

Final Level      Management Accounting – Case Study

# 15

# FLCS

**PRE-SEEN MATERIAL**, PROVIDED IN ADVANCE, FOR PREPARATION AND STUDY  
FOR THE EXAMINATION TO BE HELD ON THE AFTERNOON OF  
THURSDAY, 27 MAY 2004

#### INSTRUCTIONS FOR POTENTIAL CANDIDATES

This booklet contains the **pre-seen case material** for the May 2004 examination. It will provide you with context information that will help you to prepare yourself for the examination on 27 May.

**You may not take this copy of the pre-seen material into the examination hall.** A fresh copy will be provided in the examination hall.

The Assessment Matrix is available separately on the website, as is guidance on how to prepare for the examination. The matrix will also be provided in the examination hall.

Unseen material will be provided for the examination: this will comprise further context information and the examination question.

The examination will last for three hours.

You will be required to answer one question, which may contain more than one element.

#### *Contents of this booklet:*

	<i>Page</i>
Ofood4U	2
Appendix 1	16
Appendix 2	17
Appendix 3	18

## **Background**

A rapidly-expanding new industry is the production and retailing of organic foods. Under European Community (EC) law, an authorised body must inspect the production of food that is to be sold as organic. There are a number of authorised bodies within the EC, and they strictly enforce their rigorous standards before foods using their symbols of authenticity are allowed to be marketed.

The demand for organic food increased in the United Kingdom by over 55% between 1999 and 2000, reflecting the UK population's concerns over genetically-modified (GM) foods and other scares over food safety. Demand has been growing at over 30% per annum since 2000. One of the leading UK supermarket chains now stocks over 1,300 different organic products. There are around 4,000 organic farmers in the UK at present, and almost 2,000 organic processing facilities. There is also a wide variety of produce that is grown organically in overseas countries and imported into the EC to meet the demand by consumers. Of the organic products on sale in the UK in 2002, around 70% were imported products with the remaining 30% being produced in the UK. In 2003, the level of UK-produced organic products increased to 40%. With the increased amount of organically licensed land and the number of organic food producers increasing, it is forecast that organic food production in the UK will meet over 55% of sales during 2004. The UK organic retail market was worth over £2,000 million by the end of 2002 and is growing fast.

Many customers are selecting organic meat and produce because of what is left out rather than what it contains. There has been an unprecedented rise in food scares in recent years and consumers are becoming more aware of other issues, such as the routine use of pesticides and toxic chemicals used on crops, which have been linked to many forms of cancer. This, together with growing concern over GM crops, has caused consumers to look for food that is produced naturally, and this has resulted in a growing demand for organic produce. Organic foods are believed to contain higher levels of vitamin C and essential minerals and have higher levels of secondary nutrients and salicylic acid, which has health benefits.

In conventional farming, over 500 pesticides are routinely used and some fruits are sprayed up to 16 times with 36 different pesticides, which are hard to remove, even when the fruit is washed. Organic farming allows the use of only four pesticides. Organic farming is certainly not going to be the way that all food is produced in the future, as with a global population of nine billion forecast for the year 2050, this farming method would not produce enough food. Organic methods yield about half the amount of food that conventional methods produce and there is not the amount of land available for farms to produce all food organically. It is forecast that organic produce will remain as a market sector in rich countries, to meet the demands of consumers who are prepared to pay a premium for organically-produced food.

## **History of Hall Farm**

The Hall family has owned Hall Farm for several generations. After the death in 1994 of David Hall, the owner and farm manager, his eldest son Richard Hall, then aged 37, inherited the land and the business. Richard Hall had qualified with a degree in farm management and had worked in a number of areas of farming and food production. He had not previously wanted to work on his father's farm, as he had strong views on the use of pesticides and insecticides. However, when his father died at the age of 63 after a short illness, he agreed that he would return to Hall Farm.

Richard Hall has a brother, Alan Hall, who is five years younger than he is. Alan Hall had worked abroad for several years but by 1994 he had returned to the UK but he had no interest in farming. Alan Hall worked for a large marketing company.

Richard Hall and his wife, Sarah, and their two young children moved from the small organic farm that he had been working at, to take up the ownership and running of Hall Farm in the summer of 1994. He had already decided that he wanted the farmland to be converted into organic ground. This required the land to be managed organically for over two years, before it was eligible to be certified to be organic. He had registered the land as being "in-conversion" with one of the authorising organic bodies and he had prepared business and operational plans for the next few years. During this conversion period of two years, all food production was sold, but not as organic produce. Hall Farm was granted a certificate for organic production in February 1997 and Richard Hall commenced growing a range of organic produce. The business plan for Hall Farm was to produce a limited number of organic crops that his market research had shown to be in steady demand.

### **Sales outlets for Hall Farm produce**

Richard Hall sold the organic produce from Hall Farm in three ways during 1997 and 1998. These three ways of selling were:

- through market stalls at over twenty local markets, selling direct to customers;
- by mail order;
- bulk sales of some produce to a large regional organic food wholesaler, *Organics for Everyone*, which then sold the produce on to other retailers, including supermarkets.

Richard Hall was very reluctant to sell the majority of his produce to *Organics for Everyone* as he received very low prices compared to selling direct. During 1997 and 1998, the direct sales through markets and the mail order business were managed almost entirely by Richard and Sarah Hall. However, Sarah Hall continually had staffing problems and difficulties meeting customers' demand and each week she experienced trouble with staffing for market stalls. They had employed a close friend, Jonathan Winters (see page 5 for details on Jonathan Winters), who managed the packaging of the produce, with some help from temporary staff.

A farm manager was recruited in August 1998, which allowed Richard Hall to become less involved with the day-to-day running of the farm and enabled him to concentrate on selling the organic produce.

In December 1998, at a large family get-together at Hall Farm, Richard Hall's younger brother, Alan Hall, suggested that the retailing of the organic produce from Hall Farm should become more business-like and better organised. Sarah Hall couldn't agree more, as she had become far less involved in their children's lives due to the demands of the business. She also worried that Richard Hall was going to make himself ill with the long hours and hard work that were needed to manage Hall Farm, as well as being involved with the selling of the produce.

