ROLE SIMULATION EXAMINATION

ADVANCE INFORMATION

This material is issued prior to the examination session.

Candidates **must** bring this material with them
to the Examination Hall.
No copies will be provided.

ADVANCE INFORMATION

This Advance Information is issued prior to the examination session to allow you to familiarise yourself with the information provided and to undertake any other appropriate research and analysis. The Advance Information is also published on the website: www.icaew.com/students.

You must bring this Advance Information with you to the Examination Hall, annotated if you wish, together with any other notes of your preparatory work. You must carry out sufficient and appropriate analysis work **of your own** in order to have a detailed understanding of the Advance Information. You should also undertake any additional research and analysis you feel necessary to enhance your awareness of the industry and market context and to enable you to clarify any technical terms or other issues of vocabulary. You will need to be able to refer back quickly to the Advance Information and your notes during the examination; you are therefore unlikely to benefit from taking large quantities of additional material with you into the Examination Hall.

At the start of the examination you will receive some additional material which will complete the description of the role simulation scenario and state the role simulation requirements. Your answer must be submitted on the paper provided by ICAEW in the Examination Hall. Any pre-prepared papers, or papers comprising annotated exhibits from this Advance Information, included in your answer will not be marked.

The examination is based on the 2019 Learning Materials.

Assessment of the Role Simulation Examination

The marks in the Role Simulation Examination are awarded for demonstration of competence in the knowledge, skills and behaviours set out in the Level 4 Accounting Technician assessment plan. The marks are allocated broadly as follows:

- Knowledge 30% - 40%
- Skills 30% - 40%
- Behaviours 30% - 40%

The knowledge, skills and behaviours will be assessed through a series of requirements in the Role Simulation Examination. Marks available for each requirement will be shown next to each requirement.

Presentation of Answers

Answer each task in black ballpoint pen only.

Answers to each task must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.

For multiple choice questions, you should clearly record the response you wish to select in your answer booklet. If the examiner is in any doubt as to which option you consider to be correct, you will receive no marks for that question.

The examiner will take account of the way in which answers are presented.

PackUp Ltd

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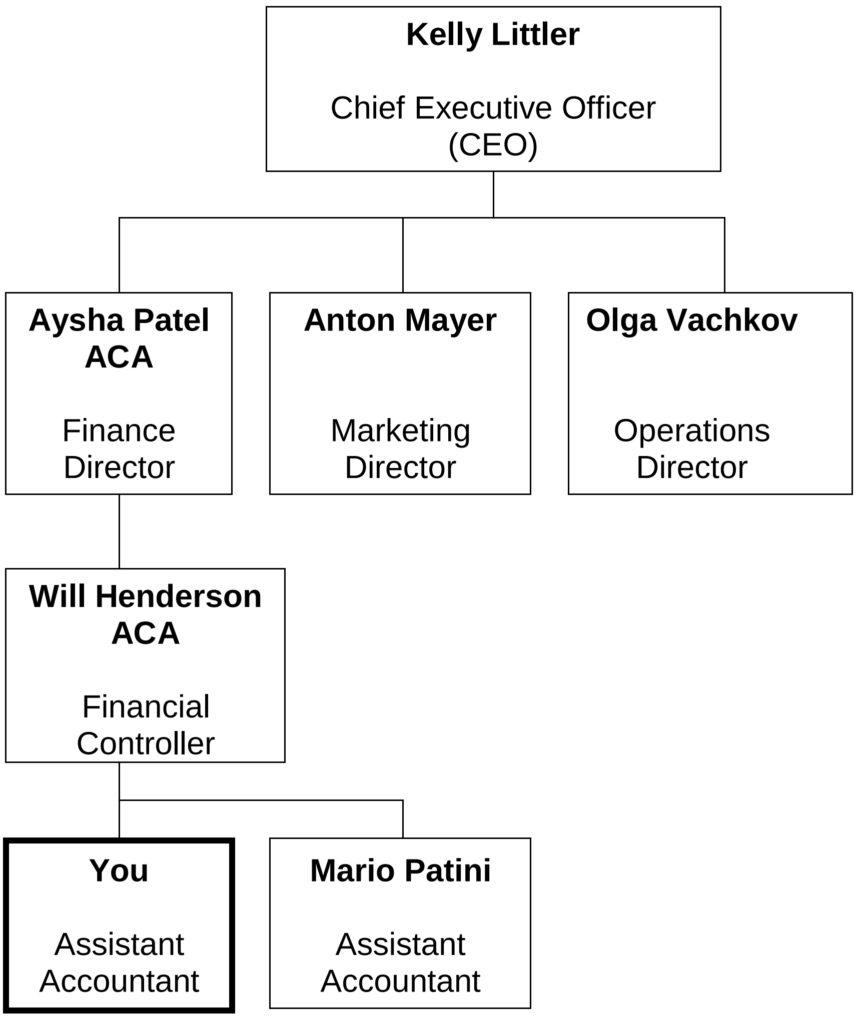
This document reflects information available as at 1 July 2020.

