

Operational Case Study Examination

May-August 2024

Pre-seen material

Kanann



Context Statement

We are aware that there has been, and remains, a significant amount of change globally. To assist with clarity and fairness, we do not expect students to factor these changes in when responding to, or preparing for, case studies. This pre-seen, and its associated exams (while aiming to reflect real life), are set in a context where current and on-going global issues have not had an impact.

Remember, marks in the exam will be awarded for valid arguments that are relevant to the question asked. Answers that make relevant references to current affairs will, of course, be marked on their merits.

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Your role

You are a Finance Officer working within the Finance Department of Kanann. You are principally involved in the preparation of management accounting information and providing information to managers to assist with decision making. At times, you are also expected to assist with the preparation of the financial statements and answer queries regarding financial reporting and other financial matters.

Introduction

Kanann is a company that designs, makes and sells saddles for horse riding. Kanann only makes saddles, it does not make bridles. Companies such as Kanann are known as saddle makers. The company is based in Keeland, a country located in mainland Europe which has the K\$ as its currency.

Kanann was founded in 1906 by William Kanann. William started his working life as an apprentice saddler and, after completing his apprenticeship at a local company, started his own business making saddles for the Keeland Army. He purchased a site on the outskirts of his local town and built a workshop. The company remains on this original site, although it has expanded over the years to incorporate a production facility, inventory warehouses and offices.

During the 1920s and 1930s, the customer base widened to include civilian customers and customers in other European countries. During this time, the company became known for its high quality, stylish saddles.

The saddles made and sold by Kanann today are based on traditional designs and are marketed as general purpose saddles rather than specialist saddles. Their more traditional design means that Kanann saddles have limited appeal in some modern markets. The innovation and developments seen in the products offered by other saddle makers, but lacking in Kanann's saddles, are thought to be reasons why Kanann's sales have not increased as much as those of some other brands. The general perception in the market is that, although Kanann's saddles offer value for money, the company has significantly fallen behind the times.

A saddle consists of a tree (the inner skeleton of the saddle), webbing and leather pieces which are stitched together to create the saddle. The company currently offers a range of three different styles of saddle and different options in respect of the tree and the quality of the leather used. Today, Kanann's saddles tend to be used by amateur equestrians who typically use them for hacking and occasionally for very low-level competition.

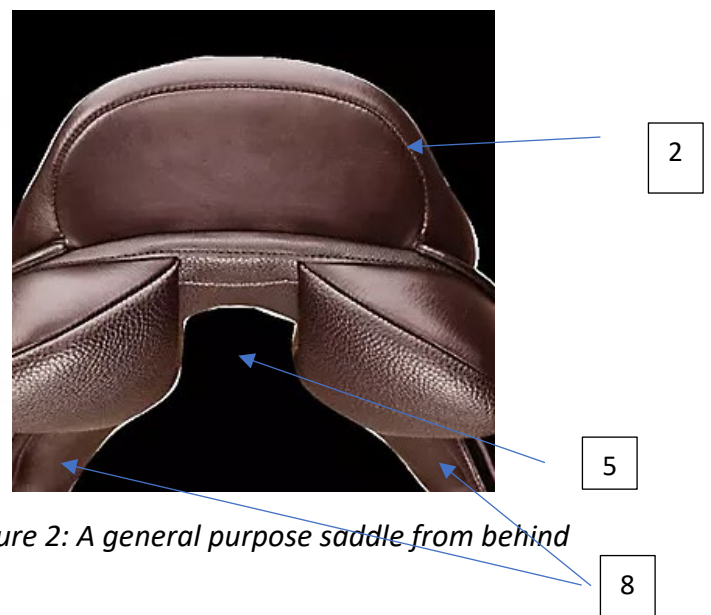
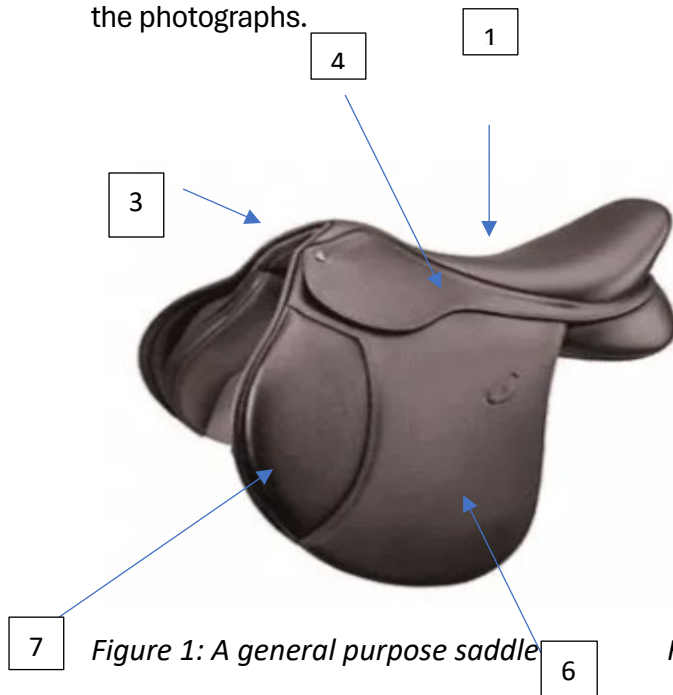
Throughout the company's history, it has been owned and managed by the Kanann family. The company's current Managing Director is John Kanann. John has a sister, Ann, and they hold 80% and 20% of Kanann's equity shares respectively. Ann is a successful author of romantic novels and has no interest in horses or equestrian pursuits. She is not involved in the management of Kanann.

