3 Restaurants (1 mark)

This revenue stream generates the highest proportion of revenue (2023: 75%, 2022: 66%) but delivers the lowest gross profit and operating profit margins, the increase in sales mix towards the restaurant business does therefore partly explain the reduced overall profit margins.

Overall restaurant revenue has however fallen by 11% (Appendix 2).

A summary of the financial results of each Restaurant business stream can be found in Appendix 2 and the performance of each will be considered in turn.

1.4 Lorenso's – analysis of performance (6 marks)

Revenue

Lorenso's generates 94% of the restaurant revenue (2022 and 2023) and so is the main driver of the 11% decline in this revenue stream.

Restaurant revenue has declined due to a fall in the volume of customers as indicated by the 23% fall in the average number of covers per restaurant (67,600 to 52,000).

The impact was lessened by the opening of a further ten restaurants and an 8% increase in the average spend per head from £21.67 to £23.45.

If the increase in spend per head is due to price increases, then this may provide an explanation for the reduced volume of covers.

It is acknowledged that prices are usually higher given the celebrity status attached to the chain, however in such a competitive market, consumers are likely to be price sensitive and, given the cost-of-living pressures, may prefer to dine in lower priced restaurants or simply stay at home.

The reviews and average feedback score indicate that there are problems with quality and service at certain locations, this will also explain a fall in covers.

Gross profit

Lorenso's has seen an improved gross margin (2023: 7% vs 2022: 6%).

This may be partly explained if the higher average spend per customer is the result of increased prices.

The improved gross profit margin is excellent given the numerous factors (pay rises, inflation, and supply shortages) driving up the cost of goods sold.

The move to UK sourced ingredients could explain in part the reduced cost of sales.

It should be noted though that whilst cheaper and more favourable for the environment, this policy is at odds with the current messaging for Lorenso's, namely that authentic Italian sourced ingredients are used to recreate the original Italian recipe.

Operating profit

Despite improved gross margins, operating margins are significantly below market averages (2023: 1% and 2022: 1% compared with an industry range of 3 - 5%).

The decline in operating margin is driven primarily by a rise in distribution costs as a percentage of revenue (2022: 3% vs 2023: 4%). Higher transportation costs are likely to be the driver of this change, driven by the additional ten locations and cost inflation.

Administration costs have increased by 3% (2023: £6,005k vs 2022: £5,850k) despite a fall in sales volume. Possible explanations could be the 2% wage inflation and an increase in headcount as a result of the ten new Lorenso's restaurants.

1.5 Actions to improve Lorenso's operating profit (3 marks)

Benchmarking

To identify underperforming locations the board should conduct a benchmarking review of all the Lorenso's restaurants.

The board can then put improvement plans in place, as and where needed.

Staffing

Service is key within this industry and so appropriately skilled front of house staff should be employed. The current strategy of using part-time short-term contract staff should be reconsidered.

Menu

The menu has seen little change since the original design in 2005 and so is unlikely to inspire customers. The menu should be refreshed on a regular basis, for example different winter and summer menus.

If possible, data analysis of customer menu choices would identify unpopular menu items and the sensitivity to price; this can then be reflected in the design and development of new menus.

Ingredients

Analysis of ingredient usage and wastage may identify less efficient restaurants or highlight potential theft or fraud within a particular branch.

Simplifying recipes to use common ingredients may facilitate bulk purchase discounts.

Continuing the strategy of using cheaper UK sourced ingredients is encouraged, provided the marketing message of using Italian sourced ingredients is adapted accordingly.

Promotions

Promotions and loyalty schemes can be used to generate new customers and encourage repeat visits.

Maintain margins

Where possible price increases should be passed onto customers.

1.6 Table Romero (3½ marks)

Note to markers: This is a section where candidates might reach different conclusions – they could decide to sell as TR generates minimal contribution while taking up a lot of time. Or they could conclude that TR is profitable and could be a growth area. Analysis and action marks should be awarded regardless of which approach is taken.

Analysis of performance

Table Romero comprises 2% of restaurant turnover and generates minimal contribution in monetary terms from the five restaurants (see Appendix 2).

The level of revenue has stayed fairly steady at around £3.7 million. The average spend per customer has increased by 3% and there has been a small decrease in the number of covers.

The gross profit margin of 15% is higher than the other restaurant streams and the operating profit margin of 4% is in line with the industry average for full-service restaurants of 3-5%.

Each restaurant manages their own menu, and this might lead to disparity between restaurants, and possibly increased costs due to the lack of economies of scale. However, using local produce might also be attractive to customers.

Actions to improve Table Romero operating profit

(i) Option to sell

Whilst still profitable the board should analyse head office costs to identify if any of these are avoidable if the Table Romero restaurants ceased to trade.

