The Dossier

AAT Professional Diploma Synoptic Assessment

Ruby Dale Ltd – Pre-Release Material

The following issues have been identified in respect of Ruby Dale Ltd.

"Ruby Dale Ltd has expanded rapidly over the last few years, more than doubling the workforce and opening three new shops in London, Paris and New York, one in each location".

Rapid expansion of a company is often a sign of overtrading. The company is aware of this risk and has highlighted "risk of overtrading" in its SWOT analysis as a weakness.

Overtrading is where sales levels increase rapidly which can lead to a shortage of working capital and liquidity problems.

One sign of overtrading is weakening liquidity ratios. The receivables collection period appears to be slightly higher than it should be at 42.0 days and the inventory holding period also appears quite high at 89.4 days. However, what is most concerning is that the payables payment period is very high at 74.5 days. As typical trade credit terms are one month, this suggests that the company is very slow in paying its suppliers which may result in suppliers putting the company 'on stop' until the existing account balances are paid and would also prevent increases in credit limits being approved.

However, the company is planning to expand even further and has highlighted "open new shops to achieve a greater high street presence, for example in the growing markets of Asia and the emerging economies" as an opportunity in its SWOT analysis.

This give a contradictory message and suggests a lack of clarity in the strategy of the business. It also raises questions about the economic sustainability of the business.

Other issues which could arise from having shops in different countries are a lack of control over how the shops operate and how the staff who work there behave. This is due to the shops being so far away from the rest of the company, which is based in Manchester.

It is concerning to note that the company includes the following weaknesses in its SWOT analysis:

"Diseconomies of scale arising as a consequence of the larger workforce, for example communication issues, loss of co-ordination and low staff motivation".

"Internal control weaknesses as a result of controls not evolving in step with the growing business".

The following video will help explain diseconomies of scale:

https://www.youtube.com/watch?v=OBTeXJPeqTc

Diseconomies of scale can be broadly split into the following areas referenced in the SWOT analysis:

- Employee coordination – the SWOT analysis states "limit reached on current in-house manufacturing capacity" which suggests overcrowding in the production function. In addition, there are twelve marketing staff which seems high for the size of the company

- Employee motivation – the business has grown rapidly, and it is possible that as new staff have joined the company, existing staff have become demotivated as their role and position within the company has diminished or become unclear. It also states that there has been a "large influx of new members of staff" which would have resulted in significant change

- Employee communication – the business may have adopted a 'top down' approach to management which may contribute to low staff motivation. A specific situation relating to a lack of employee communication is where the company experienced 'temporary stockout shortages'

Technical areas which could arise from this situation include:

- Motivational aspects of budgeting – the need for budget holders to participate in the budget setting process rather than having a 'top down' approach to budgeting from management. Budgets also need to be 'challenging but achievable' to motivate budget holders

- Diseconomies of scale relates to the average cost per unit of output increasing – there may be questions on calculating unit costs using marginal costing and absorption costing techniques. This may include the distribution costs involved in transporting goods to the shops in London, Paris and New York

- Limiting factor questions – these could arise as a result of limitations in manufacturing capacity and could include limitation in production materials, labour hours or machine hours

"As Ruby Dale Ltd has grown it has diversified its portfolio of products, and now complements its core offering of luxury women's shoes with handbags, men's evening shoes and luxury trainers".

However, it is important to note that, from a financial point of view, women's shoes, which were the original product the business produced, still accounts for eighty percent of turnover and the company has "launched a number of new styles across its product range".

It is quite possible that this diverse range of products has incurred significant overhead costs, for instance in respect of marketing, design and development.

The total costs, including overhead costs, involved in producing this diverse range of products may well outweigh the twenty percent of turnover they generate.

There may also be issues with how overheads are absorbed as overheads now often account for the major part of product costs and using absorption costing may only provide an arbitrary way of accounting for overheads. The business may instead want to consider using Activity Based Costing (ABC) which allocates costs into 'cost pools' and identifies the factors which drive costs, called 'cost drivers'.

The company has highlighted "diversify further the product range, for example into eyeware, fragrance, watches and jewellery" as an opportunity in its SWOT analysis.

However, it is questionable whether this is a sensible approach, especially given the weaknesses of diseconomies of scale, internal control weaknesses and risk of overtrading, combined with the fact that most of the turnover is still generated by the sale of women's shoes.

If the company decides to go ahead with some or all of these new products, it is likely that it will need to use life cycle costing techniques to decide whether the products are financially viable, as they are likely to incur significant development costs before they can be launched.

"Ruby Dale Ltd made the decision in the latter part of the financial year to outsource production of its handbags to a manufacturing company in Asia. Further outsourcing opportunities are also to be considered as the company looks to reduce its cost base and further expand its product range".

This may involve the use of 'make or buy decisions', comparing the cost of manufacturing products in-house and outsourcing production. In addition, the following non-financial factors will need to be considered:

- Price – the company needs to ensure that prices are fixed for acceptable length of time

- Quality – the company needs to ensure that quality is the same as if the products were produced in-house

- Supply – the company needs to ensure that continuity of supply is guaranteed

- Commercial sensitivity – the company needs to ensure that any designs and other intellectual property it owns are adequately protected

The company has highlighted "rise in the cost of materials" as a threat in its SWOT analysis and there may be questions on this, such as calculating the materials price variance.

