



**CPA**

CHARTERED  
PROFESSIONAL  
ACCOUNTANTS  
CANADA

# CPA Common Final Examination

**BOARD OF EXAMINERS' REPORT**

May 2016

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## THE BOARD OF EXAMINERS' REPORT ON THE MAY 2016 COMMON FINAL EXAMINATION

### OBJECTIVES OF THE REPORT

The objective of this report is to explain the Common Final Examination (CFE) process and to assist the profession in improving the performance of candidates on the CFE.

The report sets out the responsibilities of the Board of Examiners, the methods used for guide setting and marking the CFE, and the results of the marking process. The report also includes recommendations to candidates from the Board of Examiners.

Seven appendices provide more detailed information on the design, guide setting, and marking of the 2015 CFE, as well as the board's expectations of candidates on the simulations. Readers are cautioned that the marking guides were developed for the entry-level candidate and that, therefore, all the complexities of a real-life situation may not be fully reflected in the content. The CFE report is not an authoritative source of GAAP.

### RESPONSIBILITIES OF THE BOARD OF EXAMINERS

The Board of Examiners (the board) comprises a chair, a vice-chair, and sixteen members appointed by the provincial bodies.

The board's responsibilities, as set out in its terms of reference, include the following:

- Setting the CFE in accordance with the *Chartered Professional Accountant Competency Map* (the *Map*) and other directions from the Professional Education Management Committee;
- Submitting the CFE and the marking guides to the provincial bodies for review;
- Marking the candidates' responses and recommending to the provincial bodies the pass or fail standing that should be given to each candidate; and
- Reporting annually on the CFE to various CPA committees and the provincial bodies, in such form and detail and at such time as is satisfactory to them.

The chair is responsible for the supervision of the evaluation process. A CFE subcommittee of six is actively involved in the preparation of the CFE simulations, the preparation of marking guides, and the setting of the passing profile. The full board is responsible for determining the passing standard.

## THE CFE

### Preparation and Structure of the CFE

The board staff works in conjunction with authors to ensure that simulations achieve the overall intent and design objectives of the board while adhering to the competencies and the proficiency levels specified in the *Map*.

The CFE subcommittee of the board provides guidance as to the content and nature of simulations to be included on the examination. It also reviews and refines these simulations to make up the three-paper evaluation set.

### Nature of the Simulations

The CFE comprises a set of simulations that are both essential and effective in evaluating the candidates with regard to their readiness to be a CPA:

**Day 1** – The first paper is a four-hour examination consisting of a single simulation that is linked to the Capstone 1 group case.

**Day 2** – The second paper is a five-hour case, with four different roles and requirements. Additional information tailored to each role is provided in four separate appendices.

**Day 3** – The third paper consists of three multi-competency area simulations.

### Assessment Opportunities

The board applies competency-based marking procedures that enable it to decide which candidates demonstrate readiness to enter the profession.

Assessment Opportunities are designed to answer the question, "What would a competent CPA do in these circumstances?" To attain a pass standing, candidates must address the issues in the simulations that are considered significant.

**Appendix A** contains a comprehensive description of the evaluation process.

### Marking Guides

Marking centre leaders and assistant leaders provide valuable input during the testing and setting of the marking guides, before live marking begins. The board chair and senior evaluations staff hold meetings with the leaders and their assistants during both the guide-setting and the marking processes. See **Appendices B to F** for the RSI Day 1 simulations, marking guides, and sample responses. **Appendix J** contains the marking results by assessment opportunity, and **Appendix K** contains the BOE comments on the Day 1 simulations. A copy of the Day 1 V1 (CHEI), Day 2 and Day 3 simulations can be found in **Appendices G, H and I**. The marking guides for these simulations are not published for the May 2016 CFE and no BOE comments are provided.

**Day 1** – The marking guide is designed to assess the candidate on the stages of the CPA Way: 1) situational analysis; 2) analysis of the major issues; 3) conclusions and advice; and 4) communication. Based on these four summative assessments, the candidate's response is then holistically judged to be either a passing or a failing response.

**Day 2 and Day 3** – Marking guides are prepared for each simulation. Besides identifying the assessment opportunities, each marking guide includes carefully defined levels of performance to assist markers in evaluating a candidate's competence relative to the expectations set out by the board when developing the passing profile for a competent CPA.

Five categories of performance are given for each assessment opportunity (AO). The candidate's performance must be ranked in one of the five categories:

- Not Addressed
- Nominal Competence
- Reaching Competence
- Competent
- Competent with Distinction

### **Setting the Passing Standard**

The chair of the board participates in the monitoring of live marking. Near the completion of the marking process, the CFE subcommittee satisfies itself that the markers applied the marking guides as intended by the board.

In determining which candidates pass the CFE, a passing profile is developed by the CFE subcommittee of the board. A candidate is judged in relation to these pre-established expectations of an entry-level chartered professional accountant. The passing profile decisions are ratified by the full board. In setting the passing profile, the board considers the following:

- The competency area requirements described in the *Map*
- The level of difficulty of each simulation
- The level of difficulty of each assessment opportunity
- The design and application of the marking guides
- Comments from leaders and assistant leaders regarding any marking difficulties encountered or any time constraints noted
- Possible ambiguity of wording or of translation

## The Decision Model

The purpose of the CFE is to assess whether candidates possess the competencies required of an entry-level CPA through a written evaluation that is common to all CPAs. Each day of the CFE is unique and is designed specifically to assess different skills:

- Day 1 is linked to the Capstone 1 group case work. It assesses the candidates' ability to demonstrate professional skills. It is independent from Day 2 and Day 3.
- Day 2 is the **depth** test. It assesses technical **depth** in one of four unique roles (that reflect the four CPA elective choices) and provides **depth** opportunities in the common core competency area of Financial Reporting and/or Management Accounting. Candidates pre-select one role and respond from that role's perspective.
- Day 3 supplements the **depth** test in the common core areas of Financial Reporting and/or Management Accounting. It is also the **breadth** test for all common core competency areas.

Candidates must pass all three days in order to qualify for entry to the profession.

### Day 1

Day 1 is assessed independently from Day 2 and Day 3. A pass or fail decision is made based on a holistic assessment of the candidates' performance in applying the CPA Way to demonstrate essential professional skills.

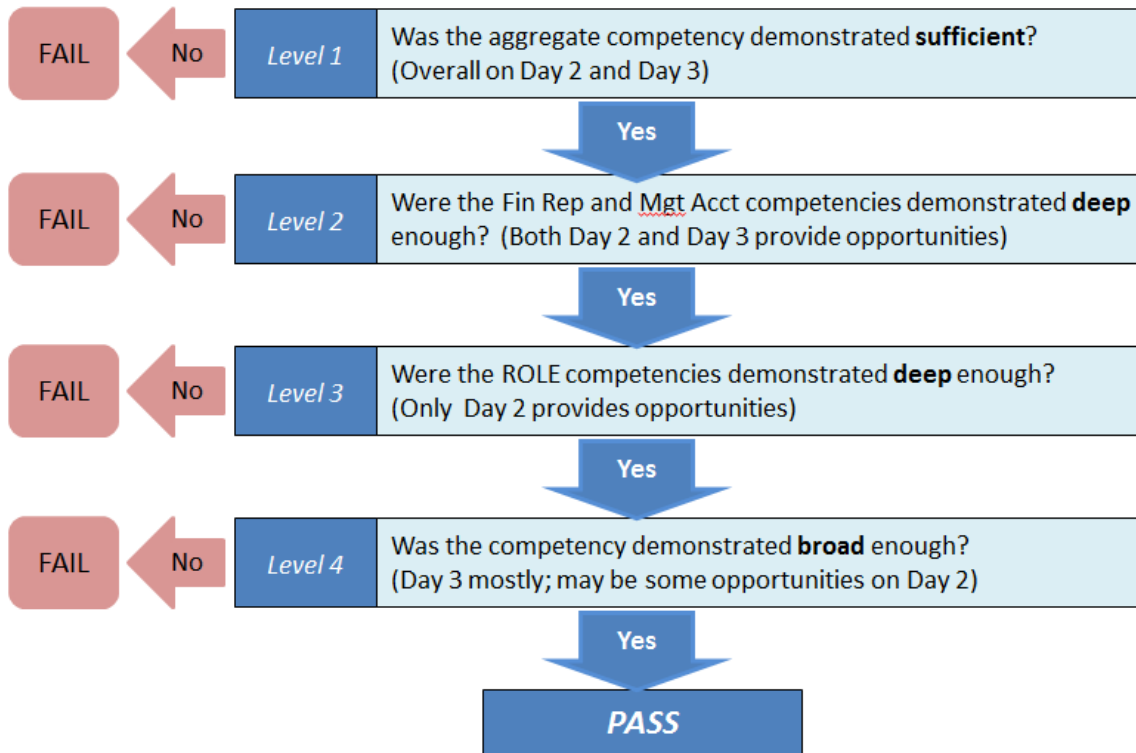
### Day 2 and Day 3

The decision model used by the board is presented in Exhibit I. Four key decision points, or levels, are applied in reaching a pass or fail decision, as follows:

1. The response must be **sufficient**; i.e., the candidate must demonstrate competence in the Assessment Opportunities presented on Day 2 and Day 3 (Level 1).
2. The response must demonstrate **depth** in the common core area of Financial Accounting or Management Accounting (Level 2).
3. The response must demonstrate **depth** in the pre-selected elective role (Level 3).
4. The response must demonstrate **breadth** across all competency areas of the *Map*, at a core level, by not having avoided a particular technical competency area (Level 4).



**EXHIBIT I  
DAY 2 AND 3 PASS/FAIL ASSESSMENT MODEL**



## Approving the Results

The CFE subcommittee reviews and approves the marking results for each simulation. Day 1 is assessed separately from Day 2 and Day 3.

**Day 1** – The CFE subcommittee discusses the profiles for both the marginally passing and marginally failing candidates to confirm that the board's pre-established passing profile has been appropriately applied by the markers.

**Day 2 and Day 3** – As part of the development process, the CFE subcommittee sets preliminary requirements for the three levels (tests of depth and breadth) being assessed on the Day 2 and Day 3 simulations. After the marking is completed, the board reviews and finalizes those requirements. The board establishes the Level 1 (sufficiency) requirement for the combined Day 2 and Day 3 simulations.

During the approval process, the board continues to consider whether the results could be affected by any inconsistency in the evaluation or the board's processes.

## Reporting

In reaching its decision, the board determines which candidates pass on a national basis only, without regard to provincial origin or language. Similarly, the detailed comments are based on analyses of the performance of all candidates.

The board reports the following information by candidate number:

- Overall pass/fail standing and pass/fail standing for each of Day 1 and of Day 2 and Day 3 combined.
- A pass/fail standing for Day 1.
- A pass/fail standing for Level 1, Sufficiency.
- A pass/fail standing for Level 2, Depth in Financial Reporting and/or Management Accounting.
- A pass/fail standing for Level 3, Depth in role.
- A pass/fail standing for Level 4, Breadth in all technical competency areas.

**Thank You**

All board members wish to express their warm and sincere appreciation for the outstanding energy, support, and commitment of the small group of Board of Examiners staff members whose dedication and talent contributed in large measure to the achievement of our objectives and the fulfilment of our responsibilities.

We also wish to acknowledge the contributions made by the provincial reviewers, markers, authors, translators, and editors. The commitment, energy, and skill demonstrated by all the markers were outstanding, resulting in the sound application of marking procedures and producing an appropriate evaluation of the candidates. Everyone's commitment to the quality and fairness of the process is appreciated.

A handwritten signature in black ink, appearing to read "P. Norwood", with a horizontal line underneath the signature.

Peter Norwood, FCPA, FCA, FCMA  
Chair  
Board of Examiners

## A MESSAGE TO CANDIDATES

***To attain a pass standing, candidates needed to achieve a “Pass” on Day 1 and, on Day 2 and Day 3 combined, demonstrate sufficient competence in all areas and meet the two depth standards and the breadth standards.***

### INTRODUCTION

The May 2016 CFE Report puts emphasis on candidates' performance on the Day 1 linked cases. Detailed commentary is provided on Version 1 (written in September 2015) and Version 2 (written in May 2016) of the RSI case in the body of this report. The CFE simulations, marking guides, marking results, and Board of Examiners' comments can be found in **Appendices C through K**.

Commentary on the performance of candidates on the remainder of the May 2016 CFE, which includes Day 1 (CHEI Version 1), Day 2, and all Day 3 simulations, is provided in a summary format only in this message to candidates, since detailed information on these cases is not being published in the May 2016 CFE Report.

***Note: Refer to the September 2015 Board of Examiners Report for a copy of the simulations and the detailed marking guides for Day 2 and Day 3 [Appendices B, C, and D]. Commentary is not provided on the May 2016 CFE for Day 2 and Day 3. The next full report on Day 2 and Day 3 will be provided in September 2016.***

The intent of this message is to help candidates understand how to improve their performance.

### Nature of the CFE

The design of the CFE is such that each day of the examination allows candidates to demonstrate a different skill set. Day 1 allows candidates to demonstrate their high-level professional skills, such as critical analysis, decision-making, and professional judgment, as well as communication. Day 2 allows candidates to demonstrate their technical competence in the common Financial Reporting and Management Accounting competencies and in their chosen role, which ties to one of the four elective areas. Day 2 clearly directs candidates to the work to be done and is not designed to be time constrained, allowing candidates to demonstrate depth. Day 3 allows candidates to demonstrate depth in the common core Financial Reporting and Management Accounting competencies and provides multiple opportunities to demonstrate breadth in all the technical competency areas. Day 3 is less directive and more integrative than Day 2. It is also time-constrained, requiring candidates to prioritize their time per issue.

## **Specific Strengths and Weaknesses**

### Communication

The Board was quite impressed by the quality of candidate responses on the September 2015 CFE. The Board noted that the level of communication on all days was clear and professional. For the most part, candidates' responses were well organized, with a logical flow.

This was not the case for the May 2016 CFE. Many responses were unclear, often due to the use of extreme point-form. It was often difficult to interpret the meaning and intention of a bullet point. Alternatively, candidates merely repeated the case facts, with no further explanation as to why the fact was listed. This seemed to be most prevalent on Day 1 and Day 3.

For the most part, candidates' quantitative analyses were better organized than in September 2015, with a logical flow. However, many candidates still did not always explain the details of their calculation, making it hard to know what assumptions they used or how they arrived at their figures. For example, on Day 2, in the Audit and Assurance role, candidates did not support the adjustments they made to the supplier bonus calculation. In the Finance role, the Excel worksheets were sometimes hard to decipher or were not properly labelled. In the Performance Management role, candidates needed to calculate profitability, integrating a variety of costs, including opportunity costs. However, many candidates did not clearly label the inputs or did not provide an audit trail to explain how they arrived at certain figures. On Day 3, the same issue was noticed with the required Management Accounting and Finance calculations. Candidates did not always show the details of a calculation, and it was sometimes difficult to understand where the figures used in the calculations came from.

### Time Management

The Board noted time management issues on all three days of the September 2015 CFE. Time was better managed on the Day 2 and Day 3 simulations, with few candidates mismanaging their time, on what was a less time-constrained examination.

However, some time management issues were still evident on Day 1 (RSI V2 and CHEI V1). Some candidates still spent an inordinate amount of time doing a full situational analysis, rather than simply addressing the changes that were relevant based on the case facts presented. Others spent too much time analyzing one of the three or four issues presented, to the detriment of the others. Neither of the Day 1 cases on the May 2016 CFE were time constrained in their design.

On Day 2 (all roles), some candidates created issues and spent time discussing accounting balances and treatments that were in fact properly recorded and, therefore, did not need to be discussed. These candidates did not appear to spend sufficient time thinking about an issue before beginning to write their response. Some candidates in the Day 2 Performance Management role spent up to 20 pages of their analysis on common financial reporting issues. As a result, they misallocated time that could have been better spent discussing either accounting issues in which there were errors or the other requirements related to their role. The Board reminds candidates to take time to plan responses and to do some preliminary analysis of the issues before they begin writing their response. Day 2 in particular is designed to allow time for filtering information and planning the response. Candidates are encouraged to use the time that is provided.

**Day 1**

**Points have been excerpted from the September 2015 Board of Examiners' report on Day 1, Version 1. Additional commentary based on candidates' performance on Version 2 has been added.**

**Additional Comments Specific to Day 1 (RSI Version 1) [excerpted from the September 2015 CFE]**

The following paragraphs elaborate on the strengths noted and draw attention to the common weaknesses identified by the Board of Examiners on September 2015 Day 1, Version 1.

The Board was surprised that some candidates did not provide a quantitative analysis of the major issues presented. Several responses did not address a single number, even though there were several opportunities to do so (i.e., the lease option, the Pure Health and Beauty offer or capacity constraint, and the MTC valuation). The Board did not expect candidates to tackle all of the quantitative analyses that could have been performed and certainly did not expect detailed quantitative analyses based on the role and directive of RSI's board. However, avoiding the numbers completely was not acceptable to the Board. Candidates are reminded that Chartered Professional Accountants are expected to perform both quantitative and qualitative analyses, as appropriate, to support their recommendations.

A number of candidates spent a large part of their response (one-third) on a situational analysis. The points made were typically valid and identified many of the decision factors to be considered. However, these points were simply listed as pros or cons, or they were part of a SWOT analysis that was done as an independent section of the response. Many candidates failed to then take this great upfront analysis and incorporate it into their discussions of the specific issues and the recommendations they were making. Candidates are reminded that the situational analysis is there to help provide a frame of reference for the decision factors they should be bringing into their analysis of the issues in order to help them make relevant recommendations that consider the goals, objectives, mission, vision, et cetera, of the company.

Many candidates spent a significant amount of time addressing the Pure audit procedures, likely due to their comfort level with the technical nature of this issue. However, in the ranking of issues, this was minor, and the more important, strategic aspect of the issue was going back to the previous owner of Pure for the liability. Candidates are reminded to step back and consider the broader implications rather than focusing on the technical aspects when answering the Day 1 case.

**Additional Comments Specific to May 2016 Day 1 (RSI Version 2)**

The following paragraphs elaborate on the strengths noted and draw attention to the common weaknesses identified by the Board of Examiners on May 2016, Day 1, Version 2.

As was the case in September 2015, several responses did not address a single number, even though there were several opportunities to do so (i.e., the Lavish valuation, the MTC financial performance analysis, the bonus calculation for Barbara, the HAWI franchise revenue, the investment costs). The Board did not expect candidates to tackle all of the quantitative analyses that could have been performed and certainly did not expect detailed quantitative analyses based on the role and directive of RSI's board. However, avoiding the numbers completely was not acceptable to the Board. The quantitative analysis that was expected was not complex. Candidates are reminded that Chartered Professional Accountants are expected to perform both quantitative and qualitative analyses, as appropriate, to support their recommendations.

As was the case in September 2015, a number of candidates spent a large part of their response (one-third) on a situational analysis. See commentary under Version 1, because it was the very same issue.

However, the May 2016 CFE also saw a higher incidence of candidates not providing any upfront situational analysis at all. These candidates jumped right to the analysis of the issues, which would have been acceptable if they had used the mission, vision, objectives, and key success factors to support their analysis. The assessment of the potential investments, in particular, was an excellent opportunity for candidates to link back to the mission, vision, et cetera. However, no links to these important strategic decision-making elements were made.

Ranking of the issues continued to be important on the May 2016 case. The September 2015 case had two major issues to be addressed. In the May 2016 case, there were also two. The other issues were less significant but still needed to be addressed. Candidates could still demonstrate competence if their response was weak on one of the major issues by doing a good job addressing the other issues in the case. However, candidates could not pass Day 1 if they did not attempt the major issues. The Lavish offer and MTC (Barbara's bias and agreement breaches) were considered critical for the candidate to address. The HAWI franchise offer and the assessment of the potential investments were important to address but were not as critical when considering the case facts (Lavish presented a deadline; MTC's and the manager's performance issues need to be addressed quickly).

Many candidates addressed the control issues and bonus design for Barbara and the incentive program for employees without considering the broader strategic implications. Instead, candidates listed the weakness-implication-recommendation for the controls, generically described the possible bonus plans, and explained how they could motivate Barbara to do different things, depending on what RSI wanted. The same was done for the incentives. Candidates were so focused on demonstrating their knowledge of controls and bonus structures that they lost sight of the big-picture issue: Barbara's behaviour and the financial results of MTC.

The Board considered the controls and bonus structure design on their own as secondary issues, and they were put in the case to make candidates think about MTC's and Barbara's performance and what might be driving it. At no point did these candidates consider that the current bonus plan was motivating Barbara to maximize revenue and not worry about cutting expenses.

Candidates are reminded to step back and consider the broader implications rather than becoming too focused on the technical aspects when answering the Day 1 case.

Some candidates created issues that were not relevant to the case, some of which were important in Version 1. For example, some candidates attempted to modify the MTC agreement and recommended steps that RSI should take to monitor MTC's activities. These candidates failed to consider the change in case facts from Day 1 Version 1. By Version 2, MTC had been bought and a manager had already been hired, making an attempt to redraft the agreement or a suggestion to hire someone to monitor irrelevant.

### **Additional Comments Specific to May 2016 Day 1 (CHEI Version 1)**

Candidates generally performed an appropriate situational analysis. Most candidates identified the important factors that had changed from the Capstone case and linked them into their analysis of the issues. Most candidates appropriately analyzed the financial situation of CHEI, which was an essential component of this case's situational analysis. Weak candidates simply recapped case facts or went into too much depth in their situational analysis, redoing the entire analysis rather than focusing on the changes (which the case specifically directed them to do).

There were two major issues that candidates were expected to analyze from both a qualitative and a quantitative perspective (Hwy 507 and Homes performance). There were also two other issues candidates were expected to analyze mainly from a qualitative perspective. Most candidates ranked the issues appropriately and spent adequate time discussing the major issues. Weak responses tended to include brief qualitative discussions (almost cryptic point-form, often a repetition of case facts without further explanation of importance), provided minimal quantitative analysis, or included minimal consideration and application of the situational analysis.

Candidates are reminded that it is important on Day 1 to discuss the strategic implications, not just identify the operational issues. Often those issues are presented in the case to raise broader issues. Candidates are reminded to step back and think about the interrelationships. For example, the CDI offer could be analyzed in isolation, or it could be seen through the broader lens of Homes performance. Candidates sometimes failed to relate the issues.

Candidates were expected to conclude on each analysis they completed, and their conclusions were expected to be consistent with the analysis they performed. Concluding that "additional information is required" was acceptable as long as it was substantiated. Weak candidates were unclear in their conclusion, or their conclusion could only be implied from their discussion.



## Additional Day 2 and Day 3 Comments

The following paragraphs elaborate on the strengths noted and draw attention to the common detracting characteristics identified by the Board of Examiners on Day 2 and Day 3.

### Technical Knowledge

Candidates had to demonstrate technical knowledge throughout the CFE. Most candidates were able to do so.

On Day 2, candidates across all four roles appeared unfamiliar with the concept of an onerous contract (Common AO#5). Candidates were told that ASI had moved out of a building in December but was not able to cancel the lease and, therefore, had to continue to pay the monthly fee for the next 27 months. The majority of candidates struggled to see the issue at hand. As a result, they either avoided the issue all together or tried to create an issue regarding the lease, such as discussing whether the lease should be treated as finance or operating. This discussion was of no value because the lease was clearly operating based on the case facts provided. Although onerous leases are not a topic encountered regularly by entry-level candidates (the issue was rated Hard), the Board was surprised by the number of candidates who seemed unaware of the existence of specific IFRS *Handbook* guidance on the topic of onerous contracts in section IAS 37 – *Provisions, Contingent Liabilities, and Contingent Assets*. Candidates could still have demonstrated competency by drawing on first principles, thereby realizing that the lease met the definition of a liability. The Board encourages candidates to draw on their fundamental knowledge of accounting and the accounting framework when unfamiliar with a specific topic.

On AO#7 on Day 2, Assurance role, the Board was disappointed to see a surprising number of candidates incorrectly support their chosen materiality level by linking it to their risk assessment, rather than linking it to the users' needs. On AO#12 on Day 2, Assurance role, some candidates demonstrated a significant lack of technical knowledge with respect to different reporting options. Many candidates were confused as to the nature of the different reports, the type of work that would be performed, and the level of assurance provided.

On AO#1 on Day 3, Simulation 2 (PPI), some candidates were not able to use the data provided in the case to perform a reasonable allocation of costs to the activities that added to the cost of a job. Candidates did not appear to know how to determine what the cost drivers and activity rates were.

On AO#3 on Day 3, Simulation 1 (National Mail), some candidates wrongfully included depreciation in their cash flow. Others had errors in their calculations, incorrectly excluding significant items such as capital expenditures, which is a fundamental error, or confusing the increases and decreases (adjustments going the wrong way).

On AO#1 on Day 3, Simulation 3 (CHHP), some candidates struggled with how to calculate the price to charge for the exam. They took fixed costs and divided by the per-exam variable cost.

On AO#4 on Day 3, Simulation 3 (CHHP), many candidates struggled with the financial accounting treatment of the banked questions. Some candidates concluded that the questions should be accounted for as inventory and tried to make the criteria from the *Handbook* fit the case facts, when it was clear that the situation did not meet the definition of inventory. These

candidates failed to consider alternative treatments for the banked questions and, therefore, demonstrated limited financial reporting knowledge.

On AO#5 on Day 3, Simulation 3 (CHHP), many candidates demonstrated technical weaknesses in their attempt to calculate the present value of the two options. Candidates seemed to struggle with the concept of present value, and many recommended the option with the higher present value when, in fact, CHHP would want to choose the option with the lower present value. Some candidates also wrongfully included the sunk cost in their analysis.

On AO#13 on Day 2, Performance Management role, candidates made attempts at determining the profitability of the competitor's proposal. Some candidates made several fundamental errors. Typical errors included ignoring the capacity constraint, using irrelevant inputs like fixed costs, and missing very relevant inputs. Some candidates either misunderstood the case or simply did not understand the task at hand, which was evident from erroneous calculations or their use of the wrong tools, such as net present value.

On AO#11 on Day 2, Taxation role, some candidates demonstrated a significant lack of technical knowledge with respect to the tax implications of stock options. Many attempted a discussion of both the employee and employer sides of stock option benefits. However, while most recognized that an employment benefit would arise, many made technical errors in addressing other parts of the issue, including the deferral, deduction or employer side of the benefit. Many candidates could not identify how the stock option benefit would be taxed to the employee — if they identified that it would be taxable at all (some thought it would not be), many did not understand how it would be taxed. A number of responses also stated, incorrectly, that the benefit would be deductible by the employer.

On AO#12 on Day 2, Taxation role, some candidates struggled to identify the tax implications for the employee or employer, and many made technical errors, usually concluding the exact opposite of the correct rule (for example, concluding that employer contributions are not deductible by the employer, or that registered pension plan contributions are taxable to the employee at the time they are made).

### Lack of Integration with Case Facts

In addition to demonstrating technical weakness, many candidates listed case facts on their own without any explanation of why the fact was listed, leaving the reader to guess, while others provided generic lists of “knowledge” without any application to the case facts.

For example, on AO#6 on Day 3, Simulation 1 (National Mail), some candidates provided a general list of audit procedures that were not tied to any of the specific revenue or expense items from the case. On AO#3 on Day 3, Simulation 3 (CHHP), some candidates provided the factors to consider when discussing whether the markers were self-employed or employees but did not apply case facts to them. They provided general advice and analysis that could be applied to any situation, instead of specifically addressing CHHP's situation, when many case facts were available to be integrated to their discussion.

On AO#1 on Day 3, Simulation 3 (CHHP), candidates spent time discussing whether the exam fit with CHHP's mission and vision, which was not relevant in this case because the decision had already been made to go ahead with the exam. On the same simulation, on AO#2, despite their being many control weaknesses in the case, some candidates discussed weaknesses that were not related to specific case facts from the simulation. For example, some candidates

discussed the need for markers to take breaks, but this was not a significant issue in this case since case facts mentioned that markers were allowed to take breaks whenever they wanted.

#### Identification of Issues to be Addressed and Level of Direction

The Board noted that candidates did not perform as well on the non-directed assessment opportunity provided on Day 2, Assurance role (AO#14). Candidates were expected to identify the fact that they should recalculate the covenants and discuss the audit implications of the covenant breaches. Candidates, in properly playing their role, should have realized the impact a covenant breach could have on the engagement.

On AO#7 on Day 2, Performance Management role, many candidates understood the need to conduct a situational analysis, and nearly all candidates performed some form of qualitative analysis. However, many candidates did not even attempt a quantitative analysis of the situation. Candidates were not explicitly asked to do a quantitative analysis; however, the case contained two years of financial statements, a page of industry benchmarks, covenants, and key performance indicators. As a result, there were abundant figures provided to lead candidates to perform some form of quantitative analysis, an essential component of their situational analysis.

Candidates are reminded that they will not be specifically directed to all the issues the Board considers mission critical. Candidates need to take time to understand the situation, their role, and the needs of their client, and they need to address all the significant issues, whether directed or not. Interestingly, some candidates attempted to discuss governance issues in other places on the CFE, but in those cases it was not relevant or the discussion was not suited to their role.

**APPENDIX A**

**EXAMINATION DESIGN, MARKING GUIDE DEVELOPMENT, AND MARKING  
OF THE COMMON FINAL EXAMINATION**

## CFE Design

Day 1 is one four-hour case that is linked to the Capstone 1 case, which candidates work on in groups for eight weeks prior to the CFE. When writing the Day 1 case, candidates are allowed access to their Capstone 1 case but not their group's answer or any sample response. The Day 1 case is designed to assess the enabling (professional) skills. Candidates are directed to *not* perform any detailed technical analysis, but rather to target a "board room and senior management" level of discussion, with high-level analytics. There are two versions of the Day 1 case. Candidates pre-select the version they will write.

Day 2 is one four-hour case on which candidates are given five hours to respond. The extra hour gives candidates time to filter and find the information that they need to answer *their* role requirements from within the common information presented. Day 2 is designed to assess the technical competencies in depth (Level 2 and Level 3). Candidates pre-select a role (Assurance, Finance, Taxation, or Performance Management). All candidates work with the same case — it has a common section and four sets of appendices containing additional information applicable to each of the four unique roles. The required tasks, regardless of the role, are clearly directed, unless there is an undirected/enabling issue in the case that the board expects candidates to identify on their own. Day 2 evaluates the competencies listed in the *CPA Competency Map* mostly in the elective area and in common Financial Reporting and/or Management Accounting areas in **depth**. The role **depth** test (Level 2) may also include coverage of other competency areas from the common core.

Day 3 is a four-hour examination containing a mix of small cases (45 to 90 minutes each) that evaluate the common core competencies only. The Day 3 cases provide additional opportunities for **depth** in Financial Reporting and Management Accounting and all the **breadth** opportunities for all the other technical competency areas. Cases are time constrained, and they are designed to cover different competency areas within each case. A higher level of integration and judgment is required on Day 3 of the CFE than in the core modules, although the technical competencies are tested at the common core level of expectation.

The assessment opportunities on the Day 2 case are given mark values such that each of Day 2 and Day 3 are weighted equally.

## The Development of Marking Guides and the Provincial Review Centre

Approximately three months prior to the Common Final Examination being finalized and printed provincial reviewers meet to examine the simulations and the preliminary marking guides. The provincial reviewers' comments are considered by the board when it finalizes the examination set and again when the senior markers review the marking guides in the context of actual responses.

## **The May 2016 CFE Marking Centre**

From the marker applications received, approximately 85 individuals were chosen to participate in the May 2016 CFE marking centre. The criteria for selection included marking experience, motivation, academic achievement, work experience, personal references, and regional representation.

The Day 1 CHEI Version 1 case was marked by a team of 10 markers in Toronto from June 5 to June 13, 2016. The Day 1 RSI Version 2 case was marked remotely by a team of three markers from June 5<sup>th</sup> to June 14<sup>th</sup>.

Day 2 Assurance role was marked by a team of 21 markers in Toronto from June 5 to June 14, 2016. The other three Day 2 roles were marked in Toronto over a 5-day period in June, immediately following the preliminary evaluation centre.

Two of the three Day 3 simulations were marked in Toronto from June 5 to June 15, 2016. The third simulation was marked remotely over the same time frame. Each Day 3 case was assigned marking teams of between 13 and 15 markers.

Before the opening of the marking centre, some board members, leaders, and assistant leaders attended a five-day preliminary evaluation centre (PEC). Participants reviewed the marking guides, applied them to randomly selected candidate responses, and made necessary revisions to the marking guidelines. The written comments on the marking guides received from provincial reviewers were carefully considered at this meeting.

At the beginning of the marking centre, the leaders and assistant leaders presented the marking guides to their teams. The teams undertook a two-phase test-marking procedure prior to actual marking. Phase one consisted of marking guide familiarization, during which markers applied the marking guide to copies of candidates' responses and collectively reviewed their results. Phase one thus ensured that all markers understood the issues in the marking guide and the basis on which to apply each expectation level. Phase two consisted of an expanded test marking of several responses to establish marker congruence.

After the training and test-marking phases, and only when marker congruence was achieved, live marking commenced. All teams, for all days, have a leader, an assistant leader, and both French-speaking and English-speaking markers. Each team had one or more markers who are capable of marking in both languages.

The board strives for the highest possible marking consistency and quality control. Leaders and assistant leaders therefore devoted much of their time to cross-marking and other monitoring activities. Markers' statistics were reviewed to ensure that marking remained consistent throughout the centre. Based on analysis of the statistics, leaders reviewed and, if necessary, re-marked responses to ensure that the assessment opportunities were fair for all candidates. Bilingual markers marked responses in both languages, and their results were compared to ensure that the marking was consistent in both languages.

**Borderline Marking (Day 1, Version 1 and Version 2)**

Each candidate's paper was marked once. All candidates' responses that were assessed as clear fail, marginal fail, and marginal pass were marked a second time by the team leader or assistant team leader. Clear pass results were also audited on a random basis to ensure accuracy of marking.

**Double Marking (Day 2 and Day 3)**

Each candidate's paper was marked independently by two different markers. If the two initial markings differed on any assessment opportunity, an arbitrator (the leader, the assistant leader, or a senior marker) compared the two initial markings and determined the final result.

As an added measure to ensure that markers were consistently applying the marking guide, a two-day rule exists which results in the second round of marking not beginning until two days have elapsed since the first marking. Adherence to this rule ensures that any movement in the application of the marking guides due to marker interpretations during the first two days of live marking are stabilized before the second marking and arbitration procedures begin.

**Subsequent Appeal of Results and Request for Performance Analysis**

Failing candidates may apply for an appeal of their examination results for Day 1, Day 2, Day 3, or any combination of days within 15 business days of the results being publically released.

**Appeal Approach**

Great care is exercised in the original marking and tabulating of the papers and results. The following appeal procedures are applied to all three papers constituting the Common Final Examination.

Under the supervision of the chair of the Board of Examiners, as well as CPA Canada Evaluations and International Assessment staff, the responses are reviewed by the leaders and assistant leaders who did the original marking. The leaders and assistant leaders read the responses and compare them to the marking guides used at the marking centre. In reviewing candidates' results, two aspects are considered. First, it must be determined that the basis of marking the papers has been consistent with that accorded other candidates who wrote the examination. Second, all responses reviewed are subjected to a careful check to ensure the markers have indicated that consideration has been given to all material submitted by the candidate.

The results are then tabulated and the decision made regarding whether any candidates have been treated unfairly and should be granted a pass on the examination.

The appeal results are then forwarded to the provincial bodies for notification of the candidates.

**APPENDIX B**

**CAPSTONE 1  
RSI BACKGROUND CASE**



## Rejuvenating Spa Inc. — Case

### Capstone 1

In 2005, a group of ten friends and coworkers purchased a local day spa, Rejuvenating Spa Inc. (RSI) in Halifax. Effective January 1, 2014, RSI purchased the shares of Lavish Spa Inc. and recorded them in an investment account. The companies have continued to operate independently under their own brands and management. Financial statements and background information for the companies are presented in Exhibits 1 to 4.

RSI's shareholders think that now is a good time to expand further. They envision an expanded RSI that will be able to provide them with income in the future, and they also want to be in a position to sell the company when and if they choose to do so. In June of last year, Sally Rice, one of RSI's shareholders, retired from her day job as the CEO of the regional health authority and the shareholders hired her as CEO of RSI, in order to better organize the company and manage this expansion. Her mandate includes bringing RSI and Lavish's spas together to operate under the same brand identity and with the same administration, accounting, information systems (reservations), website and social media, and banking.

The plan for expansion is focused on two initiatives:

1. Developing a franchise of day spas that provide a full range of services (massage, manicures and pedicures, facials and body treatments) and sell related products. Sally sees this as the quickest and easiest way to expand and increase the revenue and profitability of RSI. The franchise will be modeled after RSI's operation and image. As part of this process, RSI will bring Lavish Spa under the same brand identity by changing to the same name, decor, operating standards, etc.
2. Partnering with Forevermore Fit Limited (FFL), a privately owned corporation and the largest fitness chain in Atlantic Canada. FFL wants to add massage therapy to the services it offers its members and approached RSI with the idea of opening Massage Therapy Centres (MTC) in its fitness centres. The massage centres will operate as a separate entity with its own name, logo, etc. The proposal is that FFL and RSI will each contribute expertise and the new entity will hire management/administrative staff and therapists as required. FFL will make space available and RSI will provide expertise in management of the massage service. Details need to be worked out on how to proceed in terms of the structure and the contributions of each of the parties. The process has been started, including writing a draft agreement and collecting data on prices and costs.

These two expansions are seen as ways for RSI to exploit opportunities in different areas of the marketplace, serving different clients and meeting different consumer needs. The proposed franchises will be full-service spas focused on self-indulgence,

while the massage facilities in the fitness centres are aimed at health-conscious and fitness- and sports-oriented clients.

In addition to these initiatives, another opportunity has presented itself. The owner of Pure Substance Inc. (Pure), a manufacturer of spa products, has approached RSI with an offer to sell the company. It is important to the owner that the purchaser of Pure has similar values and will continue to operate the existing facility employing local people, and he believes RSI will do this. RSI has used Pure Substance products for the past few years and found that the company is reliable and consistent (in terms of both product quality and on-time delivery). The potential purchase is in the exploration stage.

Rubinoff & Rubinoff LLP (RR), a professional services firm providing public accounting, tax and consulting services to small businesses, has been hired by RSI to help with the expansion plans and other related issues. Jacob Rubinoff attended the most recent quarterly shareholder meeting of RSI to obtain an understanding of exactly what RSI wants the firm to include in the engagement (Exhibit 5).

You, CPA, work for RR. It is now February 14, 2016, and you are a member of the engagement team assigned to this project. The team is to perform the necessary analysis and prepare a draft report that will be presented to RSI's shareholders for consideration and action. The report should include an analysis of the current position of RSI and Lavish and evaluation of the plans for expansion as well as other issues raised in the quarterly shareholder meeting. Sally and the other shareholders are eager start the expansion and would like RR to include in the report a recommended course of action.

