



TPE 2023 – Mock 2

Darkfurn – Case Study Part 1

History

TPE examination, November 2022. Pass rate 95%. 2½ hrs in the morning and 3 hrs in the afternoon.

Technical Content

FA 2022

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This mock exam is taking place remotely.

ICAS would remind you to continue to be ethical and observe the exam conditions applicable to the TPE exam.

BACKGROUND NOTES

It is a Tuesday morning in late October Yr52 as you are walking to your new place of work for only the second time. You are Artemis, a newly qualified chartered accountant, who has just joined the Bristol office of Brunel Clifton Blaise & Partners Ltd ('BCB'), a management consultancy company spun out of Smythe Icarus Amelia & Co ('SIA & Co'), a large firm of registered auditors with offices in the Republic of Ireland and England.

You previously spent four years working at the Bristol office of SIA & Co where, latterly, you were part of the external audit team of a UK registered company called Darkfurn Ltd ('Darkfurn'). Your manager is Britney who, until six months ago, also worked within the audit department of SIA & Co.

"Good morning, Artemis. Do come in and take a seat," says Britney.

"Do you remember Michaela Xa, the managing director of Darkfurn, the retailer of premium-priced dark-wood furniture from when you did the audit? She telephoned me yesterday afternoon to ask if we would be interested in tendering for the appointment of management consultants to Darkfurn. We briefly discussed our hourly charge-out rates and these were acceptable to her. However, she wants to assess the quality of our work before formally appointing us and so I agreed we would produce a briefing paper for her covering two areas currently of interest to her. I'll discuss these in a moment. However, we will not be charging her for this work and, so, it was agreed we would spend no more than 2½ hours on it. The briefing paper does of course need to be professionally presented but, at this stage, it is the quality of the content that is of prime importance."

"This sounds interesting," you reply. "Michaela has the reputation of knowing everything there is to know about retail marketing and has an HR background. She was very easy to get on with; generous too. Just as I was leaving SIA & Co I heard that she was arranging for the company to gift bespoke intricately-carved coffee tables to each of the senior members of the audit team. They are hand-made and are due to be delivered in December. My understanding is that they are produced by trainees and are not considered to be of sufficient quality to be sold as new items in the stores. However, very similar items are selling on the internet for nearly £1,200."

"That is indeed generous," says Britney.

She continues, "I know you are familiar with Darkfurn from when you audited the company but do refamiliarize yourself with it. Here are the background notes on the company (Section 1) and also the draft trading accounts for the year ended 30 September Yr52 (Section 2), which Michaela emailed to me after our conversation."

"After having been in the job for a few months she is now thinking of fine-tuning the way in which the company trades and would like our comments in this regard. Based on the limited information available, the first area Michaela would like us to look at is the underlying trading performance of the company. From this she would like us to identify the areas of the operations that could be improved upon and to provide recommendations on how this could be achieved. One of her thoughts is that she should close some underperforming stores and wants our views on which ones she should give priority to and why. Needless to say there will be non-financial factors to consider as well as the financial ones. She asked us not to include any detailed comments on marketing; in any event you will not have time to consider these in any depth."

"It makes sense to consider the current portfolio of stores," you say. "Since the Covid pandemic the retail environment has changed quite significantly and so successful historical trading formats may no longer be quite so relevant today."

"I agree," replies Britney.

"The second area Michaela wants us to review is the original contract between WHM Plc ('WHM'), Darkfurn's majority shareholder, and Darkfurn (Section 3). This was drawn up in Yr33 when Darkfurn was incorporated and so is well out of date. It was also written at a time when Darkfurn was a wholly-owned subsidiary, which is now no longer the case. She is intending to renegotiate the terms and conditions ('T&Cs') with the board of WHM with a view to updating them and wants our input on this. She did reiterate the point that she is the managing director of Darkfurn and

therefore wants us to produce arguments that would help her persuade the board of WHM to change the T&Cs in Darkfurn's favour.

"I therefore want you to include a section in the briefing paper that appraises the main clauses of the contract and to put forward arguments that would assist Michaela in her negotiations with the board of WHM. Where you identify commercial practices that are clearly out of date, do include suggestions for improvement but restrict them to the existing clauses in the contract. We won't get any credit for advising on something that was not asked for.

