



TPE 2023 – Case Study – Part 1

Pagmari

Comprehensive Case Study

Initial Information

09.00 - 11.30 (2½ hours)

13.00 - 16.00 (3 hours)

History

TPE examination, May 2018. Pass rate 77%. 2½ hrs in the morning and 3 hrs in the afternoon.

Technical Content

FA 2021

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PAGMARI

Background Notes

You are Rosemary, a newly qualified chartered accountant working for Tyme & Co (“Tyme”), a six-partner firm of chartered accountants based in the West of Scotland. It is just after 8am on a Monday morning in mid-May Yr 18 and you are in a meeting room sitting opposite Sam, the firm’s Business Services partner.

After some initial pleasantries Sam starts to talk about Pagmari Ltd (“Pagmari”).

“As you will have read on our internal blog, as from last Friday, I have been assigned as the new engagement partner of Pagmari, a garden centre owned and run jointly by two women, one of whom is a chartered accountant. Unfortunately, the previous engagement partner, Jasper, resigned from the partnership due to ill-health. I have been advised by the firm’s insurance company that under no circumstances should we contact him about any work-related matters. During this assignment, do keep your eyes open for any issues that relate to Jasper’s time as engagement partner and make a note of them. We can discuss these later if they are important.”

“That sounds terrible,” you interject. “I had heard rumours that he was not well, which is a shame since he had the reputation of ‘getting things done’ and, seemingly, gave clients practical advice as opposed to simply handling the compliance issues.”

“Yes, Jasper did have that reputation, for better or worse,” replies Sam. “However, be that as it may, yesterday I met Jan, who is a CA and one of the co-owners of Pagmari, over a cup of tea in the company’s tearoom. She said she is keen to expand the business but was concerned that the company is not performing as well as she had expected. She asked for our appraisal of the business, as it is today, in the form of a briefing paper. She also wants the briefing paper to include our views on a lesser matter, which I shall come onto in a moment.

“The company has two divisions:

- a retail and wholesale division, which is managed by Jan and Februum (the other co-owner); and
- a landscape division, which is run by Martius and Brian (Jan and Februum’s respective husbands).

Here are some extracts of the background information of Pagmari (Section 1) and the draft management accounts and other information (Section 2). I have also included the company objectives (Section 3) extracted from our files.”

Sam hands you the documents.

He continues. “As Jan and I tucked into some delicious doughnuts from the company’s tearoom, Jan explained that Martius and Brian had come across an opportunity to acquire the shares of a local pond installation and maintenance company for £125,000. She understands that it has been loss-making for the last few years and that it has, effectively, no net assets. It is this opportunity that has prompted her request for the briefing paper and she wants to read this before any decision is taken. Jan stressed she wants our appraisal to be of the Pagmari business as it is today, including any suggestions for improvements. She thinks that a ‘fresh pair of eyes’ looking at the operation may give her some ideas as to how to develop the business and thinks a regular ‘health-check’ is always a good idea.”

“Does she want comments on the potential acquisition?” you ask.

“No, let’s do the appraisal and suggestions for improvements first. I think it will be highly unlikely she will want to proceed with the purchase but I can ask her if she wants our comments on this tomorrow,” replies Sam. “Do make sure the briefing paper includes plenty of practical advice and recommendations, after all, we are following in the footsteps of Jasper.

“The lesser matter that Jan would also like our opinion on relates to the landscape division. Martius and Brian are considering changing suppliers for the aggregate used in this division, that’s stone chippings to you and me. At the moment they simply search the internet and purchase what Brian thinks is the best deal at the time. However, this, of course, means they are missing out on bulk-purchase discounts, which can be considerable in this line of business. They have narrowed down the search to two suppliers (Section 4) and Jan would like a concise assessment of the proposals included in the briefing paper with a clear recommendation on which supplier to select.”

“This sounds like an interesting job. What is the deadline?” you ask.

Sam replies, “I’ve arranged to meet Jan here tomorrow afternoon, so I’ll need to review the first draft of the briefing paper this lunchtime, so it can be emailed to her by close of business this afternoon.

