# TPE 2023 – Practice Case Study

## Andka – 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 "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.

ICAS is providing this Guide to Answer to provide direction for your own learning. Do not use this example for any other purposes.

# MORNING PAPER

## Briefing Paper

| | |
|---|---|
| To: | Directors of Andka |
| From: | Lee CA |
| Subject: | Financial analysis and other matters relating to Andka |
| Date: | May Yr59 |

This briefing paper covers two areas, as discussed:

- Divisional financial analysis and general business improvements
- An evaluation of the Dubai luxury car proposal

## 1. Divisional performance and business improvements

I have used the draft financial statements, quarterly information and notes that you provided to analyse each division. All of the calculations can be found in Appendix 1 to this briefing paper.

As you mentioned in our meeting, the overall profitability of Andka has declined during the year ended 31 March Yr59, despite an increase in revenue.

| | *UK cars Yr59* | *UK vans Yr59* | *Dubai Yr59* | *Total Yr59* | *Total Yr58* |
|---|---|---|---|---|---|
| Gross profit margin | 25% | 37% | 50% | 35% | 40% |
| Operating profit margin | 4% | 12% | 29% | 12% | 18% |

### 1.1 UK car division

#### *Profitability*

| | *UK cars Yr59* | *UK cars Yr58* |
|---|---|---|
| Gross profit | 25% | 35% |
| Operating profit | 4% | 14% |

This division has the lowest gross and operating profit margins and the profitability has worsened year on year.

There is a small increase in annual revenue but a bigger increase in cost of sales, leading to the drop in gross profit year on year.

Cost of sales includes vehicle maintenance, vehicle depreciation and fleet insurance. From the information provided by the finance manager, depreciation has remained fairly similar each year, so the increase in cost of sales seems to be driven by an increase in maintenance, fleet insurance and any other associated costs.

The finance manager has provided me with a breakdown of cost and accumulated depreciation per quarter. It is clear from these figures that the UK car fleet replacement programme has slowed down considerably during Yr58/59. There were £200k of additions in Q1, but only £15k in Q4. The cost of your UK car fleet is around £6.5 million. Your policy is to replace vehicles after 2 years or 50,000 miles, so additions should be at least £800,000 [1]per quarter. For the year ended 31 March Yr59, you only added cars with a cost of £450k.

This could have a number of implications for the business including:

- lack of customer satisfaction – customers expect to rent new or nearly-new vehicles with little "wear and tear". An aging fleet may also lead to more mechanical issues during rentals.

- increasing repairs costs – older vehicles generally incur higher repairs costs. The repair costs provided by the manager indicate that repairs have risen each quarter.

It is important that the fleet replacement programme is restarted as soon as possible. There is a risk that you will lose the level of bulk discount from the manufacturers as your order levels have dropped.

It is unclear who has responsibility for fleet insurance while Wes O'Reilly is absent. The current policy should be reviewed to find out why charges are higher than the previous years and you should attempt to negotiate with the insurance provider to obtain lower prices.

### *Utilisation*

I have calculated UK car fleet utilisation as 70% (see Appendix 1) which is significantly below the industry average of 80% and suggests that you may have too many cars.

Based on current year revenue, you could have achieved 80% utilisation with only 591 cars[2], a reduction of 84 cars from your current fleet levels. I would recommend selling some of the older fleet vehicles as soon as possible.

However, there is normally a seasonal nature to your business, and you should consider utilisation on a quarterly basis to decide what the optimum number of cars is for your business, particularly when social/ tourism demand starts to return to normal levels.

If you reduced the size of your fleet, you could consider using some of the capital saving to invest in marketing to improve utilisation in the quieter periods of the year, which would improve revenue.

[1] £6.5m / 2 / 4 = £813k

[2] Vehicles required to achieve 80% utilisation:
Fleet utilisation = actual revenue / no.of cars x average daily rental x 365 days
Therefore, number of cars
= actual revenue / 80% fleet utilisation x average daily rental x 365 days
= £3,452k / (80% x £20 x 365 days)
= 591 cars

## 1.2 UK van division

### *Profitability*

| | *UK vans Yr59* | *UK vans Yr58* |
|---|---|---|
| Gross profit | 37% | 42% |
| Operating profit | 12% | 17% |

Although the UK van division is more profitable than UK cars, the profitability has declined year-on-year as well. The fall in gross profit appears to also be related to increasing repairs costs, based on information from the finance manager that depreciation has remained fairly constant with the previous year.

There has been a significant increase in van repairs in Q4, increasing about 50% on the previous three quarters. It is not clear exactly what this is due to, but it should be investigated and monitored going forward. It is possible that the stop/ start nature of courier deliveries, which has driven demand for vans during the COVID 19 outbreak, is causing more wear and tear.

### *Utilisation*

Van utilisation has been calculated as 84%. This is higher than the industry average of 80%.

Currently you only rent vans on a monthly basis. You should investigate whether moving to a weekly, or daily rental basis would allow more flexibility to increase revenue and, therefore, utilisation. However, it is possible that shorter rentals could result in reduced revenue, so market research and analysis should be undertaken before any change is made.

Revenue appears to be fairly constant throughout the year and, therefore, you should consider whether you could reduce the fleet slightly to maximise utilisation.

Revenue was highest in Q1 at £1.26m. This level of revenue could be achieved with only 875 vans rather than 1,000, assuming 100% utilisation (subject to operational issues).

Each van costs around £16,600. If you could increase utilisation, you could potentially reduce the van fleet by, say, 100 vans which would save the business around £1.7 million in future expenditure, while maintaining the same level of revenue.

### *Credit offered*

You offer 90 days credit for van rental. This seems like an excessive amount of credit and you should compare this to your competitors and consider reducing the credit offered on any future rentals.

## 1.3 Dubai division

### *Profitability*

| | *Dubai Yr59* | *Dubai Yr58* |
|---|---|---|
| Gross profit | 50% | 49% |
| Operating profit | 29% | 29% |

Dubai has shown an increase in revenue and in profitability for the year ended 31 March Yr59, unlike the other two divisions. This division also has the best profitability in the company.