"It would be helpful if you could have the briefing paper available for my review by lunchtime. Also, do bear in mind any ethical points you come across but don't include them in the briefing paper as I want you to concentrate on what Michaela has asked for. We can consider any ethical points of significance at a later time. Any questions at this stage?"

"No, I don't think so," you reply as you get up to leave thinking about the intricately-carved coffee tables.

Required:

- Prepare the briefing paper for Britney that she can present to Michaela.
- Review all the information in preparation for the afternoon session.

SECTION 1

Background Information on Darkfurn

History

Incorporation

Darkfurn was incorporated in the UK in Yr33 and was originally a wholly-owned subsidiary of WHM plc ('WHM'), one of the Republic of Ireland's largest privately-owned companies with its headquarters based in Dublin. WHM is a holding company for a number of subsidiary companies that focus on the manufacturing and retailing of high-quality domestic furniture made primarily from dark wood. At that time, it had retail stores in the Republic of Ireland, France, Italy and Spain and several large factories in East Asia where all of the furniture was produced. Following positive market research in Yr32, the board of WHM decided to expand its retail operations into England and Darkfurn was incorporated. WHM's auditors are SIA & Co, a large Irish firm of chartered accountants with offices in the Republic of Ireland and England.

Darkfurn was set up, effectively, as a sales outlet for WHM. One of the remits of the newly appointed managing director was to open up 100 out-of-town retail stores over a ten-year period. All stores had to be rented on five-year leases with a condition that Darkfurn had the option of renewing every five years on revised terms. To ensure the brand image of the group was consistently maintained, the layout and location of the stores had to conform to tight specifications as set out by the board of WHM. Furthermore, the store staff members, in keeping with the WHM's family tradition, had to undergo a week's induction training at one of the larger Irish stores.

Over the years, the composition of the staff at each store has tended to conform to a similar 'template'. Historically, all the store managers have been male and all the sales assistants have been female university graduates with at least a 2.1 honours degree. The sales assistants are recruited shortly after graduating and are trained in the traditional methods used by Darkfurn to generate sales. This 'template' seems to have been successful for WHM and the board intends to continue with it in the future.

Prior to any store being opened, it has to have the written approval of the WHM board. The original business plan for Darkfurn was that the initial 25 stores were all to be of a similar size and layout (small stores). After the Darkfurn name had become established in England the company was to start opening 'super stores' (large stores) in conjunction with the continued expansion of the small stores.

The business model is that all the goods sold by Darkfurn are to be purchased from WHM and include all the typical furniture required for a home. These range from beds, with a low profit margin, to intricately carved tables and chairs and ornaments, which have a much higher profit margin. The furniture in the Darkfurn stores is for display purposes only. Customers who want to purchase the goods place a sales order for a future delivery date, usually within a month of placing the order with Darkfurn.

After collating all the orders for the week, the store manager places a weekly order with WHM. The goods are then despatched, usually within a week, from a WHM warehouse in the Republic of Ireland and delivered to the individual stores. All the furniture is pre-assembled and, after having been checked is then delivered to the customer via local delivery firms. The terms and conditions of the trading arrangement are included in a contract between the two companies (Section 3), which has remained unchanged since Darkfurn was incorporated.

After Yr33, WHM expanded rapidly and increased the number of factories to keep up with demand. However, as the demand grew so did the pressure on sourcing timber and skilled local labour. In Yr44, the board of WHM decided to close down all but one of its factories and subcontract out the production of the furniture to manufacturers who had access to cheaper materials and very cheap employees. This had the short-term effect of increasing margins, which were initially passed on to Darkfurn. However, this lasted for less than two years after which the cost of purchasing the furniture started to increase and the WHM group started to experience increased financial pressure. In order to

recover some of the lost profits, the WHM group increased the mark-up applied to the goods sold to Darkfurn by small amounts each year as from Yr48.

Part disposal to Uventus

In Yr46, the managing director of WHM approached his brother, who was a partner in Uventus, a venture capital investment partnership, and asked if his firm would be interested in taking a 49% shareholding in Darkfurn. The reason for the approach was that he believed Darkfurn's profits could be improved substantially with a cash injection to provide funds to accelerate the opening of more stores. He persuaded his brother that this would be a recipe for success and he gave him his verbal assurance that there would be a good return on any investment made in the company. After some basic due diligence, and relying on the managing director's verbal assurance, the investment was made.