John's daughter, Freya Kanann, has participated in equestrian sports from when she was a small child. She is now an international show jumper and represented Keeland at the recent World Equestrian Games. Freya's medal-winning performances in individual and team events at the World Equestrian Games led to her inclusion in Keeland's Olympic team. Freya's sporting prowess is matched by her intellect. She recently graduated from a prestigious Keeland university with a first-class honours degree in Accountancy and Finance. After graduation, Freya started working at Kanann, although she does take substantial periods of leave to continue her equestrian career. John is immensely proud of his daughter's academic and sporting achievements and welcomes her involvement in the company, which he freely admits has an ageing management profile and needs new ideas.

Extract from Keeland Pony Club Manual

Chapter 3: The general-purpose European style saddle

A general-purpose European style saddle (*figures 1 and 2*) is designed to accommodate different riding styles and disciplines. It is important to understand the different areas of a saddle when looking after your horse. Below, we have a numbered list of the different areas of a European style saddle with an explanation of each area. These correspond to the numbers in the photographs.



1. **Seat:** The seat of the saddle is where the rider sits. It should provide a comfortable and balanced position for the rider.
2. **Cantle:** The cantle provides support and security for the rider, helping to keep them in place during riding. The height and angle of the cantle can affect the rider's position.
3. **Pommel:** This is the raised front portion of the saddle seat.
4. **Tree:** This is the internal framework of the saddle that gives it its shape and structure. It plays a crucial role in distributing the rider's weight evenly across the horse's back. A well-designed tree is essential for horse comfort. The tree cannot be seen in the photographs.
5. **Gullett:** This is the channel which runs along the length of the saddle underneath the seat. It provides clearance for the horse's spine, ensuring there is no pressure on the horse's back.
6. **Flaps:** These are the large leather panels that hang down on both sides of the saddle.
7. **Knee rolls and thigh blocks:** Knee rolls and thigh blocks are padded areas on the front of the saddle flaps. They provide additional support and stability for the rider's legs.
8. **Panelling:** The panels are the padded areas which come into direct contact with the horse's back. They should be designed to distribute the rider's weight evenly and provide cushioning.

After a saddle has been assembled, it is then stuffed with flocking to provide padding in the seat. Flocking can be made of wool or synthetic material or a mixture of both.

Article in Keeland Equestrian News

How have European Saddles developed over the last 500 years?

Ella Winter-Barker for The Keeland Equestrian News



Medieval soldiers on horse back



17th Century rider

Horse riding saddles have a rich history, dating back millennia and their design has evolved significantly over the last 500 years. This development has been driven by the changing needs of riders, improvements in materials and manufacturing, as well as a deeper understanding of equine anatomy and biomechanics. This looks set to continue.

The Medieval Era (15th Century) saw saddles which were simple and practical and, as the illustration above shows, were designed mainly for military use. High pommels and cantles provided stability for knights in armour. Stirrups, introduced around the 9th century, were pivotal in developing improved control and balance.

The 16th and 17th Centuries, in the Renaissance and Baroque periods, saw saddles becoming more decorative and focussed on rider comfort. The rise of Equestrian arts and a desire for elegance led to saddles being elaborately adorned.

With The Age of Enlightenment, the 18th and 19th Centuries saw more advancements. With saddles becoming lighter and more balanced, with better weight distribution, the introduction of wooden saddle trees and developments in design, these all allowed greater freedom of movement for the rider.

Saddle design continued to be revised during the 20th Century with disciplines like dressage, show jumping and eventing driving the creation of specialised saddles tailored to the unique demands of each discipline.