“Ah, one other thing. Do make a separate note of any ethical matters you think should be brought to my attention from your appraisal of the business and review of the figures. After I’ve met with Jan tomorrow, you can prepare a memo with any matter that needs to be brought to my attention, which can include those from your work this morning. Are you clear with what you need to do this morning?”

“Yes,” you reply.

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;
- draft the briefing paper for Jan, as requested by Sam, covering the two issues discussed; and
- note down any ethical matters that should be dealt with later in this assignment.

SECTION 1

Background information on Pagmari Ltd as held by Tyme & Co

History

The business was started approximately 10 years ago by two friends: Jan, who is a chartered accountant and Februum. They both have a keen interest in horticulture and they initially grew their own plants and sold them at local shows and fetes to raise money for a local homeless charity. This proved to be so successful they decided to set up a small garden centre with the intention of donating some of the profits to a homeless charity. At the time, their accountant suggested it would be safer and more tax efficient to trade via a limited company and so Pagmari Ltd ("Pagmari") was incorporated in April Yr 09. It has an initial share capital of 1,000 £1 ordinary shares with 500 shares each being held by Jan and Februum, the only directors of the company.

Initially, the company sold plants that were grown 'on-site' by the two directors via a company shop, which was situated adjacent to the main road leading to the picturesque site of Loch Lomond and the Trossachs National Park. As a result of the philosophy of growing and selling a wide-range of high-quality local flora for the local area, the business was successful, and the company grew from strength to strength.

The initial shop was rented from Forestry and Land Scotland (formerly the Forestry Commission) and was part of a much larger group of unused rural buildings, which formed a U-shaped steading. As the business expanded it rented additional units within the steading and it now currently rents the entire steading plus approximately 40 acres of land behind the buildings. The rental agreement is on a month-to-month basis and there is an abundance of land surrounding the existing site that can be rented from Forestry and Land Scotland as and when required.

Four years ago, the husbands of both Jan and Februum worked for a national building contractor but were made redundant when the company decided to close down its Scottish operations due to lack of demand. The husbands, Martius and Brian, decided, with the agreement of their wives, to join Pagmari and to set up a separate landscape division.

Personnel

Jan Paganowski (aged 43) Joint managing director and head of procurement; gross salary £50,000

Martius Paganowski (aged 45) Head of marketing of the landscape division; gross salary £10,000

Februum Mariko (aged 42) Joint managing director and head of sales; gross salary £50,000

Brian Mariko (aged 41) Head of purchasing and personnel of the landscape division; gross salary £10,000

Jan and Martius rarely take time off and live in a modest three-bedroom house. They do not have any children but have two young pet Bernese Mountain Dogs, which roam around the 40-acre site during the day. It has been said by some visitors that they visit the garden centre regularly just so that their children can interact and play with the dogs. Jan is a regular user of social media and uses this to keep in touch with friends and family most days of the week.

Februum and Brian have five children ranging in ages from seven to 19 and all take a foreign holiday together each year. They live in a five-bedroom house with an acre of garden and two of their children have recently started to attend private, fee-paying, schools. Februum keeps saying the house is a bit cramped and life is tough, but they make do with their two, top of the range, 4x4 cars.

Retail and wholesale division

Retail

About half of the land is used to grow plants for sale in the shop. A further ten acres has been landscaped and developed so that visitors can walk round the gardens and admire the established plants and borders, all of which are for sale. The gardens have been subdivided into different types of plants/ themes by decorative wooden fencing and hedging so the visitors get the impression of moving from one environment to another. The company has won a number of local horticultural awards for the designs and this is a big attraction in drawing in visitors to the garden centre. Each year, at least two acres are redesigned and replanted so that visitors can have a new experience, thus encouraging repeat business. The garden centre can accommodate about 600 visitors per day without it starting to feel overly crowded.

Over the years the business has diversified away from simply growing and selling plants. In Yr 12, it opened a large tearoom/ café where visitors could purchase freshly prepared food and drink, much of which was cooked using the company's own-grown produce as well as herbs and spices. Due to the excellent culinary skills of the chef, who has been with the company since the tearoom opened, it has gained a good reputation and within a year it was more or less operating at full capacity. Many customers combine a visit to the garden centre with dining at the tearoom.