Revenue has peaked in Q4 and is considerably higher than in previous quarters. The maximum revenue that could be earned from 120 cars in a quarter is £496,800 assuming average rental of £45 (AED 225). Revenue of £610,000 has been recorded in Q4.

The additional 'revenue' perhaps relates to gains on the trade-in of fleet cars, but this should not be recorded as revenue.

It is important that this is investigated and corrected promptly so that the annual financial statements do not contain errors.

### *Staff costs*

Staff costs are considerably lower than the other divisions. I understand that there are 8 members of staff, including the depot manager, yet staff costs are only £50,000 this year, an average of £6,250 per employee.

Whilst employment legislation in Dubai is not the same as the UK, it is important that as a UK-based company you are paying all staff a fair wage. I recommend that you review the contracts of all Dubai-based staff and benchmark these against similar organisations in Dubai.

### *Utilisation*

Fleet utilisation in Dubai has been calculated as 91% which is very good.

Hamad's note mentions that you plan to increase the fleet numbers in Dubai. Before you do this, you should do some market research and also consider the optimum number of vehicles necessary to keep the utilisation figures high, so that you don't waste cash buying vehicles which will not be utilised for most of the year. Although travel to Dubai is permitted despite COVID 19, demand may be affected by overseas travellers being reluctant due to the associated risks.

## 1.4 General business improvements

### *Profitability levels*

The profitability of Andka has declined overall during the year ended 31 March Yr59.

| | *Total Yr59* | *Total Yr58* |
|---|---|---|
| Gross profit margin | 35% | 40% |
| Operating profit margin | 12% | 18% |

Global rental companies make gross profit margins in excess of 50% and operating profit margins of around 30%. Andka has lower margins, particularly for the UK car rental division, but is unlikely to be able to reach the margins of a global rental business due to the economies of scale such a business will benefit from. Andka should investigate ways of controlling and reducing costs by carrying out a full review of expenditure.

### *Staff costs*

Staff costs are a significant part of business expenditure, around 16% of revenue. You should review staffing levels across each part of the business and consider the mix of skills you will need in future. For example, as intense cleaning is likely to become less important as public health measures to control COVID 19 ease, and you should consider whether to return staff deployed in this area to front-of-house activities or to other aspects of the business.

You also have staff at each depot for 24 hours a day to allow customers to return vehicles and also to provide security. Customers could deposit vehicle keys in a secure key box outside of office hours and vehicles should be kept in a secure area with CCTV cameras. Returned vehicles would however still need to be inspected when staff arrived each day. This would allow you to reduce staffing across each depot.

### *Fuel costs*

It is assumed that you fill each new vehicle with fuel, before the first hire. With a vehicle fleet of around 1,800 vehicles, you are filling up approximately 900 new vehicles a year. Given rising fuel prices, this is a significant and rising cost to your business of at least £50,000 per annum, if assumed to be around £55 per tank.

You should approach a fuel supplier, considering proximity to all of your depots, and negotiate a discount and then use that supplier for all fuel requirements.

### *Repairs costs*

Each depot sources tyres and other spare parts from local suppliers. You should have an agreed list of suppliers for new tyres and other spare parts and attempt to negotiate bulk discounts with these suppliers to reduce costs. Local suppliers have been used to ensure parts are received quickly, but any supplier should be able to provide parts within 24 or 48 hours if necessary.

### *Use of third-party booking agents / website*

Most of your car rentals are made via third-party booking apps who take commission between 10% - 20%. You should investigate whether you could make more direct sales by increasing the marketing of your business. If you can identify where most of your car rental customers come from, you may be able to target that sector of the market and increase the profitability of each rental.

Your current website is not optimised for mobile devices, and many people use their smart phone or tablet to make bookings these days. The IT manager should be asked to upgrade the website and even consider whether an app should be developed to make booking more straightforward for the customer. This should be a priority given the huge shift to online purchasing that has occurred during the COVID 19 outbreak, which many commentators now see as being a permanent change.

### *Cash reserves*

Your cash reserves have increased significantly during the year, but this is to be expected as the car fleet has not been refreshed as much as usual towards the end of the year.

You should ensure that the older cars are replaced, but due to the lower fleet utilisation for UK cars, you may not need to replace all vehicles.

### *Appropriate records – Dubai*

There are a few discrepancies in the information for the Dubai depot. It is important that, as directors, you scrutinise the information for each depot each quarter. Budgets should be prepared for each financial year, and the quarterly information should be compared to budget so that any discrepancies can be identified and explained.

It would appear that the financial records for Dubai are kept in Dubai and there is little visibility of the financial information by the UK-based finance manager. She would be able to do more analysis of the quarterly returns if she had information from Dubai.

## 2. Evaluation of luxury car proposal

### 2.1 Market / competition

It is likely that there is a market for luxury car rental in Dubai, given that some of your competitors are already moving into this market. However, that in itself is a risk. The global car hire companies have already entered the market and they benefit from economies of scale as well as premium airport-based locations.

Furthermore, as Dubai has remained mostly open during the COVID 19 pandemic, this may not impact as much as other locations.

There is also a risk of other independent business, such as your own, entering the market. Although Dubai has a sizeable tourist market, there is a risk of saturation if too many competitors enter the market simultaneously.

Providing the services of a driver along with the rental car introduces a number of risks. Rental cars are usually provided on a daily rental basis – however, you could not expect one driver to be available for a 24-hour period.

You appear to be mixing regular car rental with chauffeur / taxi-style services which are more usually offered on a journey-by-journey basis. It is possible that there is a market for a chauffeur service, but this would need to be marketed and priced differently from your existing car-rental model.

Your proposed business model is ambitious with different types of luxury car. I would recommend that you undertake further market research to fully understand the needs of car renters in Dubai. This would ensure that you don’t commit to purchasing more vehicles than are needed, and that the vehicles you purchase are appropriate for the needs of the renters.

Perhaps you may be able to tap into a unique sector of the market, such as performance sports cars. It is unlikely that global car hire companies would rent such vehicles. This would allow you to differentiate yourself from your competitors.

Your existing marketing channels may not be appropriate for this type of business. You may have to do more direct marketing or identify third-party online sites that deal in the luxury market in order to maximise customer numbers.