It is likely that these luxury restaurants take a disproportionate amount of management time compared to the level of profit generated.

There are unlikely to be any negative consequences on the Lorenso brand if Table Romero did close as the target demographic for other revenue streams is very different to this brand.

If the analysis identifies that the group would increase profits by divesting in Table Romero then the board should look to close this revenue stream.

As there are only five restaurants, individual restaurants could be closed as and when leases expire.

Alternatively, all five could be sold together if a suitable buyer is found, note the Table Romero brand name should not be sold.

(ii) Option to expand

This is a profitable, but small part of the business. Management should consider whether further restaurants would increase the margins from this business.

The average spend per customer is much higher than the other restaurant streams, so some market research should be undertaken to explore the demand for luxury restaurants in the current financial climate and also to identify suitable locations.

1.7 Bomerano (2 marks)

Analysis of performance

Bomerano generates only 4% of restaurant revenue and continues to be loss making (Appendix 2).

Revenue is 17% lower, year-on-year due to a reduction in covers by 11% and a decrease in customer spend of 7%.

In 2023 the position has become significantly worse as the stream did not generate sufficient revenue to return a positive gross margin. Industry margins for quick service restaurants are usually between 6-9%.

The poor performance of Bomerano is significantly impacting the results of the group.

Ignoring any potential head office savings, if the group were to dispose of Bomerano there would be an improvement in operating margin from 3% to 5% (see Appendix 3)

Actions to improve operating profit

A full cash flow forecast and strategic review of Bomerano should be performed urgently to determine whether any improvement can be made to make this business profitable.

The board should consider divesting in Bomerano.

1.8 Lorenso Media (3 marks)

Analysis of performance

Lorenso Media is the most profitable revenue stream of the group delivering high gross and operating margins.

The brand is currently strong with all books currently still in print and a global audience.

2023 was a low performing year as there were no new television series or books. Despite this the media company generated 85% of the group contribution. Note the loss of Bomerano has been excluded when calculating this percentage (see Appendix 4).

Lorenso Media has increased the percentage of revenue spent on research and development (2022 1% vs 2023 3%). This is most likely in relation to the new television series and book due for release in December 2023.

Actions to improve Lorenso Media operating profit

Given the significance of this revenue stream to the Lorenso Group it is important to continue to invest in research and development - the ability to generate new shows with new themes is important for future sales.

Reputation risk is perhaps even higher for this revenue stream as the success is dependent on the success of the television shows and books, both are very much influenced by the public persona of Lorenso himself.

The recent events with the deleted social media comment and local protests are likely to bring adverse publicity. This needs to be sensitively managed to avoid any disruption to trading and the imminent release of the new television series and book.

1.9 Lorenso Produce (3½ marks)

Analysis of performance

Lorenso Produce, representing 8% of 2023 revenue, is the only revenue stream to have grown in 2023, albeit by only 4%. As prices have not been increased this is driven by a change in mix or volume (Appendix 1).

The 21% gross profit margin is particularly disappointing as this is significantly below other manufacturers in the industry (Pettle: 48%, Applecore: 32%).

Lorenso Produce is however significantly smaller and so is unlikely to benefit from the economies of scale of larger manufacturers.

The fall in gross margin (25% down to 21%) is disappointing and is most likely due to the rising cost of ingredients without any increase in retail price to consumers.

Other costs are largely consistent with prior year with the exception of distribution costs which have had to absorb higher fuel and transportation costs as with the restaurant business.

Actions to improve operating profit

The current strategy of absorbing rising costs is not sustainable in the longer term.

If pricing is sensitive, then alternative solutions should be considered. This might include using alternative cheaper ingredients and/or reducing the weight of products.

The produce is sold through limited distribution channels and so future growth prospects are minimal unless new channels are identified.

If new distribution channels can be identified for Lorenso Produce, then this might facilitate an increase in scale that generates lower operating costs and hence higher operating profits and margins.

1.10 Lorenso Group (2 marks)

Actions to improve profit at group level

A review of administration and head office costs should be considered to identify where any cost savings can be made.

The Lorenso Group is exposed to considerable reputational risk due to the reliance on the Lorenso name. Any adverse media comments could have a significant impact on the future trading performance of all revenue streams.

Lorenso has been in the public eye for many years and so should be experienced in these matters, however it may be useful to invest in some refresher public relations and social media training to avoid any future problems.

The CMO should review and update the marketing plan to ensure the Lorenso brand is promoted positively in the lead up to the new television series and book.

Head office costs largely comprise property, head office staff costs and directors' remuneration. If the Table Romero and Bomerano revenue streams are disposed of it is likely that head office staff costs can be reduced too.