The industry

Overview of the market

Kanann's market share in Keeland is relatively small in terms of the volume of saddles sold. However, there is a flourishing equestrian market in Keeland, with the sector generating K\$4 billion of GDP each year. Approximately 1% of the 26 million households in Keeland own horses with an average of 2.4 horses being owned by each horse-owning household.



Countries with a tradition of horse ownership usually have saddle makers which only sell into the domestic market as well as saddle makers which sell globally. Saddle makers typically sell saddles to wholesalers and retailers of equestrian equipment. Such equestrian equipment retailers usually have their own in-house saddle fitters who will connect with the end user to make the sale. Saddle makers do not usually sell directly to the end user.

Today, individual riders may have multiple saddles for one horse, with each designed to improve performance in a specific discipline. For instance, a show jumping saddle will be made with large knee rolls to allow better grip when jumping, whilst a dressage saddle is likely to have a deeper seat to allow better contact with the horse when completing dressage tests. In addition, riders with multiple horses are also likely to have saddles specifically sized to each horse they own. The move to riders having specific horses for specific disciplines has driven global sales over the past few years and is expected to continue in coming years.

Global saddle manufacture

Saddle manufacturing is an industry with many national and global manufacturers. There is a high concentration of saddle makers in areas such as the USA, Australia and South Asia where there are long equestrian traditions. However, the equestrian saddle market is very diverse and includes different separate equestrian pursuits such as polo, horse racing and European and Western riding. Manufacturers in each of these individual fields do not compete in most cases, with only a very few global firms operating in more than one market.

Developments are being seen in the saddle industry in terms of both production and design. Production, which has previously been very labour intensive, is now seeing a move to more automated production techniques in areas such as leather cutting. However, despite this, the production of a saddle still relies heavily on the skilled labour of the saddle makers in relation to stitching and assembly.

Design improvements are being seen in the use of high-tech materials, for instance, using carbon fibre in tree manufacture to obtain a lighter and stronger tree and the introduction of


synthetic materials in the production of saddles. There have also been moves to introduce more automation into the production process, which has traditionally been very labour intensive.



Extracts from the Kanann sales brochure

Our saddle range

At Kanann, our long history as equestrian saddle makers shows in our range of traditional saddles and designs. Each saddle has evolved with the aim of helping both horse and rider to enjoy their activity.



We offer you three different styles of saddle, each named after horses that have been owned by the family over the years. These are:

Astral

Meteor

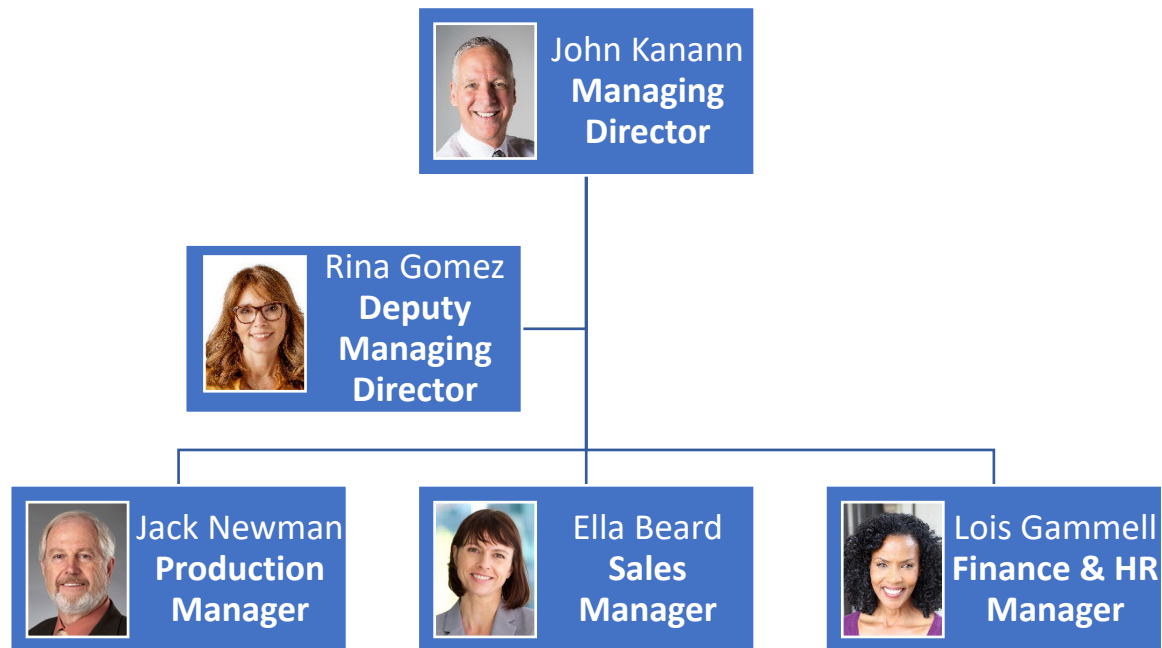
Comet

There are two models of the Astral, two models of the Meteor and one model of the Comet. Each model uses a different grade of leather, from E grade (economy quality) to A (premium quality) and either a Type 1, Type 2 or Type 3 saddle tree.