### **Formation of Ofood4U Limited**

After many discussions and meetings, Richard and Sarah Hall decided to form a new company to market and sell organic produce, and Ofood4U Limited (Ofood4U) was formed in March 1999.

There were two differences in the way that Ofood4U operated compared to the retailing business that had been operated from Hall Farm. First, it was going to bulk buy organic produce from a range of suppliers, and it planned to retail organic produce grown in the UK and from overseas. The company was planning to procure overseas-grown produce from a number of organic wholesalers, but it did not plan to procure any overseas-grown produce directly from growers. One of its key UK suppliers would be Hall Farm, but it had also established business links with a few other organic farms and organic dairies, from which it planned to procure the majority of its produce. The production and farm operation costs at Hall Farm are entirely separate from Ofood4U.

Secondly, the company was planning to expand not only the product range, but also the range of routes to the largely untapped market for organic produce. Richard Hall had an enormous number of ideas for expansion, including selling through the Internet and opening shops in key cities. In 1999, it was planned that the existing routes to customers, through mail order and at local markets, would continue for the time being.

Richard Hall had many ideas but lacked the detailed expertise to put his ideas into practice, although many of his early dreams of retailing organic produce had already become a reality. It was Richard Hall's brother, Alan Hall, who had decided to join the new company as Sales and Marketing Director, who felt that with his experience, the company could be a leading player in this growing retail sector. Alan Hall was confident that sales could be rapidly expanded if ready-prepared packaged (cartons and bottled goods) organic foods were available. Ofood4U planned to prepare its own brand of packaged organic goods, which in 1999 were not readily available from other organic food retailers.

The company decided to initially rent a large warehouse, together with offices, in the nearest large town to Hall Farm. Sarah Hall was looking forward to a less stressful lifestyle than she had experienced since she had moved to Hall Farm in 1994. She was hoping that when the new company was adequately staffed, a lot of the crises that had beset the retailing business at Hall Farm would simply not occur. What she had not realised was how quickly the company would grow.

Richard Hall's brother, together with two close friends, who had helped with the pricing, packaging and selling of organic produce over the last two years at Hall Farm, agreed to become even more actively involved and to invest some finance of their own in this new business. The company also recruited a Procurement Director from a competitor that it had been trading with for the past two years. The person appointed as Finance Director, Derek Smythe (details on page 5), had been involved with Hall Farm in an advisory capacity and was a trusted and experienced accountant. Details of the seven Directors in the new company follow:

#### *Sarah Hall – Chairman*

It was agreed that Sarah Hall, then aged 40, who was a very organised and entrepreneurial woman, with the ability to delegate and manage many responsibilities well, should be the Chairman. Sarah Hall did not want to take on a full-time role, with the growing demands of family life, but wanted to be involved with the company at all levels.

Sarah Hall had worked in a number of different offices, mainly in secretarial and personal assistant roles to senior managers. She had not had any experience at a senior level in industry, but all of her fellow Directors felt that she was sufficiently experienced to manage this challenging role.

#### *Richard Hall – Chief Executive*

Richard Hall, then aged 42, took on the main responsibility of running the new business. He had appointed a new farm manager at Hall Farm, which left him free to work full time at Ofood4U. In addition to his role as Chief Executive, Richard also agreed to be responsible for all IT initiatives for the company and planned to work closely with Derek Smythe, the part-time Finance Director.

#### *Alan Hall – Sales and Marketing Director*

Richard Hall's brother, then aged 37, left his role as marketing manager of a medium-sized wine merchanting company, where he had worked for over five years. Prior to that, he had worked in sales at a number of food and wine retailers and had a lot of marketing experience that he felt would be invaluable in his new role.

He was very confident about the future of the new company and felt that his skills would complement those of his brother well. Richard Hall had always had good ideas for new products, or ways to sell the produce, but almost never got round to putting these good ideas into practice. Alan Hall had the ability to convert some of his brother's ideas into reality. Furthermore, Richard Hall respected his brother's opinion, and would not take offence if Alan Hall were to state outright that he considered that a particular idea was unworkable. Alan Hall had inherited some funds from his father some five years earlier, which he had invested wisely, and was very confident in the new company and its possibilities, if it could satisfy the demand for organic produce.

### *Jonathan Winters – Operations Director*

Jonathan Winters, then aged 43, had been involved with Hall Farm's organic produce for the previous two years and had been responsible for the packaging and distribution operations at Hall Farm. He was also responsible for all aspects of customer service. He wanted to get involved with the new company and was confident that Ofood4U could offer unrivalled products and service. He decided to re-mortgage his own home in order to invest £100,000 in the new company.

### *Peter Collins – Procurement Director*

Peter Collins, then aged 34, had previously worked as a buyer for the large regional wholesale organic company named *Organics for Everyone*, which had purchased organic produce from Hall Farm for the previous two years. He had previously worked in procurement for a large national supermarket chain for eight years and had then been recruited to *Organics for Everyone* where he had consolidated his experience in this specialist food retailing market.

He had been very impressed by Richard Hall when they had first met over three years ago and they had got on well together, both in business and socially. He admired all that Richard Hall had achieved at Hall Farm in the few years he had known him. He was keen to join this new company and invest some funds into what he felt could be a leading company in this market within a few years. He resigned from his job in February 1999 and was moving house to be near to the town where Ofood4U was setting up its business. He had also borrowed funds in order to invest in shares in Ofood4U.

He also shared many of Richard Hall's growth ambitions for the company and agreed that the company needed to create innovative organic products, both fresh and prepared packaged foods, and to market them effectively. Most of the suppliers that Ofood4U planned to deal with were small businesses, with the exception of two suppliers who would supply much of the overseas-grown produce. Peter Collins would have a challenging role managing these key suppliers. His role also encompassed selection of new suppliers, which would meet with Ofood4U's stringent organic quality specifications, so that the company could keep up with growing demand levels.

### *Amy Mullen – Human Resource Director*

Sarah Hall's best friend, whom she had known since schooldays, agreed to take on the role of Human Resource Director. Amy Mullen, also aged 40, had worked as a human resource manager for an international bank for over 10 years, but had been made redundant when the bank had downsized its administration staff.

