Wednesday 12 February 2014 **(4 hours including reading time)**

ICAN CASE STUDY PILOT PAPER 2

CANDIDATE NUMBER

DO NOT TURN OVER UNTIL YOU ARE TOLD TO DO SO

1. When instructed:

   a. check that your question paper contains all the required pages. The Institute's consecutive page numbering may be found under the base line at the foot of each page;

   b. enter your candidate number in the box provided above.

2. Number each page of your answer consecutively using the space provided at the top right of each sheet.

3. Workings that specifically support the answer to the case study, typically calculations, should be submitted with your answer. Workings should be separately referenced with a 'W' prefix. The answer should be referenced to the relevant workings.

4. After the instruction to stop writing at the end of the paper, you will be given five minutes to assemble your answer in this folder. Fasten your complete script inside this folder using the hole in the back page and the tag provided.

5. Answer folders and examination stationery, used or unused, must **not** be removed from the Examination Hall. Question papers may, however, be retained by candidates.

ICAN Case Study

Pilot Paper 2

LAG Film and DVD Limited (LAG)

Requirement

You are Jack Osage, a final year trainee in the firm of Corn Wilma ICAN Chartered Accountants. You are to prepare a draft report to Sanai Victor – an ICAN ACA – and the Finance Director of a client company, LAG Film & DVD Limited (LAG), as set out in the memo **(Exhibit 1)** from Anya Wilma, one of the directors of the business advisory arm of the firm Corn Wilma.

The following overall time allocation is suggested:

Reading	1 hour
Planning and calculations	1 hour
Drafting report	2 hours

LIST OF EXHIBITS

Exhibit	Description
1	Email from Anya Wilma, partner in Corn Wilma Chartered Accountants (CW) to you, Jack Osage
2	Email from Sanai Victor, Managing Director of LAG Film & DVD Limited (LAG), your client, to Anya Wilma
3	Email from Doran Raft Regional Manager of PH Bank to Sanai Victor and LAG Board
4	Draft Loan Terms from PH Bank
5	3-year summarised financial statements of LAG to 31 December 2013
6	Explanatory notes to the LAG financial statements
7	Details of non-current asset investment proposal provided by LAG

EXHIBIT 1

Corn Wilma

Email

From: Anya Wilma
To: Jack Osage
Re: LAG Film & DVD Limited
Date: 12 February 2014

Please find attached an email from Sanai Victor, the Managing Director of one of our clients, LAG Film & DVD Limited (LAG), a digital film and DVD retailer, which I have attached to this email (**Exhibit 2)** together with all the attachments which he sent to me (**Exhibits 3-7**).

The attachments include a summary set of LAG financial statements for the three years ended 31st December 2013 (**Exhibit 5**) together with explanatory notes relating to those summary financial statements (**Exhibit 6**).

In summary LAG operates as a film streaming distributor and supplier of DVDs as hard copies to retail outlets and other client organisations as well as directly to individual customers in both download or as delivered hard copies.

As Sanai Victor states in the email LAG are in correspondence with Dora Raft the Regional Manager of PH Bank plc, the bank who has always handled its banking and lending business. LAG is looking to take out a new loan to finance the purchase of new IT and manufacturing equipment (**Exhibit 7**).

I have just had a phone conversation with Sanai to follow up on the email and LAG would like us to prepare an independent report to the LAG board.

Required

Using the attached information prepare a draft report to the LAG Board. Your report should comprise

1. An analysis of whether LAG meets the key financial criteria identified by PH Bank (**Exhibit 3**) by identifying LAG's financial strengths and weaknesses from an examination of the information provided in the LAG financial statements (**Exhibit 5**) and related explanations (**Exhibit 2**) and information in the notes (**Exhibit 6**).

   Your analysis will be used by LAG in preparation for its meeting with PH Bank. You must therefore include an explanation of the reasons why LAG may have failed to meet any of the bank criteria and how LAG might either overcome these financial weaknesses or justify itself to the bank in the light of those failures. Your report should only concentrate on the material figures and issues, and should provide a clear explanatory commentary together with your judgement and conclusions on the key items which you identify.

