



TPE 2023

Modni – Case Study Part 1

Comprehensive Case Study
Initial Information

You have **2½ hours** to complete this paper

History

TPE examination, Nov 2021.
Pass rate 81%.
2½hrs in the morning
3hrs in the afternoon.

Technical Content

FA2022

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A large, stylized graphic on the right side of the page. It consists of two concentric circles. The outer circle is a bright green, and the inner circle is a darker teal. The letters 'tpe' are written in a large, white, lowercase, sans-serif font across the center of the circles.

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Background notes

It is late October and you are Charlie Tarazi, a recently qualified accountant working in the business advisory department at Pemberton LLP, a large firm of chartered accountants based in the north of England. Your manager, Jess Sharp, has asked you to join her to discuss some project work that she would like you to complete.

“Good morning” you say, “how was your weekend?”

“I doubt it was as good as yours! One of the managers is on long term sick leave and we have all had to take on extra clients, so I spent most of it working. Anyway, I won’t bore you with my troubles. I do however have some interesting work for you.

“Do you recall Modni, the fast fashion retailer?”

“I’ve heard of them yes, but I don’t know very much about them.” You reply.

“Well, that can’t be helped, but don’t worry it won’t be a problem. There is a lot of information in the files about the company and the industry, so you’ll soon pick it up!

“As I am sure you know, trading conditions have been difficult over the last couple of years and the board has asked us to conduct a review of the company’s recent performance and evaluate the current position. I think the board would value an honest, independent appraisal. Once the board has reviewed our report, they plan to devise their five year strategic plan. There is no need for us to include suggested strategies as part of our work.

“Teddy Lotz, the CEO, is under a lot of pressure from the shareholders to bring the company back to profit and whilst he wants an objective appraisal, I think he is worried that the poor performance will reflect badly on him. He wants the board and shareholders to recognise that this was a difficult time for all retailers and that his leadership was not the cause of the recent losses. I think we should do this as much as we can.

“I’d like you to complete this work for me and prepare an internal briefing note for me covering the matters requested by the board. It will form part of a larger report so there is no need for you to produce it in report format, I’ll do that later. There is some useful background information on the company and the industry, it is all in the file. (Section 1)

“I’ve also made notes on some of the initiatives Teddy has introduced so we can showcase them a little within the report. (Section 2)

“I’d like you to look at the financial position and performance of Modni. The management accounts (Section 3) are in good shape and include some KPI’s (Section 4), so I suggest you start there. It would be useful if you analysed the performance of the different distribution channels. (Section 1)

“Benchmarking against other fashion retailers would add insight. Modni does this already, so I suggest that you incorporate these figures into your work. Use Modni’s figures as provided as this will cut down on the work that you need to do and enable us to turn this around quite quickly for them.”

“Right. I’ll get started then; I assume you need this as soon as possible?” you say.

“You know me so well! Yes please.

“Oh, I almost forgot, Teddy was hoping we could report on the underlying performance and exclude the extraordinary periods during 2020 and 2021 when the shops were closed for some of the time, and sales were zero. He has sent over some analysis which shows the effect, it’s all in the file. (Section 5)

“Ok, will do” you say. “Just thinking about the lockdown, wouldn’t they have benefitted from the government relief? It was all over the news – reduction in business rates, staff retention and re-employment schemes, that must have helped?”

“Yes, you are right they did, again you’ll find all you need in the files. (Section 5), Jess continued.

“There are some media articles in the file too. We had a student doing some intern work over the summer and I asked him to do some internet research on the fashion industry. It might be useful for your report. (Section 6)

“Sorry, there is one more thing. It may surprise you but Modni’s website is a non-transactional website and so, currently, it is just a showcase for the brand, used for product information, CSR, that sort of thing. Hard to believe in this day and age, I know. Anyway, the good news is that the board has signed off the investment and work is currently underway sourcing a suitable partner to launch a new transactional site early in the new year. I have a call with Teddy later this afternoon to discuss this. He has asked for an outline of what practical operational factors the board will need to consider when introducing this new distribution channel. Please could you draft some separate notes for me to use on the call.

Jess continued, “The lack of an online sales channel meant that Modni was significantly affected during the difficult trading conditions of 2020 and 2021. It really has been a very difficult few years for the fast fashion industry.”

“Well, not all.” You add, “I remember reading that during the 2020 lockdown, kk girl, the online fast fashion retailer, reported an increase in their active customers from 13 to 14 million. And I can see why; I have the app on my phone, and it is so easy to order, literally a couple of clicks and my order is complete. And get this, I pay an annual fee of £10 and get free next day delivery for a whole year. And it’s so cheap too, honestly, I can’t believe they actually make any profit. They also use models that look like ‘normal people’...”