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Appendix 1 – Financial analysis of the group (marks awarded within the relevant report section)

Total Revenue	**2022**	**%**	**2023**	**%**		**Change**
	£'000		**£'000**		**£'000**	**%**
Restaurants	220,875	66%	196,674	75%	(24,201)	(11%)
Media	95,000	28%	46,000	17%	(49,000)	(52%)
Produce	20,500	6%	21,300	8%	800	4%
	336,375	**100%**	**263,974**	**100%**	**(72,401)**	**(22%)**

Gross profit/(loss)	**2022**	**%**	**2023**	**%**		**Change**
	£'000		**£'000**		**£'000**	**%**
Restaurants	13,537	18%	12,250	32%	(1,287)	(10%)
Media	57,000	75%	22,000	57%	(35,000)	(61%)
Produce	5,150	7%	4,450	11%	(700)	(14%)
	75,687	**100%**	**38,700**	**100%**	**(36,987)**	**(49%)**

Operating profit/(loss)	**2022**	**%**	**2023**	**%**		**Change**
	£'000		**£'000**		**£'000**	**%**
Restaurants	572	1%	(2,215)	(18%)	(2,787)	(487%)
Media	49,500	96%	14,100	114%	(35,400)	(72%)
Produce	1,520	3%	530	4%	(990)	(65%)
	51,592	**100%**	**12,415**	**100%**	**(39,177)**	**(76%)**

Net profit/(loss)	**2022**	**2023**		**Change**
	£'000	**£'000**	**£'000**	**%**
Operating profit	51,592	12,415	(39,177)	(76%)
Head office costs	3,200	3,264	64	2%
Net profit/(loss)	**48,392**	**9,151**	**(39,241)**	**(81%)**

Note to markers: The calculations presented in these appendices are more detailed than a candidate is expected to prepare. There are included for completeness.

Appendix 2 – Financial analysis of Restaurants (marks awarded within the relevant report section)

Restaurants	**2022**	**%**	**2023**	**%**		**Change**
Revenue	**£'000**		**£'000**		**£'000**	**%**
Lorenso's	208,015	94%	185,349	94%	22,666	(11%)
Table Romero	3,646	2%	3,702	2%	56	2%
Bomerano	9,214	4%	7,623	4%	(1,591)	(17%)
	220,875	100%	196,674	100%	24,201	

	2022	**%**	**2023**	**%**		**Change**
Gross profit/(loss)	**£'000**		**£'000**		**£'000**	**%**
Lorenso's	12,643	93%	12,615	103%	(28)	0%
Table Romero	547	4%	552	4%	5	1%
Bomerano	347	3%	(917)	(7%)	(1,264)	(364%)
	13,537	100%	12,250	100%	(1,287)	

	2022	**%**	**2023**	**%**		**Change**
Operating profit/(loss)	**£'000**		**£'000**		**£'000**	**%**
Lorenso's	3,043	531%	1,795	(81%)	(1,248)	(41%)
Table Romero	153	27%	147	(7%)	(6)	(4%)
Bomerano	(2,623)	(458%)	(4,157)	188%	(1,534)	58%
	573	100%	(2,215)	100%	(2,787)	

Appendix 3 (marks awarded within the relevant report section)

Group position excluding Bomerano

	Year ended 30 September 2023		
	Total	**Bomerano**	**Revised**
	£`000	**£'000**	**£'000**
Revenue	263,974	7,623	256,351
Cost of sales	(225,274)	(8,540)	(216,734)
Gross profit	38,700	(917)	39,617
Distribution costs	(13,760)	(890)	(12,870)
R and D	(1,470)	0	(1,470)
Administration	(11,055)	(2,350)	(8,705)
Operating profit/(loss)	12,415	(4,157)	16,572
Head office costs	(3,264)	0	(3,264)
Net profit	9,151	(4,157)	13,308
Gross profit %	15%		15%
Operating profit %	5%		6%
Net profit %	3%		5%

Appendix 4 (marks awarded within the relevant report section)

Relative importance of Lorenso Media

	Year ended 30 September 2023		
	Group excluding Bomerano	**Media**	**Media**
	£'000	**£`000**	**%**
Revenue	256,351	46,000	18%
Cost of sales	216,734	24,000	11%
Gross profit	**39,617**	**22,000**	**56%**
		0	
Distribution costs	12,870	4,100	32%
R and D	1,470	1,200	82%
Administration	8,705	2,600	30%
Operating profit	**16,572**	**14,100**	**85%**

2 Notes on the proposed gift of shares (9 marks)

2.1 Financial considerations (1 mark)

This is a significant disposal for Lorenso and would lead to a 40% fall in dividend income which is a significant part of Lorenso's annual income.