Saddle style	Astral		Meteor		Comet
Average price	K\$2,750	K\$3,250	K\$3,500	K\$4,000	K\$4,500
Saddle tree type	Type 1	Type 2	Type 2	Type 3	Type 3
Leather grade	E	D	C	B	A

Each model is available in different sizes to allow the saddles to fit different height riders and different size horses.

The directors and key managers



John Kanann, Managing Director

John has overall responsibility for the business and is actively involved in all areas. He insists on having the final sign off on new designs and products. John started with the business at the age of 16 and is now 52 years old. He trained as a saddler and is a member of the Keeland Guild of Saddlers.

Rina Gomez, Deputy Managing Director

Rina joined the company from university in 1993 as a member of the sales team. Before becoming Deputy Managing Director, she was Sales Manager. As part of her duties, she oversees the sales, finance and HR functions and deputises for John when he is away.

Jack Newman, Production Manager

Jack Newman started as an apprentice with Kanann in 1985. He has worked in each of the company's production departments before becoming Production Manager and is responsible for all aspects of production and raw material procurement.

Ella Beard, Sales Manager

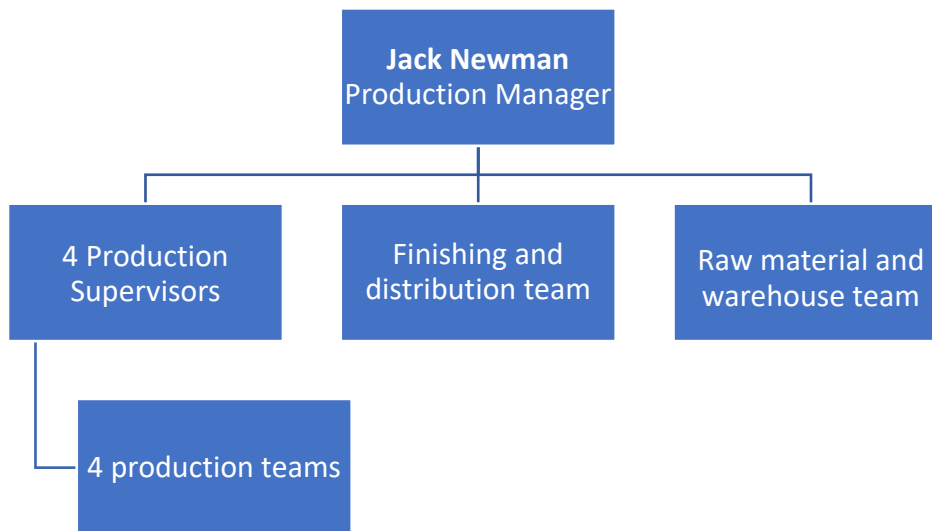
Ella is responsible for the company's sales and marketing. She reports to Rina Gomez. She joined Kanann in 2022. Immediately prior to her appointment at Kanann, Ella held a senior sales position for a competing saddle maker in Keeland.

Lois Gammell, Finance & HR Manager

Lois Gammell qualified as an accountant in 1988 and has worked for Kanann since 1995. She is responsible for all finance, human resources and IT issues. Before joining Kanann, she worked at Keeland Health Service.