**Exhibits**

	<b>Title</b>	<b>Page number</b>
1	RSI financial statements (including notes)	24
2	RSI background material (prepared by RSI's manager and reviewed by Sally)	28
3	Lavish Spa Inc. financial statements (including notes)	30
4	Lavish Spa Inc. background material (prepared by Lavish's manager and reviewed by Sally)	33
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13	Pure Substance Inc. financial information	57
14	Financing alternatives	59

**Exhibit 1**  
**Rejuvenating Spa Inc.**  
**Statement of financial position (Note 1) Non-consolidated**  
**as at December 31**

<b>Assets</b>	<b>2015</b>	<b>2014</b>
Current assets		
Cash	\$ 12,401	\$ 3,000
Accounts receivable (Note 2)	63,012	45,430
Prepaid expenses	3,150	2,181
Supplies and linens	7,562	9,540
Inventory (Note 3)	62,125	45,430
Other	1,000	1,000
Total current assets	<u>\$ 149,250</u>	<u>\$ 106,581</u>
Property, plant and equipment net of accumulated depreciation (Note 4)	\$ 950,000	\$ 986,873
Investment in Lavish Spa Inc. (Note 5)	1,000,000	1,000,000
<b>Total assets</b>	<b><u>\$ 2,099,250</u></b>	<b><u>\$ 2,093,454</u></b>
<b>Liabilities and shareholders' equity</b>		
Current liabilities		
Accounts payable and accruals (Note 6)	\$ 60,295	\$ 74,613
Income tax payable	8,678	4,544
Current portion of long-term debt	93,839	93,839
Total current liabilities	<u>\$ 162,812</u>	<u>\$ 172,996</u>
Long-term debt		
Mortgage on building (net of current portion \$25,714; 2014 \$25,714) (Note 7)	\$ 488,566	\$ 514,280
Term loan bank — purchase of Lavish (Net of current portion \$68,125; 2014 \$68,125) (Note 8)	545,000	613,125
Due to shareholders — Lavish shares (Note 9)	250,000	250,000
Total long-term debt	<u>\$ 1,283,566</u>	<u>\$ 1,377,405</u>
Total liabilities	<u>\$ 1,446,378</u>	<u>\$ 1,550,401</u>
Shareholders' equity		
Common shares	\$ 200,000	\$ 200,000
Preferred shares	200,000	200,000
Retained earnings	252,872	143,053
Total shareholders' equity	<u>652,872</u>	<u>543,053</u>
<b>Total liabilities and shareholders' equity</b>	<b><u>\$ 2,099,250</u></b>	<b><u>\$ 2,093,454</u></b>

**Exhibit 1**  
**Rejuvenating Spa Inc.**  
**Statement of earnings**  
**for the year ended December 31**

	<b>2015</b>	<b>2014</b>
<b>Revenue</b>		
Spa services	\$ 504,100	\$ 454,300
Product sales	248,500	227,150
	<u>\$ 752,600</u>	<u>\$ 681,450</u>
<b>Expenses</b>		
Wages and benefits	\$ 191,054	\$ 177,177
Cost of products sold	124,250	109,032
Administration and other expenses	142,103	131,694
Marketing	37,630	30,665
Depreciation	55,873	58,968
Interest — mortgage	29,314	32,400
Interest — Lavish shares	48,431	61,313
	<u>\$ 628,655</u>	<u>\$ 601,249</u>
Earnings before other income	\$ 123,945	\$ 80,201
Other income — dividends Lavish	99,619	-
Earnings before income tax	\$ 223,564	\$ 80,201
Income tax	18,592	12,030
Net earnings	\$ 204,972	\$ 68,171
Earnings as % of revenue	0	0
Retained earnings, beginning of year	143,053	74,882
Dividends	95,152	
Retained earnings, end of year	<u>\$ 252,873</u>	<u>\$ 143,053</u>

## Notes to financial statements

1. These financial statements are prepared for internal management reporting and for income tax filing purposes.
2. Accounts receivable

	<b>2015</b>	<b>2014</b>
Client accounts	\$6,842	\$8,330
Insurance (direct billing)	53,920	35,900
Shareholders and employees	<u>7,250</u>	<u>6,200</u>
Subtotal	68,012	50,430
Estimate uncollectible	<u>5,000</u>	<u>5,000</u>
Net	<u>\$63,012</u>	<u>\$45,430</u>

3. Inventory — cost estimate is based on retail selling price and markup

	<b>2015</b>	<b>2014</b>
Pure Substance organic products (resale)	\$34,605	\$23,280
Pure Substance organic products (bulk)	7,540	6,200
Cosmetics and other beauty products	14,500	10,410
Miscellaneous	<u>5,480</u>	<u>5,540</u>
Total	<u>\$62,125</u>	<u>\$45,430</u>

4. Property, plant and equipment  
RSI's building is being depreciated at the same rates and methods used for income tax purposes.

	<b>2015</b>			<b>2014</b>		
	<b>Cost</b>	<b>Acc. deprec.</b>	<b>Net book value</b>	<b>Cost</b>	<b>Acc. deprec.</b>	<b>Net book value</b>
Land	\$140,000	\$0	\$140,000	\$140,000	\$0	\$140,000
Building	900,000	210,000	690,000	900,000	181,250	718,750
Equipment	<u>225,000</u>	<u>105,000</u>	<u>120,000</u>	<u>206,000</u>	<u>77,877</u>	<u>128,123</u>
	<u>\$1,265,000</u>	<u>\$315,000</u>	<u>\$950,000</u>	<u>\$1,246,000</u>	<u>\$259,127</u>	<u>\$986,873</u>

5. Investment in Lavish Spa Inc.  
The investment is recorded at cost.

At the time of purchase it was estimated that Lavish's customer list had a value of \$100,000 and its brand identity had a value of \$100,000.

## 6. Accounts payable and accrued liabilities

	<b>2015</b>	<b>2014</b>
Accounts payables	\$55,514	\$70,723
Wages and benefits payable	<u>4,781</u>	<u>3,890</u>
Total	<u>\$60,295</u>	<u>\$74,613</u>

## 7. Mortgage

20 years, 6%, \$25,714 per year  
Security is land and building.

## 8. Loan for purchase of Lavish Spa Inc.

9%, \$68,125 per year.  
Security is shares of Lavish and personal guarantees of shareholders.

## 9. Due to shareholders

Non-interest bearing, no set terms of repayment.

**(in dollars)**

<b>Payable to</b>	<b>Amount</b>	<b>Payable to</b>	<b>Amount</b>
Sally Rice	40,000	Trent Carle	20,000
Richard Brown	40,000	Joanne Gibb	20,000
Bob Gallant	35,000	Janique Theroux	15,000
Lisa Wiley	25,000	Marilyn Cote	15,000
Dave Conyers	25,000	Cary Gammon	15,000

## **Exhibit 2**

### **RSI background material**

Our mission is to run a profitable business by providing affordable massage and other spa services in a warm and welcoming environment. We offer a variety of massage services, including deep tissue massage, sports massage and Swedish massage, as well as facials, body treatments, manicures and pedicures. Our staff is professionally trained. We provide individualized treatments tailored to our clients' needs, and clients are encouraged to provide feedback to help us improve our services and to encourage repeat business and referrals. We are mindful of the overall experience and use quality products. We aim to be respectful of the environment.

#### **Space**

We have 2,500 square feet, which includes private treatments rooms and an area used to provide facials, manicures and pedicures. We have a reception area that includes a display area for the products we sell.

#### **Location**

Our building is in downtown Halifax close to many universities and hospitals. There are many retail boutiques close by as well as medical clinics and other services. Limited off-street parking is available.

#### **Hours**

We are open Monday to Thursday 10 a.m. to 6 p.m. and Friday, Saturday and Sunday 10 a.m. to 9 p.m.

#### **Customer profile**

Based on our observations, customers are 70% female, but this is gradually decreasing. The average age is 40, but ranges from late teens to mid-seventies. Customers are mostly middle class, many with health insurance coverage for massage treatments. We had approximately 7,100 visits last year, up about 600 over the year before.

Prices for 2015 averaged \$75 per massage, \$80 per facial, \$85 per body treatment and \$35 for nail treatments; prior year averages were \$74 per massage, \$80 per facial, \$85 per body treatment and \$35 for nail treatments.



**Exhibit 3**  
**Lavish Spa Inc.**  
**Statement of financial position (Note 1)**  
**as at December 31**

	<b>2015</b>	<b>2014</b>
<b>Assets</b>		
Current assets		
Cash	\$ 14,600	\$ 2,500
Accounts receivable (Note 2)	15,125	11,377
Prepaid expenses	3,781	2,617
Supplies and linens	27,500	26,935
Inventory (Note 3)	59,400	55,798
Other	1,000	1,000
Total current assets	<u>\$ 121,406</u>	<u>\$ 100,227</u>
Leasehold improvements (net of accumulated depreciation \$145,833; 2014 \$116,667) (Note 4)	\$ 204,167	\$ 233,333
Equipment (net of accumulated depreciation \$248,000; 2014 \$174,000) (Note 4)	338,000	334,000
Net book value	<u>\$ 542,167</u>	<u>\$ 567,333</u>
Website (Note 5)	58,500	38,500
<b>Total assets</b>	<b>\$ 722,073</b>	<b>\$ 706,060</b>
<b>Liabilities and shareholders' equity</b>		
Current liabilities		
Accounts payable and accruals (Note 6)	\$ 58,275	\$ 55,125
Income tax payable	2,865	2,725
Current portion of long-term debt	80,000	80,000
Total current liabilities	<u>\$ 141,140</u>	<u>\$ 137,850</u>
Long-term debt (net of current portion \$80,000) (Note 7)	<u>\$ 350,000</u>	<u>\$ 400,000</u>
Contingent liability (Note 8)		
Total liabilities	<u>\$ 491,140</u>	<u>\$ 537,850</u>
Shareholders' equity		
Common shares	\$ 1,000	\$ 1,000
Retained earnings	229,933	167,210
Total shareholders' equity	<u>230,933</u>	<u>168,210</u>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 722,073</b>	<b>\$ 706,060</b>

**Exhibit 3**  
**Lavish Spa Inc.**  
**Statement of earnings**  
**for the year ended December 31**

	<b>2015</b>	<b>2014</b>
<b>Revenue</b>		
Spa services	\$ 1,375,000	\$ 1,282,600
Product sales	440,000	424,000
	<u>\$ 1,815,000</u>	<u>\$ 1,706,600</u>
<b>Expenses</b>		
Wages and benefits	\$ 618,750	\$ 538,692
Cost of products sold	198,000	199,280
Administration and other expenses	257,119	254,775
Depreciation equipment	74,000	66,800
Depreciation leasehold improvements	29,167	29,167
Marketing and promotion	116,875	102,608
Rent	300,000	300,000
Interest	30,100	33,600
	<u>\$ 1,624,011</u>	<u>\$ 1,524,922</u>
Earnings before income tax	\$ 190,989	\$ 181,678
Income tax	28,647	27,252
Net earnings	162,342	154,426
Retained earnings, beginning of year	167,210	12,784
Dividends	99,619	-
Retained earnings, end of year	<u>\$ 229,933</u>	<u>\$ 167,210</u>

## Notes to financial statements

1. These financial statements are prepared for internal management reporting and for income tax filing purposes.

Costs of the loyalty program, discounts and gifts are included in the marketing and promotion expense line.

2. Receivables

	<b>2015</b>	<b>2014</b>
Client accounts	\$17,625	\$13,477
Allowance for doubtful accounts	<u>2,500</u>	<u>2,100</u>
Net	<u>\$15,125</u>	<u>\$11,377</u>

3. Inventory

Inventories are measured at the lower of cost and net realizable value, with cost determined using the weighted average cost method.

	<b>2015</b>	<b>2014</b>
Pure Substance organic products (resale)	\$31,998	\$31,098
Pure Substance organic products (bulk)	6,802	5,980
Cosmetics and other beauty products	11,500	9,000
Clothing	6,250	7,520
Miscellaneous	<u>2,850</u>	<u>2,200</u>
Total	<u>\$59,400</u>	<u>\$55,798</u>

4. Equipment

Equipment is recorded at cost and amortized on a straight-line basis over six to eight years.

Leasehold improvements are being written off over the term of the lease plus the renewal (12 years).

5. Lavish's website provides information on its services, packages, special offers, etc., and offers online booking and gift cards. It was updated in 2015. The update included the addition of a feature that allows online tracking of the reward program for members.

## 6. Accounts payable and accrued liabilities

	<b>2015</b>	<b>2014</b>
Account payables	\$17,755	\$26,175
Salary and bonus	16,700	12,500
Gift cards	<u>23,820</u>	<u>16,450</u>
	<u>\$58,275</u>	<u>\$55,125</u>

## 7. Long-term debt

Equipment financing: Equipment is financed over a term of three to seven years at interest rates from 3% to 8%, with the equipment financed being pledged as security.

Leasehold improvements: Improvements were financed over a five-year term.

## 8. Contingent liability

Organic Spa Products (a former supplier) sued Lavish in 2012 for non-payment of amounts owing of \$138,900 plus interest. Lavish's position is that the product was not up to standard and it was returned to Organic. Lavish has filed a lawsuit against Organic for return shipping costs of \$5,100. Lavish's lawyers' assessment of the loss is that it is only a 20% likelihood that Lavish will have to pay.

## **Exhibit 4**

### **Lavish Spa Inc. background material**

#### **Vision**

“Our philosophy focuses on creating an atmosphere to help rebuild your strength, recapture your energy, and reflect on what’s truly important in your life. Taking time for yourself is crucial; otherwise your health, family, work and spiritual needs will suffer. We're proud to offer you what your body and spirit need most: relaxation, revitalization and a chance to heal from the intensity of your daily routines. A visit to the Lavish Spa is an investment in yourself and your future well-being. We provide you with the latest in treatments and the highest quality in products. By means of innovation, the passion of our employees, exceptional personalized service in a truly regenerating environment as well as informative teaching on wellness and prevention, we provide you with the pampering you truly deserve to improve your overall health and well-being.”

#### **Services and space**

Lavish Spa occupies 10,000 square feet and features four individual treatment rooms and two side-by-side treatment rooms. We provide a large lounge space for clients to relax in before, between and after treatments. We also have a dedicated product area where clients can view and sample our products before purchasing to use at home. We were fortunate in signing a multi-year lease for this location when we first opened, as the market rates increased substantially two years later. The rate has been stable for the last few years, but the market rate today is about \$8 higher per square foot than when we signed the lease. The original lease was for seven years with an option to renew for an additional five years (with the rate to be negotiated on renewal).

Lavish Spa offers a complete selection of spa treatments, including massage, facials, reflexology, body wraps and polishes, and manicures and pedicures. We also offer packages such as Relaxation Time, Bridal packages, Couples, and Mother and Daughter specials. Each season, therapists at Lavish Spa work together to create a “Treatment of the Season” designed, and only available, for that time of year. We offer a reward program (at no cost with initial treatment package) that provides our loyal customers with rewards. Members earn five points per hundred dollars spent, and each 150 points can be redeemed for a \$100 gift card.

#### **Products**

We are pleased to offer high-quality, contemporary spa products to enhance the experience and to purchase for enjoyment at home between spa visits. We sell Pure Substance products, manufactured in Prince Edward Island from organic ingredients combines the intelligence of science with a holistic and sensorial approach, to achieve the ultimate balance between skin, body, and mind. Nutrient-rich seaweed, harvested off the island, combined with other natural ingredients, is transformed into certified organic Pure Substance Skincare and Pure Substance Mineral Cosmetics.

### Location and hours of operation

We are located on the top floor of the Opal Hotel, a five-star hotel in the downtown core of the city. Parking is available in the underground lot. Our lounge has a panoramic view of Halifax harbour. We are open weekdays from 7 a.m. to 9 p.m. and weekends 9 a.m. to 9 p.m. Reservations are required.

### Customer profile

Data gathered from the membership reward program:

	2015	2014
Average age	50	52
Ratio male/female	30/70	26/74
Income level	High average and above	High average and above
Local versus visitor	40/60	42/58
Visits per year	11,000	10,600
Average \$ per visit	\$125	\$121
Average retail \$ per visit	\$40	\$40

Prices for the current year averaged \$120 per massage, \$125 per facial, \$130 per body treatment, and \$55 for nail treatments (manicures and pedicures); prior year averages were \$118 per massage, \$123 per facial, \$130 per body treatment, and \$55 for nail treatments (manicures and pedicures).

**Exhibit 5**  
**Transcript from quarterly shareholder meeting**

Date: February 14, 2016

Location: RSI (after retail hours, in Sally's office)

In attendance:

Sally Rice, CEO and shareholder  
Bob Gallant, shareholder  
Lisa Wiley, shareholder  
Jacob Rubinoff, Rubinoff & Rubinoff LLP

In attendance for part of meeting:

Emily Blais, Manager RSI  
Michael Bernard, Manager Lavish Spa Inc.

Sally: Welcome to the meeting Jacob. Bob, Lisa and I act on behalf of the shareholders for RSI. We generally meet quarterly and review the financial results and other issues related to the operation of the company. All the shareholders attend our annual general meeting. We have our annual general meeting at the spa, which is convenient for all and helps with attendance. Shareholders can come to our quarterly shareholder meetings too if they choose, but this doesn't happen often — everyone is so busy these days, and any of the shareholders can call one of the executive members if they want to discuss any issues. I have compiled some information on our shareholders for you, Jacob, to help you get to know us better (Exhibit 6).

Bob: It is nice to meet you Jacob. Now that we are embarking on an expansion plan for RSI, it will be good to have a professional services firm to help us get off to a good start. One of the things that motivates me is for our businesses to contribute to the community in terms of healthy living, and I believe that making spas more available to the average consumer is a step in the right direction, keeping in mind that we also want to promote social responsibility and environmental sustainability and, of course, earn a return on our investment.

Lisa: I agree that it is a good idea to pursue a growth strategy, but I want to make sure we do it sensibly. I have heard of businesses growing too quickly and don't want us to fall in to that trap.

Bob: Good point, but growth has been very strong across the spa industry. Sally has put together some data on the spa industry (Exhibit7).

Sally: Let's start with a discussion of the Forevermore Fit Limited Massage Therapy Centres. I have given each of you a copy of the background information (Exhibit 8) and the draft agreement with FFL (Exhibit 9). There are details that RR will need to advise us on, including the tax implications and any potential problems with the agreement, but I think we are essentially ready to sign the agreement and get started. From my perspective, I think this is a relatively easy project. It will not take much time from us once it is established and will not require much, if any, financing. One thing I do want you to consider, Jacob, is the organizational structure of this venture. Right now, it is set to operate as a partnership but maybe incorporating would be better?

Lisa: It sounds too good to be true and to me it seems that FFL will get more benefit from this project than we will. FFL will benefit by providing this extra service to members and I expect this will provide them with a competitive advantage that will enable them to retain existing members and attract new members. What benefit will we get from it? Although I know that FFL has been in business for close to twenty years and appears successful, we don't have any information on its financial position, for example. Should we have more information before getting into business with them?

Sally: The partnership will expand our operations in a new market segment (health and fitness) and geographically (across Atlantic Canada). If we go ahead with the purchase of Pure, which we'll discuss in a bit, we will be able to sell products in FFL's Massage Therapy Centres. We will also be providing training to massage therapists in the centres and will earn revenue on this.

Bob: Perhaps we should include in the agreement some identification of RSI with the massage centres as a way to promote our brand?

Sally: That might be worth considering. To sum up, RR will analyze the work we have done on this, and review the information to make sure it is accurate from a financial perspective. It will be good to get a fresh look at it from someone not directly involved. RR may identify improvements to the agreement and areas where we may need more information.

Anything else on this? ... OK, let's move on to the franchise plan. I am really excited about this and have put lots of time and effort into it. I would like Jacob to hear your views on it as well as mine.

Lisa: One question I have is the amount of work that will be involved. It will depend on the number of franchise applications we get and how many we approve. We should consider this in the approval process and not overdo it in the beginning.

Bob: Yes, but on the other hand I think having a larger number of franchisees is part of what we need to succeed — both in terms of covering costs and developing the brand and network. RR should help us determine the numbers on this one;



how many franchises do we need to sell to make it work? How much will we make per franchise? And overall? How much will it cost? What are the risks? On the upside, developing the franchise will allow us to spend more money on updating the Rejuvenating (RSI) brand or even creating a new one that combines RSI and Lavish. To assist RR, I have drafted up some expected revenues and expenses pertaining to the Franchise Development (Exhibit 10).

Sally: My expectation is that many of the franchisees will be massage therapists who are operating an independent massage clinic or spa. I expect that we will have from 5 to 15 new franchisees a year, with half of them being independents joining the network, and half being new entrepreneurs.

Bob: In my experience, franchisee brochures often have some certification on the contents to provide potential franchisees with confidence in the franchisor and the offer. We have this in the draft (Exhibit 11). Maybe we should also require some assurance on the information the applicants provide us?

Sally: That should be part of a process we put in place to award franchises. We will want to determine if an applicant has the necessary financial resources and experience.

Bob: I think you have made a great start on this Sally. I agree getting RR to take a fresh, unbiased look at this will be really helpful. They may identify issues or risks that we have not considered and advise us on how to deal with them.

Sally: The last area we need to consider in our growth plan is a potential acquisition of Pure Substance. This opportunity came up very recently and we have not had much discussion of it as a group. I don't know if any of you know Matthew Chung? He is the owner and manager of Pure. He is a fellow Rotary Club member and recently approached me at a meeting with the idea of RSI purchasing his company. I must say it came as a bit of a surprise that he is planning to sell.

I know we had not been thinking of going into manufacturing but, given that Pure is available; I thought it was worth considering. It may be a good fit with RSI and our other plans.

I met with Matthew and we had an interesting discussion around his plans. This is all very confidential at this stage, as he does not want his employees to be concerned. One of Matthew's main concerns is to retain the long-standing business in PEI and keep the current workforce. He is concerned about the economy of PEI. I have a copy of my notes from the meeting (Exhibit 12) for each of you, including the financials (Exhibit 13).

Lisa: It does sound interesting and although I can see it is related, it does seem a bit removed from what we have been doing to date.

Bob: True, but I think it is something that would create synergies and additional profit. More importantly, there is potential for growth. I have briefly looked at Pure's statements and see it is not making much profit. It may be in our best interest to retain the company in PEI for a few years until we fully understand in the production process as well as the product recipes, and then close the PEI production facilities and outsource the production to a larger company. A larger manufacturing plant will likely be able to save us money on the production as well as the shipping of the items. RR should analyze the financials and related information on this and report back to us.

Sally: Yes, while that may make better business sense, I cannot help feeling bad when a business leaves the East Coast. After all, remember what happened to the McCain business back in 2014.<sup>1</sup>

I think Michael and Emily are here now. Let's ask them to join us for a bit — it would be good for Jacob to meet them and for us to get our quarterly update on how things are going.

*Managers join meeting at this point.*

Sally: Welcome to the meeting Michael and Emily. As you both know we are working on expansion plans for RSI and have hired Rubinoff and Rubinoff, a professional services firm, to help us out. Jacob Rubinoff is with us for this meeting and we thought it would be useful for him to meet you and hear about any concerns and suggestions you have, as well some more details on the current operations of the spas. To start off, one area that we would like your thoughts on is staffing and the ideas we have been discussing about employee bonus plans and equity ownership.

Emily: I have been manager at RSI for almost 15 years. There have been many changes over the years, but the basics are the same. In order to provide quality service we must have great service providers such as estheticians, manicurists as well as therapists. It has always been a challenge to attract and keep good people and I think it is getting more difficult all the time. Being a therapist is a demanding job physically and I am not sure that providing equity to staff will help with retention. Providing this incentive to me, as a manager, would be good though. For our therapists, we need to be competitive in terms of the salary and benefits we provide. The work environment and professional development are also important, as well as a flexible work schedule.

Michael: We are a newer spa than RSI, and most of our staff has been with us from the start — but it has only been five years, and I can see that burnout could be an

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1 Stewart, Dave. "McCain Foods plant closure leaves people in shock." *The Guardian*, August 8, 2014. <http://www.theguardian.pe.ca/News/Local/2014-08-08/article-3827856/McCain-Foods-plant-closure-leaves-people-in-shock/1>

issue. We provide bonuses to staff based on revenue now. Changing this might be difficult, especially if it results in them earning less. Personally, I would welcome the opportunity to own part of the company, but there may be better ways to motivate and compensate therapists that would reward generating revenue, but also reward based on other measures, such as repeat business, new clients, and level of retail sales.

Emily: Sally has discussed with me the idea for developing a franchise and it sounds exciting, but I wonder how much time I would be expected to devote to this. I am already working full time, but I would like to be involved in the new venture. I have lots of experience and feel I could make a valuable contribution, but would there be extra help for the work I do now? Some of our experienced therapists might also welcome the opportunity to help with the manuals and training. It might make their work more interesting and help with retention, but then we would need to hire extra staff.

Sally: Thanks Emily — good ideas that we will consider in our plans.

Michael: From what I have heard on the franchise plan, I understand that Lavish will be required to change to come in line with the new image. I am not sure that this is a good idea. Our operation is quite different than that of RSI, and while I can see that things could be streamlined from an administrative side, I am not in favour of going beyond that.

Bob: Point noted.

Michael: I try to keep up on the trends and new developments in the spa industry so that we can offer new services to clients and market our services in a way that will attract new clients. One trend that is emerging, for example, is the concept of mindfulness, and we are developing a Mindfulness Package that includes a mindful massage and mediation session.<sup>2</sup> Other trends I am watching include an increase in male clients, urban wellness retreats and the rise in tourism-related spa visits.<sup>3</sup>

Lisa: Interesting — it is good that you are keeping up on the industry. We should make sure that we consider things like this in our plans. We would also like to get your views on pricing of services and loyalty and other promotional programs.

Bob: We have also been discussing how to compete — price versus quality service.

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2 SpaFinder Wellness, Inc., *2013 Trend Report: Top 10 Global Spas and Wellnes Trends Forecast*, [http://www.spafinder.ca/newsletter/pt/trends2013/SFW\\_2013\\_Trend-Final.pdf](http://www.spafinder.ca/newsletter/pt/trends2013/SFW_2013_Trend-Final.pdf) (accessed Feb 26/15)

3 Ibid.

Michael: Our prices are perhaps a little lower than the industry average for hotel spas, but we also cater to the local market and want to be competitive — keeping in mind that we offer a premium service.

We do offer a membership reward program. It is not a big cost to the company, and it rewards our loyal customers, which encourages repeat business and makes customers feel special. We also provide small gifts for referrals and for special occasions. We have been in business just over five years and have built up a loyal customer base among locals and regular visitors to the Halifax area.

Emily: Our prices are lower than Lavish's, which is to be expected given that we cater to a different clientele and are in a more competitive environment, price wise.

We don't have any loyalty programs, but maybe it is something we should consider. However, it might be an issue because our prices are already low and it could affect the bottom line.

Sally: We plan to offer some kind of loyalty program as a feature of the franchise.

Michael: It might be useful for Jacob to visit our spas so he can see firsthand what we offer.

Lisa: Yes, I think that would be an excellent idea! I will leave it to you, Michael and Emily, to arrange for Jacob to have a tour of the spas, meet some of the staff and try out some of our services.

Sally: Thanks again for coming to our meeting, Michael and Emily.

*Managers leave the meeting.*

Sally: We have also discussed the need to develop an overall strategy for RSI. I think it would be useful to review this with Jacob.

When we purchased RSI, we created a mission and vision statement and have reviewed it at our annual general meeting each year.

Our vision is "to provide exceptional client-centered spa services in an atmosphere that is relaxing and in a manner that is environmentally friendly and sustainable." Our mission is "to provide professional quality services while developing relationships with our clients, our community and the environment."

Now that we are planning to grow RSI, we need to keep the mission and vision in mind.

Bob: We need to establish and build on what makes our spas unique, and then ensure that this is conveyed to potential franchisees and any other businesses we invest in — that they have the same principles and values.

Lisa: One key area is hiring and keeping quality staff. I think this has been difficult at times, as Emily in particular noted.

Sally: One of the ideas we started discussing earlier ties in here: employee ownership through an equity compensation plan. Maybe the compensation could be linked to different measures. I think that this would help attract and keep great employees and encourage them to think like shareholders and focus on the same things — customer satisfaction and profitability. I understand the bonus plan in place at Lavish is based on revenue, but perhaps this should change to a different measure. There may be better ways to encourage employees to focus on the same goals as our shareholders.

Bob: We also need to consider how best to organize and monitor the business.

Sally: I agree. We meet quarterly and review financial reports and discuss any matters the managers bring to us, but our meetings and reports will need more structure.

Bob: And we shouldn't ignore the ownership and corporate structure of the companies. It is important for tax purposes, and to facilitate financing and the future transfer of ownership to family members or others.

Sally: Once we decide on the details of our growth and expansion plans, we will need to obtain financing. I have talked with our bank and gotten some preliminary information on the terms they can offer and the requirements we will have to meet to secure financing for our expansion from them (Exhibit 14).

I have also been researching the possibility of arranging private financing debt financing, as an alternative. I met with a business broker, who introduced me to a potential lender, Blair Cummings. My understanding is that private lenders are more open to negotiation and will consider a wider range of options for fees, repayment terms, collateral and other requirements. I agreed with Blair that we would prepare an information package for him as a starting point for negotiations, including a description of the use of the funds, range of fees we would be willing to pay, interest rate we anticipate getting, financial information we will provide (when and what), performance benchmarks we are willing to track, repayment terms we would like, and collateral we can provide. Jacob, please add this to what we require from RR.

Based on my preliminary discussions, the shareholders will have to provide some funds as well, which seems reasonable — if we want to grow the business we need to be willing to invest and assume some of the risks.

Depending on how we decide to proceed, we may need to invest significant amounts and need to consider the best way to structure the investment; it may be that some of us will be able or willing to invest more than others, and we may even consider bringing in additional shareholders.

Bob: I hope we haven't overwhelmed you, Jacob. You have listened very patiently to all of our discussions. We look forward to receiving RR's report.

### **Exhibit 6 Shareholder Information**

The core shareholder group comprises Sally, Bob, Lisa, Cary and Richard. This is the group that organized the purchase of RSI initially. They recruited the other investors (friends and family).

Sally Rice	60 years old, family physician, retired CEO of Regional Health Authority, member of Halifax Rotary Club, Chair of the Halifax Progress Club, member and frequent visitor of Spa Traveler Club
Bob Gallant	47 years old, family physician in private practice, chair of the Nova Scotia Wildlife Conservation Association, active in sports and a member of the Halifax Golf and Curling Club
Lisa Wiley	52 years old, registered dietician and department head, Regional Health Authority, President of Nova Scotia School Breakfast Clubs, member of Forevermore Fit Limited
Cary Gammon	40 years old, professional social worker, Children's Health Authority, Chair of the Halifax chapter of the Optimist Society, active volunteer in several community groups promoting healthy living and environmental issues
Richard Brown	43 years old, chiropractor in private practice, cross country runner, member of the Halifax Rowing Club, adventure travel lover
Trent Carle	59 years old, physiotherapist Regional Health Authority
Joanne Gibb	70 years old, widow of a cardiologist who formerly practiced with Dave Conyers
Janique Theroux	62 years old, lawyer in private practice, Sally Rice's sister
Dave Conyers	38 years old, cardiologist in private practice, close friend of Bob Gallant
Marilyn Cote	55 years old, registered nurse, Regional Health Authority, Bob Gallant's cousin

**Exhibit 7**  
**International Spa Association (ISPA) 2013 U.S. spa industry study**

<b>Metric</b>	<b>Average</b>				<b>Median</b>			
	All	Day	Resort/Hotel	Other	All	Day	Resort/Hotel	Other
Revenue per spa	\$ 701,000	\$ 616,000	\$ 1,524,000	\$ 664,000	\$ 439,000	\$ 350,000	\$ 1,000,000	\$ 450,000
Revenue per visit	87	78	127	111				
Revenue per square foot	180	203	119	213				
Revenue per employed person	40,711	39,406	44,004	44,041				
Visits per spa	8,040	7,930	11,970	5,980	4,854	4,476	7,500	4,000
Square footage per spa	3,890	3,030	12,790	3,120	2,500	2,400	10,000	2,000
Total employees per spa	17.2	15.6	34.6	15.1	14.0	14.0	28.0	9.0
Full-time employees	7.6	6.9	15.6	6.2				
Part-time employees	7.3	6.5	16.8	5.8				
Contract employees	2.4	2.3	2.2	3.1				
<b>Prices per service</b>								
Per massage	87	82	129	n/a				
Per facial	94	89	133	n/a				
Per body treatment	97	90	136	n/a				
Per hair service	66	67	72	n/a				
Per nail service	42	39	57	n/a				
Per service	82	76	112	n/a				
<i>2012 prices showed a 2% increase over 2011, slightly below the CPI increase of 2.1%.</i>								
<b>Offerings percentages</b>								
Special discounts for the spa's social media audience	51%							
Loyalty programs	47%	51%	37%					
Online option to book treatments	45%	49%	33%					
Treatments using organic ingredients		41%	65%					
Treatments using local products		7%	20%					
Retail								
Retail purchases per guest	\$ 35	\$ 31	\$ 38	\$ 66	\$ 22	\$ 20	\$ 28	\$ 36

**Exhibit 7 (cont'd)****Excerpts from the International Spa Association (ISPA) 2013 U.S. PWC study<sup>4</sup>****Spa establishments**

In 2012, the number of spa establishments is estimated to have increased for the first time since 2008. The rate of new spa openings (an estimated 5.2%) was slightly in excess of the closure rate (an estimated 4.6%). Consequently, the number of spa locations increased from 19,850 in 2011 to 19,960 in 2012 (+0.5%). Reflecting the modest increase, the 2012 number remains lower than the estimated peak number of spa locations (21,310), which was reached in 2008. Nonetheless, the reversal of the declining trend in the number of spa locations marks an important milestone in returning to growth.

**Spa revenues**

Total spa revenues for 2012 are estimated at \$14 billion<sup>5</sup>, an increase of \$0.6 billion (+4.7%) on the 2011 revenues. The estimated 4.7% increase in total spa revenues exceeded the rate of consumer price inflation (2.1%) by a margin of 2.6%. This would indicate growth equivalent to the nationwide expansion in economic activity over the course of 2012. Average revenues per spa rose to \$701,000 in 2012, an increase of 4.1%. This marks the third year in a row that revenues per spa have increased, reversing the downward trend that had been evident through to 2009.

**Spa visits**

The total number of visits to spa establishments is estimated to have risen from 156 million in 2011 to 160 million in 2012, an increase of 2.8%. After declining to 143 million in 2009 in the wake of the economic downturn, spa visits have steadily recovered and, by 2012, had regained their 2008 peak (160 million). The 2.8% increase in spa visits was the main factor driving the 4.7% revenue increase. Average visits per spa rose to 8,040 (+2.3%). The 2012 level is the highest recorded since 2005.

**Looking ahead: Confidence**

Spas remain confident that revenues will increase over the foreseeable future. Almost four in five spas (78%) said they were “confident” or “very confident” of an increase in revenue within the next couple of years. The proportion of spas expressing confidence in their revenue prospects varied little by type of spa. Among day spas, 77% said they were “confident” or “very confident” of an increase in revenues. Slightly higher confidence levels were reported by resort/hotel (83%) and other spas (83%).

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4 <http://www.experienceispa.com/media/facts-stats/>. Accessed Nov 5/14

5 <http://www.experienceispa.com/articles/index.cfm?action=view&articleID=706&menuID=0>. Accessed Nov 5/14.



## Looking ahead: Key challenges facing the spa industry

The following is a summary of responses made by spa business owners when asked what they think is the biggest issue facing the industry the future.

### 1. The economy

Over one in four respondents (27%) expressed uncertainty regarding the outlook for the U.S. economy in 2013. The main concern was that the economy would slow down, leading to reduced disposable income and consumer spending on discretionary purchases such as spa services.

### 2. Discounting/competitive pricing

Seventeen percent (17%) of respondents identified this as the main issue facing the industry. Spas were especially concerned about the impacts on consumer behaviour, such as shopping around for the lowest priced deal and the effect of that on customer retention.

### 3. Staffing

Recruitment and retention of staff was seen as the most important issue by 13% of respondents. This is the kind of challenge that typically faces a growing industry.

### 4. Staff skills

Almost one in 10 spas (9%) highlighted issues around staff qualifications and skills. Many of these spas (39%) linked the issue of staff qualifications to recruitment difficulties.

### 5. Consumer perceptions

Tackling the public perception of spa services as pampering/luxury and educating the consumer on the health benefits of the spa experience was seen as the main priority by 10% of respondents.

### 6. Market

Issues around change and competition in the marketplace were cited by 9% of spas, i.e. growth in the number of other spa providers as well as competition from providers of other related services.

### 7. Labor and operating costs

These were cited as the main issue by 6% of spas; 3% of spas highlighted rising prices/inflation.

Other issues mentioned by spas included switching to a more wellness-focused orientation (4%), strategies to generate loyalty/retention (3%), and promoting new business (2%).

## **Type of operation**

The majority of spas (68%) describe themselves as single location operations; resort/hotel spas are the main exception. More than one in three resort/hotel spas (35%) are affiliated with a national corporate headquarters. This can be compared with the average for all spas of 6%. Almost one in five spas (19%) said they are one of a number of locations within the same state or region and owned by the same owner/company. Operations with a franchise affiliation account for 7% of spas.

The study noted that “the most common ownership structure in the Canadian spa market is sole proprietorship at 43%, partnership at 19% and small corporations at 22%. According to the 2000 Spa Industry Study prepared by Price Waterhouse Coopers, stagnation is a frequent and understandable occurrence for the isolated spa owner.”

## **Canadian customer study**

### **Reasons for selection/spa image**

Convenient location (74%) is the reason most frequently cited by Canadian spa-goers as the reason for selecting the spa they chose on their last visit. Having friendly staff members (55%) is of critical importance, as is atmosphere of the spa facility (52%). Past quality of treatment (45%), professionalism (44%), price (42%), overall reputation (41%) and past experience (38%) also score at significant levels.

As 91% of spas in Canada are day spas, according to the ISPA 2002 spa industry study, Canadian respondents' reasons for choosing a spa are compared to those of U.S. day spa visitors. Results are generally comparable, although Canadians report choosing spas because of special services not offered by other spas (4% U.S. vs. 20% Canada) and appear more concerned with employees having professional qualifications (19% U.S. vs. 34% Canada), a key point to emphasize in marketing materials. Nearly four times as many Canadians as Americans (19% Canada vs. 5% U.S.) indicate that they chose the spa they last selected because it is the only one they know. Further research is needed to establish whether this finding indicates room for more facilities and/or different types of specialties. Spa visitors view spas as a place to relax and gain health benefits. Non-spa-goers reveal ignorance of what spas offer, feel “out of place,” and are less comfortable with exposing their bodies. Marketers to potential Canadian spa-goers can exploit these findings in their promotional materials. In a growing market, it is essential to educate potential consumers on spa benefits so that non-spa-goers both understand their value and become comfortable with visiting them.

## Exhibit 8 Information on Forevermore Fit Limited Massage Therapy Centres

### Background information on Forevermore Fit Limited

Forevermore Fit Limited (FFL) was established in 1995 by a well-known personal trainer, Andy Johnson. Andy is a celebrity trainer, author and creator of online fitness training programs. FFL initially operated facilities in major cities in Atlantic Canada, expanding to smaller towns about five years ago. FFL operates full service fitness centres equipped with up-to-date equipment. Its facilities are open to members as well as to non-members who pay per session or for a set program. It provides personal and group training and fitness classes, as well as programs for weight loss and healthy living.

### Partnership financial and operational information projections

	Typical large centres	Typical small centres	Notes
Number of facilities currently operated by FFL	7	18	
Number of members	2,500	1,000	
Membership growth rate	10%	5%	
Ratio male to female members	50/50	40/60	
Hours of operation	Weekdays 5 am to 11 pm Weekends 9 am to 10 pm	Weekdays 6 am to 10 pm Weekends 9 am to 10 pm	By appointment only in smaller centres; by appointment and drop in at larger centres
Massage hourly rates	\$80	\$75	Set in line with local market
Treatment rooms	4	1	
Equipment cost per room	\$7,500	\$7,500	
Uniforms and supplies per therapist	\$2,000	\$2,000	
Retail space (products)	Dedicated space Assume revenue @ 15% of therapy revenue	With other fitness centre retail products; assume revenue @ 15% of therapy revenue	Cost of sales 50%
Utilization rate for therapists	75%	70%	
Wages and benefits	45% of therapy revenue	45% of therapy revenue	
Marketing	5% of revenue	5% of revenue	
Supplies	5% of revenue	5% of revenue	
Administration/other expenses	\$50,000	\$50,000	

## **Exhibit 9**

### **Draft agreement — Forevermore Fit Limited Massage Therapy Centres**

#### **Management**

FFL and RSI will form a partnership, MTC, which will operate Massage Therapy Centres in FFL locations. There will be a management group comprising one member each from RSI and FFL and the manager hired for MTC. This management group will make all major decisions for MTC.

Profits will be shared equally between FFL and RSI. Operating cash flows from the partnership will be distributed to the partners quarterly.

#### **Identity, image and branding**

The centres will be called Forevermore Fit Limited Massage Therapy Centres.

#### **Locations**

FFL will decide where to set up the Massage Therapy Centres (MTC). It plans to start by opening two MTCs in larger facilities and two in smaller centres. FFL expects to have massage centres in all of its fitness centres within five years.

FFL will provide the space in its facilities at no charge. MTC will pay the costs of renovating the space where required and lease the necessary equipment. FFL will provide funds required for renovation and charge MTC interest on the borrowing at prime plus 2%.

FFL and RSI will invest \$15,000 per small centre and \$60,000 per large centre that is opened to cover opening costs and provide initial working capital (including uniforms, linens and supplies). FFL and RSI will also guarantee any financing required by MTC.