The fact that the company has re-launched its 'made-to-order' service producing bespoke products suggests that there may be questions on job costing.

The company identifies "internal control weaknesses as a result of controls not evolving in step with the growing business" as a weakness in its SWOT analysis.

Whilst the information provided does not appear to have a specific focus on a particular financial system, there are a range of factors that point to payroll as an area which has a number of weaknesses which, along with the lack of controls, could be exploited by staff for fraudulent purposes:

- Large number of new staff joining the company – fictitious staff members could be set up on the payroll and payments made to the Payroll Clerk's bank account without being noticed by management

- Communication issues, loss of co-ordination and low staff motivation – this could result in theft of money, raw materials or finished goods by staff or alternatively staff may fraudulently claim overtime hours or falsify their timesheets as 'compensation' for the problems they are experiencing

- Staff working at the company's shops in London, Paris and New York are geographically remote from the company's headquarters in Manchester – this is likely to result in a lack of control and staff in the shops, particularly in Paris and New York, knowing that there is little chance of monitoring and inspection and this may result in staff being more willing to, for instance, falsely claim overtime, falsify their timesheets or steal money or goods from the company.

In conclusion, Ruby Dale Ltd states that one of its strengths is that it is a "globally recognised brand" in its SWOT analysis. Whilst the company is developing a growing reputation for selling women's shoes in a number of countries, it is a long way from being one of the globally recognised brands in the luxury goods market, such as the Richemont Group and LVMH (Louis Vuitton Moet Hennessey) which all have multi billion pound turnovers.

For Ruby Dale Ltd to try and compete with these companies through a process of rapid expansion and a wide ranging diversification of the product range away from the core offering of women's shoes risks overtrading and demonstrates a lack of a clear business strategy.

Ruby Dale Ltd states in its SWOT analysis that one opportunity is to "float on the stock market to obtain additional finance to fund investment". This would appear unwise, as the company has not adapted well to its current level of expansion and would do better by consolidating its position by firstly addressing the issues arising from diseconomies of scale and implementing sound procedures to address the control weaknesses in place at the company.

Appendix One

PEST Analysis

Political Factors

- Imposition of trade tariffs with Europe, the USA and the wider world
- Uncertain political situation, both within the UK and internationally, especially in emerging economies, with a rise in policies designed to protect national interests
- Possibility of additional taxes being levied on ‘luxury goods’ as a ‘wealth tax’

Economic Factors

- Possibility of a downturn in the macro-economic environment “which would impact upon the demand for luxury products”
- Falling real terms wealth and less disposable income, especially amongst younger people, which affects their ability to purchase luxury goods
- Imposition of trade tariffs which could affect the selling prices and impact on the demand for the products
- Possible rises in the cost of labour and materials which could affect selling prices and impact on the demand for the products
- Fluctuations in exchange rates between Pounds Sterling and other currencies

Social Factors

- Changes in what people, especially younger people, choose to spend their money on, with a shift away from purchasing goods to spending money on experiences
- Greater levels of social and environmental engagement, especially from younger people. This includes ensuring that products are ethically sourced and sustainable and a refusal to purchase products containing fur or leather
- Rise of the ‘celebrity culture’, including people who have found fame through social media and reality television programmes, whose endorsements of a brand or product may influence customers’ buying decisions

Technological Factors

- Growth in e-commerce as people have less time to shop for goods in person and may also prefer to shop online
- Increased use of social media as a channel for communication with customers and for marketing purposes

- New communication technologies can aid communication with shops in Paris and New York and production sites in Asia
- New technologies, materials and working practices within the fashion and luxury goods industry

Appendix Two

Performance Indicators

Profitability Indicators

Gross Profit Margin

(Gross Profit / Revenue) x 100

= (25,946 / 41,380) x 100

= 62.7%

Operating Profit Margin

(Profit from operations / Revenue) x 100

= (7,358 / 41,380) x 100

= 17.8%

Interest Cover

Profit from operations / Revenue

= 7,358 / 1,420

= 5.2 times

Return on Capital Employed

((Profit from operations / (Total equity + non-current liabilities)) x 100

= (7,358 / (36,836 + 20,286)) x 100

= 12.9%

Asset Turnover

Revenue / (Total assets - Current liabilities)

= 41,380 / (61,398 - 4,276)

= 0.7 times

Liquidity Indicators

Current Ratio

Current assets / Current liabilities

= 9,218 / 4,276

= 2.2:1

Quick (Acid Test) Ratio

(Current assets – Inventories) / Current liabilities

= (9,218 – 3,780) / 4,276

= 1.3:1

Receivables Collection Period (Days)

(Trade receivables / Revenue) x 365

= (4,762 / 41,380) x 365

= 42.0 days

Payables Payment Period (Days)

(Trade payables / Cost of sales) x 365

= (3,150 / 15,434) x 365

= 74.5 days

Inventory Holding Period (Days)

(Inventories / Cost of sales) x 365

= (3,780 / 15,434) x 365

= 89.4 days

Working Capital Cycle (Days)

Inventory days + Receivables days – Payables days

= 89.4 days + 42.0 days – 74.5 days

= 56.9 days

Gearing Indicators

Gearing Ratio

(Non-current liabilities / (Non-current liabilities + Total equity)) x 100

= (20,286 / (20,286 + 36,836)) x 100

= 35.5%