### 2.2 Source / cost of vehicles

Purchasing 60 new luxury vehicles with an average cost of 300,000 AED / £60,000 would be a significant cost for the business of around £3.6m.

You state that you expect to receive a bulk buying discount of 15%, however this is only likely to apply if you purchase your luxury cars from the same manufacturers as you currently use. It is unlikely your existing manufacturers will have sufficiently luxurious models for your requirements.

Depending on the results of further market research, you will need to identify which new manufacturers you wish to purchase from and negotiate deals with each of them. You may not be able to receive bulk discounts at the same level as with your existing manufacturers.

You will also have to raise funds to purchase these cars as you don't currently have sufficient resources in your bank account. However, if you were to build up the business over a period of time, this would avoid the need for additional debt finance.

The insurance costs for these luxury vehicles are likely to be significantly higher than your existing fleet insurance, particularly for any performance sports cars. You should contact some insurance providers prior to purchase to get an indication of the cost of insurance cover and build these values into your projections.

Maintenance costs are also likely to be higher for luxury vehicles, both in terms of parts and also staff costs as you will need to hire staff with the necessary knowledge and experience to service and maintain these cars.

## 2.3 Currency risk

Expanding the business in Dubai introduces a greater currency risk to the business as the exchange rate is likely to fluctuate over time. Assuming that the Dubai business remains profitable, you will need to consider whether you wish to transfer cash reserves from Dubai to the UK or keep all profits in Dubai. You should consider whether it is possible to mitigate the exchange rate risk through use of foreign currency options or forward contracts.

## 2.4 Projections

The projections appear quite simplistic and you have made a number of assumptions. Some additional research would allow you to include more realistic figures and would allow you to make a more informed decision about this project.

- The turnover figures seem ambitious, particularly in year 1. You have assumed high utilisation rates on all 60 vehicles from day 1. The business will take time to grow so this is not realistic. You have also assumed average daily rentals at the higher end of your scale.

- You appear to have assumed that approximately 30 of the cars will be rented without a driver and 30 with a driver. As discussed previously, the option of renting a car on a daily basis with a driver is unlikely to work. Were you to opt for the chauffeur option, your pricing model would change, and this would have to be incorporated into these projections.

- It is unclear whether your figures include Dubai VAT of 5%, as you quoted rental prices including VAT. Turnover figures should be reported net of VAT.

- Although these projections look very good, it would also be important to produce cashflow projections due to the significant initial cash outlay for these luxury vehicles. Doing so would enable you to understand better the cash requirements to fund this project.

- Assuming cost of sales is 50% of turnover is not accurate enough. Your cost of sales figures in your existing business are made up of vehicle repairs and maintenance, vehicle depreciation and fleet insurance. The cost of drivers should be included in the cost of sales figures. Fleet insurance is likely to be significant for these vehicles and you should get a quote for this to include in the projections. Depreciation is the spread of the cost of the vehicles over the period of time you plan to use them in your business. You would need to decide how long you would use each luxury vehicle for before replacing it to determine the correct depreciation rate to use.

- Staff costs have been based on a percentage of “rental only” turnover rather than total turnover. The adjusted costs would be higher, reducing your profitability.

- It is likely that your staff costs would be higher than 3% if you were to employ a number of drivers for your fleet.

- This is a new business and you would need to market it well to attract customers. Your marketing costs seem very low and you should perhaps seek some marketing advice from a marketing agency in Dubai.

## 2.5 Recommendation

More market research is required before you make a decision on this new venture. Other, larger, competitors have already started to enter the market, so it is important that you consider how you might differentiate your product to be competitive. Your projections need further research to make them more accurate and you should also produce a cash flow projection to understand the amount of any financing required.

## Appendix 1 –Utilisation and profitability calculations

*UK cars*

| | *Q1* | *Q2* | *Q3* | *Q4* | *Y/e 31/3/59* | *Y/e 31/3/58* |
|---|---|---|---|---|---|---|
| | *£'000* | *£'000* | *£'000* | *£'000* | *£'000* | *£'000* |
| Turnover | 934 | 961 | 796 | 761 | 3,452 | 3,362 |
| Cost of sales | (705) | (728) | (592) | (571) | (2,596) | (2,202) |
| Gross profit | 229 | 233 | 204 | 190 | 856 | 1,160 |
| | **24.5%** | **24.2%** | **25.6%** | **25.0%** | **24.8%** | **34.5%** |
| Staff costs | (154) | (154) | (150) | (152) | (610) | (594) |
| Property costs | (18) | (18) | (18) | (18) | (72) | (69) |
| Management charges | (8) | (8) | (8) | (8) | (32) | (30) |
| Admin expenses | (5) | (5) | (5) | (4) | (19) | (13) |
| Operating profit | 44 | 48 | 23 | 8 | 123 | 454 |
| | **4.7%** | **5.0%** | **2.9%** | **1.1%** | **3.6%** | **13.5%** |

**Fleet utilisation**

= actual revenue / possible revenue

= actual revenue / (no. of cars x average daily rental rate x 365 days)

= £3,452k / (675 cars x £20 x 365 days)

= £3,452k / £4,927.5k

= 70%

*UK vans*

| | *Q1* | *Q2* | *Q3* | *Q4* | *Y/e 31/3/59* | *Y/e 31/3/58* |
|---|---|---|---|---|---|---|
| | *£'000* | *£'000* | *£'000* | *£'000* | *£'000* | *£'000* |
| Turnover | 1,260 | 1,189 | 1,210 | 1,179 | 4,838 | 4,685 |
| Cost of sales | (770) | (745) | (759) | (772) | (3,046) | (2,732) |
| Gross profit | 490 | 444 | 451 | 407 | 1,792 | 1,953 |
| | **38.9%** | **37.3%** | **37.3%** | **34.5%** | **37.0%** | **41.7%** |
| Staff costs | (235) | (226) | (226) | (221) | (908) | (856) |
| Property costs | (38) | (38) | (39) | (39) | (154) | (164) |
| Management charges | (12) | (12) | (13) | (13) | (50) | (58) |
| Admin expenses | (20) | (20) | (20) | (20) | (80) | (67) |
| Operating profit | 185 | 148 | 153 | 114 | 600 | 808 |
| | **14.7%** | **12.4%** | **12.6%** | **9.7%** | **12.4%** | **17.2%** |