#### **Human resources**

RSI and FFL will jointly hire the manager for MTC and the manager and RSI will work together to hire the staff for the MTC locations. RSI will provide the initial training for therapists (for no charge). Subsequent professional development will be provided by RSI at a fee. Only qualified massage therapists will be hired.

In the larger centres there will be a separate receptionist and multiple therapy rooms, but in the smaller centres the receptionist for the fitness centre will handle the MTC as well and there will be only one therapy room.

**Services**

A range of different types of massages will be offered, but no other services. The focus will be on deep tissue and similar types of massage related to sports and fitness. Direct billing to insurance companies will be provided and promoted.

FFL members will receive a 10% discount off the regular price for services and products. Members will also earn “points” for massage treatments and for reaching their fitness goals that they can redeem for massage treatments, product purchases or personal fitness consultations. A process will be put in place to track where points are earned and spent.

**Exhibit 10**  
**Information on franchise development**  
*Analysis of proposed franchise network from RSI's perspective*

**Revenue**

Startup fees — new entrepreneurs	\$ 40,000
Startup fees — existing businesses transitioning to RSI spa franchisee	25,000
Assume percentage new	50%
Ongoing franchise fee	6%
Advertising fund	0.25%
Other	
Total revenue	

**Expenses**

Marketing material development	\$ 200,000
Marketing material (annual updating starting in year 2)	-
National advertising — equal to the total assessed franchisees	
Operating manual and training material development	-
Operating manual and training material (annual updating starting in year 2)	5,000
Training costs per franchise unit (per year)	2,500
Quality control per franchise unit (per year)	2,500
Sales, administration and other	40,000

## **Exhibit 11**

### **Draft promotional material — RSI franchise**

#### **Why join Rejuvenating Spa?**

Opening a spa or converting your existing operation to a Rejuvenating Spa can help you in your pursuit of a profitable independent business operation. We have the expertise and resources you need and will support you all the way. Belonging to a network of spas will increase your business and reduce your expenses.

#### **Our philosophy**

- Provide the best value and a unique experience, with the client being the focus of the experience. Provide attention to detail; for example, develop and maintain a client file that includes client preferences: treatments, music, therapist, skin type, etc.
- Operate a spa that is involved in the local community through participation and support of groups and activities that promote healthy living.
- Be environmentally friendly.

#### **Qualifications for a franchisee and the process required from application to acceptance**

- Agree with philosophy.
- Pass a net worth test to ensure sufficient financial resources (minimum \$100,000 assets that can be used as collateral for a loan, plus \$100,000 cash or liquid securities).
- For existing spas<sup>6</sup> that want to become part of the franchise, the net worth test is replaced by a successful track record in business.
- Have a background and experience in a personal service business and/or sales, and an entrepreneurial mindset.
- Be in an area with sufficient population base — exclusive area for each franchisee (based on population and right to open others in the area).

#### **RSI provides the following:**

##### ***Startup assistance and support***

- Provide guidance in all phases of the startup process, including site selection criteria, assistance with facility design, exclusive equipment purchasing and grand opening promotion planning.
- Financing resources — help arrange financing for equipment and general supplies.

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<sup>6</sup> Existing spas converting to a franchise will be required to close for a minimum of two weeks to make the transition.

- Human resources — help recruit qualified massage therapists, hire and train staff members, and provide professional development (training seminars and workshops).
- Supplies — source and provide criteria for linens and supplies.

### ***Comprehensive marketing program***

All franchises will have the rights to use the Rejuvenating Spa name, logo and other intellectual property. Advertising and promotional material is supplied (media costs are the responsibility of the franchisee in local media).

### ***Multiple revenue opportunities***

We maximize sales through additional potential revenue sources, including gift cards, and retail sales of skin care and related products.

### ***Training***

- complete classroom training program
- on-site training at your facility (pre-opening)
- marketing and sales training
- use of confidential training and reference manuals
- periodic refresher training (as part of the franchise fee, and additional professional development for a fee)

### ***Operations***

RSI provides fully computerized operations; Rejuvenating Spa clients will have the ability to book appointments with any Rejuvenating Spa location through the company's online booking system. A gift card system that is common to all locations will be used, and Rejuvenating Spa will offer an optional membership reward program to clients.

### ***Franchisee obligations (ongoing requirements)***

- For new spas: provide startup fees of \$40,000.
- For existing spas becoming franchisees: provide transition fee (\$25,000), ongoing franchise fee (6% of gross revenue) and marketing fee (0.25% to advertising fund for development of promotional material).
- Marketing on local media (minimum of 1.75% of the revenues received from spa services).
- Maintain specified insurance coverage.
- Hire only registered massage therapists<sup>7</sup> and other treatment providers with appropriate education and experience, including certification where applicable.
- Use standard decor and equipment.
- Use standard linens, robes and sandals, and other specified products.

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<sup>7</sup> In provinces with regulations. In other provinces, require education and experience.



- Use standard pricing, within range given local market.
- Participate in marketing program specials and packages.
- Be a member of and participate in a franchisee “group.”
- Perform quality assurance procedures — franchisees must have a yearly audit done by an independent professional, and report to RSI on meeting standards established by RSI.

**Exhibit 11 (cont'd)**  
**Sample pro forma statement for franchisee**

	per therapist		<b>1</b>	<b>3</b>	<b>5</b>	
Numer of Therapists						
<b>Revenue</b>						
Average rate	70					
Number of hours	1,920					
Utilization rate	70%					
Spa services	94,080		\$ 94,080	\$ 282,240	\$ 470,400	
Product sales	28,224	30%	28,224	84,672	141,120	30%
Other						
Total revenue	<u>\$ 122,304</u>		<u>\$ 122,304</u>	<u>\$ 366,912</u>	<u>\$ 611,520</u>	
<b>Expenses</b>						
Wages and benefits	37,632	40%	\$ 37,632	\$ 112,896	\$ 188,160	40%
Cost of products sold	14,112	50%	14,112	42,336	70,560	50%
Administration and other costs	24,000		24,000	60,000	96,000	16%
Franchise fee	5,645	6%	5,645	16,934	28,224	5%
Marketing fund	235	0.25%	235	706	1,176	0.19%
Marketing — local media	1,646	1.75%	1,646	4,939	8,232	1.75%
Occupancy and communication costs	22,000		22,000	55,000	88,000	14%
Depreciation						
Interest						
Other						
Total expenses	<u>\$ 105,270</u>		<u>\$ 105,270</u>	<u>\$ 292,811</u>	<u>\$ 480,352</u>	
Earnings before income tax	<u>\$ 17,034</u>		<u>\$ 17,034</u>	<u>\$ 74,101</u>	<u>\$ 131,168</u>	
% of revenue	14%		14%	20%	21%	

**Minimum investment required.** Signage \$5,000; equipment \$7,500 per therapist; linens and uniforms \$2,500 per therapist; working capital \$15,000.

**To be signed off by RR:**

**Assurance statement on the contents of the brochure by CPA firm**

We have reviewed the information contained in this brochure and are satisfied that it is reasonable and contains the information necessary for users in assessing the franchise opportunity.

CPA firm date and location

**Exhibit 12****Notes from Sally Rice's meeting with Matthew Chung (Pure Substance owner)**

- According to Matthew, Pure has been profitable and has contributed to the community by providing good jobs and financial support for worthwhile causes.
- Matthew wants to sell and pursue other interests. He is promoting Pure as a great investment with lots of potential for growth. It has a great reputation in the industry.
- Pure is one of the larger employers in Cavendish, Prince Edward Island, and has been operating for about 25 years.
- It manufactures organic products for use and sale in spas across the country. It customizes labels with the Pure Substance brand and the spa name for resale to spa customers. The products that are used by the spas are provided in bulk.
- Right now, Pure is solely a wholesale operation, but there is potential to expand. Matthew says large retail chains have expressed interest in carrying Pure's products.
- Both RSI and Lavish use and sell Pure's products, and are completely satisfied with the products and the company. Approximately 75% of product sales are products supplied by Pure, and spas use Pure products almost exclusively.
- Matthew performed a valuation of the company using free online resources, and he thinks that somewhere between eight and nine million dollars is a reasonable asking price for the shares of the company.
- Selling shares is his preference, as he thinks it will be the easiest option for him and provide him with tax advantages.
- He will consider an asset sale, but would expect RSI to pay additional costs, including any additional professional fees and tax costs.
- Matthew has provided financial information on Pure (Exhibit 13).
- Matthew said he has been receiving dividends in lieu of salary.
- The trend on the revenue seems good, but the bottom line is suffering. Matthew explained that the biggest issue is cost of goods sold, and within that the shipping costs, both shipping in and out.
- Alternatives he has been considering include price increases and/or charging for delivery.
- He also mentioned that Pure is facing increasing competition from imported products. Matthew mentioned that one thing that has been helpful has been government aid. Apparently, there are programs available to help with upgrades to equipment and job creation and retention. Pure has received grants, loans and low-interest financing in the past; there are often strings attached, but there have been no real issues. Matthew promised to fill us in on the details and introduce us to his contacts.
- Another thing that Matthew credits with contributing to Pure's success is its employees. Many have been with the company from the early years; they work hard and often have good ideas on how to improve efficiency and the product. In return, the company pays them well and looks after them in tougher times.
- I told him that we would need time to study the financials in more detail and that we will have more questions and may require additional information.

**Exhibit 13**  
**Pure Substance Inc.**  
**Summary of financial and operating data**  
**December 31 (000's)**

	2014	2013	2012	2011	2010
<b>Earnings before income tax plus depreciation</b>	\$ 1,499	\$ 2,165	\$ 2,590	\$ 2,413	\$ 2,011
Five year average	\$ 2,136				
Multiple	3.5				
	7,475				
<b>Net assets</b>					
Book value	4,815				
Market value of capital assets in excess of book value	2,000				
Intangibles — brand, customer base and goodwill	2,000				
	<u>\$ 8,815</u>				
 Average of above methods	 \$ 8,145				
 <b>Financial information</b>	 <b>2014</b>	 <b>2013</b>	 <b>2012</b>	 <b>2011</b>	 <b>2010</b>
Product revenue	\$ 19,500	\$ 18,720	\$ 17,784	\$ 16,539	\$ 16,043
Cost of goods sold	14,235	13,104	12,093	11,247	10,909
Administration	3,120	2,808	2,489	2,316	2,567
Marketing	195	187	178	165	160
Community support — % of prior year net earnings	61	82	78	67	75
Other	390	374	356	331	321
Depreciation on building	16	17	18	18	18
Depreciation on equipment	695	1,050	1,104	1,003	788
Earnings before income tax	<u>788</u>	<u>1,098</u>	<u>1,468</u>	<u>1,392</u>	<u>1,205</u>
Income tax	158	220	294	278	241
Net earnings	<u>\$ 630</u>	<u>\$ 878</u>	<u>\$ 1,174</u>	<u>\$ 1,114</u>	<u>\$ 964</u>
 <b>Dividends</b>	 \$ 335	 \$ 486	 \$ 573	 \$ 534	 \$ 442

**Exhibit 13 (cont'd)**  
**Pure Substance Inc.**  
**Summary of financial and operating data**  
**December 31 (000's)**

	2014	2013	2012	2011	2010
<b>Current assets</b>					
Cash	\$ 38	\$ 62	\$ 82	\$ 40	\$ 100
Accounts receivable	2,438	2,340	2,223	2,067	2,006
Inventory	2,373	2,184	2,016	1,874	1,818
Other	138	154	134	142	131
Total current assets	<u>\$ 4,987</u>	<u>\$ 4,740</u>	<u>\$ 4,455</u>	<u>\$ 4,123</u>	<u>\$ 4,055</u>
Land	100	100	100	100	100
Building	2,310	2,310	2,310	2,310	2,310
Accumulated depreciation	1,918	1,901	1,884	1,866	1,848
Equipment	10,425	9,825	9,005	8,210	7,500
Accumulated depreciation	9,850	9,156	8,106	7,003	6,000
Net book value	<u>\$ 1,067</u>	<u>\$ 1,178</u>	<u>\$ 1,425</u>	<u>\$ 1,751</u>	<u>\$ 2,062</u>
<b>Total assets</b>	<b><u>\$ 6,054</u></b>	<b><u>\$ 5,918</u></b>	<b><u>\$ 5,880</u></b>	<b><u>\$ 5,874</u></b>	<b><u>\$ 6,117</u></b>
<b>Current liabilities</b>					
Accounts payable and accruals	\$ 842	\$ 772	\$ 708	\$ 659	\$ 713
Income tax payable	13	18	24	23	21
Current portion of long-term debt					
Total current liabilities	<u>855</u>	<u>790</u>	<u>732</u>	<u>682</u>	<u>734</u>
Long-term debt due to shareholders	384	608	1,020	1,666	2,437
Total liabilities	<u>1,239</u>	<u>1,398</u>	<u>1,752</u>	<u>2,348</u>	<u>3,171</u>
Shareholders' equity					
Common shares	100	100	100	100	100
Retained earnings	4,715	4,420	4,028	3,426	2,846
Total shareholders' equity	<u>\$ 4,815</u>	<u>\$ 4,520</u>	<u>\$ 4,128</u>	<u>\$ 3,526</u>	<u>\$ 2,946</u>
<b>Total liabilities and shareholders' equity</b>	<b><u>\$ 6,054</u></b>	<b><u>\$ 5,918</u></b>	<b><u>\$ 5,880</u></b>	<b><u>\$ 5,874</u></b>	<b><u>\$ 6,117</u></b>

### **Exhibit 14** **Financing alternatives**

Purpose of financing: fund expansion

Funding available: maximum \$15 million, in increments of \$100,000

Interest rate: variable — prime plus 2.5%

Fees: 0.5% of amount borrowed

Repayment: Interest is due annually. Principal is due at the end of five years. There is no pre-payment option.

Collateral: cross-guarantees of the relevant companies involved; personal guarantees from RSI shareholders to total 80% of amount borrowed

Requirements:

- consolidated financial statements prepared in accordance with ASPE
- financial statement audit required if debt exceeds \$10 million, otherwise review engagement acceptable
- debt to equity maximum 1:1
- debt to assets maximum 1:2
- no payments to shareholders if interest coverage ratio is below 10 times
- in the event of default on payments, the bank may demand payment in full immediately

**APPENDIX C**

**THE COMMON FINAL EXAMINATION  
DAY 1 RSI VERSION 1 BOOKLET – SEPTEMBER 16, 2015**



**Common Final Examination  
September 16, 2015 – Day 1 Version 1**

**Case****(Suggested time 240 minutes)**

It is March 15, 2018, and Jacob Rubinoff, your boss at the professional services firm, Rubinoff & Rubinoff (RR), tells you that RR has another consulting engagement with Rejuvenating Spa Inc. (RSI). You, along with the other team members that worked on the original consulting engagement, will also be working on this one.

Jacob met with Sally Rice and other board members of RSI in order to gather information (Appendix I). In general, the spa industry is continuing to grow, and the trends that were expected to occur in the industry are bearing out. The International Spa Association suggests that the wellness spa trend is on the rise. Offered in a comfortable and welcoming environment, wellness spas provide healthy food, intensive fitness programs and other stress-relieving options. Halifax is continuing to grow as a tourist destination, which has been good for RSI. However, looming in the background is the threat of a downturn in the economy in the next year or two.

As is normal practice, RSI's mission and vision are reviewed at each annual general meeting. No changes were made to the wording last time, but Sally admitted that the Board of Directors is gravitating back to RSI's original mission of "running a profitable business by providing affordable massage and other spa services in a warm and welcoming environment." The vision is expected to remain the same.

RSI and related companies are once again in the process of making changes, and have some major decisions to make. Jacob assigns you the following tasks: "Please prepare a draft report to RSI. Taking into account what you have learned about RSI in the previous engagement, please recap the important decision factors for RSI's board to consider, highlighting any changes from the previous situational analysis. Further, provide your assessment of the major issues facing RSI. A detailed analysis is not required as it will be completed later by internal or external teams, as deemed appropriate by the board. For each of the major issues, we need to advise the board of any significant factors they may not have considered, and identify any additional information they must obtain before making their decisions. RSI is asking us to consider the strategic and operational issues that are related to each decision. Finally, where there is sufficient information to do so, please suggest a course of action."

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**APPENDIX I**  
**JACOB RUBINOFF’S NOTES FROM HIS MEETING WITH SALLY RICE**  
**AND OTHER RSI BOARD MEMBERS**

**General discussion**

I met with Sally and two other board members for RSI, Bob Gallant and Lisa Wiley. We talked about the several changes that have occurred over the past few years.

I compiled the following summary of the major events relating to RSI:

2014	January 1	RSI purchases shares of Lavish Spa Inc. (Lavish)
2015	June	Sally Rice starts as CEO of RSI
2016	February 1	Rubinoff & Rubinoff LLP consulting engagement (Capstone 1)
2016	July 1	Lavish and RSI are amalgamated; Lavish is rebranded in line with RSI
2016	July 1	RSI and Forevermore Fit Limited (FFL) sign an agreement; Massage Therapy Centre Inc. (MTC) is launched
2017	January 1	Five of the ten RSI shareholders <sup>8</sup> purchase the shares of Pure Substance Inc. (Pure); Matthew Chung, Pure’s previous owner and manager, stays on for one year as manager and to train replacement
2017	June 1	Ben Daniels is hired and starts as manager-in-training of Pure
2017	December 31	Matthew Chung finishes as manager of Pure
2017	December 31	Lavish’s lease with Opal Hotel is renewed for a five-year term
2018	January 1	Ben Daniels officially assumes the role of Pure’s manager
2018	January 1	FFL gives notice of intent to buy RSI’s shares in MTC
2018	March 1	RSI receives FFL’s purchase offer for RSI’s shares in MTC

<sup>8</sup> Sally Rice, Bob Gallant, Cary Gammon, Dave Conyers, Marilyn Cote

**APPENDIX I (continued)**  
**JACOB RUBINOFF'S NOTES FROM HIS MEETING WITH SALLY RICE**  
**AND OTHER RSI BOARD MEMBERS**

**Specific items of discussion**

1. Lavish Spa Inc.

*Lavish's location*

Lavish was brought under the RSI name shortly after an amalgamation was done in 2016. The rebranding has not been successful, mainly because Lavish remains in its original location, and is therefore still perceived by its customers as a high-end spa. It has not been able to draw on the same customer base as RSI's other spas.

Lavish's lease expired in 2017. The rate had been significantly below market and, as expected, there was a large increase upon renewal. Lavish also made a lump sum payment on renewal for the right to extend the lease, and signed for a five-year term (2018 to 2022). Sally explained that, at the time they renegotiated the lease, they did not see any other options.

Recently, a property became available on the outskirts of Halifax. It was operated as a day spa by Joey Jones until about two months ago, when Joey closed the business to study yoga in India. Joey has offered to lease the property, with the option of buying it, to Sally, who believes that Lavish could move in with very little effort required to renovate the space. The spa has not been closed for long and she expects that some of the previous clientele could be recovered. As Sally strongly believes that the move would be good for RSI, she had RSI's accounting calculate some values (Appendix II). According to the accounting department and based on discussions with the bank, RSI would pay 7% interest on any funds borrowed for this property.

Bob suggested moving and rebranding Lavish again, but this time as an urban wellness retreat; he thinks that, rather than being grouped in with RSI's spas, it is perhaps better suited to that niche of the market.

Sally loves the idea of capitalizing on the urban wellness retreat trend. She sees an opportunity to expand the services Lavish offers by adding saunas and steam baths, and exercise and diet programs, which would enhance current services and bring in revenue with minimal costs. Sally would love to open more of those kinds of spas. There is extra space that can be rented out until a decision is made on the extra services.

Lisa expressed some concern that the new lease with Opal Hotel was just signed and that Lavish has made significant payments already. She also wondered whether an urban retreat is in alignment with RSI's current mission and vision.

**APPENDIX I (continued)**  
**JACOB RUBINOFF'S NOTES FROM HIS MEETING WITH SALLY RICE**  
**AND OTHER RSI BOARD MEMBERS**

Bob asked about the pricing structure for Lavish. Although all the spas are now under the same RSI brand, Lavish is still selling at much higher prices than RSI; beyond renaming Lavish as RSI, not much else has changed. Bob questioned what will happen to the brand if they reposition it again.

Lisa suggested increasing all the RSI locations' prices to match Lavish's rates, as that would provide additional funds for expansion. She suggested that all discounts should be eliminated at the same time, which would also provide additional funds. In addition, Lisa does not like that certain customers get discounts while others do not.

Sally has asked for our assessment of the Lavish situation and whether the move makes sense, and for advice on pricing.

2. Pure Substance Inc.

Overall, Sally is pleased with how well Pure is doing since being purchased by some of RSI's shareholders. Revenue continues to increase and RSI is benefitting from the synergies.

*Drug store chain offer*

When Pure was purchased, Matthew Chung, the previous owner and manager, had mentioned the possibility of a sales contract with Health and Beauty (HB), a large Canadian drug store chain. HB wants the exclusive right to retail Pure products (outside of those sold to spas). If Pure accepts the contract with HB, it must guarantee to supply the volume required. The board members agree they would not cut current sales volumes to fill this new contract.

Sally is excited and believes the deal has enormous potential for Pure, and could help expand RSI and Lavish through increased exposure of the products they use in RSI's spas.

Sally admits the size of the contract is a bit intimidating. To handle this contract, Pure must increase capacity. She is considering two short-term options: using overtime; or using an imported ingredient to supplement what it currently produces.

Lisa expressed her, and the board's, concern that using imported material will support foreign producers rather than supporting the Canadian market. She is also worried about adversely affecting the quality of the product.

**APPENDIX I (continued)**  
**JACOB RUBINOFF'S NOTES FROM HIS MEETING WITH SALLY RICE**  
**AND OTHER RSI BOARD MEMBERS**

Sally responded that she thinks they can allow up to 20% of imported material to be added without affecting the quality of the product, and still be able to label it as local and organic.

Sally provided a draft of Pure's 2017 statement of earnings (Appendix III), excerpts from the draft agreement with HB (Appendix IV), and some preliminary analysis of the offer (Appendix V). Pure's existing sales are expected to continue to grow at an average of 5% per year.

To increase capacity on a longer-term basis, consideration needs to be given to adding a second shift, expansion of the facility, and automating certain functions within the production process. Sally has asked for our thoughts on both the short- and long-term decisions.

*Government assistance programs*

The company received a letter from the government, advising that the terms of a grant Pure received do not appear to have been met. As a result, the funds will have to be repaid, subject to a government audit, which will begin in two weeks from now. Sally recalled Matthew saying he had obtained several government grants for Pure.

Sally obtained additional information on the government grants received by Pure in 2015 and 2016 (Appendix VI). She is unsure what to do with the information, and asks us to look it over and recommend next steps.

3. Massage Therapy Centre Inc.

In accordance with the final agreement between RSI and FFL (Appendix VII), two large and two small locations have been opened. A manager has yet to be hired, and Andy Johnson, the owner/manager of FFL, is acting as manager in the interim.

Andy approached RSI with an offer for FFL to buy its shares in MTC. The offer, which expires on June 30, 2018, consists of a base price of 50% of the book value of MTC's net assets, plus an additional payment of 50% of the net earnings for the three years subsequent to the date of the sale for all locations in operation at the time of the buyout (paid out after each year end).

Sally has mixed feelings about the offer. If bought out, RSI will miss the opportunity to share in the growth of MTC. Based on MTC's statement of earnings for the year ended December 31, 2017 (Appendix VIII), MTC is doing relatively well, although not to the extent originally anticipated, but she sees the potential for growth.

**APPENDIX I (continued)**  
**JACOB RUBINOFF'S NOTES FROM HIS MEETING WITH SALLY RICE**  
**AND OTHER RSI BOARD MEMBERS**

On the other hand, if RSI is bought out, Sally sees an opportunity to dedicate more time to Pure, in which she also sees potential for growth, or to return to exploring the franchising option for RSI.

Sally learned that Andy wants to integrate MTC into FFL, using the combined staff to reduce overhead costs and gain other efficiencies. In the MTC agreement, only FFL members are entitled to discounts. FFL's gym memberships have been dropping off lately and Andy has instituted a points program at MTC for FFL members, effective March 1, 2018. He is also now offering commissions and bonus incentives to MTC employees who sell FFL gym memberships. Andy believes the changes will benefit both MTC and FFL.

Bob expressed concern that Andy is introducing programs, such as the FFL points program, that had specifically been left out of the joint venture agreement when negotiated. He worries that decisions are being made without going through the management committee.

For comparison to Andy's offer, Sally will ask RSI's accounting group to value MTC using an industry capitalization rate of six times earnings. Before looking at the numbers in any detail however, she wants the board to identify and discuss the significant factors to be considered in making the decision of whether to accept the buyout offer.

4. Additional comments from Lisa and Sally during the meeting are as follows:

Sally reminded the others that, as per the Pure purchase agreement, the former owner, Matthew Chung, is liable for any additional liabilities identified by June 30, 2018, and that they need to think about whether there are any issues that need to be raised with him.

Sally also reminded Bob and Lisa that, at the next meeting, they would be reviewing and approving the annual financial statements for both RSI and Pure, for presentation at a combined annual general meeting. Lisa questioned why they would approve both sets, as only five of the ten RSI shareholders have ownership in Pure.

**APPENDIX II**  
**INFORMATION REGARDING LAVISH SPA INC.'S LOCATION DECISION**

**Opal Hotel Lease**

- Term: January 1, 2018, to December 31, 2022
- Rate: \$32,500 per month
- Upfront, non-refundable payment made on renewal: \$90,000
- Cancellation penalty: 6 months' rent (\$195,000)
- Included in rent: operating costs for utilities, property tax and maintenance; free parking for customers; advertising of Lavish Spa on the hotel's website

**Lease with purchase option/ Establish an urban wellness retreat in new location**

- Term: July 1, 2018, to December 31, 2022
- Rate: \$25,000 per month
- Appraised value on January 1, 2018: \$5 million
- Estimated annual appreciation in property value: 4%
- Option to purchase: on December 31, 2022, for 73% of the market value of the property at the time
- Estimated operating costs for utilities, property tax and maintenance: \$7,500 per month
- Rental revenue from extra space: \$5,000 per month (any additional operating expenses would be insignificant)



**APPENDIX II (continued)**  
**INFORMATION REGARDING LAVISH SPA INC.'S LOCATION DECISION**

The accounting department has prepared the following quantitative analysis of the two alternatives:

	<b>Opal Hotel Lease</b>	<b>Urban Retreat Lease</b>
Monthly lease payments	\$ 32,500	\$ 25,000
Monthly operating costs	included	7,500
Incremental monthly revenues-extra space	NA	(5,000)
Net cost	<u>32,500</u>	<u>27,500</u>
Tax savings at 27%	<u>(8,775)</u>	<u>(7,425)</u>
Net monthly cost after tax	<u>\$ 23,725</u>	<u>\$ 20,075</u>
Present value (7% for 54 months)	<u>\$ 1,096,270</u>	<u>\$ 927,613</u>
Present value of lease cancellation	<u>\$ NA</u>	<u>\$ 195,000</u>
Present value of purchase option(if sold)	<u>\$ NA</u>	<u>\$ 932,748</u>
Total present value of each alternative	<u>\$ 1,096,270</u>	<u>\$ 189,865</u>

Sally has confirmed that the above numbers, provided by the accounting department, accurately reflect the information she gave them to work with. She is unsure of the cost of the renovations, moving, marketing, offering new services, etc. Sally said she will get those figures to them later, but she believes they will be insignificant.

**APPENDIX III**  
**NET EARNINGS FOR PURE SUBSTANCE INC.**

*Pure Substance Inc.*  
*Year ended December 31, 2017*  
*(in thousands of dollars)*

	<u>Bulk (spa use)</u>	<u>Consumers (sold by spas directly to customers)</u>	<u>Total</u>
<b>Revenue</b>			
Sales	\$ 4,747	\$ 17,860	\$ 22,607
Discount of 20% (to RSI and MTC)	<u>(31)</u>	<u>(116)</u>	<u>(147)</u>
Net sales	<u>4,716</u>	<u>17,744</u>	<u>22,460</u>
<b>Production cost</b>			
Direct costs			
Labour	1,779	5,134	6,913
Material	1,264	3,466	4,730
Packaging	200	1,925	2,125
Overhead (25% of direct labour)	445	1,284	1,729
Shipping	<u>321</u>	<u>1,027</u>	<u>1,348</u>
Total cost of goods sold	<u>4,009</u>	<u>12,836</u>	<u>16,845</u>
Gross margin	<u>707</u>	<u>4,908</u>	<u>5,615</u>
Gross margin (% of gross sales)	15%	27%	25%
Administration			3,420
Advertising			201
Community support			5
Other			402
Depreciation of building and equipment			<u>677</u>
Earnings before income tax			910
Less income tax			<u>182</u>
Net earnings			<u>\$ 728</u>

**APPENDIX IV**  
**EXCERPTS FROM HEALTH AND BEAUTY DRUG STORE CHAIN OFFER**

The offer from the Health and Beauty (HB) drug store chain includes the following:

- In the first year of the contract, Pure must be able to provide a minimum volume of \$5 million in sales to HB. However, HB does not guarantee it will purchase this volume.
- Pure will provide a graduated discount to HB, as follows:
  - Purchases up to \$5 million 10%
  - Purchases from \$5,000,001 to \$6 million 12%
  - Purchases of \$6,000,001 and above 15%
- Pure will pay shipping to HB's central warehouse in Ontario; orders will be for full truckloads; HB will pay shipping for any rush orders.
- HB will advertise Pure's products. Pure will pay 10% of HB's advertising costs, to a maximum of 1% of HB's annual gross purchases from Pure.

Note: estimates of gross sales volume for the first year range from a low of \$5 million to a high of \$7 million.

**APPENDIX V**  
**PRELIMINARY QUANTITATIVE ANALYSIS OF HEALTH**  
**AND BEAUTY DRUG STORE CHAIN OFFER**

*Health and Beauty (HB)*  
*(in thousands of dollars)*

	Low	Mid	High
Revenue			
Gross Sales	\$ 5,000	\$ 6,000	\$ 7,000
Promotional fund (max of 1% of sales)	(50)	(60)	(70)
Volume discount (10%/12%/15%)	(500)	(620)	(770)
Net sales	<u>4,450</u>	<u>5,320</u>	<u>6,160</u>
Production costs			
Direct costs			
Labour	1,438	1,725	2,013
Material	970	1,164	1,358
Packaging	539	647	755
Overhead (25% of direct labour)	359	431	503
Shipping (at 2%)	100	120	140
Total cost of goods sold	<u>3,406</u>	<u>4,087</u>	<u>4,769</u>
Gross margin	<u>\$ 1,044</u>	<u>1,233</u>	<u>1,391</u>
Gross margin (% of gross sales)	21%	21%	20%

Assumptions made for the above calculations are as follows:

- Direct costs and overhead are estimated using Pure's Consumers sale percentages, which may not be the same as the drug store retail market. Adjustments are required depending on the capacity decision made (see next analysis).
- Shipping costs on sales to HB will be 2% of sales, which is significantly less than on current sales, because Pure will only have to ship to HB's central warehouse.

**APPENDIX V (continued)**  
**PRELIMINARY QUANTITATIVE ANALYSIS OF HEALTH  
AND BEAUTY DRUG STORE CHAIN OFFER**

**Short-term decision – Incremental analysis of overtime or use of imported material**

At 100% production \$25,119,000 in gross sales can be generated. To meet the 5% increase expected in existing sales and the minimum \$5 million in sales to HB, the revenue needs to increase by another \$3,618,000.

Overtime

To meet that demand solely through overtime, a rate premium of 50% is applied, resulting in added labour costs. The incremental cost of overtime, for all three levels in the HB contract, is estimated at:

Incremental cost (in thousands of dollars):	<u>Low</u>	<u>Mid</u>	<u>High</u>
Labour – overtime premium of 50% (at 28.7% of gross sales)	\$ 520	\$ 664	\$ 808
Overhead (at 25% of direct labour)	<u>130</u>	<u>166</u>	<u>202</u>
Incremental cost of overtime	<u>\$ 650</u>	<u>\$ 830</u>	<u>\$ 1,010</u>

Import

By using an imported ingredient, Pure will no longer have to process one of its raw materials, and can use that capacity to meet the extra demand. Therefore there is no incremental labour cost. The increase in direct material cost is 50%. The incremental cost of importing, for all three levels in the HB contract, is estimated at:

Incremental Ingredient Cost (in thousands of dollars):	<u>Low</u>	<u>Mid</u>	<u>High</u>
Existing cost (19.4% of gross sales)	\$ (702)	\$ (896)	\$ (1,090)
If purchased at 50% higher cost (represents 29.1% of gross sales)	<u>1,053</u>	<u>1,344</u>	<u>1,635</u>
Incremental cost of importing ingredient	<u>\$ 351</u>	<u>\$ 448</u>	<u>\$ 545</u>

Note: Based on our analysis, when demand goes up to \$6 million, Pure will exceed the 20% allowable maximum.

**APPENDIX VI**  
**INFORMATION REGARDING GOVERNMENT ASSISTANCE**  
**TO PURE SUBSTANCE INC.**

Based on a review of Pure's files, the company appears to have received a total of seven grants in 2015 and 2016. The following sample was reviewed.

**Environmental Energy Saver Program**

Pure obtains funding regularly through this program, which covers 50% of the cost of renovations to make buildings or equipment more energy-efficient.

The latest grant was for building upgrades. Eligible expenses included windows, insulation and new heating equipment (furnace) for renovations made between June 1, 2015, and May 31, 2016. The grant file includes the grant form, a purchase order and the related invoices. The dates on some invoices are outside of the allowed dates and the invoices include one for labour hours to install the new windows, which was carried out by Pure employees and charged at market rates.

**Capital funding under the same energy program**

The requirements for the grant were as follows:

- The grant will fund 75% of the purchase cost of the energy-efficient equipment, up to a specified maximum.
- The piece of equipment is to be used for a minimum of five years.
- If the equipment is taken out of use or sold before five years' time, repayment is required equal to the fair market value at the time the piece of equipment is taken out of service.

Two invoices related to this equipment grant were in the file. One was for \$500,000, the other for \$375,000. Both invoices are from the same supplier and have the same invoice number and date. When checked to the grant file, the \$500,000 supplier invoice was the one filed with the claim, and a grant of \$375,000 (75%) was received.

The accounts payable clerk remembers talking to Matthew about this at the time. Matthew explained that, in this case, the actual equipment cost came in under the original estimate of \$500,000. He said that it sometimes works out the other way, with the equipment costing more than the maximum allowed. Matthew said they therefore were okay to receive the full grant of \$375,000, since it works itself out over multiple claims. Full payment was made to the supplier for \$375,000.

The equipment is being stored under a tarp on the shop floor in case it is needed, but is currently not in use.

**APPENDIX VI (continued)**  
**INFORMATION REGARDING GOVERNMENT ASSISTANCE**  
**TO PURE SUBSTANCE INC.**

**Advertising support**

This program will reimburse 10% of total advertising costs to a maximum of \$50,000 per year if the company agrees to use the “100% Made on Prince Edward Island” tagline and the related logo in its advertising. The program, which was started in 2016, is ongoing. The reimbursement claims are for advertising Pure’s products as one-hundred-percent organic and local in trade magazines. The funding received under this program was \$44,000 in 2016, and \$25,000 in 2017.

**APPENDIX VII  
EXCERPTS FROM MASSAGE THERAPY CENTRE INC. FINAL AGREEMENT**

**Final Agreement**

**NOTE: major additions from draft are italicized and bolded; major deletions from draft are struck out and bolded.**

Management

~~FFL and RSI will form a partnership, MTC.~~ ***A new corporation***, Massage Therapy Centre ***Inc.*** (MTC) ***will be established***, which will operate massage therapy centres in selected FFL locations. ***RSI and FFL will each make an initial investment in share capital of \$100,000 cash.***

There will be a management group comprised of one representative from each of RSI and FFL, and the manager hired for MTC. This management group will make all major decisions for MTC.

Profits will be shared equally between FFL and RSI. Operating cash flows from the **partnership joint venture** will be distributed to the **venturers partners** quarterly.

Identity, image and branding

The massage therapy centres will be called “Forevermore Fit – Massage Therapy Centres.”

Locations and financing

FFL will decide where ***and when to open*** MTC locations. ~~It plans to start by opening two MTCs in larger facilities and two in smaller centres.~~ The expectation is to have MTCs in all of FFL’s centres within five years.

FFL will provide the space in its facilities at no charge. MTC will pay the costs of renovating the space, where required, and will lease the necessary equipment. ~~FFL will provide funds required for renovation and charge MTC interest on the borrowing at prime plus 2%.~~

~~FFL and RSI will invest \$15,000 per small centre and \$60,000 per large centre that is opened to cover opening costs and provide initial working capital (including uniforms, linens and supplies). FFL and RSI will also guarantee any financing required by MTC. After the initial investment in share capital is used, FFL and RSI will each provide debt financing on a 50-50 basis, to cover investment in new centres. FFL will provide funds required for renovation and charge MTC interest on the borrowing at prime plus 2%.~~ Each will make its own financing arrangements.

FFL and RSI will guarantee any financing required by MTC.



**APPENDIX VII (continued)**  
**EXCERPTS FROM MASSAGE THERAPY CENTRE INC. FINAL AGREEMENT**

Human resources

RSI and FFL will jointly hire the manager for MTC. This manager **and FFL** will work together to hire the staff for the MTC locations. RSI will provide the initial training for therapists, at no charge. Subsequent professional development will be provided by RSI for a fee. Only qualified massage therapists will be hired.

In the larger centres, there will be a separate receptionist and multiple therapy rooms; in the smaller centres, the fitness centre receptionist will handle MTC as well, and there will be only one therapy room.

Services

A range of massages, but no other services, will be offered — the emphasis will be on deep tissue massage and other types of massage specific to sports and fitness. Direct billing to insurance companies will be provided and promoted.

FFL members will receive a 10% discount off the regular price of products and services. ~~Members will also earn 'points' for massage treatments and for reaching their fitness goals that they can redeem for massage treatments, product purchase, or personal fitness consultations. A process will be put in place to track where points are earned and spent.~~

Financial

***MTC's financial statements will be prepared in accordance with ASPE.***

**APPENDIX VIII**  
**FINANCIAL INFORMATION – MASSAGE THERAPY CENTRE INC.**

<b>Massage Therapy Centres</b>	<b>6 months ended Dec 31, 2016</b>	<b>Year ended Dec 31, 2017</b>
Therapy revenue	\$ 533,033	\$ 981,708
Product sales	63,964	98,171
	<u>596,997</u>	<u>1,079,879</u>
Expenses:		
Wages and benefits	293,167	539,940
Cost of product sales	30,063	46,140
Administrative and other costs	235,259	418,594
Interest	0	7,677
Total expenses	<u>558,489</u>	<u>1,012,351</u>
Earnings before income tax	38,508	67,528
Income tax	<u>11,552</u>	<u>20,258</u>
Net earnings	<u>\$ 26,956</u>	<u>\$ 47,270</u>
<b>Investment made</b>		
Renovations	\$ 31,200	\$ 20,450
Equipment	76,450	46,620
Uniforms and linens	22,630	12,600
Working capital	<u>60,000</u>	<u>30,000</u>
	<u>\$ 190,280</u>	<u>\$ 109,670</u>
<b>Funded by</b>		
Original investment – equity		
RSI	\$ 100,000	NA
FFL	\$ 100,000	NA
<b>Subsequent funding – debt</b>		
RSI	NA	\$ 54,835
FFL	NA	\$ 54,835

Note: MTC is accounted for by RSI as a joint venture, using the equity method in RSI's financial statements.

**APPENDIX D**

**DAY 1 (VERSION 1) – SEPTEMBER 16, 2015  
MARKING GUIDE AND SAMPLE CANDIDATE RESPONSE**

**MARKING GUIDE  
REJUVENATING SPA INC. (RSI)  
VERSION 1**

**Assessment Opportunity #1 –Summative Assessment #1 – Situational Analysis (Update)**

**Competencies**

*2.3.2 Evaluates the entity’s internal and external environment and its impact on strategy development*

*Enabling:*

*2.1.1 Defines the scope of the problem*

*2.1.2 Collects and verifies relevant information*

*2.1.3 Performs appropriate analyses*

**For Summative Assessment #1, the candidate must be assessed for reasonableness of attempt:**

**Yes** – The candidate used a reasonable situational analysis when analyzing the major issues facing RSI.

**Unsure** – The candidate attempted to use a reasonable situational analysis when analyzing the major issues facing RSI.