The injection of cash did enable more stores to be opened. However, this coincided with a time when both traditional retail and online competition became much stronger and margins became tighter. Within a few years, both Darkfurn and WHM started to report declining profits and experience cash flow difficulties. This had an impact on Darkfurn's store opening programme which, coupled with the tight specifications imposed by WHM, meant that only 65 stores had been opened by Yr48 with no more being opened, or closed, since then. The current profile of the stores in England is:

<u>Geographic area/store size</u>	Small	Large	Total
North	9	4	13
Midlands	13	5	18
South	<u>24</u>	<u>10</u>	<u>34</u>
	<u>46</u>	<u>19</u>	<u>65</u>

Personnel

Michaela Xa	Managing director, age 29. She joined the company in July Yr52 after being approached by the shareholders. She is a partner in Uventus, the venture capital investment partnership that owns 49% of the share capital of Darkfurn.
Natalie Young	Operations director, age 42. She joined the company in Yr46 after spending fifteen years at WHM. She is the daughter of the managing director of WHM.
Olly Zagar	Financial controller, age 60. He was transferred to the company from the holding company on incorporation.

Each of the directors receive a market rate remuneration package amounting to approximately £100,000 per annum. Prior to July Yr52, James Watt, who is a son-in-law of the managing director of WHM, was the managing director of Darkfurn since it was incorporated in Yr33. He received a basic salary of £200,000 per annum which, when taken together with other benefits and pension contributions, gave him a basic remuneration package of £250,000. On 24 June Yr52, the representatives of the shareholders of Darkfurn met with Mr Watt to discuss his performance. At that meeting he tendered his resignation from the company with immediate effect and Michaela Xa was appointed as his replacement shortly thereafter.

Staff

Staff for the stores are recruited from the local catchment area and have to be educated to at least undergraduate-degree standard, preferably from one of the local universities within a 25 mile radius of the store location. All staff have to be presentable with an engaging personality appropriate to selling in a retail environment.

The staff are given an initial week's training at WHM's head office in the Republic of Ireland and paid the market rate for their services. One of the conditions of the employment contract, which is a zero-hours contract, is that all members of staff are expected to keep up to date with the latest retail-selling practices. No further formal training is provided by Darkfurn.

SECTION 2

Draft trading accounts and other information for Darkfurn for the year ended 30 September Yr52 as provided by Michaela

Trading statement

	Notes	Draft Yr52 £m	Actual Yr51 £m	Actual Yr50 £m	Actual Yr49 £m
Turnover	1	396.0	265.3	365.7	435.3
Direct costs		<u>(236.7)</u>	<u>(156.5)</u>	<u>(208.4)</u>	<u>(235.1)</u>
Gross profit	2	159.3	108.8	157.3	200.2
Store variable costs	3	(39.6)	(26.5)	(36.6)	(43.5)
Store fixed costs	4	<u>(135.1)</u>	<u>(109.2)</u>	<u>(122.4)</u>	<u>(129.7)</u>
		(174.7)	(135.7)	(159.0)	(173.2)
Store profit/(loss)		(15.4)	(26.9)	(1.7)	27.0
Administration expenses:					
Marketing		(10.0)	(10.0)	(10.0)	(10.0)
Other, including Head Office		<u>(6.0)</u>	<u>(5.8)</u>	<u>(5.7)</u>	<u>(5.5)</u>
		(16.0)	(15.8)	(15.7)	(15.5)
Trading profit/(loss)	5	<u>(31.4)</u>	<u>(42.7)</u>	<u>(17.4)</u>	<u>11.5</u>

Notes :

1.	Turnover per geographic area/store size	Small £m	Large £m	Total £m
	North	18.9	39.6	58.5
	Midlands	35.1	71.0	106.1
	South	<u>74.4</u>	<u>157.0</u>	<u>231.4</u>
		<u>128.4</u>	<u>267.6</u>	<u>396.0</u>

The vast majority of the sales are made to UK customers although approximately 0.5% of the sales are exported to approximately 500 overseas customers. These sales are delivered to the customers using international couriers after the goods have been received by the stores in the UK.