Production, sales and finance teams

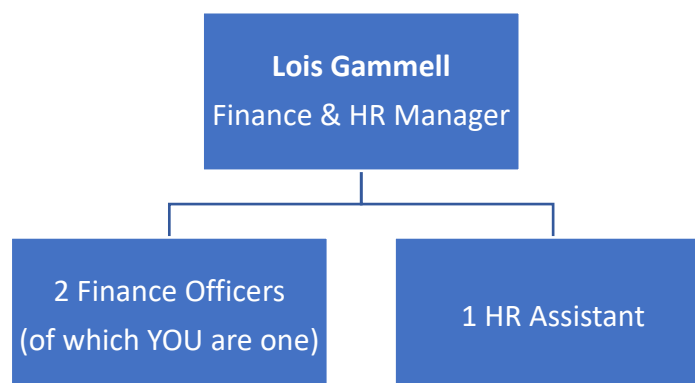
Production team



Sales team



Finance team



Article: a 5-minute interview with Freya Kanann

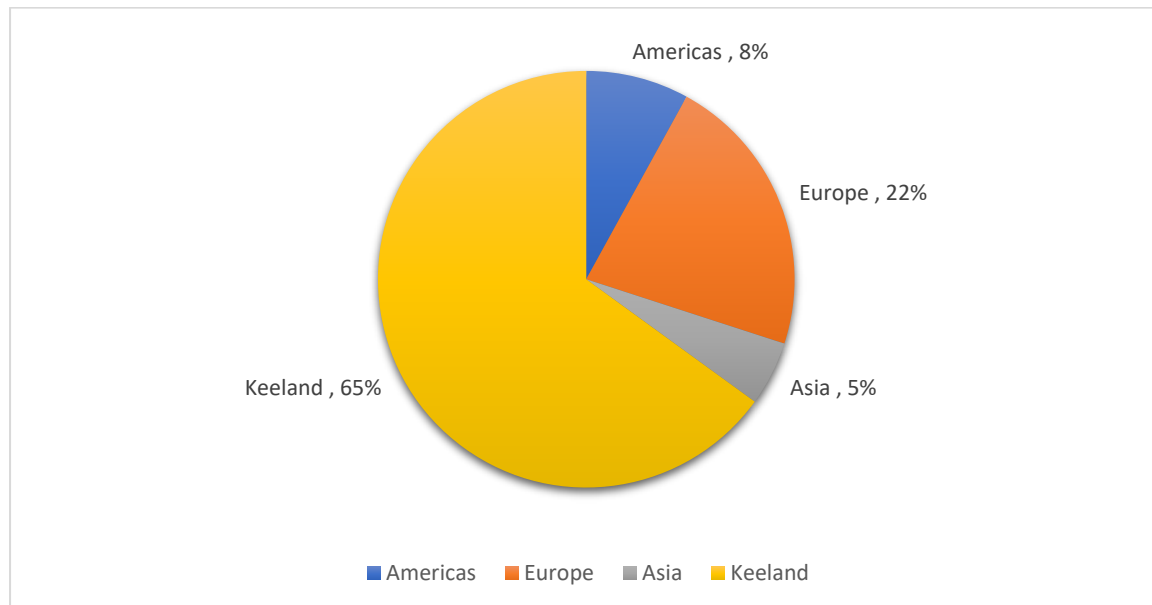
Equestrian Pursuits
The 5-minute interview with Jon Ford, Senior Editor
<p>Jon: Lovely to meet you finally Freya. I've followed your equestrian career with great interest over the past few years and hear that despite being busy competing you have also just graduated from university as well. A great achievement, many congratulations. What are you going to fill your time away from riding with now?</p> <p>Freya: Thank you, Jon. It was a bit of a juggle at times, especially with international competitions covering the whole of the year because of the timing of competition seasons in different countries. But I'm competitive and determined, so I just put my head down and worked hard. In terms of next steps, I've just spent some time shadowing my father at Kanann to start learning about and seeing how the business operates.</p> <p>Jon: I see – so the idea is to move into the family business full time at some point?</p> <p>Freya: Yes, although thankfully Dad knows that my equestrian career takes precedence at the moment, so doesn't expect me there all the time.</p> <p>Jon: So, the Kanann name is well known for general purpose saddles and the company has a long history. Do you have a Kanann saddle yourself that you use?</p> <p>Freya: Actually, I do use a Kanann saddle when I'm riding for leisure. I have different saddles for competing though and these come from the brand that is best suited to the specific event and the horse I'm riding at that time.</p> <p>Jon: Will you now become the face of Kanann?</p> <p>Freya: Actually, I guess I will. In fact, I recently received an offer of sponsorship from the manufacturer of one of the brands of saddles I use when competing. Although it was a lucrative offer, and tempting from a personal perspective, I declined it because, given that Kanann is my family business, I don't want to be seen as an ambassador for another brand of saddles.</p> <p>Jon: So, does that mean that Kanann might move into the field of specialist saddles for competing?</p> <p>Freya: In time, possibly. Many of the people I know at the higher levels of the sport have heard of Kanann saddles, but very few have them because they tend to use saddles from brands that they are already familiar with. In time, I'd like to push Kanann forward to become the number one choice for general purpose and discipline-specific saddles.</p> <p>Jon: So, plenty to keep you busy with over the next few years! Good luck with all of that and your next championships. I shall be following you with great interest.</p> <p>Freya: Thanks Jon.</p>

Other information about company operations

Sales markets and sales channels

Kanann sells its saddles in Keeland, other parts of Europe, Asia and the Americas. Sales in Keeland accounted for 65% of total revenue for Kanann in its year ended 31 December 2023.

