CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

CPA Common Final Examination

BOARD OF EXAMINERS' REPORT

PART B — The Day 1 Report

September 2017 and September 2018 Examinations

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THE BOARD OF EXAMINERS' REPORT ON THE SEPTEMBER 2018 COMMON FINAL EXAMINATION

OBJECTIVES OF THE REPORT

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

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

The September 2018 CFE Report is presented in two parts: Part A is the Day 2 and Day 3 Report and Part B is the Day 1 report.

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

RESPONSIBILITIES OF THE BOARD OF EXAMINERS

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

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

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

The chair is responsible for the supervision of the evaluation process. The entire board is actively involved in the preparation of the CFE simulations, the preliminary marking guides, and the setting of the initial passing profile. A CFE subcommittee, made up of six members, participates in the Preliminary Evaluation Centre where the marking guides are tested against candidate responses and finalized. The chair and vice-chair participate in the start-up of the marking centre and provide oversight throughout the marking process. The full board is responsible for determining the passing standard.

THE CFE

Preparation and Structure of the CFE

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

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

Nature of the Simulations

The CFE comprises a set of simulations that are both essential and effective in evaluating the candidates' readiness to enter the profession:

Day 1 – The first paper is a four-hour examination consisting of a single simulation that is linked to the Capstone 1 group case. There are two versions of the linked cases. Version 1 is linked to the most current Capstone case, and is written by first time writers and by repeat writers who chose to attempt the new case rather than Version 2 of the previous Capstone case. Version 2 is written by repeat writers and candidates who deferred and are writing Version 2 as their first attempt.

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

Day 3 – The third paper, is a four-hour paper, consisting of three multi-competency area simulations.

Assessment Opportunities

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

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

Appendix A contains a comprehensive description of the evaluation process.

Marking Guides

Marking centre leaders and assistant leaders provide valuable input during the testing and setting of the marking guides, before live marking begins. The board chair, the vice-chair, selected board member(s) and senior evaluations staff hold meetings with the leaders and their assistants during both the guide-setting and the marking processes. See **Appendices B to F** for the FVT Day 1 simulations and related capstone case, FVT marking guides, and FVT sample responses. **Appendix G** contains the marking results by assessment opportunity, and **Appendix H** contains the BOE comments. A copy of the Day 1 V1 (HEVW), Day 2 and Day 3 simulations can be found in **Part A** of the CFE Report. The marking guide and detailed BOE commentary for the HEVW Day 1 simulation will not published until version 2 is written on the September 2019 CFE.

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

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

Five categories of performance are given for each Assessment Opportunity. The candidate's performance must be ranked in one of the five categories:

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

Setting the Passing Standard

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

In determining which candidates pass the CFE, a candidate is judged in relation to the board's pre-established expectations of an entry-level chartered professional accountant. Any changes to the initial profile that were made throughout guide-setting and the marking centre are ratified by the full board. In setting the passing profile, the board considers the following:

- The competency area requirements described in the *Map*
- The level of difficulty of each simulation
- The level of difficulty of each Assessment Opportunity
- The design and application of the marking guides
- Comments from leaders and assistant leaders regarding any marking difficulties encountered or any time constraints noted
- Possible ambiguity of wording or of translation
- Input on critical decision factors from an independent board of three CPAs who review the fair pass package

The Decision Model

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

- Day 1 is linked to the Capstone 1 group case work. It assesses the candidates' ability to demonstrate professional skills. It is independent from Day 2 and Day 3.

- Day 2 is the **depth** test. It assesses technical **depth** in one of four unique roles (that reflect the four CPA elective choices) and provides **depth** opportunities in the common core competency areas of Financial Reporting and/or Management Accounting. Candidates pre-select one role and respond from that role's perspective.

- Day 3 supplements the **depth** test in the common core areas of Financial Reporting and/or Management Accounting. It is also the **breadth** test for all common core competency areas.

Candidates must pass all three days in order to qualify for entry to the profession. Those seeking licensure must obtain depth in Financial Reporting and in the Assurance Role.

Day 1

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

Day 2 and Day 3

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

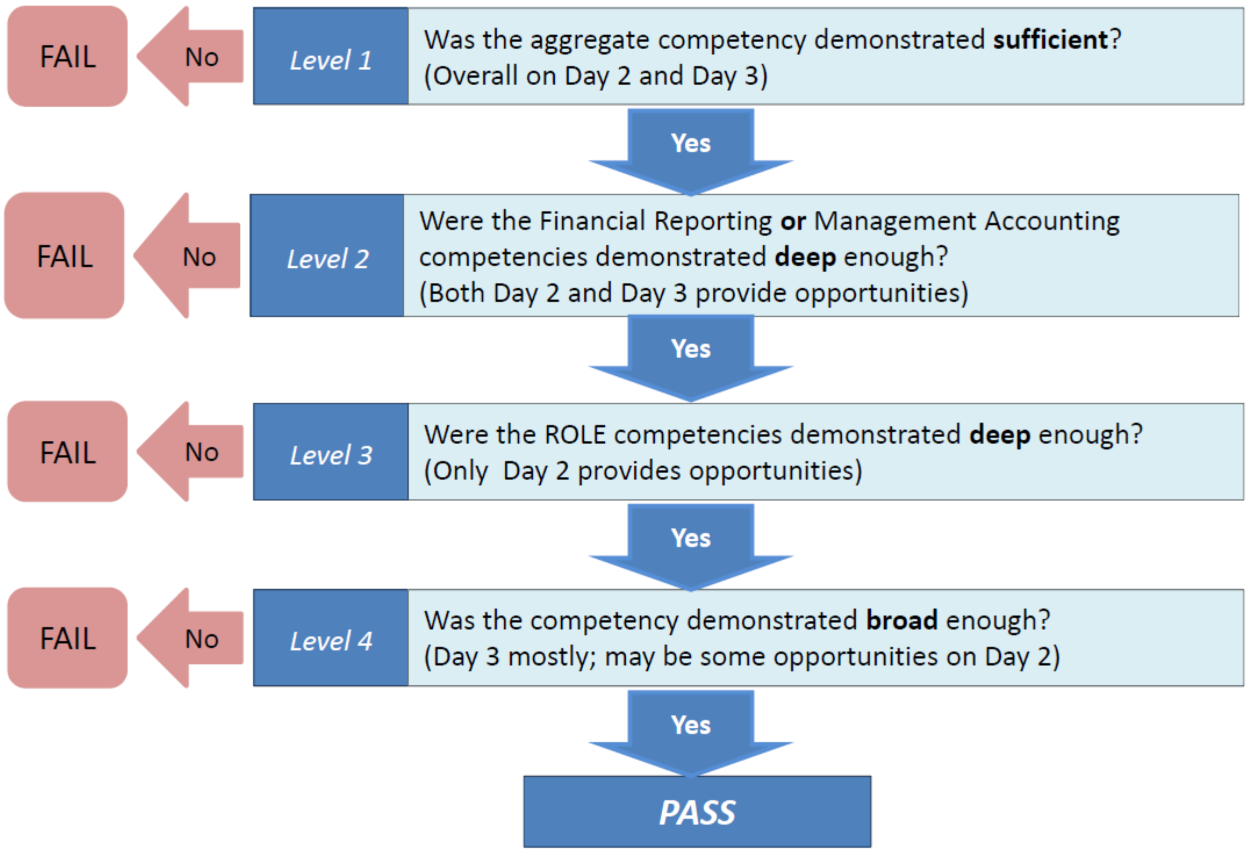
1. The response must be **sufficient**; i.e., the candidate must demonstrate competence in the Assessment Opportunities presented on Day 2 and Day 3 (Level 1).

2. The response must demonstrate **depth** in the common core area of Financial Accounting or Management Accounting (Level 2).

3. The response must demonstrate **depth** in the pre-selected elective role (Level 3).

4. The response must demonstrate **breadth** across all competency areas of the *Map*, at a core level, by not having avoided a particular technical competency area (Level 4).

EXHIBIT I
DAY 2 AND 3 PASS/FAIL ASSESSMENT MODEL



Approving the Results

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

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

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

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

Reporting

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

The board reports the following information by candidate number:

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

Thank You

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

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

Terry Booth, FCPA, FCA, CF
Chair
Board of Examiners

A MESSAGE TO CANDIDATES

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

INTRODUCTION

The September 2018 CFE Report presents detailed information on candidates' performance for all the examination cases, except for HEVW, the Day 1 linked case, Version 1. Commentary on the performance of candidates on Day 1 (HEVW Version 1) is provided in a summary format only in this message to candidates, since detailed commentary on HEVW will only be provided after Version 2 is written in September 2019. The simulations, marking guides, marking results, and Board of Examiners' comments on the rest of the examination are found in this document (Part A of the CFE Report). Similar information on Day 1 (FVT Version 1 and Version 2) can be found in Part B of the CFE Report.

The intent of this message is to highlight common areas of deficiency and to offer advice from the Board to help candidates understand how to improve their performance on the CFE.

Nature of the CFE

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

Specific Strengths and Weaknesses

<u>Lack of Support/Generic Discussions</u>

A common theme across all the days was the fact that some candidates presented case facts without elaborating on why they were relevant to the discussion or the position being argued. This was typically done in point form. Also, some candidates made generic comments or drew conclusions on an analysis that failed to integrate the case facts, resulting in a superficial analysis of the issues and unsupported conclusions.

For example, on Day 2, Performance Management role, many candidates provided a bullet-point list of case facts, under the headings of strengths, weaknesses, opportunities, and threats, without any further explanation. In addition, on the two assessment opportunities (AOs) for which a qualitative analysis was necessary, many candidates listed case facts labelled as pros or cons but did not explain any further. On Day 3, Simulation 1, the Board saw a similar approach taken to the qualitative discussion of the two offers. Some candidates simply listed case facts under either Offer A or Offer B, with no further explanation as to why each factor would be either an advantage or a disadvantage of each option. Similarly, on Day 3, Simulation 3, some candidates merely listed the case facts that identified issues with the current board of directors, without any further explanation as to why these were issues that needed to be addressed.

The Board also noted AOs for which candidates provided generic discussions or made unsupported conclusions. On Day 2, Common, AO#3 (business acquisition), many candidates concluded that the purchase of Bright Sun Power's assets qualified as a business combination, without providing any supporting case facts. On Day 2, Assurance role, AO#8 (inventory procedures), candidates provided only very generic inventory procedures and did not apply the relevant case facts (for example, the fact that it was now after year end or the fact that the inventory was different and at different locations) to their discussions to come up with more specific and relevant procedures.

The above tendencies were also noted on Day 1.

Candidates must ensure that they answer the questions "Why?" or "So what?" when they make any point using case facts. Simply repeating case facts without any further explanation, even if it is in a logical format, is insufficient. The Board is interested in understanding a candidate's logic and wants to see evidence of the analysis and professional judgment that has been applied. Candidates are reminded that all competent candidate profiles on the CFE require supported arguments and defensible positions that are case specific.

Time Management

An improvement in time management was noted on the September 2018 CFE. With a few exceptions, described in this section, time was well managed on all three days of the CFE.

In the past, the Board had noted that on Day 1, some candidates have spent an inordinate amount of time preparing a full situational analysis, rather than addressing the changes that were relevant based on the case facts presented. While this continued to be the case on Version 2 of FVT, and often resulted in candidates running out of time, the Board was pleased to see an improvement on Version 1 of HEVW. Version 2 of FVT also had a number of candidates who appeared to address the issues in the order in which they appeared in the case. While candidates are free to address the requireds in the order they like, the most significant issue on Version 2 of FVT this year happened to appear last in the case. For those candidates who did not rank the issues, this resulted in not leaving enough time to fully address this issue.

Although Day 2 is not designed to be time constrained, the Board saw some evidence of time management issues. Several candidates spent too much time addressing the common financial reporting AOs; specifically, the revenue recognition issue, for which some candidates' responses were ten pages long. While this resulted in strong responses on that one required, it also resulted in some candidates running out of time on other requireds. This was most commonly seen on the Day 2 Finance and Day 2 Performance Management role responses.

Candidates are reminded that spending too much time on any one required can hurt performance on another required. Allocating sufficient time to cover all of the requireds, while still ranking the importance of the issues, is essential. Judgment is required in determining how much evidence to provide to demonstrate competence per AO. The Board is looking for sufficient, but not excessive, depth to be demonstrated. Day 2 is specifically designed to allow time for filtering information and planning the response. Candidates are encouraged to use the time provided to ensure sufficient time is allocated to all the requireds.

The Board was pleased to see candidates generally following the suggested times for each simulation on Day 3 to ensure they had the opportunity to answer all the requireds. The Board continued to see some evidence of candidates going over the suggested times on Simulation 1 and sometimes Simulation 2, to the detriment of their performance on Simulation 3. Also, some candidates seemed to spend a lot of time preparing a quantitative analysis on Simulation 1, without having a clear purpose in terms of what they were trying to achieve. This resulted in some candidates running out of time on Simulation 3.

The Board was pleased to see a decrease in the number of candidates skipping issues on Day 2 and Day 3 (see the percentage of Not Addressed by AO). Candidates appeared to make a concerted effort this year to attempt all of the AOs. When candidates did skip an AO this year, it appeared to be due to time constraints rather than intentionally avoiding the issue. In addition, most candidates who experienced the time management issues noted in this section generally chose to still try and address all of the AOs rather than skipping some AOs all together. This was typically evidenced by rushed or brief responses on the last one or two AOs of those simulations. While there is still room for improvement, the Board was encouraged by the candidates' efforts to attempt all of the AOs this year. The Board reminds candidates that the CFE has not only depth and breadth tests but also a sufficiency score, which is impacted by skipping issues. Therefore, it is important that candidates continue to attempt all of the requireds, managing their time carefully in doing so.

Day 1

Points have been excerpted from the September 2017 Board of Examiners' report on Day 1, Version 1 of FVT. Additional commentary based on candidates' performance on Version 2 has been added.

Comments Specific to Day 1 (FVT Version 1) [excerpted from September 2017 CFE Report]

Most candidates dedicated the first section of their response to a situational analysis. Most used their situational analysis later in their response, making links back to the work they did while analyzing the specific issues. Most also used the information provided in the case (for example, financial ratios and industry benchmark) to perform a general financial assessment of FVT. The most frequently used element of the situational analysis was the focus on new technology (for example, the new mission and trends toward new technology). Some candidates calculated the covenant based on the internally prepared financial statements and recalculated it incorporating their recommendations for financing.

Weak candidates simply recapped case facts or went into too much depth in their situational analysis, redoing the entire analysis rather than focusing on the changes, which the case specifically directed them to do.

Candidates are reminded that the purpose of the situational analysis is to identify relevant changes in circumstances since the Capstone 1. It is not intended to be a full SWOT, nor is it intended to be a standalone analysis that is rewarded. Only when the information is integrated into the discussion of the specific issues is there value added.

There were five issues that candidates were expected to analyze from both a strategic perspective and an operational perspective. Four were investment opportunities that the candidates were specifically asked to analyze, and the fifth was an undirected requirement about the governance and ethical issues facing FVT. Candidates were expected to provide a qualitative and quantitative analysis for each of the four investment opportunities. Candidates were also expected to integrate the case information to recognize at least one of the ethics and governance issues and to recommend appropriate action.

Overall, most candidates provided a balanced response, with appropriate depth in the qualitative discussion on every issue, and they showed some numeracy skill in most of the major issues. Strong candidates tended to discuss the issues with the strategic implications at the forefront of their analysis. Weak candidates tended to list qualitative points that were mostly restated case facts, and they also tended to focus on the operational decision factors. Some weak candidates were not able to use the quantitative information in a useful way for FVT. Candidates are reminded that avoiding the numbers is a fatal flaw for the Day 1 case and are strongly advised to perform a balanced quantitative and qualitative analysis. Candidates are also reminded that it is important on Day 1 to discuss the strategic implications, not just identify the operational issues, keeping in mind that often the operational issues are presented in the case to raise broader strategic issues. Candidates are reminded to step back and think about the interrelationships between the issues.

For example, candidates were expected to realize that FVT had financial constraints, such as the financial covenant and the limit on spending on investment ($2.5 million), that they should have considered when assessing the investment options. Weak candidates did not understand the constraints that FVT was facing.

Candidates were not specifically directed to the ethical and governance issues but were given multiple examples in the case of these issues. Many candidates recognized the unethical actions of Zobair and realized that the FLIXREWARDS points should be remitted to the clients in order to maintain FVT's reputation. However, some did not see the issue at all, which was disconcerting to the Board. Candidates are expected to address ethical issues that could have an impact on the business, even though they are not directed to them. Candidates need to step back and integrate all the case facts to uncover those non-directed issues.

Candidates are expected to conclude on each analysis they complete, and their conclusions are expected to be consistent with the analysis they perform. There was no one correct solution to the case. Strong candidates provided thorough conclusions for all the issues they analyzed. Most candidates took into account the constraints provided in the case by either comparing the investment needed for each project with the spending limit or attempting to recalculate the financial covenant based on the projects recommended.

Only a few candidates struggled with effective communication. The approach most candidates took was well structured and the language used was clear. However, the presentation of the exhibit in Excel by some candidates was hard to follow. The use of decision matrix and column format in Word (with pro/con listings) is also not an effective communication technique because it is difficult to clearly communicate the thought process in this format.

Comments Specific to Day 1 (FVT Version 2)

Generally, candidates provided an appropriate situational analysis, recognizing some of these issues and integrating them into their analysis. Most candidates recapped the mission and key success factors and framed the situational analysis in a SWOT. Some candidates still spent excessive time on this part of their response, with many spending nearly half of their total response performing a SWOT analysis and providing a detailed discussion of FVT's performance relative to the industry benchmarks. Many of these candidates discussed each of the nine benchmarks in detail. Some even recalculated the ratios (such as the current ratio) using the numbers from the financial statements, even though the calculated ratios were provided in Appendix II.

There were four major issues and one minor governance issue that candidates were expected to analyze from both an operational and a strategic perspective. Candidates were expected to qualitatively and quantitatively analyze each of the major issues, keeping in mind FVT's current problems (cash flow and debt issues) and its new financial targets.

The first issue was the potential sale of Cinema LaRoche (CLR). Even though it was presented last in the case, candidates were expected to identify the issue as the most significant one in the case, due to the impact on cash flows and revenue. Many candidates addressed the issues in the order they appeared in the case, so many of these candidates were rushed when it came to their CLR discussion and as a result did not do an adequate analysis. Candidates are reminded to take the time to assess the relative importance of the issues before responding, to ensure that the most important issues are addressed adequately.

The second issue was whether to close The Games Place or leave it open and lease the games. Alternatively, although not specifically mentioned, FVT could always maintain status quo. Candidates generally did well on this issue. However, some failed to clearly identify status quo as being a feasible option.

The third issue was whether to renovate part of FVT's Tillsonburg theatre to accommodate live performances. Most candidates determined that the live theatre was more profitable, although some struggled with what was considered a basic quantitative analysis. However, many candidates provided a biased analysis and tended to ignore the fact that FVT did not have the funds to pay for the renovation. Candidates are reminded to consider both sides of the decision before concluding, to ensure that all relevant decision factors are weighed into the conclusion.

The fourth issue was the supplier contract (KC or TBG). Most candidates provided a reasonable qualitative comparison of the two suppliers. However, many candidates' quantitative analysis was merely a restatement of case facts (for example, TBG would reduce cost to 23% of revenue, while KC would reduce it to 25%) that focused on comparing the operational choices. By taking this approach, candidates did not get a sense of the magnitude of the actual dollar savings and how that fit into the strategic discussion and overall decision of how best to resolve the cash issue facing the company. Candidates are encouraged to take the time to step back and consider how the issues presented tie into the bigger picture of the company's objectives before they conclude on the issue and move on to the next discussion.

Some candidates simply restated case facts, with no added value (for example, that FVT had purchased CLR and was experiencing operating problems). Candidates are reminded that stating their final position is important, particularly when there are several pros and cons for each alternative and multiple issues to address. Summing up is necessary to convey which courses of actions should be pursued first and why. In this case, since the issues were highly integrative, an overall conclusion helped demonstrate the candidate's strategic thinking.

Many Version 2 candidates persist in using point form to list the pros and cons related to an issue, with little explanation of their thought process. This can be a poor communication technique because it can lead to responses that are unclear and in many cases challenging to understand, since the point listed can often be interpreted more than one way. Candidates are not discouraged from using point form; however, they need to ensure they go beyond the case facts to clearly explain why the point is relevant.

Comments Specific to Day 1 (HEVW Version 1)

Most candidates dedicated the first section of their response to a situational analysis. Most used their situational analysis later in their response, making links back to the work they did while analyzing the specific issues.

Weak candidates typically recap the case facts or go into too much depth in their situational analysis, redoing the entire analysis rather than focusing on the changes, which this case specifically directed them to do. The Board was pleased to see that there was less evidence of candidates doing that this year on Version 1 of HEVW.

There were four major issues that candidates were expected to analyze from both a strategic perspective and an operational perspective. These four major issues related to important decisions HEVW was facing that the candidates were specifically asked to analyze from both a qualitative perspective and a quantitative perspective; however, the case required far more quantitative analysis, and far fewer qualitative points could be provided for each issue. There were also some minor issues that candidates could discuss at an operational level and in less depth.

Overall, most candidates provided an appropriate response, considering sufficient qualitative factors for the issues presented, and they showed reasonable numeracy skill in most of the major issues. Strong candidates tended to discuss the issues with the strategic implications first, whereas weak candidates tended to focus on the operational decisions. Some weak candidates listed qualitative points that were mostly restated case facts and were not able to present the quantitative information in a way that was useful to HEVW, although most attempted some of the required calculations.

Generally, avoiding the numbers is a fatal flaw for the Day 1 case, and candidates are strongly advised to perform a balanced quantitative and qualitative analysis. However, for HEVW Version 1, it was appropriate to provide more quantitative and less qualitative analysis. Candidates are reminded to judge, on a case-by-case basis, the amount of qualitative and quantitative analysis that is necessary and appropriate in the circumstances by what will provide the most useful information.

Candidates are also reminded that it is important on Day 1 to discuss the strategic implications, not just identify the operational issues, keeping in mind that often the operational issues are presented in the case to raise broader strategic issues. Candidates are reminded to step back and think about the interrelationships between the issues. For example, candidates were expected to realize that HEVW was experiencing a short-term cash flow shortage that they should have considered when assessing each of the decisions. It was the key issue in the case.

Candidates are expected to conclude on each analysis they complete, and their conclusions are expected to be consistent with the analysis they perform. There was no one correct solution to the HEVW case. Most candidates considered the cash flow constraint when evaluating each of the decisions, made a recommendation, understood it was a short-term issue that would resolve itself as capacity was reached, and offered some way to find cash in the short-term that was feasible. Candidates are reminded to provide well-supported conclusions for all issues, in order to justify their position, but also to integrate any broader constraints and objectives into an overall conclusion.

Only a few candidates struggled with effective communication. The approach most candidates took was well structured and the language used was clear. However, some candidates' presentation of the exhibit in Excel was hard to follow due to poor labelling or a lack of formulas.

Additional Day 2 and Day 3 Comments

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

<u>Technical Knowledge</u>

Most candidates were able to demonstrate the technical knowledge required throughout the CFE. In general, candidates performed well across most of the depth and breadth tests. The following are some examples of the technical weaknesses noted on the Day 2 and Day 3 simulations that contributed to the weaker results on those AOs.

Most candidates were able to provide a complete analysis of the basic accounting issues, but they continued to struggle with the more difficult issues. On Day 2, Common, AO#3 (business acquisition), many candidates struggled with applying *Handbook* guidance, frequently misinterpreting paraphrased sections, including entire sections without identifying the subsection relevant to the scenario, or using guidance from a *Handbook* section that did not apply to the situation (such as *IFRS 10 – Consolidation*, *IFRS 11 – Joint Ventures*, or *IAS 32 – Financial Instruments*). On Day 2, Common, AO#5 (EPS), many candidates had numerous errors in their EPS calculations. For example, some candidates used incorrect figures, such as gross profit instead of net income in the numerator or retained earnings instead of the number of common shares in the denominator. Dilutive EPS calculations often contained errors such as the inclusion of both the in- and out-of-the-money options in the denominator, instead of recognizing the options were antidilutive and should not be included. Many candidates also incorrectly deducted the interest paid on the convertible bonds from net income, instead of correctly recognizing it should be added to net income.

On Day 2, Assurance role, AO#11 (summary of misstatements), candidates struggled with completing the summary, with many providing incorrect or one-sided journal entries to correct the misstatements presented. They also struggled with applying the concepts of materiality and pervasiveness to specific case facts, and at times would provide either irrelevant audit report options (such as disclaimer of opinion) or incorrect advice on how a clean opinion could be obtained (such as suggesting that materiality could be changed). On Day 2, Assurance role, AO#13 (interim review of financial statements), most candidates only provided generic discussions of the nature of audits versus reviews, and they struggled with providing any discussions on the specific characteristics of interim reviews. Candidates struggled with this topic and seemed to lack a basic understanding of what an interim review is and how it is different from a year-end review. As a result, they were unable to provide discussions that had value for Jeremy.

On Day 2, Performance Management role, AO#10 (transfer pricing), a hard assessment opportunity, candidates struggled to link the transfer pricing options to the evaluation of the plant managers' performance for compensation purposes. They were only able to provide theoretical discussions and to quantify the impact on the bonuses, which was not really addressing the issue adequately.

On Day 2, Finance role, candidates frequently made errors in calculating the cash conversion cycle (AO#12) or avoided the calculation altogether in favour of a discussion that indicated they did not understand the cash conversion cycle. In addition, candidates had difficulty explaining the nature of the solar farm project financing (AO#9), even though its definition was provided in the case itself, and many instead wrote in generic terms.

On Day 2, Taxation role, candidates addressed simpler topics, such as the calculation of taxable income, the calculation of CCA, and employee versus contractor considerations, with strong technical analyses that showed they clearly understood the issues being tested. On the more difficult topics, however, many candidate responses contained significant technical errors. For example, when discussing acquisition of control (AO#9), an alarming number of candidates stated that all assets of the corporation were deemed to have been disposed of at fair market value, while the technically correct rule is that assets with accrued losses are deemed to have been disposed of at fair market value, and assets with gains are eligible for an election for a deemed disposition anywhere up to fair market value. Candidates also struggled with the treatment of the windup of a subsidiary corporation after disposition of its assets (AO#10 OWF sales of assets versus shares). Many candidates attempted to apply rules applicable to individuals instead of rules applicable to corporations.

Candidates struggled the most on Day 3, Simulation 1, AO#5 (boat rental breakeven), where they failed to understand the basic elements of a contribution margin and breakeven calculation. For example, candidates incorrectly included fixed costs in the contribution margin analysis, such as the attendant's salary, and included capital costs in their breakeven calculation. On Day 3, Simulation 2, AO#2 (packing coordinators), candidates calculated the variance in salary and compared it to the reduction that was expected after eliminating the packing coordinators, without incorporating the changes in volume of skids handled to their analysis. This lack of understanding of basic management accounting concepts left the client with a superficial analysis of the issues that would not allow them to fix the problems.

Candidates also struggled on the Financial Reporting AO on Day 3, Simulation 3, AO#3 (lease). Candidates incorrectly concluded that the purchase option price was a bargain price, although the purchase option price was equal to the fair value of the soundboard at the time the option could be exercised. In addition, whether candidates concluded that there was a bargain purchase option or not, many made mistakes in treating the purchase option in their present value calculation in a way that would be consistent with their interpretation.

Finally, candidates demonstrated a lack of knowledge on Day 3, Simulation 1, AO#4 (tax implications). Candidates struggled with the technical tax knowledge that was required to help the client. For example, some candidates did not understand the difference between the regular tax rate of 13% and the tax rate of 52% that should have been used in this case. They also wrongly applied the lifetime capital gain exemption to the capital gain generated with Offer A, mixing up personal and corporate tax rules.