She had then taken a career break, had two children, and was looking to return to the job market. Over the last two years, Amy Mullen had helped Sarah Hall in an informal way with the recruitment and selection of staff and Sarah valued her skills. Amy Mullen was very flattered when she talked over the role with Richard and Sarah Hall, who both had faith in her abilities. She also agreed to invest in the company using her personal savings and by securing a personal loan.

### *Derek Smythe – Finance Director*

Derek Smythe was a partner in a local branch of a national firm of accountants, whom Richard Hall had got to know and trust since he had moved to Hall Farm. The other six Directors had decided that the company would not require a full-time Finance Director initially, and Derek Smythe felt that he could manage this role in addition to his responsibilities at his firm of accountants.

Derek Smythe would also have responsibility for all financial advice for Ofood4U, and his firm of accountants was appointed to undertake all preparation of financial and management accounts. It was agreed that accounts would initially be prepared quarterly. However, to ensure that suppliers were paid in accordance with their contracts, it was agreed that Sarah Hall, supported by an administration assistant, would be responsible for all payments.

Business plans had been prepared by Richard and Sarah Hall with help and advice from Derek Smythe. Derek Smythe decided to borrow £100,000 in order for him to be able to invest in Ofood4U.

Ofood4U was formed with 3 million authorised shares of £1 each, of which 1.6 million shares were allocated and fully paid up at par value. At the time the shares were issued, £1 per share at par value was considered a fair value. All seven Directors invested their own personal funds at £1 per share, as follows:

	<i>Number of shares</i>	<i>% shareholding</i>
Sarah Hall	400,000	25.00
Richard Hall	400,000	25.00
Alan Hall	400,000	25.00
Jonathan Winters	100,000	6.25
Peter Collins	100,000	6.25
Amy Mullen	100,000	6.25
Derek Smythe	<u>100,000</u>	<u>6.25</u>
Total shareholdings	<u>1,600,000</u>	<u>100.00</u>

Ofood4U started trading in April 1999, and the company commenced purchasing organic produce from a small range of UK producers of organic produce, including Hall Farm. From April 1999, all produce from Hall Farm was sold to Ofood4U, at agreed prices, and Hall Farm discontinued all of its retail operations. However, the new company continued to use the distribution routes and customer database that Hall Farm had supplied to Ofood4U.

In order to finance the required capital expenditure and working capital requirements, a loan of £2.0 million was agreed with a local bank, using Richard Hall's house at Hall Farm as security for the loan. The terms of this four-year loan were 8% interest per year, payable monthly. The loan would be repayable in 2003.

### **Ofood4U routes to the market**

Ofood4U continued the mail-order business that had been built up at Hall Farm. With the marketing expertise of Alan Hall, the customer base was expanding fast and the range of products was greatly expanded. The challenges facing Ofood4U in 1999 were twofold. First, to have an attractive range of products that were competitively priced and secondly, to have different routes to the market. When Ofood4U began trading in 1999, most of the national supermarkets gave very little shelf space to organic foods, which were then not considered to be in high demand. Therefore, in 1999, the national supermarkets were not serious competitors to companies such as Ofood4U, as the supermarkets had very limited ranges of organic foods. At this time, Ofood4U was able to supply wide ranges of organic produce to customers who had no other local shops which could supply them with the goods that they demanded.

Ofood4U planned to have four routes to the market operational by the end of 2003, which were:

1. mail-order business (already operational in 1999);
2. market stalls (already operational in 1999);
3. Internet trading (planned for late 1999);
4. shops in key cities (planned for 2003 onwards).

During 1999, Ofood4U had operated the mail-order business that had been established by Hall Farm and had retained the majority of its customers. Despite undertaking very little marketing for the mail-order business, the company saw its customer base grow by over 30% in 1999, much of the growth arising from recommendations from existing customers. The mail-order business was operated from Ofood4U's new warehouse, and orders were taken both by post and by telephone.

Ofood4U quickly established a loyalty scheme to retain its customers and offered them discounts for introducing new customers. The company's loyalty scheme entitled customers to discounts as their cumulative order value increased during each calendar year. Therefore, customers who had spent more than £500 for example, were able to enjoy a discount of 5% on all orders for the rest of that calendar year. Lower discounts were available for customers who spent more than £200 each year.

The packaging and despatch of orders worked far better at the new warehouse than they had when they worked from the farm buildings at Hall Farm. Initially, the company employed a small number of full-time staff in its operations and despatch departments and it was a delight for Sarah Hall to see operations running smoothly, with good, well-trained staff processing orders in a business-like, organised way. As turnover grew, more staff were recruited to keep up with the faster-than-expected growth in the business.

For the mail-order business, during 1999 over 95% of orders were despatched for next day delivery. However, Jonathan Winters wanted to increase this to 100% of orders despatched the same day during 2000, but due to the growth in demand, Ofood4U has generally achieved around only 90% of despatches on time from 2000 to 2004. It has always had difficulties keeping up with its growing customer base and the problems of recruiting staff to meet increases in demand.

Ofood4U also continued to buy organic produce and sell it at local markets, and this proved to be an effective way of promoting the mail-order business. By the middle of 2001, with the growth in the mail-order business and also Internet trading, the company decided to cease selling produce at local markets. This decision was based on two factors, which were first, the growth and loyalty of mail-order and Internet customers, and secondly, the increased availability of organic produce in national supermarkets. With organic produce becoming more widely available, Ofood4U had to adapt and change the way it operated. Additionally, the main supermarkets were already able to undercut some prices offered to customers, and Ofood4U had to realign a number of retail prices for fresh produce to remain competitive.

Richard Hall had numerous ideas for new ways to sell organic produce but agreed with Sarah Hall that the company needed to establish itself and its brand name before it expanded too fast. What was unknown to Ofood4U back in 1999 was how quickly the supermarkets would expand their range of organic produce, and indeed the speed of growth in the overall market.

### **Commencement of Internet trading**

One of Richard Hall's first major projects for Ofood4U in 1999 was to launch an Internet trading service. This would enable the company to widen its customer base in the UK, and would also give many consumers access to a wider range of organic produce than was available to them locally. The UK supermarkets did not stock a very wide range of organic produce in 1999, and many consumers simply did not have access to the products that they wanted.