2. A payback analysis for the new LAG project identifying the potential payback time and an explanatory commentary and evaluation of that calculation using the information provided by LAG (**Exhibit 7**) and the PH Bank loan criteria and interest charges (**Exhibit 4**). Your evaluation should consider the adequacy of the assumptions made by LAG. You should also provide an analytical explanation of the statement of cash flow and the overdraft at the year end. You should clearly identify to LAG whether in your opinion the project proposal will meet the loan criteria set by PH Bank.

EXHIBIT 2

LAG Film & DVD LIMITED

Email

From: Sanai Victor Finance Director of LAG Film & DVD Limited
To: Anya Wilma
Re: Investment in new equipment
Date: 11 February 2014

Dear Anya,

Please find attached a summary set of LAG's financial statements for the three years ended 31 December 2013 (**Exhibit 5**) together with a set of explanatory notes (**Exhibit 6**). The figures in these financial statements are in agreement with the audited financial statements for 2011 and 2012 and the recently completed 2013 audit – by Throng Adele Chartered Accountants. All years were unqualified. This information will provide you with a comprehensive financial picture of our business.

Recent issues

As a result of a flood in a studio which we have been renting until recently – for which it appears neither LAG nor the landlord were insured – there was considerable damage to LAG equipment held there. As a result this damaged equipment was no longer fit for purpose and LAG has had to dispose of it at an extremely low value – you can see the result of this disposal in our financial statements.

LAG made the payment of the last instalment on its previous loan to PH Bank on 31 December 2013. The fact that these payments fell on the last day of our financial year, combined with other operational factors meant that LAG dipped into overdraft – the limit for which is set at ₦100million. That overdraft is secured by way of a floating charge on LAG's current assets.

LAG future investment in new IT

It is apparent that the downloading or "streaming" of films by individual customers is becoming more popular. In order for LAG to meet that increasing demand it needs to upgrade its IT and back-up system to improve the speed and the stringent security needs of downloading or streaming of films, and to improve the computer-aided production of DVDs (see **Exhibit 7** for project information).

We are sure that this will also have a significant impact on direct sale revenues to individuals by being able to respond to their increasing requests. Other streams of revenue should also benefit and continue to increase in line with or ahead of past trends.

We are due to meet with Dora Raft of PH Bank next week to discuss borrowing the necessary amount to pay for the new IT. Ahead of that meeting she has sent us details of the criteria for a business customer to become an "approved" customer for any future bank loans (**Exhibit 3**).

Assuming that LAG achieves "approved" customer status LAG have already indicated to PH Bank that in order to ease its cash flow over the duration of the loan LAG would want to borrow the money on an "interest only" repayment basis for the duration of the loan. LAG would pay back the full principal of the loan on the last day of the agreement. Dora has sent a draft of the detailed loan terms which PH Bank would apply in such circumstances (**Exhibit 4**).

Instructions

I will call you tomorrow to discuss and confirm the Board of LAG's instructions for Corn Wilma.

EXHIBIT 3

PH BANK

Email

From: Dora Raft
To: Sanai Victor
Re: General criteria for bank loans: LAG investment in new IT and equipment
Date: 10 February 2014

Dear Sanai,

This is to confirm that since the start of 2014, PH Bank has established a new set of financial and business criteria which all business customers should meet in order to become an “approved” customer for any new business loans. Being an “approved” customer is an essential first step in any loan application.