At the same time, a small range of low-priced horticultural accessories such as trowels, spades, forks, etc, were also purchased with the aim of becoming more of a 'one-stop' shop for their customers. Although this was moving away from the original ethos of the business, this change in strategy was moderately successful and continues to this day. The retail side of the business does not sell via the internet although it does have an internet presence. However, the website only provides the browser with basic information on what type of plants are generally for sale, a map, opening hours and contact details.

Wholesale

In Yr 13, the directors took the decision to enter the competitive wholesale market. Part of the company's unique selling proposition is that it specialises in growing a variety of plants that can thrive in the Scottish climate. The directors decided to focus on selling a selection of the more high-value plants such as rhododendrons, hydrangeas, begonias and unusual varieties of heathers.

During her time training with an international firm of chartered accountants, Jan worked on the audits of two large UK-based home and garden improvement retail chains that sold high-value plants. She has kept in touch with some of the client staff from the retail chains via social media and this enabled her to be introduced to the appropriate buyers. After an initial successful trial order, both of these retail chains signed up Pagmari as their sole supplier of high-value Scottish plants.

However, each deal involves the retail chains setting the price at which the plants are purchased and the gross margin Pagmari is allowed to make at no more than 10%. Every three months, the retail chains receive the relevant extracts from Pagmari's management accounts showing the quarter's sales and cost of sales figures. They have the

right to inspect the underlying records to substantiate the gross margin although, to date, this right has not been exercised. If the gross margin exceeds 10%, a penalty equal to 50% of that quarter's sales is payable to the retail chains. The contracts include procedures to be followed if there is a dispute over the gross margin calculation, although it is defined very clearly within the contract. These two retail chains make up approximately 90% of the turnover of the wholesale business and the contracts are renewable every 12 months in October.

To produce sufficient plants to satisfy the orders, the company invested heavily in high-tech computer-controlled equipment. These were financed using hire-purchase agreements lasting five to 10 years depending on the nature of the equipment. A number of greenhouses of varying sizes were also constructed to enable plants to be made available throughout the year. The area set aside for the wholesale operation is approximately ten acres.

Landscape division

The biggest strategic change for the company came at the start of Yr 14 when the husbands of the directors joined the company and started the landscape division. Although this operates from one of the out-buildings at the side of the 40-acre plot it is run completely autonomously with its own bank account and accounting records. Most of the work is undertaken as a sub-contractor for larger landscape businesses and for housebuilders.

Accounting

The day-to-day recording of the accounting information within the retail and wholesale division is undertaken by staff of Pagmari. Jan and Februum have adopted good segregation of duties and consider the controls over the division's assets are generally good. Once a week, the services of a local bookkeeping firm are used to process the company payroll and to check the reconciliations. The local bookkeeping firm also processes the accounting information of the landscape division, which is overseen by Brian.

At the end of each month, the local bookkeeping firm produces the management reports including a comparison of the current year's management trading figures with prior year figures.

SECTION 2

Draft management trading accounts and other information of Pagmari for the year ended 30 April Yr 18

The management trading account figures are shown below. The comparative management trading account figures for Yr 17 were used to prepare the final unaudited statutory accounts, without any amendments. All figures are quoted net of VAT unless otherwise stated.

	Note	Yr 18 Retail and wholesale £'000	Yr 18 Landscape £'000	Yr 18 Total £'000	Yr 17 Retail and wholesale £'000	Yr 17 Landscape £'000	Yr 17 Total £'000
Turnover.....	1	7,401	2,505	9,906	7,385	2,550	9,935
Cost of sales.....	2	<u>6,134</u>	<u>2,630</u>	<u>8,764</u>	<u>6,068</u>	<u>2,627</u>	<u>8,695</u>
Gross Profit/(Loss)		1,267	(125)	1,142	1,317	(77)	1,240
Overhead Expenses:	3						
Rent and rates....		150	-	150	150	-	150
Utility expenses...		36	-	36	35	-	35
Management salaries.....		100	20	120	100	20	120
Directors' pension premiums.....		80	-	80	80	-	80
Communications..		30	-	30	27	-	27
Travelling.....		30	-	30	29	-	29
Advertising.....		85	2	87	84	2	86
Repairs and renewals.....	4	64	-	64	14	-	14
Bank charges.....		79	-	79	77	-	77
Depreciation.....		67	-	67	57	-	57
Other.....		<u>15</u>	<u>-</u>	<u>15</u>	<u>15</u>	<u>-</u>	<u>15</u>
		736	22	758	668	22	690
Earnings before interest and taxation.....		<u>531</u>	<u>(147)</u>	<u>384</u>	<u>649</u>	<u>(99)</u>	<u>550</u>