In May 1999, Ofood4U appointed a local IT company that had been recommended to it and set up a website which would allow prospective customers to view the ranges and prices of products available and to order on-line. The specifications for the website were updated several times over the period of a few months, and the fees for the construction of the website and supporting IT solutions grew. The original budget was estimated to be £120,000, but the fees paid to the IT contractors exceeded £300,000 during 1999. Richard Hall managed much of the process and soon became much more IT-literate than he had been previously.

When Ofood4U started Internet trading in December 1999, it had not expected a high level of demand and was taken by surprise. In the first three weeks in December, Internet orders totalled the same turnover level that the mail-order business had for the preceding six months. The only way that demand could be met during December 1999 was by diverting much of the already procured produce from being sold at markets, and by delaying despatch of some of its mail-order deliveries. However, Richard Hall was disappointed in having to let down many of his regular and loyal customers. He wanted Peter Collins to expand the number of suppliers that Ofood4U used and to procure greater quantities where possible for high-selling product lines.

In January 2000, Peter Collins committed the company to purchase much higher levels of stock for the next three months, to meet the expected demand for the Internet service. Trading was even higher than expected in the first three months of 2000, resulting in attracting, on average, over 100 new customers each week. On the basis of forecast demand, Peter Collins had committed to procure even higher quantities of produce. Again, demand for this new service was good and the company was managing to fulfil its commitment to deliver overnight for over 90% of orders.

However, at the beginning of June 2000, Ofood4U experienced several problems. Due to larger than expected usage of the Internet site, the system kept "crashing" causing customers to have to log back in and any orders that had been partially prepared by customers were lost and they had to start preparing their order again. Many frustrated prospective customers simply gave up and did not place an order. Additionally, many customers thought that they had placed an order and Ofood4U had processed it, only to find that nothing was delivered, and they could not access the company's website. This resulted in many frustrated customers who did not order with Ofood4U again. The customer service team was inundated with queries from customers about their orders, and also many angry calls regarding orders that had not been delivered. This caused a lack of confidence in the company's website and all Internet orders were temporarily suspended in mid-September 2000.

Therefore, much of the bulk orders for produce for the next two months, which were now committed, were in excess of Ofood4U sales potential with the Internet service being unavailable. Some of the perishable foods were wasted. The company tried to sell more at lower prices at local markets, but they too had lost some of their regular customers. This was partly caused by not having the quantity and choice of produce that customers had wanted over the past few months, which had caused them to switch their buying to other organic suppliers. Some others, who had purchased Ofood4U produce at local markets, had started to use Ofood4U's Internet service. Richard Hall was very disappointed in this unfortunate turn of events and felt that the company had become a victim of its own success.

The only way to improve the situation would be to ride the temporary storm by winning customers back at their regular markets and to get the website operational again. Richard Hall sought new advice on the company's Internet ordering capacity from a large international IT specialist. The conclusion was that the company's site was well constructed and easy for customers to use, but that it was not built to deal with the level of users experienced by mid 2000. The IT specialist recommended a substantial investment in both upgraded hardware and software requirements. The forecast cost for this was in excess of £1.2 million, and the full cost of the previous system would have to be written off.

The new Internet retailing service went live in February 2001 and the re-launch of the service went well with few operational problems. Alan Hall had arranged good media coverage, and new and returning customers were soon placing regular orders. As the Internet customer base grew, the company found that it continually had to upgrade its IT requirements to cope with demand. It also had to rapidly recruit staff (and associated office space and equipment) to deal with the volume of business generated from its website. By the end of 2002, all office staff had moved to rented offices a short distance away from Ofood4U's main warehouse.

### **Ofood4U's product range and suppliers**

During the first 18 months of the new business, Alan Hall undertook much market research. Alan Hall had identified that an increasing number of new customers were purchasing organic produce for the first time, and that they wanted to be able to purchase not only the produce itself but also ranges of prepared meals, sauces and other organic produce including fresh bread.

Alan Hall was very enthusiastic about introducing a range of bottled and pre-packaged organic foods, some of which were not available from other companies. His market research confirmed that the demand for such products was present. When Ofood4U first started to consider how these new products could be manufactured, there were very few competitors for packaged organic food.



When Peter Collins joined Ofood4U, his first role was to select key suppliers for the organic produce and also to select food preparation companies that Ofood4U could use to manufacture organic foods, such as sauces, soups and other ready-made products that would be marketed under the brand name of Ofood4U. The company also wanted to select a range of current producers of organic foods and to market their products in its mail-order catalogue and on its Internet site.

Peter Collins and his small team selected over 150 suppliers of organic goods who supplied their own brand goods to Ofood4U to sell to the end customer. The gross margin on these products that were bought in was low and averaged only 15% but gave Ofood4U a much larger choice of goods in order to attract and retain customers.

New ideas and recipes were trialled in Sarah Hall's kitchen back in 1999, and then a food processing company was contracted to prepare and bottle ranges of soups and sauces, exclusively for Ofood4U. These were included in Ofood4U's food catalogue in September 1999 and immediately proved popular.

By the end of 1999, Ofood4U had recruited a product development manager, Jane Cole. She was responsible for selecting, preparing and trialling recipes for new own brand prepared packaged organic foods. She also worked closely with Peter Collins in the selection of sub-contractors for bulk manufacturing. The company had invested £0.6 million on equipping a kitchen and food preparation areas that were used exclusively to trial new own brand organic foods. Within the next 12 months, over 220 new own brand prepared organic foods were available in either bottled or carton form. All of the mass production of bottled organic produce was sub-contracted out to specialist food preparation companies, and Peter Collins was responsible for monitoring quality.

In 2001, Ofood4U broke its contract with one of these food manufacturers, as the quality of the finished branded Ofood4U products did not meet the quality standards agreed, despite several warnings and discussions over a two-month period. Richard Hall felt strongly that he did not want Ofood4U's name associated in any way with food that did not meet the company's high standards. However, the food manufacturer felt that it could prove that agreed food standards had been met. Due to its contractual obligations, Ofood4U agreed, reluctantly, to make a one-off payment for terminating the contract, without the proper notice. Peter Collins and Jane Cole both agreed to ensure that quality standards were explicitly agreed in all future contracts and that Ofood4U's inexperience with food manufacturers had been an expensive lesson to learn.