Whilst Lorenso still has more than 51% of the shares and so has a majority control of the group, he would no longer have a 75% holding and so he will relinquish control when a 75% majority is required.

2.2 Non-financial considerations (3 marks)

Personal

The details of Lorenso's family life are not public information, however with five children it is worth noting that giving such a high percentage to one child may antagonise the other four children. This may of course be deliberate but is mentioned here for completeness.

Business

Lorenso Holdings is not a listed company and so does not need to demonstrate good corporate governance to external shareholders. As such there is no need for a nominations committee, which would be expected in similar sized listed companies.

Although there is no obligation for good governance, the principles embodied in this are seen as good practice for organisations.

The appointment as a director will be seen as nepotism and may be resented by the other board members and indeed those that are employed in Lorenso Produce.

Sophia's lack of experience would suggest that she is not the most suitable person, at this moment in time, to lead such a key part of the business.

It is quite reasonable for her to have a senior position within Lorenso Produce, perhaps with a longer-term plan of taking over this or indeed another director role in the future.

2.3 Tax implications (4 marks)

The gift of shares will have capital gains and inheritance tax implications.

Capital gains tax

The disposal of shares will be deemed to take place at the open market value.

As Lorenso Holdings is not a listed company this will need to be determined and agreed by HMRC.

The capital gain is likely to be significant given the organic growth achieved and the size of the Lorenso Group.

Currently the gain would be subject to capital gains tax at 20%, however there are two reliefs available to Lorenso.

Firstly, the gain will qualify for business asset disposal relief ('BADR') and so would be taxed at 10% rather than 20%.

Alternatively, Lorenso and Sophia could make a joint claim for gift relief. There would be no gain for Lorenso now and this would effectively be deferred to Sophia.

Sophia will however have a much bigger gain if she disposes of the shares in the future.

As Lorenso is likely to have amassed considerable personal wealth it is recommended that a claim for BADR is made, and the gain is not deferred to Sophia.

BADR is available for a maximum lifetime limit of £1 million.

Inheritance tax

A gift of shares to an individual is a potentially exempt transfer and so there is no tax to pay at the time of gift.

If Lorenso were to die within the next seven years, then inheritance tax at 40% of the value when gifted would be due.

It is likely that the disposal will qualify for business property relief ('BPR') as the shares are in a holding company of a trading group. In this case there would be no inheritance tax to pay provided Sophia still owned the assets when her father died.

2.4 Recommendation (1 mark)

Lorenso should gift the shares as part of his estate on death as there would be no capital gains tax and BPR would be available as before and so there would be no inheritance tax to pay.

It is possible for Sophia to join the board without the gift of shares and Sophia should initially join the company in a more junior role.

Report to the Lorenso Group board of directors

Corporate reorganisation

Prepared by Max Douglas
31 October 2023

Confidential

Contents

Introduction

This report has been prepared for the board as requested by, and using the information provided by, Sapna Sran.

Executive summary

This report considers the proposed disposal of Bomerano Limited ('Bomerano') and the acquisition of Arola Winery S.r.l ('Arola Winery') and the due diligence process when acquiring a new subsidiary.

The report recommends that the Lorenso Group should dispose of Bomerano by share sale, this is the most cost effective and straightforward way of divesting in the subsidiary. The integration of the supply chain is a valid way to improve operating profit. The acquisition of a vineyard and winery could therefore bring savings to the Lorenso Group and thus improve operating profit.

This report does not recommend the acquisition of Arola Winery for several reasons:

- **Poor performance**

  The Arola Winery has suffered from a period of underinvestment and requires management attention and investment to return the business to profit.
- **Lack of industry experience**

  The board do not have experience of this highly skilled industry and do not therefore have the necessary expertise to improve the performance.
- **Prioritise existing operations**

  Management should focus attention on improving the performance of existing revenue streams before adding additional underperforming ones.
- **Lack of strategic fit**

  The wines produced by Arola Winery are those from older vines that typically produce high quality expensive wines. This does not compliment the Lorenso's current business model and so would not generate supply chain cost savings.

The acquisition of a winery should not be excluded as a matter of course. In the future a more suitable, profitable winery could be a viable option for the Lorenso Group. If this situation arises then detailed due diligence must be conducted.

Given the importance of due diligence it may be appropriate to engage a professional firm of accountants to conduct this work. The due diligence would provide assurance over a comprehensive range of matters including the financial information, legal relationships, and strategic and operational aspects of the acquisition.

3 Disposal of Bomerano (13 marks)

3.1 Strategic evaluation (1 mark)

The sale of the Bomerano business, whether via a share sale or sale of assets including the brand name, is unlikely to be detrimental to the Lorenso Group. The business is yet to make a profit and the Lorenso name is not used.

The board should consider whether there are any other potential buyers for the business, as a more favourable offer may be available.