Introduction: PackUp Ltd

PackUp Ltd (PackUp) produces packaging for use by the fast-food industry. PackUp is a private limited company founded in 2009 by Kelly Littler, who is the chief executive officer (CEO) and owns 90% of the ordinary share capital. Kelly's sister owns the remaining 10% of the share capital but is not involved in the company in any other way.

Organisation chart (extract)

You are an Assistant Accountant in PackUp's finance function, working with Mario Patini, an Assistant Accountant who has just joined the company. You are training to be an ICAEW Chartered Accountant. You are aware that you need to comply with the PackUp finance function handbook (**Appendix B**) which also contains ethical guidance from PackUp's Corporate Code of Ethics.



Industry information

The fast-food packaging industry is fragmented and highly competitive, with low barriers to entry. The industry's growth is linked to the success of fast-food retailers.

Fast food includes hot drinks, soups and food such as burgers, pizzas and fried chicken which are designed to be taken away by the customer (in cups, bags, boxes and cartons) and consumed off the retailer's premises. It also includes more upmarket deli-style snacks, sandwiches and salads. Some countries seek to regulate the composition, availability and pricing of fast food on public health grounds, but consumer demand for an ever-widening variety of fast food has continued to grow.

Conventional fast-food packaging is mostly made of plastic, polystyrene and other non-biodegradable materials. As a result, the packaging is 'single-use' i.e. the used packaging cannot be recycled and must ultimately be disposed of in landfill sites, which is expensive. Since 2017 consumers have increasingly demanded packaging that is more sustainable and less harmful to the environment. In consequence, single-use packaging is being superseded by new types of packaging which are easy to recycle after use. In addition, some environmentally-conscious consumers prefer to provide their own containers for fast-food retailers to fill with food and drink, as these containers can be reused multiple times.

International regulations affecting fast-food retailers require all food packaging to be suitable for close contact with foodstuffs. The international symbol for safe food packaging is a graphic of a glass and a fork. Every country has different regulations regarding responsibility for the collection and disposal of used fast-food packaging.

A key way in which businesses compete in the industry is to innovate by developing materials, processes and product designs. Various intellectual property rights, including patents, protect these innovations from being copied for specific periods of time.

PackUp's products and markets

PackUp's products include boxes, cartons, cups, lids, trays, cutlery, straws and drinks stirrers. Its main product lines are all single-use items, ranging from very basic, low-quality packaging to high-quality, bespoke packaging for specialist use. PackUp also has some recyclable and reusable product lines, but together these only made up 20% of PackUp's revenue in the year ended 31 August 2019.

Materials used by PackUp to manufacture its products include various types and grades of paper, paperboard and foil, plus plastic including cellophane and polystyrene.

Most of PackUp's manufacturing is carried out in-house at its factory in Northampton using fairly basic machinery. About 15% is outsourced to suppliers in other European countries. All PackUp's outbound logistics are outsourced.

PackUp's clients are all located in the UK. They include:

- large specialist fast-food chains selling burgers, pizzas, fried chicken etc
- smaller cafes and restaurants selling a wider variety of food.

Most PackUp products are printed with the client's name or logo. PackUp prides itself on its good service and most of its clients are long-standing and have been loyal.

PackUp must supply a declaration of compliance to its clients as written evidence that the client has complied with safe food packaging regulations by using PackUp's products. Because of its size, PackUp is registered as a packaging producer under the UK's Packaging Waste Regulations. These regulations aim to increase recycling and reuse and thereby limit the amount of packaging that ends up in landfill. As a packaging producer PackUp is obliged to help finance the UK's collection and recycling of packaging waste by purchasing Packaging Waste Recovery Notes (PWRNs) from the Environment Agency. PWRNs are therefore an added cost for PackUp.

Product/market strategy

Since 2017, revenue from PackUp's single-use product lines has fallen sharply because of growth in demand for recyclable packaging, especially from clients which promote themselves as environmentally friendly. In addition, clients increasingly require PackUp to provide formal assurances that environmental regulations are complied with throughout their manufacturing process and at every manufacturing location.

