TEST OF PROFESSIONAL EXPERTISE EXAMINATION

COMMENTARY ON PERFORMANCE

TPE Exam November 2023 – Lorenso Group

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Lorenso Group - Commentary on Performance

Introduction

This question has a newly qualified CA, Max (you), employed by Stephens and Henderson LLP ('SH'), a large accountancy partnership. You have recently moved from SH's North London office to its Manchester office where you have just started a secondment to the Lorenso Group of companies ('Lorenso Group') to provide maternity cover for the Financial Controller. You are working for Robin Sinclair, a partner in the Manchester office of SH.

The Lorenso Group is headed by Lorenso Holdings Ltd which is wholly owned by Lorenso Romero, a high-profile celebrity chef active on social and other media. Lorenso Holdings has 100% control of the six other companies that make up the group. Robin and Lorenso have known each other for some time. Although your experience to date has mainly been in tax Robin has assured Lorenso that you have the skills to carry out the Financial Controller role.

In the morning session Lorenso has asked Robin for an evaluation of the financial performance (revenue and profitability) for the group as a whole and each of its five revenue streams. The revenue streams comprise Lorenso Restaurants (made up of three separate chains – Lorenso's, Table Romero and Bomerano), Lorenso Media and Lorenso Produce. Lorenso is puzzled by the fall in operating profit and would like to know possible reasons of what could have caused this and recommendations to improve profitability. Extracts from management accounts for the current and previous year and other relevant information, including details of a controversial tweet made by Lorenso, is available to you. Robin would like you to prepare the evaluation as a briefing paper to the board of the Lorenso Group. Although she appreciates this is in addition to your normal duties under the secondment, she has made clear you should find the time to do this and that SH will not charge additional fees for the work. You have heard that staff morale is low in the Manchester office and staff turnover high. Some of the partners put pressure on staff to work longer hours.

Robin also informs you that Lorenso is considering gifting 40% of the shares in Lorenso Holdings to Sophia, the eldest of his five children, who has just graduated from university. Lorenso would also like her to join the board now and become the Chief Operating Officer of Lorenso Produce within the next 12 months. Robin has asked you to prepare notes for a meeting she is to have with Lorenso to discuss financial and non-financial considerations concerning the gift including an explanation of the tax implications.

In the afternoon session, one week later, you have been called to a meeting with Sapna Stan, the Chief Finance Officer of the Lorenso Group. She has asked you to prepare a draft report that she can review and send to the board of Lorenso Holdings. The report is to cover two issues.

The first relates to the sale of one of the restaurant chains, Bomerano, which has been loss making since it was acquired. The board has accepted an offer from MB plc ('MB'). MB has suggested two possible acquisition methods – the acquisition of 100% of the shares of Bomerano Ltd or the acquisition of the trade and assets (including the brand name) of Bomerano. The report is to analyse the two alternative approaches to the sale and to make a recommendation. Brief details of the two acquisition methods are provided.

Secondly, the board has decided that the group should identify new opportunities in related industries and Lorenso has identified Arola Winery S.r.l (‘Arola’) as a possible acquisition. Arola is an Italian company and operates a vineyard and winery in Italy. The plan is that Lorenso would bottle the wines under the Lorenso name and sell it exclusively in Lorenso’s restaurants replacing wines from one of the existing suppliers. Lorenso is confident this will increase operating profit and Sapna would like you to quantify this as well as comparing the return on investment against the group’s benchmark of 18%. She tells you that Lorenso is passionate about the plan and trusts you can make it look an attractive proposition. Sapna also wants you to advise in the report on the due diligence process that would need to be followed if Arola is acquired. Background information on Arola and the wine trade is provided.

During your meeting with Sapna it becomes apparent that long hours are expected in the company but one of the perks is the ability to download vouchers to use at Lorenso’s restaurants. She advises just to ask head office staff how it is done. Sapna also makes derogatory comments about the FC whose maternity leave you are covering and that she is trying to think of ways of getting rid of her. She asks if you would be interested in the role and to think about what salary would make it worthwhile to you.

<u>TECHNICAL</u>

Generally, candidates were able to attempt all sections in the morning and afternoon papers.