3.2 Financial evaluation (2 marks)

When determining a fair price for the business there are three traditional approaches, based on assets, earnings, or cash flows.

In the case of Bomerano, the company is in a net liability position, is yet to make a profit and there is no information regarding future earnings or cashflows. The traditional methods of company valuation would suggest a zero value for the business.

MB already operates many takeaway outlets across the UK, and it is likely that there are economies of scale and other operating synergies that make the acquisition of Bomerano an attractive proposition and hence will add value to MB.

Under both acquisition methods, MB wants to acquire the trading name of Bomerano and given the negative net asset position of the company, this suggests that the Bomerano brand has a value which is not recognised in the statement of financial position.

Evaluation of offers

3.3 Sale of shares (4½ marks)

This is the simplest approach as the shares are simply transferred to MB.

Under this proposal there would be a small capital loss (£10,000) on the disposal of the shares for £1.

In addition, the intercompany loan of £13 million would be written off.

There would be no tax relief available for the capital loss on sale or the write-off of the loan due to the substantial shareholder exemption.

MB would take on the responsibility of the lease payments and the obligation to repay the bank loan of £2 million.

In total, net liabilities of £1,430,000 would leave the group Appendix (i))

The Lorenso Group would have no further liabilities and will not be exposed to further losses.

The Lorenso Group will not be able to trade under the Bomerano name as this is now owned by MB.

Under this option MB may be able to make use of Bomerano's brought forward trade losses, however as there is likely to be a change in the way the trade is conducted, HMRC would disallow the use of the loss and so there will be no value attached to it.

3.4 Sale of trade and assets (5 marks)

Bomerano will dispose of assets in exchange for proceeds of £2 million. There may be corporation tax to pay on these disposals, the extent of this will depend on how the proceeds are allocated to the individual assets and the trading name of Bomerano.

A fair valuation may approximate the 31 December forecast statement of financial position as shown in Appendix (ii). This shows that a substantial part of the proceeds, approximately £1.38 million, is likely to be allocated to the Bomerano brand name, as this is internally generated goodwill and as such has no acquisition cost, the full proceeds would be subject to corporation tax.

This will reduce the net proceeds available to repay the bank loan and trade creditors.

The £2 million received is not sufficient to meet all the liabilities and Bomerano Limited would remain insolvent.

The intercompany loan will be written off and a capital loss will arise assuming the company is subsequently liquidated. As before there are no tax reliefs for the loss or write off.

Under this option the Lorenso Group may choose to provide additional funds to settle the liabilities remaining in the company: corporation tax on disposals, trade creditors and the bank loan.

This will leave the group in a worse financial position.

Alternatively, the Lorenso Group would not provide additional funds and the unsecured creditors would not recover the amounts owed to them. This would have a negative impact on the Lorenso Group reputation.

Given the new television series is due to be streamed in December, the timing of the adverse publicity may be particularly damaging to the Lorenso Group.

3.5 Conclusion (½ mark)

The disposal should be a sale of shares as this is a simple, cost-effective solution with no reputational consequences.

4 Acquisition of Arola Winery (27 marks)

Introduction

The acquisition of Arola Winery would introduce a new business to the Lorenso Group. The board would now be responsible for the production and importation of some of the wine sold in the Lorenso's restaurant chain, this type of investment is described as the vertical integration of the supply chain.

4.1 Valuation (2½ marks)

The family have indicated that an offer of £10 million (payable in euros) will be accepted. The Lorenso Group need to satisfy themselves that this is a fair valuation for the business. Additional calculations should therefore be completed to corroborate this valuation. Common practice would use several different approaches and produce a range of values that can be used as a basis of discussion and form part of the negotiation process.

The lack of profitability in recent years suggests that an asset-based approach may be more appropriate.

The Arola family are clearly keen to sell and consequently may be prepared to accept a lower offer.

If possible, the Lorenso Group should ascertain whether there are any other potential buyers for the business, and so understand its relative bargaining position. (½)

4.2 Profitability (4 marks)

Note to markers: This is a section where candidates will do a lot of different calculations. *Marks should be awarded accordingly for suitable calculations.*

Based on current yields the approximate return on investment is a low 7%, much lower than the target return of 18%. (see Appendix(iii))

The average retail price of a bottle of wine is £24 which currently results in profit of £10 (50% profit margin). The profit from a bottle of wine manufactured within the group would be £15.26, a margin of 76%. (see Appendix (iv))

The integration will lead to additional profit per bottle of wine of £5.26. (see Appendix (iv)) Based on the current yields the Lorenso Group would therefore generate additional profit of £757k per year[1].

This would marginally improve the operating contribution for Lorenso's from 1.5% to 1.8%[2].