To address these issues, in 2018 Kelly identified the need for PackUp to innovate more and to create recyclable and reusable product lines that would in time fully replace the single-use ones.

PackUp has recently started to produce and sell reusable solid plastic cups with a unique, aesthetically pleasing design, under the brand name 'Warm&Safe'. Manufacturing is outsourced to LMP Ltd, a company which has a factory near Northampton. The cups are sold to supermarkets and department stores as well as to PackUp's traditional clients, for onward sale to consumers. They can be filled with hot drinks and soup at home or in a fast-food shop for consumption on the go. Warm&Safe cups are guaranteed not to crack, split or spill.

PackUp applied for and received patent protection on its Warm&Safe design. Despite the excellence of the design and the popularity of the Warm&Safe product, Kelly has concerns that the quality of manufacture has been poor. Serious problems have arisen with LMP Ltd and its activities which have recently been discussed by the board (**Appendix E**).

Another of PackUp's new product lines is the 'PackWild' recyclable range of cartons (**Appendix D**) which has had a successful launch recently.

PackUp's financial performance

Compared with some of its competitors, PackUp was slow to address sustainability concerns and to anticipate changes in the type of packaging demanded by its key clients. This has been the main reason for a decline in profitability and cash flows from mid-2017 onwards:

Year ended 31 August	**2017 (actual)**	**2018 (actual)**	**2019 (actual - see Appendix A)**	**2020 (forecast)**
Revenue	£36,950,000	£36,150,000	£34,013,000	£33,500,000
Gross profit margin	25.9%	25.0%	21.8%	19.0%
Operating profit margin	15.8%	14.7%	10.5%	7.5%
Cash from operations	£4,480,000	£4,206,000	£3,959,000	£2,655,000

In spite of its declining financial performance, PackUp has continued to pay a dividend of £500,000 in total in December each year, split between Kelly and her sister.

Cash flow since 1 September 2019 has been affected by:

- rising inventory levels
- a trend towards clients taking longer to pay
- investment in new machinery for production, particularly of new recyclable and reusable product lines
- the disposal of old production line machinery for cash.

Loan covenants

PackUp has a loan from Franchay Bank plc (Franchay) which is at a very competitive interest rate. However, the loan agreement contains covenants with which PackUp must strictly comply. These state that:

- the quick (or liquidity) ratio must be a minimum of 1.0;
- the inventory turnover period must be a maximum of 80 days (calculated as closing inventory/cost of sales x 365); and
- the trade receivables collection period must be a maximum of 90 days (calculated as closing trade receivables/revenue x 365).

If PackUp fails to comply with these covenants, Franchay has the right to review the interest rate on the loan. Ultimately the bank can demand immediate repayment of the loan if covenants are persistently breached.

Working capital management

From the financial statements for the year ended 31 August 2019 (**Appendix A**), PackUp's actual performance in relation to the ratios specified in the loan covenants was as follows:

Quick (liquidity) ratio	1.0
Inventory turnover period	76 days
Trade receivables collection period	87 days

The finance function is making working capital management a priority and in particular is reviewing the collection of cash from clients. A limited analysis of cash collections has been prepared (**Appendix D**).

New methods of working capital management, such as offering clients a settlement discount or seeking the services of a debt factor, must be sanctioned by PackUp's finance director, Aysha Patel, who must obtain approval from the board.

Product costing

To date PackUp has used batch costing to cost its products at full absorption cost with overheads absorbed using a labour hour rate (**Appendix B**).

In September 2019 PackUp invested £3,150,000 in new, computer-controlled equipment which has made a significant change to the way in which it operates its in-house manufacturing. As a result, Aysha is considering a revision to the product costing of in-house production and the pricing of products.

External audit

PackUp's external auditor is Strinder LLP (Strinder), a small local firm which was appointed several years ago. The audit engagement partner is Frank Marple.

During the audit for the year ended 31 August 2019, Frank expressed some concern to Kelly about PackUp's declining profitability and cashflow. Ultimately it was agreed PackUp was a going concern, sufficient appropriate audit evidence was obtained and the auditor's report was unmodified.

Since then however relations between PackUp and Strinder have deteriorated and a challenging meeting took place on 15 June 2020 (**Appendix C**).

On 21 June 2020 a newly-established local audit firm, HC LLP (HC), approached PackUp, offering a variety of services. HC's offer included acting as PackUp's external auditor for a fee significantly below Strinder's 2019 external audit fee. At a board meeting on 26 June 2020, PackUp's board discussed HC's offer, among other issues, but no decision was taken (**Appendix E**).