Candidates are reminded that the CFE requires them to have a strong foundation of technical knowledge in order for them to clearly demonstrate their professional skills, apply their judgment, and thereby demonstrate competence.

Irrelevant Discussions

Similar to the prior year, there were a few incidents of candidates providing irrelevant discussions.

For the first time last year, there was an enabling AO on Day 2. Some Assurance candidates appeared to think that there was an enabling skills AO/undirected required in the case again this year, bringing up the fact that Elite was putting significant pressure on SPS to perform well financially or suggesting that SPS may not be a going concern due to the declining share price and the company's need for additional financing. These discussions were often very brief and were not relevant in this case. There were no hints in the case to suggest that Elite's interest in SPS's financial performance was beyond that of a normal significant investor, or that going concern was an issue for SPS, given the company still had significant net income for the year and obtaining financing is a normal part of business operations for most companies. While candidates are encouraged to always keep the big picture in mind and should consider any non-directed issues, they should ensure that the issues identified are supported by the actual case facts presented.

Also on Day 2, Assurance role, AO#13 (interim financial statement review), some candidates provided discussions of several special reports (such as Section 5815, Section 8600, and Section 9100 reports) that did not at all address the required in the case. It appeared that candidates applied their own interpretation of the required, instead of taking the time to read and clearly understand the case required.

On Day 2, Taxation role, AO#11 (treatment of employees versus contractors), many candidates dwelled on a discussion of whether workers would be employees or contractors. It was clear in the case that the company would do what was necessary to have these workers treated as contractors, so the discussions were not useful. In addition, many candidates described rules for deductions that can be claimed by employees when they were clearly asked to discuss deductions that can be claimed by independent contractors.

On Day 3, Simulation 3, AO#4 (carryforward and deadlines), some candidates misinterpreted the question from the client when she asked about the filing and payment requirements and deadlines for GHT/HST. The client had said that she was not sure she had been doing it properly. Some candidates misinterpreted this statement and discussed whether or not KST should register for GST/HST, when Ellen was already dealing with GST/HST.

Candidates are reminded to use their judgment in deciding whether a discussion is pertinent to the issues at hand or the role. Candidates should be careful not to assume that the required is identical to something that was asked for in a previous case, which could lead to providing a rote response that is incorrect.

<u>Ignoring/Contradicting Case Facts</u>

As in the prior year, the Board saw several instances of candidates directly contradicting case facts presented to them, even when the facts were presented by authoritative sources in the simulation.

For example, on Day 2, Common, some candidates discussed the accounting treatment of the bonds and options, despite the fact that they were specifically told the auditors had already reviewed the accounting for these. Candidates are reminded that, while they should remain skeptical of unreliable sources, they should not be suspicious of all the information presented to them. Candidates are expected to apply their judgment to determine what information can be relied upon and what information should be treated with skepticism.

On Day 2, Performance Management role, the case mentioned that if the solar farm did not produce enough electricity to provide Comcap with the contractual number of kilowatt hours, the shortfall could be purchased from the public utility at market prices. Many candidates ignored that case fact when addressing AO#7, which led them to conclude by mistake that the proposed upgrade to the solar farm was mandatory, when, in fact, a calculation had to be performed to determine if the upgrade was a profitable investment.

On Day 2, Taxation role, despite there being no CCPCs in the simulation (except for one unrelated entity mentioned only briefly), candidates discussed the implication of loss of CCPC status instead of discussing acquisition of control on AO#9. Perhaps these candidates were using the 2017 exam as a template, since such a situation occurred on that exam.

On Day 3, Simulation 2, AO#2 (packing coordinators), some candidates ignored the timing related to the elimination of the packing coordinators. They based their analysis on the three periods presented, instead of focusing on the period right before the packing coordinators left and the one right after to home in on the impact of their departure.

On Day 3, Simulation 3, AO#1 (ShowTix proposal), many candidates ignored the fact that only one-third of the online sales would be from new patrons. These candidates based their analysis on all revenue that would be generated online, rather than only using the revenue from new patrons. Therefore, they were not able to provide an incremental quantitative analysis (in other words, showing the incremental net income that the project would provide to KST).

Candidates are reminded to take the time to read the simulations and carefully assess what are the relevant case facts.

Qualitative versus Quantitative Analysis

New this year, the Board noted a few AOs where candidates listed factors under their qualitative analysis that were actually quantitative and were elements they had already considered in their quantitative analysis. These candidates seemed to think that they were performing a qualitative analysis, when they were simply describing their quantitative analysis.

For example, on Day 2, Performance Management role, AO#8 (solar farm - qualitative), candidates were required to perform a qualitative analysis of the solar farm. However most of the elements raised by candidates were quantitative in nature, despite them labelling their analysis as “qualitative.” These candidates merely repeated each key component of their quantitative analysis in a narrative form as either a pro or a con, failing to discuss enough of the actual qualitative elements.

There were also a few examples of this on Day 3. On Day 3, Simulation 1, AO#3 (qualitative on Offer A versus Offer B), although most candidates did well in providing qualitative factors to consider, some provided factors that they had already considered in their quantitative analysis. For example, some of these candidates compared the difference in repairs and maintenance or propane costs under each offer, but that had already been accounted for in the quantitative analysis. On Day 3, Simulation 3, AO#1 (ShowTix proposal), some candidates repeated that there was an upfront fee of $20,000 that had to be paid, or that total tickets sales would be higher with ShowTix, when these were already factored into their quantitative analysis.

APPENDIX A

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

CFE Design

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

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

Day 3 is a four-hour examination containing a mix of small cases (60 to 90 minutes each) that evaluate the common core competencies only. The Day 3 cases provide additional opportunities for **depth** in Financial Reporting and Management Accounting and all the **breadth** opportunities for all the technical competency areas. Cases are time constrained, and they are designed to cover different competency areas within each case. A higher level of integration and judgment is required on Day 3 of the CFE than in the core modules, although the technical competencies are tested at the common core level of expectation.

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

The Development of Marking Guides and the Provincial Review Centre

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

The September 2018 CFE Marking Centre

From the marker applications received, approximately 268 individuals were chosen to participate in the September 2018 CFE marking centre. The criteria for selection included marking experience, motivation, academic achievement, work experience, personal references, and regional representation. The marking was supervised by the CPA Canada Evaluations and International Assessment full-time board staff (6 staff).

The Day 1 HEVW Version 1 linked case was marked by a team of 34 people in Montreal from October 5 to October 27, 2018. The Day 1 FVT Version 2 linked case was marked remotely by a four- member team from September 24 to October 17, 2018. [See the September 2017 Board of Examiners' Report for details on the Day 1 FVT Version 1 marking centre.]

The Day 2 Common assessment opportunities were marked by a separate team from the role teams for the first time this year. Day 2 Common was marked in Montreal by a team of 42 people from October 5 to 19, 2018. Day 2 Assurance was marked by a team of 59 people in Montreal from October 3 to October 17, 2018. Day 2 Performance Management was marked by a team of 19 people in Montreal from October 5 to October 15, 2018. The other two Day 2 roles (Taxation and Finance) were marked by a total of 16 people, remotely, from September 22 to September 30, 2018, immediately following the preliminary evaluation centre.

Whereas only one Day 3 case was remotely marked for the past two years, all three Day 3 cases were marked remotely from October 7 to October 24, 2018. The Day 3 simulations were marked by a total of 92 people.

Before the marking centre, the members of the CFE subcommittee, staff, leaders, and assistant leaders attended a five-day preliminary evaluation centre (PEC). Participants reviewed the marking guides, applied them to randomly selected candidate responses, and made necessary revisions to the marking guidelines, taking into account the written comments on the marking guides received from provincial reviewers.

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

After the training and test-marking phases, and only when marker congruence was achieved, live marking commenced. All teams, for all days, had a leader, and anywhere from one to six assistant leaders, and had both French-speaking and English-speaking markers. Each team had one or more markers who marked in both languages.

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

Borderline Marking (Day 1)

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

Double Marking (Day 2)

Each candidate's Day 2 paper was marked independently by two different markers. If the two initial markings differed on any assessment opportunity, an arbitrator (the leader, the assistant leader, or a senior marker) compared the two initial markings and determined the final result.

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

Borderline Marking (Day 3)

Unlike Day 2, Day 3 was marked using a borderline model. All Day 3 responses were marked once and then the Day 2 and Day 3 results were combined. All failing candidates who passed the Day 2 role test, had their Day 3 response marked a second time by an independent marker, and any differences between the first and second markings were arbitrated by a leader or senior marker.

Subsequent Appeal of Results and Request for Performance Analysis

Failing candidates may apply for an appeal of their examination results and/or a performance analysis for either Day 1, or Day 2 and Day 3, or for all three days.

<u>Appeal Approach</u>

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

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

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

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

APPENDIX B

CAPSTONE 1
FVT BACKGROUND CASE

Capstone 1

First View Theatres Inc. – Case

(All dollars are Canadian dollars unless specifically stated otherwise.)

It is March 21, 2017, and it is your third month working as a CPA with Renker and Curtis Co. (RCC) Management Consultants. You have been assigned responsibility to develop a report for the Board of Directors (the board) and management of First View Theatres Incorporated (FVT).

FVT has approached RCC with a request to assist them in conducting a strategic analysis and to set a new direction for the company. FVT is questioning its ability to meet growth and profitability targets, and there are conflicting ideas at the board level regarding the company's future. There are also many operational issues that FVT's board would like you to address.

You have been provided with the following information to review and analyze.

First View Theatres Inc. (FVT)

First View Theatres Inc. (FVT) is a Canadian privately held company operating theatres in southwestern Ontario. Each screen is located in an auditorium1 that has between 200 and 300 seats. FVT began as a division of First Lands Limited (FLL), a family-owned, privately held company that builds and leases shopping malls and industrial complexes. FLL was started and is still owned by Sheila and Kent Lightfoot, each of whom holds 50% of the shares. Sheila and Kent have three children, all of whom are involved in the business: Stephanie, Viktor and Lanny. FVT's organizational chart is provided in Appendix I.

Industry information

Description and size

The motion picture industry consists of film production, film distribution (through a variety of channels) and film exhibition in theatres. FVT operates in the theatre exhibition industry where newly released films are shown to the public for the first time.

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1 "Auditorium" is the term used for each room that holds one screen. Each auditorium generally has between 200 and 300 standard theatre seats.

The industry includes outdoor and indoor movie theatres, drive-ins and film festival exhibitors.2

During 2015, the Canadian theatre exhibition industry generated total revenues of $2 billion, and it experienced an annualized growth rate of 2.6% over the past five years.3 Admissions account for 54.4% of total industry revenue, while concessions contribute 30.4%, and the remaining 15.2% of revenue is generated from other sources.4

The theatre exhibition industry is in a mature stage, with annualized growth rates expected to be only 1.2%5 to 2020. Consolidation during the past five years has resulted in a few key players dominating the market and forcing smaller operators to exit the industry. The major industry leader commands 65% of the market share and the second-largest operator controls 8.2%.6 The remaining 26.8% of the market is shared by 416 companies.7

Since potential movie theatre attendees have a variety of ways to conveniently watch films at home at a lower cost (such as movies available from networks via cable and satellite, in-home videos and DVDs, pay-per-view, digital downloads and Internet streaming on computers), there is fierce competition for those individuals who actually prefer to view films in theatres.

To remain competitive, smaller operators negotiate favourable rights to blockbuster films, and upgrade their facilities with better technology, comfort and additional amenities.8 Most theatres are now using digital projection systems, which give companies quicker access to better quality films, reduces storage costs and maintains a consistent projection quality. More recently, there has been a move to 3D and 4D capabilities, surround-sound systems and floor-to-ceiling screens. Competitors are attempting to improve the theatre-going experience by installing luxurious seating (larger, more comfortable, reclining seats), D-BOX seating (seats that move), in-theatre bar and dining service, reserved seating and a tiered seating format that improves screen visibility, in the theatre auditoriums.

To encourage individuals to attend movie theatres on a regular basis, many operators are implementing rewards programs. Customers earn points on the purchase of admission tickets and concession items, and these points can be redeemed for free movies. In addition, theatres are using mobile apps to encourage attendees to play

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2 Darryle Ulama, IBIS WORLD Industry Report 51213C Movie Theatres in Canada, Issued December 2015

3 Ibid

4 Ibid.

5 Ibid.

6 Ibid.

7 Ibid.

8 Ibid.

games or to complete surveys in the theatre during the pre-show presentations, allowing more reward points to be earned and viewer data to be collected.

The success of the industry is highly dependent on the quality of the films that are released during the year.9 Clearly, blockbuster releases result in higher revenues for the theatre exhibition industry. Revenues are also dependent on per-capita disposable income10 since movie attendance is a discretionary activity, and theatres compete against other leisure activities that consumers may choose.

Exhibitors negotiate film costs on a film-by-film and theatre-by-theatre basis with distributors. Film distributors can represent the major production companies who own the film, or they may be independent. Exhibitors negotiate a rental arrangement for each film, and the fee comprises a minimum rental amount as well as a percentage of the box office receipts, based on a sliding scale.11 These amounts may be based on a “firm term formula” where the percentage of revenue to be paid is negotiated prior to exhibition, or the agreement may be a “review or settlement” arrangement whereby the percentage of the receipts is set at completion of the run in the theatre.12 Costs for the films are typically affected by foreign exchange rates since many of the films are produced abroad, primarily in the United States.

Film distributors license films for exhibition in either free licensing zones or competitive licensing zones.13 In free licensing zones, there is no limit to the number of companies exhibiting the film at the same time. In competitive licensing zones, where there is more than one exhibitor for the film in a single zone, the licence is allocated among those exhibitors based on demographics, seating capacity and revenue potential.14

Over the past few years, there has been a move toward exhibiting films for a shorter period of time, which allows new releases to be legally available online more quickly, thereby reducing the risk of pirating (illegal downloading).15 As this trend continues, theatre revenues will continue to decline.

There is little regulation in the movie exhibition industry. The movies themselves are rated, although the rating standards can vary by province. Ontario follows a rating system similar to the United States, where movies are rated by age appropriateness and parental accompaniment. There are also no national disability access laws, but many companies make their theatres wheelchair accessible.16

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9 Darryle Ulama, IBIS WORLD Industry Report 51213C Movie Theatres in Canada, Issued December 2015

10 Ibid.

11 Regal Entertainment 2014 Annual Report

12 Ibid.

13 Cinemark Holdings Inc. 2014 Annual Report

14 Ibid.

15 Darryle Ulama, IBIS WORLD Industry Report 51213C Movie Theatres in Canada, Issued December 2015

16 Ibid.

Major trends in the industry involve a continued move toward updated projection capabilities, as well as a broadening of concession items to include lunches, dinners and bar service, as the goal for many of the companies in this industry is to attract customers who are interested in a "night out" rather than just seeing a film. Companies are also attempting to generate revenue from other sources, which include investments in:

- on-screen advertising and other exhibition advertising, including indoor digital signage
- supporting smaller film companies to bring different film genres to the theatre that are not available for in-home viewing
- companies that sell or stream films for in-home viewing
- enhanced food service companies that prepare the concession foods but also have stand-alone locations
- an entertainment venue that provides a wide selection of video and other interactive amusement games, including pool tables and ping pong tables, along with food and liquor
- video game distributors that provide games in theatre lobbies in addition to other locations

There are many risks faced by companies operating in the theatre exhibition industry. The main risks are briefly discussed below:17

- industry risk — the availability, diversity and appeal of the films released during the year
- exhibition competition risk — the company competes for film licences, attendees and for theatre locations
- technology risk — the ability of the company to keep pace with new technology for projecting the films, including the risk of losing attendees who can get a comparable viewing experience at home as technology in the home advances
- customer risk — competition for the customer's leisure time and entertainment dollar that can be spent on many other substitutes
- real estate risk — risk that renewal terms on leases will not be favourable
- health and safety risk — risks related to food safety and product handling, and the health and safety of customers

Company background

Early in 2009, a corporate restructuring of FLL resulted in the creation of a separate corporate entity called FVT. The restructuring was proposed by Viktor and Lanny because the two sons believed that since the division was not part of FLL's core

17 Cineplex Inc. 2015 Annual Report

business, it was not being managed in a way that would allow the division to fully capitalize on the opportunities in the industry. For example, at a time when investment in technology was vital to the division's survival, no resources were made available to make these investments. Viktor believed that there was an opportunity for growth and value creation with enough capital investment.

Viktor and Lanny each purchased 5,000 common shares of the newly formed company. At the same time, FLL took back 10,000 retractable preferred shares with voting rights as part of the consideration for the transfer of assets and debt. Appendix II outlines the details of these preferred shares. In 2009, Viktor and Lanny each had voting ownership of 25% (5,000/20,000), and FLL controlled 50% of the votes.

As of early 2017, 4,000 preferred shares have been repurchased, leaving 6,000 of the preferred shares still outstanding. As a result, Viktor and Lanny have voting ownership of 31.25% (5,000/16,000) each, and FLL has voting ownership of 37.5% (6,000/16,000).

Since 2009, FVT has concentrated on updating its auditoriums and remodelling the theatre lobbies. All of the auditoriums now have digital capability and the concession food services have been expanded to include light lunches. FVT has also added arcade games to its theatre lobbies.

FVT had annual sales of $65.5 million in fiscal 2016 and currently employs 750 people, 91% of whom are part time. The company is profitable, although total revenues fell by 8.6% in 2016, due primarily to a reduction in the number of attendees. Appendix III presents the company's most recent draft financial statements, which are prepared under accounting standards for private enterprises (ASPE), for the year ended December 31, 2016.

FVT's business

Kent has always had a passion for movies, which is shared by his wife and children. Having grown up going to the movie theatre on a weekly basis, Kent believes that the local movie theatre plays a significant role in the entertainment sector of smaller communities. Kent believes that FVT can differentiate itself from the large national exhibitors because the company knows its local patrons and can select films to exhibit that will specifically appeal to the local community. Kent wants his customers to leave FVT's theatres feeling that they enjoyed their time out and wanting to return in the future.

Corporate mission

FVT's vision and mission statements approved by the board in 2011 are as follows:

Vision statement: Our vision is to ensure every guest enjoys a premier entertainment experience each and every time they visit our theatres.

Mission statement: Our mission is to provide a premier entertainment experience tailored to the local community. We accomplish this by hiring and training employees to be respectful, attentive and friendly; selecting the best films to appeal to the local community; ensuring clean and safe venues for employees and attendees; and supporting entertainment and arts in the local community.

Corporate values

Kent and Sheila believe that it is important to be a part of the community that their businesses serve. As such, the Lightfoots have always tried to treat customers like family and to give back to the community. Kent and Sheila are involved in several charitable boards and hold special events at FVT's theatres that raise funds for the many not-for-profit organizations in the communities that their theatres serve. FVT hires theatre staff from the local communities when it can and tries to promote from within, where possible. FVT ensures that employees are well trained and motivated to provide customers with a good experience.

Currently, FVT's stated objectives for 2017 are to increase box office revenue per attendee by 5% to $9.10, to improve concession margins by reducing concession costs as a percentage of concession revenues to 23%, and to increase net earnings by 5%. FVT's objectives use 2016 as the base year, and FVT hopes to maintain this performance for the next few years. Industry benchmarks are provided in Appendix IV.

Company structure

Board of Directors

Currently, FVT's Board of Directors consists of five members, three of whom must be appointed by FLL. The directors are Viktor and Lanny, representing their common share ownership, and Stephanie, Sheila and Kent, representing FLL's interests. Kent is the chair. This was the board composition outlined in the original agreement when the company was formed in 2009.

The board meets formally twice a year. As the company has a December fiscal year end, the first meeting usually occurs in late March, where the audited financial statements for the previous fiscal year are approved. The second meeting occurs in mid-December to approve any management bonuses to be payable at the fiscal year end, to declare any dividends and to officially elect the officers for the coming fiscal year.

There are no formal board committees, although Stephanie has been trying to push for some committees that might be appropriate for a private company.

Relationship with FLL

Although Sheila and Kent own all of the shares of FLL, they now spend approximately 80% of their time working for FVT. As Kent likes to say, he has hired strong managers for FLL and he lets them have autonomy to make the day-to-day operating decisions. This frees up time for Kent and Sheila to contribute to building FVT.

There are no related-party transactions between FLL and FVT and the two companies operate independently. However, since they are associated companies under the Income Tax Act, they share the small business deduction. In the past, the two companies have allocated the full small business deduction to FVT.

Management team

FVT's corporate management team is composed of the following individuals:

Stephanie Lightfoot is the chief executive officer (CEO). Stephanie, who is 39 years old, graduated with a master of business administration (MBA) in 2006 from a Canadian university. Before joining FLL, Stephanie worked as a manager in the marketing and business development departments at Wharten Media Inc., a company involved in producing television and film series. In 2014, Kent and Sheila decided that Stephanie's strengths in business strategy development and leadership would be best utilized in the capacity of CEO at FVT, and she moved from FLL to FVT on a full-time basis.

Stephanie realizes that FVT is now at a crossroads, having completed its planned updates to the theatres and screen technology. She wants the company to build its reputation and grow within the theatre exhibition industry by expanding geographically and enhancing the theatre experience for attendees. Stephanie believes that the company should move into other provinces where the types of films desired by attendees are different, thereby allowing the company to be more diversified in the genres of films exhibited.

Lanny Lightfoot is the chief financial officer (CFO). Lanny is 37 years old and graduated with a bachelor of commerce from a Canadian university in 2002. Lanny worked as a bank manager in the corporate loans department before coming to work for FLL in 2008. Lanny is responsible for corporate finance, accounting and human resources.

Lanny wants to grow FVT horizontally by increasing the number of theatres and screens to achieve some economies of scale. He wants to invest in opportunities to enhance the theatre-going experience, thereby not only increasing the number of attendees, but also the revenue per attendee and overall profits. However, Lanny is also cautious and wants to grow at a pace where profits are still maintained, bonuses remain at least at historical levels and little or no debt is added to the company's statements.

Viktor Lightfoot is the chief technology officer (CTO). Viktor is 34 years old and graduated from a local college with a diploma in interactive multimedia development.

Viktor has always had an interest in technology and computers. He worked as a programmer for a local software developer for three years before joining the family business full time. Viktor is responsible for the theatre technology, the corporate computer systems and the company's website.

Viktor wants to diversify the company into other areas that are complementary to film exhibition, but that aren't directly tied to the success of individual films. Viktor is concerned with falling attendance and ever-increasing substitutes for in-home viewing, and so he believes that FVT needs to look at investment opportunities in other areas. He wants to expand on the vision of the company providing a "premier entertainment experience" by providing customers with a variety of alternatives.

Zobair Terdel is the chief operating officer (COO). Zobair joined FVT in 2014. He is 49 years old with a bachelor of science. Zobair worked as a COO for 10 years with a national drug store chain, and before that as a manager in the operations department of a plastics manufacturer. Zobair is primarily responsible for the day-to-day operations of the company, including management of the theatre operations and real estate.

Suisui Yang is the chief of filmed entertainment (CFE). Suisui is 42 years old and joined the company in 2015. Previous to this, she worked for a Toronto-based film production company as a manager responsible for acquiring animated programs for distribution. Suisui is responsible for deciding on the films that will be shown and negotiating the appropriate contracts. Suisui is also responsible for the company's marketing.

Kent and Sheila do not have official management titles but they do assist in various parts of the business based on their interests and past experience. Both Kent and Sheila are keen to stay in management, although they realize that the next generation must now decide on the direction of the company and take responsibility for making important decisions. Kent is involved in managing the company's real estate, including finding new theatre locations, and works closely with Zobair. Sheila works with Suisui in researching the films to show and reviewing the contractual arrangements. Both Kent and Sheila are compensated for these roles and are considered part of the senior management team.

Kent wants to see the company grow as it has in the past: by opening or acquiring new theatres in local communities surrounding London, Ontario. Kent believes that FVT's strength is in knowing the needs of the local communities. To exploit this advantage, he wants the company to expand into southern Ontario since customer needs are not likely to differ substantially between communities. Kent wants to be sure that FVT's reputation, which he has spent his lifetime building, continues. Sheila, on the other hand, would like to diversify the films exhibited by FVT. She believes that there is a large untapped market for exhibiting special events, as well as unique and small-budget films with a message. At the same time, Sheila also wants to protect FVT's brand.

Human resources

FVT's workforce has the following age distribution:

	Senior management	Management and other full-time employees	Part-time employees	Total
25 and under			374	374
26 to 39	3	20	243	266
40 to 59	2	33	68	103
60 and over	2	5		7
Total	7	58	685	750

Part-time employees work an average of 15 hours per week as ushers, ticket takers, concession staff and cashiers. Part-time employees receive a discount of 50% off food and free drinks during their work shifts, as well as free admission to any movie at any of FVT's locations. Part-time employees also receive annual bonuses. The annual turnover rates for FVT's part-time employees is 45%, which is significantly below the industry average of 74.9%.18

FVT's full-time employees have the same benefits as the part-time employees, with the addition of dental and medical coverage and paid vacation. These benefit plans are commensurate with industry standards. Full-time employees also receive bonuses that can be quite generous, depending on FVT's annual financial results. As a result of these bonuses, turnover rates for full-time employees have been very low, with only one employee leaving in the past five years.

Bonuses are paid annually as part of the compensation package for employees, and the amount paid is at the discretion of the board, based on net earnings. Currently, there is no fixed formula, but the directors consider the amount of net earnings, taxable income and other factors that change from year to year. There are also no fixed guidelines on how the bonus will be distributed. Based on the average of the past four years, senior management has received 50% of the total bonus, management and full-time employees have received 30%, and the remaining 20% has been allocated to the part-time employees on an equal basis. The allocation to management and full-time employees is based only on each individual's performance, as judged by their managers. There are no formal indicators that are used for this assessment.

The final benefit, exclusively for each of the senior executives, excluding Kent and Sheila, is a taxable annual car allowance of $24,000 per executive. Viktor has asked whether or not the company could provide him with a car rather than paying him a car allowance. He said his friend had just negotiated a similar deal with his employer and

18 Median turnover rates for part-time retail workers were found to be 74.9% in 2013. Krystina Gustafson, *Retail's turnover a plus for economy but challenge for stores* (http://www.cnbc.com/2014/09/23/retail-turnover-rates-on-the-rise.html, 2014)

had found that overall, there were tax savings for the employee. Currently, FVT pays for all of the related vehicle operating costs.

FVT has no pension plan for its employees, but both Stephanie and Viktor have recently complained to Lanny that they wish that the company had some kind of retirement plan or deferred profit sharing plan for all of the senior management team, excluding Kent and Sheila.

Company operations

Theatre operations

The company has 11 theatres with a total of 106 screens, with seating for 200 to 300 per screen. All of the projection technology is now digital, with 50 screens having 3D capabilities. The locations of the theatres in Ontario, and related information for each theatre, is provided below:

	Number of Screens	Digital 3D screens	Annual Attendance	Number of arcade games
London #1	12	6	616,560	16
London #2	9	3	458,290	10
London #3	12	5	465,380	20
London #4	7	4	310,422	11
Sarnia #1	12	5	471,135	20
Sarnia #2	6	4	231,990	11
Chatham	9	4	436,080	15
Leamington	10	6	493,506	10
St. Thomas	12	5	479,712	12
Tillsonburg	9	4	350,850	10
Woodstock *	8	4	422,348	10
Total	106	50	4,736,273	145

*Actual attendees higher than box office admissions collected

The following table shows highlights of FVT's theatre operations for the past three years:

	2016	2015	2014
Number of screens	106	106	106
Total attendance	4,736,273	5,231,875	5,156,251
Box office revenue per attendee	$8.67	$8.89	$8.75
Total box office revenue ($)	$41,057,418	$46,511,369	$ 45,117,196
Concession revenue per attendee	$4.95	$4.63	$4.36
Total concession revenue	$23,444,551	$24,223,581	$ 22,481,254
Other income — arcade games	$ 659,780	$ 650,820	$ 647,690
Other income — party room rental	$ 343,900	$ 340,800	$ 349,870
Total revenue	$65,505,649	$71,726,570	$ 68,596,010

(1) Box office revenue: revenue generated from movie ticket sales. Admission to each movie is dependent on age and movie type. General admission tickets are priced as follows:

- children up to age 13: $7.50
- adults, aged 14 to 64: $10.00
- seniors, aged 65+: $8.00

Every Wednesday is "senior's day," and the general admission for seniors falls to $5.00. For 3D movies, the ticket price is $3.00 extra for all age categories.