These figures are based on several assumptions. It is assumed that Lorenso's will sell the same number of bottles as sold previously, replacing other suppliers with their own branded and sourced bottles. It is assumed that all the wine produced will be sold. As the wine is to replace existing wine that retails at £24 a bottle it is also assumed that the retail price is the same.

4.3 Sensitivity (5½ marks)

The calculations are based on the yield information provided by the Arola family.

It has been suggested that the yields are currently low and would improve with investment and good management.

Yields typically vary between 2,000 and 10,000 kg per acre, this would translate into a return-on-investment range of 3% to 17%. (Appendix (iii))

Further work should be conducted to establish and independently verify the current yields.

The yield will be influenced by many factors however, the age of the vines is a key determinant of yield.

At least some of the wines will be classed as old-vine wines as the first vines were planted more than fifty years ago.

The yields from old vines would be at the lower end of the range and therefore are unlikely to improve.

It is possible that old vines produce a higher quality wine and potentially Lorenso's could sell at a higher retail price.

Further information should be obtained on the current range of Lorenso's wines and the respective retail prices.

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[1] £5.26 x 144,000 bottles

[2] (3,043 +757)/208,015 = 1.8%

As the wines are for distribution through Lorenso's, research should be conducted to ascertain if diners would be prepared to purchase a more expensive wine, if so, this would generate further improvements in operating margin.

4.4 Business Strategy (4½ marks)

The Lorenso Group's performance in 2023 was poor, the exploration of ways to generate additional operating profit is therefore important.

Vertical integration usually brings greater control and lower costs.

However, the acquisition of the vineyard and winery may be driven more by sentiment than commercial logic.

The acquisition represents diversification for the group as the winery is a new business area, this is in line with the strategic direction, however wine making is a complex and highly skilled industry.

The board do not have any experience of this industry and the acquisition of a poorly performing business in an unfamiliar area is not likely to be a sound business decision.

In addition, if the winery is purchased the wines would be sold under the Lorenso label and not the Arola name. This may be inadvisable if the current wine labels are well regarded as customers would not appreciate that they were purchasing Arola wines and the group would lose the benefit of the Arola brand.

Further research should also be conducted to assess the quality and reputation of the wine and hence ascertain the value of the Arola brand.

The range of wines produced should be considered in more detail, the older vines are likely to produce higher quality and hence higher value wines. This will assist in determining the value if any that can be attributable to the brand.

4.5 Funding (3 marks)

The acquisition requires an investment of GBP 11 million (in euros). It is likely that both the Arola family and Lorenso Group would favour a cash purchase as this would release cash for the Arola family and would not relinquish any control in the Lorenso Group.

The Lorenso Group can fund the cash acquisition through a combination of existing funds, an equity injection or through borrowing.

If there is sufficient surplus cash, then this is the simplest and obvious solution.

Alternatively, it may be relatively simple for Lorenso to invest some personal wealth into the group in exchange for additional shares.

Finally, it may be possible for the group to borrow, however the low operating margins would lead to low interest cover and additional debt would be more difficult to obtain.

The level of assets available as security and current gearing ratios would also be relevant.

4.6 Exchange rate risk (2½ marks)

The acquisition would introduce additional risks for the business. The acquisition and investment are in EUR, and this would introduce additional exchange rate risk for the Lorenso Group.

Transaction risk would apply as many of the costs are in EUR and the revenue is in GBP.

Translation risk would also exist as assets are valued in EUR.

Translation risk can be reduced by using EUR borrowing to finance the acquisition. As the Lorenso Group is based in the UK it may be harder to obtain favourable rates when borrowing outside the UK.

It may be possible to enter a SWAP agreement to reduce borrowing costs.

Transaction risk can be hedged in the short term however any longer-term exchange rate movements cannot be hedged.

4.7 Due diligence (4 marks – marker note, must be tailored to Arola)

This report has already identified key information that needs to be verified. If the Lorenso Group decides to progress with the acquisition, additional due diligence should be performed.

There are typically four areas of focus for due diligence:

- Financial
- Legal
- Strategic
- Operational

Financial

The board will need to satisfy themselves that the financial information presented by Arola Winery can be relied upon.

This would include for example, historic earnings, cashflow forecasts, asset valuations and completeness of liabilities.

Legal

This would cover the ownership of assets and brand names together with an assessment of any potential liabilities that may arise in the winery.

Details of any existing supply agreements would be included here too.

Strategic

This would consider the strategic position of the Arola Winery, so for example the quality and reputation of the wine, the soil quality, climate, and opportunities to increase production through acquisition of nearby land.

In addition, the wine should be tasted again, and assurances given that the wine is from the Arola winery.

Operational

This involves discussions with employees, customers, and suppliers to understand the processes and risks at an operational level.