**No** – The candidate clearly did not use a reasonable situational analysis when analyzing the major issues facing RSI.

*Competent candidates should complete a sufficient situational analysis. The candidate should focus on describing the factors that have changed that will affect the decisions to be made (e.g., economy), or on the key factors that are relevant to the decisions to be reviewed—so a recap of the mission/vision and key success factors (KSF), as well certain elements of the SWOT, is appropriate. A quantitative analysis is not necessary/is not appropriate at this stage (this will form part of the analyses). Candidates should draw upon their situational analysis when analyzing the major issues facing RSI (Lavish relocation, H&B contract opportunity, and the potential sale of MTC).*

**Mission/Vision Points**

- Day 1 – The board of directors was gravitating back to Rejuvenating Spa Inc.’s (RSI’s) original mission of “running a profitable business by providing affordable massage and other spa services in a warm and welcoming environment.” Candidates may have recommended some changes to the mission and vision in their Cap 1 work, since there were some differences between Lavish Spa Inc.’s (Lavish’s) and RSI’s missions and visions and the strategic decisions made in their

group work that could affect the mission. The intent of the statement in Day 1 is to give them a statement to “ground” their new Day 1 decisions to.

- Day 1 – The vision is expected to remain the same.

**Candidates are NOT expected to recap KSFs and SWOT in detail – they may draw upon these in their Day 1 case analysis, though.**

### **KSFs for Spa Industry (from Cap 1)**

- Convenient location
- Professional and qualified staff
- Atmosphere of the facility
- Up-to-date services offered
- Only quality products used
- Competitive pricing
- Good reputation
- Cleanliness
- Customers happy with past spa experiences
- Value provided through special services not offered by other spas

### **Strengths – RSI (from Cap 1)**

- Reputation as good community supporter (Strength #36 Appendix 1A in Cap 1 solution); links back to their mission and vision; NOT RELEVANT TO DAY 1 Version 1
- Competitive prices for RSI spas (Strength #37 Appendix 1A)

### **Strengths – Lavish (from Cap 1)**

- Highly trained staff and good retention to date – ties to KSF (Strength #1 and #38 Appendix 1A)
- Location and quality space (Strength #20 and #21 Appendix 1A)
- Good customer base and loyalty program (Strength #30 and #17 Appendix 1A)
- Full range of services provided (Strength #1 Appendix 1A)
- Up to date on industry trends and offering new services (Strength #39 Appendix 1A)
- Prices competitive (high-end but below industry average) (Strength #40 Appendix 1A)

### **Weaknesses (from Cap 1)**

- New CEO with minimal experience (Weakness #19 Appendix 1A)
- An issue with RSI staff retention (Weakness #8 Appendix 1A)
- Differing operational guidelines between Lavish and RSI (Weakness #11 Appendix 1A)

**NEW Info in Day 1 Case:** The rebranding of Lavish has not been successful, and there have been pricing issues.

**Opportunities (NEW Info in Day 1 Case)**

- The spa industry is continuing to grow, and the trends that were expected to occur in the industry are bearing out (specifically the trend towards urban retreats).
- Halifax is continuing to grow as a tourist destination.
- The joint venture arrangement with Forevermore Fit Limited (FFL) creating Massage Therapy Centre Inc. (MTC) is still very new but appears to be generating earnings for both venturers.

**Threats (NEW Info in Day 1 Case)**

- Looming in the background is the threat of a downturn in the economy in the next year or two.
- A new manager for MTC has not been hired yet, so Andy, the owner and manager of FFL, is acting as interim manager. He is biased towards making decisions that benefit FFL more than RSI. (There are some comments in Cap 1 that raise questions around what FFL's motivations are for forming the partnership with RSI.)

**Quantitative Analysis (based on looking at and/or comparing new financial statements to Cap 1)**

No financial statements are provided for RSI (which would include both RSI and Lavish spas).

Pure Substance Inc.'s (Pure's) financial statements are provided such that the Health and Beauty (H&B) offer can be assessed by candidates using margins. No ratio analysis or other analysis of Pure's financial statements is required as part of situational analysis.

MTC's financial results are presented so that its performance and the FFL buyout offer can be assessed. No ratio or other analysis of MTC's financial statements is required as part of the situational analysis.

Credit is awarded for candidates who provide a high level assessment of Pure and MTC financial results (i.e., profitability, revenue trend for MTC, margins of Pure).

## Summative Assessment #2 – Analyzes the Major Issues

**For Summative Assessment #2, the candidate must be assessed for reasonableness of attempt:**

**Yes** – The candidate completed a reasonable assessment of the major issues facing RSI.

**Unsure** – The candidate attempted to complete a reasonable assessment of the major issues facing RSI.

**No** – The candidate clearly did not complete a reasonable assessment of the major issues facing RSI.

### **Competencies**

*2.3.3 Evaluates strategic alternatives*

*Enabling:*

*2.1.3 Performs appropriate analyses*

*2.1.4 Integrates information to investigate each potentially viable solution or conclusion*

This summative assessment is based on Assessment Opportunity #2 to #5.

## Assessment Opportunity #2 (Strategic Issue # 1 – Lavish Spas)

*Competent candidates will complete both a qualitative and a quantitative assessment of this alternative.*

*Candidates are expected to demonstrate an understanding of the quantitative analysis presented in the case and to explain, in a manner that client will understand, what the qualitative decision factors are.*

### **Quantitative Analysis of the Lavish Location Decision (Lease versus Buy)**

*Quantitative analysis – Candidates should compare the option of remaining in the present location at Opal Hotel to the option of moving to the urban retreat location. The quantitative analysis was provided to the candidates in the case. Candidates needed to **interpret** the analysis.*

Key tools candidates could use or do are as follows:

- capital budgeting (discussion of PV figures provided); and

- compare cash flows (accepted a discussion of income effect), in particular address the impact of the purchase decision on the PV figures provided.

Based on the quantitative analysis, the move to the urban retreat appears favourable, since the present value of the cost of this option is about \$190,000 versus \$1,096,000 for not relocating, including the value of the purchase option contained in the proposed new lease agreement. Excluding the value of the purchase option of the retreat (i.e., \$932,748 provided in the case), the cost of \$1,122,613 (\$927,613 + \$195,000) is slightly more than that the cost of staying at the Opal Hotel. All figures are from Appendix II of the case.

Candidates should note missing renovation costs, etc., in their analysis and the need to redo the analysis once the company has more information.

### **Qualitative Analysis of the Lavish Location Decision (Lease versus Buy)**

*Qualitative analysis – Candidates should consider the qualitative factors and draw conclusions or make recommendations based on a combination of the quantitative and qualitative analyses.*

#### Key Points from Cap 1 that Could Be Integrated:

- Impact on revenue – customers who are visitors to Halifax and staying at the Opal Hotel may not go to the new location, and there is potential for a large drop in revenue. (LINK TO SWOT – said tourist market was expanding)
- The hotel may find another spa to operate in the space that Lavish is vacating, and this may affect revenue and add competition. (LINK TO SWOT – increase in competitors entering the market)
- Lavish may attract clients of the spa formerly operated at the proposed “urban retreat” location.
- Lavish may not attract its previous client base, or the clients may not follow it to the new location if it is not in the downtown or inner city. (LINK- KSF – convenient location)
- Impact on staff availability – it may be more difficult to keep the same staff, depending on travel time to the new location. Staff retention has historically been an issue in the industry (KSF), and if a new spa moves into Lavish’s present location, the staff may have job opportunities there. (LINK to SWOT – retention and quality of staff)
- Could also consider, given RSI’s growth objective and Sally’s desire to open “more of those,” operating the new location **in addition to** the present location. More work would have to be done to determine if this is feasible, particularly considering the risk of an economic downturn. (LINK TO change in SWOT)
- RSI needs to address its pricing strategy and policies anyway, and could consider whether pricing adjustments are necessary before the spa is opened, not afterwards (per case facts). [INTEGRATION]



Key Points from Day 1 Case that Could Be Integrated:

- Bob suggested moving and rebranding Lavish again, but this time as an urban wellness retreat.
- Sally loved the idea of capitalizing on the urban wellness retreat trend.
- Lisa expressed some concern that, although the new lease with Opal Hotel has just been signed, Lavish has made significant payments already. She also wondered whether an urban wellness retreat aligns with RSI's current mission and vision.
- Lisa suggests increasing RSI's prices to match Lavish's – need to recognize there are different market segments being served.

Additional Considerations Candidates Could Discuss

*New pricing structure for Lavish*

Sally indicated they would be able to expand their services. Sally thinks Lavish could add things that would enhance the services and bring in revenue with little variable costs – e.g., saunas, steam rooms, etc. However, there will likely be some increase in costs associated with these services. There are potentially more renovation costs to consider if they pursue the urban wellness retreat option. As well, there could be lost sales and profits due to the need to shut locations during the move. Therefore, accounting should redo calculations before any final decisions are made.

Lavish went from targeting a high-end luxury market to a mid-range market with more cost consciousness. However, the rebranding has not been successful, mainly because Lavish remains in its original location and is, therefore, still perceived by its current and potential customers as a high-end spa. It has not been able to draw on the same customer base as RSI's other spas. There may be brand confusion in the marketplace.

### Assessment Opportunity #3 (Strategic Issue # 2 – Health and Beauty/Pure)

*Competent candidates will complete both a qualitative and a quantitative assessment of the issues related to Pure's proposed contract with H&B. Candidates are provided with Pure's financial statements and a draft analysis of the short-term options to accept the H&B contract, and are asked for their "thoughts." Candidates should consider whether Pure (it is not RSI's issue)\* should or should not do the deal and should analyze the related capacity issues (short-term and long-term discussions). This assessment opportunity tests candidates' ability to read and interpret the financial information provided.*

*\*Candidates may discuss the "conflict" issue; i.e., that they have been hired by RSI to consult on RSI's issues. Since Pure is a separate company, technically CPA should not be discussing this issue as part of the RSI engagement. Candidates could suggest a separate engagement letter be obtained with Pure to allow CPA to address the issues in Pure.*

#### Quantitative Analysis of the Contract with Health and Beauty

*Candidates are provided with most, but not all, of the calculations required. They should recognize the need to compare the gross margins to determine which of the two short-term production options (overtime versus imported product) is most lucrative.*

Key tools candidates could use or should recognize are as follows:

- capacity management; and
- incremental revenue/income.

Key findings of comparing overtime to use of imported material:

- Recognize that margins are better if Pure imports material versus incurring overtime, but that overall the margins are lower than Pure's consumer sales' current 27% margin and bulk spa sales of 15% (see Appendix III of case). Okay to do in short run, but there may be better options in the long run.
- Recognize that the volume discount and promotional fund costs cut into margins.
- Recognize that accepting the H&B contract would be quantitatively favourable for Pure regardless of how they meet production.

#### Qualitative Considerations

Key Points from Cap 1 that Could Be Integrated:

- The RSI board said they might buy Pure and run it or learn about it in the short run, and then maybe sell it or close it and outsource to a larger company. Candidates could identify the "twist" and see that, instead of RSI buying Pure, only 5 of the 10

shareholders bought in directly. Bob and Sally, two of the board members of RSI, are part of the five. (LINK TO CAP 1)

- The product will now be available to the mass market through a drugstore chain. Is this what Pure's board wants to do?
- If Pure's product is sold through H&B, RSI's board will then need to consider how Pure's new relationship may affect RSI, but it should not have a say in the decision. Sally and Bob will have a say as members of Pure's board. (LINK TO MISSION AND VISION)
- The core business is supplying spas with product for retail sale exclusively through spas and in bulk for use within spas. Will offering Pure's product in the consumer retail market affect sales and image related to bulk sales to spas? (INTEGRATION – understanding of CORE business at Pure).
- Shipping costs were a concern of Pure's. (LINK TO CAP 1) This contract provides significant savings in shipping, but may be offset quickly by the discounts.

**BOE Comment:**

*Candidates may not pick up on the subtleties between Pure's board making decisions that make sense for Pure and RSI's board having to deal with the fallout and assess the impact of those decisions on RSI. Candidates were not penalized if they mixed up the two levels of decision-making in their discussions because this is a difficult issue i.e., a complex structure to identify.*

**Key Points from Day 1 that Could Be Integrated:**

Pure's board:

- Sally (one of the five shareholders who bought into Pure) has expressed some trepidation in terms of the size of the H&B contract versus the size of Pure.
- Does the drugstore chain brand align well with Pure? (Pure is a high-end brand, but the chain sells discount items.)
- The contract is exclusive and includes minimum volumes that Pure must provide, but there is no minimum that H&B must purchase. This is something that could be renegotiated if possible, since it is only of benefit to H&B and is a risk to Pure.
- Capacity issue/20% import – only at the lowest volume is the imported product required within the 20% that Sally believes is acceptable without affecting the “local and organic” labelling of Pure's products (CAP 1 LINK). Will using the imported product affect the quality of the product?
- The contract might be putting the government grant for labelling local and organic at risk – outsourcing does not align with the funding requirements (i.e., the “100% Made on Prince Edward Island” tagline).
- Is there a possibility that bulk sales will be cannibalized by consumer retail sales?
- Regarding overtime or importing product for Pure, consider the obligation and goal of the previous owner and RSI related to the employment of local people. Also, consider the impact on employee morale if overtime is required of them over an extended period of time.

RSI's board:

- Will spa retail sales be reduced if the product is no longer exclusive (since it can be bought in any H&B pharmacy)?
- Will having such a large contract affect RSI's ability to obtain bulk product for its spas? (CAP 1 LINK– RSI/Lavish spas sell almost exclusively Pure products)

Candidates should also discuss a long-term solution to meeting the H&B requirements. They should suggest adding a second shift, expanding the facility, or automating additional functions within the production process. Since no additional information has been provided, candidates are not expected to provide a lengthy discussion.

#### **Assessment Opportunity #4 (Strategic Issue #3 – Buyout Offer from FFL for MTC)**

*Competent candidates will complete both a qualitative and a quantitative assessment of the significant factors related to making a decision with respect to this offer.*

#### **Quantitative Analysis of the MTC Buyout Offer from FFL**

*Quantitative: Candidates should do a rough calculation to assess the reasonableness of the offer.*

Key tools candidates could use, or do, are as follows:

- valuation estimate; and
- calculation of an estimated book value and bonus buyout amount (based on earnings).

Candidates should compare the two values and discuss.

Since the case stated “Sally will ask RSI’s accounting group to value MTC,” candidates were not required to complete a calculation. However, they were required, at a minimum, to recognize that the valuation is an important part of the decision and that it needs to be reviewed once a valuation is done.

#### **Qualitative Considerations of the MTC Buyout Offer from FFL**

*Qualitative: Candidates are expected to identify that MTC’s performance for the next three years affects how much RSI gets paid in the buyout. In addition, candidates can discuss how FFL and MTC “control” many of the decisions, even though MTC is set up as a joint venture, because of the wording of the agreement and current circumstances (e.g., how Andy’s adding perks affects the bottom line), since RSI has no say in the decision (Andy is acting manager). Candidates may question whether Andy is manipulating (or can manipulate) the earnings to FFL’s benefit.*

Key Points from Cap 1 that Could Be Integrated:

- RSI went into the joint venture as part of its objective to grow. Selling out to FFL goes against RSI's growth objective. (LINK to OBJECTIVES)
- Many changes were made to the draft agreement that affect FFL's level of control. (INTEGRATION back to Cap 1 and "FFL's intentions" – interpreting the changes that are highlighted)

Key Points from Day 1 that Could Be Integrated:

- RSI has a vested interest in MTC doing well for the next three years since it will get 50% of MTC's earnings. Key insight: RSI should be motivated to increase earnings as much as possible (as suggested by Sally). However, the allocation of joint costs will have a significant impact on the amount of earnings RSI receives.
- There should be a management committee. There is an issue already as a result of the decision Andy made to institute a points program at MTC, since it is for FFL members only. In addition, he is offering commissions and bonus incentives to MTC employees who sign up FFL gym members. There is a question of whether he is manipulating the operations and results in FFL's favour.
- Financial results are just okay at this point (positive net income, but only around \$48,000), compared to the additional investment required to be made of \$54,835. The ROI isn't great and is declining.
- FFL's membership is declining, which may have a negative impact on MTC.
- The threat of an economic downturn could have a negative effect on future earnings and growth.

Additional Considerations Candidates Could Discuss

Since Andy's actions are questionable, candidates could discuss the need for financial statements to be reviewed or audited to ensure the income reported is accurate.

### Assessment Opportunity #5 (Additional Issues)

*Generally, competent candidates will reasonably discuss at least two of the additional issues presented in the case.*

*Candidates should see that there is potential exposure to contingent liabilities for Pure and its shareholders as a result of government funding being mishandled by the previous owner, Matthew Chung. Candidates should identify where there are red flags and suggest next steps, which should include pursuing the recourse option in Pure's purchase agreement – RSI can go back to Matthew if there are liabilities found.*

*Candidates should step back and think about the governance and strategy issues. They should pick up on the statement in the case questioning the fact that the two AGMS are being held together.*

*They can also discuss RSI's board's decision-making processes, based on the information provided on the decisions and outcomes since Sally took over (related to Pure and maybe the MTC joint venture).*

*Candidates could also discuss the possibility of raising RSI's prices (and removing discounts) to match the prices charged by Lavish.*

### Qualitative Considerations

#### A. The government grants received by Pure

ETHICS/FRAUD: The duplicate invoices for this equipment raise the possibility of intentional misrepresentation and perhaps even fraud on the part of Pure and Matthew.

It is important to identify liabilities before the June 30th deadline for recovery of liabilities from Matthew, the former owner.. (INTEGRATION of case facts)

#### Advertising Grant

In this particular case, the funds are received if the company agrees to use the "100% Made on Prince Edward Island" tagline and the related logo in its advertising.

It is possible that more than 10% of costs were claimed or it may be that some costs are included in other expense categories. Further investigation is required.

This program is ongoing. Might be putting the gov't grant for labelling local and organic at risk- importing does not align with the funding requirements. I.e., 100% Made on Prince Edward Island" tagline.

### Environmental Energy Saver Program

For this particular grant, the grant form in the file includes a purchase order as well as invoices and some invoices outside the dates. The preliminary findings raise questions as to whether the agreement was followed.

### Equipment Grant (under same energy program)

The equipment is idle and sitting under a tarp “in case it is needed.” According to the terms of the agreement, if a piece of equipment is taken out of service within five years of receiving the grant, repayment is required equal to the fair market value of the equipment at the time it was taken out of service. Seeing as the grant was received in 2016, Pure’s board needs to find out more about this grant. Pure may be in breach of the grant’s requirement. As well, two invoices (with different amounts) were located for the same equipment purchase. It appears as though the higher invoice was used for the grant submission but the lower invoice was the one actually paid.

## **B. Governance Issue with Pure Ownership**

Sally’s involvement with Pure – What is Sally’s official role with Pure? Is she CEO or just a shareholder? She seems to be devoting considerable time and energy to Pure. She is making decisions that could favour a subset of RSI shareholders: those who are part of the Pure shareholder group. There are two issues: the Pure board should be approving these decisions, not the RSI board; and RSI itself has no ownership and should not control the decision-making.

AGMs – Pure’s and RSI’s AGMs should not be held together. These are sister companies, related by only 5 of 10 common shareholders. The financial statements to be presented to RSI’s executive and annual general meeting include those of Pure. It appears that Pure does not have its own board.

Rubinoff & Rubinoff (RR) – RR has been hired by RSI, but some of the requests and discussions include issues that Pure is facing. Pure is owned by half of the shareholders who own RSI, so this should be a separate engagement. An engagement letter should be obtained by RR before it does work on Pure.

## **C. Pricing Structure at RSI**

It is suggested that RSI increase prices to match Lavish. Candidates could discuss the pros and cons of the suggested price increase and come to a reasonable conclusion. Linking to the mission of providing affordable massage is a key part of the discussion.

**Assessment Opportunity #6 –Summative Assessment #3 (Conclude and Advise)**

**Competencies**

*Enabling 2.1.4 – Integrates information to investigate each potentially viable solution or conclusion*

*Enabling 2.1.5 – Recommends and justifies a solution or conclusion based on an integrative view of information for the situation*

**For Summative Assessment #3, the candidate must be assessed for reasonableness of attempt:**

**Yes** – The candidate provided reasonable conclusions for each major issue.

**Unsure** – The candidate attempted to provide reasonable conclusions for each major issue.

**No** – The candidate clearly did not provide reasonable conclusions for each major issue.

*Competent candidates will provide a logical conclusion that is consistent, and flows from their analysis.*

The candidate should provide a logical conclusion that **integrates** the analysis for all three major issues (Lavish, H&B for Pure, MTC).

The candidate's recommendations should be consistent with the analyses performed. As well, the candidate should present an overall conclusion to provide a sense of completion to the report (a wrapping-up and prioritization of the recommendations).

The candidate should consider key elements: RSI pursuing a growth strategy, weighing risks and opportunities for each of the options, the governance structures, ethics, etc.

The recommendations should address the key concerns of the shareholders and display good professional judgment. Suggesting that further information is required is acceptable as long as it is justified and consistent with the analysis.

**Assessment Opportunity #7 –Summative Assessment #4 (Communication Hurdle)**

**For Summative Assessment #4, the candidate must be assessed for reasonableness of attempt:**

**Yes** – The candidate adequately communicated his/her response.



**No** – The candidate clearly did not adequately communicate his/her response.

Insufficient communication in a candidate's response would generally include some of the following problems:

- The reader needs to re-read sections several times to gain an understanding.
- It is not clear what point the candidate is trying to make.
- The quantitative analysis doesn't make sense because of a lack of labelling or illogical ordering.
- There is an offensive amount of spelling and grammatical errors.
- The language used is unprofessional.

### Summative Assessment #5 (Overall Assessment)

**For Summative Assessment #5, the candidate must be assessed in one of the following, based on their overall performance:**

**Clear Pass** – Overall, the candidate provided an adequate response clearly meeting the minimum standards for each of the summative assessments above.

**Marginal Pass** – Overall, the candidate provided an adequate response, with some errors or areas of omission, but including the underlying key concepts.

**Marginal Fail** – Overall, the candidate provided an attempt at a response, with several errors or an incomplete analysis.

**Clear Fail** – Overall, the candidate did not provide an adequate response because the response was deficient in multiple areas.

To be assessed a Pass, candidates were expected to perform adequately in all the summative assessments and demonstrate that they addressed the issues of importance to Sally and the RSI board in a cohesive, professional manner.

Markers were asked to consider the following in making their overall assessment:

- Did the candidate step back and see the bigger picture, and then address the broader issues identified?
- Did the candidate prioritize the issues by discussing the major and minor issues in appropriate depth?
- Did the candidate use both quantitative and qualitative information to support their discussions and conclusions?
- Did the candidate use the appropriate tools to perform quantitative analysis?

- Did the candidate use sufficient case facts (current case and Capstone 1 case) about the external and internal environments to support their discussions?
- Did the candidate communicate their ideas clearly, integrating and synthesizing the information?

## **SAMPLE RESPONSE- RSI VERSION 1**

*Below is an actual passing candidate response.*

To: RSI Shareholders

From: Consulting Team at RR

The following report has been prepared to address the issues currently facing RSI.

### **Lavish Decisions**

RSI has the option to remain at the Opal Hotel location, and not make any changes in regards to location or rebranding, or Lavish can be relocated to the outskirts of Halifax and rebranded with an urban wellness retreat. The two options are analyzed further below:

*Opal Hotel Lease* - under this option, no changes would be made in regards to location and branding.

#### Pros:

- No changes will be necessary to the location in terms of renovations, marketing, moving, offering new services, etc that would be required under the urban retreat option; thus, this is a safe option as there are no significant operational or financial changes
- Current customers at Lavish will not have to change their commute to the spa which would occur if Lavish changes locations, and there is no risk that current customers will not return due to changed operations, branding or location

#### Cons:

- NPV of this option is \$1,096,270 which is significantly higher than the NPV of the urban retreat option; even though no additional funds will be needed for new location or

renovations, continuing this lease has an NPV almost 6 times greater than the NPV of the urban option

- Rebranding Lavish to RSI has proven not to be very successful, and hasn't been able to draw on the same customer base as RSI's other spas; even if Lavish doesn't move, the current operation clearly isn't working well and changes will be required if Lavish is to grow financially

*Urban Retreat Lease* - under this option, Lavish would move to a different location, and rebrand to the urban wellness retreat trend.

Pros:

- NPV of the costs for this option is \$189,865 which is much lower than the NPV of costs of the Opal option; even with the cancellation of the Opal lease cost, the option still will be significantly less costly mainly due to the purchase option at the end of the lease
- The location used to be a spa, and there is potential for the previous clientele from that spa to come to Lavish's spa which will increase profits and increase Lavish's customer base which has been a problem at the current location
- The wellness spa trend is on the rise according to International Spa Association, so rebranding Lavish with an urban wellness retreat will optimize on this increasing trend which might lead to increased profits, increased customers, etc;
- The stress relieving options provided by urban retreat are aligned with RSI's mission to provide spa services since typically customers go to a spa to relax and be stress-free; this is good since Lavish will still operate under RSI's brand

Cons:

- Although the NPV of costs is much lower, there is potential under this option for uncertain costs from renovations, moving, marketing, offering new services, etc. These costs could significantly add up for Lavish
- Joey, the previous owner of the spa location, might have closed the option due to losses from the business, problems with the property, or poor customer attraction to the location and then decided to move to India for yoga as a better option; this is risky since the location might not have worked for the old spa and if Lavish moves here, the same problems could be faced if there were low customers, remote location, etc
- The urban retreat also focuses on providing healthy food and intensive fitness programs which isn't necessarily aligned with RSI's mission to provide massage and other spa services and RSI's customer base might not be happy that there are food or fitness facilities where they are going for a spa service

I recommend going with the urban retreat lease. The current location of Lavish has proven not to be successful in regards to rebranding with RSI and hasn't drawn a customer base similar to RSI's. Thus, the amalgamation didn't really help Lavish, as it only changed the spas name, and no other changes were made. Therefore, even if Lavish doesn't relocate and rebrand with the urban retreat, the current rebranding isn't working well and isn't drawing a strong customer base as RSI. The urban retreat is a current trend, and provides a good market for Lavish to rebrand to. Although the food and fitness programs aren't necessarily aligned with RSI's mission to provide spa services, customers attend a spa to relax and be stress-free, and giving them access to fitness programs or healthy food will further provide options that will relax customers (since fitness has

proven to be a stress-reduction mechanism as well as healthy eating). There might be additional costs with this option for marketing, or offering new services, but as you mentioned renovations aren't really necessary. Thus, additional costs likely won't be too high, and the additional programs offered for healthy food and fitness might prove to be very successful. RSI could see this option as a trial of adding healthy food and fitness options to the services offered, and if there is a strong positive response from customers, it might provide an additional revenue stream for other RSI locations to offer if customers respond well.

### **Lavish - Pricing**

Lavish is still selling at much higher prices than RSI despite the fact that Lavish amalgamated under the RSI brand. This has led to confusion in terms of the rebranding since Lavish rebranded to RSI, but it does not offer the same prices as RSI. Lisa suggested increasing all the RSI locations' prices to match Lavish's rates. However, I do not think this is wise since RSI's mission is to provide affordable massage and spa services. Since Lavish amalgamated to RSI's brand, I think Lavish should change its prices to match RSI's rates. This would increase the chance of Lavish attracting a more similar customer base to RSI and remain consistent with its brand. Even though I recommend Lavish goes with an urban retreat brand, I still think it should remain under RSI's branding, and thus lowering its prices to match RSI's rates will be more aligned with RSI. More information is needed to determine if lowering Lavish's rates to match RSI's is a good option since it might mean lowering the rates won't cover Lavish's costs. Thus, more information is needed to conclude on this decision.

In regards to the discounts, customers would not be happy if RSI suddenly stops offering the products at a discount. There is the possibility to offer the discount only if the customer/supplier

signs a contract to purchase a set amount of products. However, more information is needed to determine if getting rid of the discount completely is a good option.

### **Pure - Short-Term Decisions**

Per Exhibit 1, it can be seen that the gross margin for the overtime option is lower than the gross margin of the import option. Therefore, quantitatively, the import option would be recommended. However, the qualitative factors of each option are considered below:

#### *Overtime*

- Higher incremental cost than the import option, but this is aligned with your goals of not supporting foreign producers
- Although the production remains inhouse by the same production team so quality in regards to materials used in production process won't be compromised, having employees work overtime will make them tired and more prone to errors in the production process which possibility compromises quality, so this option doesn't necessarily mitigate your concern of adversely affecting quality
- More production employees could be hired and trained in the production process so that the employees don't necessarily need to work overtime, but instead there are more employees overall available to work additional shifts - this would lower costs since employees would need to be paid the normal labour rate and not overtime rate

#### *Import*

- Once demand goes up to \$6 million, which is at the mid range, the 20% maximum would be exceeded and thus the products couldn't be labelled local and organic - the contract requires Pure to guarantee the volume needed, so no changes can be made to ensure the volume won't

exceed \$6 million, and thus this will always be a problem

- Your concern of supporting foreign producers is not mitigated and will be increased as the volume levels increase and more production is needed from the foreign suppliers
- Quality might be compromised since Pure will not have control of the production process for those products outsourced, thus this option does not mitigate your concern
- This also results in higher costs of purchasing the products by outsourcing in comparison to continuing to produce them inhouse

Overall, I would recommend going with the overtime option since it mitigates your concern of supporting foreign producers. In regards to your concern for impacting quality, there are options for Pure to undertake in order to mitigate the risk of quality being affected through overtime. For example, more employees could be hired and trained so that more employees are available to work different shifts and won't all need to work overtime thus increasing risk of them being tired and increased risk of errors. Increased quality controls can also be placed throughout the production process to mitigate the risk of products not passing the quality tests passing through the production process unnoticed. It is assumed that with the overtime option, demand will be able to be met at all levels of the HB contract, and that the actual facility isn't what would hold back capacity. Although overtime will work for now, employees will get tired and more steps need to be taken in the long-term to be able to meet increased capacity.

### **Pure - Long-Term Decisions**

As mentioned above, Pure should hire and train more employees so that there are more employees available to work a second shift and thus the increased demand can be met without



compromising quality. However, eventually there might come the time when even a second shift won't meet capacity if in fact there isn't enough equipment or space in the facility to meet capacity. More research will need to be done on the three options - second shift, expand facility, or automate functions in the production process to determine which option will allow demand to be met with the required capacity. The costs of each option need to be analyzed, and Pure needs to research automatic production processing companies that would be able to help automate the production processes. Since the overtime option will help meet demand in the short-term, the longer-term options aren't as pressing. However, within the next couple months these long-term options need to be further explored.

### **Pure - Government Funds**

Pure is going to be inspected by the government in 2 weeks in order to determine if the grants have been violated. If so, a significant portion of money will need to be repaid, and given that Matthew is still liable for assumed liabilities at Pure until June 2018, we should let him know ASAP of these potential liabilities he might need to assume.

#### *Environment Program:*

Some of the costs claimed were incurred outside of the allowed dates the costs would be covered by the grant. As such, the costs outside the allowed dates will need to be repaid to the government, since these aren't eligible costs. It doesn't appear the this grant requires the full repayment of the amounts received if found in breach of the conditions, but rather it appears that only costs not eligible for funding will need to be repaid if determined to be not eligible. Therefore, 50% of the costs outside of the allowed dates will need to be repaid to the government. More information is needed to quantify the amount, but Matthew should be informed of this liability ASAP.

*Capital Funding Program -*

The program specifies the grant will be fund 75% of the purchase cost, and that if the equipment is taken out of use before five years' time, repayment is required equal to fair market value (FMV) at the time the equipment is taken out of service. The equipment is not currently being used, so repayment will be required. Repayment is equal to FMV at time the equipment is taken out of service. It appears that FMV of the equipment is \$375,000 since that is what the supplier sold the equipment for, despite the initial receipt of \$500,000 since this was only an estimate. Matthew needs to be informed of the liability of \$375,000 to repay this loan.

*Advertising Support -*

An amount of advertising costs was to be reimbured if Pure used the "100% made in PEI" tagline and logo in its advertising. Pure's products were advertised stating 100% organic and local, so this implies that the products were produced locally, thus in PEI. However, more information is needed and clarification is required with the program to determine if Pure's advertisements meet the requirements. If it is determined the advertisement's weren't adequate in meeting the programs requirement, a repayment of \$69,000 (\$44,000 in 2016 and \$25,000 in 2017) will be required.

*Issues to Raise to Matthew:*

Per the above, Matthew will incur a liability of minimum \$375,000 for the violation of the government grant, and possibly \$444,000 if factor in the advertising support, as well as additional funds for the violation of the environmental program which cannot be quantified without the required info. Regardless, Matthew needs to be informed of these potential liabilities. Since Matthew is liable for any additional liabilities identified by June 30, 2018, it is likely that Matthew will need to come up with the required funds to repay the government. Therefore,

Pure's statements will not need to be adjusted for these repayments since Pure doesn't need to assume the liabilities. Regardless, we should perform additional work on all of the grants that Pure has with the government currently, in order to ensure that there are no other liabilities at this time. If any breaches of the grant requirements occur after June 30, 2018, Pure will be liable and will need to make the necessary adjustments to their Financial statements. As such, more work on these grants should be performed now in order to determine if any additional liabilities might arise so that we can have Matthew assume the liabilities.

### **MTC's - Agreement**

Although RSI and FFL jointly hired Andy as the manager for MTC, he was hired to make decisions for the MTC's. The proposed changes Andy has implemented are more for the benefit of FFL than the MTCs. For instance, Andy wants to offer commissions and bonus incentives to MTC employees who sell FFL gym memberships. This option will benefit FFL by increasing the number of gym memberships, and although that might increase revenue at MTC's, that is not the focus of the commission and bonus incentive.

RSI and FFL split the costs of the MTC's, and thus RSI would be paying for the cost of the commissions and bonuses paid that are targeted at increasing FFL's revenues. Andy should be focused on implementing plans that will encourage employees to increase FFL's members use of the MTC's. For example, the commissions and bonus incentives should be based on MTC employees ability to increase the number of FFL members who use MTCs services. This will directly provide increases to MTCs revenues, rather than the current bonus incentive which directly increases FFL's revenues.

The management team for the MTC's consist of Andy, one member from RSI and one member from FFL. No changes should be allowed to be instituted to the MTC's without the consent from the entire management team, and it appears that you didn't agree to these changes and new programs before they were implemented by Andy on March 1. More decisions might have been made without your consent, and might be in the process of being made still without your consent. Assuming Sally is the representative from RSI on the management team for MTCs, I suggest Sally contacts Andy and the FFL rep for a meeting. Sally should discuss her concerns with regards to the new programs instituted by Andy and overall on Andy's focus of the decisions he implements. If the decisions are not going to be changed, or Andy's focus isn't on MTC's success, this is a concern to RSI and would support the decision to accept a buy out offer, discussed further below.

### **MTC's - Buyout Offer**

The following are the qualitative considerations of accepting and rejecting the buyout offer.

#### Accept Buy Out

- Pros
  - You will be able to dedicate more time to Pure where there is significant potential for growth and more time can be spent on researching and analyzing the long-term options at Pure to determine the best option
  - More time to focus on the Lavish rebranding to an urban retreat in order to ensure growth occurs and determine if the urban retreat method should be implemented in other locations of RSI
  - As discussed above, Andy's focus is on benefiting FFL which is a concern since MTC

has growth potential but if Andy isn't focusing on MTC's the potential for growth will be lost

- Per Exhibit 2, the value of MTC's is \$202,584 which will result in an increase in funds and these funds will be able to cover the NPV of the costs of Lavish's new location and rebrand of \$189,865 and leaves room for minor additional costs that might be incurred
- Cons
  - Even though FFL isn't doing well, the MTC's are doing well and have experienced growth and this growth is expected to continue; RSI would miss out on this opportunity if they accept the buyout option
  - A lot of time has gone into the MTC's and if bought out, it was all wasted; however, it might be recovered by the purchase price but still won't recover the time invested by Sally and other employees at RSI

Reject Buy Out:

- Pros
  - MTC's have potential for growth and RSI will be able to continue to share in the profits from the growth
  - If FFL gym memberships increase with the proposed changes, there might be an increase to MTC's revenue if these new gym members use the services at MTCs
- Cons
  - Sally will still need to dedicate her time and not have additional time to dedicate to Pure and Lavish which are going to incur significant changes
  - Changes are being made to MTCs for FFL's benefit and this will result in increased costs to the MTCs with no guarantee in increased revenues at MTCs

Exhibit 2 provides a buyout option of \$202,584 using an industry capitalization rate, however the actual buyout price Andy provided RSI needs to be quantified also to determine the final buyout offer. More information is needed to quantify that buyout option, and it might result in a lower or higher value than the one we have determined in Exhibit 2. When considering the qualitative pros and cons of each option, it is more beneficial for the buyout to be accepted given the current changes being made that benefit FFL, and given Andy's focus on FFL's success rather than on the success of the MTCs. These factors indicate the MTCs might decrease in success despite there being opportunity for growth since these opportunities are not being acted on. Further, you will be able to spend more time on the short and long-term options at Pure and the changes to Lavish for the move and rebranding which both have the potential for increased growth.

Although approximately \$202,584 can be recovered from the MTCs, RSI put in a total of \$154,835, and although these are sunk costs since they were already incurred, the net profits from the buyout when considering these costs is only approximately \$50,000.

Despite all of these factors, the MTC's are still doing relatively well and have earnings before tax of approximately \$67,000 and this is only within 2 years of implementation. Thus, there is potential for further growth in subsequent years of operation. I think more info should be gathered on the future plans in place for the MTCs to determine if there is potential for growth and revenues given the proposed plans. If significant investments will still be required by RSI, such as the \$54,000 investment in 2017, the best idea might be to sell for \$202,000 instead of putting in increased investments if there is no guarantee of an increase in value.

Lastly, given that there is the risk of a recession soon, the value of the MTC's might be decreased and thus the option to buyout MTC or not needs to be considered ASAP before the valuation gets lower in the event that the final decision is to accept the buyout offer.

### **Approval of RSI and Pure Financial Statements**

Lisa, you wanted to know why you and the other shareholders need to approve both RSI and Pure's financial statements (FS) at the annual meeting. Given that half of RSI's shareholders purchased the shares of Pure, RSI has control over Pure since 50% of the shareholders of RSI own 100% of Pure. Further, the meeting is a combined annual meeting for RSI and Pure, so both statements need to be reviewed before the annual meeting.

#### **Exhibit 1 - Pure's Short-Term Options**

##### **Purpose: To further analyze the costs of the short term options for Pure to meet capacity**

<b>Option 1 - Overtime</b>	<u>Notes (Note 1)</u>	<u>Low</u>	<u>Mid</u>	<u>High</u>
	Per App III * 5% growth			
Existing Sales Increase		23,737	23,737	23,737
HB Contract Sales	Per App V	<u>5,000</u>	<u>6,000</u>	<u>7,000</u>
Gross Sales	A	28,737	29,737	30,737
	Per App III * 5% increase			
Total COGS of Pure		17,687	17,687	17,687
Total COGS of HB Contract	Per App V	3,406	4,087	4,769
Overtime	Per App V	<u>650</u>	<u>830</u>	<u>1,010</u>
Total COGS	B	21,743	22,604	23,466
<b><u>Gross Margin</u></b>	A/B	<b><u>6,994</u></b>	<b><u>7,133</u></b>	<b><u>7,271</u></b>

<b>Option 2 - Import</b>	<u>Notes</u>	<u>Low</u>	<u>Mid</u>	<u>High</u>
	Per App III * 5% growth			
Existing Sales Increase		23,737	23,737	23,737
HB Contract Sales	Per App V	<u>5,000</u>	<u>6,000</u>	<u>7,000</u>

Gross Sales	A	28,737	29,737	30,737
Total COGS of Pure Total COGS of HB	Per App III * 5% increase	17,687	17,687	17,687
Contract	Per App V	3,406	4,087	4,769
Import	Per App V	<u>351</u>	<u>448</u>	<u>545</u>
Total COGS	C	21,444	22,222	23,001
<b><u>Gross Margin</u></b>	A/C	<b><u>7,293</u></b>	<b><u>7,515</u></b>	<b><u>7,736</u></b>

Notes:

1. All numbers in thousands of dollars.

### **Exhibit 2 - MTC's Value**

**Purpose: To estimate the value of the MTC's.**

	<u>Notes</u>	Year Ended <u>31-Dec-17</u>
Net Earnings before tax	Per App VIII	67,528
Capitalization Rate	Per Meeting	<u>6</u>
Value of MTC		405,168
RSI's Share of the Value		<u>50%</u>
<b>RSI's Value of MTC's</b>		<b>202,584</b>



**APPENDIX E**

**THE COMMON FINAL EXAMINATION  
Day 1 RSI VERSION 2 BOOKLET – MAY 25, 2016**

**RSI Version 2 – Case****(Suggested time 240 minutes)**

In early 2016, you, CPA, were on the Rubinoff & Rubinoff LLP (RR) team that completed the consulting engagement for Rejuvenating Spa Inc. (RSI). On November 28, 2016, you were hired by RSI as an assistant to the Chief Executive Officer (CEO), Sally Rice.