(2) Concession revenue: revenue generated from concession sales. Concession products include popcorn, snacks, soft drinks, coffee, hot dogs, pizza, chocolate bars and ice cream. In the last two years, FVT has introduced healthier choices such as sandwiches, fresh wraps, salads, nuts and nutrition bars, and all of these items have been successful. FVT is continually introducing new food choices in an effort to increase concession sales. In addition, promotions are run on certain food items and "combos" of drinks and food items are offered for a bundled price.

(3) Other income — arcade games: each FVT theatre has between 10 and 20 arcade games, including a variety of interactive video games. Tokens are required to play the games and can be purchased from machines in the lobby at a price of three tokens for $1.00. FVT has a revenue-sharing agreement with the supplier of the games, Playitall Inc., which specifies that Playitall will supply, maintain and rotate the games every six months, and that FVT will share 50% of the revenues generated by the games with Playitall. With this arrangement, FVT has no upfront costs to purchase the machines and the only operating cost is electricity. On average, each machine generates $175 gross revenue per week, of which FVT receives 50%.

(4) Other income — party room rentals: each theatre has a room that is available for parties for children aged five to 13, with a maximum capacity of 25 children per

party. The fee charged is $18 per child, which includes one movie admission ticket, one drink and one snack. For accounting purposes, this revenue is split between box office revenue, concession revenue and other income — party room rental. In the past year, the average party room rental income was $115 per party.

Film costs

Film costs represent the amounts paid to film distributors to license films. These films include not only the blockbuster films, but also special event films such as operas, ballets and other theatrical performances. The company enters into licensing agreements with the film distributors for each film to be shown. Suisui and Sheila decide which films to bring in to each theatre based on many factors including, but not limited to, the producer, genre, film budget size, popularity, release date, cast and the film's success to date. Suisui and her team, which includes the local theatre managers, look for films that will appeal to the local community in which each theatre operates.

Suisui and Sheila negotiate the terms of each film licence. During 2016, the licences were negotiated under either the "firm term formula" or "review and settlement" arrangement. In addition, there were some licences that had to be shared with other exhibitors, and the terms for these were not negotiated by FVT. Sheila, having been in the business for a long period of time, has a good rapport with the film distributors and as a result is usually able to get the licences for films that the company wants to exhibit.

Accounting for film costs

In the case of licensing agreements that are based on the "review and settlement" format, management will make its best estimate on the final settlement costs since these costs may not be known until two to three months after the opening release of the film. During this period of time, an estimate of the cost and related payable is recognized. Once the final settlement is agreed, the expense and payable are adjusted to the agreed-upon amounts.

Concession costs

Concession costs include the cost of food and beverage and related supplies. Theatre managers are responsible for managing their own purchases and inventories and placing the orders, and suppliers ship directly to the theatres. Concession inventory is counted weekly and reconciled to the perpetual inventory balances.

The point of sale system captures the concession sales by item so that the food and beverage inventories can be monitored and managed. Accordingly, low-selling items are not reordered and well-performing items may have to be ordered more frequently.

Theatre operating costs

Theatre operating costs include employee uniforms, 3D glasses, cleaning and maintenance expenses, utilities, insurance and other related costs.

Property, plant and equipment

Of the 11 theatres operated by FVT, the company owns all four of its London, Ontario, locations and leases the remaining seven locations. The company also owns its own head office building, which is adjacent to the London #1 theatre, located in downtown London.

The book values related to the classes of property and equipment, as at December 31, 2016, are as follows:

	In $'000s	**Amortization policy**
Land	1,646	
Buildings	18,143	Straight-line over 25 years
Equipment	13,023	Straight-line over 8 years
Leasehold improvements	7,594	Straight-line over 10 years
Total	40,406	

The current leases are due to expire between 2019 and 2024 and most are for a 10-year initial term, with a 10-year extension clause. The leases are net leases, so FVT is responsible for costs related to insurance, maintenance and taxes. All of the leases have a fixed monthly base rate, as well as a variable component based on a percentage of the box office and concession revenues over a minimum amount, which is different for each theatre location.

All of the theatres have undergone upgrades and renovations, which are recognized as leasehold improvements for those theatres that are leased. Recently, market prices in London have been increasing and a few realtors have approached Kent about selling the theatre locations owned by FVT. Yesterday, a developer phoned Kent and expressed an interest in purchasing FVT's head office building and leasing it back to FVT for a period of up to 10 years. Appendix V provides the details of the proposed sale and leaseback arrangement.

Advertising and promotion

To date, FVT has spent very little on marketing and has a small advertising budget. Film distributors and film studios promote their own movies with nationwide and multimedia advertising campaigns. As a result, the amount of box office revenue will depend on the success of the films being presented. FVT spends its advertising dollars in each theatre's local market to:

- list movies and show times for the week
- promote special events such as special movie features or concession sale items
- develop in-theatre advertising as part of the previews

FVT also has a website that provides information on movies, show times, promotions and party rental costs. However, the company's webmaster has been complaining that the site is outdated and should be more interactive by allowing customers to book tickets and party rooms online. He would also like the company to have a mobile application (app) developed that would allow customers to view information and trailers of the feature movies, book tickets, post reviews and respond to company surveys on their phones. The webmaster recently contacted a mobile application developer who could develop this app and update the website. The design, architecture and content of the app and website would be assessed based on competitor and customer research. The estimated cost of all of this work is $125,000 and the app would be designed to work on any mobile unit and also tie into the company's website. Suisui is interested in learning more about the benefits of a mobile strategy and whether or not the cost would be justified, since it would likely come out of the company's current advertising and promotion budget.

Suisui has been looking into launching a customer loyalty program since she believes that FVT would benefit from implementing a program that rewards regular customers. Loyalty points would be earned as theatre tickets are purchased, and the points could be redeemed for free movies. Suisui has received information from FLIXREWARDS, a company specializing in implementing reward programs for companies. FLIXREWARDS will provide the technology to collect and manage the points and also the data analytics. Appendix VI outlines details of the information gathered by Suisui to date.

Financial reporting and budgeting

FVT prepares its financial statements using ASPE. The bank requires that both FVT and FLL prepare annual audited financial statements. For the 2017 fiscal year, FVT (as well as FLL) appointed Waynman & Co. (WC) as the companies' auditors. WC has acted as FLL's auditors since 2005, and FVT's auditors since 2009. WC will audit the 2017 financial statements and prepare the corporate tax returns. FVT's average corporate tax rate is 25%.

Lanny has been reviewing the goodwill that arose on the purchase of the two Sarnia operations some years ago. Due to a national competitor opening a new movie theatre in the Sarnia area, attendance has been falling and projections for 2017 are now even worse than expected. Lanny is concerned that there might be an impairment of the goodwill that needs to be recorded in 2017 and has collected information on this. (See Appendix VII.)

Recently, Lanny has found a discrepancy between the number of actual attendees viewing films at the Woodstock theatre and the revenues collected at this location's box office. In addition, there are shortages that have been found in the Woodstock theatre's concession inventories. Based on this evidence and the associated rumours, Lanny believes that some employees at the Woodstock theatre are allowing friends to see movies for free and are also giving away food and beverages at no cost. Appendix VIII outlines the current procedures in place with respect to admission and concession sales.

Banking and financing

FVT has one term bank loan outstanding, which matures in October 2022. It is secured by the property and equipment, bears interest at 4.6% and is repayable in monthly payments of $106,250. The term loan has one covenant: long-term debt (including the current portion of long-term debt and excluding the retractable preferred shares) to earnings before interest, taxes, depreciation and amortization (EBITDA) cannot exceed 2.5.

Approximately 90% of the company's film costs are paid in U.S. dollars. The average U.S. dollar exchange rate has fluctuated significantly since 2014, and the average rate in 2016 was C$1 = US$0.7413. Lanny has been suggesting for several years that the company try to mitigate this risk by purchasing derivatives for some portion of these costs, with the intent to reduce the volatility of the company's earnings. Based on discussions with the bank, Lanny has gathered information outlined in Appendix IX about two proposals for hedging this risk.

Kent and Sheila would like to receive dividends rather than salaries from FVT since they are both thinking of cutting back on the time they spend working at the company. Currently, each of them receives a salary of $350,000 annually, before any bonuses. Kent would like input on developing a dividend policy and a discussion of the factors that need to be considered. Kent is also wondering about the tax implications to all shareholders of receiving dividends.

Board meeting dialogue

FVT's board met for an extraordinary meeting on March 19, 2017. Prior to the meeting, a briefing was distributed to the board members on the four new projects that had been discussed at earlier meetings: the purchase of Cinéma LaRoche (CLR) (Appendix X and XI), the investment in Connery's Bar and Grill (Appendix XII), the premium plus viewing (PPV) proposal for an enhanced theatre experience (Appendix XIII) and The Games Place (TGP) proposal (Appendix XIV).

The meeting's agenda was announced as follows:

1. Consideration of the four proposed investments.
2. Other business.

Excerpts from the discussions that took place are detailed below.

Kent: First of all, let's discuss the most pressing issue, which is the possible purchase of CLR. I know my friend Marcel is quite anxious to get this settled since he must sell, and he will start to approach other buyers if we do not want to move ahead with the purchase.

Stephanie: I have prepared the information regarding this proposal and have visited all of the theatres that CLR owns. I was very impressed with how Marcel has been able to bring in other types of films to CLR theatres, as well as the positive response to the film club. I found the CLR employees to be very friendly and attentive. As you know, I think that we need to expand beyond Ontario in an effort to diversify our revenues.

Lanny: I am concerned with operating FVT in another province and with making this large investment. I would like to see an analysis of the operating ratios of CLR to determine if the purchase would contribute to our bottom line right away and whether It would improve some of our own ratios.

Sheila: I really like the idea of buying CLR. I am particularly excited about the film club and the possibility of showing alternative films at FVT, since I believe that there is an untapped demand for these types of films. This acquisition would also give FVT access to alternative film distributors with whom Marcel has a very long-standing relationship.

Kent: I am not sure we should expand FVT outside of Ontario. One of our strengths is that we know the local market, and we have no experience in Quebec. Are there differences between Quebec and Ontario with respect to type of services and products that we provide? I really don't know.

Viktor: Instead of expanding to Quebec, why don't we expand right here in London? I have a friend, Fred, who is a chef, and he wants to open a new restaurant. He is looking for an investor, and I think this would be a good investment for us to make. There would be many synergies with our business, particularly with respect to the cost of the light lunches, although I am not sure what the savings will be for this.

Lanny: Is this the proposal you talked to me about the other day — the Connery's Bar and Grill proposal?

Viktor: Yes. Fred wants to set up a corporation where FVT would own 40% and he would own 60% of the restaurant, but where decisions are made jointly.

Lanny: I am not too familiar with this type of arrangement. How would it be recorded in our books? If we are putting up so much cash, shouldn't our proportionate ownership be more? With our cash reserves being low right now, I am concerned about getting involved in businesses that might not be successful since this would further drain our cash reserves.

Stephanie: For a quick calculation, can we assume that the annual forecasted operating cash flows would be paid out as dividends and determine an estimated internal rate of return on this investment?

Lanny: Yes, that is a good way of looking at it. We can run the numbers and estimate this return. I think we should also look at what proportionate ownership would give us the after-tax return of 17% that we are looking for with this investment, using the same assumptions. We may be able to approach Fred for a larger ownership interest.

Kent: I would rather we spent our cash on improving our theatres. I know our competitors are putting in luxury and motion seating, larger screens and improved sound systems. If we don't offer this type of premium experience, I think that our customers will go elsewhere. It is also a way for us to charge more at the door.

Lanny: I agree with you. I think we should make additional investments in our theatres. We could call this additional investment "premium plus viewing," or PPV. We could try it and see how it works in a couple of our owned auditoriums, remembering that we would want to see a 15% return (after tax) on this investment. Because there is a range of ticket prices being used by our competitors, our analysis should look at the two possible outcomes: one using a price premium of $8.50 and one using a price premium of $10.00 over current prices.

Stephanie: This investment would certainly improve our brand in London.

Lanny: We should assess the impact on earnings if we make this investment. I think we should also look at the new contribution margins expected and compare them to our current contribution margins.

Viktor: If you don't like the restaurant idea, what about an interactive game place with amusement games of all types and a restaurant with a licensed bar? I even have a possible name for it: The Games Place. Some of our competitors are entering into this market and I think that it would be a way for FVT to expand the premier entertainment experience for our customers, while still complementing the film entertainment that FVT provides.

Kent: I like that idea! It will allow us to keep up with our competitors, and provide a new experience for our customers.

Lanny: Is this the idea where we would have a variety of interactive games, and customers would pay to play?

Viktor: Yes, we would have another source of income other than box office revenues. We could also sell food and liquor. Guests would earn points for winning games, and these points could then be redeemed for a variety of prizes, keeping guests coming back until they have earned enough points for the prize of their choice.

Lanny: Does this mean that we have more liabilities on our balance sheet?

Viktor: That's a good question Lanny. I'm not sure.

Lanny: With all of these proposals, I am also concerned about our cash flows. Where will the cash required to finance some of these proposals come from?

Kent: I have a few ideas to address our cash flow shortage. First of all, I have had conversations with a local developer that would like to buy some of our buildings and lease them back to us. Prices have increased quite a lot and I was surprised at what the developer would be willing to offer us. At this moment, we have a sale/leaseback offer for the head office land and building. Also, Sheila and I have been talking about the preferred shares. We are considering waiving the required redemption on the preferred shares for a period of up to five years. This would also free up some cash for the company.

Lanny: Are you sure you want to do this?

Kent: Absolutely. We want to be sure that the company doesn't get strapped for cash as we try to figure out where FVT should go from here. Now is the time to invest in the company rather than be pulling cash out.

Viktor: I agree. Having some added cash on hand will allow FVT to take on multiple investments rather than just one.

Kent: It sounds like we are going to need some help to figure out where our cash should be used in the coming year. I would like to engage RCC to help us with this analysis. Remember when RCC provided consulting services to FVT for an acquisition that we made a few years back? The staff at RCC are CPAs that think broadly and understand our industry and our company, and I think they can provide us with an unbiased analysis. We could ask RCC to look at all of these proposals and to provide us with recommendations. I am making a motion to hire RCC to review these proposals.

Stephanie: I think that is a great idea. And they could also help us with some operational issues that we are dealing with. I will second the motion.

Kent: Before we move to the discussion of the operating issues, let's get this formalized. All in favour, say yes.

Remaining board members: Yes.

Stephanie: Based on the discrepancies found by Lanny at the Woodstock theatre, I wonder if we should update our corporate policies to deal with these kinds of issues. Do you think that we need a code of conduct and code of ethics? If so, what would be put into these documents? I have also been thinking about the company's current Board of Directors. With all of the new strategic proposals that we are considering, do we need to make any changes to the existing board structure or changes to how the board operates to make it more effective? Let's ask RCC make some recommendations here.

Lanny: I think that these are all good ideas. As you know, I am considering a writedown of goodwill at the end of 2017 given the recent attendance forecasts for the Sarnia theatre. Our auditors have agreed that no adjustment will be necessary in 2016. I need to understand what procedures the auditors follow to perform this calculation. In particular, what information will they need to support the calculation?

Kent: Are there any other issues that should be addressed?

Stephanie: I have one more issue and it concerns our bonus plan. I have heard rumours from employees that they do not think that the bonus plan is fair. Since we have moved to hire RCC, perhaps we could ask RCC to look at the bonus plan and provide us with recommendations on how to improve it so that the plan better incents our employees.

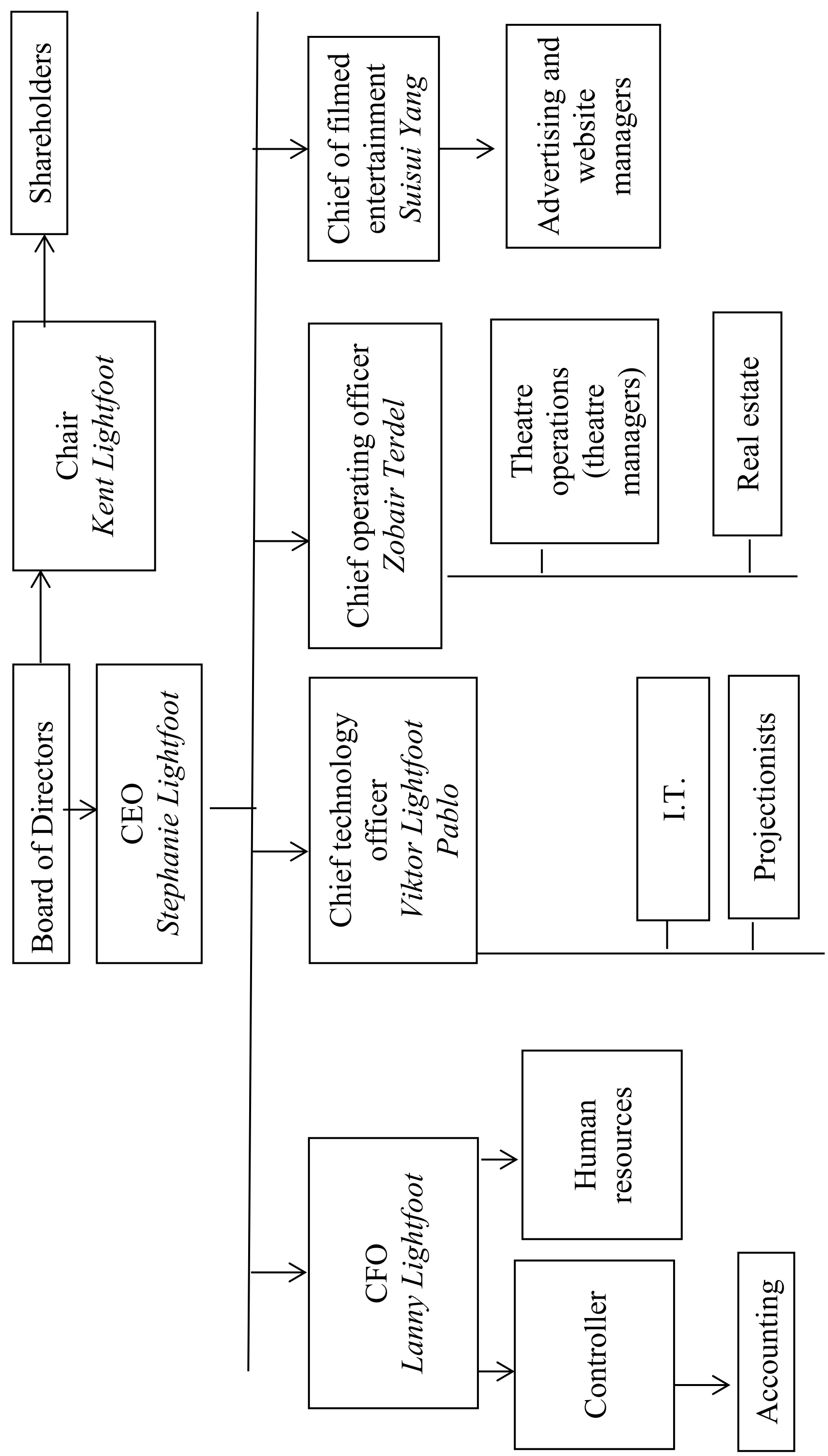
Kent: RCC could also provide options for a retirement plan for executive management and provide guidance on the accounting and tax rules that FVT will have to follow. I will call RCC right away to arrange a meeting to review these items. I will ask RCC to prepare a report and be prepared to discuss their findings with us. I suggest that we give RCC two months to perform the analyses and schedule a meeting for late May, when they will present their findings to the board. Shall we adjourn?

Remaining board members: Yes.

The meeting is adjourned.

Table of appendices

Appendix I
FVT organizational chart



Appendix II
Terms and conditions of the preferred shares
Prepared by Lanny Lightfoot, CFO

Authorized

There are 10,000 retractable preferred shares authorized.

Issued and outstanding

There are 6,000 retractable preferred shares issued and outstanding to FLL.

These preferred shares have a redemption price of $1,500 each and a mandatory redemption of 1,000 shares per year, commencing in 2013.

The preferred shares are voting, carrying one vote per share, and are fully participating in dividends, so that they are paid the same dividends per share as are the common shares.

If, in any year, the required number of shares are not redeemed, the redemption price will increase by 10% each year that the redemption has not been made, unless FLL has agreed to waive this requirement as detailed below:

In any year, FLL can waive the annual redemption for a period of up to five years. If this consent is given, the penalty of the 10% increase in the redemption price will not be enforced.

Appendix III
FVT Financial statements (under ASPE)
Prepared by Lanny Lightfoot, CFO

First View Theatres Inc.
Statement of earnings
For the years ending December 31 (in thousands of C$)

	DRAFT 2016 $	AUDITED 2015 $	AUDITED 2014 $
Revenue			
Box office revenue	41,057	46,511	45,117
Concession revenue	23,445	24,224	22,481
Other income — arcade games	660	651	648
Other income — party room rentals	344	341	350
Total revenue	65,506	71,727	68,596
Expenses			
Film costs	24,142	25,953	23,362
Concession costs	5,887	5,261	5,176
Advertising and promotion	718	703	695
Amortization	4,691	4,640	4,628
Employee wages and benefits	11,868	13,075	13,292
Employee bonuses	1,250	3,975	1,850
Rent	3,926	4,020	3,978
Theatre operating costs	7,972	8,607	9,550
General and administrative	1,536	2,078	2,080
Total expenses	61,990	68,312	64,611
Operating income (loss)	3,516	3,415	3,985
Interest income	22	23	15
Interest expense	(792)	(851)	(910)
Foreign exchange gain (loss)	(93)	(172)	(55)
Income before taxes	2,653	2,415	3,035
Income taxes (25%)	663	604	759
Net earnings	1,990	1,811	2,276
Statement of retained earnings			
Balance — beginning of year	12,389	10,578	8,302
Net earnings	1,990	1,811	2,276
Balance — end of year	14,379	12,389	10,578

Appendix III (continued)
FVT Financial statements (under ASPE)
Prepared by Lanny Lightfoot, CFO

First View Theatres Inc.
Balance sheet
As at December 31 (in thousands of C$)

	DRAFT 2016 $	AUDITED 2015 $	AUDITED 2014 $
Assets			
Current assets			
Cash and cash equivalents	1,859	2,560	1,568
Concession inventories	371	389	365
Prepaid expenses	275	265	259
Total current assets	2,505	3,214	2,192
Property, plant and equipment — net	40,406	42,962	42,224
Intangible assets	4,133	4,548	4,963
Goodwill	2,423	2,423	2,423
Total assets	49,467	53,147	51,802
Liabilities			
Current liabilities			
Trade payables and accrued liabilities	1,692	1,642	1,598
Film costs payable	2,160	2,430	2,315
Income taxes payable	400	350	325
Employee bonuses payable	1,250	3,975	1,850
Current portion of long-term debt	1,275	1,275	1,275
Current portion of redeemable preferred shares	1,500	1,500	1,500
Total current liabilities	8,277	11,172	8,863
Long-term debt — term loan	15,311	16,586	17,861
Redeemable preferred shares	7,500	9,000	10,500
Total liabilities	31,088	36,758	37,224
Shareholders' equity			
Share capital	4,000	4,000	4,000
Retained earnings	14,379	12,389	10,578
Total shareholders' equity	18,379	16,389	14,578
Total liabilities and shareholders' equity	49,467	53,147	51,802
Property, plant and equipment			
Opening balance	42,962	42,224	40,845
Capital additions	1,720	4,963	5,592
Amortization	(4,276)	(4,225)	(4,213)
Closing balance	40,406	42,962	42,224
Amortization of intangible assets	415	415	415
Total amortization	4,691	4,640	4,628

Appendix III (continued)
FVT Financial statements (under ASPE)
Prepared by Lanny Lightfoot, CFO

First View Theatres Inc.
Statement of cash flows
For the year ended December 31 (in thousands of C$)

	DRAFT **2016** **$**	AUDITED **2015** **$**
Operating activities		
Net earnings	1,990	1,811
Add back amortization	4,691	4,640
Change in working capital balances		
Inventories	18	(24)
Prepaid expenses	(10)	(6)
Trade payables and accrued liabilities	50	44
Film costs payable	(270)	115
Income taxes payable	50	25
Employee bonus payable	(2,725)	2,125
Total cash flow from operating activities	3,794	8,730
Investing activities		
Investment in PP&E	(1,720)	(4,963)
Financing activities		
Increase (decrease) in term loan	(1,275)	(1,275)
Redemption of preferred shares	(1,500)	(1,500)
Total cash flow from financing activities	(2,775)	(2,775)
Change in cash	(701)	992
Opening cash and cash equivalents	2,560	1,568
Closing cash and cash equivalents	1,859	2,560

Appendix IV
Industry benchmarks
Prepared by Lanny Lightfoot, CFO

Ratios	**Benchmarks**
Box office revenue per attendee	$9.10
Concession revenue per attendee	$5.25
Box office revenue per theatre (in $thousands)	$3,948
Liquidity ratios	
Current ratio	0.67
Quick ratio	0.64
Solvency ratios	
Long-term debt to equity	0.47
Total debt to equity	1.2
Total debt to assets	0.54
Activity ratios	
Days in concession inventory (using ending inventory only, and not average)	21
Days in payable	32
Days in film costs payable	35
Profitability	
Film costs to box office revenue	52%
Concession costs to concession revenues	23%
Advertising as percentage of revenues	2%
Employee wages and benefits as percentage of revenues	19%
Theatre costs as percentage of total revenues	12%
General and administrative as percentage of total revenues	6%
Operating margin	9%
Net profit margin	6%
Return on assets	4.7%
Return on assets adjusted for after-tax bonuses	4.7%
Return on equity	10.4%

Appendix V
Sale and leaseback proposal
Prepared by Kent Lightfoot

The original cost, book value and undepreciated capital cost (UCC) of the land and building are as follows:

	Original cost $	Book value $
Land	400,000	400,000
Building	8,750,000	5,370,000

The building has a remaining economic life of 20 years.

The company's incremental borrowing rate is 6%.

The UCC for all of the buildings is $20,567,000.

The total price offered was $10,120,000. Kent estimates that the fair value allocated to the land is $1,200,000.

Lease arrangement:

The lease proposal is for an initial five-year term, with a five-year renewal option at the same lease rate. The monthly lease payment will be $72,500 for the first five years, payable at the signing of the lease and at the beginning of each month thereafter. The lease can be renewed for another five years at the lessee's option. The lease requires that FVT pay all operating costs, insurance and property taxes.

Appendix VI
Customer loyalty program
Prepared by Suisui Yang

Proposal provided by FLIXREWARDS

The following outlines the proposal provided by FLIXREWARDS for implementation of a customer loyalty program:

- FVT will pay an upfront fee of $3.5 million to FLIXREWARDS.
- FLIXREWARDS will design and implement software to collect and manage points by member. Loyalty customers will access their accounts via the FLIXREWARDS website. FLIXREWARDS will contribute an agreed-upon portion of the costs to upgrade FVT's website to allow customers to purchase tickets online and redeem points for movie admission or concession products.
- FLIXREWARDS will manage and collect the data analytics requested by FVT.
- FLIXREWARDS will charge $0.02 cents for each point rewarded.
- Points will be earned on movie admissions and concession purchases. The proposed plan is for members to earn one point for every $1.00 spent on movie admission and concession items.
- No upfront membership fee will be charged when customers sign up for the program.
- Points can be redeemed as follows:
    - 40 points for a child's admission ticket
    - 60 for an adult's admission ticket
    - 50 for a senior's admission ticket
    - 30 points for a popcorn and drink at the concession
- FLIXREWARDS will provide up to $150,000 for upfront marketing of the new loyalty program for FVT.
- The contract will be for a minimum of four years. If terminated early, FVT will be required to pay a penalty based on the number of months still remaining in the contract.
- During the contract, FVT will have access to all of the customer data that is collected.
- On termination of the contract, the customer data will no longer be available to FVT.
- FLIXREWARDS agrees not to enter into any similar programs with local competitors of FVT.