Given the skill involved, key members of Arola staff should be identified, and employment contracts scrutinised to ensure they will remain within the winery after acquisition.

4.8 Recommendation (1 mark)

Acquisition of the Arola Winery is not recommended.

The Lorenso Group should focus attention on improving the performance of existing revenue channels. The Arola Winery has low yields and to be profitable requires investment, industry knowledge and the correct distribution channels for the quality of wine that will be produced.

Once the operating profit has been increased the Lorenso Group can look for other winery acquisitions that have a more appropriate profile that is a better fit with the needs of the Lorenso Group.

Appendix (i)

Bomerano: Net assets after write-off of intercompany debt 31 December 2023

	£'000	£'000
Non-current assets		
Right of use assets	3,500	
Plant and machinery	550	
		4,050
Current assets		
Inventory	10	
Receivables	65	
Cash	20	
		95
		4,145
Creditors: amounts falling due within one year		
Trade creditors	50	
Lease obligations	75	
		(125)
		4,020
Creditors: amounts falling due after one year		
Lease liability	3,450	
Bank loan (unsecured)	2,000	
		(5,450)
Net liabilities		**(1,430)**

Appendix (ii)
Valuation of Bomerano brand

	£'000	£'000
Non-current assets		
Right of use assets	3,500	
Plant and machinery	550	
		4,050
Current assets		
Inventory	10	
Receivables	65	
Cash	20	
		95
		4,145
Creditors: amounts falling due within one year		
Lease obligations	75	
		(75)
		4,070
Creditors: amounts falling due after one year		
Lease liability	3,450	
		(3,450)
Net assets		620
Bomerano name (balancing figure)		1,380
		2,000

Appendix (iii)
Arola Winery Return on Investment calculations

Yields	**Low**	**Current**	**High**
Acres	50	50	50
Yield per acre (kg)	2,000	4,000	10,000
Bottle per 1,000 kg	720	720	720
Bottles produced each year	72,000	144,000	360,000
Additional profit per bottle	£5.26	£5.26	£5.26
Additional profit	**£378,720**	**£757,440**	**£1,893,600**
Investment	£11,000,000	£11,000,000	£11,000,000
ROI	**3%**	**7%**	**17%**

Appendix (iv)
Profit per bottle before integration of supply

Per bottle	**£**	
Restaurant		
Retail price	24.00	
VAT at 20%	(4.00)	
Restaurant income	20.00	100%
Restaurant cost	(10.00)	
Restaurant profit	**10.00**	**50%**
Distributor		
Distributor income	10.00	100%
Duty	(2.23)	
Shipping costs	(0.25)	
Bottle cost	(4.52)	
Distributor profit	**3.00**	**30%**
Winery		
Winery income	4.52	100%
Winery cost	(2.26)	
Winery profit	**2.26**	**50%**

Profit per bottle after integration of supply

Per bottle	**£**	
Restaurant		
Retail price	24.00	
VAT at 20%	(4.00)	
Restaurant income	20.00	100%
Duty	(2.23)	
Shipping costs	(0.25)	
Winery cost	(2.26)	
Total profit	**15.26**	**76%**

Additional profit per bottle if integrate supply £15.26 - £10.00 = £5.26

Email to the ethics partner

To: ethicspartner@stephensandhenderson.com
From: maxdouglas@stephensandhenderson.com
Date: 31 October 2023
Subject: Secondment at the Lorenso Group

Dear ethics partner

I am currently on secondment covering the financial controller position at the Lorenso Group and there are several matters that I think you should be aware of. I have grouped these as internal uses with the firm, and issues concerning the client.

Note to markers: Candidates are not expected to cover all of these ethical issues. See guidance in the Competency Grid.

Issues with Stephens & Henderson LLP / Robin Sinclair

Lack of experience for secondment

I was assigned a secondment position to provide maternity cover for the financial controller. This was a role that I had no experience of and I may lack the **professional competence** to carry out my role adequately.

ACTION: I should be supported by the firm to perform my role, with extra training if necessary. Future secondments should be based on the skill set of the individual to ensure this doesn't happen again.

Exaggeration of experience to the client

When I raised this with Robin, she confessed that she might have exaggerated my skills to the client but did nothing to resolve the situation. This was a potential **intimidation** threat as I had to take on work that was not within my own area of competence.

ACTION: It should be stressed to Robin that it is not ethical to exaggerate professional skills to a client.

Familiarity of Robin with the client

It appears that there is a **familiarisation / objectivity** threat as Robin and Lorenso have known each other for many years and per Robin, "help each other out". No indication was given of what this might mean but it should be investigated further.

A similar overfriendly relationship may also exist between Sapna and Robin. The two are socialising during the working day under the guise of attending a technical briefing.