You realise that you are rambling, and Jess is looking slightly bored,

“Sorry, you were saying?”

“Yes,” Jess continued, “obviously the online retailers have had an advantage. As I was saying bricks and mortar retail has been significantly affected with many retailers, including Modni, closing unprofitable stores.

“So, are you clear on what I need? I’ve got to go to another meeting now but if you have any questions just message me.”

“No problem” you say, “leave it with me. I’ll start straight away and will email my notes across by lunchtime.”

“Excellent, thanks, I knew I could rely on you.” Jess gave a parting smile as she put on her coat and headed out of the door.

Required

- Prepare briefing notes that:
 - Review the recent financial performance;
 - Evaluate the current financial position of Modni; and
 - Make any other relevant observations
- Prepare separate notes that:
 - Outline the practical operational matters that the board will need to consider when introducing an online distribution channel
- Review all the information in preparation for the afternoon session

SECTION 1

Background information

Company

Modni Plc (“Modni”) is an established company listed on the London Stock Exchange. The share ownership is not diverse with 40% owned by Orlando Kane, the original founder, 40% owned by financial institutions and the balance by private investors. The company is 100% equity financed and has a December year end.

Modni is a fast fashion retailer with a strategy to deliver reasonable quality, affordable clothing to a target market of 16-25 year olds.

Industry

Fast fashion is a term used to describe a sector of the clothing industry. The industry produces low cost clothing that is ‘in fashion’, in other words it is desirable, but this only applies for a short period of time, hence ‘fast’.

Companies in fast fashion will produce multiple ranges of clothes, each with a short shelf life. Once a product has been sold from a store, it is replaced with a different product thus making the previous one outdated. The consumer is then targeted, with the aid of advertising, to buy new products. The effect is a continuous cycle with products often being worn for only a few weeks before being discarded and replaced.

It is a competitive industry comprising many well-known brands. Traditional bricks and mortar retailers have seen significantly increased competition from challenger online brands. Modni frequently benchmarks against two competitors:

kk girl

kk girl is an online challenger brand. The product quality is typically of a lesser standard and price points are much lower. While not directly comparable to Modni, the board considers this a useful benchmark as this represents a growing sector of the market.

Joe Dexter

Joe Dexter has a similar target market to Modni and produces garments of a similar quality; the board considers this a very useful benchmark. Joe Dexter does, however, operate through bricks and mortar and online, and consequently was able to generate revenue throughout the lockdown periods in 2020 and 2021.

Product lines

Modni’s current product lines are as follows:

- Fashion wear
- Junior
- At Home
- KB Sportz

In addition to Fashion wear, Modni expanded product lines in 2018 to include the Junior and At Home range. Unfortunately, these ranges have not been very successful. The lower price point of Junior products and the necessary clearance discounts for At Home have led to very low margins for these product lines.

KB Sportz is the result of a partnership with the celebrity music personality, Kaity Brandon. This fashion leisure/sportswear has been extremely successful, and even more so since the change in consumer preferences following the lockdown in 2020. Modni charges a premium for the brand and generates high gross margins of around 60%. This product line provides a good return for Modni, even after the royalty payment to Ms Brandon.

A new product line, Shoe, is to be launched in 2022. This is another new partnership, this time with the Hollywood actress Bella Blue. Modni is still negotiating the terms of the contract, but it is hoped that this will be as successful as KB Sportz.

Distribution channels

The business operates through two core distribution channels, retail and wholesale. These are serviced by two distribution centres which are located close to motorway networks.

- **Retail**

Retail trade is business to consumer and currently operates through two sub channels.

- **Retail own store**

Modni currently has 180 own stores predominately based in the UK. Modni has full operational responsibility for own stores. The portfolio of stores was reduced in 2020 as this period of lockdown accelerated a review of store profitability and longer term viability.

The current portfolio comprises a combination of leasehold and freehold properties. Most of the lease liabilities are fixed and not linked to revenue, resulting in significant pressure on cash flow in 2020. Fortunately, Modni's large cash balance enabled the board to maintain liquidity, but this has meant that levels of cash are now much lower than previous years.

Operating costs include all direct operating costs and a share of distribution centre overheads.

- **Concession stores**

Modni currently operates through 125 concession stores. The gross profit margins are much lower for concessions, however the operating costs are also significantly less. Concessions typically relate to outlets within department stores, though could extend to retail space within airports or similar.