Appendix VI (continued)
Customer loyalty program
Prepared by Suisui Yang

FLIXREWARDS is a national provider of loyalty program systems not only for movie theatres but also restaurants, grocers and clothing retailers. Several local merchants currently use FLIXREWARDS to manage their loyalty programs. As a customer, FVT will have access to a database of all members that currently use FLIXREWARDS. This would give FVT the ability to market to new customers.

FLIXREWARDS has provided FVT with the following estimates, based on its past experience with similarly sized loyalty program implementations:

- It is expected that 70% of the company's loyal customers will sign up for the program.
- It is expected that each loyalty member will buy two more box office admission tickets with related concession than they would normally purchase in the year if they were not a member of the loyalty program. In other words, implementing the loyalty program is expected to increase sales as each member will purchase two tickets above and beyond what they would normally have purchased in order to increase their point balance.
- It is estimated that 80% of the points will actually be redeemed in the year.
- A cannibalization rate of 35% represents an estimate of revenue from admissions that the company could have sold instead of giving free admissions upon redemption of points as some members would have paid to attend the movie if they did not have points available to redeem.

Suisui has estimated that FVT has approximately 600,000 loyal customers that see about seven movies per year. She also expects that the redemptions will be for adult box office admission tickets. Suisui has estimated that initial marketing costs will not exceed $150,000, since much of the initial promotion can be done via FVT's website or in-theatre viewing during the previews. She has also estimated that ongoing annual marketing costs will be carried out using existing marketing dollars.

Appendix VII
Data related to Sarnia theatre locations #1 and #2
Prepared by Zobair Terdel

Information gathered

- Total attendance numbers for the two theatre locations for 2015, 2016 and forecasted for 2017 are:

  2015 — 870,600; 2016 — 703,125; 2017 — 565,000

- The managers at the Sarnia theatres have provided the following forecasts for 2017:

	Location #1	**Location #2**
Attendance numbers	376,000	189,000
Box office revenue per attendee	$ 8.50	$ 8.25
Concession revenue per attendee	$ 4.50	$ 4.60
Other revenue	$ 12,000	$ 8,000
Film costs	55% of box office revenue	
Concession costs	25% of concession revenues	
Advertising and promotion	$ 30,000	$ 25,000
Amortization	$ 233,000	$ 116,500
Employee wages and benefits	$ 1,056,000	$ 377,400
Rent	$ 424,000	$ 285,000
Theatre operating costs	$ 875,000	$ 390,000

- The anticipated carrying value of the assets and related liabilities at Sarnia #1 and Sarnia #2, as at December 31, 2017, are as follows:

Inventories	$ 39,000
Leasehold improvements	$ 1,290,000
Equipment	$ 2,210,000
Goodwill	$ 2,423,000
Trade payables	$ 265,000
Film costs payable	$ 327,000

  - The remaining life of the assets is eight years.
  - 2018 results are expected to be similar to the 2017 forecast.
  - In the current market, theatres are selling for five times EBITDA.

Appendix VIII
Current procedures for box office admission sales and concession sales
Prepared by Zobair Terdel

Film admission

- Customers purchase their admission ticket from a cashier upon entering the theatre. The date, time, film choice, auditorium number and category (child, adult or senior) are printed on the admission ticket. The point of sale system transfers this sales data to the main system. One admission ticket is printed for each attendee.
- At the end of each shift, the cash received and the credit card receipts are reconciled to the sales receipts by the manager.
- After purchasing a ticket, customers enter the hallway where the auditoriums are located by passing by a customer service desk. The desk is staffed by one person who takes the customer's ticket and checks the auditorium number, date, time and category to the person being admitted to ensure that the admission ticket is valid. The ticket is split in half — one half (ticket stub) is kept by the company and one half is given back to the customer. The half kept by the company is put in a locked box.
    - This locked box is collected by the manager on a regular basis and given to the bookkeeper, who sorts the receipts by auditorium and by time and then counts the attendance numbers for each film exhibited during the day. The bookkeeper then enters these numbers into the accounting system.
- Once past the customer service desk, customers then go into the appropriate auditorium to view the film.
- Once the film is finished, customers exit the auditorium and pass the desk again as they proceed out to the main lobby.
- When a film is finished, a cleanup crew of three people enters the auditorium to clean and ensure that all customers have left.
- One of the assistant manager's responsibility is to watch for people not exiting after the film is finished and trying to sneak into another show.
- The assistant manager also counts the number of people in each auditorium prior to the film starting. This number is entered into the computer system for the auditorium number, date and time.
- On a daily basis, the manager compares this count of people actually sitting in the auditorium to the number of admission ticket stubs collected for the time and date of that film exhibition as counted by the bookkeeper. It is based on this comparison that discrepancies have been found for the past two months. The reconciliation shows that the number of people viewing the films has been higher than the tickets sold and collected at the Woodstock theatre location.
- Employees are allowed to enter the theatre and attend films for free as part of their benefits. Their ID is checked at the customer service desk. No other record is made of their admission.

Appendix VIII (continued)
Current procedures for box office admission sales and concession sales
Prepared by Zobair Terdel

Concession revenue

- Sales are entered into a point of sale system by concession staff. The point of sale system requires that a product code be used for each item sold. Cash is collected or a debit/credit card is used to pay for the concession items.
- The point of sale system updates the perpetual inventory as items are sold.
- Similar to the admissions point of sale system, the sales data is transferred to the main system. At the end of each shift, the cash received and the credit card receipts are reconciled to the sales receipts by the manager.
- An inventory count of the concession products is conducted weekly, and this count is compared to the perpetual inventory records maintained by the system. Again, discrepancies have been found at the Woodstock theatre location. For the past few months, the actual inventory on hand has been less than the perpetual inventory balances for a variety of items.

Based on these analyses and rumours, Lanny believes that staff at the Woodstock theatre location have been allowing their friends into the films for free and also providing them with free concession items.

Appendix IX
U.S. dollar information and proposed derivatives
Prepared by Lanny Lightfoot

The average exchange rate for 2016 was C$1 = US$0.7413.

Currently, in March 2017, the exchange rate is C$1 = US$0.794 and is expected to be US$0.770 by the end of the year.

Lanny is looking to hedge about 25% of last year's film costs for a period of nine months, to November 2017.

Based on discussions with FVT, the bank has provided the following two proposals:

1. Forward contract

   The minimum contract is for US$30,000, and periods of duration range from two days to 12 months. There is a 1% upfront administration fee, up to a maximum of $650 to be paid to the bank on signing the contract. At the maturity date, settlement is made by taking delivery of the U.S. dollars contracted. The following forward rates has been provided:

   Maturity in nine months — forward rate is 0.7704.

2. Futures contracts

   Futures contracts are available for purchase in amounts of US$100,000 for each contract. They are settled quarterly with delivery of U.S. dollars. The current contracts available are settled either in September 2017 with a contract rate of 0.7731, or in December 2017 with a contract rate of 0.7766. The price is $C10 per contract.

Appendix X
Purchase of Cinéma LaRoche
Prepared by Stephanie Lightfoot

Cinéma LaRoche (CLR), a company that operates in Quebec, has eight theatres in smaller local communities that are very similar to the type and size of the theatres run by FVT. In total, the company has 70 digital screens. Approximately 25 of the screens have 3D capabilities. Each auditorium has seating for 225 to 250 people. CLR exhibits both French and English films. The most recent financial statements for CLR are provided below. The theatre attendance figures for 2016 and 2015 were 3,450,810 and 3,267,500, respectively.

The sole owner of CLR is Marcel LaRoche, who is 60 years old and wants to retire. He has been in the business for 40 years, and has built good relationships with French film and event film distributors. His theatres have been very successful since they exhibit films that appeal to the local communities, similar to FVT. In fact, attendance at the theatres has been increasing rather than decreasing. Marcel has been looking to sell CLR and thought of Kent Lightfoot. Kent and Marcel met 10 years ago at a convention and have become good friends since then.

CLR has developed a loyal customer following by starting a film club that exhibits unique films and events on a monthly basis. These films are smaller budget films and usually deal with provocative and/or controversial topics. Once the film is over, CLR hosts an after-film party with alcoholic refreshments and appetizers, allowing patrons to mingle and discuss the issues in the films. For some events, guest speakers are also brought in. Patrons pay an annual membership fee of $500 to the film club and in return receive a discounted admission ticket to the film, reserved seating and free refreshments at the after-film party. CLR’s film club currently has 5,750 members. Non-members may also attend the after-reception by paying a $25 fee for each event. However, since the events are very popular, there is often no available seats for non-members. The membership fees for the film club are non-refundable.

Marcel is paid solely in dividends. In addition, although the head office building is owned personally by Marcel, CLR pays no rent for this building. As part of the sale arrangement, Marcel would agree to rent the building to FVT for $250,000 per year, which is comparable to surrounding rental rates. Currently, CLR pays all of the taxes, insurance and maintenance related to this building, and this would stay the same under a new lease arrangement. The lease term would be five years.

Over the past five years, CLR has been renovating its theatres to upgrade the seating and projection equipment. The required capital expenditures for equipment are estimated to be $2.3 million annually.

Marcel has prepared a list of the assets to be sold, along with an estimate of their fair value, which was determined by the equipment suppliers who are familiar with the age and type of equipment. Marcel estimated the fair value of the leasehold improvements.

Appendix X (continued)
Purchase of Cinéma LaRoche
Prepared by Stephanie Lightfoot

The fair market value for the existing assets is $19,450,000, and the UCC for the existing assets is $16,070,000, as follows:

	Book value $	UCC $	FMV $
Equipment — Class 8	16,940,000	12,570,000	17,030,000
Leasehold improvements — Class 13	4,355,000	3,500,000	2,420,000
Total	21,295,000	16,070,000	19,450,000

The future annual capital cost allowance (CCA) claim for the leasehold improvements is as follows:

2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
525,000	505,000	496,000	445,000	403,000	389,000	296,000	211,000	175,000	55,000

CLR currently leases all of its theatre locations. The leases are for 15 years with renewable periods for another 10 years at renegotiated lease rates. Most of the leases are at comparable market rates and were recently negotiated; however, there are three theatre locations that have favourable rates. Information on these leases is provided below:

	Monthly lease amount, paid at the beginning of month	Comparable market rate	Number of months remaining in the lease starting April 1, 2016
Theatre — Pierre	$43,250	$45,790	130
Theatre — Laurent	$39,210	$42,800	98
Theatre — Sharone	$37,110	$40,720	116

Marcel has indicated that he might be interested in staying on for two years to help with the transition, provided that an annual payment can be agreed upon.

Each theatre has a manager, but Marcel has always been very involved in the business, and has the final say in all decisions. CLR is a very flat organization with all theatre managers reporting directly to Marcel. Marcel also has the managers of finance and accounting, human resources and sales reporting directly to him. Marcel selects the films to be exhibited and negotiates his own contracts with the film distributors. By his own admission, Marcel works approximately 100 hours per week on a regular basis, and never takes any holidays.

Appendix X (continued)
Purchase of Cinéma LaRoche
Prepared by Stephanie Lightfoot

Based on a preliminary analysis, Stephanie estimates that two managers would be required to replace Marcel with an annual salary of $170,000 each, and benefits would be an additional 25% of gross salaries. Stephanie also believes that with this acquisition, general and administration costs at FVT can be reduced by $300,000 annually.

CLR's controller mentioned that the marketable securities have an adjusted cost base of $1,409,000. The income generated from the marketable securities is netted against the general and administrative expenses, and was $178,000 in 2016 and $195,000 in 2015. The selling costs for any assets will equal 3% of gross proceeds.

Based on research, Lanny has determined that an appropriate after-tax discount rate will be between 14% and 16% (+/– 1% of the 15% weighted average cost of capital (WACC)). Lanny would also like to know how CLR's ratios compare with those of FVT for profitability, solvency and efficiency.

Marcel has suggested a selling price of $14 million for the shares of the company. However, he is only interested in selling shares so that he can take advantage of the capital gains exemptions. Marcel would consider $6 million payable on closing and he would take back a note payable of $6 million and an earn-out of $2 million payable in two years, if revenue and operating profit margins are maintained. The note payable would bear interest at only 2% and the principal would be repayable in annual payments of $1 million, commencing in 2020.

Appendix XI
Financial statements for Cinéma LaRoche (under ASPE)
Prepared by controller of CLR

Cinéma LaRoche
Statement of earnings
For the years ending November 30 (in thousands of C$)

	2016 $	2015 $
Revenue		
Box office revenue	31,920	29,780
Concession revenue	18,415	17,220
Other income — subscription	2,875	2,600
Total revenue	53,210	49,600
Expenses		
Film costs	16,982	15,678
Concession costs	4,605	4,133
Advertising and promotion	2,690	2,792
Amortization	2,013	2,040
Employee wages and benefits	9,680	9,158
Rent	3,560	3,560
Theatre operating costs	7,350	7,106
General and administrative	1,743	1,692
Total expenses	48,623	46,159
Operating income before taxes	4,587	3,441
Interest paid on shareholder's loan	355	329
Income before income taxes	4,232	3,112
Income taxes	1,058	778
Net earnings	3,529	2,663
Statement of retained earnings		
Balance — beginning of year	9,908	12,245
Net earnings	3,529	2,663
Dividends	(5,000)	(5,000)
Balance — end of year	8,437	9,908

Appendix XI (continued)
Financial statements for Cinéma LaRoche (under ASPE)
Prepared by controller of CLR

Cinéma LaRoche
Balance sheet
As at November 30 (in thousands of C$)

	2016 $	2015 $
Assets		
Current assets		
Cash and cash equivalents	20	65
Marketable securities	1,690	1,540
Concession inventories	315	317
Prepaid expenses	378	402
Total current assets	2,403	2,324
Property, plant and equipment	21,295	19,908
Total assets	23,698	22,232
Liabilities		
Current liabilities		
Trade payables and accrued liabilities	1,923	1,995
Film costs payable	1,860	1,723
Deferred subscriber fees	985	754
Total current liabilities	4,768	4,472
Shareholder's loan	8,623	5,982
Total liabilities	13,391	10,454
Shareholders' equity		
Share capital	1,870	1,870
Retained earnings	8,437	9,908
Total shareholders' equity	10,307	11,778
Total liabilities and shareholders' equity	23,698	22,232
Property, plant and equipment		
Opening balance	19,908	18,308
Capital additions	3,400	3,640
Amortization	(2,013)	(2,040)
Closing balance	21,295	19,908

Appendix XI (continued)
Financial statements for Cinéma LaRoche (under ASPE)
Prepared by controller of CLR

Cinéma LaRoche
Statement of cash flows
For the year ended November 30 (in thousands of C$)

	2016
	$
Operating activities	
Net earnings	3,529
Add back amortization	2,013
Change in working capital balances	
Inventories	2
Prepaid expenses	24
Trade payables and accrued liabilities	(72)
Film costs payable	137
Deferred subscriber fees	231
Total cash flow from operating activities	5,864
Investing activities	
Purchases of marketable securities	(150)
Investment in PP&E	(3,400)
Total cash flow used for investing activities	(3,550)
Financing activities	
Increase (decrease) in shareholder's loan	2,641
Dividends paid	(5,000)
Total cash flow from financing activities	(2,359)
Change in cash	(45)
Opening cash and cash equivalents	65
Closing cash and cash equivalents	20

Appendix XII

Investment in Connery's Bar and Grill
Per discussion with Viktor Lightfoot

Recently, space became available in downtown London, adjacent to FVT's London #1 theatre. Fred Connery, a chef and a close friend of Viktor, has been looking for an ideal location to open his own restaurant. He has worked as a chef for the past 15 years for two different local restaurants, and now believes he is ready to open his own establishment. He has researched the local competition and found that there is a need for a pub style restaurant in London. After finding the space and deciding on the concept, he now needs some help with the financing. Fred has approached Viktor about becoming a partner in this new restaurant, to be called Connery's Bar and Grill (Connery's). The restaurant would be decorated with movie memorabilia to tie to the theme of films.

Fred believes that a sharing of discounts across the two businesses could drive both restaurant and theatre attendee revenues. The restaurant could provide discounts on food and beverages to moviegoers who provide an FVT theatre admission ticket for the same day. FVT theatres could provide discounted admission tickets to diners who provide their restaurant bill for the same day. FVT could also assist with the promotion of Connery's by showcasing the restaurant as part of their film previews.

Fred is very excited and sees this as just the beginning of a profitable partnership with FVT. He plans to experiment with the concept for the next two years, and once Connery's is realizing a profit and the restaurant's name becomes known, Fred plans to open a second location, close to one of FVT's other theatres.

Fred has already hired a business advisor who has been able to provide an estimate of the initial capital investments that would be required, as well as profit projections to 2019. Fred has also had some preliminary discussions with three banks, but so far none has been interested in helping to finance this startup. After 2020, revenues and costs would grow at 2%, the expected inflation rate. The company's corporate income tax rate is expected to be 25%.

The proposed lease is for five years, and Fred has suggested that five years be used for the analysis of this investment. The lease also has a termination clause requiring the company to leave the space as it was found. The consultant has estimated that the costs to remove the leasehold improvements will be $45,000 at this time and that the equipment will have no resale value. Forecast assumptions are provided below.

Initial costs will consist of the following:

- Leasehold improvements for the kitchen, dining area and bar: $850,000 (CCA Class 13)
- Cost of dining tables and chairs: $95,000 (CCA Class 8)

Appendix XII (continued)

Investment in Connery's Bar and Grill
Per discussion with Viktor Lightfoot

- Tableware, linens, kitchen utensils and equipment, and bar equipment and signage: $80,000 (CCA Class 12)
- Initial food and beverage inventory: $20,000
- IT system, including point of sale, accounting and inventory management: $30,000 (CCA Class 50)

Assuming that the restaurant will open in July of this year, and its year end will be June 30, revenues and related costs are expected to be the following:

	2018	2019	2020
Revenues	$ 1,820,000	$ 2,300,000	$ 2,800,000
Cost of food and beverage	36% of revenues	35% of revenues	35% of revenues
Labour	26% of revenues	26% of revenues	26% of revenues
Annual insurance	$ 10,000	$ 11,000	$ 12,000
Permits and licences	$ 6,000	$ 6,200	$ 6,200
Menus and advertising	$ 25,000	$ 12,000	$ 13,000
Tableware, linens, ongoing costs	$ 15,000	$ 15,000	$ 15,000
Opening event	$ 25,000	—	—
Fred's salary	$ 150,000	$ 200,000	$ 250,000
Rent and operating costs, including utilities	$ 175,000	$ 176,000	$ 177,000

Fred believes that a fair salary for himself would be $250,000. However, he is willing to take a reduced amount for the first two years, as is reflected in the forecasted expenses above.

In addition, Fred has suggested that the restaurant's kitchen be used to prepare the light lunches that are currently sold by FVT at their concessions. In the future, FVT could even provide hot meals for lunch or dinner. For London theatres #1, #2, #3 and #4, the sandwiches, salads and wraps are prepared by a local caterer and their current cost is 70% of the selling price. During the most recent year, sales of these items (at these four theatres) represented about $1 million. Fred believes that Connery's can make and deliver these items for a cost of 55% of the selling price. Currently, FVT cannot customize its order for these items; the products received are based on what the caterer is making that day. With Connery's, FVT's orders could be made based on what sells and new items could be tested. This would likely increase overall sales.

Appendix XII (continued)
Investment in Connery's Bar and Grill
Per discussion with Viktor Lightfoot

As Fred has very little savings, he is looking for FVT to make an investment of $1,000,000. Fred will contribute all of the "sweat equity" along with cash of $75,000. In return for the $1,000,000, Fred is prepared to give FVT 40% ownership of the business. He is proposing a business arrangement whereby all decisions are made jointly, regardless of ownership. The restaurant business would be incorporated and operate as a separate enterprise, and FVT and Fred would share in the net assets and the net earnings of Connery's. A contract outlining the details of this arrangement would be signed by both investors.

Based on some preliminary research, Lanny has suggested that an after-tax discount rate of 17% should be used for this analysis.

Appendix XIII
Enhancing the theatre experience with luxury seating and 4D capability — PPV
Per discussion with Zobair Terdel

Over the last year, Zobair has been looking at various opportunities to increase FVT’s box office admission price. Zobair knows of at least one local competitor that has already commenced renovations that are intended to enhance the customer’s theatre experience, with others considering doing the same.

Zobair recently approached Kent with an idea to renovate some of the auditoriums to install luxury recliner seating, a new screen that is floor-to-ceiling and wall-to-wall, and surround sound. Zobair would also like to see the auditoriums have D-BOX motion seats in the first four rows. The proposed changes require that the number of seats per auditorium be reduced from 250 to 175. Based on his research of other theatres that have made these investments, the admission price for this type of film viewing commands a premium of $8.50 to $10 over the standard admission prices. These auditoriums would be adult only, with bar service available selling liquor, wine and beer. Servers would provide at-seat service before the film showing commences. Zobair has suggested that this form of entertainment be called “premium plus viewing,” or PPV.

In his discussions with various suppliers, Zobair has estimated that the cost of the new reclining seats and the D-BOX motion seats, including installation, is $1,017,000 per auditorium. The cost of the new screen and surround sound is $750,000 per auditorium. These prices are expected to increase annually by 3%. These capital costs qualify for Class 8 for income tax purposes. Finally, an investment of $20,000 in additional inventory will be required at each theatre location for the new bar service to be provided.

Zobair suggests that two auditoriums in the London #1 theatre be renovated in 2017, followed by the renovation of two more auditoriums in the Leamington theatre in 2019. In this way, FVT can see the impact of the renovations in two different locations. If the renovations are successful, then the concept can be extended to other theatre locations. Zobair has decided to forecast out 10 years, to the end of 2026.

The theatre auditoriums will be closed for one month during renovation. Based on seasonal attendance numbers, Zobair suggests that the renovations made to the London #1 theatre be completed in October 2017, since it will take some time to get quotes and place the orders. The renovated auditoriums should then be ready for use by November 1. Zobair has suggested that the renovations to the Leamington theatre be completed in July 2019 to be ready for use by August 1.

Based on this timing, Zobair has made the following forecasts of attendees for the renovated auditoriums. He has also forecasted what the attendance numbers would have been in the auditoriums if the renovations had not been completed (“status quo” attendance).

Appendix XIII (continued)
Enhancing the theatre experience with luxury seating and 4D capability — PPV
Per discussion with Zobair Terdel

	2017	**2018**	**2019**	**2020**	**2021**	**2022 and each year thereafter to 2026**
PPV	10,000	76,000	130,000	166,000	169,000	170,000
Status quo	17,200	102,760	119,960	205,520	205,520	205,520

Zobair expects that 75% of the new attendees will be adults and 25% will be seniors. The admission price for the status quo scenario is estimated to be the current average box office revenue per attendee of $8.67.

The concession revenues are also expected to change. Offering alcoholic beverages is expected to increase concession revenue per attendee to an average of $19.00, compared to the current concession revenue per attendee of $4.95. However, if the proposed changes are adopted, concession costs are expected to increase to 30% of total concession revenues — up from the current 25%. Film costs are expected to remain at 55% of box office admission revenue.

Additional costs for the new, renovated auditoriums are as follows:

	2017 **$**	**2018** **$**	**2019** **$**	**2020** **$**
Permits and licences	2,000	6,000	12,180	12,363
Additional concession supplies	4,000	17,000	34,510	35,028
Labour — wait service	8,500	50,000	101,500	103,023
Marketing expenses	10,000	25,000	45,000	25,000
Opening event	25,000		30,000	
Additional maintenance and operating costs	10,000	30,000	60,900	61,814

For 2021 and each year thereafter to 2026, costs will increase at the rate of inflation, expected to be 2%.

Appendix XIV
Investment in The Games Place (TGP)
Prepared by Viktor Lightfoot

Viktor wants the company to invest in other forms of premier entertainment that are not tied to film successes. He has been looking into an interactive party place for adults and children to be named The Games Place (TGP). The proposed 30,000 square foot facility will be separate from FVT's theatres. This new location will consist of three sections: the first section will contain a variety of amusement games, the second section will consist of a casual dining restaurant and the third section will host a large, centrally located bar. There will be several large-screen televisions throughout the venue that will display sports or other events. It is estimated that there will be at least 100 amusement games available, including billiards, shuffleboard, ping pong, simulators and other interactive games. The dining room will serve casual upscale food for families. FVT will also rent the space out for special events such as corporate events and parties.

Customers will pay to play each of the amusement games. Each player will get a play card. Customers will pay to load the play card with credits that will be used as each game is played. Machines that customers will use to load their cards with credits will be available throughout the location. The credits will not expire, so at any point in time there will be an amount of deferred amusement revenue that represents the value of the credits purchased but not yet used. Amusement revenue will be recognized as the credits are used to play the games. At any point in time, it is expected that deferred amusement revenue will represent 4.3% of the annual amount.

As games are won, customers will earn points that can be redeemed for a variety of prizes. The play card will keep track of the prize points that customers have won. Unredeemed prize points will also represent a liability for the company, and the year-end liability is expected to be about 3% of amusement revenues for that year.

There are no similar establishments in London. Viktor and Kent have already found a possible location for this proposal, which is about five kilometres from the company's head office. The landlord has agreed to a 20-year net lease with a five-year renewal term. The base rate will increase annually with the inflation rate. FVT will be responsible for maintenance, insurance and property taxes. These costs, in addition to the lease costs, are included in the "other operating costs" below. If terminated early, there will be penalties to be paid based on the number of months still remaining in the lease. At the end of the lease, FVT will be responsible for leaving the premises as found.

Upfront costs totalling $6,070,000 will be required for the following:

- leasehold improvements $1,881,000 (CCA Class 13)
- furniture and fixtures $1,689,000 (CCA Class 8)
- games $2,460,000 (CCA Class 16)
- computer hardware and software $40,000 (CCA Class 50)

Appendix XIV (continued)
Investment in The Games Place (TGP)
Prepared by Viktor Lightfoot

There will also be an initial investment in inventories of $220,000 for food, beverages and game prizes.

Viktor suggests that for analysis purposes an eight-year period be used to determine whether or not the investment is viable.

Based on discussions and research, Viktor has been able to estimate the following annual revenues and costs. Based on the time required to order the assets and renovate the property, he estimates that the location will be open for business on January 1, 2018.

Revenues	**2018** **$**	**2019** **$**	**2020** **$**	**2021** **$**
Food	1,250,000	1,696,000	1,805,000	1,950,000
Beverages	525,000	768,000	975,000	1,160,000
Amusement	2,590,000	3,856,000	4,150,000	4,505,000
Special events	250,000	630,000	850,000	880,000

For 2022 and onwards, the revenue will increase at 2% per year.

Expenses	**2018**	**2019**	**2020**	**2021 and onwards**
Cost of food	26% of food revenue			
Cost of beverages	23% of beverage revenues			
Cost of amusement games	15% of amusement revenues			
Wages and benefits	24% of total revenues			
Marketing and advertising	$450,000	$390,000	2% increase	2% annual increase
Other operating expenses	$1,392,000	2% annual increase		
General and administrative	$245,000	3% annual increase		

There will also be an opening event in 2018 costing $25,000.

Since the games have only about a five-year life, there will be investments made in new games of $860,000 in each of 2022, 2023 and 2024. The expected life of the furniture and fixtures and the computer hardware and software are expected to be 10 years and eight years, respectively. FVT uses the straight-line method of amortization for reporting purposes. At the end of the project life, the furniture and fixtures could be sold for $620,000, and the games for $450,000. Viktor has also estimated that at the end of the project life, asset retirement obligations will be $325,000.