**Fleet utilisation**

= actual revenue / possible revenue

= actual revenue / (no. of vans x average monthly rental rate x 12 months)

= £4,838k / (1,000 vans x £480 x 12 months)

= £4,838k / £5,760k

= 84%

*Dubai*

| | *Q1* | *Q2* | *Q3* | *Q4* | *Y/e 31/3 Yr59* | *Y/e 31/3 Yr58* |
|---|---|---|---|---|---|---|
| | *£'000* | *£'000* | *£'000* | *£'000* | *£'000* | *£'000* |
| Turnover | 430 | 371 | 380 | 610 | 1,791 | 1,611 |
| Cost of sales | (225) | (219) | (217) | (233) | (894) | (830) |
| Gross profit | 205 | 152 | 163 | 377 | 897 | 781 |
| | **47.7%** | **41.0%** | **42.9%** | **61.8%** | **50.1%** | **48.5%** |
| Staff costs | (12) | (12) | (13) | (13) | (50) | (43) |
| Property costs | (25) | (26) | (26) | (26) | (103) | (62) |
| Management charges | (30) | (60) | (30) | (60) | (180) | (172) |
| Admin expenses | (13) | (10) | (10) | (16) | (49) | (45) |
| Operating profit | 125 | 44 | 84 | 262 | 515 | 459 |
| | **29.1%** | **11.9%** | **22.1%** | **43.0%** | **28.8%** | **28.5%** |

**Fleet utilisation**

= actual revenue / possible revenue

= actual revenue / (no. of cars x average daily rental rate x 365 days)

= £1,791k / (120 cars x £45 x 365 days)

= £1,791k/ £1,971k

= 91%

# AFTERNOON PAPER

**Private & Confidential**

Report to the directors of Andka Vehicle Rental Ltd (‘Andka’) on the future of the business.

Prepared by: Lee CA

Date: May Yr59

## Table of Contents

## 1. Introduction

The following report has been prepared for the directors of Andka to provide advice on a number of matters, including the proposed sale of one of the UK depots and a change of direction into mobile vehicle rental.

The contents of this report are intended for the sole use of the addressees and should not be disclosed to any third party without our express written permission. In producing this report, we have relied on the information provided to us in order to produce our advice, and should any of this information be incorrect, we are not responsible for any consequent errors in our advice.

## 2. Executive Summary

- I recommend that you consider accepting the offer for the sale of the Chelmsford depot, as doing so will bring a significant cash boost to the business, after taking into consideration costs associated with the sale.

- An independent valuation should be carried out to assess if the £3m offer is a fair offer which will aid negotiation of the sale price.

- Based on a sale price of £3m, there will be approximately £87,000 of corporation tax payable which can be deferred depending on how the proceeds from the sale are reinvested.

- There are a number of implications of the sale of the Chelmsford depot that would need to be thoroughly considered such as staff redundancies, impact on customers and impact on existing bank funding before a final decision is taken.

- I do not recommend that you accept the RNC offer to purchase a mobile car rental franchise in Birmingham. Control of the franchise would lie with RNC and will restrict how you operate the business and there is a lack of relevant financial data for the Birmingham franchise. The restrictions of entering into the franchise outweigh the benefits.

- The General Data Protection Regulation (‘GDPR’) place a number of responsibilities on companies to protect their customer data. It is important that you report your data breach and ensure that all Andka staff are aware of their GDPR responsibilities.

## 3. Sale of Chelmsford depot

I have considered the potential sale of the Chelmsford depot, including the impact on funding requirements. There are several areas that should be explored in more detail but, in principle, I recommend that you consider accepting the proposal.

### 3.1 Impact on remaining business

You have received an offer from a developer to purchase the Chelmsford depot for £3m. This could be a significant cash boost to the business, but there are many implications that must be considered before a decision is made.

#### *Valuation*

I recommend that you obtain an independent valuation of the Chelmsford depot to ensure that £3m is a fair offer. If the valuation suggests you might receive more, you may wish to advertise the depot to attract other potential buyers.

#### *Closure of the car rental business*

You would need to cancel any existing customer bookings. As customers are only charged at the start of the rental period, this is unlikely to have a significant financial impact. To reduce any negative reputational damage, you could consider arranging alternative rental arrangements with other car rental businesses, to minimise the inconvenience to your customers.

You will need to alert all third-party booking websites that are used by Andka to ensure that you are removed from their sites and that future bookings cannot be made.

The existing car fleet would either be sold or used in a new venture such as the RNC franchise.

## *Location*

Your two UK locations are only about 20 miles apart. If you close Chelmsford, you need to consider whether your existing corporate van customers would travel an additional 40 miles (20 miles each way) to pickup/drop off their rental vehicle.

There is no guarantee that COVID 19 travel restrictions will not be tightened at some point in the future, restricting customers being able to travel to Romford instead of Chelmsford. This should be closely monitored and contingency plans drawn up eg: creating a temporary facility in Chelmsford.

You would need to consider how you could retain business from Chelmsford-based customers e.g. providing a vehicle drop-off service, offering a discount etc without incurring significant additional expense for the business. Alternatively, you could increase marketing activity in and around Romford to increase revenue from local businesses.

Based on the information provided by Hamad, there are currently around 1,000 vehicles based in Romford and around 670 in Chelmsford.

| | *Romford* | *Chelmsford* | *Total* |
|---|---|---|---|
| Cars | 338 | 337 | 675 |
| Vans | 667 | 333 | 1,000 |
| Total vehicles | 1,005 | 670 | 1,675 |

There are 1,000 vans in the fleet, and as there are currently around 1,000 vehicles based in Romford, so there should be sufficient capacity on site. Additionally, van utilisation (81%) is higher than car utilisation (70%), indicating that there would be fewer vehicles on site generally.

## *Staffing*

You will need to consider what to do with the staff members based in Chelmsford. Staff could be offered a move to the Romford depot, if you think there will be a need for additional staff there. The locations are only 20 miles apart, so some staff may consider transferring. However, realistically, most staff are not going to want an extra 20-mile commute, and this might not be a particularly attractive offer.