Notes

1. Retail and wholesale ('R&W') turnover

		Yr 18 £'000	Yr 17 £'000
Retail			
Average sale per transaction	£26.25		£25.50
Transaction numbers	155,000		166,000
Turnover		4,069	4,233
Tearoom			
Average sale per customer	£7.50		£7.50
Customer numbers	119,100		114,600
Turnover		893	860
Wholesale			
Average plant sale	£4.85		£5.05
Transaction numbers	502,900		453,900
Turnover		<u>2,439</u>	<u>2,292</u>
Total turnover – R&W		<u>7,401</u>	<u>7,385</u>

Due to COVID restrictions, the garden centre and tearoom remained shut throughout March and April. Although this meant transactions were negligible in these months, Pagmari had already enjoyed a successful financial period up to this point – with significantly higher sales in the Summer months when compared to the prior period.

Pagmari continued to pay its staff throughout March and April and did not take advantage of the government's furlough scheme.

The garden centre and tearoom will reopen in June, following advice from the Scottish Government. It is expected that revenue and costs will fall in next financial period as travel restrictions are expected.

Landscaping services were able to continue throughout March and April.

2. Cost of sales

		Yr 18 £'000	Yr 17 £'000
R&W			
Retail			
Cost of sales %	81%		80%
Cost of sales		3,296	3,386
Tearoom			
Cost of sales %	72%		72%
Cost of sales		643	619
Wholesale			
Cost of sales %	90%		90%
Cost of sales		<u>2,195</u>	<u>2,063</u>
Total cost of sales – R&W		<u>6,134</u>	<u>6,068</u>
Landscape			
Cost of sales %:			
Materials, depreciation and other direct costs	72%		71%
Subcontractors and casual staff	33%		32%
Cost of sales		<u>2,630</u>	<u>2,627</u>

The retail and wholesale division employs 92 (Yr 17: 89) full-time equivalent members of staff all of whom are under contracts of employment. The hourly rate ranges between £7 and £15 per hour and the company has a policy of not employing anyone under the age of 21.

This contrasts with the landscape division, which only employs half a dozen Eastern European employees, not all of whom hold a full UK passport. The landscape employees are paid weekly. The rest of the landscape workforce is obtained via agencies and subcontractors as and when the need arises, which is essentially all the time. Five of the subcontractors have been working full time for the division since it was established.

The landscape division does not own any substantial equipment. If equipment is required for a job it is usually hired either directly from a local merchant or via the subcontractors. Some equipment such as scaffolding, forklift trucks, tractors and cherry pickers are effectively hired on a full-time basis since they are required for most of the work undertaken.

For both divisions, depreciation charged on plant and equipment is included in the cost of sales figure. Depreciation on store fittings and display units is included as an overhead charge.

When the landscape division requires plants, such as rhododendrons and heathers, these are acquired from the wholesale business. Brian is of the view that, since the plants all belong to the same company, there is no point in wasting time and money raising unnecessary paperwork for the acquisitions and so they have not been recorded at all. He estimates about £60,000 (valued at wholesale selling price net of VAT) of such plants were used during both the Yr 17 and Yr 18 financial years. It is unclear whether Jan and February know the full extent of the amount of plants used in the landscape division.

The landscape division sources materials such as forest bark, wood, paving slabs, cement, aggregate etc. from the internet on a week-to-week basis and will purchase from any number of suppliers. Much of the wood is from the Amazonian rain forest and, due to the 'free' transportation costs, is ordered almost on a weekly basis to keep the inventory holding down to a minimum.

3. Overhead expenses

The invoices for most of the overhead expenses are not split between the two divisions. To make the accounting straightforward, the invoices are assumed to belong to the retail and wholesale division with no attempt to allocate any costs between the two divisions. This was suggested by Brian on the grounds that he spent enough time dealing with the existing paperwork and that he did not want to waste any more time dealing with unnecessary stuff only of use to accountants. An estimate of the administrative expenses, excluding repairs, incurred by the retail and wholesale division on behalf of the landscape division is £10,000 per annum.