Appendix XIV (continued)
Investment in The Games Place (TGP)
Prepared by Viktor Lightfoot

Based on analysis of public company data for companies operating in this industry, the following information has been gathered:

- The beta is 2.
- The cost of debt is 6%.
- The debt-to-equity ratio is 20%.
- The risk-free rate is 2%.
- The market risk premium is 5%.

Because FVT is a private company, 7% should be added as a premium to the WACC calculated from the public company data.

APPENDIX C

THE COMMON FINAL EXAMINATION
DAY 1 FVT VERSION 1 BOOKLET – SEPTEMBER 13, 2017

COMMON FINAL EXAMINATION
SEPTEMBER 13, 2017 – Day 1

<u>Case</u> (FVT-Version 1) **(Suggested time: 240 minutes)**

It is May 5, 2020, and Chris Renker, your boss at Renker and Curtis Co Management Consultants (RCC) tells you that you will be working with the original consulting team on another consulting engagement with First View Theatres Inc. (FVT).

Chris recently met with Stephanie, Viktor, and Lanny Lightfoot and Zobair Terdel to discuss the events that occurred between 2017 and 2020 (Appendix I). Industry growth rates for regular box office revenue have been nil and are predicted to decline as entertainment substitutes gain popularity. Many smaller companies have been forced out of the industry, and the larger nation-wide companies have gained more negotiation power with film distributors. This change has increased film costs and decreased margins for FVT's film exhibition business.

During 2017, FVT invested in the Premium Plus Viewing (PPV) technology in two auditoriums in London and two auditoriums in Leamington. Due to these successful investments, FVT has remained profitable, despite the increased film costs. The proposed investments in CLR, the Quebec-based company, and The Games Place were not pursued. The sale leaseback of the head office building was not pursued either.

Updated statistics on 2019 attendance numbers by theatre locations and industry benchmarks are in Appendix II and III. Financial statements for the year ended 2019 are included in Appendix IV.

To better compete for qualified staff, FVT increased its hourly part-time rate and changed some part-time positions to full-time. Interest rates have increased, and the Canadian dollar is expected to remain stable against the U.S. dollar. Consumers appear willing to spend more of their discretionary income than in the recent past.

Changes, including luxury seating and service, along with four-dimensional (4D) technology, have made film watching very different from home viewing. As attendees are willing to pay a premium for enhanced viewing experiences, an increasing number of theatres are upgrading their technology. The latest technology is virtual reality (VR). Although no feature-length VR movies have yet been released, industry experts believe the technology will be perfected within the next two years.

Change is so rapid that it is increasingly expensive to stay informed of, and implement, the changes. Some of FVT's competitors have gained significant financial benefit by investing in new technology at the developmental stage, resulting in lower implementation costs and increased profits on sale of the technology to competitors.

At FVT's most recent board meeting, the mission and vision statements were changed, after much heated discussion, with Stephanie being the only dissenting shareholder. The company is still committed to providing a premier entertainment experience. However, the board supported more aggressive investment in new technology.

Vision statement: *Our vision is to be at the forefront of providing premier and, state-of-the-art entertainment to our guests.*

Mission statement: *Our mission is to provide a premier and state-of-the-art entertainment experience tailored to the local community. We accomplish this by investing in leading-edge film projection technology in order to be the first company to implement this technology for our customers' viewing experience. We also strive to train employees to be respectful, attentive, and friendly, select films that best appeal to the local community, ensure clean and safe venues for employees and attendees, and support entertainment and arts in the local community.*

The board also modified some of FVT's objectives. The board wants to ensure that operating cash flow and net income increase by at least 5% in 2020. In addition, shareholders want to improve FVT's solvency ratios by continuing to pay off the term loan, and they want to reach a return on equity of 10% by 2021. FVT is less focused on revenue per attendee and more focused on growing profits.

FVT needs to make some decisions quickly. Chris assigns you the following tasks: "Please prepare a report for the board of FVT. Taking into account what you learned about FVT in the previous engagement, please recap the important decision factors for FVT's board to consider, focusing on significant changes from our previous situational analysis that will impact FVT. Further, provide your assessment of the major issues currently facing FVT. For each of the major issues, identify for the board any significant considerations they may not have taken into account and any additional information they must obtain before making their decisions. FVT's board wants us to focus on the strategic decisions but to also address any operational issues that need to be considered first. Finally, where there is sufficient information, you are to suggest a course of action."

INDEX TO APPENDICES

APPENDIX I
BOARD MEETING WITH CHRIS RENKER IN ATTENDANCE

Stephanie: Thank you, Chris, for attending our special board meeting. For your information, since our last engagement, the management positions have not changed. The board has decided to limit FVT's total spending on investments at this time to $2.5 million.

Here is a summary of major events since the last engagement.

2017	May 16	FVT sold its head office land and building, but there was no leaseback. Consequently, FVT moved its head office to a new location and entered into a 10-year operating lease.
2017	June 1	FVT invested $0.5 million in Connery's Bar and Grill (CBG) for a 75% ownership in the joint arrangement.
2018	January 1	Stephanie invested $3 million for 5,000 common shares of FVT.
2018	February 17	Cost-cutting measures were implemented at the Sarnia locations, and the number of auditoriums showing films at Sarnia #1 was reduced to six.
2018	August 27	Suisui Yang left and was replaced by Caterina Lavine.
2018	October 15	FVT implemented the FLIXREWARDS program.
2018	December 31	The remaining preferred shares were redeemed. Kent and Sheila Lightfoot officially retired from FVT and FLL and are no longer involved in either business.
2019	February 19	FVT invested another $0.5 million in CBG for a second location in London. Fred invested a proportionate amount; FVT's ownership remained at 75%.
2019	April 22	The bank approved a new line of credit, to a maximum amount of $5 million, which expires in 2025. It has the same covenant as the bank loan and is secured by selected equipment and the personal guarantees of Viktor, Lanny, and Stephanie Lightfoot. The interest rate is prime plus 1% (prime is currently 2.8%).
2020	January 1	Zobair Terdel was given the opportunity to buy into FVT and invested $0.6 million for 1,000 common shares.

APPENDIX I (continued)
BOARD MEETING WITH CHRIS RENKER IN ATTENDANCE

Viktor: I believe that VR technology is the next big step. Virtual Reality Tech Inc. (VRT) is a private Canadian company that currently uses this technology to produce five-to-ten-minute promotional videos. Yuxuan Zhang, the owner of VRT, asked me if FVT would consider investing to further develop this leading-edge technology. Yuxuan conducts research and development in the use of VR technology for producing and viewing feature films. Yuxuan has been unable to raise funds through traditional sources and has had limited success raising funds through crowd sourcing. I am surprised, as I think this capability will be another "landmark" in film technology. Investing in VRT would help us diversify.

Stephanie: I am concerned that we will be asked to make more than one cash investment before a product is available for commercialization. R&D is expensive. This direction is very different from the vision of our parents, who would want us to upgrade our theatres.

Lanny: We cannot live in the past. Viktor is the only one of us who understands new technologies and who has experience in this area. If Viktor believes our future profits will benefit from this investment, I am supportive of investing. Viktor, what kind of return do you think we might see from this investment?

Viktor: Due to its unique nature, we will want an annualized return of 30%. We would get this return by selling this investment to a major strategic buyer in five years. I have had the accounting department prepare some preliminary numbers (Appendix V).

Lanny: As there is little growth potential, we have to move away from our heavy reliance on general box office admission fees. But I still need to better understand how we will make a return from this investment. It looks like we would recognize this investment at cost and would receive no income, and the only return will be on the eventual sale to a strategic investor.

Chris: Do any of you know anything about Yuxuan's past successes?

Zobair**:** Yuxuan has both technical expertise and the experience of bringing two other technological advances to market. I am confident that, with Yuxuan's involvement, this investment could be the first step in gaining experience in investing in the earlier stage of new technology development. I really like the idea of working with an experienced partner. I also see it as a way to diversify our income streams.

APPENDIX I (continued)
BOARD MEETING WITH CHRIS RENKER IN ATTENDANCE

Stephanie: Chris, we need an assessment of this investment opportunity. What is up next for discussion?

Zobair: The Sarnia locations continue to underperform. As you know, we closed six of the twelve auditoriums in the Sarnia #1 location during 2018, and we cut costs by reducing staff and limiting the hours of operation at both Sarnia locations. As we still have a loyal, although shrinking, customer base, I vote to keep these locations open. My research on the Sarnia competitor that is taking away our customers indicates that they are charging the same admission price as us. In addition, if we want to keep our staff, we probably have to further increase our wages as other companies are offering higher hourly rates to attract part-time staff.

Viktor: Both Sarnia locations were last upgraded nine years ago. This is most likely the cause of the attendance decline. For the same admission price, the competitor offers newer projection technology and an ambience far superior to FVT's. It would cost us at least $2 million to upgrade the two theatres, and I am not sure this is the wisest use of our cash.

Stephanie: If we close these locations, it will look like we have abandoned our customers. Kent and Sheila would be completely against closures. FVT has always been about the community, and closures, or even lowering our admission prices, could have a detrimental impact on FVT's reputation. If customers outside Sarnia hear of this, it could negatively impact our other locations. I also do not want to lay off staff, some of whom have been with us for a long time.

Lanny: With the loss of both Sheila and Suisui, FVT has lost many of its film distribution contacts, and we are now having difficulty negotiating favourable film costs. I think we should close the theatres. Realistically, we have already made as many cost cuts as possible. Attendance numbers are falling, and the losses from both Sarnia locations have been hurting FVT for years now. Keeping Sarnia open will only continue to negatively affect us.

Zobair: I asked the accounting department to look at different options (Appendix VI).

Stephanie: I think we need to better understand the impact. Let's get Chris to look at it.

Let's discuss CBG. Fred has recently developed serious health issues and needs to sell. As Fred is the head chef and manages both restaurants, we have had little involvement with the daily operations and have relied heavily on Fred. In fact, Fred only sought our input when he wanted to invest in another location. We received an offer from George McCain yesterday to purchase all outstanding shares of CBG – both Fred's and FVT's.

APPENDIX I (continued)
BOARD MEETING WITH CHRIS RENKER IN ATTENDANCE

Zobair: A few weeks ago, I personally offered Fred $700,000 for his shares. As you know, my wife is a chef who wants to open her own restaurant, and we both thought this might be great for her. Fred has not yet gotten back to me but is considering my offer.

Stephanie: I am surprised! Why didn't you tell us?

Zobair: When I learned that McCain was considering making an offer, I needed to act quickly, for my wife's sake.

Lanny: Zobair, I cannot believe that you did not let us know right away that McCain was considering making an offer, and that you acted on this information by making your own offer!

Zobair: The restaurant has proven to be very profitable and I did not want McCain to get it. I think CBG will continue to be successful, which is why I want to invest. I just assumed FVT would not be interested in buying out Fred.

Stephanie: Well, we now need to consider what to do. We could sell out entirely to McCain, or hope that Fred accepts Zobair's offer and continue in a JV arrangement with Zobair as our new partner. Or, maybe FVT should buy out Fred?

Lanny: I believe that CBG will continue to be successful. The JV arrangement outlines how a buyout price would be determined. We need an idea of the value of CBG in order to make a decision. I do not think there has been any change in the rate of return of 17% in the restaurant business since 2017.

Viktor: I think we should sell CBG to McCain and invest the proceeds in technology. With Fred no longer involved, the restaurant may not continue to be as successful. I think it is far too risky to go forward with a new chef and managers in the highly competitive restaurant business.

Stephanie**:** But, due to the crossover benefits of discounts for movie goers and diners, the investment in CBG has helped to increase revenues at the London theatre locations. CBG also prepares our light lunches for our PPV experience and charges FVT cost, without any markup. CBG's cost is substantially lower than we would normally have to pay, which has helped reduce our overall costs, and the revenue value of those light lunches is three times what was originally estimated.

APPENDIX I (continued)
BOARD MEETING WITH CHRIS RENKER IN ATTENDANCE

Zobair: If my wife takes over as chef, FVT won't have to worry about who will make the day-to-day decisions. Fred and I started looking for a location in Tillsonburg (near London) for a third restaurant to open in 2021, and I want to continue pursuing this expansion. However, since Fred was completely dedicated to CBG, it will require a chef and two managers to replace him, just to run the existing restaurants, at an annual total cost of $350,000.

Stephanie: Chris, here are excerpts from the proposed purchase offer from McCain, and a copy of the JV arrangement (Appendix VII). Can you give us the value of CBG?

Chris: Anything else?

Viktor: I want to continue our PPV upgrades in one auditorium in each of three more locations – Tillsonburg, St. Thomas, and Chatham. We already know they have been successful at the other locations, and our St. Thomas and Chatham customers are asking for these improvements. The accounting department says the capital budget would be similar to the one in 2017, which was $2 million for each location. This project has a positive NPV. We expect annual operating cash flows before tax to increase by $1.15 million in total. I would like to start these upgrades immediately.

Zobair: Good idea. I am confident these new investment projects will proceed more quickly, with less revenue lost due to the closures during renovations.

Lanny: Where is all this cash coming from? We have to place orders for the equipment, screens, and seats very soon. I think we can better use this money on some of the other investments we have discussed and put off the upgrades until we have at least $6 million built up in the bank.

Viktor: Why can't we borrow on our new line of credit? The return on this project will be far greater than the interest we have to pay on the loan. Also, equipment costs are going up. In January 2021, a totally new and advanced system is expected to be launched. The supplier is predicting that prices will increase by 8%. They are selling off their current equipment at reduced prices, which is great for us. That is why we want to upgrade all three locations now and not wait.

Stephanie: I have a bigger concern. How will closing Sarnia look to the Sarnia customers and employees? People will wonder why we made major upgrades in some locations, but not in Sarnia. This might have a negative impact on FVT's reputation and employee morale.

APPENDIX I (continued)
BOARD MEETING WITH CHRIS RENKER IN ATTENDANCE

Lanny: Chris, what do you think about this potential investment? Could you also suggest how the company could finance the upgrades?

Stephanie: Our last issue is the customer loyalty program. In October 2018, we implemented our FLIXREWARDS program. We now have a strong web presence, and more customers signed up than originally projected. In June 2019, we made a program change, and last week we discovered that, since then, our customers have been earning one-tenth the number of points they should have been. Our IT department has fixed the program error, but we have not yet adjusted the accumulated points balances. The number of accumulated points in the customer accounts is not right. IT staff are asking what we want them to do.

Zobair: We have fixed it going forward and we have had no complaints from customers. The total amount is likely not material to FVT's financials. Why tell them or adjust?

Viktor: We owe those points to our customers, and we probably owe FLIXREWARDS something too. We can't just ignore that.

Zobair: FLIXREWARDS provides us with reports each month. I am surprised that they did not notice that reward points numbers dropped dramatically after June. Maybe we should get FLIXREWARDS to pay us what we owe our customers. We could argue that FLIXREWARDS missed this change and should have been monitoring it.

Stephanie: It is time to wrap up this meeting. Chris, can you identify what we need to consider based on what you learned at this meeting?

APPENDIX II
THEATRE STATISTICS

For the year ended December 31, 2019

1. Statistics for 2019

	Number of auditoriums	With digital 3D screens	PPV auditoriums	Attendance, excluding PPV	PPV attendance	Total attendance
London #1	12	6	2	518,935	105,060	623,995
London #2	9	3		456,300		456,300
London #3	12	5		472,500		472,500
London #4	7	4		295,800		295,800
Sarnia #1	6	5		254,250		254,250
Sarnia #2	6	4		215,780		215,780
Chatham	9	4		442,130		442,130
Leamington	10	6	2	406,649	87,140	493,789
St. Thomas	12	5		481,900		481,900
Tillsonburg	9	4		346,980		346,980
Woodstock	8	4		425,110		425,110
Total	100	50	4	4,316,334	192,200	4,508,534

2. Average revenues per attendee

	2019
Average box office revenue – regular	$ 8.75
Average box office revenue – PPV	$19.70

APPENDIX III
INDUSTRY BENCHMARKS

	2016 Benchmark	2019 Benchmark	2016 Actual	2019 Actual
Ratios				
Box office revenue per attendee	$9.10	unchanged	$8.67	$9.22
Concession revenue per attendee	$5.25	unchanged	$4.95	$5.25
Box office revenue per theatre (in thousands of dollars)	$3,948	unchanged	$3,732	$3,778
Liquidity				
Current ratio	0.67	unchanged	0.30	0.49
Quick ratio	0.64	unchanged	0.22	0.39
Solvency ratios				
Long-term debt to equity	0.47	unchanged	1.39	0.47
Total debt to equity	1.20	unchanged	1.69	0.64
Total debt to assets	0.54	unchanged	0.63	0.39
Activity ratios				
Days in concession inventory	21	unchanged	23	21
Days in film costs payable	35	unchanged	33	35
Profitability				
Film costs to box office revenue	52%	unchanged	58.8%	57%
Concession costs to concession revenue	23%	unchanged	25%	23%
Advertising as percentage of revenues	2%	unchanged	1.1%	1.3%
Employee wages and benefits as percentage of revenues	19%	unchanged	18.1%	17.3%
Theatre costs as percentage of total revenues	12%	unchanged	12.2%	14.3%
General and administrative as percentage of total revenues	6%	unchanged	2.3%	2.6%
Operating margin	9%	5%	5.4%	4.4%
Net profit margin	6%	4%	3%	3%
Return on assets	4.7%	5%	4%	4.5%
Return on equity	10.4%	7.5%	10.8%	7.4%

APPENDIX IV
INTERNALLY PREPARED FINANCIAL STATEMENTS

First View Theatres Inc.
Statement of Earnings
For the year ended December 31, 2019
(in thousands of dollars)

Revenues		
Box office revenue – regular	$	37,768
Box office revenue – PPV		3,786
Concession revenue		23,670
Other income – arcade games		657
Other income – party room rentals		375
		66,256
Expenses		
Film costs		23,700
Concession costs		5,444
Advertising and promotion		831
Amortization		5,525
Employee wages and benefits		11,450
Employee bonuses		400
Rent		4,786
Theatre operating costs		9,480
General and administrative		1,710
		63,326
Operating income		2,930
Equity income from Connery's Bar and Grill		310
Finance costs – net interest expense and foreign exchange gains and losses		(558)
Income before taxes		2,682
Income taxes		(671)
Net earnings	$	2,011
Statement of retained earnings		
Balance – beginning of year	$	18,336
Net earnings		2,011
Dividends		(600)
Balance – end of year	$	19,747

APPENDIX IV (continued)
INTERNALLY PREPARED FINANCIAL STATEMENTS

First View Theatres Inc.
Balance Sheet
As at December 31, 2019
(in thousands of dollars)

Assets		
Current assets		
Cash and cash equivalents	$	2,362
Concession inventories		313
Prepaid expenses		285
Total current assets		2,960
Investment in Connery's Bar and Grill (equity method)		2,193
Property, plant and equipment (net)		38,648
Intangible assets		890
Goodwill		145
Total assets	$	44,836
Liabilities		
Current liabilities		
Trade payables and accrued liabilities	$	1,705
Film costs payable		2,273
Income taxes payable		350
Employee bonuses payable		400
Current portion of long-term debt		1,275
Total current liabilities		6,003
Long-term debt – term loan		11,486
Total liabilities		17,489
Shareholders' equity		
Share capital		7,600
Retained earnings		19,747
Total shareholders' equity		27,347
Total liabilities and shareholders' equity	$	44,836

APPENDIX V
INFORMATION ON INVESTMENT IN VRT

Virtual Reality Tech Inc. (VRT) Investment Proposal

- Investment in common shares – $2 million is required for a 10% ownership. Yuxuan would own 85%, with 5% widely held. Currently, VRT has no debt.
- VRT is expected to have losses totalling $1.5 million over the next five years, mainly due to the research and development costs. Yuxuan estimates that the technology could be sold for $100 million in five years' time. He has already had lower offers from three potential buyers.
- Any future sale negotiation will include the right of FVT to purchase the technology at a 20% reduction from the normal selling price, giving FVT a competitive advantage when upgrading its theatres.

APPENDIX VI
INFORMATION ON SARNIA LOCATIONS

Forecasted 2020 revenues per attendee are based on 2019 actuals and the proposed changes being considered.

	Option 1	**Option 2**	**Option 3**
	Keep open with current prices	**Lower price by 15%**	**Renovate**
Forecast box office revenue	$7.88	$6.70	$7.88
Film costs (at 57%)	(4.49)	(3.82)	(4.49)
Admission contribution margin	3.39	2.88	3.39
Plus concession contribution margin	2.88	2.88	2.88
Total contribution margin per attendee	**$6.27**	**$5.76**	**$6.27**
Expected number of attendees	470,030	517,033	525,000
Total contribution margin	$2,947,088	$2,978,110	$3,291,750
Operating loss before taxes	$(404,612)	$(373,590)	$(329,950)
Total annual cash flows before taxes	$175,788	$186,810	$500,450
Breakeven attendance (calculated)	**534,561**	**585,365**	**577,624**

Option 4 – Close Sarnia locations

Listing of net assets at the Sarnia locations:

Carrying value of net assets:	
Inventories	$ 23,000
Leasehold improvements and equipment	2,451,500
Goodwill	145,000
Net carrying value	**$ 2,619,500**

APPENDIX VI (continued)
INFORMATION ON SARNIA LOCATIONS

Option 4 – Close Sarnia locations (continued)

Add additional cash outflows to close:	
Total costs to close and terminate leases (before taxes)	$ 609,031
Severance payments for both locations	50,000
Total cash outflows required to close	**$ 659,031**

Notes:

- The operating loss before taxes includes the allocation of overhead costs. Fixed costs include an overhead allocation of $310,900 from head office. Closure of the locations would reduce overhead costs by only $95,000.

- Costs of $609,031 to close and terminate leases consist of lease cancellation penalties for the remaining 38 months of the leases, plus an estimated cost of $160,000 to remove the leasehold improvements, equipment, and games.

APPENDIX VII
INFORMATION ON CONNERY'S BAR AND GRILL

1. The most recent joint venture income statements is as follows (*in thousands of dollars*):

Summarized Income Statement

	2019
Revenues	$ 5,141
Expenses	
Operating costs	4,140
Fred's salary	450
Income before taxes	551
Income taxes (25%)	(138)
Net earnings	$ 413

2. Excerpts from the offer from George McCain, dated May 4, 2020, are as follows:

    - The price offered is $2.75 million.
    - The closing date will be June 30, 2020.
    - The full purchase price will be paid in cash on the closing date.
    - The offer includes all of the food and beverage inventory and equipment, tables and chairs, tableware, linens, kitchen equipment, and computer systems.

3. Excerpts from the JV arrangement are as follows:

- If one of the parties wants to sell their share, the other party has the right of first refusal.
- The price to buy out the other party's share will be determined as follows:
  Adjusted annual net earnings × Multiple, where:
  - Adjusted annual net earnings is equal to the net earnings as calculated using the most recent annual financial statements plus the after-tax cost of Fred's salary less a reasonable after-tax cost to replace Fred.
  - Multiple is equal to 1 divided by a discount rate, where the discount rate is the required rate of return for a privately held restaurant business at the date of the valuation.
- The purchase price will be payable in five equal annual instalments, with the first instalment due on closing of the sale.
- If the other party is not able to pay this purchase price, the seller has the right to find another buyer. If another offer is made, the other party has the right to match the terms of such an offer.

APPENDIX D

DAY 1 (FVT VERSION 1) – SEPTEMBER 13, 2017
MARKING GUIDE AND SAMPLE CANDIDATE RESPONSE

MARKING GUIDE
FIRST VIEW THEATRES (FVT)
VERSION 1

Summative Assessment #1 – Situational Analysis (Update)

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

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

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

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

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

Enabling:
2.1.1 Defines the scope of the problem.
2.1.2 Collects and verifies relevant information.
2.1.3 Performs appropriate analyses.

Competent candidates should complete a sufficient and appropriate situational analysis.
The focus should be on describing the factors that have changed that will affect the decisions to be made (e.g., investment in new technology). Highlighting the changes in the mission/vision, recapping the KSF, and presenting relevant elements of the SWOT are appropriate. An analysis of the provided ratios is required to compare where FVT is at the end of 2019 to benchmarks. Candidates should draw upon their situational analysis when analyzing the major issues facing FVT (VRT, Sarnia closures, CBG, and PPV).

Stakeholder Analysis

With the redemption of the preferred shares, the retirement of Kent and Sheila, and the new shares issued, the shareholders and ownership of FVT have significantly changed. Based on the 16,000 outstanding common shares (the original 10,000 and 5,000 issued to Stephanie and 1,000 issued to Zobair Terdel), the current proportionate ownership is as follows:

Shareholder	Shares Owned	Proportionate Ownership
Stephanie	5,000	31.25%
Viktor	5,000	31.25%
Lanny	5,000	31.25%
Zobair	1,000	6.25%
Total	16,000	100%

Mission and Vision Points

The board has changed the company's vision and mission to reflect a move to more actively investing in leading-edge film technology, while still providing a premier viewing experience to its customers.

Candidates may have recommended some changes to the vision in their Cap 1 work since there may have been some differences between FVT's vision statement (i.e., just pertaining to theatres) and strategic decisions made in their group work if investments other than theatres were recommended. The intent of the statement in Day 1 is to give candidates a statement on which to "ground" their new Day 1 decisions.

The new mission statement indicates the board's desire to move toward investments in new technologies that will place the company at the leading edge, at the same time providing premier entertainment to their local guests. FVT appears to be trying to diversify away from general film exhibition due to unfavourable industry and economic forecasts. In its effort to diversify, the company is looking to make investments in technology or areas of business that are less reliant on general film exhibition.

FVT's vision statement: *Our vision is to be at the forefront of providing premier, state-of-the-art entertainment to our guests.*

FVT's mission statement: *Our mission is to provide a premier, state-of-the-art entertainment experience tailored to the local community. We accomplish this by investing in leading-edge film projection technology in order to be the first company to implement this technology for our customers' viewing experience. We also strive to hire and train employees to be respectful, attentive, and friendly, select films that best appeal to the local community, ensure clean and safe venues for employees and attendees, and support entertainment and arts in the local community.*

New Objectives (changed from Cap 1)

In Cap 1, FVT's stated objectives were to increase revenue per attendee by 5% to $9.10 (which was the industry benchmark), to improve concession margins by reducing concession costs as a percentage concession revenue to 23%, and to increase net earnings by 5% in 2017.

The company's objectives are now as follow:

- To increase operating cash flows and to increase net income by at least 5% in 2020;
- To improve FVT's solvency ratios by continuing to pay off its debt;
- To improve FVT's ROE to 10% by 2021; and
- To meet the term loan covenant.

The focus has shifted from revenue per attendee to growth.

Candidates are NOT expected to recap key success factors (KSFs) or do a SWOT in detail. They may draw upon these various elements in their Day 1 case analysis, though.

KSFs for Film Exhibition Industry (from Cap 1)

Key success factors in the industry include:[1]

- Diversification of revenues
- Using up-to-date technology
- Low-cost film licence contracts
- Having a large part-time/flexible workforce
- Low and competitive operating costs
- High return on capital investments
- An improving (high) average dollar spent per attendee; i.e., maximize it

Strengths (from Cap 1, that are still relevant for this case)

- FVT has a strong presence in southwestern Ontario.
- Earnings are relatively stable.
- Management is experienced.
- Local customers are loyal/FVT knows what this market wants.
- FVT has invested in up-to-date technology — it has four premium plus viewing (PPV) auditoriums, which allows for a premium admission price.
- FVT has some diversification in income sources due to JV investment in Connery's Bar and Grill.
- FVT has a customer loyalty program, a strong web presence, and mobile apps.
- The cash balance is improving — the cash balance in 2019 is $503,000 more than in 2017 ($2,362,000 − $1,859,000) and the current ratio and quick ratio have both improved.