It is likely that a number of your Chelmsford staff may need to be made redundant, as it unlikely that all of the UK-based staff members will be required in one location. Staff who have been employed for at least two years are entitled to redundancy pay based on their age and length of service. I recommend that you seek the services of an employment law specialist to assist with this process.

It is important that you communicate with the employees affected and offer support to them in finding alternative employment. You should also ask the employment law specialist to estimate the possible cost to the business of the redundancies.

## 3.2 Tax implications

The company will need to pay corporation tax on the chargeable gain made on the disposal of the depot which will reduce the cash inflow. The estimated tax payable is £87,000 (see Appendix A) although rollover relief may be available if you reinvest the proceeds in a qualifying business asset.

## 3.3 Impact on funding

The offer of £3m for the Chelmsford depot would result in a sizeable cash inflow into the business. Along with the existing cash balance, you would be in the position to either repay some of your debt finance or to expand the business.

You would need to check your loan agreement with the bank to understand whether selling the Chelmsford land and buildings could have an impact on the bank loan. It is likely that the land and buildings form part of the security pool for the loan, so selling the depot may trigger repayment of the loan. You should contact your relationship manager at the bank to discuss as soon as possible.

## 3.4 Recommendation

The sale of Chelmsford would be a significant cash boost to the business. However, there are a number of other costs, some of which might be significant, which you must also consider before you make your final decision. You will most likely incur redundancy costs and lose some revenue going forward unless you can attract new customers.

However, these costs are likely to be more than covered by the sale price and I would recommend that you consider accepting the offer.

## 4. RNC franchise

I have reviewed the RNC franchise information and prepared some initial cashflow projections (Appendix B). There are some significant initial cash requirements to enter into the franchise. I would not recommend entering into the franchise as it stands.

### 4.1 Major risks

I consider the major risks of entering into a franchise with RNC to be as follows:

| Risk | Implication to Andka |
|---|---|
| Loss of control | Operating a franchise means that your business model and practice is determined by the owner of the franchise, in this case, by RNC. They would determine how and where you operate.<br><br>You would have to operate the business within their policies, even though you would still own the vehicles and be negotiating with the local council. Given that you already run a £10 million successful business, this lack of control might feel restrictive. |
| Lack of growth potential | The number of vehicles you can operate is restricted to 800 in this franchise, limiting your profit-making potential.<br><br>There would be limited room for expansion without purchasing further franchises. |
| Location | You currently operate in the East London and Essex areas. Birmingham is a considerable distance away. You will need a number of staff based in Birmingham to maintain the vehicles and premises to do it.<br><br>Existing staff are unlikely to transfer, so you would need to set up a base in Birmingham and recruit and train staff. |
| Relationship with Council | It is unclear from the letter from RNC whether they have already established links with the road department at Birmingham City Council.<br><br>The availability and ability to lease parking spaces around the city is critical to the success of the venture. |
| Market research/ demand | I assume that RNC have done market research to determine the suitability of Birmingham for a franchise. You should ask to see a copy of this. You should also do your own research to check if any other operator is considering Birmingham. Although the contact would not start until local travel restrictions have been lifted, |

| | |
|---|---|
| | customers may still be wary about travelling and there is no guarantee that restrictions will not be re-imposed. Sensitivity analysis of various risks to demand, and their impacts on revenue, is recommended. |
| Lack of financial information | There is a risk that the financial information provided by RNC (and used in section 4.3) is not accurate for operating in Birmingham. There will also be additional costs, such as staff costs, for which we do not have information. There is a significant risk that the true cost of the venture is not clear without further research. |
| Renewal of the franchise / disputes | The franchise agreement is only for four years. You should negotiate with RNC to have discretion to extend the franchise if Andka meet certain criteria. This would prevent RNC from using Andka to build up a profitable business and then take it over themselves.<br><br>The letter also doesn't discuss possible termination of the franchise by either party or how any disputes might be arbitrated. |
| Knowledge of RNC | As RNC have approached you, you might not have done much research / due diligence into RNC themselves. You should take steps to understand the key management of RNC, their trading history, their quality procedures etc. |

## 4.2 Potential benefits

Despite the risks, there are some advantages to entering into a franchise, which should also be considered before taking a final decision.

### *Experience and marketing power of RNC*

RNC state they are "successfully operating this model in London". They understand how to build up a business in a new location and will be able to give you plenty of advice.

However, you should do your own research to determine how successful they truly are. What are their profit margins, how many vehicles do they operate etc.? To be able to compare the new model to your existing business you need detailed financial, as well as non-financial, information.

They are also offering to provide a marketing budget and assist you with marketing. You would want clarification of the size of the budget and the amount and type of marketing assistance they will provide you with. Is this strategic assistance or merely administrative assistance?

### *Use of existing fleet*

RNC require franchisees to use cars from an approved list. If the cars in your existing fleet are on that list, you would be able to use these, at least to form part or all of your mobile rental fleet. This would be a significant cost saving.

You have 675 cars in your existing fleet. If you started the franchise with the minimum of 500 cars, this would mean no initial capital outlay for vehicles, although as the cars reach the age of four years, you would be required to replace them.

If you did have to purchase 500 new cars, based on the average list price stated in the letter of £16,000, this would be an outlay of £8 million. Even with the possible sale of the Chelmsford depot, you do not have sufficient cash reserves to make this purchase without additional finance.

It is not clear from the franchise agreement whether RNC has negotiated a bulk discount with its preferred suppliers, and if that discount would be available to you. This should be discussed with them. If you cannot benefit from any discounts negotiated by RNC, you should attempt to negotiate your own deal or negotiate with RNC to allow you to use some of your existing fleet.

One thing to be mindful of is that the cars used in the RNC franchise will be modified with GPS devices, logos, key boxes etc. All of these modifications may well decrease the selling value of the cars, so may increase your depreciation costs in the business.