ACTION: Provide refresher training to partners and employees on the familiarity and self-review threats. Ensure that audit partners are rotated, for example every five years, as a safeguard against this threat. S&H to consider whether Robin should act as the partner on this client.

Pressure to work overtime to do additional reporting

In addition to this full-time role, Robin agreed that I would be able to take on additional ad hoc reporting. There was a potential **intimidation** threat as Robin suggested that the additional work would be acknowledged within my appraisal. I am quite willing to take on additional work provided this is a reasonable request, I have been at the clients less than two weeks, and I have already been asked to complete additional work at short notice on three separate matters. Given my lack of experience and knowledge of the client these have all meant considerable additional work to deliver as requested.

ACTION: Discussion with Robin about HR expectations for work/life balance and pressure placed on staff members.

General overworking of staff in the Manchester office

My understanding is that Robin is one of the Manchester partners that routinely pressures staff to work longer hours. This shows a lack of **integrity** to require staff to do this and may lead to errors being made.

ACTION: SH should review the workloads of employees in respect of future engagements ensuring that there are sufficient suitably qualified employees in place. If not, either recruit, utilise under used resource from other SH offices, or decline the client work.

Robin also suggested that I would be able to manage the audit next year as my knowledge of the business would enable less time to be spent on the client work. There is clearly a **self-review** threat as I would be auditing information that was produced as part of my duties as the financial controller.

ACTION: Review of independence training for all staff, including Robin.

Acting for Lorenso as an individual

S&H in engaged to act for the Lorenso Group. I have been asked by Robin to do some work for Lorenso Romero himself, offering tax advice on a potential gift of shares. I do not know if an engagement letter is in place for this and this could be a breach of **professional behaviour** to provide work for a client, without the necessary paperwork in place.

ACTION: Check whether an engagement letter is in place.

Accepting gift vouchers from the client

Finally, there appears to be inappropriate behaviour leading to a lack of **objectivity** whereby Robin and others have access to discount vouchers for Lorenso's. This could also be in breach of the firms policy that projects against actual and perceived bribery.
ACTION: Reminder to Robin about the policies in place around accepting gifts and hospitality from clients.

Reputational damage for acting for Lorenso Group

There is a reputational risk of S&H continuing to represent the Lorenso Group following the social media backlash. This should be monitored and reviewed and may be considered to be show a lack of professional behaviour and integrity.
ACTION: Monitor the situation and senior partners to consider whether to cease to act for this client.

Issues with the client – Lorenso Group

Current Lorenso FC

Sapna has openly criticised the performance of the current financial controller. If there are performance issues these should be managed in a professional and legal manner and discussing it with me is a breach of **confidentiality**.
Sapna has suggested that she might change the financial controller's role and make it difficult for her to return on a part time basis which indicates a lack of **professional behaviour**. There is a risk that the Lorenso Group might be exposed to an employee dispute and legal challenge if the relevant employment law is not followed in respect of this.
ACTION: SH should advise Sapna to seek legal guidance in respect of any performance issues with the current financial controller.

Offer of FC role

Sapna has offered me a full-time role working at the Lorenso Group as the new financial controller. There is an element of **intimidation** here as to continue to work on a secondment basis may cause friction between us.
ACTION: SH to advise Sapna of the terms of the secondment, and to remind her to seek legal guidance in respect of any performance issues with the current financial controller.

Favourable report recommendation

There was a hint of **intimidation** as Sapna suggested that I should present the acquisition of the Arola Winery in a favourable way as Lorenso is emotionally invested in the opportunity. This makes it difficult to present an unbiased report on the acquisition.
ACTION: SH to ensure that Sapna is clear on the terms of the secondment and SH's professional responsibilities.

Lack of control over gift vouchers

There appears to be a lack of control as assets within the business are not safeguarded appropriately. Head office staff are able to access discount vouchers for Lorenso's. There do not appear to be any controls over the issue of these vouchers.
ACTION: SH to advise Sapna of the risk this presents and to suggest suitable controls to mitigate this.

Reputational damage

The recent social media controversy surrounding Lorenso Romero has had a negative impact on the Lorenso business and shows a lack of **professional behaviour** from Lorenso himself.
ACTION: Lorenso group should increase staff training on social media use / monitoring of personal posts for key staff members. Consider implementing social media policy for staff

General intimidation at Lorenso

There appears to be a general atmosphere of intimidation at Lorenso. Staff morale is likely to be poor and management may be bullying staff members which is **unprofessional.**
ACTION: Management at Lorenso should receive training around expectations and management of staff. SH should consider the impact on the secondee.

If you would like me to provide additional information in respect of any of these matters, please let me know.

Kind regards

Max Douglas