[1] IBIS WORLD Industry Report 51213C Movie Theatres in Canada, Issued December 2015, written by Darryle Ulama

Weaknesses (from Cap 1, that are still relevant for this case)

- FVT has little supplier power in negotiating film rental contracts and the concession's costs of goods sold (Cap 1, and mentioned in Day 1 as an increasing issue).
- There is a loss of contacts and potential loss of good reputation with key film distributors due to retirement of Sheila and loss of Suisui.
- Net earnings are reliant on box office revenues/"hits."
- FVT is only present in southwestern Ontario, resulting in high concentration risk.
- Sarnia continues to underperform, with attendance numbers declining.

Opportunities (**new** info in Day 1 case)

- PPV presents an opportunity to update more locations to increase revenues and profits (based on results for first four).
- Investment in Connery's Bar and Grill (CBG) restaurant is profitable and provides diversification of revenues and income.
- Technology in the industry is changing rapidly and providing many new opportunities for investment (was changing in Cap 1 too, but now seems to be a quicker pace of change).
- Attendees are still willing to pay a premium price for enhanced viewing experiences that are different than at-home viewing, hence a growing market for luxury seating and service and 4D viewing (also mentioned in Cap 1 that PPV can demand higher price).
- The Canadian-dollar-to-US-dollar exchange rate is expected to remain stable, which will keep film costs from further increasing.
- Consumers are willing to spend more of their discretionary income, which should result in higher revenues for FVT.

Threats (**new** info in Day 1 case)

- Fred, the chef and manager of CBG, has become ill and has to withdraw from the JV. FVT has had little involvement in CBG's operations and is dependent on Fred's expertise.
- Regular viewing attendance is expected to decline.
- Investments in technology are becoming more expensive.
- Technology is changing at an ever-increasing pace and becomes obsolete more quickly.
- Competitors are investing in new technologies at the development stage, giving them a competitive advantage on costs of implementation.
- Interest rates are increasing; therefore, FVT will have higher interest costs on any additional debt that it takes on.
- Shortage in the part-time labour market is causing higher wage rates for FVT and a move to more salaried positions, as well as competitors increasing wage rates, which will increase employee wages.

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

Candidates should compare the financial results of 2019 to those of 2016 and to the industry benchmarks using the financial ratios provided in Appendix III, and they should specifically identify areas where performance has improved or worsened. They also need to calculate the loan covenant. The industry benchmarks remain the same as in Cap 1 *except* for the following profitability benchmarks:

	Day 1 Case	Capstone 1
Operating margin	5%	9%
Net profit margin	4%	6%
Return on assets	5.0%	4.7%
Return on equity	7.5%	10.4%

Candidates are expected to provide a high-level assessment of FVT's financial results to get a sense of which changes/strategies have and have not worked (i.e., box office revenue per attendee, concession revenue per attendee, liquidity ratio, solvency ratio, profitability ratios).

<u>Revenue Analysis and Comparison with 2016 Operations</u>

Candidates should note the following with respect to the revenue breakdown provided in Appendix II:

- The number of screens is down by 6 (106 in 2016 to 100 now).
- Total attendance is down from 4,736,273 to 4,508,534, indicating an overall reduction in attendance.
- However, the attendance number per screen has increased — it was 44,682 (4,736,273 ÷ 106) in 2016 and is now 45,085 (4,508,534 ÷ 100).
- Total revenue for 2016 was $65.5 million and in 2019 is up slightly to $66.3 million, even with six fewer screens. Part of this increase has to be driven by the higher admission prices ($19.70) for the PPV.

Summary of ratio analysis (from Appendix III information; key points that candidates should determine):

- The debt covenant: the ratio of long-term debt (including current portion) to EBITDA cannot exceed 2.5 (Cap 1 link). In 2019, it is 1.5 ((1,275 + 11,486) ÷ (2,930 + 310 + 5,525)), well below the requirement. Note that the new CBG equity income has been included in EBITDA for 2019. The 2016 ratio was about 2.04. [FX was excluded in the Cap 1 ratio calc. Could not be split out here based on f/s info provided.]

- The other solvency ratios have improved significantly too:

Solvency Ratios	**2019**	**2016**	**Benchmark**
Long-term debt to equity	0.47	1.24	0.47
Total debt to equity	0.64	1.69	1.20
Total debt to assets	0.39	0.63	0.54

  This is due to the redemption of the preferred shares. The ratios are now in line or better than industry.
- The current ratio of 0.49 has increased from 2016 (0.30) but is still below the industry average of 0.67, indicating that the cash on hand is likely below the industry average.
- Film costs as a percentage of box office revenues are 57% compared to 58.8% in 2016. They are still significantly higher than the industry benchmark of 52%. This is likely due to the loss of experienced management (in 2018) who was able to negotiate contracts with the film distributors.
- Concession costs as a percentage of sales (23%) have improved from 2016 (25%) due to the selling of higher-priced items with the luxury service provided in the PPV auditoriums and the use of CBG to prepare the light lunches. The industry benchmark is 23%.
- Overall, the net profit margin of 3% is similar to 2016 (3%) but is still slightly below the industry benchmarks of 4%. (Note: Was 6% in Cap 1, but has come down.)
- Net earnings went from $1,990,000 in 2016 to $2,110,000 in 2019 — 6% growth over a period of 3 years, which does not meet FVT's earnings growth target of 5% in 2020 (the Cap 1 objective was also to grow 5% in 2017 alone). **[This does not meet FVT's objective.]**
- For return on assets, the Cap 1 benchmark was 4.7%, and now in the Day 1 case it is 5%; FVT's ROA is 4.5%, up from 4.0 in 2016.
- Return on equity is 7.4% and has worsened since 2016 (10.8%). **[This does not meet FVT's current objective, so will need to consider as part of the investment decisions.]** However, it is close to the industry benchmark of 7.5% (it was 10.4% in Cap 1). FVT's situation is likely due to the increase in equity related to the issuance of the new common shares that was completed in 2018 and 2020.

Candidates could comment on other ratios too (based on the list provided in Appendix III). The ones noted above relate to the benchmarks that changed or to the objectives. What is most important is that they somehow gather enough different information to assess the company's position.

<u>Conclusion</u>

FVT has limited cash available for investment (although the cash balance is up from 2016). At the same time, it wants to reduce debt and will likely not take on any new debt that will cost more, particularly since interest rates are rising. The investments to be made in the various alternatives being considered need to consider FVT's cash position. The board has set a $2.5 million limit on spending for investments.

FVT needs to move away from its reliance on regular film viewing income and into other areas that will generate higher profit margins and overall profits and are consistent with its new mission and vision. Industry growth rates from film are expected to stay flat. The industry margins and returns have dropped from 2016 to now. FVT's film costs are significantly higher than those of the industry and are predicted to remain at this level. FVT has little opportunity to improve these costs since it has lost its key contacts and is a small player in the industry.

The changes FVT has made to move toward greater use of technology seem to be paying off, based on the improved financial results. This supports further investment in technology to help increase revenues.

Summative Assessment #2 – Analyzes the Major Issues

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

Yes – The candidate sufficiently completed a reasonable assessment of the major issues facing FVT.

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

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

Competencies
2.3.3 Evaluates strategic alternatives

Enabling:
2.1.3 Performs appropriate analyses.
2.1.4 Integrates information to investigate each potentially viable solution or conclusion.

This summative assessment is based on Assessment Opportunities #2 to #6.

Assessment Opportunity #2 (Strategic Alternative #1 – Investment in VRT Technology)

Competent candidates will complete both a qualitative and a quantitative assessment of this alternative. Candidates are expected to demonstrate an understanding of the quantitative information presented in the case (Appendix V) and to explain in a manner that the client will understand what the qualitative decision factors are.

Quantitative analysis – *Candidates should complete an analysis of investing in virtual reality technology in its early stage of development. The quantitative analysis involves looking at whether the return on the estimated value in five years is greater than the return required by FVT. The quantitative analysis also includes a discussion of the impact on FVT's earnings and objectives over the next five years (cash, covenant, growth, etc.).*

Qualitative analysis – *Candidates should recognize that this decision ties directly to the new mission and vision for the company.*

Candidates should consider both the quantitative and the qualitative factors and draw conclusions/make recommendations based on a combination of the quantitative and qualitative analyses.

Quantitative Analysis

Key tools candidates could use/recognize:
- Capital budgeting tools — look at the implied IRR of the investment
- Examine the impact on income and return on equity

Based on the quantitative analysis, this investment has a 38% annualized return. This was calculated as follows (all figures from Appendix V of case):

FV = $100 million [Yuxuan expects to sell for this amount in 5 yrs] × 10% ownership = $10 million
PV = $2 million [amount to be invested for 10% ownership]
N = 5 [years]
CPT I = 38%

This is higher than the return of 30% suggested as required by Viktor. From this purely quantitative perspective, this investment should be made since it could have a substantial return.

However, more information is required on the offers that VRT has received up to now, since they are lower than the $100 million. This would help give more insight into how reasonable the $100 million price estimate five years from now is.

Tie-back to objectives (i.e., impact on cash flow, earnings, ROE, etc.):
- The impact on the financial results is not advantageous.
- This investment will show initially as an investment at cost of $2.0 million, which is within the $2.5 million limit set by the board.

- If the cost method is used for this investment (as suggested by Lanny), then income is only recognized when dividends are declared (not likely in this type of business) or the investment is sold.
- There will be no immediate impact on net earnings, operating cash flows, or return on equity until the investment is sold and a gain or loss is recognized.
- Consequently, this investment will not help to achieve the company's new financial objectives for 2020 or 2021.

Qualitative Analysis

Key points from Cap 1 that could be integrated:

- FVT only has experience in the film exhibition part of the industry.
- This investment allows for diversification of income sources.
- Technology in the industry is rapidly changing — a KSF is the need to keep up.

Key points from Day 1 case that could be integrated:

- Virtual reality is the newest technology, so this investment gives FVT access to it indirectly at first through research and directly in five years when sold (FVT gets it at a discounted price).
- However, there is no guarantee that the R&D will result in a usable product or that VRT isn't beaten to the market by a competitor. This is a high-risk venture for FVT compared to what they have done so far.
- This investment fits with the mission and vision, moves FVT into other areas of income potential and away from its current heavy reliance on the general box office admissions, and fits with the desire to move more to investing in technologies at earlier stages of development. This new technology could be a "landmark" in film viewing, and Viktor is eager for FVT to be part of this development.
- This investment is not reliant on general box office admissions, which are predicted to fall.
- VRT seems to have had success in developing marketing material, which is different than film production. As a result, there is an increase in the risk of failure, since film production will be a new area for VRT.
- Other companies (competitors) have taken this approach of investing in technology development and appear to have been successful; therefore, it may not be as risky as it first appears.
- However, as raised, there is concern that FVT has no managerial experience in the area of development of new technologies, noting that Viktor is the only one who understands the technology (so the board is relying on him — may be a risk).
- VRT has losses and is not yet profitable. There is a risk that additional funds will be required to further finance the R&D prior to commercialization, which increases the risk.
- VRT has tried to raise funds using crowd sourcing to help finance further R&D in feature film production but has had limited success, indicating high risk, a lack of interest, or perhaps both.

- The 30% return that Viktor is suggesting as the required annual return, and the fact that he calls it a "unique investment," suggests that he knows it is a risky investment.
- Zobair notes that Yuxuan, the majority shareholder of VRT, appears to have been successful at commercializing technologies in the past. As a result, he believes that VRT is a good partner to have in FVT's first foray into investments in technology at the early development stage. The question is whether Yuxuan's past success is "transferrable" to a different product.
- The VRT investment is significant. To fulfill the mission and vision, this becomes the new normal — to have to invest large amounts in technology. Trying to fulfill the mission and vision of being on the leading edge could put FVT out of business if management is not careful.
- No part-time staff is required for this investment, so it is not affected by the labour shortage; VRT is a Canadian company, so there is no exchange risk; and younger customers/trends are moving toward more use of technology, so it is a good fit *if* it can be developed.

<u>Next Steps</u>

This investment has potential and is worth investigating further. The board of FVT will want to do some due diligence on the existing technology and VRT's financial statements. For example, is all of the R&D being spent in this area? What are the forecasts for future sales? How well financed is the company, and will further funds need to be invested? What are the other offers received? How much has been invested so far? How long has Yuxuan worked on the project? Are there any other possible technologies in the market?

Assessment Opportunity #3 (Strategic Alternative #2 – Closing the Sarnia Locations)

Competent candidates will complete both a qualitative and a quantitative assessment of the issues related to closing the two Sarnia locations.

There are four courses of action that candidates must consider: keeping the locations open with no change, dropping the price to increase volumes, renovating, or closing. Candidates are provided with most, but not all, of the calculations required.

Quantitative analysis – *Candidates are provided with the estimated impact of the options (Appendix VI). The only one not fully calculated is the "closing" option; i.e., impact on FVT — need to consider what the "ongoing" savings are. For each option, candidates need to consider the impact on FVT cash flows, net earnings, and ROE.*

Qualitative analysis – *Candidates should recognize that the Sarnia locations do not provide a "premier entertainment experience" and, therefore, do not currently meet the mission and vision. If the locations are kept open, FVT would need to consider upgrading (to meet the mission/vision and objectives), and the attendance numbers do not warrant the expenditures. Candidates need to also consider that no further cost cuts can realistically be made.*

Candidates should consider both the quantitative and the qualitative factors and draw conclusions/make recommendations based on a combination of the quantitative and qualitative analyses.

Quantitative Analysis

Key tools candidates could use/recognize:
- Contribution analysis
- Cash flow analysis
- Calculation of net earnings and ROE under each proposal

Impact on Cash Flows and Net Earnings

After analyzing the four scenarios, the following conclusions were reached (all analyses are on before-tax basis as requested):

1. Sarnia locations are kept open with no changes: Currently, the Sarnia locations generate annual operating cash flows of $175,788 (before taxes).
2. Admission price is reduced: If the admission price is reduced as suggested, the annual operating cash flows increase to $186,810 (before taxes). [With this option, FVT would also have to consider the impact on other locations.]
3. Renovate, and no change in prices: If FVT invests the same amount as it did previously, that would be at least $2.0 million. With upgraded facilities, the highest amount the annual operating cash flows increase to would be $500,450 (before taxes). However, in this scenario, FVT must use almost all of the $2.5 million to upgrade the facilities (the maximum amount the board wants to invest is $2.5 million).
4. Sarnia locations are closed: The total immediate cash outflow would be $659,031, which is within the $2.5 million limit set by the board (information from Appendix VI).

Additional comments on the quantitative analysis:
- The Sarnia locations generate positive cash flow annually, so closing them would reduce annual cash flows by this amount.
- But keeping the locations open results in net losses and reduced ROE, which is consistent with objectives.
- The leases have 38 months remaining. Consider keeping the locations open until the leases expire and then close, which would save the lease termination penalties.
- Currently, the box office admission per attendee for Sarnia is only $7.88, which is substantially below the average for the company of $8.75 for general admission (not PPV), but it is in line with what the competitor is charging, so FVT may not be able to increase the price.
- If prices were reduced, there would be a small increase in the contribution margin if the volumes increased as expected, but there is no guarantee that the volumes would increase enough. The forecasted volume is still below the breakeven amount, and losses would still occur.
- If the renovations were completed, there would be a slight increase in attendance, but this volume is still below breakeven and there is no guarantee that these increases would materialize. Losses would still occur for the Sarnia locations.

Link to Objectives, Impact on Earnings and ROE, etc.

In all scenarios there are still net losses from Sarnia. If Sarnia is kept open, the attendance forecasted is still below the breakeven attendance numbers whether there are no changes, the price is reduced, or the renovations are completed. Therefore, the ROE will be lower if the locations remain open.

If the locations are closed, there will be closure expenses (of $659,031) to be paid in 2020, but thereafter earnings before taxes will increase by $188,712.

If close, ongoing impact on loss before taxes (after 2018):

Operating loss (no longer incurred)	$ 404,612	
Less overhead costs still to be incurred (Appendix VI – savings $)	(215,900)	(310,900 – 95,000)
Net impact on earnings before taxes	$ 188,712	

Candidates should note that only part of allocated overhead is saved on closing of the locations.

The net assets of the company will be reduced by the total net carrying value of the assets that are written off, which could be as high as $2,619,500 (Appendix VI), depending on whether there are other uses for the assets or not. This write-off will initially be recognized as an expense, which will reduce net earnings in the year of closure. However, because the write-off will also reduce equity, ROE should improve going forward.

Overall, closing the locations will help to achieve the company's objectives of increasing net earnings and increasing ROE.

Qualitative Considerations

Candidates should realize that currently the Sarnia locations do not seem to be meeting the vision and mission from Cap 1, which was to provide a premier entertainment experience. Since renovations and upgrades have not been done and locations are sub-par in comparison with the competitor's, this cannot be "a premier entertainment experience," so either the situation needs to be fixed or the locations closed.

Key points from Cap 1 that could be integrated:

- FVT has already closed six auditoriums in Sarnia #1, reducing the number from 12. In the Cap 1 case, FVT was looking at a write-down of the goodwill related to Sarnia due to loss of attendees and revenue. At that time, a significant write-down in the goodwill was recommended, and this adjustment was made in 2018 (as noted in Appendix VI). This indicates that the problems at Sarnia are not new and that FVT has been aware of the issue since 2016. Perhaps now is the time to finally act.

- FVT's mission and vision was (and still is) to provide a premier entertainment experience to all of its guests. The Sarnia locations, which are less attractive to customers than the competitor's, are not providing a "premier" experience.
- FVT's board's mission and vision is to support entertainment and arts in the local community. If the locations are closed, the company will no longer be supporting the Sarnia community.
- A KSF is to achieve high returns on capital asset investments, but negative earnings result in negative returns on the $2.6 million of assets invested in the Sarnia locations.

<u>Key points from Day 1 that could be integrated:</u>

- If prices are reduced, there may be an impact on the other locations since attendees may complain that their location's prices are too high or higher so are not fair.
- Sarnia already has below-average admission price/box office revenue of $7.88, in comparison to the $8.75 average for the company, and below-average concession margins of 55% (i.e., $2.88/$5.25 revenue) in comparison to FVT margin of 77% per financial statements — cost of concessions as a percentage of revenue is around 23%, consistent with industry benchmark.
- Closing the theatres could damage FVT's reputation. Could this have an eroding impact on other locations?
- Stephanie wants to keep the locations open to keep the people employed, which would be consistent with corporate values.
- Stephanie wants to keep the locations open to keep the company's reputation intact and to continue to support the local community.
- Sarnia will be or is facing a part-time employee shortage due to the car assembly plant paying more, which will require FVT to pay higher wages in the future.
- The trend is that regular film exhibition has been flat and is predicted to decline. Getting out now may make the most sense. However, if the company closes the locations, it will lose a market segment in its geographic area, which may be a reason to keep them open.
- Film costs are increasing for FVT, and margins and profits for Sarnia may be further reduced.

<u>Additional Considerations Candidates Could Discuss</u>

Financial reporting implications (identification of issues):
If the Sarnia locations are closed, these may qualify as discontinued operations if they meet the appropriate definitions. If so, the losses from Sarnia from the beginning of the year to the date of closure would be reported as a discontinued operation, along with any write-down in the assets. This will allow the earnings from continuing operations to be reported without the Sarnia losses.

Assessment Opportunity #4 (Strategic Alternative #3 – Connery's Bar and Grill (CBG): Buy Out Fred's Share or Sell, or Let Zobair Buy Out Fred's Share)

Competent candidates are expected to complete both a quantitative and a qualitative assessment of the "significant factors" related to selling all of CBG or carrying on with the investment with Zobair as the new JV partner. They should also consider the option of FVT buying out Fred's share (put on the table by Stephanie).

Quantitative analysis – *Candidates are expected to do a "rough" calculation to assess the purchase price as per the JV arrangement and compare this to the offer from McCain. Candidates can also compare this to the offer made by Zobair to Fred and question why it is exactly the same as the JV buy-out clause.*

Qualitative analysis – *Candidates should discuss the fit with the new FVT mission and vision and discuss pros and cons of each option.*

Candidates should consider both the quantitative and the qualitative factors and draw conclusions/make recommendations based on a combination of the quantitative and qualitative analyses.

Quantitative Analysis

Key tools candidates could use/recognize:

- Valuation estimate (i.e., estimate the buyout price)

Candidates can quantitatively

- Do a valuation of CBG
- Calculate the impact on FVT of the loss of synergies due to the better margin on the light lunches
- Discuss the potential impact on FVT's cash flows, net earnings, and ROE of selling its investment in CBG, continuing with Zobair as the new JV partner, or buying Fred out

Valuation

Purchase price as determined by the JV arrangement			
Net earnings as per the most recent annual report		413,000	
Add back after-tax cost of Fred's salary	(450,000 x (1-0.25))	337,500	
Less after-tax cost to replace Fred (350,000x (1-.25))		(262,500)	
Adjusted net earnings		488,000	
Discount rate		17%	(as from Capstone 1-LINK)
Multiple		6.00	
Valuation of CBG		2,928,000	
Fred's share is		25%	
Buyout price for Fred's share		732,000	(Note: FVT already has $,1000,000 invested)
Offer from McCain (for 100% of co)		2,750,000	

- Candidates are expected to use the excerpts of the JV agreement to determine a buyout amount to be paid to Fred for his 25% [link from Cap 1 — percentage was 40/60] (information taken from Appendix VII).
- This valuation was done using the discount rate of 17%.
- Take Fred’s compensation out, but consider the added cost of two managers and a chef (total cost of $350,000) in the valuation.
- Compare the offer price from McCain ($2,750,000) to JV’s buyout price (calc. $2,928,000). The buyout price (value of CBG is $2,928,000) is greater than McCain’s offer price of $2,750,000 (from Appendix VII). It appears that the offer is low by $178,000 compared to the “value” of FVT.

Candidates should notice that the price offered by Zobair ($700,000) is very close to the buyout price determined by the JV agreement. As a result, the price offered by Zobair to Fred appears to be fair and has a high likelihood of being accepted by Fred.

The concern to FVT is this: how did Zobair come up with the price? He must have reviewed the JV arrangement before making the offer. [See Ethical discussion later.]

Other issues with offer (candidates are specifically told “besides the price”):

- FVT should negotiate to obtain a favourable cost on the light lunches, similar to what it has now: the savings on light lunches sold at the concession that CBG is currently preparing. Currently, the company has a savings of: 3 × $1,000,000 × (70% − 55%)(1 − 0.25) = $337,500.
- The crossover benefits — this is missing information. In Cap 1, Appendix XII, there is mention of the discounts that could be provided by the restaurants for moviegoers who show their same-day admission tickets, and the discounts for the movies for diners who show their same-day dining receipts. The company will have to gather additional information on the revenue impact of these crossover benefits of discounts.

- If FVT purchases Fred's share, the buyout price is $732,000. This amount of cash is below the $2.5 million limit set by the board.

Impact on Earnings

If CBG is sold:
- FVT will have lower net earnings, since currently CBG contributes approximately $310,000 (75% of 413,000).
- The cost of the light lunches would increase by a total of $562,500 annually. This represents 17% (338 ÷ 2,011) of current net earnings, which is significant. However, FVT might be able to negotiate to have the light lunches still provided at a reasonable cost, in which case some of this savings may still be maintained.
- Currently, the investment in CBG is $1 million, with a profit of $310,000. The ROE on this investment is 31%, which is substantially higher than the current ROE of 7.4%. If this investment is sold, the ROE will decline.
- If it sells CBG, FVT will have additional cash of $2,062,500 before taxes (75% × $2,750,000) that can be invested in another opportunity.

If CBG investment is retained with 75% or 100% ownership:
- The company will continue to have its share of earnings of $310,000 in profits, if only 75% is retained, or $413,000, if 100% is owned. This may even increase with the addition of the third restaurant.
- CBG generates positive earnings that contribute to FVT's earnings.
- If Fred's salary ($337,500, after tax of 25%) is replaced with a lower amount for the chef and two managers ($262,500, after tax of 25%), this will increase CBG's net earnings by $75,000 and FVT's portion by $56,250 (75% x $75,000).
- The investment will continue to have a positive impact on the ROE even with the additional $732,000 invested.
- CBG generates a higher ROE for FVT.

Qualitative Analysis

Key points from Cap 1 that could be integrated:

- FVT invested in CBG as part of its objective to diversify its revenue and income. Selling to McCain goes against FVT's objective.
- FVT also went into the initial arrangement to reduce the cost of light lunches and increase movie attendance numbers to meet its objectives in Cap 1. Selling would go against and take away some of the things that contributed to better results.
- Since Fred is known to FVT, FVT has some confidence in Fred's capabilities as a chef. If Zobair's wife were to be the chef, she is not really known to FVT (only through Zobair's recommendation), and, with two other added managers, more supervision will be required.

Key points from Day 1 that could be integrated:

- Fred is ultimately the one making the decision since he owns 25%, unless the right of first refusal clause is triggered by FVT. FVT has to live with Fred's decision if the company doesn't buy out Fred.
- If FVT does not buy Fred's share, Zobair, who is a minority shareholder of FVT, will be a JV partner, which may result in conflicts in managing CBG's business. Zobair has acted in secret to make this offer and also did not tell the board about the proposed offer from McCain.
- If FVT purchases Fred's share, it will have full control of CBG, will not have to deal with Zobair as a JV partner, and will have full control of the discounts provided to FVT for the light lunches.
- If Zobair's wife is the chef, this may also cause some conflicts. How would a conflict be resolved if, for example, FVT was not happy with the chef's performance?
- Investing more in the restaurant business is against the new mission and vision to invest in technology that will improve the entertainment experience for guests.
- Investing in the restaurant business is in fact diversifying the income for FVT, so it is still consistent with the revised mission.
- FVT could risk giving up restaurant profits along with the synergies on lower concession costs and higher attendance. There are significant additional earnings for FVT (17% of net earnings as calculated above) due to the low cost of the light lunches and the crossover benefits between the theatre and the restaurant that increase attendance for both businesses. Stephanie is reluctant to lose these benefits; they are at risk if CBG is sold to McCain.
- Without Fred, it is riskier to remain in the restaurant business. Zobair's wife is an unknown to FVT. CBG has generated good returns for the company in the past, and Lanny believes it will continue to do so. This may depend on the chef.
- There are already plans for a third restaurant (2021) that will increase earnings and ROE for the investment. Would McCain proceed with it?
- Since the offer price from McCain is close to the JV calculated value, FVT may want to negotiate up to a price of $2,928,000, as well as negotiate for a good price on the light lunches. However, even with the negotiations on the light lunch costs, there is still a risk that McCain may not be willing to negotiate such a favourable price.
- The success of the restaurant depends somewhat on general box office revenues (due to the crossover benefits), which would decline if the crossover deal were no longer in place.
- The increase in disposable income for consumers should increase the demand for dining out and increase the revenue in the restaurant business.
- Since the restaurant business hires a lot of part-time labour, the restaurant costs may increase due to the labour shortage.

Assessment Opportunity #5 (Strategic Alternative #4 – Investment of PPV in Three Other Theatres)

Competent candidates will complete both a qualitative and a quantitative assessment of the "significant factors" related to making a decision on whether to roll out PPV in three more locations.

Quantitative analysis – *There is minimal quantitative analysis required for this alternative. Some data is given in the case, and some is to be taken directly from Cap 1 information. Candidates are only to calculate the investment cost using the 2017 data in Cap 1 and the impact on operating cash flows, net earnings, and ROE.*

Qualitative analysis – *Candidates are expected to identify that the investment in PPV supports the new mission and vision and draws on strengths and opportunities. The major drawback is where the funds will come from for this investment, given the urgency to invest now, when the prices are low, or the option to wait for six months to install the "leading-edge" technology, which is more in line with FVT's new mission and vision.*

Candidates should consider both the quantitative and the qualitative factors and draw conclusions/make recommendations based on a combination of the quantitative and qualitative analyses.