For the year ended 31 December 2023, the company sold 1,705 saddles, generated revenue of K\$5,860,000 and a gross profit margin of 33.8%. Kanann's revenue is analysed as follows:



Kanann does not sell direct to the public: it sells to equestrian wholesalers and retailers. These wholesalers and retailers are independent of Kanann. Some specialise and sell only saddles whilst others sell saddles and other equestrian equipment (such as horse rugs and bridles). Some wholesalers and retailers only sell Kanann saddles, but others sell different brands of saddles too.

Kanann receives orders from the wholesalers and retailers by either e-mail or by them placing orders with Kanann's sales team by phone or in person. The sales team try to visit the wholesalers and retailers based in Keeland at least twice each year.

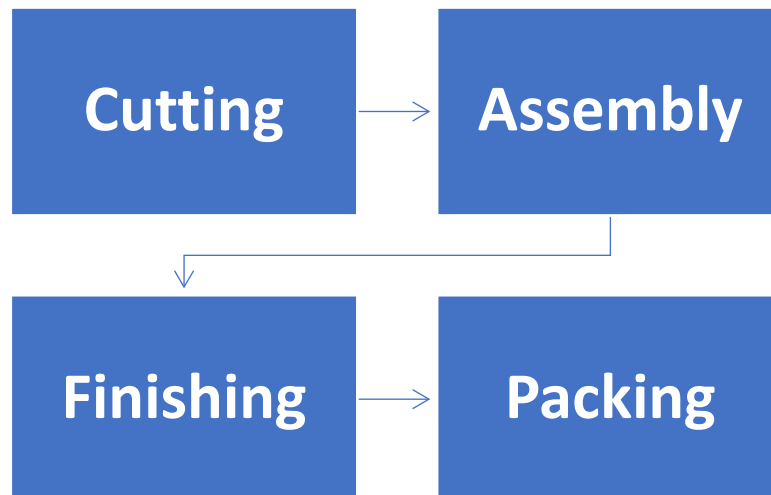
The credit period given to wholesalers and retailers ranges from 30 to 60 days and, because of close relationships with the sales team, all of the wholesalers and retailers pay within the appropriate credit period.

Production

Kanann manufactures all of its saddles at its single Production Facility. The facility includes several different buildings which are used for production as well as a raw materials and finished goods warehouse.

The total production and packing time for one saddle is approximately 28 direct labour hours, depending on the model being produced.

The four main stages in producing a saddle are:



<p>Cutting</p>	<p>A saddle consists of several pieces of leather. All the leather is bought in as butts and there are five grades of leather used across the range of saddles. A 'butt' is a sheet of leather.</p> <p>The main leather parts of a saddle are the seat, the knee rolls, the flaps and the panel. These parts are cut to shape and size for a single saddle from a single leather butt. The pieces are cut and prepared by hand using cutting dies and machines. The offcuts from the leather butt are not used.</p>
<p>Assembly</p>	<p>Assembly starts with the tree. The 'tree' is the inner skeleton of the saddle and forms a base onto which the leather is attached. The company purchases the trees used to form the skeleton of the saddle from third-party suppliers who use six to eight layers of plywood in each tree. The company insists that their saddle tree suppliers source wood from sustainable forests.</p> <p>The trees used come in three different qualities and the type of tree used depends on the model of saddle it is included in. The trees supplied are already reinforced with metal strips around their full length. The first stage of assembly is to add head plates (which form the shape at the front of the saddle) and stirrup bars using rivets and screws.</p> <p>The next stage is 'webbing' which makes the 'seat', which is the suspension platform for the rider to sit on. It separates the seat from the tree. This process is done by adding the webbing (which is made of nylon) which is stretched lengthways and across the tree to form the seat shape. When the webbing has been stretched, the next stage is to apply foam padding, then add the leather and stretch it over the tree.</p> <p>The saddle is then sewn together. Each saddle is stitched together using a mixture of hand sewing and an industrial sewing machine. After the saddle pieces have been sewn together, the saddle is then stuffed with flocking and any design elements are added.</p>
<p>Finishing</p>	<p>Completed saddles are moved to the Finishing Department. Here, the saddles are oiled. Oiling the saddle prevents the leather from cracking, ensuring it remains supple and extending its life. The saddle also undergoes final quality checks. After these checks are completed, the company's promotional labels and other branding are added.</p>
<p>Packing</p>	<p>The finished saddles are moved to the Packing Department. Packing is extremely important given the high value of each saddle and the risk of damage during transit. The differing types and sizes of saddles are packaged in bespoke boxes which are bought in. These boxes are designed for the presentation of the saddles by the wholesalers and retailers to their customers. The boxes are also used by customers to transport the saddles to different venues and as such are essential for protecting the product during transport.</p>

Distribution

Distribution of saddles is outsourced to a major distribution company which delivers anywhere in Keeland 6 days a week. The same distributor is also used for sales to other countries.