The company procured dairy and fish produce but for a number of reasons decided not to procure any meat products at all. In 2001, Ofood4U launched its own range of dairy products using 100% of the capacity available at one of its regular dairy suppliers. This was the start of much closer business links with some of its key suppliers who saw how successful Ofood4U had become and who were keen to associate themselves with the company and produce organic goods exclusively for Ofood4U.

Early in 2003, the company opened its own bakery in a small manufacturing unit near Ofood4U's main distribution centre and was able to offer its customers organic breads and cakes that were not available from many other organic food retailers. This line of produce also produced a high gross margin, of over 50%, but the overall value of sales was low compared with Ofood4U's total turnover. There was also little wastage as all production was being made to meet orders that had been placed that day.

Peter Collins also introduced a range of organic wines in 2002, that have proved popular with regular customers and these have achieved a higher than usual gross margin of over 40%.

## **Ofood4U loans**

The company had commenced trading in 1999 with a four-year loan from its bankers of £2 million (at 8% interest per year), which it used to finance both capital expenditure and working capital in its first year. The loan was repayable in 2003.

In 2000, the company had added a further loan of £3 million, which was for five years, repayable in 2005 (also at 8% interest per year). The loan was used to expand the assets of the company (such as warehousing equipment, forklift trucks, refrigeration equipment and packaging machines) to support the high growth achieved. At the end of its second year, the company therefore had loans totalling £5 million.

A third increase in the company's loan financing occurred in 2001 for a further £1 million, which was also at 8% interest per annum for a five-year period, repayable in 2006. The company managed to fund all of its working capital and some capital expenditure from operating cash flows in 2002, but needed to finance a large amount of planned capital expenditure during 2003, as it had outgrown much of the warehousing and distribution space that it had rented. The company also needed to expand its office space and its IT capabilities to meet the demands of its growing customer base. By the end of 2002, the company was renting three premises. These were its main distribution centre, a second smaller distribution centre and offices.

In order to expand the company's turnover to meet the increased demand, Ofood4U rented a further building in early 2003, which housed the company's bakery and a large area was allocated to commence food preparation for some of its established own brand product lines (*not* for trialling of possible new product lines). Around 5% of the company's pre-packed foods were forecast to be prepared at these new premises within 2003. Operational staff, under Jonathan Winters, had been recruited to run the food preparation and bottling operations. This would reduce Ofood4U's dependence on some of its external food preparation companies.

During 2003, the company repaid its initial four-year loan of £2 million (that had been taken out in 1999) and took on a new loan for £6 million (also at 8% interest per year), resulting in total loans at the end of 2003 of £10 million. The latest £6 million loan that was taken on in 2003 was over 10 years, and is repayable in 2013. The company's second loan of £3 million, taken on in 2000, is due to be repaid during 2005.

The bank was impressed with the company's business plans and its strong growth and all that it had achieved in the last five years. The loan for £6 million was secured by a floating charge on all of Ofood4U's assets and was used to finance the ongoing purchase of assets to cope with the growth in demand, including the costs of a major upgrade to the company's IT equipment, which was needed in order for the company's new management information systems to become operational in 2003.

## **Product profitability**

Until the end of 2002, very little detailed accounting had been undertaken on product profitability. The Directors were content with two facts, which were that the company was growing fast and that each year had been profitable. However, it was increasingly becoming apparent that it was necessary to be aware of a more detailed breakdown of each product's net profitability.

Until 2003, when a management accountant joined the Finance department of Ofood4U, the only profitability analysis undertaken was to analyse the company's gross profit. Gross profit is defined as turnover less directly attributable variable costs. Direct variable costs include the costs of the produce, sub-contractors' costs for food preparation, packaging costs and distribution costs, and staff costs for staff specifically involved in order taking and packing and distribution, as well as the small number of food preparation staff. The gross margin does not include any costs associated with all of the rented premises, depreciation or product development costs or staff costs for staff involved in marketing, IT and other non-operational staff.

A comparison of the actual gross margins, by product grouping and sales route, for the last two years is shown below:

	2003		2002	
	Gross margin £ million	Gross margin %	Gross margin £ million	Gross margin %
<b>Sales by mail-order and Internet:</b>				
Fresh produce	1.1	11.0	1.2	13.2
Own brand prepared packaged foods	3.9	31.5	3.2	33.6
Bread	0.2	50.1	0.2	52.5
Wines	0.2	41.2	0.1	41.5
Dairy produce	1.2	25.2	0.9	25.3
Other organic products	0.2	30.0	0.1	30.2
<b>Sales by other sales routes:</b>				
Direct sales to supermarkets of own brand prepared packaged foods	0.1	8.9	0.0	–
Ofood4U own shops	<u>0.1</u>	38.0	<u>0.0</u>	–
Total	<u>7.0</u>	23.2	<u>5.7</u>	24.8

### Management and IT changes at Ofood4U

Richard Hall learnt two main lessons from the Internet ordering crisis in 2000. First, that Ofood4U needed some senior in-house IT expertise and secondly, how dependent the company was on its ability to respond rapidly to customer demand. Richard Hall felt that the company needed to ensure that it could procure produce from all of its suppliers to meet demand. He considered that IT systems should be in place between Ofood4U and its key suppliers, and that all IT systems should be disaster proof.

The Board agreed to recruit an IT manager in 2002, but the company still planned to outsource all of its IT development work. The IT manager recruited in June 2002 was Geddes Shah, who had previously worked for an international IT company. He saw the potential growth in Ofood4U and liked the opportunity offered, particularly as Richard Hall had discussed the possibility of a directorship and shares in the company in the future. However, no specific dates or commitments had been agreed.

On joining, Geddes Shah reviewed the company's operations and found that the security, running and IT development plans lacked the professionalism that he had been used to. He also missed all the back-up support from IT-literate colleagues, which he had taken for granted in his previous company. As far as staff members at Ofood4U were concerned, any problem related to a computer was referred to him and he quickly found himself inundated with demands on his time. He also realised that he needed more hands-on assistance with staff training and writing IT specifications. Initially, the Board did not approve the request for more staff, but by the end of 2002, it was agreed that more in-house IT staff would be needed to support Geddes Shah.