Quantitative Analysis

Key tools candidates could use/recognize:
- Net present value

Quantitative analysis:
- The NPV of the project is positive, as indicated in the case.
- The initial investment is $2 million per location (three locations), for a total of $6 million (case fact).
- The $6 million required is higher than the board's spending limit of $2.5 million; can't implement in all three, but could maybe do one or two.

Some candidates might suggest that only one location be upgraded, which would cost $2 million and be within the spending limit.

<u>Objectives and impact on earnings, cash flows, and ROE, etc.:</u>

Since this is a positive NPV investment, it is an investment that will add value to FVT.

- Annual operating cash flows (before tax) to increase by $1,150,000 (case facts). Amortization is over 10 years (Cap 1 Appendix XIII), calculated to be: $6,000,000 ÷ 10 = $600,000
  Net earnings: (1,150,000 − 600,000) (1 − 0.25) = 412,500
  After-tax impact on operating cash flows: 412,500 + 600,000 = 1,012,500
  Impact on ROE: 412,500 ÷ (6,000,000 − 600,000) = 7.6%

The net earnings will increase by $412,500. The operating cash flows will increase by $1,012,500. The ROE on just this investment is initially 7.6%, which will increase as the net book value of the assets declines with annual amortization. This investment will cause ROE to increase or stay about the same, since 7.6% is a little greater than the current ROE of 7.4%, but it does not achieve the goal of 10% by 2021.

The investments will increase cash flows, net earnings, and ROE.

Qualitative Considerations

Key points from Cap 1 that could be integrated:

- FVT has invested in PPV in four auditoriums already, to provide a premier entertainment experience.
- Charging a premium price increases the average box office revenue amount per attendee.
- The investment also increases concession revenue, increasing net earnings and concession revenue per attendee.
- Investment in new technology is a KSF.
- The investment increases the number of theatres that provide a premium entertainment experience.
- The average PPV admission price is currently $19.70 from Appendix II (which is slightly higher than that of $19.50 with the $10 premium (75% × $20 + 25% × $18) originally forecasted in Cap 1).

Key points from Day 1 that could be integrated:

- Customers are willing to pay more to have a premium viewing experience.
- If debt is added, this will increase the long-term debt to EBITDA ratio, moving it closer to the $2.5 million investment maximum.
- Interest rates are increasing, so if debt is added, interest expense will be even higher.
- Although this is an investment in updated technology, by January 2021 (in about eight months) it will be completely out of date due to the introduction of new products in 2021. To comply with the mission statement, it might be best to wait the eight months and purchase the state-of-the-art technology. This would be more in line with the new mission to invest in leading-edge technology.
- Viktor supports this investment since he has seen how successful it is and he recognizes that customers are asking for this.
- Zobair believes that it can be done now more quickly and with less lost revenue than previously.
- The four auditoriums that had PPV upgrades have produced strong results (supported by sit. analysis quants).
- This is still in the film exhibition business, which the company is trying to move away from.
- Although a higher price can be charged, film costs are also increasing (and film costs are tied to revenues), which may cause margins to decline.

- One of the company's objectives is to reduce the debt, and Lanny is not in favour of borrowing to make this investment, so he wants to put off the investment until the total $5.8 million (he says $6 million) is available in cash.
- Lanny raises a legitimate concern about where the cash is going to come from; using debt (line of credit) is not consistent with the objective of reducing debt.
- There is only limited cash available. If FVT makes this investment, there will be no cash available for any of the other alternatives being considered, in particular the VRT and the closing of Sarnia, which requires some upfront cash flows.
- Stephanie is more concerned about how this will look — FVT is closing Sarnia locations and at the same time spending a large amount to renovate other locations. This may have a negative impact on the company's reputation and employee morale, since employees may be terminated if Sarnia is closed.
- This investment does require more part-time labour, which may be affected by higher costs due to the labour shortage in the market.
- The increase in consumer disposable income should increase the demand for the PPV experience.
- FVT is less focused on revenue per attendee and more focused on growing profits.

Financing Options

Viktor suggests using the line of credit. In 2019, the company renewed its line of credit from the bank. The maximum credit line available is $5 million and currently bears interest at 3.8% (prime, which is currently 2.8%, plus 1%). The company could use some combination of cash on hand and debt to finance this investment. Although the company wants to reduce debt to nil, using debt can actually increase the company's ROE. In this case, the interest on the debt is 3.8% but the return on the investment is in excess of 12%. This would not achieve FVT's goal of 10% by 2021. If interest rates increase, this would further reduce the net return. Any difference will accrue to the shareholders. (Note: A KSF is capital investment.) However, there is a loan covenant of long-term debt to EBITDA that cannot exceed 2.5 (FVT has room currently).

Assessment Opportunity #6 (ADDITIONAL ISSUES – Ethical/Customer Loyalty Program; Governance; Shareholders; Zobair)

Competent candidates will reasonably discuss the impact of the error on customers and on FLIXREWARDS' and FVT's reputation. Candidates should see that there is no choice — the error needs to be corrected, customers advised, and FLIXREWARDS paid. Candidates should discuss the need for the company to act ethically and in the best interest of FVT or they will be committing a fraud.

Candidates should focus on describing how the shareholders are reacting and if a change to the board positions should be made. Candidates should raise questions about Zobair's recent activities and comments.

The candidate completes a qualitative analysis of the error in the customer loyalty program.

Customer Loyalty Program

The company knows that the amount is incorrect but needs to decide how should it handle the error correction. Materiality is not relevant here, and the company needs to do the right thing. If the company does nothing and just carries on from here without going back and making the corrections (as suggested by Zobair), then this is fraud. Therefore, this becomes an ethical issue for the company if FVT doesn't make the right decision.

The following points need to be considered:

- The company made a commitment to the customers to award them with points, which it has not done.
- The company also signed an agreement to pay FLIXREWARDS a fee of two cents per point and, therefore, owes for the missing points.
- To put all of the blame on FLIXREWARDS (as again suggested by Zobair) is not taking responsibility for errors that FVT made and acting to correct them.
- To make this correction does not result in additional losses being incurred, since these are costs that should have been reported and were not.
- The balance in the accounts for the customer loyalty program liability is also understated at the year end and will continue to be understated unless the missing points are recognized. Although FVT had originally predicted that only 80% of the points would actually be redeemed (from Cap 1) and the total amount of the error might not be material for reporting purposes, it is still material to the board. In making ethical decisions, dollar materiality is not relevant.
- [With respect to making the prior period adjustment for the error in FVT's financial reports, if it is not material, then we would not have to restate and reissue the prior year's reports. (Note: IAS 8.41 states that corrections of material errors only need to be made retrospectively.) The correction can be made in 2020, and any adjustment will increase current costs.]
- The auditors should be made aware of the error and how FVT plans to correct it.
- The company's reputation will also be affected. It is likely that some customers have already noticed the missing points and not yet mentioned it to FVT.
- The IT control environment is probably weak, since this problem arose. Proper testing, supervision, or review has probably not been done.

Ethically, the correction for the missing points must be made. FVT should contact FLIXREWARDS immediately to advise them of the error and the correction required, and it should pay the fee amount. Customers should also be advised of the error and that the correction has been made retroactively. The liability needs to be adjusted to the correct amount, with the adjustment expensed in the current year.

Zobair

The other major issue arising from this is Zobair's unethical comments on how the company should proceed: either to not go back and correct it or to blame FLIXREWARDS for the mistake and make them pay. This brings into question whether he is fit to be a board member and business partner. Candidates should acknowledge that although the family has majority ownership of 93.75%, they will have to be cognizant that the minority shareholder, Zobair, also has rights that need to be considered in all decisions. This may affect the dynamics at board meetings.

Zobair has made comments and taken actions that should cause the board members to question his honesty and ethics and whether he is acting in the best interests of FVT. Another example of this is that Zobair has offered to purchase Fred's share of CBG without advising FVT. He has also reviewed the JV agreement (in secret) to determine the exact buyout offer that the agreement requires. This is a conflict of interest and also unethical. He also knew that McCain was going to propose an offer for CBG and did not let the board know. If this offer is accepted by Fred and the McCain offer is rejected, then Zobair will also be a JV partner in this venture. At the same time, Zobair's wife will be the chef in the restaurants. This will certainly cause conflicts to arise, since Zobair's bias will be to protect his own personal interest when it comes to decisions in CBG, whereas, as a shareholder of FVT, he should be representing FVT's best interests. Zobair and FVT will have to agree on how to work through any of the issues that arise, and Zobair should declare a conflict and remove himself from FVT discussions concerning CBG.

The board may have made a mistake in having Zobair join the board. The shareholders should be concerned about how Zobair is representing the company and the types of comments he might be making with customers or suppliers. Zobair does not appear to be acting in the best interests of FVT. In light of the above discussion, the Lightfoots may want to look at how to buy out Zobair's shares. Is there a shareholders' agreement that outlines how to deal with this situation? The Lightfoots may wish to seek legal advice on how to proceed.

Stephanie

Stephanie appears reluctant to change from the vision set by Kent and Sheila, despite indications in the industry that change might be required. Indicators of how the existing shareholders have adapted to changes, in contrast with Stephanie, are as follows:

- Stephanie was the sole shareholder against the change in vision and mission. The remaining three shareholders supported the change in direction.
- Stephanie's bias is to not invest in any opportunity that would be against the original vision of Kent and Sheila. She seems to be "stuck in the past" and continues to want to only invest in the theatres, regardless of what changes are occurring in the industry and the economy, and the financial impact of sticking with just theatres. She appears to be more concerned about the company's reputation than its financial growth.

Her preferences in each of the alternatives considered appear to contradict those of most of the other shareholders. Candidates may question whether Stephanie has the ability to lead the company under this new vision and mission when she was against it and seems reluctant to change, given her stand on each of the opportunities presented.

This is a tough issue for the candidates to raise with the board, with Stephanie being the current CEO and chair of the board. All candidates can do is suggest to Stephanie that she listen to her fellow board members and to let her know it is okay to move into the future for the company to survive.

Summative Assessment #3 (Conclude and Advise)

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

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

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

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

Competencies
Enabling 2.1.4 Integrates information to investigate each potentially viable solution or conclusion.
Enabling 2.1.5 Recommends and justifies a solution or conclusion based on an integrative view of information for the situation.

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

The candidate completes a logical conclusion that **integrates** the analysis for all four major issues (VRT, Sarnia, CBG, and PPV).

The final recommendation should tie back to the mission and vision, as well as the financial objectives to increase net earnings and operating cash flows by 5% in 2020, increase ROE to 10% by 2021, maintain the term loan covenant, and continue to reduce the debt to nil. The other constraint is that the company only wants to spend $2.5 million in total, so all of the recommendations must not require more than a total of $2.5 million of cash.

The following are some highlights to keep in mind:

Candidates should consider key elements. FVT is trying to hold on to its market share by investing in technology in the film exhibition industry, and it is also trying to diversify its profits away from its heavy reliance on film exhibition. Candidates should weigh the risks and opportunities for each of the options, consider the ethics, etc.

The recommendation should be consistent with the analysis performed. As well, an overall conclusion should be presented to provide a sense of completion to the report (a wrapping up/prioritization of the recommendations).

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

A competent candidate will conclude the following:

- The Sarnia locations should be closed because they have had nothing but losses and there is no indication that they will have breakeven volumes in the near future. They are not consistent with the new mission and vision.
- The PPV investment of $5.8 million does not meet the constraints of no new debt and investment of no more than $2.5 million. Some candidates may decide to upgrade only one location, but they should keep in mind that as soon as this is installed, it will not be leading-edge technology.
- If CBG were sold, there would be additional funds available to spend — the company would have additional available cash of $2,062,500 before taxes. This would give the company $5 million in total to spend. However, the company could lose the significant savings on light lunches that it currently has (representing 17% of current net earnings). Even if a favourable price could be negotiated, the agreement would be for a limited period of time. If FVT wants to retain CBG, then, given the issues with Zobair, it should buy Fred out. This would give it total control over all of the profits generated by CBG and also control over the discounted prices paid for the light lunches.
- The VRT investment appears to meet the new vision and mission, except it would have no immediate impact on cash flows and net earnings and is a high-risk investment. It would cause ROE to initially decline. However, there would be a large payoff and return once sold, assuming the product can be developed. Candidates may conclude either way (provided it is consistent with their analysis).
- The governance issue surrounding Zobair and his unethical behaviour needs to be addressed. Included in this discussion needs to be the fact that he is a minority shareholder but has not acted in the best interests of FVT with respect to CBG or the loyalty points program.

Summative Assessment #4 (Communication Hurdle)

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

Yes – The candidate adequately communicated his/her response.

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

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

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

Summative Assessment #5 (Overall Assessment)

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

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

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

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

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

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

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

1. Did the candidate step back and see the bigger picture, and then address the broader issues identified?
2. Did the candidate prioritize the issues by discussing the major and minor issues in appropriate depth?
3. Did the candidate use both quantitative and qualitative information to support their discussions and conclusions?
4. Did the candidate use the appropriate tools to perform quantitative analysis?
5. Did the candidate use sufficient case facts (Day 1 case and Capstone 1 case) about the external and internal environment to support their discussions?
6. Did the candidate communicate their ideas clearly, integrating and synthesizing the information?

SAMPLE RESPONSE – FVT VERSION 1

Below is an actual passing candidate response.

TO: Board of Directors FVT

FROM: CPA, RCC

DATE: May 2020

RE: Analysis of Issues Presented

SITUATIONAL ANALYSIS

Mission and Vision

The mission and vision were updated at the most recent board meeting to the following:

Vision - to be at the forefront of providing premier and, state-of-the-art entertainment to our guests.

Mission - to provide a premier and state-of-the-art entertainment experience tailored to the local community. We accomplish this by investing in leading-edge film projection technology in order to be the first company to implement this technology for our customers' viewing experience. We also strive to train employees to be respectful, attentive, and friendly, select films that best appeal to the local community, ensure clean and safe venues for employees and attendees, and support entertainment and arts in the local community.

Based on the changes the company wishes to focus more on technology upgrades and being a first mover in the industry to provide a premier guest experience. However, there is still a focus on providing services tailored to the local community.

Key Success Factors

As previously determined, the key success factors for FVT are:

- diversification of revenue streams
- large part time staff

- premier guest experience
- low/controlled operating costs
- low film licence costs
- film offerings tailored to the local community
- up-to date technology - in particular it is becoming increasingly important to implement upgrades very early in their development
- facilities which are updated/well maintained

A previous key success factor was that the company was a family run business. However, although the family still controls most of the shares, an outsider was invited to invest in the company in January for 1,000 common shares.

Objectives

The objectives of the company have changed slightly to be less focused on revenue per attendee and more focused on growing profits, including the following:

- operating cash flow increase by at least 5%
- net income increase by at least 5%
- improve solvency ratios (continue to pay off the term loan)
- return on equity of 10% by 2021

The mission, vision, key success factors and objectives of the board should be considered when analysing the operational issues.

STRENGTHS

- FLIXREWARDS has been very successful, with more people signing up than projected.
- The PPV upgrades to four auditoriums have been popular with customers and have allowed the company to stay competitive technologically in those locations.
- The upgrades also allowed PPV to charge a premium for the movie experience which has increased revenues.
- The partnership with CBG has been successful and has improved margins and therefore profits in concessions for FVT.

- FVT was able to attract a new investor into the firm.

WEAKNESSES

- The Sarnia location has not been performing well as there is a competitor in the area offering a better experience (facilities and technology are outdated as they have not been upgraded for nine years). This appears to also be negatively impacting the company's reputation in the area.
- The CBG investment relies heavily on the knowledge and experience of Fred, who has developed health issues and will not longer be able to be involved in the operation of the company.
- FVT has had to increase its hourly part-time rate and changed part-time positions to full-time in order to compete for and keep qualified staff. This increases the operating costs of the company and is not in line with the key success factor of relying on part-time staff to help minimize costs.
- Kent and Sheila have retired from the business, which has led to a loss in relationships with film distributors and led to increasing film license costs. Film costs are also increasing because of the negotiation powers of the nation wide larger firms.
- There is disagreement among the management team regarding the future direction of the company.
- There are ethical issues which have come to light (Zobair's offer for Fred's shares which threatens independence and the treatment of the FLIXREWARDS program change).

OPPORTUNITIES

- Consumers appear willing to spend more of their discretionary income than in the past.
- Up-grades to technology, including 4D and luxury seating, have made the film watching experience different from home viewing, so more people are willing to pay to attend the theatre for the premier experience.
- The Canadian dollar is forecasted to be stable, which means that film costs should not be negatively impacted, and planning should be easier than if rates were expected to be fluctuating.

THREATS

- Industry growth rates for regular box office revenue have been nil and are expected to decline based on the popularity of substitutes. Therefore, the need to offer upgraded technology is being highlighted.
- Smaller companies are still being forced out of the industry due to the consolidation of larger nation-wide companies (who can negotiate favourable film license deals and take advantage of economies of scale to keep admission prices lower while attaining the same margins as smaller firms).
- Interest rates are increasing, so taking on debt will be more costly for companies.

QUANTITATIVE - based on a comparison of the ratios/benchmarks from previous years and the 2019 financials. Based on the figures presented in Appendix III, the following points were noted:

Liquidity

- Although still below the industry average, the current and quick ratios have improved from 2016 to 2019. However, there is still concern as the numbers are below one and the industry average that FVT may not have the available resources to meet short term obligations (may be a cash flow issue).
- Box office revenue per theatre has increased, but is below the industry benchmark. Improving the operating cash flow by 5% will help to improve the company's cash flow position.

Solvency

- As stated, one of the objectives has been to improve solvency ratios by paying off the term loan. FVT has been very successful in this area with ratios that have improved since 2016 and are better than benchmarks.
- Total debt to equity has decreased from 1.69 to 0.64 and is well below the industry average of 1.20. This shows that the company could in fact take on additional debt to finance future investments and is well within the debt covenant imposed by the lender.

The following decision factors should be considered when determining the direction of the company:

- The board of directors has limited FVT's total spending on investments at this time to $2.5 million;
- The decision must be in line with the mission, vision, objectives and key success factors as mentioned above;
- Profitability;
- Sustainability;
- Risk; and
- The company's reputation.

ANALYSIS OF STRATEGIC OPTIONS

The following is an analysis of the four key strategic options presented during the board of directors.

1. Investment in VRT

A qualitative analysis of the pros and cons of this investment includes the following:

PROS	CONS
- the company is already producing short films, so it appears that there will be the ability to apply the technology to full length films	- owner was unable to raise funds from traditional sources or crowd funding which indicates that this could be very risky/not a belief that it is feasible or desired by customers
- the owner has technical experience and previous experience bringing technological advances to market	- R&D is very expensive, it may mean that the company is not able to finance the necessary amount to finish the project (may require more funds from FVT than forecasted which will negatively impact cash flows)
- would provide FVT with first mover advantage in virtual reality technology - low cost of implementation compared to competition and take advantage of ability to	- a return on investment would not be realized for five years and this is dependent on finding a buyer (require 30% return on this type of investment)

charge higher admissions at onset	
- allow for diversification of revenue streams, less reliance on general box office admissions which are forecasted to decline	- would only have 10% ownership for $2 million dollar investment
- there have already been offers from 3 potential buyers to purchase the technology	- losses are expected for the next five years
- FVT would have the right to purchase the technology at a 20% reduction to the selling price which will give the company a competitive advantage in the future.	- there could be other companies also working on developing the technology which would be closer to releasing their product, so there is the risk that FVT would invest and lose out on the first mover advantage.

In addition, a quantitative analysis was taken from Appendix V and completed in Exhibit I. From the analysis the following was noted:

- more information regarding the negative cash flows is required (if additional investment will be required from FVT) in order to calculate the NPV of the project for FVT.
- based on the information provided, the annualized return

The investment appears to be in line with the updated mission and vision as it would allow FVT to be at the forefront of development in a new technology which will be state-of-the-art and provide a premier guest experience.

It does not appear that there will be any financial reporting decisions immediately regarding this investment as FVT will not have significant influence (therefore, the investment will be recorded at cost on the financial statements). However, in the future, if FVT takes the option to purchase the company you will have to determine how to account for the subsidiary (consolidation, equity method or cost method). In addition, costs associated with research and development of intangible assets will have to be examined to determine if they should be expenses or capitalized at that time.

Recommendation

Based on the qualitative and quantitative analysis above, I would suggest that FVT not invest in

VRT because of the high level of riskiness (possible profit in five years).

2. Sarnia Locations

The issue has been raised regarding whether the Sarnia locations should remain open as is, remain open and lower prices, be closed, or be updated and the impact that each will have on FVT.

A. Remaining Open (As is, or lowering prices, or Upgrading)

From a qualitative standpoint, the following should be considered:

- The company would maintain a presence in the area for the loyal customer base.
- The reputation may still be negatively impacted as the theatres do not offer the technology of other theatres owned by FVT or competitors in the area (the theatres have not been upgraded in 9 years).
- The general admission revenues are expected to decrease across the industry, so it is likely that revenues from those locations will continue to decrease.
- To not update the facilities and have them remain open is not in line with the revised vision and mission of the company to provide state of the art technology.
- Wages would have to be increased to retain staff, which will lead to further decreases to profits.
- The competition are charging the same price but offering a better experience.
- Improvements would require cash flow and would mean that other investments could not be made to diversify, etc.
- Charging a lower price could negatively impact other theatres as customers may feel that it is unfair to pay more for the same service in another location if they are unaware of the lack of upgrades.
- Even if the theatres remain open there is likely impairment of the goodwill, which should be examined.

From a quantitative perspective, as per Appendix VI:

- All three options result in operating losses, although the contribution margins are positive. Therefore, the allocation of fixed costs should be examined further to determine if this is negatively impacting the analysis. This is supported by the fact that closing the theatres will result in only $95,000 savings although $310,900 of fixed overhead relating to head office is currently being allocated to the theatres.

- More information would be required regarding the costs of the upgrades in order to determine a the NPV of the renovation. However, given that there are operating losses it does not appear that the NPV would be positive.
- Under all the options the attendance does not meet the required break even, which further indicates that the theatres should not be maintained.

B. Closing the theatres

From a qualitative standpoint, the following points should be considered:

- The reputation of the company could be negatively impacted by the closure if customers feel abandoned.
- Staff would have to be laid off, which could also negatively impact the image of the company.
- While there would be initial costs associated with the closure, this would remove operating losses going forward for those locations.
- Closing the theatre is not in line with the focus on the local communities based on the job losses.

From a quantitative standpoint, the following was noted from Appendix VI:

- More information is required to determine the loss on the closure as some of the leasehold improvements and equipment could possibly be sold to other theatres (although this is unlikely given that it is outdated).
- Inventory may be able to be transferred to another location.
- The total cash outflows required to sell are $659,031, most of which relates to lease cancellation penalties. The remainder is $160,000 to remove leasehold improvements and $50,000 for severance payments.

To summarize, the three options were compared against the decision criteria in Exhibit II.

Recommendation

Based on the decision criteria matrix and the points outlined above, the Sarnia locations should be closed as the break even number of guests cannot be achieved and the theatres will continue to operate at a loss which will just be further negatively impacted by increasing operating costs. To mitigate the impact on the company's reputation in the area residents could be given coupons to the nearest FVT location and staff could be offered jobs at other theatres where there is room (this may help to retain qualified staff).

There will be financial reporting impacts as the operations will be considered discontinued and any assets which can be sold will be classified as "held for sale", rather than remain included in net assets on the balance sheet. This will have a slight negative impact on the debt to equity ratio as earnings will be decreased in the year of the closure. However, going forward there should not be an impact.

<u>3. Connery's Bar and Grill</u>

As Fred's health has deteriorated, the issue of whether to sell FVT's interests in the business, buy Fred's shares or work with Zobair and his wife has been raised.

Before evaluating the three options, the value of the company has been determined in Exhibit III as approximately $2,924,000.

A. Sale to George McCain

Qualitative Analysis

- would allow for the company to exit the industry following the loss of Fred's expertise and operational guidance.
- Provide funds for investment in other ventures.
- Would be a loss of a positive income stream and cash flows which is not in line with objectives of the board.
- Would be a loss of a revenue stream separate from the theatre business.
- FVT would no longer benefit from savings for concessions based on being sold food at cost, which will result in decreased margins/profits.
- Would no longer be cross-over benefits of discounts between for movie goer's and dinners.

Quantitative Analysis

- based on the value of the company determined the price offered is less than what the company is valued at.
- FVT would receive $2,062,500 for it's ownership percentage (in cash) on June 30, 2020.

B. Buy Fred's Shares and Continue Operations

Qualitative Analysis

- The management team does not have any experience operating a restaurant as they have allowed Fred to run operations.
- The restaurant has been proven to be very profitable, so even with new management the company should be able to continue this trend.
- There could be negative implication for the board/managment team if this route is taken as Zobair could be resentful if his wife is not given an opportunity to be a chef as desired.
- The restaurant business is highly risky, which is magnified by the board's lack of experience.

Quantitative - Exhibit IV

- based on the calculations it will cost $700,000 to buy the shares from Fred as this amount was offered by Zobair (have the opportunity to match).
- However, when calculated the amount was much higher based on the agreement at over $2 million.

C. Continue with Zobair and his wife as partners

- There could be potential independence and conflict of interest issues based on Zobair's current position.
- Neither him or his wife have experience at this point in time and may not be able to earn the profit that Fred does currently.
- The current agreement between the two companies (concessions, discounts), would continue which is favourable for FVT.
- FVT would still be involved with the risky restaurant industry.

Recommendation

Based on the analysis above, the shares of the business should be sold to McCain as this will provide funds to invest in technology. Although this will result in a loss of a positive revenue stream, there is no guarantee that it would continue to be as profitable with Fred's absence, especially given the high risk associated with the industry. In order to maintain a similar advantage FVT should approach other restaurants in the area to establish a similar relationship, perhaps with multiple operations or chains which could still include food at cost for the potential increase in patrons.

3. PPV Upgrade

Qualitative analysis:

PROS	CONS
- PPV upgrades have been well received and resulted in increased profits	- it is not the "newest" 4D technology
- will help to mitigate decreasing attendance at general admission theatres	- there is a rush to invest to take advantage of cost savings
- FVT already has the knowledge and experience in the area and should be able to proceed quickly as a result which will decrease the negative impact of shut-downs	- $2 million is required for each location, which is all of the investment dollars available
- the upgrades will take place in three different areas potentially, allowing for differentiation in those markets	- the theatres will have to be closed for the renovations, causing a decrease in revenues/profits
- customers have been asking for the upgrades	

Quantitative analysis - Appendix II:

- based on the information provided the NPV for the project is positive. This means that the investment should take place.
- The attendance per theatre is higher at the three proposed locations than at Sarnia.
- There would be some cannibalization of attendance, as movie goer's would be attending the PPV rather than regular. However, this impact is mitigated as the cost per attendee is almost double, which will increase NI.

Recommendation

The company should invest in the PPV upgrades at the three locations. However, given the cash flow constraints it should be done in phases with the theatre that has the highest attendance per auditorium first (Chatham, then St. Thomas then Tillsonburg). Woodstock should also be considered given that it has higher attendance and is in a larger city (larger potential customer base) given the control issues at that location have been addressed. This should be delayed however until the new technology is released, as rushing to implement outdated equipment is not in line with the mission and vision.

OPERATIONAL ISSUES

Financing Investments

The required investments can be financed from the sale of the shares in CBG. This will result in an immediate influx of cash of over $2 million in June and will also cover the expenses required to close the Sarnia locations (assuming this is in addition to the $2.5 million allocated for investment). This would allow for PPV to be implemented at two locations in January 2021 when the new equipment is made available.

In addition, it will allow for the company to continue to pay off long-term debt (improve solvency) and will allow for the company to invest in future opportunities similar to VRT but with less risk.

Ethical Issues

Based on discussions with management there were two ethical issues raised.

The first is that one of the board members made an offer for Fred's shares before mentioning the offer from the outside buyer in order to help his wife. This shows a lack of independence, as he was operating in a manner to better position his wife in the future rather than FVT. In order to avoid similar instances in the future a Code of Conduct should be implemented to address such situations and the potential consequences.