For bank business customers the PH Bank business and financial criteria for becoming an “approved” customer are that the business will have:

1. A history (3-year) of increasing revenue streams in absolute and percentage terms
2. Annual gross profit (3-year) is steady or improving in absolute and/or percentage terms
3. Earnings before interest, tax, depreciation and impairment (EBITDA) – not operating profit – is constant or improving.
4. Profit before tax percentage against revenue in latest Financial Statements is at least 5%
5. The business should have a positive Net Current Asset position and history (3-year)
6. Customer should have a good financial history with respect to any previous loan schedule and terms

In instances where the business does not meet any (or all) of the above criteria then the business is given the opportunity to present clear justifications for any failure or financial weakness either in a report or in person, which identify and explain ways of dealing with those issues. These should:

- offer a clear explanation of the financial circumstances relating to the issue
- provide evidence of compensating financial and business strengths to address the issues and weaknesses that have been identified

EXHIBIT 4

PH BANK

Draft Terms of Bank Loan to an "approved" customer

The PH Bank will make an "interest only" repayment loan to an "approved" customer on the following terms:

1. The statement of cash flows for the business should show a positive net inflow and in the most recent balance sheet the balance at the bank should be positive at the financial year end – if this is not the case then a full analysis and explanation of the statement of cash flows must be provided.

2. Linked to point (1) If the business has an overdraft at the financial year end then a justification must be provided.

3. For any new loan the period of an "interest only" loan will be either 3-years or 4-years

   - A **3-year** interest only loan will be charged at **20% per annum** on the principal borrowed

   - A **4-year** interest only loan will be charged at 24**% per annum** on the principal borrowed

4. All annual interest is to be paid to the bank on the last day of the 12-month period to which it relates

5. Interest cover in the latest Financial Statements is sufficient to cover the interest on any proposed loan

6. The principal is to be repaid on the last day of the overall period of the loan

7. For the duration of the loan the bank will secure its loan by holding a "floating charge" over the business current assets for the amount of the loan principal and interest outstanding.

EXHIBIT 5

LAG Film & DVD Limited
3 year financial summary (to 31 December 2013)

Statement of Profit and Loss	**Notes**			
Year ended 31 December		**2013**	**2012**	**2011**
		₦'million	**₦'million**	**₦'million**
Revenue	**1**	5,564	4,018	3,107
Cost of sales	**2**	(3,413)	(2,374)	(1,762)
Gross Profit		**2,151**	**1,644**	**1,345**
Overheads/administrative costs	**3**	(1,881)	(1,367)	(1,046)
Operating profit		**270**	**277**	**299**
Finance expense	**4**	(42)	(64)	(96)
Profit before taxation		**228**	**213**	**203**
Taxation		(57)	(53)	(51)
Profit for the year after taxation		**171**	**160**	**152**

LAG Film & DVD Limited
Statement of financial position
As at 31 December

	Notes	2013	2012	2011
		₦'million	**₦'million**	**₦'million**
Non-current assets				
Property, plant and equipment	**4**	739	1,067	1,269
		739	1,067	1,269
Current assets				
Inventories	**5**	492	328	249
Accounts receivable	**6**	1,436	963	671
Cash and cash equivalents		4	4	36
		1,932	1,295	956
Total assets		**2,671**	**2,362**	**2,225**
Shareholders' equity				
Ordinary share capital		100	100	100
Retained earnings		867	696	536
Total shareholders' equity		967	796	636
Non-current liabilities				
Loan	**7**	-	-	400
		-	-	400
Current liabilities				
Accounts payable	**8**	1,606	1,085	789
Loan	**7**	-	400	400
Bank overdraft		98	81	-
Total current liabilities		1,704	1,566	1,189
Total shareholders' equity and liabilities		**2,671**	**2,362**	**2,225**