## 4.3 Profitability

RNC have provided some information from their London operations to allow you to make some projections. However, the RNC London operation is not a franchise and London is quite a different market to other cities in the UK. There is a risk that the figures might not be comparable. In particular:

- rental income will be subject to commission at 20% withheld by RNC. This reduces the average rental income per vehicle per year from £20,000 to £16,000 assuming the same utilisation as London.
- it is very unlikely that initial utilisation will be as high as the established London market.
- the lease cost per parking space is likely to be lower outside of central London, where land prices are very high.
- the annual cost of a parking space in London is £12,000. For 500 spaces that would be a cost of £6 million, rising to £9.6 million for 800 spaces.
- I recommend that you speak to Birmingham City Council to understand whether they would lease you enough spaces and what the cost of the spaces would be. This will be your most significant annual cost and it is vital that you have a good understanding of the likely cost.

As mentioned in section 4.1, not all of the costs have been identified. For example:

- staff costs – staff will be required to check and maintain the cars. As well as the ongoing salary cost, there will be recruitment and training costs for new staff members.
- RNC will provide the GPS trackers and will link your system to the mobile app. It is not clear who is responsible for any ongoing costs of this technology or who bears the financial responsibility if the app crashes. Would RNC compensate Andka for loss of revenue?
- There will be some level of repairs required such as new tyres and MOTs for the cars more than 3 years old.

I have performed a basic cashflow analysis, based on the figures provided by RNC, but excluding the possible additional costs listed above. These calculations do not take into account the time value of money. I have assumed that the existing fleet could be sold for an average of £5,600 per car and that vehicles will have no resale value at the end of four years. The full workings are in Appendix B.

The net cashflow at the end of the 4-year franchise is:

| | *500 CARS* | | *800 CARS* | |
|---|---|---|---|---|
| | Initial outlay | Net cashflow over 4 years | Initial outlay | Net cashflow over 4 years |
| Using existing fleet | (£7,050,000) | £991,000 | (£12,800,000) | (£1,050,000) |
| Purchasing a new fleet | (£15,050,000) | £1,980,000 | (£23,600,000) | £1,830,000 |

No matter which option is chosen there is a considerable initial cash outlay. Selling the existing fleet and purchasing a new fleet results in a higher net cashflow for a franchise fleet of either 500 or 800 cars. This is mainly due to the fact that the existing fleet is mainly less than two years old and has an estimated net realisable value of £5,600. At the end of the four-year contract, the vehicles will likely have a negligible resale value. Using the existing fleet and replacing vehicles as they reach four years old has a lower net cashflow, as there is no “bumper” inflow from the sale of the newer vehicles. You should note though that your fleet, at the end of the four-year contract, will consist of a mixture of newer and older vehicles with a considerably higher potential resale value. Further work is needed to get more complete and accurate projections.

## 4.4 Other strategic options

As a business, you are already in a comfortable cash position and would be able to purchase the franchise, even without selling the Chelmsford depot. Perhaps it would be worth considering adding this, or even another, franchise to your existing business rather than ceasing more traditional car rentals completely?

You might consider entering into the mobile car market on your own. You already have a fleet, so the significant capital expenditure would be on the technology – the app and website for booking.

This expense could be prohibitive, but you might consider researching whether the software is available for purchase or discuss with a software designer.

**Operating by yourself would give you control over where to operate and you could consider a closer metropolitan location, even East London. Of course, you would have to do the market research to explore location further. 4.5 Recommendation**

Purchasing a franchise gives you access to experience and advice about the business, but the downside is the lack of control. Given that you already operate a successful business model, I would caution you to explore the market and RNC in more detail before you make your decision, in particular looking for more detailed financial data relevant to the Birmingham market. Based on the information currently available, I would not recommend that you proceed.

## 5. Dubai matters

Viraj has identified a potential source of luxury sports cars in Dubai as he has a friend who manufactures them and has offered to sell Andka 50 cars.

### 5.1 Sports car proposal

The cost to Andka is 900,000 AED, or £180,000 per car before shipping and taxes.

Firstly, you need to decide if this fits the strategic objectives of Andka. Do you want luxury cars? Would you use them as rental cars, or sell them on? These are expensive, high-performance sports cars and would be a considerable expense to the business.

There are additional costs to be considered, were you to start importing cars manufactured in Dubai into the UK. As well as the freight and insurance costs that Viraj has identified, Andka would also be liable for customs import duty and import VAT.

Import duty would be a percentage (determined by HMRC, but likely to be in the region of 10%) of the cost of the vehicle including insurance and freight charges. You would then also be liable for VAT at 20% on the total cost, plus customs import duty.

The possible outlay per car imported to the UK would be:

| | £ |
|---|---|
| Cost | 180,000 |
| Shipping (15%) | 27,000 |
| | 207,000 |
| Customs import duty (10%) | 20,700 |
| | 227,700 |
| VAT (20%) [reclaimable] | 45,540 |
| | **273,240** |

If you were to import 30 cars, there would be customs duty of around £621,000 to pay.

You would need to compare the cost of around £227,700 per vehicle (once VAT was reclaimed) to the potential income that could be earned from each vehicle – either rental income, or sales proceeds. If you could sell or rent the cars at a profit, then the offer might be attractive, despite the high initial outlay.

Buying and selling high performance sports cars is quite different from your current business practices. I would not recommend that you proceed with this venture without a lot of further investigation and understanding as to how it would fit in with the current business and market research to identify the potential customers.

## 5.2 Insufficient accounting records

As directors of a UK company, you are responsible for having systems and processes in place to record all transactions. It would appear that the record-keeping system in Dubai needs to be improved as soon as possible. If possible, all transactions should be recorded on the same systems as in the UK, so details of all transactions are visible in the UK, allowing your accounts manager to monitor and review activity.

## 5.3 Management charges

I have also noted that the management charges do not seem to be spread evenly across the business – the Dubai charges appear to be much higher than the other divisions at £180,000 compared to £50,000 for UK vans and £32,000 for UK cars. In addition, management charges for Q2 and Q4 appear higher for Dubai, but charges are evenly spread across the other divisions.

# 6. Data Breach

## 6.1 Legal obligation under GDPR

General Data Protection Regulations ('GDPR') are in force in the UK. Companies have a responsibility to securely store the personal data of their stakeholders, including customers. Personal data includes name, email, address and ID numbers such as passport or driving licence details.