4. Repairs and renewals

During Yr 18 there was a one-off repair of £50,000 to the roofs of the two buildings used to accommodate the administration functions of the wholesale operation and the landscape division. Both roofs are approximately the same size and needed similar amounts of repair work undertaken.

5. Miscellaneous

- No dividends have been paid for the last two years.
- There are no directors' loan accounts at either year end.
- The company has paid corporation tax for each year since it was incorporated.
- The total net assets at 30 April Yr 18 are stated as £275,000 with the share capital being £1,000 and retained reserves being £274,000.
- Small donations to homeless charities have occasionally been made.

SECTION 3

Corporate Goal, Objectives and Principles of Pagmari

Pagmari goal

To become the leading Scottish supplier to customers of high-quality, locally grown plants, which have been grown in an environmentally friendly manner.

Pagmari objectives and principles

- To sell high-quality merchandise and to promote a healthy lifestyle by encouraging customers to enjoy their garden and the 'great outdoors'.
- To be operationally excellent and environmentally friendly by investing in the latest machinery using eco-friendly materials.
- To provide consistent, exceptional customer service by continually educating and training staff.
- To commit to fairness and integrity in all aspects of the business.
- To invest in our staff and to provide a safe and enjoyable working environment for all employees and to continually monitor their working environment.
- To provide local jobs for local people.
- To trade profitably and to donate a percentage of profits to Scottish homeless charities.
- To own, either personally or within the company, the land and buildings from which the company trades.
- To continue to search for appropriate premises available for sale from which the business can trade.

SECTION 4

Aggregate Supplier Quotations

The following are two quotations based on an anticipated annual purchase level of 2,000 tonnes of grey/ blue aggregate.

National supplier

Standard size aggregate is sourced from all over the world and thus over 1,000 different types of colours, shades and combination of colours are readily available. However, not all variations are held as inventory items and, thus, there may be a lead-time of two months for some less common aggregate.

If aggregate is available from the local depot it can be delivered the day following receipt of a telephone order to the call centre in Birmingham. If it is held at a non-local depot, it is likely to be delivered a day later. Due to the company's health and safety policy, all aggregate must be delivered by an authorised insured company driver and, thus, cannot be collected by Pagmari's staff.

All deliveries are in disposable one-tonne sacks and can be delivered to the customer site.

The price for standard grey/ blue aggregate is £100 per tonne. After 2,000 tonnes have been ordered in a calendar year, a 10% discount will be applied to all subsequent orders in that year. Delivery is free of charge unless the order is for less than 10 tonnes in which case a £25 charge is applied.

Local quarry

The aggregate is sourced from a large quarry just outside the Trossachs National Park under highly controlled and regulated conditions. The quarry is operated by a family-owned company which has been extracting the aggregate for three generations. When the quarry has reached the end of its economic life, which is anticipated to be in Yr70, the area will be landscaped and returned to its original natural condition as far as possible.

The colour of aggregate is based on the grey/ blue spectrum with varying differing natural hues being always available.

In addition to the standard aggregate sizes (e.g., 40mm and 20mm), the machinery can produce aggregate of any desired size for an additional £100 per order to cover the work involved in changing the mesh size of the crushing machinery.

Same day delivery can be made for orders of standard size aggregate placed before midday and the following day for orders placed after midday. Aggregate can be collected from the quarry and emergency deliveries arranged, if required.

Deliveries are usually made to the customer site by tail-end tipper trucks. However, if required, aggregate can be supplied in heavy-duty, reusable one-tonne sacks. There is a £3 charge per sack, which is refunded upon return.

The price is £115 per tonne. However, if the cumulative orders in any calendar year exceed 2,000 tonnes, a 10% rebate is applied retrospectively to the account and to all subsequent orders in the year. Delivery is free of charge, although this will be reviewed if orders of two tonnes or less are commonplace.

Both the national and local suppliers have recently confirmed that, despite expected COVID restrictions, there are no supply or delivery issues expected.

END OF PAPER