Purchasing and suppliers

The main raw material inputs into the production process are:

Tree	<ul style="list-style-type: none">•The company uses three grades of general purpose trees in their saddles. They are Type 1, Type 2 and Type 3. Type 3 trees are lighter than the Type 1 and Type 2 trees and therefore more expensive.
Leather	<ul style="list-style-type: none">•Leather butts come in five grades, A to E, with A being the highest grade.•A butt is 1.5 square metres (1.5 metres x 1 metre). All butts are the same size.
Flocking	<ul style="list-style-type: none">•Kanann uses 100% long fibre white wool flock. White wool flock is one of the best quality flocks as it is very hard wearing.
Consumables	<ul style="list-style-type: none">•Webbing is purchased in 100m rolls and is made from recycled nylon.•Tools include: bone folders, awls, needles and plastic mallets.•Other consumables include: dyes and glues, polyester, linen and nylon thread and stirrup bars, rivets and screws as well as packaging.

Kanann has good relationships with its suppliers. Many of the suppliers have been with Kanann for over a decade. In fact, some suppliers have been with the company since its inception.

Where possible, Kanann chooses suppliers with a commitment to follow sustainable production processes. For example, Kanann insists that the packaging bought in for its own saddles is made from 100% recycled packaging.

Credit terms from suppliers range between 30 days and 75 days. Some suppliers offer prompt payment discounts, although Kanann does not always take advantage of these. Bulk discounts are also available on the flocking and many of the consumables used in production. Kanann does take advantage of these where possible.

Warehouse

Receipt and storage of good inwards, issues to production and storing of finished saddles are all labour-intensive activities.

Employees

Kanann had the following employees on 30 June 2023

	Number
Production Facility	40
Head Office*	15
	55

*Head Office includes the sales, finance and human resources teams and the directors.

Finance

Kanann's financial recording systems are not integrated and must be reconciled on a regular basis to ensure each area is accurate.

The company operates a standard absorption costing system based on direct labour hours with a single fixed absorption rate. The standard cost of a saddle is updated for known changes in raw material prices, labour rates and overheads each year.

Record keeping is not sophisticated. For example, webbing, when issued for production, is simply allocated to "production" as opposed to the specific saddles being made and as such is classified in the accounting system as a consumable. Webbing is therefore included in variable overhead in the costing system.

The treatment of webbing in the costing system echoes the traditional views within the company that, to a large extent, it manufactures a homogenous product: a saddle is a saddle. Originally, the cost of a saddle was calculated as total costs for the year divided by the number of saddles produced.

In recent years, efforts have been made to refine the system, for example, by recording direct labour times per saddle, in addition to the specific materials needed for each type of saddle. Historically, Kanann's financial systems were focussed on producing financial statements rather than providing useful management information.

Budgets are prepared annually on an incremental basis.

Financial statements for the year ended 31 December 2023

Kanann

Statement of profit or loss for the year ended 31 December 2023

	2023 K\$000	2022 K\$000
Revenue	5,860	5,690
Cost of sales	(3,878)	(3,699)
Gross profit	1,982	1,991
Selling and distribution costs	(705)	(691)
Administrative expenses	(760)	(742)
Operating profit	517	558
Finance costs	(12)	(12)
Profit before tax	505	546
Income tax expense	(100)	(110)
Profit for the year	405	436

Kanann**Statement of financial position at 31 December 2023**

	2023 K\$000	2023 K\$000	2022 K\$000	2022 K\$000
ASSETS				
Non-current assets				
Property, plant and equipment		1,142		1,187
Current assets				
Inventory	590		645	
Trade receivables	867		811	
Other receivables	115		120	
Cash and cash equivalents	212		85	
		1,784		1,661
Total assets		2,926		2,848
EQUITY AND LIABILITIES				
Issued K\$1 equity share capital		10		10
Retained earnings		1,771		1,716
Total equity		1,781		1,726
Non-current liabilities				
Borrowings		200		200
Current liabilities				
Trade payables	530		505	
Other payables	315		307	
Tax liability	100		110	
		945		922
Total equity and liabilities		2,926		2,848