An ex-employee entering your system without authorisation is a data breach, even without loss of payment details.

You have a legal responsibility to report the data breach to the Information Commissioner's Office ('ICO'), within 72 hours of the breach, if this is feasible.

The ex-employee has downloaded considerable personal information about a number of customers. You should contact a data protection legal expert and seek legal advice as to whether you should make contact with this ex-employee to determine what they have done or plan to do with the data. This information could be sold or used to impersonate a customer and may have a detrimental impact on the customers involved.

Due to this high risk to the rights of these individual customers, you are obligated to inform them as soon as possible. Again, you should seek legal advice before doing so.

Failure to notify the ICO and the relevant customers could lead to a significant fine of up to 10 million euros.

## 6.2 General data security advice

Given this situation, it is important that the accounts of any employees leaving Andka are deactivated on the day the employee ceases to be employed.

The IT manager would usually do this, but another member of staff should be trained in case of the absence (or the departure) of the IT manager.

Under the GDPR you, as directors, have a legal requirement to safeguard personal data of your customers, suppliers, employees etc. All systems which contain personal data must be appropriately safeguarded. For example, requiring strong passwords, regularly changing passwords, restricting system access to certain individuals, monitoring system access etc.

Any system which is accessible online must also have suitable encryption and firewalls.

## APPENDIX A – Tax calculation for capital gain on disposal of Chelmsford

| | | £'000 | £'000 |
|---|---|---|---|
| Disposal value | | | 3,000 |
| Less: | | | |
| Initial cost | | 2,000 | |
| Refurbishment costs | | 150 | |
| | | | (2,150) |
| Unindexed gain | | | 850 |
| Less: indexation allowance | indexation factor x cost | | |
| | = 0.182 x £2,150k | | (391) |
| Chargeable gain | | | 459 |
| | | | |
| Tax payable | = £459k x 19% | | 87 |

Indexation factor

$$\frac{\text{RPI Dec 2017* – RPI Jun 2011**}}{\text{RPI Jun 2011**}} = \frac{278.1 - 235.2}{235.2} = 0.182$$

*Indexation frozen at Yr55 (Dec 2017)

**Acquisition at Yr49 (Jun 2011)

## APPENDIX B – Cash forecast for franchising model

*Using existing fleet in year 1 – 500 cars*

| | | Year 1 | Year 2 | Year 3 | Year 4 | *Total* |
|---|---|---|---|---|---|---|
| | | *£'000* | *£'000* | *£'000* | *£'000* | *£'000* |
| INFLOW | Rental income | 10,000 | 10,000 | 10,000 | 10,000 | |
| | Less: commission | (2,000) | (2,000) | (2,000) | (2,000) | |
| | Net rental income | 8,000 | 8,000 | 8,000 | 8,000 | |
| | Selling excess fleet (175 cars) | 980 | - | - | - | |
| | | 8,980 | 8,000 | 8,000 | 8,000 | 32,980 |
| OUTFLOW | Franchise cost | (800) | (250) | (250) | (250) | |
| | Replacement of fleet | - | (2,000) | (2,000) | (2,000) | |
| | Fit-out costs | (250) | (63) | (63) | (63) | |
| | Lease of spaces | (6,000) | (6,000) | (6,000) | (6,000) | |
| | | (7,050) | (8,313) | (8,313) | (8,313) | (31,989) |
| NET CASH | | 1,930 | (313) | (313) | (313) | **991** |

*Purchase new fleet in year 1 – 500 cars*

| | | Year 1 | Year 2 | Year 3 | Year 4 | *Total* |
|---|---|---|---|---|---|---|
| | | *£'000* | *£'000* | *£'000* | *£'000* | *£'000* |
| INFLOW | Net rental income | 8,000 | 8,000 | 8,000 | 8,000 | |
| | Proceeds from disposal of existing fleet | 3,780 | | | | |
| | | 11,780 | 8,000 | 8,000 | 8,000 | 35,780 |
| OUTFLOW | Franchise cost | (800) | (250) | (250) | (250) | |
| | Replacement of fleet | (8,000) | - | - | - | |
| | Fit-out costs | (250) | - | - | - | |
| | Lease of spaces | (6,000) | (6,000) | (6,000) | (6,000) | |
| | | (15,050) | (6,250) | (6,250) | (6,250) | (33,800) |
| NET CASH | | (3,270) | 1,750 | 1,750 | 1,750 | **1,980** |

*Using existing fleet in year 1 – 800 cars*

| | | Year 1 | Year 2 | Year 3 | Year 4 | *Total* |
|---|---|---|---|---|---|---|
| | | *£'000* | *£'000* | *£'000* | *£'000* | *£'000* |
| INFLOW | Rental income | 16,000 | 16,000 | 16,000 | 16,000 | |
| | Less: commission | (3,200) | (3,200) | (3,200) | (3,200) | |
| | Net rental income | 12,800 | 12,800 | 12,800 | 12,800 | 51,200 |
| OUTFLOW | Franchise cost | (800) | (250) | (250) | (250) | |
| | Additional vehicles required (125 cars) | (2,000) | - | - | - | |
| | Replacement of fleet | - | (3,200) | (3,200) | (3,200) | |
| | Fit-out costs * | (400) | (100) | (100) | (100) | |
| | Lease of spaces | (9,600) | (9,600) | (9,600) | (9,600) | |
| | | (12,800) | (13,150) | (13,150) | (13,150) | (52,250) |
| NET CASH | | - | (350) | (350) | (350) | **(1,050)** |

* I have assumed all cars will need to be fitted out in year 1, and just the new cars in subsequent years.