Geddes Shah was responsible for specifying, selecting and implementing a new management information system for Ofood4U that became operational in 2003. This new system provided Ofood4U with data in order to monitor sales and profitability levels by product. It also enabled the tracking of products from source of produce (by supplier and location of crop) through to batch numbers of final bottled products. Geddes Shah also implemented an IT solution enabling Ofood4U to have a direct on-line ordering system with its suppliers. This latter system became operational at the end of 2003.

By the end of 2001, the Board agreed that more financial assistance with the day-to-day matters was required. Derek Smythe joined the company as the full-time Finance Director in February 2002 and he recruited two other qualified accountants, which eased the strain on Sarah Hall and her administration assistants. All accounting functions were brought in-house at Ofood4U and all of the accounting work that had been undertaken by Derek Smythe's firm of accountants ceased in June 2002. However, with the continued rapid growth in Ofood4U's business, the in-house accounting function has experienced problems. There has been an increasing need for more detailed management information and data on product profitability. The new accounting system that was introduced in 2002 also added to the workload, and there remains a need to improve these IT systems to give more financial data.

Jonathan Winters was initially in charge of all operations including customer service, but with the growth in the customer base, he recruited a new customer service manager, Jackie Lau, in September 2003. Jackie Lau had much customer service experience and had worked for a leading chain of restaurants before joining Ofood4U. Jonathan Winters remained in charge of warehouse operations and deliveries to customers. However, Jonathan Winters continued to work long hours and to get involved with almost everything happening in the distribution centre. While he had an able team, who coped surprisingly well with meeting demand, he always wanted to be involved with everything happening within the business. This had a positive effect, as he was always up-to-date with new trends and the success or otherwise of new product lines and whether new suppliers had met delivery deadlines.

At the end of 2003, Ofood4U employed 265 full-time employees and also up to 50 part-time staff on a temporary basis to meet peak demand, particularly at busy times such as Christmas.

### Opening of Ofood4U shops

Richard Hall was very eager to open organic food shops in key positions in large cities as both Alan Hall and himself felt that there was a large market that was relatively untapped. He wanted to establish Ofood4U as a leading brand in the market, before any competitors also opened shops.

During early 2003, the first Ofood4U shop was opened in the suburbs of a major city. A second shop was opened in February 2004. Alan Hall recruited a manager for Ofood4U shops, Robert Cooper, who was responsible for all day-to-day operations at the shops. He was also responsible for seeking new sites for future Ofood4U shops.

Both shops were rented on a short-term rental contract (three-month notice period). Turnover has been slower than anticipated and the first shop is not forecast to break even until the end of 2004. This is due to the relatively high rent costs and the fixed nature of staff costs. Additionally, the level of waste has increased at the shops due to the short shelf life of some products. In the mail-order and Internet side of the business, this level of waste has not been experienced as products are ordered in and despatched to meet customers' specific orders.

A summary of the results, planned and actual, for the shops is as follows:

	<i>Actual</i>	<i>Planned</i>	<i>Actual</i>	<i>Planned</i>
	<i>Jan to May 2004</i>	<i>Jan to May 2004</i>	<i>Jan to Dec 2003</i>	<i>Jan to Dec 2003</i>
	<i>(5 months)</i>	<i>(5 months)</i>		
	<i>£000</i>	<i>£000</i>	<i>£000</i>	<i>£000</i>
Turnover	610	800	210	500
Costs of sales	<u>370</u>	<u>480</u>	<u>130</u>	<u>300</u>
Gross margin	240	320	80	200
Fixed costs	<u>585</u>	<u>450</u>	<u>650</u>	<u>550</u>
Net loss before interest and tax	<u>(345)</u>	<u>(130)</u>	<u>(570)</u>	<u>(350)</u>

Robert Cooper had spent the agreed marketing budget to launch and establish these two shops and had held a number of promotional events. However, even though the two shops had established a small level of regular customers, they had not achieved the sales levels that had been planned.

## Customer service

Sarah Hall wanted to provide all customers with an excellent level of service so that once they had shopped with Ofood4U they would return. Jackie Lau had a number of new ideas and pushed hard to get one of her early ideas accepted. This idea was initially very costly in terms of packaging, but she felt that it might help retain customer loyalty. She also considered that customers would recommend Ofood4U to their friends and that it would be a good marketing ploy. The idea was to send out all pre-Christmas deliveries in smartly packaged hampers, which would impress new customers and exceed the expectations of their regular customers. The plan seemed to have worked, as new customer registrations were the highest ever in the early part of 2004. However, Richard Hall was startled to discover after the event that the marginal costs were almost £1 million.

By the end of 2003, Ofood4U had a customer base of over 40,000 customers, with an average order value of £64. Some customers ordered weekly, some monthly and some at irregular intervals. As the customer base was growing rapidly, it was difficult to identify the trend of customers who ordered on a regular basis.

Jackie Lau is keen to focus attention on all of Ofood4U's customers, including regular customers who place smaller orders. Alan Hall liked Jackie Lau's approach and agreed that this was a positive move for the company. He had always strongly argued that it was important to manage its customer base as it is considered that it can be six times more expensive in marketing spend to attract a new customer than it is to keep a current customer. Jackie Lau was putting together a customer service plan that would focus on customer retention. She was being pro-active about the customer base as she was aware that a number of other organic retailers were now offering Internet-based retailing and she did not want to see Ofood4U losing customers to competitors. This aspect of managing the customer base was new to Sarah and Richard Hall. Jackie Lau had also asked whether she could participate in share ownership of the company in the future, which is something that Amy Mullen was keen to progress.

## First supermarket order

In February 2003, Ofood4U signed its first contract to regularly sell some of its bottled own brand packaged goods to one of the large UK supermarket chains. Richard Hall had been reluctant to sell the Ofood4U brand produce through supermarkets for several reasons and had resisted their approaches up until now. However, the brand name of Ofood4U was starting to get established and all of the Directors agreed that this was a good opportunity. Additionally, it was considered that it would increase demand for other products by customers who liked the limited range that had been contracted for by the supermarket. The actual and forecast value of goods sold to the supermarket chain in 2003 and 2004 are as follows:

	<i>Forecast 2004</i>		<i>Actual 2003</i>	
	<i>Turnover</i>	<i>Gross margin</i>	<i>Turnover</i>	<i>Gross margin</i>
	<i>£ million</i>	<i>%</i>	<i>£ million</i>	<i>%</i>
Sales of branded Ofood4U packaged goods to supermarket chain	1.50	8.8	1.22	8.9

The supermarket chain was not prepared to negotiate terms at all with Ofood4U and simply treated it as another of its many suppliers and imposed its standard terms. However, Alan Hall considered that it was important that Ofood4U's products started to become more widely known and that this would not detract from their main method of selling direct to customers.