LAG Film & DVD Limited
Statement of cash flow

Year ended 31 December	**2013**	**2012**	**2011**
	₦'million	**₦'million**	**₦'million**
Cash flows from operating activities			
Profit before tax	228	213	203
Adjustments for:			
Depreciation	190	276	336
Losses on disposal of non-current assets	264	65	45
Finance expenses	42	64	96
	724	**618**	**680**
Change in inventories	(164)	(79)	(80)
Change in accounts receivable	(473)	(292)	(101)
Change in accounts payable	517	294	107
Cash generated from operations	**604**	**541**	**606**
Taxation paid	(53)	(51)	(44)
Finance expenses	(42)	(64)	(96)
Net cash from operating activities	**509**	**426**	**466**
Investing activities			
Purchase of property, plant and equipment	(144)	(163)	(465)
Proceeds from disposal of plant & equipment	18	24	5
Net cash used in investing activities	**(126)**	**(139)**	**(460)**
Financing activities			
Loan	(400)	(400)	(400)
Net cash (used in)/from financing activities	**(400)**	**(400)**	**(400)**
Net change in cash and cash equivalents	**(17)**	**(113)**	**(394)**
Cash and cash equivalents at start of year	(77)	36	430
Cash and cash equivalents at end of year	**(94)**	**(77)**	**36**

EXHIBIT 6

Notes to the LAG financial statements for the three years ended 31 December 2013

Note 1 Revenue

	2013	2012	2011
	₦'million	₦'million	₦'million
Sales to retailers	2,997	2,594	2,336
Direct sales: DVD downloads and deliveries	2,016	1,018	457
Sales to other corporate clients	551	406	314
Total revenue	5,564	4,018	3,107

Sales to retailers: these are made to different types of retail outlets including: supermarkets; petrol stations; small retailers and bookstores. Sales to retailers are seasonal (December accounts for 35% of annual sales). Retailers take around 45 days to pay LAG.

Direct sales: these are made to individuals who pay either per download or DVD delivered. Like retail sales, direct sales are seasonal but are paid by debit / credit card before receipt of the download code or delivery of DVD – so only transit card balances are outstanding.

Sales to other corporate clients: these are non-seasonal clients, largely public sector organisations (schools, hospitals and other government departments) which are supplied with access to films and DVDs at a substantial discount (50%) to the retail market. These clients pay with a 60 day time lag.

Note 2 Cost of sales

	2013	2012	2011
	₦'million	₦'million	₦'million
DVDs	1,771	1,293	981
Licence payments to film distributors	963	558	273
Web, promotional & delivery costs	83	68	46
Production and distribution salaries	177	146	111
Depreciation (+P/L on disposals)	419	309	347
	3,413	2,374	1,758

Purchases of DVDs and agreements with film licence holders are seasonal and take place in the month before the anticipated sales. Because LAG is an established enterprise in this market, most suppliers offer LAG at least 60 days to pay for items purchased.

Note 3 Overheads and administrative expenses

	2013	2012	2011
	₦'million	₦'million	₦'million
Office salaries and wages	868	566	408
Office and studio expenses	982	769	606
Depreciation (+P/L on disposals)	31	32	32
	1,881	1,367	1,046

Most office and studio expenses are paid within 60 days of receipt of invoice.

Notes to the LAG financial statement for the three years ended 31 December 2013

Note 4 Non-current assets

	Improvements to property	**DVD Equipment and IT**	**Motor Vehicles**	**Total**
Cost	**₦'million**	**₦'million**	**₦'million**	**₦'million**
At 1 January 2011	289	2,448	368	**3,105**
Additions	31	377	57	**465**
Disposals	-	(98)	-	**(98)**
At 31 December 2011	**320**	**2,727**	**425**	**3,472**
Depreciation				
At 1 January 2011	232	1,465	218	**1,915**
On disposals	-	(48)	-	**(48)**
Charge for the year	32	262	42	**336**
At 31 December 2011	**264**	**1,679**	**260**	**2,203**
Carrying amount 31 December 2011	**56**	**1,048**	**165**	**1,269**
Cost				
At 1 January 2012	320	2,727	425	**3,472**
Additions	-	69	94	**163**
Disposals	-	(126)	(95)	**(221)**
At 31 December 2012	320	2,670	424	**3,414**
Depreciation				
At 1 January 2012	264	1,679	260	**2,203**
On disposals	-	(75)	(57)	**(132)**
Charge for the year	32	202	42	**276**
At 31 December 2012	296	1,806	245	**2,347**
Carrying amount 31 December 2012	**24**	**864**	**179**	**1,067**
Cost				
At 1 January 2013	320	2,670	424	**3,414**
Additions	64	80	-	**144**
Disposals	-	(584)	-	**(584)**
At 31 December 2013	384	2,166	424	**2,974**
Depreciation				
At 1 January 2013	296	1,806	245	**2,347**
On disposals	-	(302)	-	**(302)**
Charge for the year	35	119	36	**190**
At 31 December 2013	331	1,623	281	**2,235**
Carrying amount 31 December 2013	**53**	**543**	**143**	**739**