*Purchase new fleet in year 1 – 800 cars*

| | | Year 1 | Year 2 | Year 3 | Year 4 | *Total* |
|---|---|---|---|---|---|---|
| | | *£'000* | *£'000* | *£'000* | *£'000* | *£'000* |
| INFLOW | Net rental income | 12,800 | 12,800 | 12,800 | 12,800 | |
| | Proceeds from disposal of existing fleet | 3,780 | | | | |
| | | 16,580 | 12,800 | 12,800 | 12,800 | 54,980 |
| OUTFLOW | Franchise cost | (800) | (250) | (250) | (250) | |
| | Replacement of fleet | (12,800) | - | - | - | |
| | Fit-out costs | (400) | - | - | - | |
| | Lease of spaces | (9,600) | (9,600) | (9,600) | (9,600) | |
| | | (23,600) | (9,850) | (9,850) | (9,850) | (53,150) |
| NET CASH | | (7,020) | 2,950 | 2,950 | 2,950 | **1,830** |

## 7. Email

To: Chloe.Andrews@andkarental.co.uk
From: LeeCA@email.com
Date: 21 May Yr59
Time: 15:00

### 7.1 Dubai - accounting irregularities

Dear Chloe,

The email that you forwarded on to me from the new accounts assistant in Dubai is very concerning. I recommend that a thorough investigation into the unusual accounting activity in Dubai is started as soon as possible. The investigation should be undertaken by someone with an accounting background who can investigate in an independent manner. You must take care not to alert anyone who may be involved in the suspicious transactions, which might include Hamad.

The accounts assistant in Dubai has indicated that there have been five 200,000 AED deposits paid into the Dubai account during Yr59. These amounts have not come from the usual third-party booking agents and appear to be slightly suspicious as there is no record of what they are.

The accounts assistant has suggested that Mr Viraj Kapoor, brother of Hamad, has knowledge of these amounts and has asked the accounts assistant to create false invoices to substantiate these amounts. This is a very serious matter. Falsification of accounting records is illegal, and you have a responsibility as a director to prepare financial statements which fairly present the activities of the company. It is important that you urgently investigate what these deposits are.

I appreciate that this is a particularly difficult situation for Hamad and would suggest that he is not involved in the investigation. It is possible that there is a genuine business reason for these deposits. The accounts assistant is new to the business and may not have a good understanding of the business yet, or he may also have something to do with the deposits.

Large cash balances may occur due to the sale of your car fleet at the end of each quarter. You should consider investigating how the purchase and sale of cars is recorded in the accounts in Dubai.

There is a possibility that these deposits may be some sort of illegal activity. If this becomes a concern, you may need to make a report to the police. I recommend that you try not to arouse suspicions when investigating to avoid any potential evidence being destroyed.

For the purposes of the financial statements, these amounts should be removed from revenue and recorded as a liability until it becomes clear what they are.

Please let me know if you need any further information.

Lee

## Andka – ethics file note May Yr59

### *Professional ethical issues – fee dependency on Andka*

| ISSUE | THREAT | ACTION |
|---|---|---|
| Andka currently accounts for 13.7% of my total fee income (£8,500 out of £62,000) and is my biggest client.<br><br>I have been preparing their tax returns, annual accounts and giving business advice to the directors.<br><br>(OBJECTIVITY) | My objectivity might be compromised due to my dependence on this client. Can I provide objective, professional advice when I am reliant on its income?<br><br>I might be less likely to challenge the client due to my reliance on its income. | I need to ensure that I approach this client in an objective manner and that I approach my work in a professional manner.<br><br>I could consider engaging another qualified accountant to check my work when giving business advice. |

### *Professional ethical issues – prospect of additional fees*

| ISSUE | THREAT | ACTION |
|---|---|---|
| I have been appointed to perform the audit for the year ended 31 March Yr59 and I have recently been asked to produce a briefing note and a report for the client as well.<br><br>The client has suggested that if the Dubai luxury car proposal goes ahead if might lead to “significantly higher fees” and possible regular trips to Dubai.<br><br>The total fees for these engagements are highly likely to result in Andka accounting for more than 15% of my total fee income.<br><br>(OBJECTIVITY, PROFESSIONAL COMPETENCE) | My objectivity might be compromised due to my dependence on this client. Can I provide objective, professional advice when I am reliant on its income?<br><br>I might make recommendations that would result in further work (income).<br><br>I might be less likely to challenge the client due to my reliance on its income.<br><br>I might not have the necessary skills and knowledge to complete each engagement to the required professional standard/competence. | I need to consider whether I should accept any additional work from Andka. I need to decide whether I can proceed with the audit engagement.<br><br>I may have to recommend that the client approaches another consultant or auditor.<br><br>I should consider discussing this with ICAS.<br><br>I could consult a third party, such as another CA to check that the recommendations I make are reasonable.<br><br>I should consider whether I have the necessary competence to undertake each engagement. If this is in question, I should consider using an expert or investigate training opportunities for myself. |

### *Ethical issues in relation to the client – Deposits in Dubai bank account*

| ISSUE | THREAT | ACTION |
|---|---|---|
| It would appear as if Viraj (brother of the director) who joined the Dubai depot in early Yr59 is aware of large round-sum cash deposits being made into the Dubai account.<br><br>There do not appear to be corresponding costs, nor any documentation as to what these amounts relate to.<br><br>Viraj has asked the Dubai accounts assistant to create falsified invoices to record these amounts as revenue.<br><br>(OBJECTIVITY of director, INTEGRITY of Dubai depot manager, CONFIDENTIALITY if Lee discloses this information to someone else). | 1 million AED (about £200,000) has been deposited into the Dubai account and it does not appear to relate to normal business.<br><br>Although no amounts have been withdrawn, in a possible attempt to 'launder' money, the payments, and the actions of Viraj are suspicious.<br><br>It is unclear whether Hamad has any involvement, but his objectivity could be threatened by the involvement of his brother. | Consider whether I should make a report to the NCA. Although money has been deposited rather than withdrawn, these are still unusual, undocumented, large cash transactions.<br><br>Contact the confidential ICAS hotline to discuss further.<br><br>I must ensure that I do not 'tip-off' the client. |

*Other more subtle ethical points that might be made include:*

- *The Dubai figures show a much lower average staff cost figure than the other divisions (only £6,250 per staff member). Candidates might raise this as an area of concern, possibly modern slavery. However, there isn't anything in the question that allows them to validate whether this level of salary is usual, or not, in Dubai.*

- *The competence of the directors may be called into question given their lack of understanding on matters such as GDPR, proper accounting records etc.*

- *The sports cars are being offered to Andka at "just above cost" rather than at an arms' length price. This might indicate suspicious activity, possibly money laundering, but it is just a suspicion.*