Section 1 – Evaluation of financial performance

Most candidates adopted a logical approach of analysing each of the five revenue streams in turn. The change in revenue, gross and operating profit was quantified in monetary and/or percentage terms. For the three restaurants many commented on the impact of customer numbers (covers) and average spend while almost all identified that the reduction in revenue of Media was due to no new books or TV series being produced in the year. Negative reviews for Lorenso’s restaurants were also commented on as a possible cause of reduced revenue. The impact of rising prices for ingredients and in distribution costs on gross and operating profit was discussed by most. Many commented on the fact that while Table Romero met typical operating margins Lorenso’s and Bomerano did not. Some identified that the fall in gross profit of Produce was due to the decision not to increase selling prices in the face of rising costs.

There was a wide range of recommendations with some showing good commercial awareness. Updating the menus, reviewing individual restaurants, loyalty schemes, progressing the new supply strategy, changing the staffing model, selling or closing Bomerano and expanding Table Romero were frequently suggested. Many mentioned the potential impact of Lorenso’s tweets and better answers stated that Media could be significantly affected and gave suggestions for managing these in the future.

Many candidates gave no commentary on the performance of the group or the three restaurants as a whole, going straight into discussion of the five individual revenue streams. There was also a lack of comment on the relative importance of each of the streams, particularly the importance of Media to overall group profit. Weaker candidates did not quantify changes in percentage terms and provided little analysis of the reasons for changes. Few commented on the need to control head office costs or query the simplistic method of apportioning these to revenue streams. Some candidates compared the performance of the restaurants to those of the food manufactures given in the background notes. These measures would not be applicable to restaurants. Others partly attributed the fall in revenue of restaurants to reaction to Lorenso's tweets. The tweets were made in the last week of the accounting year and could have had no material impact.

Section 2 – Gift of shares

The financial and non-financial parts of this section were not particularly well answered. Many candidates identified that Lorenso would still have control but very few mentioned that he would no longer have the ability to pass resolutions that required 75% of the votes or the effect of the disposal on his dividend income. The lack of experience of his daughter was quite commonly addressed but few linked it to possible charges of nepotism and poor corporate governance. Very few commented on the possible reaction of the other four children to their sibling receiving such a large part of the business.

The tax implications were better attempted. In relation to capital gains tax many discussed gift relief and its impact on any subsequent disposal by Sophie. Most candidates identified the gift as a potentially exempt transfer for inheritance tax purposes and the seven-year period. Better answers included discussion of business asset disposal relief from capital gains tax and business property relief from inheritance tax.

Many candidates failed to give a recommendation and there was some evidence of poor time allocation as this section was sometimes quite brief and appeared rushed.

Section 3 – Disposal of Bomerano

Overall, this section was not well answered.

Very few candidates discussed a basis of valuation of Bomerano and why MB might want to acquire a loss-making company. Some did comment that any disposal would likely be positive for the Lorenso Group.

Almost all candidates discussed both methods of disposal – sale of shares and sale of trade and assets. Under sale of shares many candidates recognised that the intercompany loan would be written off and better candidates noted that the Lorenso Group would no longer be responsible for the other liabilities of Bomerano. Few noted that net liabilities would leave the group or that the Lorenso Group would no longer be able to trade under the Bomerano group. Some candidates assumed that the write off of the £13m loan from Lorenso meant that MB would pay Lorenso £13m to settle the loan.

While many commented that under the sale of trade and assets £2m would be received, there was confusion over the consequences of this. Although there would be a receipt some did not appreciate that Lorenso would have to repay the bank loan and other liabilities resulting in a net cash outflow. Very few calculated the amount MB was effectively paying for the Bomerano brand. Better candidates commented that there may be corporation tax to pay on the disposal of assets. Few candidates included comments on the alternative courses of action in liquidating Bomerano and associated reputational risk. Some candidates concluded as Bomareno had over £4m of assets this was a poor deal, not appreciating that MB was taking over responsibility for the lease liabilities.

Most candidates provided a recommendation.

Section 4 –Acquisition of Arola

Few candidates questioned whether the asking price of £10m was a reasonable valuation, the valuation methods available and, as the family were keen to sell, that they may be willing to accept a lower price.

Generally, candidates made a good attempt at calculating the profitability of the winery and the ROI and compared the ROI to the 18% benchmark. A range of assumptions could be made in arriving at profit per bottle. Most identified that the total investment had to include £1m for replacement equipment. When assessing the impact on group profit relatively few took into account the existing profit on wine made by Lorenso, which would be foregone, and therefore overstated the impact. Some over-complicated the calculations (eg calculating NPV over a 10 year period) or calculated payback instead of ROI.