Sally updated you on the changes that RSI has made following RR's consulting engagement, and on other items that might impact the company (Appendix I).

Since starting last week, you have attended a meeting with RSI's board members (Appendix II), and have met with Sally on various occasions, and with Barbara, the Massage Therapy Centre Inc. (MTC) manager.

When Sally hired you, she expressly stated that you are to help her guide the board in their decision-making by providing them with financial direction and advice, and by ensuring that the decisions they make are consistent with RSI's mission and vision, are good for RSI stakeholders, and are in line with the company's specific objectives.

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**APPENDIX I  
DECISIONS AND ENVIRONMENT: TIMELINE AND UPDATE**

2005		Purchase of RSI shares by current shareholder group
2014	January 1	RSI purchases shares of Lavish Spa Inc. (Lavish)
2015	June	Sally Rice starts as CEO of RSI
2016	February 1	Rubinoff & Rubinoff LLP consulting engagement
2016	April 1	Massage Therapy Centre Inc. (MTC) begins operations
2016	September 30	Purchase of Pure Substance Inc. (Pure)
2016	November 28	CPA starts work at RSI
2016	November 30	CPA visits a massage therapy centre
2016	December 3	CPA attends board meeting
2016	December 5	<i>Current date</i>
2016	December 15	Decision required re: Opal's purchase offer for Lavish's shares
2017	January 31	Potential closing date for RSI's sale of Lavish

Changes at RSI and related companies:

1. Due to the differences between RSI and Lavish, including vision, atmosphere, client base, services provided, and price structure, RSI decided to continue to operate Lavish under its own brand in a separate corporation; however, administrative functions were consolidated.
2. RSI and Forevermore Fit Limited (FFL) signed an agreement to operate massage therapy centres. MTC was set up as a corporation and began operations on April 1, 2016.
3. The franchising option is being considered again.
4. RSI purchased 100% of the shares of Pure for \$7.5 million; the transaction closing date was September 30, 2016.

5. RSI successfully arranged financing for the purchase of Pure. 75% was financed with private debt financing with Cummings Inc. (Cummings). Interest is due annually and principal is due at the end of five years; collateral includes the assets of Pure and a guarantee by RSI's shareholders. The remaining 25% was financed by shareholder loans.

**APPENDIX I (continued)**  
**DECISIONS AND ENVIRONMENT: TIMELINE AND UPDATE**

Other update:

Growth in the Nova Scotia economy has been very strong and is forecast to continue for the next three years. Employment rates have shown steady improvement. The strong economy has led to rising labour costs, higher interest rates, and increasing prices. Two international, high-end hotel chains are opening new hotels, with spas, in Halifax in 2017.

## APPENDIX II TRANSCRIPT OF MEETING

Date: December 3, 2016

In attendance: Sally Rice, CEO and shareholder  
Bob Gallant, shareholder  
Lisa Wiley, shareholder  
CPA

Sally: Welcome, everyone. And, a special welcome to my new assistant, CPA.

I would like us to discuss the priority items facing RSI, and any other issues you would like to add.

First, RSI has received an offer from Opal Hotels (Opal) to purchase Lavish. Opal owns a large chain of hotels; the plan is to open its own brand of spas in many of them, starting with its Halifax hotel. Opal is anxious to get started as it believes that providing a high-end spa is becoming an important competitive advantage in the tourism market. Opal requires a decision by December 15. Here is a copy of the offer (Appendix III).

Bob: My understanding is that Lavish is doing quite well in terms of profit, cash flow and growth, so the offer would have to be good.

Sally: Yes, but our lease expires on December 31, 2017, and will be difficult to renew, given Opal's desire to open its own spa. Let's get CPA to provide an opinion on the offer. CPA, please review my notes and the analysis I started (Appendix IV), and provide your assessment of the consequences of selling to Opal, highlighting any issues we should consider before making a decision.

After we acquired Pure, I started researching other growth opportunities. I have identified several businesses that I see as having potential for strong growth, and have compiled a list of planned acquisitions for RSI (Appendix V).

Bob: Really? Have you identified how we will finance these acquisitions?

Sally: Yes. On the assumption we sell Lavish, those proceeds, along with the ongoing cash flow we receive from MTC and Pure, should provide the funds to invest in these new opportunities. Based on results so far, I believe the earnings and dividends from Pure will pay the interest on the debt related to Pure, and hopefully will provide enough extra funds to invest in these projects.

**APPENDIX II (continued)**  
**TRANSCRIPT OF MEETING**

- Sally: Now that we have acquired Pure, we are a much larger company. We went from revenue of approximately \$2.6 million to \$22.1 million, which is an increase of 850%! Being larger should make it easier to borrow funds, as we can leverage our equity.
- Lisa: Growth has always been a key objective of ours, and size is certainly one measure of success. Does the additional debt with Cummings change the way we assess any new deals? I think we need to limit the amount we put into new investments to no more than \$500,000 in total.
- Sally: Well, our debt load is higher, so we definitely need to consider how much more debt we are willing to take on. I am certain RSI's shareholders will agree that, if we want growth, they have to forgo dividend income! The board should consider stopping the payment of dividends and reinvesting those funds in RSI.
- Lisa: Are you expecting shareholders to put in more money? Some shareholders weren't too happy about having to do that for Lavish and again for Pure. I suppose we could also consider adding shareholders and, if individual shareholders need cash flow, they could sell some of their shares back to RSI.
- Bob: Before we go too far down this path, can we come back to the investments? I am not sure we ever envisioned growth through multiple investments, in various forms and levels, in other businesses. And, I agree with Lisa, that there should be a maximum amount invested.
- Sally: Maybe we never discussed this specifically, but it is a fast way to grow. Of course, we will need to implement monitoring mechanisms, target return on investments, etc. If we plan it right, I think we can invest in most of what I've listed all at once. I am also investigating launching a massage and esthetics academy, which would provide education and work-placement training. However, I am counting on you, CPA, to provide an opinion of all my plans, and provide some preliminary comments on how each investment fits with RSI, as well as any other points you consider pertinent.
- Sally: Okay, let's discuss MTC next. As specified in the agreement (Appendix VI), a management committee was set up. We met on July 1, and our second meeting is scheduled for next week. We will be discussing the first six months' results and any issues that either joint venture partner is having with the joint venture agreement. Here is a copy of an analysis of MTC's internally prepared financial statements that I started (Appendix VII).



**APPENDIX II (continued)**  
**TRANSCRIPT OF MEETING**

Bob: I'm surprised to see that we are ahead of schedule in terms of opening centres. I don't recall approving that many centres being opened. Also, the net earnings are disappointing compared to budget. I'm curious to know how Barbara, the new manager, is doing.

Lisa: I went to our massage therapy centre the last time I was at FFL and was impressed by the service. The massage was great and the facilities look very clean and modern. I'm happy to report that the signage and pamphlets clearly show that MTC is associated with RSI. I also appreciated getting a discount as a member of FFL, and earning points!

Sally: CPA visited an MTC location and met with Barbara (Appendix VIII). I've asked for comments on Barbara's performance and on MTC's results. I want to make sure that RSI's interest in this joint venture is protected. If there are any issues that need to be raised with FFL, I need to know about them before the meeting.

Before we move on, are there any other issues to discuss?

Lisa: The incentive plan that we have been considering for managers and employees.

Sally: Yes, we really need to make a decision. As our arrangement with Barbara includes a bonus plan, let's start with what we expect her to accomplish in order to earn that bonus. We need Barbara to be motivated to work on retention of the existing employees, right? Is there anything else we want or need her to achieve?

Bob: A strong bottom line. There are many options: bonuses based on revenue or profit, equity ownership, or some combination of these. Maybe we should look at Lavish's plan. We might learn from their experience.

What about the MTC employees, especially the massage therapists? They should get something too, such as discounts on products or services, or paid days off or training. At previous meetings, we've talked about different ways to compensate staff. I understand that Opal employees get discounts on accommodations across the entire chain.

Sally: Perhaps we can also learn something from Pure. It's a different industry, but they don't have an issue with attracting and keeping employees. I recall Matthew explaining why, but the details escape me.

**APPENDIX II (continued)**  
**TRANSCRIPT OF MEETING**

Bob: I've read research stating that companies that offer stock options have higher return on equity, increased productivity and higher profit growth than those that don't. It seems that companies that offer equity ownership, and include their employees in decision-making, perform even better.

Sally: CPA, please provide your thoughts on which form, or forms, of compensation might be suitable. The joint venture will want to compensate Barbara so that she performs to the satisfaction of both joint venture partners, but we want to ensure that the compensation plan also helps RSI meet its objectives.

Now, let's discuss franchising. We put the idea on hold while MTC and Pure got underway. We can consider doing the franchising ourselves or we can look at an alternative. I recently spoke with the CEO of Health and Wellness Inc. (HAWI). HAWI is an international company that operates several franchises, focusing on personal health. If HAWI was the franchisor, RSI would receive a revenue stream of 4% of gross revenue from HAWI without having to provide any direct investment. HAWI believes that RSI's price structure and range of services will provide an appropriate level of profits to franchisees. HAWI expects to sell and support a large franchise network, and that the franchises will be owned and operated by massage therapists. RSI would provide knowledge, training, and other services directly to the franchisees at market rates.

Lisa: This option sounds better than developing the franchise network ourselves. Is there a downside?

Sally: I'm not sure. I think the 4% RSI would earn is a little less than if we did it ourselves and HAWI would keep the fees related to start-up that would be charged to the franchisees. HAWI is confident that, by leveraging its existing network and infrastructure, it can sell more franchises and create efficiencies in terms of advertising, administration and quality control. Before we ask our accounting group to do a more detailed analysis, CPA will review the offer to determine whether we should pursue it, highlighting the pros and cons of this offer, compared to our doing the franchising ourselves.

Bob: The offer sounds good. We would be building our brand with little or no investment.

### **APPENDIX III PURCHASE OFFER FOR LAVISH SPA INC. SHARES**

Opal will purchase Lavish's shares for \$1.5 million.

Closing date: January 31, 2017

Payments: \$300,000 on closing, and \$300,000 on January 31 of each of the next four (4) years.

#### **Non-compete clause**

RSI or its current shareholders is prohibited from operating or investing in (directly or indirectly) a spa in a hotel or resort, for 10 years (excluding the provision of a management contract to operate Opal's spas). Neither RSI, nor its shareholders, will use Lavish's customer data in any manner.

#### **Staff**

Opal will offer Lavish's employees a position at comparable terms to their existing employment, and will provide employees with a signing bonus of \$1,000 and a retention bonus of \$2,000 one year after the purchase date.

#### **Pure products**

Opal will continue to use Pure's products, provided that the price is competitive with that of similar-quality products.

**APPENDIX IV  
SALLY'S NOTES ON PURCHASE OFFER  
FOR LAVISH SPA INC. SHARES**

- The present value of the proceeds<sup>9</sup>, net of income tax, is approximately \$1.2 million.
- We can use the net amount received on closing (around \$215,000) for my new investments, and I expect we can borrow from the bank against the long-term receivable portion.
- Opal appreciates that we have developed a loyal staff and clientele base, and has offered to retain our employees. Opal has also agreed to honour all outstanding gift cards.
- If we proceed with the sale, Opal has offered RSI a management contract. RSI would receive a fixed fee plus a percentage of the spa's net earnings. The initial contract would be for a five-year period.
- Lavish's net earnings were estimated at approximately \$225,000 for fiscal 2016 which was a surprisingly large increase compared to 2015. Our accounting group is working on a detailed valuation using this information. From what I've heard, spas have historically sold at between three and five times EBITDA. I think Lavish's value is therefore somewhere between \$1 million and \$1.6 million if we continue to operate it, regardless of the location.
- If we decide not to sell, our lease with Opal will expire on December 31, 2017. Despite our renewal option, I expect that Opal will want the space, and that we will have to find a new location, at a higher rental rate.

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<sup>9</sup> Interest rate of 6% based on rate RSI negotiated with its private lender; as Opal is a large chain, it appears reasonable that it is not a high credit risk.

**APPENDIX V  
INVESTMENT OPPORTUNITIES**

Name Description of business	Organization and financial information	Investment opportunity
<p><u>Footcare @ Home Ltd.</u></p> <p>Provides foot care to seniors and others in clients' homes; in operation for 10 years; has a mix of full-time and part-time staff; employees use their personal vehicles to provide the service</p>	<p>Private corporation – sole shareholder; revenue growth 200% per year for past three years</p>	<p>Owner wants to retire; RSI would purchase 100% of the shares for \$175,000</p>
<p><u>All Natural Beauty</u></p> <p>Hair and nail salon that uses only natural, chemical-free products; operates one location in downtown Halifax</p>	<p>Sole proprietorship</p>	<p>Owner is a hair stylist who is not enjoying operating a business; RSI would purchase the assets for an estimated cost of \$100,000 and open similar locations</p>
<p><u>Mobile Massage</u></p> <p>Provides massages to clients in their home and office; relies heavily on word-of-mouth and social media for referrals; independent contractors (massage therapists) provide the service; managed from a small office with two administrative employees</p>	<p>Private corporation – sole shareholder</p>	<p>Owner will sell 49% of shares if she is kept on as manager; RSI would purchase the shares for \$112,500.</p>
<p><u>New You!</u></p>		

Name Description of business	Organization and financial information	Investment opportunity
Provides nutrition counselling and dietician services; started by owner five years ago as a part-time business; has grown beyond her expectations	Private corporation – sole shareholder	Asking price is \$250,000. The owner does not want to leave her full-time day job to devote more time to this growing business, and approached me to see if RSI would get involved in the business in some way.
<u>Particular Pets</u> Spa for pets; offers grooming, nail clipping, walking and massages for dogs, cats and other pets; operated from the owner's farm property	Sole proprietorship; growing at an outstanding pace; "hot market segment"	RSI would purchase the name, logo and customer list for \$60,000 and open in a new location; owner would sign a non-compete clause.

**APPENDIX VI  
EXCERPTS FROM MASSAGE THERAPY CENTRE INC.  
OPERATING AGREEMENT**

**NOTE: The only significant changes from the draft are as follows (strikethrough for deletions and underline for additions to the agreement):**

### **Management**

FFL and RSI will form a joint venture partnership, MTC, which will operate Massage Therapy Centres in FFL locations. There will be a management group comprising one member each from RSI and FFL and the manager hired for MTC. This management group will make all major decisions for MTC.

Profits will be shared equally between FFL and RSI. ~~Operating cash flows from the partnership will be distributed to the partners quarterly. Based on the manager's recommendation, and approved by both FFL and RSI, cash distributions to FFL and RSI will be made quarterly.~~

### **Identity, image and branding**

The centres will be called ~~Forevermore Fit Limited~~ Massage Therapy Centres. The massage therapy centres will be identified with both FFL and RSI's names appearing in the logo and advertising.

### **Locations**

FFL and RSI will decide jointly where to set up the massage therapy centres.

FFL and RSI will each invest \$15,000 per small centre and \$60,000 per large centre that is opened to cover opening costs and provide initial working capital (including uniforms, linens and supplies). FFL and RSI will ~~also~~ jointly guarantee any financing required by MTC.

### **Human resources**

The MTC manager will receive a salary and bonus, to be negotiated when hired. RSI will provide the initial training for massage therapists ~~(for no charge)~~. Subsequent professional development will be provided by RSI for a fee, at market rates.

Only qualified massage therapists will be hired.

**APPENDIX VII**  
**DRAFT FINANCIAL STATEMENTS FOR MASSAGE THERAPY CENTRE INC.**

*Massage Therapy Centre Inc.*  
*Six months ending September 30, 2016*

	Budget	Actual	Actual as % of Budget
<b>Revenue</b>			
Therapy revenue	\$ 550,000	\$ 452,498	82%
Product sales	87,000	99,549	114%
Total revenue	<u>637,000</u>	<u>552,047</u>	<u>87%</u>
<b>Direct costs</b>			
Wages and benefits	247,500	226,249	91%
Cost of product sales	43,500	58,734	135%
Membership discount and loyalty points expense	33,000	37,685	114%
	<u>324,000</u>	<u>322,668</u>	<u>100%</u>
<b>Gross profit</b>	<u>313,000</u>	<u>229,379</u>	<u>73%</u>
<b>Expenses</b>			
Therapist training	0	11,250	n.a.
Marketing	31,500	37,812	120%
Administrative and other costs	96,000	101,635	106%
	<u>127,500</u>	<u>150,697</u>	<u>118%</u>
<b>Earnings before income tax</b>	<u>\$ 185,500</u>	<u>\$ 78,682</u>	<u>42%</u>



**APPENDIX VIII  
NOTES FROM CPA'S MEETING WITH  
MASSAGE THERAPY CENTRE INC. MANAGER**

- Discussed the internal financial statements for the first six-month period (Appendix VII). MTC has opened two large centres and three small centres, more than planned. Barbara and Andy Johnson, are both eager to open more centres, quickly, and have prepared a priority location list.
- The budget is based on the number of massage centres actually opened (flexible budget).
- Earnings did not meet budget. Barbara says this is mainly because revenue is not as high as budgeted.
- Barbara explained that she and Andy plan to offer promotional discounts to increase business volume, and thereby sales. She is trying to decide on the appropriate discount and is considering 10% to 30%. The promotions would be for limited time periods, perhaps tied to openings of new centres. She told me she recently read that *“more than 80% of online group-coupon users try a business for the first time because of the coupon.”*
- Barbara also discussed one of her biggest challenges—hiring and keeping trained massage therapists. She has hired people who have taken a massage course but are not licensed. She discussed the staffing problems with Emily, RSI's manager, who said she has similar problems. Apparently, Lavish is not having these problems, which Emily says might be because the pay rates, tips and bonuses are higher.
- Barbara also explained that hiring and training massage therapists is time-consuming and disruptive; clients like to have the same massage therapists, as they develop a relationship and feel they receive better treatments, which helps with client retention.

**APPENDIX VIII (continued)**  
**NOTES FROM CPA'S MEETING WITH**  
**MASSAGE THERAPY CENTRE INC. MANAGER**

- I toured the facilities and observed the following:
  - A client paid with a credit card and was given cash back, which she requested be given to the therapist for a tip. Barbara said they do this as a service to the client, and that it is just a cash-in/cash-out transaction.
  - Accounts receivable are primarily from insurance companies for direct billings. Rejected billings are transferred to a client account receivable. Barbara tries to collect from the client, but it is often difficult and is not pursued. Barbara says she is not concerned with write-offs because getting the business is most important, and collecting 80% of the fee is better than nothing.
- Because there was an opening, Barbara offered me a session with one of the massage therapists. She said staff are being paid regardless, so they may as well be doing something. She mentioned that the fitness facilities staff can drop by for massages when the therapists are not busy. Sometimes a client shows up just after a staff massage begins, and decides to leave rather than wait.
- Each location has one full-time therapist; part-time therapists are scheduled for busy periods, and are expected to be available “on call” at other times. Because it is hard to get and keep good employees, it is not unusual to have the full-time therapist work overtime, and thereby get paid at a higher rate.
- Barbara commented that FFL staff and MTC massage therapists seem to think that Pure product samples are “free,” and that she has, on occasion, seen staff taking some linens and robes home. She is reluctant to deal with these issues as hiring qualified staff has been difficult, and she does not want to risk upsetting the ones she has.
- Barbara asked me to check on the status of her bonus. When hired, she was told she would receive a bonus based on the performance of the centres. She and Andy agreed on a bonus of 4% of gross revenue and \$2,500 for each centre that reaches a minimum pre-tax income of 25% of total revenue. Andy promised that any bonus amount earned would be paid out one month after the end of the quarter. Barbara is disappointed that she hasn't been paid any bonus so far. She believes that if she concentrates on increasing the gross revenue she will be able to recoup her full bonus by the end of the year.

**APPENDIX F**

**DAY 1 (VERSION 2) – MAY 25, 2016  
MARKING GUIDE AND SAMPLE CANDIDATE RESPONSE**

**MARKING GUIDE  
REJUVENATING SPA INC. (RSI)  
VERSION 2**

**Assessment Opportunity #1 – Summative Assessment #1 – Situational Analysis (Update)**

**Competencies**

*2.3.2 Evaluates the entity's internal and external environment and its impact on strategy development.*

*Enabling:*

*2.1.1 Defines the scope of the problem.*

*2.1.2 Collects and verifies relevant information.*

*2.1.3 Performs appropriate analyses.*

**For Summative Assessment #1, the candidate must be assessed for reasonableness of attempt:**

**Yes** – The candidate used a reasonable situational analysis when analyzing the major issues facing RSI.

**Unsure** – The candidate attempted to use a reasonable situational analysis when analyzing the major issues facing RSI.

**No** – The candidate clearly did not use a reasonable situational analysis when analyzing the major issues facing RSI.

*Competent candidates complete a sufficient situational analysis. The focus should be on describing the factors that have changed that will affect the decisions to be made (e.g., high-end hotels being built in Halifax) and on the key factors that are relevant to the decisions to be reviewed, so a recap of the mission and vision statements and relevant key success factors (KSFs), as well certain elements of the SWOT analysis, is appropriate.*

**SITUATIONAL ANALYSIS**

External

- *Mindful massage and meditation sessions*
- *Increase in male clients*
- *Urban wellness retreats*
- *Increase in tourism spa visits*
- *Customers choose a spa based on value, ambiance, reputation, and proximity*
- *Economic growth in next three years, interest rates up*
- *Employment rates increasing, suggesting it may be more difficult to hire/retain staff*

- New high-end hotels being built in Halifax

#### Internal

- *RSI's shareholders want to grow and be in a position to sell if and when they chose to do so. Expansions are seen as ways to grow sensibly*
- *Contribute to community and healthy living by making more spas available*
- *Promote social responsibility and environmental sustainability*
- *Hire and keep quality staff*
- *Negative working capital, but no liquidity issues; RSI and Lavish appear to have strong CF; both are profitable, but their debt load appears fairly high*
- Purchased Pure using a large amount of debt
- Opened MTC with FFL
- *Staff retention at RSI was a problem in Cap 1; still a problem, now at MTC*
- Some shareholders don't want their dividends to stop
- RSI and Lavish still don't have their mission and vision aligned

(Note: *Italicized points* are from Capstone 1.)

### **Summative Assessment #2 – Analyze the Major Issues**

**For Summative Assessment #2, the candidate must be assessed for reasonableness of attempt:**

**Yes** – The candidate completed a reasonable assessment of the major issues facing RSI.

**Unsure** – The candidate attempted to complete a reasonable assessment of the major issues facing RSI.

**No** – The candidate clearly did not complete a reasonable assessment of the major issues facing RSI.

#### **Competencies**

*2.3.3 Evaluates strategic alternatives.*

*Enabling:*

*2.1.3 Performs appropriate analyses.*

*2.1.4 Integrates information to investigate each potentially viable solution or conclusion.*

This summative assessment is based on Assessment Opportunities #2 to #5.

**Assessment Opportunity #2 (Strategic Issue #1 – Lavish (Keep or Sell Shares to Opal Hotel))**

*Competent candidates will complete both qualitative and quantitative assessments of this alternative. Candidates are expected to demonstrate an understanding of the quantitative information presented in the case; to explain, in a manner that board members will understand, what the qualitative decision factors are; and to draw conclusions and make recommendations based on a combination of the quantitative and qualitative analyses.*

*Quantitative analysis – Assess the financial offer from Opal Hotel: do a comparison of \$1.2 million to \$1-1.6 million; do a quick valuation to confirm \$1-1.6 million is a reasonable value; and estimate cash flow and amount of debt repayment.*

*Qualitative analysis – Discuss the pros and cons of keeping and selling, highlighting the risks, and integrate back to the situational analysis.*

Quantitative

- NPV of proceeds if sell (\$1.2 million) versus value if continue to operate it:
  - valuation: 3–5 times net earnings of \$225,000 for 2016; assuming net earnings equals EBITDA (candidates could use Cap 1 info to estimate depreciation and interest and calculate a value)
  - estimated EBITDA for the year times the multiplier of 3–5 gives a range of values of \$1 million to \$1.9 million, depending on how calculated
- Compare amount calculated with \$1.5 million offer that has a present value of \$1.2 million and conclude whether the offer is reasonable (and question rates and multiple of 3-5 times EBITDA)
- Estimate the cash flow impact and discuss the debt amount owing (from Cap 1)
- By adjusting the net income for changes, the offer is higher than the value of the company
- Will contribute \$215,000 towards other investments if choose to pursue them

Qualitative (pros and cons)

Selling Lavish:

- ✓ If Opal opens other spas, it may result in increased Pure sales
- ✓ Opal is a successful business, so low risk of non-payment
- ✓ Sally is in favour
- ✓ Opal will retain existing staff
- ✓ Location is a key success factor, and it is not guaranteed after this year because the lease may not be renewed
- ✓ It is possible to keep a management contract, which brings in revenue

- × Selling is inconsistent with growth objective
- × Tourism is growing
- × Non-compete may limit future acquisitions
- × Losing customer list may limit franchising success

Keeping Lavish (additional points):

- ✓ Continued income from the profitable Lavish spa
- × Increased competition from new high-end hotels
- × May have to move anyway once lease expires

### Assessment Opportunity #3 (Strategic Issue #2 – MTC Performance)

*Candidates are expected to evaluate the performance to date for MTC.*

*Quantitative analysis – Assess the financial statements (looking at key elements – profit margins, etc.; compare actual to budget and explain changes using case facts).*

*Qualitative analysis – Discuss the current operations and how Barbara is influenced by the bonus plan, including the control issues and incentive/bonus plan for Barbara and the staff; address management committee (versus Andy) decision-making.*

#### Quantitative

- Actual as a percentage of budget
  - Discussion of revenue expectations (too high for short-term)
  - Discussion of increase of expenses
- Key metrics (wages as percentage of revenue; COGS/gross margin; discounts as percentage of revenue)
- Recalculate Barbara's bonus based on the formula provided in the case

#### Qualitative

- Discount program – impact on RSI brand; consistent with mission; impact on revenue/profits; fixed costs of therapists (from Cap 1) means any additional revenue will be beneficial; consideration of how discount program would mix with current discount program for FFL members
- Barbara's (manager's performance):
  - Discussion of control issues
    - Loss of 20% of fees that are uncollectable
    - Cash given to customers for credit card transactions
    - Losing business because staff are getting treatments
    - Based on ratios, lines and inventory are missing or wasted
    - Training costs need to be controlled
  - Barbara is focused only on top-line revenue
  - Barbara is not managing staff very well – part-time staff are on call; staff are taking samples and getting free services; unlicensed staff are being hired (may expose them to lawsuits by clients)
- RSI's interests are not being considered – additional centres opened without RSI approval; management bonus has been established without RSI approval; discounts agreed to by Andy and not RSI
- Decisions are being made with Andy and not the management committee (as required by agreement); RSI needs to be more involved



- Barbara's bonus program – cost of Andy's approved bonus plan; problems with the Andy-approved bonus (short-term only; top-line only; question of whether the bonus agreement is even legitimate if not approved; the impact on Barbara's performance level if it's taken away)
- Employee bonus plan – needs to be dealt with because it's an ongoing issue, and recruitment/retention of licensed therapists is a key success factor
- Equity ownership as a bonus (complex in private entity; not suited to joint venture)

#### **Assessment Opportunity #4 (Strategic Issue #3 – Franchising)**

*Candidates are expected to discuss whether RSI should pursue the franchising opportunity with HAWI or pursue franchising on its own.*

*Quantitative analysis – Analysis of revenue/profitability comparing with HAWI compared to without.*

*Qualitative analysis – Consider the pros and cons of franchising with HAWI. Candidates can compare with RSI franchising on their own, which they would have analyzed in Capstone 1.*

#### Quantitative

- Analysis of revenue (6% in Cap 1, 4% in Day 1); analyze/discuss start-up fee revenues given up versus expenses if run, since forgo both if use HAWI (using Cap 1 info – Exhibit #10)
- Attempt to quantify how much revenue each franchise could generate

#### Qualitative (pros/cons)

- ✓ Aligns with growth objective (a situational analysis link)
- × Lose control of product (pricing, spa's atmosphere, quality of products, etc.)
- Need to conduct more due diligence of HAWI
- ✓ Possibility of additional revenue for RSI through training of franchisees
- × Lose control of screening process and rate of growth
- × Quality control concerns
- ✓ No financial investment from RSI
- ✓ Quicker growth using HAWI expertise
- ✓ Less time and work required from RSI
- × Risk of losing money if franchises operated by RSI, no risk with HAWI
- × After franchises will be set up by HAWI, HAWI will be in a position to make decisions/ have more power over RSI

**Assessment Opportunity #5 (Strategic Issue #4 – Possible Acquisitions)**

*Candidates are expected to discuss the potential acquisitions that were brought forth by Sally. The quantitative and qualitative information provided is limited.*

*Quantitative analysis – Recognize the \$500,000 constraint Lisa/Bob want and financing ability.*

*Qualitative analysis – Consider the limited information provided by Sally to determine whether the acquisition is worth pursuing further; link back to situational analysis*

Quantitative

- Calculate how much of \$500,000 limit given by shareholders is spent
- Consider the \$215,000 in cash flow that would come in from selling Lavish; these cash flows can be used for the acquisitions

Qualitative

- Five different investments totalling \$697,500; however, RSI is considering a limit of \$500,000 at this point. If any of these are pursued, RSI should consider how it could negotiate the proposed terms to its advantage (e.g., buy shares versus assets or own 51% versus 49%)

Footcare @ Home Ltd.

- No synergies with RSI's existing business. Clients would be different from RSI's.
- It may serve clients to similar to Mobile Massage's.
- It appears to be growing quickly, which is in line with RSI's growth objective.

All Natural Beauty

- RSI does not currently operate hair and nail salons, although some spas do.
- The "all-natural, no chemical" mandate aligns with RSI's goal of environmental sustainability.
- RSI may not have the resources to open multiple locations of this business.

Mobile Massage

- Arguably fits with mission; fits with RSI's objectives (links this statement back to actual case facts).
- Owning less than 50% means not controlling the business.
- Using contract therapists is different than RSI's model.
- The use of social media is something that RSI could incorporate into its business.

### New You!

- Health-related and in line with RSI's objective (to promote healthy living).
- Clients who are interested in massage and fitness (MTC-FFL connection) may also be interested in these types of services.
- But what would RSI really be paying for? (sole proprietorship; part-time business only – essentially paying for goodwill if owner is leaving)

### Particular Pets

- Not related to the same goals as RSI, and no synergies with the existing business.
- Need a new location and staff.

### Massage Academy

- Source of trained therapists (link to KSF).
- May cost a lot to implement; no budget provided, so need to consider capital investment in light of debt and CF requirements.

**Assessment Opportunity #6 – Summative Assessment #3 (Conclude and Advise)****Competencies**

*Enabling 2.1.4 Integrates information to investigate each potentially viable solution or conclusion.*

*Enabling 2.1.5 Recommends and justifies a solution or conclusion based on an integrative view of information for the situation.*

**For Summative Assessment #3, the candidate must be assessed for reasonableness of attempt:**

**Yes** – The candidate provided reasonable conclusions for each major issue.

**Unsure** – The candidate attempted to provide reasonable conclusions for each major issue.

**No** – The candidate clearly did not provide reasonable conclusions for each major issue.

*Competent candidates will complete a logical conclusion that is consistent with their analysis.*

Candidates should provide conclusions and advice that align with RSI's vision, mission, objectives, and constraints.

The conclusions should **integrate** the analysis for all major issues (Lavish, MTC, franchising, and possible acquisitions).

All recommendations should be consistent with the analysis performed.

As well, an overall conclusion should be presented to provide a sense of completion to the report (a wrapping-up and prioritization of the recommendations).

Candidates should provide a conclusion for each of:

**A) Sale of shares of Lavish**

- Conclude that this does not align with the objectives of RSI but is financially attractive.

**B) MTC operations**

- Discuss the financial results and whether any changes need to happen.
- Discuss and recommend actions to address the control issues.

- Barbara's bonus plan: Suggest an appropriate plan. Recruitment and retention is an issue, there should be an incentive to focus on this issue. Change focus from top-line revenue to profits so there is some monitoring; and ensure monitoring of expenses too.
- Employee bonus plan: Suggest an appropriate plan that improves recruitment and retention.
- Management decision issue: Conclude that Andy and Barbara should no longer make all decisions on their own; they should consult the management committee on certain decisions (which decisions are major enough to require consultation is to be decided).

#### C) Franchising with HAWI

Discuss whether to franchise with or without HAWI (or possibly whether to even pursue franchising at this point)

#### D) Possible acquisitions

- Discuss which, if any, acquisitions RSI should pursue (rank them, working within the \$500,000 limit).

Take a step back re: financing: Consider the fact that RSI has taken on new debt and how that plays into its decisions.

The response should display good professional judgment. Suggesting that further information is required is acceptable as long as it is justified and consistent with the analysis.

### Assessment Opportunity #7 – Summative Assessment #4 (Communication Hurdle)

**For Summative Assessment #4, the candidate must be assessed for reasonableness of attempt:**

**Yes** – The candidate adequately communicated his/her response.

**No** – The candidate clearly did not adequately communicate his/her response.

Insufficient communication in a candidate's response would generally include some of the following:

- Reader needs to re-read sections several times to understand.
- It is not clear what point the candidate is trying to make.
- Quantitative analysis doesn't make sense because of a lack of labelling or illogical ordering.
- Response includes offensive amounts of spelling and grammatical errors.

- Candidate uses unprofessional language.

### Summative Assessment #5 (Overall Assessment)

**For Summative Assessment #5, the candidate must be assessed in one of the following, based on their overall performance:**

**Clear Pass** – Overall, the candidate provided an adequate response clearly meeting the minimum standards for each of the summative assessments.

**Marginal Pass** – Overall, the candidate provided an adequate response, with some errors or areas of omission, but including the underlying key concepts.

**Marginal Fail** – Overall, the candidate provided an attempt at a response, with several errors or an incomplete analysis.

**Clear Fail** – Overall, the candidate did not provide an adequate response because the response was deficient in multiple areas.

To be assessed a Pass, candidates are expected to perform adequately in all the summative assessments and demonstrate that they addressed the issues presented by the Board.

Markers are asked to consider the following in making their overall assessment:

- Did the candidate step back and see the bigger picture, and then address the broader issues identified?
- Did the candidate prioritize the issues by discussing the major and minor issues in appropriate depth?
- Did the candidate use both quantitative and qualitative information to support their discussions and conclusions?
- Did the candidate use the appropriate tools to perform quantitative analysis?
- Did the candidate use sufficient case facts (current case and Capstone 1 case) about the external and internal environment to support his or her discussions?
- Did the candidate communicate his or her ideas clearly, integrating and synthesizing the information?
- Did the candidate add value with his or her conclusions on the different matters?

**SAMPLE RESPONSE- RSI VERSION 2**

*Below is an actual passing candidate response.*

**REPORT**

To: Sally Rice, CEO

From: CPA, Assistant to the CEO

Subject: Situational Analysis Update and Analysis of Major Issues Presented

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This report is intended to guide the board in their decision making by providing financial advice and direction. This advice is taken in light of RSI's mission and vision, the good of the shareholders, and the company's specific objectives. My analysis and recommendations are presented below:

**SITUATIONAL ANALYSIS****External environment:**

- Spa trends have stayed the same since my consulting engagement, with continued growth and a focus on mindfulness. RSI is aligned with this trend across its brands by providing high-quality services, with a focus on well being.
- There is currently a high demand for luxury spas. Opal Hotel's bid to purchase the Lavish brand, which falls into the luxury category, is evidence of the competition in that space.
- Employment rates have shown steady improvement along with increased labour costs. This will provide a challenge to RSI, as hiring and retaining qualified employees is a key success factor, and historically been difficult. A tougher job market for an employer and higher labour costs means RSI's board must be vigilant around hiring and compensation.
- The economy in Nova Scotia has been strong, with a forecast for continued growth in the

next three years. This is important for RSI as growth is a key success factor for them, and they continue to expand in the near future.

- Interest rates have been rising with the strength of the economy. If RSI plans to continue growth and seeks financing for these options, they must consider increased financing costs.
- Two high-end hotels, with spas, are opening in Halifax in 2017. Adding more spas in Lavish's market space will add competitive pressure and potentially siphon sales away from the location in the Opal Hotel.
- Organic and all-natural products have historically shown strong demand and commanded a premium in the market. Pure's products fit this market space well with its certified organic offerings.

### **Internal environment:**

#### **RSI**

- Mission and vision remain the same:
  - Mission: *"To provide professional quality services while developing relationships with our clients, our community and the environment"*.
  - Vision: *"to provide exceptional client-centered spa services in an atmosphere that is relaxing and in a manner that is environmentally friendly and sustainable"*.
- Franchising opportunity available again for RSI, this time through a franchise management company rather than directly by RSI. This is a growth vector for the RSI brand, something shareholders are interested.

#### **Lavish**

- Lavish brand remained separate, as it had a different vision and client base than RSI. Its administrative functions were amalgamated with RSI.



- Lavish is doing well as a brand and operation with cash flow and growth both looking positive.
- The lease on the Lavish space in the Opal Hotel is up in 2017, with renewal unlikely.

### **MTC**

- The MTC joint venture agreement proceeded, with a management group being formed between RSI, FFL and MTC.
- MTC is ahead of schedule with opening centres, much more quickly than anticipated. It is unclear if all centres were approved for the joint management committee.
- MTC is co-branded between RSI and FFL, allowing for more exposure and growth of the RSI brand through the joint venture.
- Net earnings are below what were anticipated for this period, which negatively affects its contribution to RSI's value.
- FFL and management at MTC have a bias see rapid growth as it adds direct value to FFL, and MTC management is rewarded for revenue growth.

### **Pure**

- RSI purchased Pure for \$7.5 million in September, 2016.
- Pure has no issues continuing to attract and retain new employees.

### **Key Success Factors:**

- Quality, professional services are essential to RSI's success.
- Training and maintaining high quality staff is a key success factor for RSI and Lavish, but now MTC as well. RSI needs to ensure the right staff are in place otherwise they cannot provide the quality of service desired.

- Growth continues to be a key success factor for RSI. Growth increases the value of the companies, which increases shareholder value - the primary goal of shareholders.

### Stakeholders

- No changes to the shareholder base or their main objective of adding value to RSI for future income or potential sale.
- Shareholders contributed funds via loans for 25% of the acquisition of Pure. They were not pleased about having to further contribute cash to fund the growth of the company. They are seeking income and value growth, but given they are all older, they are more averse to higher risk growth ventures and depleting personal capital.
- Dividends are important to shareholders as they provide income, so stopping future dividends would be contrary to the goals of many shareholders.

### ANALYSIS

#### Issue Identification: Sale of Lavish to the Opal Hotel

Opal Hotels has offered to purchase Lavish from RSI. Below is my assessment of selling Opal and further issues to consider before making a decision.

#### Quantitative:

Valuation based on earnings multiple:

	<u>Low</u>	<u>High</u>
EBITDA of Lavish	\$225,000	\$225,000
Earnings Multiple	3	5
<b>Earnings Valuation</b>	<b>\$675,000</b>	<b>\$1,125,000</b>

- The valuation of Lavish, as calculated using the earnings multiple method above, indicates the value of the company between \$675,000 and \$1,125,000.
- The offer for the sale of Lavish is \$1,500,000 - that is \$375,000 over the highest assessed value.
- The cash would be delivered part on closing, part staggered in the next 4 years. However, as Opal has a low credit risk, the bank is likely to lend against the value of the future receivable, allowing the cash to be taken up front.