Some of the other leading UK supermarkets had recently approached Ofood4U and were keen to stock a similar range of Ofood4U branded packaged goods in their stores. However, the margins offered were low, although the sales volumes forecast were substantial. At present, the Ofood4U Board was considering whether it should supply to these other supermarket chains.

## Ofood4U's expansion plans

With the increase in the volume of orders from the Internet business, the company has almost outgrown its warehouse and distribution centres. By the end of 2003, Ofood4U operated from four different rented sites, all geographically close, with around 95% of its prepared organic foods sub-contracted to a variety of food manufacturers.

The company is planning to move to a large purpose-built site on the edge of a major city during 2006 that would accommodate all of the company's needs until 2009, assuming the growth that has been forecast in the current five-year plan (shown as *Appendix 3*). The company has invested in food preparation areas and a bakery that produces fresh bread and cakes each day, but with the planned move, much of this equipment would be impossible to take to the new site and would have to be written off. If the company did not move to new premises in 2006, it would need to rent additional space at another site. Derek Smythe feels that this option would not be cost effective and would further complicate the business if the company had to manage its operations around five different sites.

The proposed site, together with the cost of the food preparation areas and bottling and packaging areas, is forecast to cost £18 million. Although a site had been identified, the company had not yet made any firm commitment.

Richard Hall has been very keen to continue to expand the business, but is concerned that the company had not paid any dividends up until the end of 2003, although a small dividend is planned for 2004. All of the cash generated from operations had been re-invested in the business to finance growth.

Summary profit and loss accounts and balance sheets for Ofood4U, since it commenced trading in 1999, are shown in *Appendices 1* and *2*.

Derek Smythe has worked closely with all of the Ofood4U's managers and has prepared a business plan for the next five years. This is shown as *Appendix 3*. This plan was prepared in November 2003 and was approved by the Ofood4U Board at the Board meeting in December 2003. However, some Board members remain concerned about whether the five-year plan is achievable as some of the underlying assumptions are considered to be over-optimistic. The plan shows that over the next five years, Ofood4U plans to open a further 22 shops, and have 25 shops operational by 2009. These 25 shops are forecast to generate a net profit before interest and tax of £18.3 million in the five-year plan period.

The company has prepared a capital expenditure plan showing a total proposed spend, subject to authorisation of each project by the Board, of £35.1 million over the five-year plan period. The net operating cash flow (after tax) generated in the five-year plan period is £59.0 million, but this is before interest loan repayments, capital expenditure and dividends.

## Update of Ofood4U and its competitive position in 2004

Over the last four years, organic produce has been available in an increasing number of high-street stores and also from a number of Internet-based companies. There is an ever-increasing number of products available, and more retailers are stocking organic produce in its various forms. Ofood4U has been at the leading edge of some of the retailing initiatives, including returnable packaging for dairy products. This not only cut down on the packaging costs but also helped the company to appear to be environmentally friendly by recycling some of its packaging.

The company has also developed and uses a unique seal for its products that gives customers assurance that the foods have not been tampered with. While the cost of developing these seals, and the additional cost of packaging, is higher than some of its competitors, it is a feature that Richard Hall has always considered of great importance. With all of the food safety scares that have occurred in recent years, this feature has enhanced Ofood4U's reputation as a high-quality food producer. The Ofood4U brand, and distinct labelling, is used on its own range of packaged foods, which is currently manufactured by a large range of food processing companies.

The information contained in the boxed areas above has been amended. If you downloaded the pre-seen element of the Case Study from the CIMA website prior to 8 April 2004, please note these amendments.

As the main supermarkets have increasingly stocked more ranges of organic produce, the retail price has fallen and Ofood4U has had to realign its prices to stay competitive. Additionally, due to the limited amount of organic produce produced, both grown in the UK and imported, there is a scarcity value on this produce. This has helped maintain prices at a higher level than will continue in the future, as more farming land in the UK becomes licensed as organic and the quantity of organic produce available increases. Therefore, in the medium term, it is expected that prices, and levels of profitability, will fall. To offset this, however, is the continued high growth in the demand for organic produce, partly fuelled by food scares, and also by the increasingly selective consumer, who wants food of a higher quality.

Ofood4U has always worked closely with all of its suppliers, and the company has especially close links with the key farmers who supply 100% of their produce to Ofood4U. Ofood4U has maintained its high reputation as a quality producer and the perception by its customers is that the company is one of the leading producers and distributors of organic produce.

Aside from the large supermarkets, there are a number of small, mainly local companies, selling organic produce, as well as a small number of similar Internet and mail-order businesses operating in the UK and Europe.

*Appendices 1, 2 and 3 follow*

Appendix 2 and Appendix 3 will also follow here (as separate pages)

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End of the pre-seen material



## Ofood4U

## Summary profit and loss account

	<i>Actual</i> 1999 £ million	<i>Actual</i> 2000 £ million	<i>Actual</i> 2001 £ million	<i>Actual</i> 2002 £ million	<i>Actual</i> 2003 £ million	<i>Forecast</i> 2004 £ million
Turnover	6.2	10.9	15.5	23.0	30.2	37.5
Total operating costs	<u>5.6</u>	<u>9.2</u>	<u>14.2</u>	<u>21.2</u>	<u>27.3</u>	<u>32.5</u>
Net profit before interest and tax	<b>0.6</b>	<b>1.7</b>	<b>1.3</b>	<b>1.8</b>	<b>2.9</b>	<b>5.0</b>
Loan interest	(0.2)	(0.3)	(0.4)	(0.5)	(0.8)	(0.8)
Tax (at 30%)	<u>(0.1)</u>	<u>(0.4)</u>	<u>(0.3)</u>	<u>(0.4)</u>	<u>(0.6)</u>	<u>(1.3)</u>
<b>Net profit</b>	<b>0.3</b>	<b>1.0</b>	<b>0.6</b>	<b>0.9</b>	<b>1.5</b>	<b>2.9</b>
Dividends	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	<u>0.6</u>
<b>Amount transferred to reserves</b>	<b><u>0.3</u></b>	<b><u>1.0</u></b>	<b><u>0.6</u></b>	<b><u>0.9</u></b>	<b><u>1.5</u></b>	<b><u>2.3</u></b>