Strinder is continuing to prepare for the audit for the year ending 31 August 2020. Frank has asked for a further meeting with PackUp to discuss the audit of working capital balances. He also wishes to discuss detailed arrangements for the inventory count that will take place on 31 August 2020, following poor management of the count on 31 August 2019 by Olga Vachkov, the operations director.

Appendix A – Financial statements for the year ended 31 August 2019 (extracts)

PackUp Ltd: Statement of profit or loss for the year ended 31 August 2019

	£'000
Revenue	34,013
Cost of sales	(26,582)
Gross profit	7,431
Distribution costs and administrative expenses	(3,850)
Profit from operations	3,581
Finance costs	(198)
Profit before tax	3,383
Income tax expense	(677)
Profit for the period	2,706

PackUp Ltd: Statement of financial position as at 31 August 2019

	£'000	£'000
ASSETS		
Non-current assets		
Property, plant and equipment		7,425
Intangible assets		391
		7,816
Current assets		
Inventories	5,559	
Trade receivables	8,130	
Cash and cash equivalents	1,408	
		15,097
Total assets		22,913
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital (£1 shares)		2,000
Retained earnings		7,891
Total equity		9,891
Non-current liabilities		
Borrowings		3,800
Current liabilities		
Trade payables	8,276	
Borrowings	200	
Income tax payable	746	
		9,222
Total equity and liabilities		22,913

PackUp Ltd: Statement of cash flows for the year ended 31 August 2019

	£'000	£'000
Cash flows from operating activities		
Profit before tax		3,383
Finance costs		198
Gain on sale of property, plant and equipment		(20)
Depreciation and amortisation charges		1,567
Increase in trade payables		1,466
Increase in inventories		(1,834)
Increase in trade receivables		(801)
Cash generated from operations		3,959
Interest paid		(198)
Tax paid		(920)
Net cash from operating activities		2,841
Cash flows from investing activities		
Purchase of property, plant and equipment	(3,180)	
Proceeds from sale of property, plant and equipment	200	
Net cash used in investing activities		(2,980)
Cash flows from financing activities		
Decrease in non-current borrowings	(200)	
Dividends paid	(500)	
Net cash used in financing activities		(700)
Net decrease in cash and cash equivalents		(839)
Cash and cash equivalents at 1 September 2018		2,247
Cash and cash equivalents at 31 August 2019		1,408

Appendix B – Finance function handbook (extracts)

<u>Preparation of financial statements</u>

The financial statements are prepared under the accruals basis of accounting and the going concern assumption using International Financial Reporting Standards (IFRS).

<u>Accounting for trade receivables</u>

Trade receivables are shown in the financial statements net of any allowance for irrecoverable receivables. Changes to the allowance, and any receivables written off as irrecoverable, are included in administrative expenses.

<u>Accounting for inventories</u>

Inventories are measured at the lower of cost and net realisable value using First-in, First-out (FIFO). Any write down of inventories due to obsolescence etc is recognised, net of supplier refunds or insurance pay-outs, in cost of sales.

<u>Batch costing</u>

Batches of products manufactured by PackUp are valued at full absorption cost with overheads absorbed using a labour hour rate.

<u>Pricing</u>

PackUp prices its products using full absorption cost-plus pricing.

<u>Corporate Code of Ethics</u>

All staff and officers, including those working in the finance function, are required to comply with PackUp's Corporate Code of Ethics. In particular, they must demonstrate fairness, honesty and openness in relation to stakeholders.

Any queries regarding compliance with a request for information from a person outside the company must be raised, in person, by a staff member with their line manager or, if this is inappropriate, with a director of the company.

It is both a statutory and an ethical duty for finance function staff to provide full assistance to external auditors and assurance providers.

Finance function staff are expected to comply with both this corporate code of ethics and the code of ethics of their own professional body.

Appendix C – Notes of a meeting between Aysha Patel, finance director, and Frank Marple, audit engagement partner, held on 15 June 2020

Environmental assurance report

Aysha informed Frank that several large retailers and fast-food chains have expressed an interest in PackUp's new recyclable and reusable product lines. However these potential clients want to know how PackUp's production processes for the new products affect the environment, before they are prepared to sign any contracts. Aysha told Frank that PackUp is producing detailed information for clients about the impact of its production processes and products on the natural environment. She enquired whether Strinder could issue a report that provides assurance on this environmental information (an environmental assurance report). Frank agreed to provide Aysha with a quote for Strinder to complete the environmental assurance report as a limited assurance engagement.