**Qualitative:**

- The offer is above what Lavish is current valued at, even at the high end, which would provide extra cash for RSI to pursue other ventures with potentially higher returns.
- There is a non-compete clause in the contract that would prohibit RSI or its shareholders from operating or owning another spa in a hotel or resort. This would be a significant hindrance to future growth in their spa business, as location is a key success factor, and hotels and resorts provide excellent venues for spas. As noted in the situational analysis, spas are becoming a competitive advantage for hotels, so its likely there will be growth in this space.
- Pure products would continue to be used the spas, as long as they met quality and price constraints. While Pure is generally competitive, this does not provide real value for RSI as there is no guarantee of continued use.
- Staff will likely carry over at the location and receive a signing bonus and retention bonus. With Opal operating a space in an already competitive labour market, RSI will now be competing with them for qualified associates. If Opal recruits away from RSI, RSI's quality may suffer, which is contrary to their mission and would likely harm the

brand.

- Opal has offered a management contract for RSI, so there would be some continued participation in the operations and revenue growth, albeit limited.
- The lease on the space that Lavish occupies is up for renewal in 2017 at Opal. If Lavish did not sell to Opal, they would not likely renew the lease, forcing Lavish to move. As location is a key success factor, and there are two new hotels with spas moving into Halifax in the short-term, it would be difficult for Lavish to similarly establish itself as a brand.

**Conclusion:**

- RSI should attempt to negotiate the with Opal to see if it can guarantee Pure products continue to be used, which will guarantee sales and add value for RSI. As well, they would see if its possible to have exceptions to the Spa and Resort non-compete for cities where Opal does not operate hotels.
- Overall though, I recommend that RSI proceed with the sale of Lavish. The competitive landscape is getting tougher and the cash received can be deployed in alternative investment vehicles to foster more growth. This is in line with shareholder's objectives and will ultimately add value to RSI.
- Given the short time frame to respond to Opal and the significant impact on RSI, I recommend this information be distributed to shareholders as soon as possible and a shareholder meeting be held promptly to answer questions.

**Issue Identification: MTC Performance and Issues with the Joint Venture**

An assessment of MTC's current performance is required, as well a summary of outstanding issues with the Joint Venture.

**Quantitative:**

- Therapy revenue is only 82% of the expected budget, which sets a low ceiling for earnings. A potential cause for this is massages being given for free to FFL employees, causing some clients to leave as their appointment must be delayed to accommodate the ongoing massage.
- Products sales is 114% of budget, which is favourable, but the volume of product sales is so much lower than therapy that it is not a significant mitigating factor in the total revenue variance, 87% of budget. This may simply be understate budgeting, or there may be a stronger demand in the market for the products on offer, notably the organic and natural Pure products.
- Wages and benefits are 91% of the budget. It's likely this was caused by less employees being on staff at any given time. Although, hidden in this negative variance is overtime paid for the full time staff. Having two full time staff instead of one with overtime and several part-time employees may be a better model, costing similar but improving retention.
- COGS was 135% of budget and likely attributed to MTC and FFL employees treating Pure products as "free" samples. This should be remedied to reduce the COGS overage.
  - Even at reduced revenue levels, with COGS at budget of \$43,500, Gross Profit Actual as a % of Budget would increase by 4.8%  
 $(\$58,379 - \$43,500 = \$15,234 / \$313,000 = 4.8\%)$
- Membership and loyalty points expense is 114% of budget. There is no clear reason for the increase here, but it benefits FFL rather than RSI, as FFL members get benefits, while RSI sees none, other than increased cost.

- Marketing is 120% of budget, with clear cause for this unfavourable variance. While general promotional activity is going on, there is no evidence of a single issue inflating this expense. The use of funds in marketing should be investigated.

**Qualitative:**

- MTC has not been doing well for a variety of reasons, including those addressed above, it should seek to critically assess the sources of these variances.
- Cash given back on a credit purchase disrupts cash flow, as MTC has to wait for the credit card transaction to settle before they can receive funds. Cash back on credit purchases should not be permitted. Credit tips should be allowed instead for that use case.
- The lack of zeal with which receivables are pursued is concerning. Barbara is focused on client growth, rather than cash flow and shareholder value.
- The management group is meant to make all major decisions for MTC and where to put new locations. As more locations have opened than were understood by RSI management, this approval process has not been followed. This presents risk for RSI, as it is liable for initial investments in new centres, as well as guaranteeing financing required. If new centres are opened without their knowledge, there may be obligations they are unaware of and unprepared for.
- Barbara and Andy are interested in opening more locations, and have a bias to continue rapid growth. Their expansion plans may not be in line with RSI's capital availability, so their list of locations should be assessed and jointly approved.
- Promotional discounts have been suggested and can help a company obtain new customers, however, it can also be costly if the redemption rate is high, particularly with already depressed sales figures and inflated expenses.

- Retaining quality employees, a key success factor for RSI, and MTC, is difficult. The people currently hired need to be trained, and are sometimes not licensed massage therapists, which is offside the agreements language regarding "qualified" massage therapists.

**Conclusion/Recommendation:**

- RSI should discuss the root causes of the performance variances at the next management meeting, and where cause is evident, develop a plan with the group to remediate the issues. In particular, the free massages that cause issues for clients, and the "free" use of products.
- The management group should confirm the definition of "major" decisions and ensure that all future location expansion is confirmed by all three members of the committee.
- Do not initiate the promotional discounts until the base operation model is proven. While growing the customer base is important, providing quality services and building repeat business is essential to success.
- Discuss training and employee retention issues with RSI as they have experience in these areas. Investigate the possibility of outsourcing training.

**Issue Identification: MTC Compensation Strategies**

An opinion on the form of compensation is required for Barbara and employees is required. It should be aimed to the satisfaction of both joint venture partners and help RSI meet its objectives.

**Barbara:**

- Barbara's current bonus is negotiated as 4% of gross revenue and \$2,500 for each center

with at least pre-tax income of 25% revenue. Given that, here current bonus should be \$22,082 (4% of Gross Revenue=\$22,082). On average, the centers pre-tax income as a % of revenue is only 14.3% ( $\$78,862/\$552,047=14.3\%$ ) so she would not receive the second piece.

- The board believes that employee retention and a strong bottom line are Barbara's priorities. Given the current structure of her bonus plan, her incentives are not aligned with the board's goals which can be detrimental to MTC achieving the goals of RSI's shareholders, in particular, increasing shareholder value. A revenue focused approach will push for top line growth with less concern for actual profit and cash flow, as noted above by her apathy towards client collections.
- Barbara's bonus should be more balanced between the two goals. A possible solution for this is to have a fixed bonus pool, with the payout based on performance towards board management established KPIs. To align with RSI's goals, the KPIs should focus on bottom line earnings (such as achieving at least 80% of budget), cash flow (such as 95% of client receivables collected within 60 days) and employee retention (such as average employee tenure greater than 4 years, with a grace period as tenure builds up).

**Employees:**

- Employee compensation has been previously discussed at RSI. A good compensation structure can really enhance the morale of a workforce and improve retention.
- Stock options are a useful type of compensation, as they can be vested over time to encourage retention, and align the success of the company with the success of the employees. However, they are hidden costs on the income statement, and will cause



dilution to existing shareholders.

- Cash bonuses are good in that they are readily available to employees and are easily valued. Linking them to a company KPI, or several, ensures alignment between the company and employee. These bonuses can also take the form of RRSP matching, which can potentially allow for a more tax effective bonus for employees.
- Allowances for professional development are another great compensation method. These are not taxable to the employee, as they benefit the employee, and help MTC deal with one of its biggest challenges, having quality and trained employees.

### **Conclusion:**

- The overall quantum of the bonus pool should be assessed by MTC's management group so they can better understand its impact on earnings.
- I recommend that MTC pursue a cash and professional development based bonus system for employees, linked to similar KPIs to Barbara to ensure alignment.

### **Issue Identification: Franchise Opportunity**

RSI has been approached with an offer to have their operations franchised by a third party (HAWI). Below I have included an assessment of the pros and cons of this option, as well as doing RSI franchising on its own.

### **Outsourcing Franchising**

#### **Pros**

- No direct investment required to startup franchises, that is handled by the HAWI. This is good for RSI and it eliminates the capital requirements of franchising.
- HAWI can leverage its already large franchise network in order to find good candidates

to expand the RSI brand. This networking power is beyond the abilities of RSI on its own.

- All ongoing maintenance requirements are handled by HAWAI (i.e. operating manuals).

### **Cons**

- With only receiving 4% of the gross revenue received under the contract, RSI is likely to receive fewer proceeds from outsourcing the franchising.
- Startup funding provided by franchises, which can be sizable, is retained by HAWI. This diminished the cash received by RSI for franchising operations.
- No direct control over franchises means limited ability to direct operations and coach values for RSI. There is the potential for franchises to be running "off brand", contrary to RSI values.

### **In-house Franchising**

#### **Pros**

- RSI would have complete control over the franchising operations and how the brand was handled by franchises. It could control the rate of growth and closely monitor results. It would be able to ensure that its locations were abiding by RSI's values.
- Can add as many or few franchises as RSI wants in order to scale growth. Working directly with franchises helps spread brand evangelism.

#### **Cons**

- Franchises must be screened and their suitability assessed. This can be difficult to do and is not an area of expertise for RSI.
- A franchise manager would likely need to be hired in order to deal with the operations.
- Initial capital investment would be required by RSI to get the franchising operations up

and running, as well, it would not receive the startup funding provided by franchises.

**Conclusion:**

- Given the above noted pros and cons, I recommend that RSI pursue the franchise agreement with HAWI. It is a good vector for growth, a key objective for shareholders, and frees RSI and its shareholders of the capital burden of franchising the brand.
- Leveraging their network, HAWI would be able to spread RSI's brand much farther than RSI alone, which will add value to the brand.

**Issue Identification: Investment Opportunities and Financing**

There are several investment opportunities available. I have provided a preliminary assessment of the options, other pertinent points and where reasonable, and opinion. These options have been assessed with how they fit into RSI's strategic direction

**Footcare @ Home Ltd.**

- 200% year-over-year growth is incredible and represents a huge opportunity for RSI.
- The structure of the purchase is amenable, as the entire operation would be purchased and it could carry on as it did before. Diligence would need to be done to ensure that no undocumented but outstanding liabilities exist at the time of purchase.
- Providing foot care to seniors and others in the community is very much in line with RSI's mission, as it further develops the relationships with clients and the community.
- Given the alignment with RSI's mission and the potential for future growth, I recommend that you proceed with this investment.

**All Natural Beauty**

- The purchase of assets is good for RSI as it is a simple operation of acquiring the assets, however, no location is included with the purchase.

- The natural product focused salon align very well with RSI's mission and vision, as it focuses on its environmental impacts.
- The locations would likely be competitors to RSI spas, as day spas usually offer similar services to hair and beauty salons, so it may be harmful to RSI sales to open similar but competing locations. If RSI wanted to enter the hair and beauty only market space, it could likely move out under its own brand and be successful.
- Given the risk of revenue cannibalization, I recommend that RSI not pursue this option.

### **Mobile Massage**

- The lack of total control in this operation is not ideal for RSI as it will not have complete input on operations.
- The services provided by this operation are substantially similar to those provided by RSI and risks cutting into the customer base of established spas.
- This business hires independent contractors who can work anywhere, which may draw already scarce employees from RSI spas.
- There is no established brand, as its very referral based, so there is no tangible marketing benefit to the purchase.
- Given that it will likely cut into RSI's existing customer base and employee pool I recommend that RSI not pursue this option.

### **New You!**

- The structure of the purchase is good, as it will allow for RSI to take over total operations. Again, diligence is required to ensure there are no hidden liabilities.
- Nutrition counselling is align with RSI's mission and vision, as it further develops the relationship with the client and provides additional quality to the relaxation offered.

Additionally, it may differentiate RSI from other spas and provide them with a competitive advantage.

- A well established business with proven growth potential, this will provide RSI and new market to grow into while differentiating current offerings.
- Given the potential for growth and the good strategic fit, I recommend that RSI invest in this venture.

### **Particular Pets**

- This is a new area of business for RSI, so it would allow for differentiation in the offerings provided. However, as Bob noted, RSI was not originally intended to grow through many different investment vehicles, so this is not aligned with the growth scheme originally envisioned.
- The current market for this service is growing quickly, which is exactly what RSI is interested in, so this could provide value there.
- The purchase only provide the name, logo and customer list. All of the operations would need to be taken on by RSI. As it has no experience in this area, it would be a risk to attempt to start this operations from scratch.
- These types of services were not likely envisioned in the RSI mission, where its focus was crafted with people in mind, so this is not likely aligned with the strategic goals of the shareholders.
- Given RSI's unfamiliarity with this industry and the misalignment with RSI strategic direction, I recommend that you not pursue this investment.

With these two recommendations, only \$425,000 of cash is used in the investment, well below the limit of \$500,000 suggested by management. These opportunities are aligned with

RSI's mission and vision, and will provide growth for the company, helping it realize a key success factor.

### **Financing**

Given the above investments amount of \$425,000, RSI will need to finance these purchases. If Lavish is sold, as recommend above, the after-tax cash from that expansion would provide \$215,000 in cash. The receivable from Opal Hotel could be used as collateral for further borrowing, so the remaining \$210,000 would be provided by that collateralized loan.

This also means that no changes are needed to the dividend payments, and no additional capital it required of shareholders. As noted in the situational analysis, they wanted neither of those outcomes, so this is a good solution from the shareholder's perspective.

### **Massage and Esthetics Academy**

- Of all the future investment opportunities mentioned, I believe that the Massage and Esthetics Academy is actually the best option strategically.
- Both RSI and MTC have consistently noted how difficult it is to recruit and maintain qualified employees. Failure to do so affects their ability to execute on their objectives and abide by their mission. Unqualified employees simply can't provide "quality services".
- Qualified employees are a long established key success factor for RSI and an academy would be able to provide RSI with a guaranteed pool of employees, allowing them to provide top quality service. This is supported by the strong employment rates in Nova Scotia and a upward trend for the economy for the next three years, as noted in the situational analysis.
- The school could incorporate community support, by offering a lower priced training spa,

and use Pure products, further integrating operations and spreading the word about the Pure brand and increasing usage and awareness. Both of these options align with RSI's mission, in particular building relationships with the community and the environment.

- With the addition of two new spas in Halifax, in the luxury hotels, and with the sale of Lavish, there will be many positions to fill and maintain going forward. So, even if a student doesn't work at RSI or MTC, they'll have gone through our school and been exposed to Pure products.

### **Conclusion**

- Given the analysis above, I recommend that RSI pursue the two ventures above, *Footcare @ Home Ltd.* and *New You!*, as they are aligned with RSI's mission and vision and will support future growth.
- I also recommend that RSI seriously consider the viability of a Massage and Esthetics Academy as it is aligned with RSI's mission and would provide them with a competitive advantage in the market, help them achieve their key success factors, reducing growth risk and ultimately add shareholder value.

**APPENDIX G**

**DAY 1**

**CHEI VERSION 1 – MAY 25, 2016**



**Case****(Suggested time 240 minutes)****Update**

It is now April 24, 2018. House prices are on the decline and the Canadian home construction market is weak with 2017 housing starts only reaching 184,000. However, Canadian condominium sales have been reasonably strong for the last four years. The trend towards condominium living is expected to continue. In addition the trend towards “green living” and “green building” is starting to gain momentum. Interest rates are forecast to remain low. The Canadian federal government, and most provincial governments, are restraining their spending more so than two years ago, due to deficit reduction policies. Thus, one of the continuing trends in government contracting is the use of public-private partnerships (P3s). This trend is spreading into the not-for-profit sector, and there is more variety in partnership projects being proposed. While road and bridge construction projects have been the most traditional applications of P3s in the past, some investors are predicting a broadening of the types of projects.

CHEI’s consolidated results have gone from a net income after tax of \$28.88 million in 2016, to \$15.38 million in 2017 and a loss of \$24.48 million in the first quarter of 2018 (Q1). CHEI has drawn about \$1 million on its line of credit. Internally prepared divisional financial statements and other information is provided in Appendices I and II.

CHEI’s mission and vision remain as they were and financial targets remain the same as they were in 2016. However, to reflect the possible new direction CHEI might take, the board is open to revising the mission and vision statements for the next annual meeting.

**Highway 507 update**

CHEI purchased Highway 507 for \$300 million, financed by the Infrastructure Financing Corporation (IFC) and based on IFC’s terms. The highway’s financial results are reported as a separate division, and the cost of the highway is being amortized over 50 years on a straight-line basis. The highway loan repayments (principal plus interest) to IFC are \$11,976,000 per year, and the current loan balance is \$266,328,000.

Soon after CHEI took over the highway in January 2017, two of the largest employers at the Oshawa end of the highway shut their plants, mainly due to an economic slowdown. In early 2018, CHEI’s woes continued when part of Interchange 64 collapsed, preventing traffic from entering a portion of Highway 507 for a few weeks. As interchanges are the province’s responsibility, CHEI has filed a legal claim against the province for loss of income of \$1.2 million. Then, in mid-February 2018, a record winter snowfall combined with sudden warm temperatures resulted in the highway being flooded, so there was no toll traffic for a 24-kilometre section for six weeks while the damage was repaired. On the positive side, toll charges are as expected based on the actual traffic volumes. Apart from the above-noted events, the highway’s toll volumes have been consistent across the seasons.

It seems that the two employers are reopening their Oshawa plants very soon, which should make the original figures forecasted by the traffic consultant achievable again. However, the board is worried about sustaining the effects of another disaster and is therefore thinking of selling Highway 507, as allowed in the agreement. CHEI has received two preliminary offers, which are detailed in Appendix III.

Even though CHEI's experience with Highway 507 has not been positive thus far, CHEI's board still believes that P3s are low-risk and worth pursuing. CHEI is currently looking at bidding on several upcoming federal and provincial P3s.

### **Homes division (Homes) update**

Two of Homes' competitors declared bankruptcy last year. In spite of a continued good reputation in the industry, Advantaj Homes is struggling. Elspeth Mark says she has never seen demand for the company's homes so low. She has tried everything she can think of in terms of marketing, promotions and pricing, with little success. She is hearing that young professionals no longer want to purchase starter homes, preferring either larger homes or condominiums. The Toronto and Vancouver condominium markets are booming.

Homes has not purchased any new land since 2015. The Belman tract of land was not purchased. Land is now available for 10-15% less than it cost two or more years ago. Management is frustrated because CHEI does not have the cash to buy up land now, while it is less expensive. The Board is particularly concerned with the financial trend of the Homes division and wants to know if it's worth saving.

There continues to be concern over CHEI's aging workforce. In the Homes division, over the last two years, 27 employees quit and 40 were laid off in cutbacks. Kirk Reilly has tried to keep most core employees on staff, saying "We need to try to keep them." The current employee breakdown is in Appendix I.

### **Heavy Engineering (HE) division updates**

The HE division went ahead with Klang P3 project and is having continued success with Awani and its other projects.

In 2017, the HE division built and sold three self-storage facilities as a pilot project. These facilities are simple buildings comprised of many small storage units. Purchasers rent out the storage units to individuals and businesses.

**Board meeting – April 25, 2018**

Penelope Navire: I have asked CPA, from Chuck Poisson Smythe Management Consultants, to help us again. We need to figure out how to quickly get CHEI back on track.

I want the board to be reminded of the important decision factors we should be considering, so I've asked CPA to highlight the changes from the previous situational analysis and to provide a broad assessment of the issues facing CHEI using the information provided. CPA's assessment should identify significant factors we might not have considered and additional information that is critical to obtain before we make our decisions. Where there is sufficient information to do so, CPA should suggest a course of action.

First, do we need to sell off Highway 507? We have two very different offers on the table.

Sisi Nagy: I'm opposed to selling it. The problems we had this year were unusual — we aren't likely to have them again! If we increase the toll by 10% and find a way to reduce our operating costs, we'll be making money. Of course, that assumes that the two closed plants reopen.

Kathy Fernandez: Are you sure those were unusual events? With climate change, we need to consider the possibility of more freak events. The cost of maintaining the highway is killing us, and is more than we expected. I think we should cut our losses and sell.

Penelope Navire: I would like CPA's thoughts on whether CHEI should keep Highway 507, as well as an assessment of the two purchase offers we have received.

Kathy Fernandez: I see better opportunities for us. We agreed as a board that we wanted to increase private-sector revenues. We are in the early stages of discussions about purchasing Carter Developments Inc. (CDI) (Appendix IV). Based on an operational review our accounting staff estimates that CDI is worth between \$24 and \$34 million but I'm not sure if the offer is a reasonable one or if the deal even makes sense for us.

John Higman: It builds condominiums, right? Since we have done a few consulting contracts on condominium projects, the next logical step is to start building them. Buying a company like CDI makes sense.

Penelope Navire: You might be right. I would appreciate CPA's thoughts on the offer and on our findings thus far. CPA's suggestions as to any additional information about CDI that we should obtain are also being sought.

Next, the board needs to decide if we should continue to build and sell self-storage facilities. I personally am not ready to abandon this venture yet, and want to look at the options further. We could consider operating these facilities ourselves. We are still looking for that regular and consistent income stream that we had hoped Highway 507 would provide. If HE is the division that builds them, we have the capacity to build 15 to 20 facilities per year. Perhaps CPA can provide thoughts on the feasibility of pursuing this venture and the strategic fit, and help us figure out the key decision factors. Additional information on the proposal is in Appendix V.

John Higman: Many users are seniors and students, and, mostly, condominium owners who are strapped for storage space. This is a simple concept that works well. But would we stop selling self-storage facilities to others if we decide to start operating some ourselves?

Charles Monet: Maybe. Instead of always dealing with fluctuating company profits, depending on the success of our latest construction project, this could provide us with a stable source of revenue. I wonder, though, if this venture is better suited to Homes than HE.

Sisi Nagy: I think we should drop the whole idea — the margins are too small. I think we really need to focus on saving our Homes division. We have always survived during economic slumps, and we should be able to get through this one too. Maybe it's time to let some people go. If we let go 60% of the workforce, severance pay would average \$100,000 per employee based on CHEI's severance policy and an average salary of \$80,000.

Charles Monet: I am new on the board, but it appears that CHEI has been too dependent on various levels of government for revenue. I suggest expanding our Homes division into new market segments to increase sales. Since government is more financially constrained, CHEI should try to benefit from P3s in the other markets. They are becoming more and more common. Since we are developing expertise in P3s, I suggest we include the pursuit of profitable P3s in our mission, and pursue more of them. I saw one we could bid on that is a good fit with Homes, and that would help steady our income (Appendix VI). I'd appreciate CPA's thoughts on this project and if it makes sense for CHEI to pursue it further.

Penelope Navire: Since Homes is the core business, along with HE, we should do whatever we can to save it. I don't know if we can financially support pursuing CDI, the self-storage facilities and the P3 project. I suspect we cannot do them all. Let's have CPA prioritize our options, and provide us with thoughts and suggestions as to what we should be doing and why. Obviously, we need to consider the current market conditions and our current financial position.

**APPENDIX I**  
**UPDATED INFORMATION**

*Canada Heavy Engineering Inc.*  
*Heavy Engineering (HE)*  
*Divisional Income Statement*  
*(in thousands of dollars)*

	Q1 2018	2017	2016
Revenues	\$ 115,425	\$ 422,413	\$ 439,101
Direct cost of activities	95,572	358,206	367,967
	<u>19,853</u>	<u>64,207</u>	<u>71,134</u>
Expenses			
Sales, general and administration	9,014	35,145	32,601
Interest	65	148	105
Amortization	160	654	698
Total expenses	<u>9,239</u>	<u>35,947</u>	<u>33,404</u>
Income before taxes	<u>\$ 10,614</u>	<u>\$ 28,260</u>	<u>\$ 37,730</u>

*Canada Heavy Engineering Inc.*  
*Homes*  
*Divisional Income Statement*  
*(in thousands of dollars)*

	Q1 2018	2017	2016
Revenues	\$ 8,640	\$ 78,425	\$ 101,125
Cost of homes sold	8,502	73,798	88,383
	<u>138</u>	<u>4,627</u>	<u>12,742</u>
Expenses			
Sales, general and administration	3,080	10,402	8,800
Interest	490	1,504	1,702
Amortization	89	412	412
Total expenses	<u>3,659</u>	<u>12,318</u>	<u>10,914</u>
Income (loss) before taxes	<u>\$ (3,521)</u>	<u>\$ (7,691)</u>	<u>\$ 1,828</u>

**APPENDIX I (continued)**  
**UPDATED INFORMATION**

*Canada Heavy Engineering Inc.*  
*Homes Division*  
*Additional Statistics*  
*For the years ended December 31*

	<u>Q1 2018</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
Active development projects at period end	2	4	5	6
Land inventory in acres at period end	24	99	141	198
Homes started in period	21	399	402	561
Homes sold in period	45	390	480	580
Homes backlogged at period end	50	74	65	143
Revenues (in thousands of dollars)	8,640	78,425	101,125	131,944
Gross profit (in thousands of dollars)	138	4,627	12,742	19,660
Average revenue per unit (in thousands of dollars)	192	201	211	227
Gross profit %	1.6%	5.9%	12.6%	14.9%
Sales, general & administration expenses as % of revenue	35.6%	13.3%	8.7%	5.8%

The Homes employee breakdown is as follows:

<u>Homes division employees</u>	<u>Dec. 31, 2015</u>	<u>Q1 2018</u>
Executives	4	4
Sales people	22	14
Project directors	24	20
Supervisors	61	43
Purchasing	19	17
Others	58	23
	<u>188</u>	<u>121</u>

**APPENDIX I (continued)**  
**UPDATED INFORMATION**

*Canada Heavy Engineering Inc.*  
*Highway 507*  
*Divisional Income Statement*  
*(in thousands of dollars)*

	Q1 2018	2017
Revenues (Note 1)	\$ 9,994	\$ 42,780
Provincial fee	(340)	(1,455)
Net revenue	<u>9,654</u>	<u>41,325</u>
Expenses		
Maintenance	1,644	6,446
Repairs (Note 2)	30,355	10,450
Snow clearing	2,145	3,402
Insurance	875	3,500
Resurfacing	385	1,590
Accounting and administration	200	801
Interest	2,160	8,640
Amortization	1,500	6,000
	<u>39,264</u>	<u>40,829</u>
Income (loss) before taxes	<u>\$ (29,610)</u>	<u>\$ 496</u>

**Notes:**

1. Based on initial forecasts, 2017 revenues were expected to be in the \$50 million range.
2. Included in first-quarter 2018 repairs is the unexpected cost of \$27.8 million due to flood damage in February.



**APPENDIX II**  
**BUDGET AND OTHER INFORMATION**

*Canada Heavy Engineering Inc.*  
*2018 Comparison of Budget to Actual*  
*(in thousands of dollars)*

Quarter 1 Results								
	Homes		HE		Highway 507		Total	
	Budget	Actual	Budget	Actual	Budget	Actual	Budget*	Actual
Revenues	25,250	8,640	106,250	115,425	11,000	9,654	142,500	133,719
Direct costs	22,473	8,502	88,188	95,572	7,856	35,404	118,517	139,478
	2,777	138	18,062	19,853	3,144	(25,750)	23,983	(5,759)
Expenses								
Sales, general and admin.	2,901	3,080	8,753	9,014	200	200	11,854	12,294
Interest	288	490	31	65	1,629	2,160	1,948	2,715
Amortization	100	89	160	160	1,153	1,500	1,413	1,749
	3,289	3,659	8,944	9,239	2,982	3,860	15,215	16,758
Income (loss) before taxes	(512)	(3,521)	9,118	10,614	162	(29,610)	8,768	(22,517)
Head office costs								1,959
Total loss before taxes								(24,476)

\*excludes Head office cost

CHEI's quarterly budgets are simply one-quarter of the 2018 budget amounts.

Head office costs are on budget.

**APPENDIX II (continued)**  
**BUDGET AND OTHER INFORMATION**

*Canada Heavy Engineering Inc.*  
*Consolidated Financials*  
*Financial Analysis*

	<u>Mar. 31, 2018</u>	<u>Dec. 31, 2017</u>	<u>Dec. 31, 2016</u>
Current ratio	1.63	2.00	2.09
Quick ratio	0.64	0.87	0.91
Long-term debt-to-equity	1.98	1.75	0.11
Total debt-to-equity	2.75	2.38	0.82
Annualized:			
Days receivable (days)	35.8	32.6	35.7
Days in Inventory (days)	32.4	38.7	41.4
Days payable (days)	34.6	40.1	43.5
Total Equity (in millions)	\$100.5	\$125.0	\$117.9

Number of Shares issued: 23,100

### **APPENDIX III PRELIMINARY OFFERS TO PURCHASE HIGHWAY 507**

#### **JJ Ventures Inc.**

JJ Ventures Inc., a Canadian public company that has about 40% foreign ownership and investments in many businesses, has made a tentative offer of \$265 million for Highway 507, of which 80% would be payable immediately. The remaining 20% would be repayable in five years' time with interest, at 4.1%.

The proposal requires the seller to be responsible for the following:

1. Any shortfall of calendar-year toll revenue below net \$35 million, for five years post-purchase
2. Any maintenance and repairs in excess of \$30 million per calendar year, for five years post-purchase
3. Any highway damage due to acts of God, for three years post-purchase
4. Any legal actions against the purchaser related to highway operations, for six months post-purchase

#### **Parmalea Equity Group Inc.**

The Parmalea Equity Group Inc., a Canadian private equity firm with significant financial backing, offers to purchase Highway 507, conditional upon a complete engineering survey and financial review.

The offer is for \$250 million, either in cash or with partial debt assumption. Parmalea is willing to take over 50% of CHEI's Highway-507-related debt, subject to approval by CHEI's lender. CHEI is responsible for settling the balance.

CHEI must provide its highway maintenance algorithms, reflecting CHEI's intellectual property, free of charge.

## **APPENDIX IV CONDOMINIUM BUILDER – CARTER DEVELOPMENTS INC.**

While the Carter family is no longer involved in managing Carter Developments Inc. (CDI), three members of the family own all of the outstanding shares. The shareholders would prefer to receive cash, but will consider a 100% share offer if the valuation of their shares and CHEI's can be agreed upon, and they receive a minimum of \$2 million in dividends each year. One seat on the board would be held by one of the Carter family members.

CDI operates in Montreal, Vancouver, Calgary and Edmonton. Its stated mission is: "*with the strong values of a family-owned enterprise, we are inspired to make the world a better place to live.*" Its vision is to be "*the leader in real estate development, construction and management, with operations throughout Canada.*" CDI has been a leader in "green building" for over a decade. CDI's website says the company has always completed its projects on time and that, in 2012 it won the Top Condo Builder award from the Montreal Construction Association, and in 2014, a Leadership in Energy and Environmental Design (LEED) "gold" certification for its latest Vancouver condominium project. Its condominiums are priced at starter-to-average prices. The company has consciously decided to not pursue business in the highly competitive Toronto market.

CHEI has yet to receive interim financial statements for CDI. CDI's January 31, 2018 year-end financials, with after-tax earnings of \$4.6 million, will be signed off by their auditor in about three weeks' time. CDI's after-tax earnings for the year ending January 31, 2019 are estimated to increase and be in the range of \$4.8 to \$5.1 million on revenues of about \$70 million.

CHEI met with CDI's three biggest suppliers in structural steel, foundations, and finishing. While all three spoke positively about CDI, one supplier asked if CDI would still require the "extra payments" if they were purchased by CHEI.

CDI typically completes three or four condominium construction projects annually that range in size from 50 to 200 units and are built on one-half to one acre of land. CDI has eight land units in inventory and is awaiting zoning approval from local governments for three of them. The required paperwork for these three zoning applications was submitted quite late.

CDI has a strong marketing team. In the last six months, CDI has increased its sales inducements, offering customers incentives such as season's tickets to sporting events, large-screen televisions, and even modestly-priced cars. The inducements, which CDI usually obtains at a significant discount, have proven to be quite effective in drawing customers.

**APPENDIX IV (continued)**  
**CONDOMINIUM BUILDER – CARTER DEVELOPMENTS INC.**

The backlog of units sold and not yet delivered is at an all-time high, although only slightly higher than in the prior two years. Land in inventory, in contrast, is a little lower than in the prior years. There have been a few construction delays on the Connaught project, but management says they still expect it to be nearly on time and within budget. Delays were caused by a variety of problems. Some were within CDI's control, some were not but management is not concerned as most condo projects are completed after expected completion dates.

CDI's current projects are as follows:

Current projects	Construction Start date	Expected completion date	Total units	Units sold
Connaught	August 3, 2017	October 31, 2018	200	2
Haven	November 6, 2017	December 31, 2018	58	27
Pearl Towers	April 1, 2017	May 31, 2018	195	131

## **APPENDIX V SELF-STORAGE FACILITY VENTURE INFORMATION**

This business was started as a pilot to see if it could provide a new revenue source for CHEI. Three self-storage facilities were constructed and sold. Although the individual storage units are inexpensive to build, the margins are small. More money can be made from the rental side of the business. Issa Chewani and Eva Jones, from HE, believe that CHEI should build, and then operate, several self-storage facilities across Canada, and perhaps the U.S. Due to their simplicity, these facilities are inexpensive to maintain and operate.

The capital investment required, per self-storage facility, is \$825,000 for land, building, and land preparation costs, of which 80% will be financed, at an estimated cost of \$52,000 per year. Industrial land on the outskirts of town is cheap and easy to find. By not selling, and instead operating the facilities, CHEI's current customers would become its direct competitors, which could affect future facility sales.

Most facilities make additional income by selling moving supplies, and by having attendants help customers to move in or out of their residence. These services can contribute 5 to 6% of rental revenue net of costs. At this point, CHEI is not considering offering these services, as that would require additional staff to be hired at each facility.

Each facility would be 20,500 square feet, of which 18,000 is rentable (190 rentable units). This is 25% larger than most other facilities. An occupancy level of 53% is estimated as break even to cover the fixed costs and loan payments. Jones believes no advertising would be required, believing a 50% occupancy would be easily obtainable in Year 1, and 85% would be achievable thereafter.

At 85% capacity, pre-tax earnings are estimated at \$152,000 a year. A positive net present value of approximately \$45,000 per self-storage facility is obtainable, based on the projections provided by HE to the accounting group. The projections are based solely on HE's experience and knowledge of the three self-storage facilities built and sold, as no market studies have been done.

HE recommends building 15-20 self-storage facilities next year in each of Montreal, Vancouver, Calgary and Edmonton.

## **APPENDIX VI POTENTIAL P3 PROJECT FOR HOMES**

### **Project**

Student rental housing (Housing) for university students, designed, financed, constructed, owned, and operated by private party (Developer).

Housing will be built off-campus on land owned by the university. The university will offer Developer a 40-year lease.

The land must be fully developed into Housing. Developer will build 545 units with 1,145 bedrooms.

Developer will construct the Housing with its own funds and will have sole rights to rent out to tenants the building over a period of 40 years at no additional cost. If preferred, an external, non-profit company could be the tenant of the Housing, and Developer could lease the Housing to that company rather than renting directly to the student tenants.

### **Commencement**

January 1, 2019. The Housing must be in service by July 2020, ready for the fall semester.

### **Student and rents**

Rents are set by the university and will be priced at 20% more than comparable rates for on campus, university-owned bedrooms. At full occupancy, the project should provide a margin between 13-17% depending on cost assumptions.

If student demand is insufficient, the university will be obligated to pay an amount equivalent to the shortfall in rent revenue so that break-even is achieved, for each of the first three years of operation.

Bids will be accepted until midnight, June 30, 2018.

**APPENDIX H**

**DAY 2 SIMULATION – MAY 26, 2016**



**Case**

**Assume the pre-selected role in which you will be formulating your response. Answer all requirements as specifically directed in your role. Within the requirements for each role, candidates are directed to look at specific additional appendices, which are unique to each role. Use only the information you have been directed to refer to.**

**Information that is common to all roles is presented in the “Common information” section. Additional information, customized to each role, is presented in the “Specific information” section.**

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## COMMON – BACKGROUND

Atlantic Shellfish Inc. (ASI) is a privately-held company operating since 1992 and located in Prince Edward Island. ASI harvests, processes, distributes and markets lobsters and red sand clams (clams) to Canada and the United States. It sells primarily to large grocery retailers and restaurant chains that specialize in seafood. ASI's objective is to be a leading supplier of clams and lobsters with a well-known and respected brand name.

ASI is owned 60% by Darrell McDermott and 40% by a group of 50 ASI employees. Seven years ago, in 2010, the group of employees invested \$20,000 each and received a total of 10,000 Class B common shares, allowing ASI to raise \$1 million in equity. Darrell currently owns 15,000 Class A common shares. Having continuously reinvested its profits, ASI has not paid any dividends in over a decade.

When first approached about becoming Class B shareholders, the employee group was promised a return on investment of at least 10% annually in the form of dividends, commencing no later than 2014. The Class B shareholders have recently voiced concerns about the return on their shares. In lieu of the original contract terms, the Class B shareholders are proposing an exchange of their Class B common shares for retractable preferred shares.

The Board of Directors consists of Darrell, who is the CEO and chairman of the board, and seven representatives from the Class B shareholders. The board meets quarterly to review strategy and financial reports.

Today is February 7, 2017. On January 14, 2017, the CFO for the past 20 years passed away. ASI is in the process of hiring a new CFO. For the last four months of the 2016 fiscal year, the CFO had not been well, and was not able to perform his duties. His work was delegated to the accounting staff, including the preparation of the 2016 draft financial statements. ASI reports under IFRS. The draft financial statements are provided in Appendix I.

The board has one committee, an Audit Committee, which meets quarterly to review the statements. The committee met yesterday to review the draft 2016 financial statements before submitting them to the auditors. Extracts from the meeting minutes are in Appendix II.

### Government regulations and industry information

The Canadian Federal Department of Fisheries and Oceans (DFO) regulates the amount of harvest by issuing licences for specific species. A licence has an indefinite life. A nominal fee is paid each year to maintain each licence. The DFO sets the annual "total allowable catch" by species and by region for: 1) inshore fishing; and 2) offshore fishing. These quotas, designated to a particular enterprise, may be transferred, traded or sold.

Offshore fishing is dominated by a few, large integrated companies that, similar to ASI, own large vessels and hold significant quotas. Smaller companies and individuals tend to hold the inshore fishing licenses and utilize smaller boats with less complex equipment. It is industry practice to determine volumes in pounds rather than kilograms.

## **COMMON – BACKGROUND (continued)**

ASI owns one Canadian offshore licence for clams, which allows it an annual quota of 10.8 million pounds of clams; this amount represents 23% of the total allowable offshore catch designated by the DFO. ASI has three Canadian offshore lobster licences, with a total allowable annual quota of 600,000 pounds; this amount represents 28% of the total allowable offshore catch designated by the DFO.

ASI holds no inshore licences, but purchases additional lobsters from suppliers who have inshore licences. In 2016, this totalled a further 1.2 million pounds.

### **Red sand clams**

ASI's sales of clams totalled \$20.5 million in 2016. Clam fishing is not seasonal. During 2016, ASI harvested four million pounds of clams. ASI owns one vessel that is used exclusively for harvesting clams. The clams are taken to the plant to be shelled, blanched, frozen and then shipped.

ASI has been planning to purchase one more vessel that would allow it to harvest its remaining annual offshore clam quota; an additional six million pounds. A German supplier has tentatively been selected to manufacture the vessel at an estimated cost of \$45 million (32 million euros). The processing plant currently has excess capacity available that could be used to process this additional catch.

Darrell recently informed the board that he would be meeting with the bank soon to review the year-end results. Darrell stated that he will ask the bank manager to increase the line of credit in order to help finance the purchase of the new vessel.

### **Lobsters**

ASI's sales of lobsters totalled \$18.5 million in 2016. ASI has two vessels for lobster fishing. Lobster fishing is seasonal, with the peak periods being early spring and late fall. Once the lobsters are caught, they are taken to the plant where they are sized, graded, sorted and inventoried. Some are kept alive in the storage facility for up to three months, allowing ASI to sell live lobsters after the season has ended. This is unique in the industry, as no competitor has similar storage facilities. As customers' orders are filled, the live lobsters are packaged and shipped by overnight courier to ensure that delivery is within one to two days.