The department store would usually cover the costs of retail assistants, cleaning, power, buildings insurance and any other ancillary costs. Modni's operating costs cover a share of the distribution centre overhead, delivery and account management.

Concessions operate such that the rental charge for space is based on revenue and is reflected within the gross profit margin. The number of outlets has reduced recently due to the closure in 2020 of two large multi-location stores.

• Wholesale

Modni also sells directly to other businesses within the UK and Europe. These businesses are referred to as retail partners. The number of partners has fallen recently and this is also attributed to the economic decline during 2020 and 2021. Modni categorises partners as either Key or Independent.

Operating costs for the wholesale business include an allocation of distribution centre overheads, delivery costs and account management.

• Key retail partners

Key partners, as the name suggests, are businesses that purchase high levels of inventory from Modni. Many sell the Modni products through their own websites along with other branded products.

• Independent retail partners

Independents are smaller businesses that purchase inventory for resale in their own outlets.

Inventory

Risk of obsolescence is high within fast fashion and in 2018, to protect against this risk, Modni introduced a policy of flash sales and early promotions. Despite this, the closure of retail outlets in 2020 led to high levels of out-of-season inventory. This was compounded as Modni honoured all orders that had been placed with suppliers, despite store closures during the lockdown. This resulted in even higher levels of out-of-season inventory.

To manage this, some inventory was donated to key workers during the lockdown, some was heavily discounted and sold when stores reopened, some was written off and some was stored to be included in the new 2021 seasonal ranges. These actions resulted in a reduction in inventory at the end of 2020 down to £190 million compared with £210 million at the end of 2019.

Supply chain

Modni uses a large number of third-party manufacturers to make Modni designed products. All suppliers have to pass rigorous checks before being approved and are subject to regular inspection. Manufacturers for inventory are based in China, India, Vietnam, and Turkey. Modni regards itself as an ethical business and places high importance on treating suppliers fairly. This includes paying a fair price for inventory so that suppliers can in turn pay a fair wage to their workforce. Modni is invoiced in the supplier's local currency so that the supplier is protected from exchange rate risk. Modni has never hedged against exchange rate risk. The cost of imported goods has risen throughout 2021 due to various factors.

Modni made a gratuitous one-off payment to suppliers during 2020 to cover the cost of factory wages during the difficult lockdown period.

Leases

The distribution centres and the majority of the own-store outlets are leased. Modni has adopted IFRS16 and has reflected this within operating costs. Modni restated prior years' results for comparison purposes. (Section 5)

The restated lease commitments within the statement of financial position has resulted in a gearing ratio of 75% at the end of 2020.

SECTION 2

Strategic change

Teddy Lotz joined Modni in 2018, replacing Orlando Kane as CEO. Teddy's previous positions had been in the music industry rather than fast fashion and this experience was the driving force behind a number of new initiatives.

- **Enhanced design team**

Modni has recruited experienced and award-winning designers to enhance and extend the product lines.

- **Partnership with Kaity Brandon**

The launch of the new sportswear brand with the celebrity musician.

- **Recruitment of celebrity influencers**

Influencers receive Modni products free of charge and ensure that their social media posts feature pictures and blogs promoting Modni products. Modni partners with celebrities that appeal to the target market and have a large following on social media. The individuals are then paid for their services. Most will acknowledge this to their followers, though Modni do not police this.

- **Sponsorship of reality TV programme**

In 2019 Modni negotiated an exclusive sponsorship with a reality TV programme called Island Romance. This programme is popular with the target market and is expected to generate additional sales in the UK.

The breakdown of the costs associated with these initiatives is shown in Section 3

SECTION 3

Management Accounts (extract):

Actuals and Forecast* year ended 31 December

	2021*	2020	2019	2018	2017
Contribution	£ million	£ million	£ million	£ million	£ million
Retail own store					
Revenue	450	184	525	510	461
Gross profit	261	92	299	331	313
Contribution	17	(159)	45	48	61
Retail concessions					
Revenue	14	6	25	32	18
Gross profit	6	3	13	18	10
Contribution	2	(2)	7	10	5
Wholesale key					
Revenue	36	24	65	66	57
Gross profit	15	10	27	28	26
Wholesale independents					
Revenue	144	96	260	264	226
Gross profit	66	44	120	124	113
Gross profit wholesale	81	54	147	152	139
Contribution	38	7	100	106	94
Central costs					
New design team	10	10	10	8	-
KB Sportz	10	10	10	10	-
Celebrity influencers	15	15	15	-	-
Sponsorship	5	5	5	-	-
Other	46	47	50	55	64
Central operating costs	86	87	90	73	64
Gross profit margin	%	%	%	%	%
Modni	54	48	52	57	61
Joe Dexter	-	56	58	58	60
kk girl	-	53	55	56	55
Operating profit margin	%	%	%	%	%
Modni	(5)	(78)	7	10	13
Joe Dexter	NA	3	12	13	12
kk girl	NA	9	7	7	10