Working capital position

Aysha and Frank discussed issues raised during Strinder's audit of PackUp's financial statements for the year ended 31 August 2019. These issues included some concern about PackUp's working capital position and how it was managed, though the directors and the auditors were all satisfied that PackUp was a going concern.

A review by Strinder in April 2020 indicated that the company's financial situation had deteriorated. One reason for the decline was the loss in March 2020 of a contract with KebabHut plc, a large fast-food chain, which decided to switch supplier so it could purchase recyclable packaging in larger quantities. Frank expressed concern at the effect of the financial situation on audit risk for the audit of the financial statements for the year ending 31 August 2020. He stated that, to gain sufficient appropriate audit evidence, additional audit procedures would be required. The additional audit procedures would focus on working capital balances in the financial statements, particularly inventories.

Despite the extent of these additional procedures, Frank confirmed that the audit would still be completed in time for PackUp to file its audited financial statements at Companies House by the due date.

Audit fee

Frank said the audit fee must increase due to the additional audit procedures required. Aysha resisted this idea vigorously and stated that, unless Strinder agreed to keep the audit fee at the same level as the previous year, PackUp would immediately seek to appoint a new external auditor.

Appendix D – Analysis of sales, profit and cash collections for the PackWild product line

The finance function was tasked with improving working capital management. Will Henderson, the financial controller, recently investigated the pattern of profit and cash collections from sales of PackUp's new recyclable product line, PackWild cartons. He identified the following information:

- Sales of PackWild cartons are £295,000 per month.
- The gross profit margin on sales is 30%.
- Sales invoices are issued at the end of the month of sale.
- 42% of invoices are collected between 31 and 60 days of invoice issue.
- 55% of invoices are collected between 61 and 90 days of invoice issue.
- 3% of PackWild invoices are never paid and are written off.

The profit and cash collection schedules in respect of one month of PackWild sales are as follows:

	£
Sales Month 1	295,000
Profit schedule:	
Gross profit on sales	88,500
Irrecoverable debts	(8,850)
Profit before share of other overheads	79,650
Cash collection schedule:	
0-30 days (i.e. in Month 2)	0
31-60 days (i.e. in Month 3)	123,900
61-90 days (i.e. in Month 4)	162,250

Appendix E – Notes of PackUp's board meeting held on 26 June 2020

The directors met to discuss the following issues that face PackUp:

Outsourcing of manufacturing

In general, relationships with the European suppliers that produce some of PackUp's products are progressing well. However, Kelly was concerned about two issues:

- Klonfa, a key current supplier in Bulgaria, has failed to confirm that its production processes comply with the relevant requirements for applying the international symbol for safe food packaging to its output. Klonfa has also not confirmed that it complies with Bulgarian environmental regulations.
- PackUp pays its suppliers in European countries in their local currency. It is experiencing exchange rate fluctuations as a result of the increased level of outsourcing.

LMP Ltd and Warm&Safe

PackUp is using LMP Ltd, a small company near Northampton, as sole manufacturer of the Warm&Safe range. There have been quality issues with this supplier from the start. PackUp was recently informed that a cup, full of hot liquid, cracked and split, causing serious injury to a consumer. The retailer which sold the cup to the consumer has gone into liquidation, so the consumer is bringing a negligence claim against PackUp. Kelly is investigating the circumstances of the case, amid concerns that the problem may extend to all Warm&Safe products sold to date.

Olga Vachkov, the operations director, has heard rumours that LMP Ltd's sister company has been producing a very similar product to Warm&Safe, which it is selling under its own brand. PackUp's directors are aware that they have patent protection for Warm&Safe but are unsure how long this will last.

New manufacturing technology

PackUp's manufacturing technology at the factory in Northampton was based on only human-controlled machinery until 31 August 2018. The new machines installed in the last two financial years are controlled by a computer and make use of the internet of things, robots and artificial intelligence (AI). To ensure everything operates at peak performance the computer is permanently linked online with the supplier of the machinery, which can detect and prevent any problems with the hardware and software. While to date this system has operated very effectively, Olga is concerned that PackUp is exposed to increasing cyber risk.

External audit

Kelly informed the board that a newly-established local audit firm, HC LLP (HC), has approached her offering:

- to act as PackUp's external auditor for a fee significantly below Strinder LLP's 2019 fee
- to prepare the environmental assurance report (**Appendix C**) for a nominal fee.

Aysha voiced concerns about HC's tactics and whether HC would have the skill and resources to perform the services offered. Kelly accepted that Strinder does an excellent job but, like Aysha, she was reluctant to see the external audit fee rise. As nothing has yet been agreed with either firm, Kelly and Aysha planned to continue discussions with both.