### **Supplier bonus arrangement**

In addition to being paid for their catch, inshore lobster suppliers who have been supplying ASI for five years or more qualify for a bonus. Currently, 20 suppliers qualify for the bonus, which is calculated based on a percentage of ASI's lobster profits. The 2016 bonus is substantially less than the 2015 and 2014 bonuses.

Additional information, customized to your role, is presented in your role package.

**REQUIREMENTS FOR YOUR ROLE**  
**(READ ONLY THE ONE SPECIFIED FOR YOUR PRE-SELECTED ROLE)**

**ASSURANCE REQUIREMENTS**

You, CPA, work as an employee of CPA LLP. Recently, you met with Sarah Chin, who is a partner with the firm. CPA LLP will again perform ASI's year-end audit. Although the 2016 year-end audit plan was completed in early September, some additional issues have arisen that may require changes to the plan. This morning, Darrell contacted Sarah to discuss the audit of the draft 2016 financial statements.

Darrell is meeting with ASI's bank manager next week to review the draft 2016 financial statements and covenant compliance. He would like to promise the bank that the final audited statements will be available three weeks from today. ASI's audit committee has expressed some concerns about the initial draft, and Darrell has asked CPA LLP to review the draft financial statements, discuss any accounting issues and identify any accounting adjustments required. Sarah asks you to complete this work.

Sarah says: "I would also like you to assess the risk factors of this engagement, given the current circumstances at ASI, and provide me with your recommended materiality and performance materiality. Be sure to also discuss any changes required to our audit approach. I would like to know whether we will be able to rely on controls again this year, and if not, what procedures we will have to perform."

Sarah is also concerned about the acquisition of Freeze the Shell Co., and would like you to recommend substantive procedures related to the balances at the acquisition date and at year-end as part of your audit plan.

In addition, ASI implemented a new ordering and invoicing system in 2016. Based on discussions with Darrell, there have been many customer complaints regarding incorrect invoice amounts. Dealing with these complaints has added to the accounting staff's workload. ASI would like help in evaluating the system. Sarah asks you to identify any control weaknesses, and to suggest improvements.

Finally, the suppliers are concerned that the amount they are receiving as a bonus is not fair, and feel they are being undercompensated. As such, Sarah has asked you to verify the calculation of the 2016 bonus and to highlight any concerns you have with regards to fairness. The suppliers have also requested that a special report be prepared, asserting that the amount is calculated in accordance with the formula. ASI has consented to CPA LLP taking on the engagement. Therefore, Sarah has asked you to identify potential special reports, discuss their respective advantages and disadvantages, and recommend the option that best meets the needs of the suppliers. She would also like you to design appropriate procedures, based on the special report you recommend.

In addition to the common appendices (I to V), information provided in Appendix VI (Assurance) is relevant for your analysis.

**REQUIREMENTS FOR YOUR ROLE**  
**(READ ONLY THE ONE SPECIFIED FOR YOUR PRE-SELECTED ROLE)**

**FINANCE REQUIREMENTS**

You, CPA, work as a financial analyst for Clarence & Co. (C&C), a consulting firm providing finance and accounting-related services on an as-needed basis to clients. You work closely with Brian Clarence, a partner with C&C, who has recently met with Darrell.

Darrell is meeting with ASI's bank manager next week to review the draft 2016 financial statements and covenant compliance. ASI's audit committee has expressed some concerns about the initial draft, and Brian has asked you to review the draft financial statements, discuss any accounting issues and identify any accounting adjustments required.

Brian would also like you to provide him with an analysis of ASI's financial performance and financial condition for 2016, relative to its competitors.

You are also to look at the recent proposal by the Class B shareholders to exchange their shares. He asks you to assess the impact on the covenants and ASI's cash flows if this proposal is accepted. Additionally, you are asked to outline the advantages and disadvantages of the proposal, from ASI's and the Class B shareholders' perspectives noting any issues you see with the proposal, or modifications that you believe should be made.

Part of the discussion with the bank is arising because ASI is considering an investment in a new vessel to harvest the remaining amount of its clam quota. You are to prepare an analysis of this investment, assuming that the funds are available for this new vessel. ASI uses an after-tax weighted average cost of capital of 12%. The company's corporate tax rate is 25%.

Recently, ASI was approached by a competitor to see if there was interest in ASI purchasing lobster licences for an asking price of \$7.5 million. You are to prepare a valuation to assess whether \$7.5 million is a reasonable price, and if not, to suggest what would be an appropriate counter-offer.

Finally, ASI has a potential new Chinese customer and wants to know what impact this contract will have on ASI if accepted. Specifically:

- The impact on ASI's receivables, inventory and cash flows
- The advantages and disadvantages of accepting the contract

Additionally, since this contract is in U.S. dollars, you are to prepare a brief discussion of how to manage the foreign exchange risks. Options to be considered include forward contracts, futures contracts and purchase options to sell U.S. dollars at a certain price.

In addition to the common appendices (I to V), information provided in Appendix VI (Finance) is relevant for your analysis.

**REQUIREMENTS FOR YOUR ROLE  
(READ ONLY THE ONE SPECIFIED FOR YOUR PRE-SELECTED ROLE)**

**PERFORMANCE MANAGEMENT REQUIREMENTS**

You, CPA, work as a financial analyst for Clarence & Co. (C&C), a consulting firm providing services on an as-needed basis to clients. You work closely with Brian Clarence, a partner with C&C, who has recently met with Darrell.

Darrell is meeting with ASI's bank manager next week to review the draft 2016 financial statements and covenant compliance. ASI's audit committee has expressed some concerns about the initial draft, and Brian has asked you to review the draft financial statements, discuss any accounting issues and identify any accounting adjustments required.

Brian has also asked you to assess several issues at ASI but first he would like you to complete a situational analysis. Furthermore, he would like you to discuss the risks ASI faces and propose a mitigation strategy.

Brian has requested that you then review and critique the existing suppliers' bonus agreement to assess whether this plan appropriately motivates suppliers to meet their targets, is fair and is sustainable. He would like you to outline any other issues or concerns you have regarding the existing agreement, and to make recommendations for changes. If you believe any adjustments to the bonus are required, you are asked to present a revised calculation.

Darrell is considering a bonus plan for key managers, specifically: the CEO, CFO, plant manager and VP of marketing and sales. Recently, ASI's board set new key performance indicators (KPIs) and Brian would like you to suggest appropriate performance measures and types of incentives for these managers keeping these KPIs in mind.

ASI is assessing a possible sales contract with a new Chinese customer. You are asked to evaluate and make a recommendation on the new contract, including a discussion of the benefits and risks of this contract as a new source of revenue.

Recently, ASI has been approached to store, process and package lobsters for a competitor. You are asked to assess the impact of this proposed contract on the current lobster operations. Specifically, Brian has asked you to calculate the total profit earned from the lobster division if the contract is accepted. Finally, you are to discuss the advantages and risks related to this contract, and to make a final recommendation as to whether ASI should accept this agreement.

In addition to the common appendices (I to V), information provided in Appendix VI (Performance Management) is relevant for your analysis.

**REQUIREMENTS FOR YOUR ROLE**  
**(READ ONLY THE ONE SPECIFIED FOR YOUR PRE-SELECTED ROLE)**

**TAXATION REQUIREMENTS**

You, CPA, work as an employee of CPA LLP in the tax group. You work closely with Jim Allen, a partner with CPA LLP, who has recently met with Darrell. CPA LLP has been engaged to assist ASI with its financial reporting and taxation needs. Since you were recently transferred from the accounting group and have accounting and financial analysis experience, Jim has requested that you help him with ASI's requests.

Darrell is meeting with ASI's bank manager next week to review the draft 2016 financial statements and covenant compliance. ASI's audit committee has expressed some concerns about the initial draft, and Jim has asked you to review the draft financial statements, discuss any accounting issues and identify any accounting adjustments required.

Darrell also mentioned that ASI has recently been audited by CRA. First, Jim has asked that you recalculate the taxes payable for 2015, assuming that the CRA auditor adjustments are correct. Next, if you disagree with any of the proposed adjustments, you should explain your disagreements. You should also calculate revised taxes payable based on your disagreements, and indicate what ASI can do about them.

Jim has also asked you to calculate both the taxable income and income taxes payable for 2016. While he realizes these calculations will have an impact on the financial statements, Jim has asked you not to calculate the revised current or deferred income tax balances for now, as he will work on these after all the other issues are taken care of.

In late 2016, the board approved a stock option plan for the key managers. Before the new plan is announced to the managers, Darrell wants to be clear on the income tax implications for the participants. He also wants to understand the tax implications for ASI.

Darrell has also asked the board to consider a defined contribution plan (registered pension plan) or a matching RRSP contribution plan for all employees, and has asked for the tax considerations for this benefit, from both the company's and the employees' perspectives. Jim would like you to include this analysis in your report.

Finally, there is the proposed exchange of Class B common shares. Darrell would like to understand the tax implications of this proposal on ASI, and for the shareholders, not only for the initial exchange but also for the eventual redemption of the new shares. You are not being asked to discuss the financial reporting implications of this transaction. Assume the shares would be qualifying small business corporation (QSBC) shares at the time of the transaction.

In addition to the common appendices (I to V), information provided in Appendix VI (Taxation) is relevant for your analysis.

**APPENDIX I (COMMON)**  
**EXCERPTS FROM DRAFT FINANCIAL STATEMENTS**

*Atlantic Shellfish Inc.*  
*Statement of Financial Position*  
*As at December 31*  
*(in thousands of Canadian dollars)*

	2016 _____ (Draft)	2015 _____ (Audited)
<u>Assets</u>		
Current assets:		
Cash	\$ 720	\$ 1,678
Accounts receivable	3,742	3,581
Advances to suppliers (Note 1)	290	325
Inventory (Note 2)	4,923	4,881
Prepaid expenses	333	541
	_____ 10,008	_____ 11,006
Investment in Freeze (Note 3)	1,754	0
Property, plant and equipment (Note 4)	10,844	11,785
Licences	8,900	8,900
	_____ \$ 31,506	_____ \$ 31,691
<u>Liabilities</u>		
Current liabilities:		
Bank indebtedness (Note 5)	\$ 2,128	\$ 1,288
Trade payables and accrued liabilities	3,054	3,258
Provisions (Note 6)	430	230
Current portion of long-term debt	1,570	1,690
	_____ 7,182	_____ 6,466
Long-term debt (Note 7)	18,531	20,101
Provisions (Note 6)	970	850
Deferred tax liabilities	156	250
	_____ 26,839	_____ 27,667
<u>Shareholders' equity</u>		
Common shares	1,650	1,650
Retained earnings	3,017	2,374
Total shareholders' equity	_____ 4,667	_____ 4,024
	_____ \$ 31,506	_____ \$ 31,691



**APPENDIX I (COMMON) (continued)**  
**EXCERPTS FROM DRAFT FINANCIAL STATEMENTS**

*Atlantic Shellfish Inc.*  
*Statement of Comprehensive Income*  
*For the year ended December 31*  
*(in thousands of Canadian dollars)*

	2016	2015
	(Draft)	(Audited)
Sales	\$ 39,025	\$ 35,671
Harvesting and procurement (Note 8)	23,415	20,750
Processing (Note 8)	3,620	3,455
Freight and other transport	2,406	2,275
Depreciation	2,374	2,360
Cost of goods sold	31,815	28,840
Administrative and selling (Note 9)	4,390	3,510
Total expenses	36,205	32,350
Operating income	2,820	3,321
Finance costs — interest	(1,978)	(2,005)
Dividend income — Freeze	55	0
Foreign exchange gain (loss)	(40)	(57)
Income before taxes	857	1,259
Income taxes	(214)	(315)
Net earnings and comprehensive earnings	\$ 643	\$ 944

**APPENDIX I (COMMON) (continued)**  
**EXCERPTS FROM DRAFT FINANCIAL STATEMENTS**

*Additional Information*  
*(in thousands of Canadian dollars)*

**Note 1 – Advances to suppliers**

These are non-interest bearing, due on demand and secured by the suppliers's catch.

**Note 2 – Inventory**

	2016	2015
Lobsters and clams	\$ 4,023	\$ 3,931
Supplies and other	900	950
	<u>\$ 4,923</u>	<u>\$ 4,881</u>

**Note 3 – Investment in Freeze the Shell Co. (Freeze)**

In August 2016, ASI purchased 18% of the outstanding shares of Freeze for a total cost of \$1,754. This investment has been recorded at cost.

**Note 4 – Property, plant and equipment**

	Land	Building	Manufacturing equipment	Vessels	Total
Net book value					
Balance —					
Jan. 1, 2016	\$ 170	\$ 1,567	\$ 830	\$ 9,218	\$ 11,785
Additions	0	75	300	1,058	1,433
Depreciation	0	(150)	(436)	(1,788)	(2,374)
Balance —					
Dec. 31, 2016	<u>\$ 170</u>	<u>\$ 1,492</u>	<u>\$ 694</u>	<u>\$ 8,488</u>	<u>\$ 10,844</u>
Year-end balances					
Cost	170	5,980	6,240	53,940	66,330
Accumulated depreciation	<u>0</u>	<u>4,488</u>	<u>5,546</u>	<u>45,452</u>	<u>55,486</u>
Net book value	<u>\$ 170</u>	<u>\$ 1,492</u>	<u>\$ 694</u>	<u>\$ 8,488</u>	<u>\$ 10,844</u>

**APPENDIX I (COMMON) (continued)**  
**EXCERPTS FROM DRAFT FINANCIAL STATEMENTS**

*Additional Information (continued)*  
*(in thousands of Canadian dollars)*

**Note 4 – Property, plant and equipment (continued)**

Depreciation is recorded on a straight-line basis, as follows:

Building	40 years
Equipment	15 years
Vessels	30 years

**Note 5 – Bank indebtedness**

ASI has a line of credit, to a maximum of \$3,000, bearing interest at prime + 2% (currently, prime is 3%). It is secured by accounts receivable and inventory.

**Note 6 – Provisions**

The provisions for asset decommissioning costs relate to retirement of vessels and plant facilities. The increase of \$320 over the prior year represents unwinding of the discount, which is recognised over time in profit or loss as a finance cost.

**Note 7 – Long-term debt**

	2016	2015
Marine loan	\$ 5,832	\$ 6,792
Term loan	14,269	14,999
Total	<u>20,101</u>	<u>21,791</u>
Less current portion	<u>(1,570)</u>	<u>(1,690)</u>
Long-term portion	<u>\$ 18,531</u>	<u>\$ 20,101</u>

The marine loan, which is payable in euros, was advanced 10 years ago for the acquisition of the vessel, *Clam*, from a German supplier. The 8% loan is repayable in quarterly instalments of \$210 (150 euros), and matures in 2023. The lender requires audited annual financial statements prepared in accordance with IFRS. The vessel, *Clam*, is security for this loan. Realized foreign exchange gains and losses are recorded through profit or loss, and unrealized foreign exchange gains and losses are insignificant.

**APPENDIX I (COMMON) (continued)**  
**EXCERPTS FROM DRAFT FINANCIAL STATEMENTS**

*Additional Information (continued)*  
*(in thousands of Canadian dollars)*

**Note 7 – Long-term debt (continued)**

The unsecured term loan was advanced five years ago for plant facility and vessel upgrades. The 8.5% loan is repayable in annual instalments of \$730, matures in 2020, and requires the following covenants be maintained:

- The current ratio must be a minimum of 1.0.
- Total debt to EBITDA must be a maximum of 5.0.
- EBITDA to interest must be a minimum of 2.0.
- No dividends are to be paid or new debt issued without prior approval.

**Note 8 – Harvesting and procurement and processing**

Harvesting and procurement includes labour, fuel and repair costs related to operating the vessels. Processing includes the costs of processing lobsters and clams into fresh or frozen packages. Both of these production costs include all direct and indirect materials and labour.

**Note 9 – Administrative and selling costs**

Administrative costs include salaries and benefits, professional fees, occupancy costs and other. Selling costs include advertising, marketing and bad debts.

**APPENDIX II (COMMON)**  
**EXTRACTS OF THE MINUTES FROM THE AUDIT COMMITTEE MEETING – FEB 6, 2017**

All members of the Audit Committee were present at the meeting:

- Dorees Finnigan — employee, Class B shareholder and committee chair
- Caren Jones — external advisor (retired CPA)
- Jacques LeMare — employee and Class B shareholder

The CEO, Darrell McDermott, was also present.

Dorees: Darrell, as a result of the illness and death of the CFO, we have some concerns about the 2016 draft statements and the work performed by the accounting staff for the past four months. In particular, I have questions about the new investment in Freeze. We paid \$1,754,000 for this investment, correct?

Darrell: Yes. A valuation of the company is provided (Appendix III). We purchased 25,000 shares, which gave us 18%. The remaining shares are widely held. If you remember, we were also able to negotiate having two of the five director seats on their board and the ability to participate in policy decisions.

Jacques: I was recently on our oldest vessel, the *Lobster I*. It has deteriorated over the last year and I think this may impact the carrying value of the vessel. As a result, I requested some additional information (Appendix IV).

Caren: There were over \$1 million in additions to the vessels this year. What do these additions represent?

Darrell: In late March, we purchased and installed a new high-tech crane on the *Lobster II*. The *Lobster II* was out of commission for about one week while the new crane was installed. There were also some other costs associated with the new crane (Appendix V).

Dorees: I remember we contracted some development work. Is there an update on this project?

Darrell: In June, ASI entered into an agreement with an independent contractor for some experimental development to improve the blanching process and reduce waste water. To date, the contractor has invoiced for labour, materials and laboratory costs of \$300,000. We recorded these costs as additions to equipment since we will eventually have a new and more cost-efficient process. The contractor has produced a working prototype which has performed well during initial testing. Further testing will be performed this summer to help refine the process.

**APPENDIX II (COMMON) (continued)**  
**EXTRACTS OF THE MINUTES FROM THE AUDIT COMMITTEE MEETING – FEB 6, 2017**

Jacques: What is happening with the leased building that we moved out of in December? Have we been able to settle with the landlord with respect to the lease agreement?

Darrell: Not yet. The landlord is still sticking to the lease agreement, which requires us to pay \$2,500 at the beginning of each month until March 2019. We are paid up until December 31, 2016, and are committed to pay until the lease expires. Unfortunately, this lease has provisions that disallow cancellation or subletting.

Jacques: Will this have an impact on our year-end financial statements?

Darrell: I'm not sure. To date we have just been expensing the amounts as paid.

**APPENDIX III (COMMON)**  
**SUMMARY OF INVESTMENT IN FREEZE THE SHELL CO.**

On August 16, 2016, ASI purchased 25,000 common shares of Freeze for cash consideration of \$1,754,000.

The schedule below indicates the fair values of net assets on August 16, 2016, as prepared by an independent appraiser.

	Carrying value	Fair market value
	<u>                    </u>	<u>                    </u>
<b>Identifiable net assets</b>		
Net working capital	\$ 1,690,000	\$ 1,690,000
Land	1,000,000	2,711,000
Plant and equipment	13,029,000	13,029,000
Customer relationships	0	2,500,000
Long-term debt	<u>(11,147,250)</u>	(11,147,250)
 Total	 <u>\$ 4,571,750</u>	

Freeze has a December 31 year end and follows IFRS. For the period from August 16 to December 31, Freeze reported a net profit after tax of \$750,000. ASI received \$55,000 of cash dividends from Freeze in December 2016, and Freeze was not eligible for a dividend refund on this payment.

The customer relationships will be useful over the next fifteen years.

**APPENDIX IV (COMMON)  
DETAILS REGARDING *LOBSTER I***

Original cost	\$10,000,000
Accumulated depreciation to December 31, 2016	\$ 8,333,350

Remaining useful life is estimated to be four years, with no residual value.

Annual pre-tax cash flows to be generated by the vessel's use for the next four years are estimated to be \$335,000. ASI's pre-tax weighted average cost of capital (WACC) is 14% and its after-tax WACC is 12%.

An appraisal from a local dealer estimated proceeds of \$1.7 million on the sale of the vessel, if sold on December 31, 2016.

The dealer would charge 5% for sales commission on the gross proceeds of the sale, and ASI would be responsible for legal costs of \$1,500 to transfer title.



**APPENDIX V (COMMON)  
NEW CRANE PURCHASE**

Vessels, such as the *Lobster II*, each have three major components: the crane, the engine and the vessel structure. When the *Lobster II* was purchased in late 1998, each of these components had a useful life of approximately 30 years. At December 31, 2016, the engine and the vessel structure on the *Lobster II* each had a remaining useful life of 12 years.

In March 2016, ASI purchased a new, technologically-advanced, crane for its *Lobster II* vessel. The new crane allows for more efficient lobster fishing, reducing costs and enhancing productivity. Costs were capitalized as follows (in thousands of Canadian dollars):

Cost of new crane	\$ 845
Financing costs paid to supplier	14
Removal of old crane from <i>Lobster II</i>	34
Installation of new crane on <i>Lobster II</i>	56
Training of employees on crane operation	<u>109</u>
	<u>\$ 1,058</u>

The new crane has a useful life of at least 20 years. Training was provided by the crane supplier at an additional fee.

The removal of the old crane and the installation of the new crane were both performed by employees of ASI. The old crane is still sitting on ASI's dock. Due to its age and uniqueness, there is no market for the old crane.

***ASSURANCE ROLE  
ADDITIONAL INFORMATION***

## **APPENDIX VI**

### **ASSURANCE – ADDITIONAL INFORMATION**

#### *Preliminary Audit Planning Excerpts*

The following planning information was documented based on CPA LLP's existing knowledge of ASI, along with the preliminary planning completed in September 2016.

- ASI has been a client of CPA LLP for the past eight years.
- During previous years' audits, no errors were identified.
- ASI has strong corporate governance, with both an audit committee (meeting quarterly and including an external advisor who is a retired auditor) and a board of directors (meeting quarterly), who exercise oversight for the company.
- There have been no known changes in accounting policies applied by ASI.

#### **Materiality**

- Previous year's materiality had been set using a benchmark of income before taxes and CPA LLP's acceptable range of 5% to 7%.
- Materiality and performance materiality were not calculated at planning time, as internal financial statements were not available. Instead, the previous year's materiality of \$75,000 was used.

#### **Test of controls**

The following controls have been identified as key controls for ASI, and have been tested and relied upon for audit purposes in the past.

#### Revenue

- The CFO reviews and approves weekly sales listings, which lists all sales order numbers that were generated during the week, as well as their status.
- As part of his review, he looks at the supporting documentation to validate which sales belong in revenue. To facilitate his review, he receives the sales order, packing slip and customer invoice for completed sales (orders where goods have been shipped and delivered). For incomplete sales, he receives all supporting documentation that is available (packing slip or cancellation of sales order).
- The CFO manually marks his review of each sales order number and signs off each weekly sales listing.
- For sales orders that do not have appropriate supporting documentation, the CFO removes the sale from the listing and ensures that it is not recorded in revenue.
- The test of this process provides assurance over completeness, existence, cutoff and accuracy of revenue.

**APPENDIX VI (continued)**  
**ASSURANCE – ADDITIONAL INFORMATION**

*Preliminary Audit Planning Excerpts (continued)*

Purchases

- The CFO reviews and approves all expenditures by signing the physical cheque or by using his personal sign-in banking code to authorize the electronic funds transfer (EFT).
- The CFO must receive a signed purchase order, as well as the final invoice, in order to approve the payment.
- For expenses greater than \$10,000, sign-off from Darrell must also be obtained. Evidence of sign-off can be seen by viewing the signature on the cheque or by verifying the EFT authorization on the banking website.
- The test of this process provides assurance over the existence/occurrence and accuracy of purchases.

Payroll

- The accounting assistant processes the payroll on a bi-weekly basis.
- The CFO reviews and approves the payroll reports.
- The CFO also performs a reconciliation on a monthly basis, which accounts for any differences in payroll as a result of new hires or terminations during that time frame.
- The test of this process provides assurance over the completeness, existence/occurrence and accuracy of payroll.

**APPENDIX VI (continued)**  
**ASSURANCE – ADDITIONAL INFORMATION**

*New Order and Invoicing System*

In late October, ASI implemented a new order and invoicing system, Fast Fish (FF). ASI is leasing the software for an annual fee and ASI has the ability to request simple modifications. The system works as follows:

- Customers place their orders online and are asked to input their name as well as their billing and shipping address. FF automatically accepts the order, creates a customer account using the information inputted by the customer and assigns a sequential sales number to the order, such as S00001.
- Pricing depends on volumes. FF automatically determines prices for each order by accessing an electronic file with the prices by volume. All accounting staff have access to the master pricing file but no one has updated it since the system was implemented. Shipping charges are automatically calculated, based on the address entered by the customer, and added to the sales order.
- Sales staff can grant a discount up to 50% of the sales price at their discretion in order to close the sale.
- Once the sales order is finalized, the details are sent to the accounting department where the order is printed and reviewed to ensure that it is complete and that the pricing is accurate. The hard copy of the sales order is then initialed. An accounting department member must then open the sales order in FF and click “Accept” to move to the next step. With the absence of the CFO, the accounting department is sometimes backlogged. Therefore in order to avoid upsetting customers, they simply enter the system and click “Accept” without completing their review and sign-off.
- Upon acceptance, FF sends the sales order to the shipping department, and a packing slip is generated. The packing slips are numbered to match the sales order (P00001).
- The shipping department uses the packing slip to fill the order, and the goods are shipped.
- The shipping department then opens the order in FF using the packing slip number, and clicks “Complete”. Upon completion, the invoice is generated and the customer is billed. The invoice numbers are aligned with the sales order and packing slip numbers (IN00001).
- Before the invoice is sent to the customer, the accounting department manually verifies the accuracy of the information. When they are satisfied, they open FF and click “Send”. This triggers the invoice to be posted to the general ledger, and inventory is automatically reduced. Once again, due to the additional responsibilities the accounting department is experiencing, they sometimes just enter the system and click “Send” on all outstanding invoices, to get the general ledger up-to-date.

**APPENDIX VI (continued)**  
**ASSURANCE – ADDITIONAL INFORMATION**

*Suppliers' Bonus Arrangement*

At the end of each year, each supplier who has sold lobsters to ASI for five years or more is paid a bonus based on operating profit earned from lobster sales, calculated as follows:

Sales of lobsters  
 Less harvesting costs of lobsters  
 Less processing costs of lobsters  
 Less freight, customs and transport related to sale of lobsters  
 Less an allocation of administration and selling costs based on time spent only on the lobster division  
 Equals operating profit earned from lobster sales

Note: depreciation is excluded from the calculation.

As a group, the suppliers receive a bonus of 20% of this operating profit. The amount to be paid to each individual supplier is based on their proportion of lobsters sold to ASI during the fiscal year.

For 2016, the calculation is as follows:

Lobster sales	\$ 18,500,000
Harvesting costs (excluding the bonus)	(12,025,000)
Processing costs	(1,320,000)
Freight, customs and transport related to lobster sales	(924,000)
Administration and selling costs allocated to lobster division	<u>(2,856,000)</u>
Operating profit from lobster sales	<u>\$ 1,375,000</u>
Profit-sharing bonus — 20%	<u>\$ 275,000</u>
Pounds of lobster purchased from suppliers eligible for the bonus	<u>800,000</u>
Bonus per pound	<u>\$ 0.344</u>

In 2016, 20 suppliers earned the bonus, so the average bonus per supplier was:  $\$275,000 / 20 = \$13,750$ .

The profit-sharing bonus is included in harvesting costs and accounts payable on the draft 2016 financial statements.

**APPENDIX VI (continued)**  
**ASSURANCE – ADDITIONAL INFORMATION**

*Suppliers' Bonus Arrangement (continued)*

Recently, some information has surfaced about the allocation of the administration and selling costs. In the past, this allocation was based on time spent, but this year, due to insufficient records being kept, the allocation was simply based on last year's time, which was 68.65% for the lobster business. However, in 2016, there were the following significant differences in expenses in comparison to 2015:

- The company paid for a marketing study on clams that cost \$50,000.
- A new sales agent was hired specifically to market clams in Asia. The additional costs of this agent totalled \$420,000.
- A new lobster-packaging design was created by an advertising consultant, along with new advertising material, totalling \$270,000.
- ASI made donations totalling \$170,000 that had not been made in previous years.

Finally, there was a major repair performed on the lobster-packaging machinery. An operator had inadvertently jammed the equipment, causing damage of \$400,000. This cost has been included in processing costs, but the suppliers feel that this is not a "normal expense," and should be excluded from the bonus calculation.

***FINANCE ROLE  
ADDITIONAL INFORMATION***



**APPENDIX VI**  
**FINANCE – ADDITIONAL INFORMATION**

*Industry Benchmarks*

The following information relates to large, integrated seafood companies that harvest, process and deliver seafood within North America.

	<u>2016</u>	<u>2015</u>
<b>Profitability</b>		
Return on equity	14.0%	13.8%
<b>Margin analysis</b>		
Operating profit as % of sales	12.4%	11.4%
<b>Turnover</b>		
Days in receivables	41.0	45.1
Days in inventory	39.6	40.1
New capital investment/depreciation	150%	220%
<b>Short-term liquidity</b>		
Current ratio	2.3	2.3
<b>Long-term solvency</b>		
Total debt/Total assets	0.8	0.7
EBITDA/Interest	3.0	3.2

**APPENDIX VI (continued)**  
**FINANCE – ADDITIONAL INFORMATION**

*Retractable Preferred Share Proposal*

Currently, there are 10,000 Class B common shares outstanding. Each share was issued for \$100. Each of the 50 employees invested \$20,000, and in return, received 200 common shares.

The proposal is to exchange the 10,000 Class B common shares on a one-to-one basis for new, Class D preferred shares.

The Class D preferred shares will have the following terms and conditions:

- There will be one vote per share.
- A quarterly cumulative dividend will be payable on the 16<sup>th</sup> day of March, June, September and December. The quarterly dividend will be equal to the higher of:
  - \$2.50 per share; or
  - 10% of earnings per share (calculated by including Class D preferred shares in the number of shares outstanding).
- The shares are retractable any time after January 1, 2020, for a price of \$100.
- ASI can also redeem the shares at \$100 any time after January 1, 2022.
- All dividends in arrears must be paid prior to redemption of the shares.
- On dissolution, the Class D preferred shareholders will participate fully along with the common shareholders.

As there is a contractual obligation to deliver cash when the holder surrenders his shares, these preferred shares will be reported as a liability at the amount that ASI will be obligated to pay, being \$100 each.

**APPENDIX VI (continued)**  
**FINANCE – ADDITIONAL INFORMATION**

*New Vessel Investment Proposal*

ASI is considering the purchase of a new vessel for harvesting clams. The vessel will cost \$45 million and will allow the company to harvest an additional six million pounds of clams annually. This vessel will have state-of-the-art technology, allowing the company to process the clams to frozen state directly on board, keeping the food fresher and ensuring a better taste. ASI estimates that this product could be sold for \$6.00 per pound in 2018.

The vessel will take 12 months to complete and will be put into service at the beginning of 2018. The supplier will be paid \$30 million immediately and \$15 million in January 2018. This new vessel will have a useful life of 25 years, and qualifies for the CCA Class 7 special rate of 16 2/3% in the first year and 33 1/3% for each year thereafter.

The harvesting costs, representing all vessel operating costs (fuel, labour and fishing gear) required to harvest and process six million pounds of clams, will total \$26 million in 2018. Selling costs, including delivery, are estimated to be 5% of sales. Annual maintenance and repairs will be \$2 million. Annual administrative costs of \$1.5 million will be allocated to this project, although annual incremental costs will only be \$0.8 million. As any increase in costs should be offset by increased revenue, inflation should be ignored.

An initial investment in working capital of \$2.5 million in 2018 will be required, and will stay at this level until the end of the vessel's life. At the end of the vessel's useful life, it is estimated that decommissioning costs of \$5 million will be required.

The German supplier will finance a portion of the costs associated with the new vessel, at an interest rate of LIBOR plus 6%. LIBOR is currently at 4%. Darrel is nervous about this variable rate loan, and wonders if there is any way to mitigate the risks associated with fluctuations in interest rates.

**APPENDIX VI (continued)**  
**FINANCE – ADDITIONAL INFORMATION**

*Intangible Asset Purchase*

Recently, a competitor that is closing its business approached ASI to ask if ASI would be interested in acquiring the rights to its ten offshore lobster licences. The ten licences would allow ASI to harvest an additional 500,000 pounds of offshore lobster annually. The asking price is \$7.5 million for the ten licences. The licences have indefinite lives and only require a nominal annual fee.

ASI has been able to gather the following information with respect to historical lobster licence transactions in the open market. ASI believes that some of these lease transactions should be useful to assist in the valuation of the ten licenses that have been offered to ASI and to help determine if the asking price is reasonable.

<b>Company</b>	<b>Total annual pounds available under the leased license</b>	<b>Terms and conditions of lease</b>
Tiger Limited	250,000	Offshore lobster — Six-year lease fee of \$100,000 annually plus \$1.50 per pound with no minimum guaranteed volume. This agreement is renewable every six years.
Shore to Shore Inc.	500,000	Inshore lobster — Two-year lease fee of \$50,000 annually plus \$2.45 per pound, with a minimum guaranteed volume of 400,000 pounds annually. Not renewable.
Coldwater Seafood Inc.	250,000	Inshore lobster — Three-year lease fee of \$25,000 annually plus \$2.80 per pound, with a minimum guaranteed volume of 100,000 pounds annually. Not renewable.
Shellfish Harvester Ltd.	400,000	Offshore lobster — Five-year lease fee of \$200,000 annually plus \$1.75 per pound, with a minimum guaranteed volume of 300,000 pounds annually. Renewable every five years.

The appropriate discount rate for this analysis is ASI's WACC of 12%.

**APPENDIX VI (continued)**  
**FINANCE – ADDITIONAL INFORMATION**

*Contract with New Chinese Customer*

A restaurant chain in China, called Dragon Delights (DD), is interested in contracting for a three-year supply of red sand clams at a fixed price in U.S. dollars. They will commit to a minimum and maximum volume to be purchased each year. Currently, ASI does not have enough product to support this agreement, and will have to outsource to another company to harvest and procure the additional required clams at C\$3.50 per pound.

The proposed terms and conditions of the sales contract to DD include the following:

- The contract is for three years, from March 1, 2017, to February 28, 2020.
- DD agrees to purchase a minimum of two million pounds and a maximum of three million pounds of frozen clams annually, at a price of US\$5.10 per pound.
- The two million pounds will be ordered evenly over the year, estimated at between 160,000 and 170,000 pounds per month.
- Orders will be made every two weeks, with shipment following within one day of the order.
- DD will be responsible for all shipping and related costs.
- DD will have credit terms of 60 days.
- The contract may be renewed in 2020 if both parties are in agreement.
- The contract may be terminated without penalty by either party with sixty days' notice.

Currently, the clams are selling for US\$4.40 per pound (the current exchange rate is US\$1 = C\$1.17).

ASI's 2016 production and selling costs for the clams are detailed below:

Harvesting and procurement:

Variable costs	\$2.23 per pound
Fixed costs	\$2,500,000

Processing and manufacturing:

Variable costs	\$0.39 per pound
Fixed costs	\$760,000
Freight costs — variable	\$0.38 per pound (from the processing plant to the customer)
Selling costs — variable	\$0.21 per pound (there would be no selling costs for the DD contract)

ASI expects that it will hold, on average, two weeks' worth of sales in inventory in order to meet the delivery requirements of this contract.

***PERFORMANCE MANAGEMENT ROLE***  
***ADDITIONAL INFORMATION***

## **APPENDIX VI**

### **PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION**

#### *Information about the Industry*

##### **Harvesting seafood**

ASI operates two distinct segments for seafood fishing — seasonal fishery for lobsters, and year-round offshore fishery for clams.

Offshore fishing is dominated by a few, large, integrated companies that, similar to ASI, own large vessels and have licences to harvest large proportions of the annual total allowable catch stipulated by the government. These companies harvest, process and distribute seafood. There are economies of scale that can be obtained with integration and size, and as a result, consolidation has been predominant in the industry. The high costs of vessels and the limited number of licences create significant barriers to entry.

As health-conscious consumers demand premium, sustainable products that taste good, demand for seafood has been increasing. Since supply is fixed by government quotas, prices are increasing as demand outstrips supply.

Prices for clams are expected to increase by 26% over the next six years. Demand from Asia, and particularly China, is expected to double by 2020.

##### **Clams**

Red sand clams are the species most often preferred in the preparation of sushi, resulting in high demand in Japan and China, in addition to North America. Global growth of the clam supply is expected to increase by 15% annually for the next three years. ASI estimates that, by 2018, clams could be sold for \$6.00 per pound.

##### **Lobsters**

Global growth rates for lobster sales are expected to increase by 5% annually for the next 10 years. However, the lobster population has been declining and the Department of Fisheries and Oceans has reduced the allowable annual harvest quota for the inshore fishing licences. Many inshore lobster fishermen have complained that their annual quotas have been reduced by up to 80%. To date, offshore lobster quotas have not been impacted.

**APPENDIX VI (continued)**  
**PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION**

*Industry Benchmarks*

The following information relates to large, integrated seafood companies that harvest, process and deliver seafood within North America.

	<u>2016</u>	<u>2015</u>
<b>Profitability</b>		
Return on equity	14.0%	13.8%
<b>Margin analysis</b>		
Operating profit margin as % of sales	12.4%	11.4%
<b>Turnover</b>		
Days in receivable	41.0	45.1
Days in inventory	39.6	40.1
New capital investment/depreciation	150%	220%
<b>Short-term liquidity</b>		
Current ratio	2.3	2.3
<b>Long-term solvency</b>		
Total debt/Total assets	0.8	0.7
EBITDA/Interest	3.0	3.2

For 2017, the board has identified three key performance indicators:

- return on equity of at least 14%;
- operating profit margin of at least 10% of sales; and
- a total debt/total asset ratio of no more than 0.8.



**APPENDIX VI (continued)**  
**PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION**

*Suppliers' Bonus Arrangement*

At the end of each year, each supplier who has sold lobsters to ASI for five years or more is paid a bonus. As a group, these suppliers receive a bonus of 20% of operating profit earned from lobster sales. The amount to be paid to each individual supplier is based on their proportion of lobsters sold to ASI during the fiscal year.

For 2016, the calculation is as follows:

Lobster sales	\$ 18,500,000
Harvesting costs (excluding the bonus)	(12,025,000)
Processing costs	(1,320,000)
Freight, customs and transport related to lobster sales	(924,000)
Administration and selling costs allocated to lobster division	<u>(2,856,000)</u>
Operating profit from lobster sales	<u>\$ 1,375,000</u>
Profit-sharing bonus — 20%	<u>\$ 275,000</u>
Pounds of lobster harvested by suppliers eligible for the bonus	<u>800,000</u>
Bonus per pound	<u>\$ 0.344</u>

Note: depreciation is excluded from the calculation.

In 2016, 20 suppliers earned the bonus, so the average bonus per supplier was: \$275,000 / 20 = \$13,750.

The profit-sharing bonus is included in harvesting costs and accounts payable on the draft 2016 financial statements.

**APPENDIX VI (continued)**  
**PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION**

*Suppliers' Bonus Arrangement (continued)*

Recently, some information has surfaced about the allocation of the administration and selling costs. In the past, this allocation was based on time spent, but this year, due to insufficient records being kept, the allocation was simply based on last year's time, which was 68.65% for the lobster business. However, in 2016, there were the following significant differences in expenses in comparison to 2015:

- The company paid for a marketing study on clams that cost \$50,000.
- A new sales agent was hired specifically to market clams in Asia. The additional costs of this agent totalled \$420,000.
- A new lobster-packaging design was created by an advertising consultant, along with new advertising material, totalling \$270,000.
- ASI made donations totalling \$170,000 that had not been made in previous years.

Finally, there was a major repair performed on the lobster-packaging machinery. An operator had inadvertently jammed the equipment, causing damage of \$400,000. This cost has been included in the manufacturing costs related to lobster processing.

**APPENDIX VI (continued)**  
**PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION**

*Contract with New Chinese Customer*

A restaurant chain in China, called Dragon Delights (DD), is interested in contracting for a three-year supply of red sand clams at a fixed price in U.S. dollars. They will commit to a minimum and maximum volume to be purchased each year. Currently, ASI does not have enough product to support this agreement, and will outsource to another company to harvest and procure the additional required clams at C\$3.50 per pound. This will result in a contribution margin of C\$2.08 per pound. ASI has not yet investigated whether or not this contract would incur any additional fixed administration costs.