Each store is open for 360 days per year and the daily footfall (number of customers entering the store) per store is, on average, 100 and 500 for the small and large stores respectively. The average sale per customer per store size per geographic area is:

		Small £	Large £	
	North	580	550	
	Midlands	750	790	
	South	860	1,090	
2.	Gross profit per geographic area/store size	Small £m	Large £m	Total £m
	North	7.0	13.5	20.5
	Midlands	14.0	27.0	41.0
	South	<u>33.5</u>	<u>64.3</u>	<u>97.8</u>
		<u>54.5</u>	<u>104.8</u>	<u>159.3</u>
3.	Store variable costs			

The variable costs per store include the costs to deliver the furniture to the customers. Each store has an agreement with a local courier firm to deliver the furniture for a fixed percentage of the sales price. Other variable costs include the cost of packaging materials and a standard cost of labour based on the selling price.

4.	Fixed costs per store per geographic area/store size	Small £m	Large £m
	North	0.5	2.4
	Midlands	0.7	3.3
	South	1.1	6.9

In addition to the rent, rates and store running costs, the store fixed costs include the cost of staff at each store. The smaller stores employ a full-time store manager and up to ten part-time sales assistants who are engaged on zero-hours contracts. The larger stores also employ a full-time store manager but have an assistant manager and up to twenty-five part-time sales assistants, also on zero-hours contracts. There is no bonus scheme in any of the stores.

5. Trading profit

The trading profit excludes any management charge from WHM.

SECTION 3

Salient terms of trading agreement between WHM Plc ('WHM') and Darkfurn Ltd

1. Goods for Resale
 - 1.1 All purchases of Goods for Resale by Darkfurn will be made from WHM.
 - 1.2 The purchase price will be determined from time-to-time by WHM and will be based on the total costs, net of VAT, for WHM to supply and deliver the Goods for Resale to Darkfurn plus a mark-up. The mark-up will be no less than 25% and no more than 75%.
 - 1.3 WHM will give Darkfurn no less than three calendar months' notice of any future change of the mark-up applied to the total costs.
 - 1.4 The retail stores will contain display goods only and none of the goods on display are to be made available for immediate despatch. Based on the sales orders received for the week ended on 5pm each Thursday, Darkfurn will place an order for these same goods from WHM by no later than midday on the following Friday.
 - 1.5 WHM will endeavour to deliver the Goods for Resale ordered in clause 1.4 above to each retail location no later than seven days from the end of the day the order was received.
 - 1.6 Returns of Goods for Resale must be notified to WHM within 24 hours of receipt of delivery and any cost to return the goods will be borne by Darkfurn.
 - 1.7 WHM will issue an invoice for each order of the Goods for Resale at the start of the week following receipt of the order. Darkfurn will pay for that order no later than the end of the following month i.e. on average 45 days credit will be given. Any late payment will incur an interest charge of 1% per day it remains outstanding.
2. Overheads
 - 2.1 Darkfurn will be responsible for arranging and paying for all other costs of running the business, including payroll.
 - 2.2 Once a quarter, WHM will issue a management charge invoice to cover time incurred by management overseeing the business. This will be charged at the rate of 50% of trading profit. The minimum management charge will be based on a 100% uplift of the total cost of the actual hours of providing employees to oversee the business irrespective of the trading profit.
3. Sales
 - 3.1 The selling price of the goods in the UK will be within +/-10% of the selling price of the same goods in the Republic of Ireland.
 - 3.2 Where customers of Darkfurn want to pay for the ordered goods using a credit agreement over a period of time, they will be referred to WHM's authorised and regulated consumer credit department. The staff of the department will undertake the necessary checks on the potential customer and their decision on whether to provide credit will be final. Where credit is provided the contract will be between the customer and WHM and Darkfurn will be paid for the sale of furniture in full by WHM.

- 3.3 Darkfurn will not provide any credit to customers. All goods with a value of less than £100 must be paid in full at the time of the order. For all other sales, the customer must pay at least a 25% deposit with the balance being paid no later than at the time of the booking of a delivery date.
- 3.4 All sales proceeds will be credited to a Darkfurn bank account controlled by the treasury department at WHM. At the end of each month the funds will be used to pay for the outstanding orders of Goods for Resale received during the previous month and the balance credited to the current account of Darkfurn.

END OF PAPER