Kanann**Statement of cash flows for the year ended 31 December 2023**

	K\$000	K\$000
Cash flows from operating activities:		
Profit before tax		505
Adjustments		
Depreciation of property, plant and equipment	205	
Loss on sale of property, plant and equipment	12	
Finance costs	12	
		229
Movements in working capital		
Decrease in inventory	55	
Increase in trade and other receivables	(51)	
Increase in trade and other payables	33	
		37
Cash generated from operations		771
Tax paid		(110)
Interest paid		(12)
Net cash inflow from operating activities		649
Cash flows from investing activities:		
Purchase of property, plant and equipment	(182)	
Proceeds on disposal of property, plant and equipment	10	
Net cash outflow from investing activities		(172)
Cash flows from financing activities:		
Dividend paid	(350)	
Net cash outflow from financing activities		(350)
Net increase in cash and cash equivalents		127
Cash and cash equivalents at the start of the year		85
Cash and cash equivalents at the end of the year		212

Budget information for the year ending 31 December 2024

Total budgeted gross profit

	Astral		Meteor		Comet	Total K\$000
	Type 1 K\$000	Type 2 K\$000	Type 2 K\$000	Type 3 K\$000	Type 3 K\$000	
Revenue	1,306	1,381	858	1,140	1,328	6,013
Cost of sales	(965)	(964)	(573)	(701)	(779)	(3,982)
Gross profit	341	417	285	439	549	2,031
Gross profit margin	26.1%	30.2%	33.2%	38.5%	41.3%	33.8%

Budgeted sales

	Astral		Meteor		Comet	Total
	Type 1	Type 2	Type 2	Type 3	Type 3	
Sales volume	475	425	245	285	295	1,725
	K\$	K\$	K\$	K\$	K\$	
Average selling price	2,750	3,250	3,500	4,000	4,500	
	K\$000	K\$000	K\$000	K\$000	K\$000	K\$000
Revenue	1,306	1,381	858	1,140	1,328	6,013

Budgeted cost of sales

	Astral		Meteor		Comet	Total
	Type 1	Type 2	Type 2	Type 3	Type 3	
Sales volume	475	425	245	285	295	1,725
	K\$	K\$	K\$	K\$	K\$	
Raw materials	460	640	645	710	770	
Direct labour	680	705	735	760	815	
Variable production overheads	267	277	287	297	317	
Fixed production overheads	624	647	670	693	739	
Total	2,031	2,269	2,337	2,460	2,641	
	K\$000	K\$000	K\$000	K\$000	K\$000	K\$000
Cost of sales	965	964	573	701	779	3,982

Example standard cost card

Astral: Type 1 Tree				
	Quantity / hours	Standard price / rate K\$	Standard cost K\$	Total standard cost K\$
Direct materials:				
Tree	1	100.00	100.00	
Leather	1 butt	300.00	300.00	
Flocking	0.50 kg	40.00	20.00	
Packaging	1	40.00	40.00	
Total direct materials				460.00
Direct labour:				
Cutting	4 hours	30.00	120.00	
Assembly	17 hours	25.00	425.00	
Finishing	3 hours	20.00	60.00	
Packing	3 hours	25.00	75.00	
Total direct labour				680.00
Variable production overheads	27 hours	9.90	267.30	267.30
Fixed production overheads	27 hours	23.10	623.70	623.70
Total production cost				2,031.00

Notes on standards and budget preparation

1. Standards are reviewed and updated annually for any known changes.
2. Idle time is not budgeted for.
3. Production overheads are absorbed using direct labour hours.
4. Budgeted selling prices include an allowance for planned discount promotions.

Tax regime in Keeland

- The corporate income tax rate to be applied to taxable profits is 20%.
- Unless otherwise stated below, accounting rules on recognition and measurement are followed for tax purposes.
- The following expenses are not allowable for tax purposes:
 - accounting depreciation
 - amortisation
 - impairment charges
 - entertaining expenditure
 - donations to political parties
 - taxes paid to other public bodies.
- Tax depreciation allowances are available on all items of plant and equipment (including computer equipment) at a rate of 25% per year on a reducing balance basis. A full year's allowance is available in the year that the asset is acquired. Tax depreciation allowances are not available for property assets.
- Tax losses can be carried forward indefinitely to offset against future taxable profits from the same business.
- Sales tax is charged on all standard rated goods and services at a rate of 15%. Tax paid on inputs into a business can be netted off against the tax charged on outputs from that business. All businesses are required to pay over the net amount due monthly.