The proposed terms and conditions of the sales contract to DD include the following:

- The contract is for three years, from March 1, 2017, to February 28, 2020.
- DD agrees to purchase a minimum of two million pounds and a maximum of three million pounds of frozen clams annually, at a price of US\$5.10 per pound.
- The two million pounds will be ordered evenly over the year, estimated at between 160,000 and 170,000 pounds per month.
- Orders will be made every two weeks, with shipment following within one day of the order.
- DD will be responsible for all shipping and related costs.
- DD will have credit terms of 60 days.
- The contract may be renewed in 2020 if both parties are in agreement.
- The contract may be terminated without penalty by either party with sixty days' notice.

Currently, the clams are selling for US\$4.40 per pound (the current exchange rate is US\$1 = C\$1.17).

**APPENDIX VI (continued)**  
**PERFORMANCE MANAGEMENT – ADDITIONAL INFORMATION**

*Proposed Contract with Royal Lobster Co.*

ASI has been approached by a competitor, Royal Lobster Co. (RLC). RLC wants ASI to process and package 2.5 million pounds of lobster annually on behalf of RLC. RLC will harvest and deliver the lobsters to ASI for storage in the lobster ponds and for processing and packaging. ASI will then ship directly to RLC's customers, but shipping costs will be paid by RLC. The contract will initially be for four years.

RLC will pay ASI \$0.85 per pound for storage, processing and packaging. Any cost overruns, wastage or other costs will be ASI's responsibility. ASI will also be responsible for ensuring that the packaged lobsters comply with all food safety regulations and ASI will be held responsible for any liabilities arising from any food contamination or failure to pass inspection. ASI will also be responsible for any penalties incurred due to late delivery caused by processing problems. Annual wastage and overrun costs are estimated to be 3.5% of the total contract price.

ASI's plant has the capacity to process and package a total of four million pounds of lobster annually. In 2016, ASI processed 1.8 million pounds of lobster.

The current selling price per pound of lobster is \$10.27.

Below are the variable and fixed costs for the lobster division:

Harvesting and procurement:

Variable costs for own catch	\$3.71 per pound
Variable costs for catch from inshore lobster suppliers	\$5.66 per pound
Fixed costs	\$3,000,000

Processing and packaging:

Variable costs	\$0.20 per pound
Fixed costs	\$960,000
Freight costs — variable	\$0.51 per pound
Selling costs — variable	\$0.26 per pound
Administration and selling costs — fixed	\$2,388,000

Note: these figures do not include the suppliers' bonus that is calculated annually.

*Ignore the suppliers' bonus and tax implications in your calculations.*

RLC has stipulated that the contract is to process and package all 2.5 million pounds and is not interested in doing the contract for less.

<p style="text-align: center;"><b><i>TAXATION ROLE</i></b></p> <p style="text-align: center;"><b><i>ADDITIONAL INFORMATION</i></b></p>
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## APPENDIX VI TAXATION – ADDITIONAL INFORMATION

### *Income Tax Details*

Provincial corporate tax rates in Prince Edward Island (PEI) for both 2015 and 2016 are as follows:

Active business income up to the small business limit	4.5%
All other income	16%
Investment tax credit on qualifying SR&ED expenditures	15%

ASI uses the accrual method of accounting for its fishing income.

### **Income tax data for 2015**

ASI's 2015 T2 Corporation Income Tax Return as filed included the following:

Costs deducted related to upgrading <i>Clam</i>	\$ 750,000
Total allowable SR&ED expenditures	\$ 325,000
Taxable income	\$ 1,350,000
Taxes payable	\$ 178,500

All instalments and the final balance owing were paid on time. The CRA performed an audit of certain items after ASI filed its 2015 tax return. The auditor is proposing the following adjustments to taxable income:

- Total meals and entertainment expenses were \$48,000. Included in this amount was \$10,000 relating to the annual summer and December holiday parties. ASI deducted 100% of \$10,000, and added back 50% of the remainder (\$19,000), but CRA also denied 50% of the deduction for the parties.
- \$15,000 was paid to obtain updated appraisals for the vessels. The deduction claimed by ASI was denied by the CRA as it was considered a cost of financing.
- Several small tools, each costing less than \$500, were purchased for a total of \$28,000 and placed by ASI in Class 12 without the half-year rule. CRA reallocated these tools to Class 8 and applied the half-year rule.
- The annual insurance payment of \$180,000 was denied by CRA on the basis that it was a prepaid expense. The policy renews on January 1 annually and is paid all at once.
- The costs of the *Clam* upgrade were determined by CRA to be a betterment rather than repairs and maintenance. The costs had been correctly capitalized for financial reporting purposes in 2015. CRA added these costs to *Clam*, in Class 7.
- \$225,000 of the SR&ED expenditures were found by CRA to be capital expenditures on manufacturing equipment. CRA denied the deduction and added the costs to Class 29.

**APPENDIX VI (continued)**  
**TAXATION – ADDITIONAL INFORMATION**

*Income Tax Details (continued)*

In addition to the above, the auditor is proposing the following adjustments to the calculation of taxes payable:

- The federal and PEI small business deductions were denied based on the amount of taxable capital in the prior year.
- The additional 20% federal investment tax credit on eligible SR&ED expenditures available to Canadian-controlled private corporations was denied.

**UCC/CEC balances at December 31, 2015, prior to proposed audit adjustments:**

Class	Description	CCA rate	UCC/CEC balance
Class 1	Buildings	4%	\$ 1,354,000
Class 7	Vessel, <i>Clam</i>	15%	\$ 2,142,000
Class 7	Vessel, <i>Lobster I</i>	33 1/3% straight-line	\$ 28,000
Class 7	Vessel, <i>Lobster II</i>	33 1/3% straight-line	\$ 544,000
Class 8	Furniture, equipment and tools	20%	\$ 50,000
Class 12	Software and small tools	100%	\$ 10,000
Class 29*	Manufacturing equipment	50% straight-line	\$ 400,000
Class 50	Computer equipment	55%	\$ 40,000
ECP	Licences	7% CECA	\$ 6,200,000

\* The balance in Class 29 consists of processing equipment purchased in 2014.

Vessels manufactured outside of Canada (such as *Clam*) are pooled in Class 7, with a declining-balance CCA rate of 15%, and the half-year rule applies in the year of acquisition. Vessels manufactured and operated in Canada (such as *Lobster I* and *Lobster II*) are eligible for a separate Class 7, with straight-line CCA at 33 1/3% of the capital cost and the rate in the year of acquisition being 16 2/3% of the capital cost. CCA of \$28,000 may be claimed in 2016 on costs included in the 2015 ending UCC for *Lobster I*. CCA of \$224,000 may be claimed in 2016 on costs included in the 2015 ending UCC for *Lobster II*.

**Additional income tax data for 2016**

Included in selling costs for 2016 are meals of \$120,000 and donations of \$170,000 (\$75,000 to unregistered not-for-profit organizations and \$95,000 to registered charities).

**APPENDIX VI (continued)**  
**TAXATION – ADDITIONAL INFORMATION**

*Proposed Stock Option Plan*

The average annual income of all employees is \$150,000. ASI would like to provide some additional compensation in the form of stock options, to be granted annually to key managers. Options will be granted at the discretion of the board on an annual basis on January 1. Options will be for the purchase of new Class C common shares, which will participate in ownership in the same manner as Class A common shares.

The options will have an exercise price set at the date of grant equal to the fair market value of the shares plus \$2. The fair market value will be determined using an agreed-upon valuation model.

The options will vest after two years, with 25% vesting after the first year and 75% vesting after the second year. The options will be exercisable for five years after the vesting date.

On exercise, the exercise price will be paid to the company, and the shares will be issued.



**APPENDIX VI (continued)**  
**TAXATION – ADDITIONAL INFORMATION**

*Retractable Preferred Share Proposal*

Currently, there are 10,000 Class B common shares issued and outstanding to a group of 50 employees. When issued seven years ago, each share was issued for the fair value of the shares, being \$100. Each employee invested \$20,000 and, in return, received 200 shares.

The proposal is to exchange the 10,000 Class B common shares, on a dollar-for-dollar basis, for new Class D preferred shares, using a fair value determined using an agreed-upon valuation model.

The Class D preferred shares will have the following terms and conditions:

- There is one vote per share.
- A quarterly, cumulative dividend will be payable on the 16<sup>th</sup> day of March, June, September and December. The quarterly dividend per share will be equal to the higher of:
  - \$2.50; or
  - 10% of earnings per share (calculated by including Class D preferred shares in the number of shares outstanding).
- The shares are retractable any time after January 1, 2020, for a price of \$100 paid in cash.
- ASI can also redeem the shares at \$100 any time after January 1, 2022.
- All dividends in arrears must be paid prior to redemption of the shares.
- On dissolution, the Class D preferred shareholders will have preference over all classes of common shares, and will be entitled only to redemption at the retraction price.

Legal fees to ASI relating to the exchange are estimated to be \$10,000.

**APPENDIX I**

**DAY 3 SIMULATIONS – MAY 27, 2016**

**Case #1****(Suggested time 80 minutes)**

You, CPA, recently joined the Office of the Auditor General (OAG) as a senior accountant. Today is January 31, 2016, and you have just been assigned to the financial audit of National Mail (NM). NM has a December 31 year end and is a Crown corporation of the Government of Canada (GoC). NM offers the following three service lines:

- **Mail Services** — NM is mandated to deliver mail to every address in the country. As a result, the GoC ensures that NM has the exclusive right to provide this service. This service line is partially funded by stamp sales, and grants from the GoC covering any deficit, as presented in NM's internal financial statements. The grants are paid to NM the following year. NM delivered 1.5 billion pieces of mail in 2015.
- **Courier Services** — NM also offers local and national courier services under the name, Courier Inc. Ranging from express deliveries to large shipments, Courier Inc. has many competitors, such as FedEx. The sole revenue from this service line is courier charges. In 2015, NM couriered 150 million parcels.
- **Concessionary Services** — At all NM postal outlets, the corporation sells mail-related items, such as envelopes. The pricing of items is always cost plus 15%. The 15% margin is intended to cover general overhead costs. As at December 31, 2015, NM had 6,200 postal outlets across Canada.

This morning, you met with your manager, who had the following comments: “CPA, I have a few tasks for you to perform. We have decided to take a fully substantive approach for income statement items this year. Can you please propose substantive procedures for auditing revenue and expenses?”

“In addition, while the GoC subsidizes the Mail Services, the OAG is required to ensure that the GoC is not subsidizing the Courier and Concessionary Services. Please determine the revenues and costs, including the allocated costs, for each service line, and assess whether the GoC's subsidies benefitted Courier or Concessionary services. Provide your thoughts on NM's allocations and whether there are any factors the GoC should be considering in relation to the allocation formula. We received some draft financial information that will help you with your analysis (Appendix I).

“Please also perform a cash flow analysis for 2016, to ensure there is no liquidity concern. Make sure you incorporate the new initiatives proposed for 2016 (Appendix II), and suggest ways to improve NM's future cash flows.

“The OAG will be performing a separate engagement for NM in the coming months. In preparation for it, I'd like your thoughts on whether the new initiatives are a good fit with NM's vision and mission statements.

“Finally, you will see from the CFO's notes that NM is facing strategic challenges (Appendix III). Please let me know if you note any matters of significance we should share with its Board.”

**APPENDIX I**  
**DRAFT FINANCIAL INFORMATION**

**Revenue**

In 2015, the average piece of mail generated \$2.20 in stamp revenue, the average courier parcel generated \$15.60 in courier fees, and each postal outlet generated a gross margin of approximately \$0.1 million for the concessionary services.

**Costs**

Total expenditures for the three service lines for the 2015 fiscal year are as follows (*in millions of dollars*):

		Notes
Labour and employee benefits	\$ 3,200	1
Non-labour collection, processing and delivery	800	2
Property and facilities maintenance	300	3
Selling, administrative and other	200	4

**Notes:**

1. Approximately 60% of employees work on Mail Services, 30% on Courier Services, and 10% at Concessionary Services.
2. Collection, processing and delivery costs are incurred evenly between Mail Services and Courier Services.
3. Maintenance staff say it is difficult to estimate the time they spend on each service line due to the many things they do in a day. Internally, NM allocates 60%, 30%, and 10% of maintenance costs to Mail, Courier, and Concessionary Services respectively; these percentages were last updated in 2007.
4. Approximately 5% of “selling, administrative and other” costs are related to the Mail Services, 15% are related to the Courier Services and 80% are costs associated with storing inventory, regular advertising for clearance items, and other promotional activities for the Concessionary Services.

In addition to these expenditures, capital assets for each service line resulted in depreciation of \$100 million for Mail Services, \$75 million for Courier Services, and \$50 million for Concessionary Services.

**APPENDIX I (continued)**  
**DRAFT FINANCIAL INFORMATION**

In 2015, NM also incurred a total of \$2,100 million in headquarters administrative costs, such as maintaining the finance and legal departments. As these costs cannot be traced to each service line, NM has always allocated them evenly across the three lines in its internal financial statements. They have always wondered if there is a better basis for the allocation.

NM does not allocate investment income to the service lines. NM has significant investments in bonds and term deposits. They yielded \$390 million in income for 2015.

## **APPENDIX II FORECAST OF REVENUES AND EXPENSES FOR 2016 INITIATIVES**

### **Community mailboxes**

Starting in 2016, NM is significantly reducing door-to-door home delivery of mail. Instead, community mailboxes are being installed, which will reduce the delivery time of postal workers.

Revenue is not expected to change as a result of this initiative. Total labour costs, however, should decrease by 15% in 2016.

Installation of community mailboxes is expected to cost \$400 million and is expected to be completed by the end of 2016. Maintenance costs will increase by approximately 5% in 2016.

### **Electronic post**

Starting on April 1, 2016, customers will have the option of having their GoC-related mail delivered electronically. This initiative is not expected to have an impact on revenue, but will decrease labour costs by \$20 million, and collection, processing and delivery costs by 5% in 2016. The initial setup of the electronic portal is expected to cost NM \$140 million, all to be incurred between January 1 and April 1, 2016. There will also be promotional costs of \$60 million, to encourage Canadians to sign up for this initiative.

### **APPENDIX III EXCERPTS FROM DRAFT MANAGEMENT DISCUSSION AND ANALYSIS**

#### **Vision and mission statements**

NM's vision is to be a world leader in providing physical delivery solutions, creating value for its customers, employees and all Canadians.

NM's mission is to:

- continually improve existing services in order to ensure customer satisfaction
- focus on efficiencies of current processes, to ensure that services are provided at the lowest cost
- minimize environmental impact, to build a better future

#### **Notes from the CFO**

... In 2015, we delivered 1.2 billion fewer pieces of mail than we did in 2005. Households and businesses have moved away from mail as the primary source of communication...

... We are facing a defining moment in our history. There are fewer letters in our system every year, yet Canadians are turning to NM in growing numbers to deliver the goods they order through digital means...

... NM continues to experience operating losses, similar to the past several years. It must find ways to reinvent itself in the coming years...

... NM is looking at all options to improve its financial situation. It is currently exploring different funding models with the GoC, such as not just funding the Mail Services...

**Case #2****(Suggested time 90 minutes)**

You, CPA, started as the part-time controller for Perfecto Painters Inc. (PPI) in January 2016, one month ago. PPI, incorporated in 2010, is a Canadian controlled private corporation (CCPC). PPI is located in Fredericton, New Brunswick, and is owned and operated by Peter Steele.

Prior to 2015, PPI provided painting services solely to residential customers. However, in early 2015, Peter decided to serve both the commercial and residential markets. The real estate council reported future growth in demand for commercial spaces and renovations, and Peter believed that expansion would provide PPI with a better chance for survival as the residential market has been flooded with discount providers.

Peter reasoned that the larger size of commercial jobs would allow for efficiencies, and therefore cost reductions. He expected reduced setup, take down, and travel times in the commercial business, which would permit his crews to spend more time performing chargeable work, translating into a bump in profits. Much to Peter's disappointment, PPI is instead reporting a loss on the draft income statement for the year ended December 31, 2015 (Appendix I). Peter believes that an analysis of PPI's costs of performing painting services, performing drywall repair work and providing job support would be useful and might explain the financial results. He also wonders whether he should stay in both the residential and commercial markets, or whether he should concentrate on only one of them. He has provided you with information about the 2015 operations (Appendix II).

PPI has experienced a cash shortage and Peter applied to PPI's bank for an increase in the operating line of credit. In addition to a copy of the internal financial statements, a strategic plan for a profitable 2016 is required by the bank. If the bank is not satisfied that PPI is able to improve its performance in fiscal 2016, the operating line increase will not be granted.

Peter has reflected back over the first year in the commercial business. He is not happy with the way the business is operating, and feels he has lost control as the business has grown. He believes he can make improvements in several areas. Peter noted a few issues and asks for your help. He wonders if there are taxation considerations related to these issues, details of which are presented in the notes to the financial statements (Appendix I). He hopes you can provide him with advice.



**APPENDIX I**  
**DRAFT INCOME STATEMENT**

*Perfecto Painters Inc.*  
*Draft Income Statement*  
*For the year ended December 31*

	2015	Notes
	(unaudited)	
Revenues	\$ 1,200,000	1
Expenses		
President salary	80,000	2
Wages and benefits	500,000	3
Supplies	550,000	4
Equipment depreciation	60,000	
Vehicle expenses	90,000	5
Office costs	150,000	
Loss on investment	35,000	6
	1,465,000	
Income (loss) before tax	\$ (265,000)	

**Notes:**

- PPI has a simple fee structure, charging \$5 per estimated square metre to be painted. PPI charges the same rate for residential and commercial customers. PPI's revenues were split evenly between residential and commercial jobs.

When PPI's customer base was 100% residential, only cash, debit and credit cards were accepted. In 2015, Peter decided to extend credit to commercial customers, providing customers with an invoice at the end of the job, and allowing 30 days before payment. PPI secured many of its commercial jobs by aggressively promoting this policy. Collection issues have been much greater than Peter had expected. In fact, only 90% of the \$600,000 billed to commercial customers in 2015 has been collected to date. 75% of the uncollected balance was more than 90 days past due as of year-end. He is looking for ways to reduce the uncollectible balance and speed collections in the future.

**APPENDIX I (continued)**  
**DRAFT INCOME STATEMENT**

2. Peter used to draw a higher salary, close to the market rate for a senior site supervisor. As a consequence of the weak financial results, Peter reduced his salary in 2015 to \$80,000 to minimize the loss in the corporation. To meet his personal needs, he took out an interest-free shareholder loan of \$10,000 from PPI. It was his first time taking a company loan. He does not know when he will repay the loan. He recently heard at a networking event that there may be a tax advantage to declaring dividends instead of taking salary. He wonders what the tax implications would be of doing so.
  
3. PPI hired a new crew of two painters. These painters were hired for their ability to repair drywall. Cleanup and furniture moving for commercial jobs is frequently done during evening hours, resulting in additional overtime wages in 2015 compared to 2014 as the painters were paid time-and-a-half. Peter often drops by the site to check on the job. On a few occasions, the crew was not there, even though they said they were going to be working late. He assumed they finished earlier than expected or rescheduled. However, with the higher overtime, he now wonders if they have sometimes charged for time when they were not working. He reviewed their monthly-submitted time sheets, but could not recall the dates of his site visits.
  
4. Peter believes the supplies expense is too high. The supplies are currently kept in the open storage area and the painters take the supplies necessary to complete a job. Peter has always trusted the crews to only take what they needed. He wonders if there is wastage by the crews or if materials are being taken for personal use.
  
5. The crews use PPI's vehicles to pick up supplies at a store or to go back and forth from the office to a job site. The employees use personal credit cards to purchase fuel and supplies. They give receipts to Peter and PPI reimburses them based on the receipts they submit. Peter does not ask them for further documentation, or odometer readings. He suspects that some of the crews are charging PPI for gas used for their own personal vehicles.

**APPENDIX I (continued)**  
**DRAFT INCOME STATEMENT**

6. At the end of 2014, Peter's friend, the chief marketing officer of a start-up technology company, SBI Inc. (SBI), which is considered a small business corporation for tax purposes, convinced Peter to invest some of PPI's cash in SBI's shares at a cost of \$35,000. SBI declared bankruptcy in 2015. The investment in SBI of \$35,000 was written off in 2015 although PPI continues to hold the shares.

## APPENDIX II INFORMATION ABOUT 2015 OPERATIONS

Peter has analyzed the expenses incurred by PPI in 2015, divided them into the major activities he thinks add directly to the cost of a job, and has estimated the volume of each activity, as follows:

<b>Activity</b>	<b>Cost driver</b>	<b>Volume of Activity</b>
Painting services	Square metres painted	240,000 square metres
Drywall repair	Number of repairs	125 repairs*
Job support	Hours of job support	800 hours**
Office costs (not directly attributable to major activities)	Not applicable	Not applicable

\* 35 drywall repairs were residential and 90 were commercial.

\*\* 85% of job support (getting permits, liaising with landlords, and so on) related to commercial customers, and 15% to residential customers. Peter was surprised at how much job support some of his commercial customers required.

To determine how expenses incurred by PPI are distributed across the major activities, employees were interviewed and source documentation was reviewed. The results were determined to be as follows:

	<b>Painting</b>	<b>Drywall repair</b>	<b>Job support</b>	<b>Other</b>
President's salary	5%	0%	75%	20%
Wages and benefits	80%	10%	0%	10%
Supplies	90%	10%	0%	0%
Equipment depreciation	20%	65%	0%	15%
Vehicle expenses	0%	0%	50%	50%
Office costs	0%	0%	50%	50%
Loss on investment	0%	0%	0%	100%

**Case #3****(Suggested time 70 minutes)**

The Canadian Holistic Health Practitioners (CHHP) is a not-for-profit organization (NPO) that has run holistic health education courses in cities across Canada for the last decade. CHHP has chosen to report under Not-For-Profit accounting standards. You, CPA, have worked in the accounting group at CHHP for a few years.

CHHP's mission is to teach students integration of body, mind and spirit, and is dedicated to providing training in preventative and holistic health education. As an NPO, CHHP's vision is to produce the highest quality and trusted program at the lowest cost amongst the industry's providers.

CHHP will now provide a recognized certification of "Holistic Health Practitioner" to students who pass a new certification exam and complete a practicum within CHHP's training program. A new department has been formed to administer this exam, and you have been temporarily transferred to this department to help with its implementation. On your first day, you meet Holly, your new manager, who has the following comments:

"Welcome, CPA! The first offering of our new annual exam is a few months away and we are busy getting ready. The first decision is what amount to charge for the exam. We expect there to be around 2,000 students writing the exam each year, including repeat writers beginning in Year 2. Since the number of students may change over time, I'd also like to know the suggested amount to be charged if we have only 1,000 students, and if we have 3,000 students. As an NPO, we need to just cover our costs, which include an allocation of \$150,000 of the organization's general overhead costs to the examination department. Here are the expected revenues and costs of the exam (Appendix I).

"This is a relatively small profession and many of the practitioners and students know each other. There are many experienced practitioners who willingly take time away from their regular day jobs to author or mark exams for us. A temporary "marking centre" will be set up off-site for this intensive, week-long event. We still need to figure out who we should give priority to when vetting the marker applications. I'm a little worried that some of the practitioners we will use may know the students personally. Here are some process details (Appendix II). Let me know what you think about our proposed marking centre operations and processes and recommend improvements where you identify weaknesses.

“We have heard that some organizations are being challenged lately by Canada Revenue Agency as to whether those we outsource temporary work to are employees or self-employed. For simplicity, and to avoid CPP/QPP and EI, we would prefer that our markers be considered self-employed. Can you determine whether they meet the requirements for self-employment? Also, is there anything that we can change to make sure they are considered self-employed?”

“Finally, your manager, in the accounting group, would like you to prepare a report discussing all accounting implications related to this new department’s operations. He also needs a decision from us with respect to the specialized equipment (Appendix III).”

## **APPENDIX I ESTIMATED REVENUES AND COSTS**

- The exam fee (to be determined) will be charged and collected two months before the exam. Students who fail the exam will be allowed to rewrite the exam at a reduced rate (50% lower). Beginning in year 2, 25% of the total writers are expected to be repeat writers, as most of unsuccessful students are expected to take advantage of the reduced rate.
- The exam taking and the marking end up being separated by our financial year-end. The plan is to recognize revenue on the percentage of completion basis, as the exam is authored, offered and marked.
- Three employees work in the new department, with annual combined salaries of \$160,000. Employment benefits average 15% of salary.
- CHHP outsources the authoring of the exam questions. Multiple-choice questions cost \$50 per question. Although there are 100 multiple-choice questions on an exam, CHHP has to buy 250 multiple-choice questions in order to find 100 that fit well together on an exam. There are also three long-answer questions, which cost \$1,000 each. Again, CHHP outsources five questions in order to find three that fit well together on an exam. The unused questions are “banked” for use on future exams. In order to help build up a bank, CHHP plans to purchase a similar number of questions for the next few years.

All of the multiple-choice and long-answer questions are accounted for as prepaid expenses, but we are not sure this is correct. We have decided not to disclose the exams. Therefore, the questions can be used again. However, after a few years, changes in the profession may make some of questions outdated. A few of the multiple-choice questions probably aren't usable. We wonder how these factors impact the way the questions are accounted for in the financial statements.

- Authors sign a contract agreeing not to use or disclose the questions they write, and to remove all evidence of the questions from their computer. Authors write their questions and send them in by email. Unfortunately, one question was compromised this year. The compromised question resulted from an author's email account being hacked into.
- The examination will be offered in 15 cities across Canada at the same time, at an average cost of \$6,000 for facilities and staff at each location. If there are 1,000 students, exams will be held in only 10 cities, for the same average cost. At 3,000 students, bigger venues in the 15 cities are needed, so the average cost increases to \$10,000 per city.

**APPENDIX I (continued)**  
**ESTIMATED REVENUES AND COSTS**

- The following are the costs related to the marking centre:

Hotel cost	\$1,000 per marker
Meal expense	\$300 per marker
Travel cost	\$800 per marker
Conference room rental	\$30,000 per session
Rental of office equipment, and office supplies	\$5,000 per session

The markers mark in the hotel conference room. If there are 3,000 papers, a second conference room would be needed.

- Markers are paid a flat fee of \$2,500, with no benefits. Payment is made by direct deposit immediately following the marking centre.
- Finding markers is not an issue since we mark the exam during a time of year that is less busy for them.



## **APPENDIX II DETAILS OF MARKING CENTRE OPERATIONS**

- On the first day of the marking centre, CHHP staff will train markers on how to mark the long-answer questions. Using model answers provided by the original author and refined by CHHP staff, they then mark exams for the subsequent four days.
- The hotel has agreed to leave the conference room unlocked so that markers can mark on their own schedule. Markers randomly take several exam responses from the “to be marked” pile and a stack of blank marking keys. On the marking key, the marker documents their name, the student’s number and name, and the marks awarded. When completed, the exam response and marking key are put on the “finished” pile.
- While responsible for marking a predetermined number of responses each day, all markers may start and end their day, and take breaks, when they choose.
- One marker is needed for every 40 students writing the exam.
- Multiple-choice questions are electronically marked by specialized equipment.
- It is critical that exam responses be kept secure. As there is only the one copy, losing a response would be disastrous.

### **APPENDIX III SPECIALIZED EQUIPMENT DECISION**

CHHP needs new specialized equipment to handle the volume of exams. The supplier has offered two options to CHHP:

- Option 1: Upfront purchase at a price of \$55,000. CHHP will have to pay \$1,800 per year for an annual maintenance contract at the end of each year.
- Option 2: Lease of 48 months at \$1,500 per month to be paid at the beginning of the month. CHHP has already incurred \$800 to provide a credit report to the supplier for credit approval.

CHHP's annual borrowing cost is 9%. The specialized equipment has a useful life of four years with a salvage value of \$5,000.

**APPENDIX J**

**RESULTS BY SUMMATIVE ASSESSMENT OPPORTUNITY FOR DAY 1  
VERSION 1 AND VERSION 2**

**Results by Summative Assessment Opportunity****Marking Results - Version 1**

<b>Indicator</b>	<b>Papers</b>	<b>Did not meet standard<sup>1</sup></b>	<b>Marginal<sup>1</sup></b>	<b>Yes, met standard</b>
Situational Analysis	2680	1.01	5.45	93.54
Analysis	2680	3.36	18.21	78.43
Conclude and Advise	2680	0.52	2.39	97.09
Communication	2680	0.41		99.59

**Marking Results - Version 2**

<b>Indicator</b>	<b>Papers</b>	<b>Did not meet standard<sup>1</sup></b>	<b>Marginal<sup>1</sup></b>	<b>Yes, met standard</b>
Situational Analysis	217	2.76	8.76	88.48
Analysis	217	5.53	36.87	57.6
Conclude and Advise	217	1.38	2.3	96.31
Communication	217	0.6		99.4

<sup>1</sup>Clearly failing were marked twice. All marginally failing or passing papers were marked a second time to determine if they met the passing standard. Only the clear passes were marked once.

**APPENDIX K**

**BOARD OF EXAMINERS' COMMENTS ON DAY 1 SIMULATIONS  
VERSION 1 AND VERSION 2**

**BOARD OF EXAMINERS' COMMENTS ON DAY 1****Paper/Simulation: Day 1 – Linked Case, RSI Version 1****Estimated time to complete:** 240 minutes**Simulation difficulty:** Average 1**Competency Map coverage:** N/A; Enabling Skills**Evaluators' comments by Assessment Opportunity (AO)****AO#1 (Situational Analysis)**

Candidates were expected to highlight internal factors (e.g., mission, vision, and key success factors) and external factors (e.g., economy and trends) that would influence the decisions RSI was contemplating. It was essential that candidates highlight the changes in the situation from Capstone 1 that would affect the analysis of the issues and be constraints or overriding decision factors, and that candidates then incorporate these changes in their later work in AO#2 and AO#3. Evidence that candidates understood the changes that occurred from Capstone 1 and their impact on the decisions was critical.

Generally, candidates identified the important factors and did well in linking their situational analysis to the analysis of the issues in AO#2. Some candidates lost time simply recapping case facts or going into too much depth in their situational analysis. Some candidates treated the three main components of their response as totally independent sections, failing to integrate them (in other words, they treated AO#1, AO#2, and AO#3 as separate discussions).

**AO#2 (Analysis of the Issues)**

There were three major issues that candidates were expected to analyze from both a qualitative perspective and a quantitative perspective. There were also several minor issues candidates could have discussed.

Major issue #1: whether or not to relocate Lavish Spa's operation.

Major issue #2: whether or not to accept a large contract from Health and Beauty. Candidates had to analyze RSI's options for meeting the excess demand if it accepted the contract. That entailed determining whether the additional demand could be met through overtime or importing (primarily in the short term, with some consideration of the long-term options as well).

Major issue #3: whether or not to sell ownership in MTC to the other part-owner.

Almost all candidates identified the three major issues in the case. Generally, candidates provided a reasonable analysis of all three major issues, attempting both quantitative and qualitative analyses.

Strong candidates included a deeper, more detailed quantitative analysis than other candidates.

A few candidates appeared to have mismanaged their time, since their analysis of the third major issue was much shorter than those of the other two issues. Many of those candidates provided a lengthy situational analysis. Weak candidates tended to provide brief qualitative points, minimal quantitative analysis (with minimal consideration and application of the situational analysis), or both.

Minor issues: There were also some less significant strategic issues the candidates could discuss. The minor issues included problems with past government grants and the liability to the previous owner, a suggested change to the pricing used at RSI, and the approval of Pure's financial statements and related governance issues.

Most candidates discussed the government grants and pricing change. Many candidates did not prioritize appropriately and spent too much time discussing the government grants. Many of those candidates described the procedures required in greater detail than was appropriate for a board-level discussion.

Generally, candidates seemed confused about which appropriate governance structure they should apply with respect to Pure's financial statements. For this issue, the Board was more interested in an identification of the governance issue than a recommendation on the proper structure.

### **AO#3 (Conclusion)**

Candidates were expected to conclude on each analysis they completed. Conclusions were expected to be consistent with the analysis performed. Concluding that "additional information is required" was acceptable as long as it was substantiated.

Strong candidates provided thorough conclusions for all the issues analyzed. Weaker candidates were unclear in their conclusion, or their conclusion could only be implied from their discussion. Many strong candidates commented on the interrelationship between the issues and how one decision affected another. Many weak candidates attempted to delineate a detailed implementation timeline, which was not possible based on the case facts provided.

### **AO#4 (Communication)**

Candidates generally communicated well.

### **AO#5 (Overall Assessment)**

Overall, candidates were expected to meet minimum acceptable standards in each of the four assessment opportunities listed above in order to obtain a "Pass" on the Day 1 linked case. For each major issue, the Board expected a high-level analysis, incorporating both qualitative and quantitative factors before proceeding to a reasoned conclusion. The Board also sought evidence of having incorporated information from Capstone 1 and the changes identified in their situational analysis.

**BOARD OF EXAMINERS' COMMENTS ON DAY 1 (CONT'D)**

<b>Paper/Simulation:</b>	<b>Day 1 – Linked Case RSI Version 2</b>
<b>Estimated time to complete:</b>	240 minutes
<b>Simulation difficulty:</b>	Easy to Average
<b>Competency Map coverage:</b>	N/A; Enabling Skills

**Evaluators' comments by Summative Assessment Opportunity (AO)****AO#1 (Situational Analysis)**

Candidates were expected to highlight internal factors (e.g., mission, vision, and key success factors) and external factors (e.g., economy and trends) that would influence the decisions RSI was contemplating. It was essential that candidates highlighted the changes in the situation from Capstone 1 that would affect the analysis of the issues and were constraints or overriding decision factors. Candidates were expected to incorporate these changes in their discussions in AO#2 and AO#3. Evidence that candidates understood the changes that occurred from Capstone 1 and their impact on the decisions was critical.

Generally, candidates identified some of the important factors (economic growth, employment rates, new hotels being built) and linked them into their situational analysis to the detailed analysis of the issues in AO#2. In terms of environmental changes, the fact that RSI is in a growth mode and the economy is strong was discussed by most of the candidates.

Strong candidates were selective in what they discussed, focusing on the areas of change that would play into their later analysis.

Weak candidates lost time simply recapping case facts, or went into too much depth in their situational analysis (redoing the entire SWOT analysis).

**AO#2 (Analysis of the Issues)**

There were four major issues that candidates were expected to analyze from both a qualitative perspective and a quantitative perspective.

Almost all candidates identified the four major issues in the case. Generally, candidates provided a reasonable analysis of all four major issues, attempting both quantitative and qualitative analyses. Some candidates appeared to have mismanaged their time, since their analysis of the HAWI franchise issue was much shorter than those of the other issues. Many of those candidates provided a lengthy situational analysis which may have caused them to run out of time. Some candidates had difficulty keeping their analysis at a strategic level and were not able to identify and integrate the main risks in the case, and instead provided a more technical or theoretical analysis of the issue. Some candidates attempted to quantify the amount of financing available to RSI. However, there was insufficient information to do so.

Strong candidates included a more detailed quantitative and qualitative analysis, clearly explaining their calculations, using the case facts, and clearly explaining "why" something was either a pro or a con. They integrated the main risk factors from the case, especially in major issue #2.



Weak candidates tended to provide brief qualitative points (with little application of the situational analysis), performed a minimal quantitative analysis, or did both. Furthermore, many weak candidates did not rank the issues properly, and treated major issue #2 as a secondary issue focusing on the control weaknesses only. Weak candidates also provided a lot of theory on the employee compensation options or Barbara's bonus structure, without relating these discussions back to the actual case facts.

Major issue #1: Decide whether to sell Lavish Spa's operations to Opal.

Candidates were expected to assess the financial offer from Opal Hotel. They should have done a comparison of \$1.2 million to \$1-1.6million and done a quick valuation to confirm that \$1 to \$1.6million was a reasonable value. They could have also estimated the cash flow the sale would generate (\$215,000).

Most candidates addressed the issue adequately. They attempted to assess the offer for Lavish and discussed a few of the pros and cons of accepting it. They calculated an estimated value for Lavish using the information in the case i.e. compared the Lavish value to the industry values and tested the reasonableness of the value by applying a factor of 3-5 X \$225,000 net earnings. Most candidates did not realize the net earnings was not EBITDA.

Strong candidates considered the risks related to the lease if they did not sell Lavish and estimated the value of Lavish, recognizing that EBITDA is different than net income. Strong candidates often quantified the amount of cash flow that could be put towards the investments if Lavish were sold.

Weak candidates failed to understand the terms of the offer, and recalculated the valuation even though it was not required. They often made errors in the calculation.

Major issue #2: Evaluate the performance of Barbara, the new MTC manager, calculate and analyze her bonus, and evaluate the agreement to determine whether it is respected.

Candidates were expected to analyze MTC's financial performance and discuss Barbara's performance as the manager. There were many operational issues presented in the case related to MTC. Candidates needed to bear in mind the requirement to analyze the issues at a high level and avoid going into too much detail, as these issues were intended to raise underlying issues with Barbara's performance as MTC's manager and other bigger picture issues with the joint venture agreement, not simply for them to be addressed from a technical perspective.

Strong candidates focused on the two important issues: Barbara's bias to inflate revenues to get her bonus and the fact that Barbara and Andy are making decisions together without consulting RSI, which goes against the joint venture agreement. Strong candidates analyzed the differences between the actual results and the budget. They clearly understood that the shortfalls in the financial statements were caused by Barbara's bias and the lack of controls, which was the key insight.

Weak candidates failed to identify the breaches in the agreement or Barbara's bias to focus on earnings due to the bonus structure. They were detracted from the main strategic issues and instead analyzed the control weaknesses. This was usually followed by a theoretical discussion of stock options and employee's compensation, again without linking the discussion back to the case facts provided (i.e., the financial statement results, or Barbara's performance and bonus). They sometimes spent an inordinate amount of time discussing whether offering a discount was

a good idea. In terms of the financial statement analysis, they would simply comment on revenues being down and costs being up without using the case facts to suggest why that might be. Some weak candidates also tried to modify the already signed MTC agreement (which was what was required in V1 of RSI.)

Major issue #3: Start a franchise project with an international company or franchise on its own.

Candidates were expected to discuss the franchising opportunity with HAWI and whether RSI should pursue it or franchise on their own.

Most candidates used the case facts presented and discussed the pros and cons of the HAWI franchise offer compared to RSI franchising on their own.

Strong candidates discussed the pros and cons using the case facts and also compared the offers both quantitatively and qualitatively, comparing the 4% rate that HAWI was offering to the rate in the Capstone 1 case of 6%.

Weak candidates did a limited pro and con analysis where they restated case facts without supporting why it is was a pro or con, and failed to discuss the 4% rate offered by HAWI.

Major issue #4: Decide which, if any, of the five potential acquisitions is a good fit with RSI.

Candidates were presented with very little information on several investment opportunities and were asked to consider which, if any, should be pursued. In the board discussion there is a suggestion that no more than \$500,000 should be invested. Candidates were expected to assess the pros and cons of each potential investment considering the risk factors and the fit with the objectives, mission and vision of RSI.

Most candidates analyzed the case facts provided and identified some of the risks and potential benefits associated with each investment option.

Strong candidates not only analyzed each investment opportunity's pros and cons, but went further to consider the fit with RSI and discussed whether the investment was consistent with the company's mission, vision and objectives, and considered whether the suggested limit of \$500,000 was breached.

Weak candidates simply listed the case facts as either pros or cons without further explanation. They usually failed to link the five opportunities with the vision and mission of RSI and often did not compare the sum of the investments with the \$500,000 limit or consider the cash flow coming from the sale of Lavish.

### **AO#3 (Conclusion)**

Candidates were expected to conclude on each analysis they completed. Conclusions were expected to be consistent with the analysis performed. Concluding that "additional information is required" was acceptable as long as it was substantiated.

Strong candidates provided thorough conclusions for all the issues analyzed. Many strong candidates commented on the interrelationship between the issues and how one decision affected another.

Weak candidates were unclear in their conclusions, or their conclusions could only be implied from their discussion.

**AO#4 (Communication)**

Candidates generally communicated well.

**AO#5 (Overall Assessment)**

Overall, candidates were expected to meet minimum acceptable standards in each of the four assessment opportunities listed above in order to obtain a “Pass” on the Day 1 linked case. For each major issue, the Board expected a high-level analysis, incorporating both qualitative and quantitative factors before proceeding to a reasoned conclusion. The Board also sought evidence of candidates having incorporated information from Capstone 1 and the changes identified in their situational analysis.



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