The information on the acquisition raised a number of issues and possibilities that should have been discussed in the section on sensitivity. Many candidates made comments about the current level of production and the possibility of increased yield from young vines. A number produced alternative valuations based on different yields. Few mentioned that as old vines are said to produce higher quality wine Lorenso should investigate whether there is a demand in its restaurants for more expensive wines.

Most candidates noted that the acquisition was in line with the board’s strategy but that the board had no experience of this industry and therefore this would be a high-risk venture. Fewer discussed the current value of the Arola brand and the loss of this if the wine is rebranded as Lorenso’s. There were few comments on how Arola would be integrated into the group.

Some candidates commented on funding but most who did only considered bank loans. Many candidates realised there was exchange risk on the acquisition itself and suggested appropriate hedging instruments. Few explained that there would be on-going exposure through production in Italy and sales in the UK.

Almost all candidates discussed due diligence – those who applied this to Arola tended to score well. A significant number of answers did not do this and appeared to be cut and paste. To earn marks application to the scenario was required. This is always the case at TPE.

Note: a significant number of candidates did not remove VAT when calculating profit and others removed at the wrong rate. There was also often a mix up between margin and mark up in calculations.

PROFESSIONAL

Judgement

Candidates scored well in key items/balance as most covered all the requirements with an acceptable balance, prioritising points, and made reasonable recommendations. Most candidates recognised that additional investment in Arola was required, calculated an increase in profit and pointed out Lorenso’s lack of experience in the wine industry. Most candidates also demonstrated reasonable commercial awareness in their papers.

Weaker candidates gave insufficient coverage of the proposed share disposal in the morning paper. In covering the performance of the revenue streams many candidates did not recognise that Table Romero and Bomerano were marginal to the group, that Media was a major contributor to profit or the potential of the Produce division.

Method

Most candidates adopted a logical approach to discussing the five revenue streams, but weaker candidates did not analyse the key drivers of the change in performance. On the sale of shares while treatment of tax was generally good there was little comment on personal issues and corporate governance issues. While most candidates evaluated the two methods of the acquisition of Bomerano by MB few explained the impact of the sale on the group or attempted a calculation of the value of the brand name. Many provided reasonable calculations of the profitability of the Arola winery, but an insufficient number of unknowns were discussed. Very few made detailed comments about how Arola might be integrated into the group.

In analysing the revenue streams weaker candidates quantified movements in £ terms only – the use of percentages makes it easier for the reader to assess the scale of change.

Structure and Communication

Most candidates laid out their work in a logical, clear manner using language appropriate for the client and used sections, numbering and sub-headings to present their answer in a professional style. The majority of candidates included their calculations in cross-referenced appendices or footnotes. Executive summaries were generally concise, prioritised, included recommendations and focussed on relevant issues from the report. In almost all cases all outputs were provided, and they were easy to follow and read.

Weaker candidates did not tailor the introduction to their report and/or briefing note to recognise these were internal, instead including a number of disclaimers which were not appropriate to the scenario. Even although Max was employed by SH he was on secondment and acting as a member of staff of the Lorenso Group. As mentioned above there were cases of cut and paste without tailoring to the specifics of the case. Some executive summaries were too brief which may have been due to poor time allocation and others were too descriptive with insufficient advice.

Ethics

There was a wide range of issues that could have been included in the ethics memo and it was not expected that candidates would include all of these. Most candidates identified and evaluated a significant number of issues, linked them to the ICAS fundamental principles and provided realistic actions. Most candidates split the memo between issues for SH and Robin, and issues for the Lorenso Group. In general, the former was better performed than the latter.

In relation to issues relating to SH and Robin the most commonly discussed issues were Max's lack of experience, Robin exaggerating Max's skills, overworking in the Manchester office, Robin's familiarity with Lorenso, proposal for Max to be on next year's audit and reputational risk to the firm. For the Lorenso Group Sapna's attitude to the current financial controller, the offer of the role to Max and pressure on Max to present Arola as an attractive proposition were most commonly discussed.

Weaker candidates did not discuss a wide enough range of points or assumed that raising the issue in the email to the ethics partner was the only action that was required. A number of candidates made the categorical statement that zero hours' contracts are illegal which is not necessarily true.

Some candidates described the issues in too much detail using up valuable time in the exam – concise business writing should be applied to ethics as well as other parts of the case study. On the other hand, some candidates failed to leave enough time for this section. They identified issues but did not fully evaluate them or suggest actions.