**Ofood4U****Balance sheet**

	<i>Actual</i>	<i>Actual</i>	<i>Actual</i>	<i>Actual</i>	<i>Actual</i>	<i>Forecast</i>
	<i>End Dec 1999</i>	<i>End Dec 2000</i>	<i>End Dec 2001</i>	<i>End Dec 2002</i>	<i>End Dec 2003</i>	<i>End Dec 2004</i>
	<i>£ million</i>	<i>£ million</i>	<i>£ million</i>	<i>£ million</i>	<i>£ million</i>	<i>£ million</i>
<b>Tangible fixed assets</b> (net of depreciation)	<b>4·2</b>	<b>8·2</b>	<b>10·5</b>	<b>12·0</b>	<b>18·6</b>	<b>21·9</b>
<b>Current assets</b>						
Stock	0·1	0·2	0·3	0·4	0·4	0·5
Debtors	0·7	1·0	1·5	1·8	2·1	2·5
Cash and short-term investments	<u>0·1</u>	<u>0·1</u>	<u>0·1</u>	<u>0·1</u>	<u>0·1</u>	<u>0·4</u>
<b>Total current assets</b>	<b>0·9</b>	<b>1·3</b>	<b>1·9</b>	<b>2·3</b>	<b>2·6</b>	<b>3·4</b>
<b>Creditors</b>						
Amounts due within one year	( <u>1·2</u> )	( <u>1·6</u> )	( <u>2·9</u> )	( <u>3·9</u> )	( <u>5·3</u> )	( <u>7·1</u> )
<b>Net current assets / (liabilities)</b>	<b>(0·3)</b>	<b>(0·3)</b>	<b>(1·0)</b>	<b>(1·6)</b>	<b>(2·7)</b>	<b>(3·7)</b>
<b>Creditors falling due after one year</b>						
Loans	( <u>2·0</u> )	( <u>5·0</u> )	( <u>6·0</u> )	( <u>6·0</u> )	( <u>10·0</u> )	( <u>10·0</u> )
<b>Net assets</b>	<b><u>1·9</u></b>	<b><u>2·9</u></b>	<b><u>3·5</u></b>	<b><u>4·4</u></b>	<b><u>5·9</u></b>	<b><u>8·2</u></b>
<b>Financed by:</b>						
Called-up share capital	1·6	1·6	1·6	1·6	1·6	1·6
Profit and loss reserve	<u>0·3</u>	<u>1·3</u>	<u>1·9</u>	<u>2·8</u>	<u>4·3</u>	<u>6·6</u>
<b>Total equity shareholders' funds</b>	<b><u>1·9</u></b>	<b><u>2·9</u></b>	<b><u>3·5</u></b>	<b><u>4·4</u></b>	<b><u>5·9</u></b>	<b><u>8·2</u></b>

**Ofood4U**  
**Extracts from five-year plan**

	ACTUAL 2003	FORECAST 2004	PLAN				Total five- year plan	
	£ million	£ million	2005	2006	2007	2008	2009	£ million
<b>Turnover:</b>								
Internet sales	19.6	24.7	27.0	32.5	38.0	41.0	44.0	182.5
Mail-order sales	9.2	9.3	9.8	10.1	10.2	10.4	10.5	51.0
Ofood4U shops	0.2	2.0	6.6	12.4	21.4	33.1	48.7	122.2
Sales to supermarkets	1.2	1.5	2.5	3.0	3.6	4.2	5.2	18.5
<b>Total turnover</b>	<b><u>30.2</u></b>	<b><u>37.5</u></b>	<b><u>45.9</u></b>	<b><u>58.0</u></b>	<b><u>73.2</u></b>	<b><u>88.7</u></b>	<b><u>108.4</u></b>	<b><u>374.2</u></b>
<b>Net profit before interest and tax:</b>								
Internet and mail-order sales	3.4	4.7	4.7	5.8	7.2	8.2	9.8	35.7
Ofood4U shops	(0.6)	0.2	0.5	1.4	2.9	5.2	8.3	18.3
Sales to supermarkets	0.1	0.1	0.2	0.3	0.3	0.4	0.4	1.6
<b>Total net profit before interest and tax</b>	<b><u>2.9</u></b>	<b><u>5.0</u></b>	<b><u>5.4</u></b>	<b><u>7.5</u></b>	<b><u>10.4</u></b>	<b><u>13.8</u></b>	<b><u>18.5</u></b>	<b><u>55.6</u></b>
<b>After-tax net operating cash flows generated from operations (defined as before interest, new loans, loan repayments, capital expenditure and dividends)</b>	<b><u>4.7</u></b>	<b><u>6.3</u></b>	<b><u>6.7</u></b>	<b><u>8.8</u></b>	<b><u>11.9</u></b>	<b><u>14.0</u></b>	<b><u>17.6</u></b>	<b><u>59.0</u></b>
<b>Capital expenditure</b>								
Increased warehousing / new distribution centre	2.3	0.0	0.0	18.0	0.0	0.0	0.0	18.0
Additional in-house food processing equipment	0.9	0.6	0.6	0.0	0.0	1.2	0.0	1.8
Shop-fitting costs (assuming all shops rented)	0.6	0.3	0.9	1.2	1.5	1.5	1.5	6.6
Capital expenditure to meet growth in business (office / computers / operating equipment)	4.1	4.3	2.0	0.9	2.0	2.3	1.5	8.7
<b>Total capital expenditure</b>	<b><u>7.9</u></b>	<b><u>5.2</u></b>	<b><u>3.5</u></b>	<b><u>20.1</u></b>	<b><u>3.5</u></b>	<b><u>5.0</u></b>	<b><u>3.0</u></b>	<b><u>35.1</u></b>
<b>Number of Ofood4U shops (at year end)</b>	<b>2</b>	<b>3</b>	<b>6</b>	<b>10</b>	<b>15</b>	<b>20</b>	<b>25</b>	