SECTION 4

Key Performance Indicators: Actuals and Forecast*

KPI

	2021*	2020	2019	2018	2017
Retail KPI					
Retail square footage '000	799	799	1,155	1,046	901
Number of own stores	180	180	240	219	192
Number of concessions	125	125	250	230	200
<u>Revenue £ per sq ft</u>					
Modni (retail)	581	238	476	518	532
Joe Dexter		425	798	792	801
<u>Operating costs</u>					
Retail own store £ per sq ft	305	314	220	271	280
Wholesale KPI					
<u>Number of retail partners</u>					
Key accounts	36	40	50	51	51
Independent retailers	<u>2,300</u>	<u>2,500</u>	<u>2,750</u>	<u>2,797</u>	<u>2,846</u>
	2,336	2,540	2,800	2,848	2,897
<u>Average revenue per partner</u>					
Key accounts £'000	1,000	600	1,300	1,294	1,118
Independent retailers £'000	62	38	95	94	81
<u>Operating costs</u>					
Wholesale £'mill	43	47	47	46	45
Cost £ per retail partner	18,407	18,504	16,786	16,152	15,533

Working capital and liquidity ratios

	2021*	2020	2019	2020	2019
		Modni		Joe Dexter	
Current ratio	2.3	2.4	3.5	1.7	1.5
Quick ratio	1.2	1.2	2.4	0.5	0.4
Receivable days#					
Average	51	55	54	39	46
Retail partners	183	142	146	-	-
Payable days#	74	60	56	116	155
Inventory days#	222	215	184	264	321
Bank and cash £'million	67	80	293	(75)	15

#Ratios have been adjusted to exclude the impact of Covid-19

SECTION 5

Underlying operating profit

	2021*	2020	2019	2018	2017
	£ million	£ million	£ million	£ million	£ million
Retail contribution	19	(161)	52	58	66
Wholesale contribution	<u>38</u>	<u>7</u>	<u>100</u>	<u>106</u>	<u>94</u>
Contribution	57	(154)	152	164	160
Central costs	<u>(86)</u>	<u>(87)</u>	<u>(90)</u>	<u>(73)</u>	<u>(64)</u>
Modni operating profit/(loss)	(29)	(241)	62	91	96
Covid-19 impact**	<u>75</u>	<u>180</u>			
Underlying operating profit/(loss)	<u>46</u>	<u>(61)</u>	<u>62</u>	<u>91</u>	<u>96</u>

Note 2018 and 2017 figures have been adjusted for comparative purposes after incorporating the requirements of IFRS16 from 2019 onwards.

*Forecast

**Extraordinary net costs arising from Covid-19

	2021	2020
	£ million	£ million
Operating costs with closed stores	(120)	(200)
Supplier payment for worker wages	-	(30)
Key worker inventory donation	-	(30)
Government relief	30	40
Lease savings (revenue based leases)	10	30
Delivery costs saved	<u>5</u>	<u>10</u>
	<u>(75)</u>	<u>(180)</u>

SECTION 6

Recent media extracts

Is this the end of 'bricks and mortar' retail?

Covid-19 means a lot of things to a lot of people, but we can all agree that it led to a fundamental change in the way we spend money.

The fast fashion industry was hit hard by the lockdown periods and has been slow to recover. After months of disruption we are seeing a return to profitability for some retailers, but primarily for those that have adapted their game for the new world. Retailers in general report that online sales have remained higher than the pre-lockdown levels with many consumers not reverting to the traditional bricks and mortar outlets. A recent survey by Consumer Today found that the most popular online purchases were clothes, shoes and accessories.

This is particularly noticeable within the younger generations. Industry surveys suggest millennials and generation Z have the highest preference to shop online, and this trend is set to continue with a staggering projection that 95% of purchases will be made online by 2040.

Joe Dexter auditor resigns over stock blunder

Fashion retailer Joe Dexter has announced that inventory in the 2020 accounts may be overstated due to a major accounting blunder resulting in an error that is likely to have overvalued stock by between £50 million and £70 million. An investigation into the error is to be conducted by independent accountants. Shares in Joe Dexter fell to a 20-year low as a result of the announcement.

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