Depreciation is charged at 10% straight line on improvements to property, and 20% reducing balance on all other non-current assets.

Note 5 Inventory

	2013	2012	2011
	₦'million	₦'million	₦'million
DVDs	424	271	212
Work in progress	41	35	22
Other	27	22	15
	492	328	249

No allowance for obsolete inventory has ever been created by LAG

Note 6 Accounts receivable

	2013	2012	2011
	₦'million	₦'million	₦'million
Trade receivables	1,295	849	575
Other receivables and prepayments	141	114	96
	1,436	963	671

No provision for doubtful debts has been created by LAG in 2013

Note 7 Bank Loan

	2013	2012	2011
	₦'million	₦'million	₦'million
Amount due in more than one year	-	-	400
Amount due in less than one year	-	400	400
	-	400	800

This five-year 8% bank loan from PR Bank was fully repaid (together with the final annual interest instalment) on 31 December 2013

Note 8 Accounts payable

	2013	2012	2011
	₦'million	₦'million	₦'million
Trade payables including licence fees	1,282	869	616
Other payables & accruals including tax	324	216	173
	1,606	1,085	789

EXHIBIT 7

LAG Film & DVD LIMITED
Internal Email

From: Head of IT
To: Sanai Victor and all LAG Board members
Re: Project IT upgrade
Date: 4 February 2014

The following are the best estimates and assumptions concerning the new integrated IT project.

The operational projections are:

a) when fully operational in about two months' time the new IT system will allow LAG to increase its film streaming and production capacity by more than ten times its current capacities – which will be sufficient new capacity for the foreseeable future
b) it will also allow LAG to integrate its web activity and significantly increase its data storage capacity
c) the system will allow LAG to improve inventory control and identify in a much shorter timescale inventory needs – so reducing the need to hold as much inventory as it currently holds
d) this investment will also identify re-ordering or re-stocking needs more efficiently – hopefully reducing costs and the inefficient placing of any large orders with DVD suppliers
e) this technology will also identify which retailers are ordering which films and with what frequency which may enable better "just in time" delivery of items to them and enable LAG to establish more favourable credit terms and prompt settlement of its outstanding invoices from them
f) there will be no need for any additional personnel to be recruited

The financial projections are:

1. Initial outlay will be ₦1,000million – this IT system is expected to be current for 5 years
2. Market research indicates that this investment will allow LAG to increase its annual revenue by between ₦1,000million (minimum) and ₦1,200million (maximum) for the foreseeable future
3. The Gross Profit (excluding depreciation) on the additional annual revenue generated will be at least 45%
4. There will be an annual increase in other overheads or administration of ₦40million as a result of this investment

Additional features of the new IT system, which are not easily quantifiable in financial terms are:

1. This new IT system has the capability to allow the business to download copies of film software not only from all the main film distributors but also from cheaper unofficial sources which will reduce LAG costs in the future
2. The system has the capacity to allow LAG to hold much more detail on each individual customer than it has previously held, enabling it to keep better, and more detailed, customer profiles
3. The system will also allow LAG to monitor all the downloads of individual customers which will enable LAG to improve its marketing by targeting customers with additional "linked" films and DVDs and other future "promotions"
4. LAG would also be in a position to sell its detailed customer information to other organisations for their marketing purposes.