The second issue was the error in the points awarded to FLIXREWARDS members as a result in the program change. All customer balances should be updated to the correct amounts despite the negative financial impact as it would be unethical to do otherwise and could have a substantial negative impact on the company's reputation. Members may decide to leave the program in favour of the company if the discrepancy is noted. The issue should also be raised with FLIXREWARDS so that it can be fixed on their side as well.

CONCLUDE AND ADVISE

In conclusion, the company should sell it's ownership interest in CBG in order to finance the investment in PPV in additional locations. However, this should be postponed until new advanced system is launched in January 2021 in order to be in line with the mission and vision. FVT will be able to take advantage of a first mover in this area.

In addition the following was determined:

- FVT should not invest in VRT at this time because of the high level of risk and the high level of uncertainty regarding the project. However, given the additional cash flows from the sale of CBG, following further research it may be beneficial to invest in the project at a later date when more of the associated costs and information on potential competition is known.
- The Sarnia locations should be closed to end operating losses, as they are projected to continue and will increase due to increases in operating costs. Although the closure will negatively impact cash flow this year this is only temporary. The harm FVT's reputation in the area can be mitigated by offering coupons to residents for other locations as well as offering jobs to employees at other locations if possible.

Exhibit I - Investment in VRT

	Initail Investment	Potential Return (10% ownership)
	-2000000	10000000 10% of the total potential return
	-2000000	9633911.368 PV
Therefore, the rate of return is	3.816955684	

Therefore, this does not meet the required rate of return of 30%.

Exhibit II - Sarnia Locations Decision Matrix

	Investment Req	Mission/Vision	Profitable	Sustainable	Risk	Reputation	Objectives of Board
Remain Open As Is	no	no	no	no	low	negative	- not met as operational loss, no improvement in NI
Remain Open Decrease Admission	no	no	no	no	low	negative	- slight improvement in cash flow but not meeting other objectives
Remain Open and Upgrade Facilities	yes	yes	no	no	moderate	positive	- increase in cash flows (substantial) but does not meet other objectives
Closure of Theatres	no	-	no	yes	low	negative	- initial cash outlfow would not meet objective but future increase in NI as operating losses eliminated

Exhibit III - CBG Valuation

The investment is 75% of CBG	2193 (1000s)
Therefore, 100% is	2924

Therefore, the value of the company, based on the investment, is approximately $2,924,000.

Exhibit IV - Cost to buy shares from Fred

25% of the investment (Fred's share) 731

Based on the JV agreement the price to buy out the other party is:

adjusted annual net earnings x multiple

adjusted annual net earnings = net earnings + fred's salary after tax - after tax cost of replacement

	(in thousands)	
Net earnings	413	
Fred's salary after tax	112.5	(450*25%)
Replacement after tax	87.5	(350*25%)
	438	

Multiple = 1/17% = 5.882352941

Therefore, the agreement price is 438*5.88, which is approximately:
$2,576,471

Exhibit V - Attendace per Auditorium

Chatham	49125.55556
St. Thomas	40158.33333
Tillsonburg	38553.33333
Woodstock	53138.75

APPENDIX E

THE COMMON FINAL EXAMINATION
DAY 1 FVT VERSION 2 BOOKLET – SEPTEMBER 12, 2018

COMMON FINAL EXAMINATION
SEPTEMBER 12, 2018 – Day 1

<u>Case</u> (FVT-Version 2) (Suggested time: 240 minutes)

It is May 5, 2020, and Chris Renker, your boss at Renker and Curtis Co. Management Consultants tells you that the original consulting team has another consulting engagement with First View Theatres Inc. (FVT).

Several Canadian manufacturers and producers have ceased operations recently, and in the next twelve months, more closures and layoffs are expected in southwestern Ontario. Interest rates have started to rise and are expected to increase significantly in the short term.

The viewing industry continues to invest in technology. Theatres that lack premium auditoriums have experienced a further decline in attendance. A number of smaller operators have closed, increasing large competitors' ability to negotiate favourable supplier contracts. To increase attendee numbers and revenues, companies are offering different products and services. One positive note is an increase in demand for independent films that cannot be viewed at home. Many operators are showing this type of film in their theatres, with positive results. Attendees are willing to pay the higher admission fee.

In 2017, FVT purchased Cinema LaRoche (CLR). Since that time, the attendees and revenues at the Quebec theatres have been increasing and represented more than 50% of FVT's revenues in 2019. However, the profits from Quebec have been declining for two reasons. First, in 2018, the Quebec government increased the minimum wage by 30%, causing wages to increase significantly in 2018 and 2019. Second, FVT's management has had difficulty integrating the two companies.

After the CLR purchase, FVT successfully introduced the film club concept to Ontario. FVT has been showing independent films to its film club members since January 2018. However, because FVT is a very small player, it is paying higher film licensing fees for all types of films in comparison to the larger, national competitors.

In January 2018, FVT opened The Games Place (TGP) in London, and in November 2019, FVT closed both Sarnia theatre locations. FVT did not proceed with the other major investments that were being considered in 2017.

FVT has suffered more than its competitors as declining attendance (7,336,364 in 2019) has resulted in lower purchase volumes, declining revenues per attendee, and higher negotiated prices for film licences and for food and beverages. Profits and operating cash flows have decreased. FVT has maintained its capital assets but no additional funds have been invested in technology. With little cash on hand, FVT has focused on expanding services that require little capital investment. Bonuses were not paid last year after having been reduced in prior years. Focus has shifted from growing revenue per attendee to improving net earnings, with a goal of increasing net earnings by 10% in 2020. The Board of Directors would like the operating income and employee bonus amounts to return to 2016 levels within the next three years. The bank loan is at its maximum and cannot be increased.

The 11,000 outstanding common shares are owned equally by Stephanie, Viktor and Lanny Lightfoot. FVT has not had enough cash and First Lands Limited (FLL) has waived its annual redemption rights on the preferred shares since the last redemption in 2016.

FVT has expanded beyond theatres and wants to differentiate itself but still wants to ensure it provides a premier entertainment experience. The vision was reworded as follows:

"*Our vision is to ensure that our guests enjoy a unique, premier, entertainment experience each and every time they visit our locations.*"

The mission statement was not changed.

Chris asks you the following: "Please draft a report that will form the basis for my presentation to the FVT board. Take into account what you have previously learned about FVT, and highlight any changes in circumstances that affect the board's decisions. Assess the major issues facing FVT and discuss any significant factors FVT may not have considered. The board wants coverage of both strategic and operational decisions, but emphasis should be on the strategic elements. Where there is sufficient information, please suggest a course of action. Please identify what, if any, additional information should be obtained."

INDEX OF APPENDICES

APPENDIX I
BOARD MEETING DIALOGUE WITH CHRIS RENKER IN ATTENDANCE

Stephanie: Thank you, Chris, for attending our special board meeting. Since your last engagement, the management positions have not changed, but the following significant events have occurred:

2017	May 16	FVT sold its head office land and building, without a leaseback. FVT moved its head office to a new location and entered into a 10-year operating lease.
2017	July 6	FVT purchased the net assets of CLR for $17 million without taking on shareholder loan debt. The purchase price was paid with $13 million on closing and a $4 million note payable to CLR. The note payable to CLR bears the same interest rate and principal repayments as originally proposed by Marcel, with the first payment due in June 2020. FVT borrowed $5 million to finance the acquisition and secured the loan with the Quebec assets; the loan bears interest at 5%, with scheduled annual principal payments of $625,000, beginning on July 1, 2019.
2017	October 15	Stephanie purchased 1,333 shares from Viktor and 1,333 shares from Lanny. FVT issued 1,000 new shares to Stephanie.
2019	February 22	FVT negotiated a short-term bank loan with a maximum of $1.2 million. The loan is secured by the common shareholders' personal guarantees and a guarantee from FLL. The loan bears interest at 5% per annum.

Stephanie: We need to know the impact on our operating cash flows and net earnings for each of the issues we discuss today. We also want to know the impact on our operating income, as we want it to reach 5% of revenue in the longer term. For this meeting in particular, we must consider investments that could help improve our situation. Let's start with the TGP financials.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH CHRIS RENKER IN ATTENDANCE

Lanny: TGP has not been as profitable as anticipated, with a loss in 2019. Based on my staff's analysis, the poor results relate to the types of games and maintenance costs. Because we purchased the games, we are responsible for all related costs, which are 19% of revenue. We expected each game to last five years, but each game only generates reasonable levels of income in the first six months; after six months, revenues decline dramatically as customers are drawn to the new games. Once the novelty has worn off, they don't seem to come back.

Viktor: What about leasing the games instead? By letting our games supplier, All Games Inc. (AGI), absorb the risk of the games having shorter useful lives, I believe we can make this work.

Lanny: My staff prepared a preliminary analysis (Appendix IV). They estimated a positive operating income from entering into a lease agreement with AGI. The games lease would require that AGI maintain the games and replace them every six months.

Kent: This whole situation proves that we should stick to what we know – film exhibition. TGP, although unique, is not a premier experience and should be closed and its assets sold as soon as possible!

Stephanie: As I have stated many times, we must move away from the dying film exhibition industry. We need to give this strategy a chance.

Viktor: I agree with Stephanie. I see this as a way to diversify. We should try the leasing option for a few years and see how it goes.

Kent: Based on the last few years' results, I am not convinced you three know what you are doing. Since opening TGP, has there been a drop in our attendance numbers? Is it taking customers away from our theatres?

Lanny: The decline in our London theatres' attendance numbers is consistent with declines in our other locations.

Stephanie: AGI is motivated to keep TGP open because this is the first location AGI has supplied in southwestern Ontario, and it wants to expand further in this region. AGI wants us to be successful. I vote to keep TGP open and negotiate for the best terms we can get from AGI.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH CHRIS RENKER IN ATTENDANCE

Lanny: The games lease will be for five years with the option to renew. Closing TGP and selling the assets would give us desperately-needed cash. I would rather use that cash for other opportunities than waste more time seeing if TGP succeeds. But we signed a long-term lease for the TGP premises, so I suppose we could give this concept another chance.

Viktor: It is too early to close TGP. We just closed Sarnia. Customers may begin to worry that FVT is in trouble.

Kent: Sheila and I will certainly not be providing another penny to keep TGP open.

Viktor: Lanny, why were these problems not brought to our attention earlier? The place has been open for two years. You should have seen that interest in the games is not lasting as long as we first thought. Are you sure you are on top of this?

Lanny: I was dealing with other matters and wanted to give TGP time to settle, to see if the problem was just because it was new. My staff is very good and report to me constantly. Even when I am not here, I keep on top of things.

Stephanie: Chris, we'll need an assessment of whether to accept a new lease arrangement with AGI and keep TGP open or to close it immediately. Let's move on.

Sheila: A local theatre group asked if we would consider renovating part of our Tillsonburg theatre to create a stage for live performances. The theatre group has been operating out of a local school but their audiences have grown and they need a larger space.

Kent: They would help finance some of the cost of the renovations, although, as a non-profit organization, the contribution size will depend on the success of its fundraising. FVT would cover most of the capital costs. We would be offering a permanent location for live theatre, with comfortable seats and great ambience. FVT would rent the location to the theatre group on an as-needed basis for a fixed rate plus a percentage of ticket sale revenues.

Stephanie: Do we know the cost, and how profitable it would be for FVT?

Lanny: My staff prepared a preliminary analysis (Appendix V). To provide a stage and theatre that seats 500, we will have to use two existing Tillsonburg auditoriums. This would leave seven auditoriums available for film exhibition.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH CHRIS RENKER IN ATTENDANCE

Viktor: This sounds more like a charitable donation than a business venture! Can this be profitable? We will be relying on the theatre group to choose the right plays to draw an audience.

Lanny: My staff estimated rental income, assuming a fixed annual rent of $180,000. The theatre group plans to produce six plays per year, three more than they can do in their current space. The total estimated rental income and share of revenue from the theatre group would be $188,000. Although the theatre group will pay rent for the full year, they only need the theatre for six months of the year for their rehearsals and performances. The theater group has agreed to let FVT rent the space out to others when not in use by them.

Stephanie: Tillsonburg is one of our more profitable theatre locations. I don't think this is such a good idea. How will the community react if we reduce the number of available auditoriums and show times? It could reduce, rather than increase, our earnings.

Kent: Many of the theatre people that I know have asked me to support this endeavour. It broadens our offering of unique experiences and is a great way to give back to the community. I'm convinced people will still attend the films. The other theatres will simply be fuller than usual.

Sheila: We could also tie this into our film club, perhaps by giving members a discount on the stage productions. We may be able to attract new clientele. The theatre group thought this might be a great way to promote each other.

Lanny: I think the payback period is more than the five years that we would ordinarily look for, ignoring the tax benefit for the capital cost allowance. This sounds like a very risky venture. What if the theatre group suddenly shuts down?

Kent: Oh, that will never happen. The group has been around for more than thirty years and is very well supported by the community. Your payback estimate sounds too conservative. Maybe you should look at it again. Sheila and I are willing to help finance FVT's share of the costs. Any funds we advance would be interest-free with no fixed repayment terms. In fact, we might even forgive the loan at some future date.

Lanny: The analysis assumes we are renting to other groups wanting stage and auditorium seating. We have not done any research to validate this amount.

Kent: Why not, Lanny? I brought you this idea a month ago, and specifically asked that you research it.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH CHRIS RENKER IN ATTENDANCE

Lanny: I didn't have time, and I was waiting for this meeting before going further. I'm prioritizing my department's work, which is my prerogative. By the way, this live theatre investment will only add to my staff's workload.

Stephanie: Never mind. Let's work with the numbers we have. I would like Chris to provide an opinion on this potential investment.

Let's discuss concession costs next. We have been approached by Theatre Buyers Group (TBG), a group of small, regional theatre owners like us. There are already one hundred members in this new buying group, which operates primarily in western Canada and Ontario.

Viktor: As Lanny was unavailable, Stephanie and I met with a TBG representative. There is an annual membership fee of $25,000 to cover administration costs. Membership allows us to purchase selected concession products at the cost negotiated by TBG, which is about 15% below our current costs. While TBG controls what we buy and from whom, they only use Ontario suppliers. This deal would bring our concession costs down to 23% of concession revenues.

Stephanie: There are other conditions. First, we must commit to a three-year membership and to a minimum purchase volume for the three years based on the previous year's sales volumes. Also, their invoices are payable in 10 days and we must be willing to share some financial information, such as concession revenues, with the other members.

Kent: I am not willing to share any financial information with competitors! They will find out about our business and that our profit levels are dropping.

Sheila: Calm down, Kent. We might learn something about our competitors. I think it is more important to reduce our concession costs than to worry about sharing limited financial information.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH CHRIS RENKER IN ATTENDANCE

Lanny: I talked to KC Corp. (KC), our current supplier, to see what they could do. KC sources from the U.S. and said that, if we would agree to a fixed U.S. dollar price and assume the risk of the foreign-currency exchange rates, they would give us a 10% discount from our current costs, which would bring our concession costs down to 25% of concession revenues. They want us to commit to a minimum product volume for five years but are willing to negotiate the amount. KC's payment terms remain at 30 days.

The Canadian dollar is supposed to increase in value in the next few years. If exchange rates move in our favour, which I think they will, our savings could be even more than 10%. I like this proposal better than TBG's because we already know KC.

Viktor: Why haven't you asked our supplier for this type of contract before? Is it not your responsibility, Lanny, to manage these costs?

Lanny: I cannot do everything around here!

Stephanie: Chris, can you please identify the advantages and disadvantages, and inherent risks in the two agreements? I now want to discuss our investment in Quebec and what we are going to do about it. As you know, profits continue to fall. For 2019, Quebec contributed $4 million to FVT's EBITDA and $1.2 million to operating income.

Viktor: I propose that we get out of Quebec and sell the net assets. I have found it very difficult to deal with management. They have ignored all of my suggestions. I get the feeling they don't want to cooperate with us. I am ready to pull the plug on this investment. I blame Lanny for this mess. He asked to manage this acquisition.

Lanny: Don't blame me! You know very well that any acquisition takes time to integrate. And how was I supposed to plan for a legislated increase in minimum wage? I recently changed the manager for the Quebec operations. I have a lot more confidence in this new person. Let's give them at least another year.

Stephanie: I am not sure we have another year, Lanny. Honestly, I am not sure where we are going to get $1 million to make the first payment on the note payable to CLR. The bank has indicated that it will renew the long-term loan but will increase the interest rate to 8% and, in addition to the collateral, will require that we maintain a total debt to EBITDA ratio of 4.0 or less. Unless FVT's earnings increase, we will not be able to meet this new covenant.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH CHRIS RENKER IN ATTENDANCE

Kent: Sheila and I went to Quebec to see for ourselves what was going on, something that you have not yet done, Lanny. We spoke with Marcel and the local managers, who were very easy to talk to, and they realize that changes need to be made. In fact, they gave me a list of items that seem to have never been acted upon. Lanny, did you ever receive any such list?

Lanny: Yes, I did, and I thought I had told the manager to do whatever needed to be done.

Kent: Really? Sheila and I think we can get this all sorted out if, like our competitors, we increase prices to compensate for the higher wages. We would have Quebec generating significantly higher profits by the end of 2020, and we'd realize some of the expected synergies.

Sheila: I was quite impressed with our Quebec division and think there is a lot of potential. Kent and I have already made arrangements to move to Quebec for the next four months to be more actively involved until all the issues are resolved.

Stephanie: What? I spoke to Marcel yesterday about the note payable. CLR is prepared to buy back the net assets at 70% of the price we paid. I don't think we can wait and I am inclined to accept his offer, since it will resolve all our cash and debt problems.

Lanny: But we would be selling the assets for far less than their current market value. Based on recent acquisitions, the net assets could be sold for at least their book value of $13 million.

Viktor: I think we should take the offer. We can use the cash from the sale to invest in new areas rather than wasting it on CLR.

Kent: Stephanie, Marcel told me he spoke with you. He also talked to me yesterday and said that if we wished to keep the theatres in Quebec, he would be willing to change the terms of the note payable so as to defer the due date of the first payment until 2021, as long as we agreed to pay interest at 5% on the note.

Stephanie: Chris, can you please summarize reasons for keeping or selling the theatres in Quebec?

Thanks to everyone for participating.

Chris: Okay. I have a good idea of what you need and will start work on it immediately.

APPENDIX I (continued)
BOARD MEETING DIALOGUE WITH CHRIS RENKER IN ATTENDANCE

A few hours later, Stephanie telephones Chris.

Stephanie: Chris, this call is concerning Lanny. In March of 2019, he announced that he would only be working four days a week since he had such reliable staff in the office. The reality is that he is only working, at most, one day a week, yet is still drawing the same salary as Viktor and me. Is that fair?

APPENDIX II
INDUSTRY BENCHMARKS

Ratios	2016 Benchmark	FVT 2016 Actual	2019 Benchmark	FVT 2019 Actual
Average box office revenue per attendee	$9.10	$8.67	$8.75	$8.25
Average concession revenue per attendee	$5.25	$4.95	$5.15	$5.02
Film costs as percentage of box office revenue	52%	59%	54%	56%
Concession costs as percentage of concession revenue	23%	25%	24%	27%
Current ratio	0.67	0.3	0.75	0.1
Operating margin	9%	5%	7%	3%
Net profit margin	6%	3%	3%	1%
Return on assets	5%	4%	4%	2%
Total debt to equity	1.2	1.69	1.5	1.8

APPENDIX III
INTERNAL FINANCIAL STATEMENTS

First View Theatres Inc.
Statement of Earnings
For the year ended December 31, 2019
(in thousands of Canadian dollars)

Revenues	
Box office revenue	$ 60,525
Concession revenue	36,826
Other income – arcade games	570
Other income – party room rentals	360
Subscriptions	5,129
TGP revenue – food and beverage	1,575
TGP revenue – amusement games	1,670
TGP revenue – special events	550
	107,205
Expenses	
Film costs	33,894
Concession costs	9,943
TGP – food and beverage costs	425
TGP – amusement game operating costs	317
Advertising and promotion	4,128
Amortization	6,492
Employee wages and benefits	19,641
Rent	8,236
Operating costs	17,370
General and administrative	3,781
	104,227
Operating income	2,978
Interest expense	(1,095)
Foreign exchange loss	(177)
Income before taxes	1,706
Income taxes (25%)	427
Net earnings	$ 1,279
Statement of retained earnings	
Balance, beginning of year	$ 16,336
Net earnings	1,279
Balance, end of year	$ 17,615

APPENDIX III (continued)
INTERNAL FINANCIAL STATEMENTS

First View Theatres Inc.
Balance Sheet
As at December 31, 2019
(in thousands of Canadian dollars)

Assets		
Current assets		
Cash and cash equivalents	$	20
Inventories		908
Prepaid expenses		612
Total current assets		1,540
Property, plant and equipment, net		59,094
Intangible assets		1,335
Goodwill		1,265
Total assets	$	63,234
Liabilities		
Current liabilities		
Bank loan	$	1,200
Trade payables and accrued liabilities		3,750
Film costs payable		3,883
Deferred subscriber fees		754
Income taxes payable		400
Deferred amusement games revenue		153
Games points redemption liability		107
Asset retirement obligation		236
Current portion of long-term debt – term loan		1,275
Current portion of bank loan – purchase of CLR		625
Current portion of note payable – CLR		1,000
Current portion of redeemable preferred shares		1,500
Total current liabilities		14,883
Long-term portion – term loan		11,486
Long-term portion of bank loan – purchase of CLR		3,750
Note payable – CLR		3,000
Redeemable preferred shares		7,500
Total liabilities		40,619
Shareholders' equity		
Share capital		5,000
Retained earnings		17,615
Total shareholders' equity		22,615
Total liabilities and shareholders' equity	$	63,234

APPENDIX IV
INFORMATION REGARDING THE GAMES PLACE (TGP)

Operating income from TGP

	2019 actual results	Estimated annual results if lease games
Operating income (loss)	$(436,700)	$ 34,700
Amortization	$ 760,000	$ 268,000

Related assets of TGP

Net book value of games	$1,476,000
Proceeds on sale of games	$ 500,000
Net book value of furniture, fixtures and equipment	$2,103,600
Estimated proceeds on sale of furniture, fixtures and equipment	$ 750,000

APPENDIX V
CONVERSION OF AUDITORIUMS FOR LOCAL THEATRE GROUPS

Financial information related to renting two converted Tillsonburg auditoriums to theatre groups

- Total estimated rental income and share of revenue from theatre group: $188,000
- Total estimated concession profits from theatre attendees: $43,200
- Total estimated rental income from other groups (not validated): $106,000
- No additional expenses are expected to be incurred

Financial information related to closing two Tillsonburg auditoriums

- Lost film admission and concession profits: $93,670 (loss consists of lost revenue of $170,000 after related costs of $76,330)
- Costs of renovating auditoriums: $800,000 (FVT would pay $650,000 and theatre group would pay $150,000)
- Lanny expects the renovations to have a useful life of eight years

APPENDIX F

DAY 1 (FVT VERSION 2) – SEPTEMBER 12, 2018
MARKING GUIDE AND SAMPLE CANDIDATE RESPONSE

MARKING GUIDE
FIRST VIEW THEATRES (FVT)
VERSION 2

Summative Assessment #1 – Situational Analysis (Update)

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

Enabling:
2.1.1 Defines the scope of the problem.
2.1.2 Collects and verifies relevant information.
2.1.3 Performs appropriate analyses.

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

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

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

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

Competent candidates should complete a sufficient and appropriate situational analysis.
The focus should be on describing the factors that have changed, that will affect the decisions to be made (e.g., economy), or on the key factors that are relevant to the decisions to be reviewed—so a recap of the mission and vision and key success factors, as well as highlighting changes to elements of the SWOT, is appropriate. A quantitative analysis is required, to compare where FVT is today at the end of 2019 to industry benchmarks and to 2016 results.

Candidates should draw upon their situational analysis when analyzing the major issues facing FVT [Cinema LaRoche (CLR), The Games Place (TGP), Tillsonburg live productions, buying group for concessions versus KC proposal, governance issues].

Mission and Vision Points

Day 1 – The board changed the vision to reflect that FVT now has TGP as well as film exhibition in the theatres. In addition, the board wanted to reflect that a *unique* experience would be provided by FVT due to TGP and the types of films seen by the film club. The vision was reworded as follows:

"*Our vision is to ensure that our guests enjoy a unique, premier entertainment experience each and every time they visit our locations.*"

The mission statement was not changed. *Note: Candidates may have recommended some changes to the vision in their Cap 1 work; if investments in venues other than theatres were recommended, there may have been some differences between FVT's vision statement (i.e., just pertaining to theatres) and strategic decisions made in their group work. The intent of the statement in Day 1 is to "ground" their new Day 1 decisions.*

The new vision statement reflects the board's desire to continue to provide a premier entertainment experience that is unique and to broaden the type of experience beyond film exhibition in theatres.

New Objectives

The company's objectives are different:

1. To increase net earnings by 10% in 2020; $1,406,900 ($1,279,000 × 1.1).
2. The company would like to get back to the operating income of $3,516,000 [2016 results – LINK to Cap 1] and employee bonus amounts of $1,250,000 [2016 results – LINK to Cap 1] within the next three years.
3. FVT also wants to increase operating income to 5% of revenue in the longer term.
4. If FVT keeps CLR, it will have to maintain a covenant required by the renegotiated loan to be total debt to EBITDA of 4.0. Currently, the company has a total debt to EBITDA of 4.3 [in millions: total debt of $40,619 ÷ (operating income of $2,978 + amortization of $6,492)], which is too high.

FVT needs to keep in mind the short-term bank loan (new loan) limit of $1.2 million which is secured by shareholders' personal guarantees and a guarantee from FLL.

Also, the focus has shifted from revenue per attendee to growth in net earnings.

Candidates are NOT expected to recap KSFs and/or SWOT in detail; they should, however, use them in their Day 1 case analysis.

<u>KSFs for Film Exhibition Industry (from Cap 1)</u>

- Diversification of revenues
- Using up-to-date technology
- Low-cost film license contracts
- Having a large part-time, flexible workforce
- Low and competitive operating costs
- High return on capital investments
- An improving (high) average dollar spent per attendee (i.e., maximize it)

<u>Strengths (from Cap 1 that are relevant and new ones related to info in Day 1 case)</u>

- Strong presence in southwestern Ontario
- Experienced management
- Loyal local customers and knowing what this market wants
- Some diversification in revenue sources due to TGP
- Geographic diversification of revenues due to acquisition of CLR, which is contributing more to revenues than Ontario even though there are fewer theatres in Quebec
- The film club membership, which has increased and been successful in both Ontario and Quebec

<u>Weaknesses (from Cap 1 that are relevant and new ones related to info in Day 1 case)</u>

- Lower volumes have caused higher negotiated supplier prices for film licence fees and food and beverage costs of goods sold (from Cap 1 and mentioned in Day 1 as an increasing issue due to low attendance and volumes).
- Deteriorating cash balance; the current ratio has declined significantly from 2016 and is a major problem given the upcoming debt repayments and only having $20,000 cash on-hand.
- Increased levels of debt, resulting in worsening leverage ratios and in FVT nearing its maximum covenant which could have a significant impact on the shareholders who have personally secured the recent bank loan.
- FVT has the note payable to Marcel that requires a $1 million principal payment in 2020. Marcel said he would be willing to defer the first payment until July 2021 if FVT continued to operate CLR.
- FVT has loan payments of $1,275,000 on its existing term loan and does not currently have the cash on-hand to make this payment.
- FVT has new long-term debt (the original amount of $5 million) related to the CLR purchase, with a payment due of $625,000. The bank has indicated that refinancing will require a higher interest rate (8% versus the current 5%) and a new covenant that the total debt to EBITDA (currently at 4.3) be 4.0 or less.

- CLR profits are declining due to integration problems and a provincially-mandated increase in minimum wage making it much more difficult to reach the board's new goals.
- Since 2016, FVT has had insufficient cash available to redeem the preferred shares.
- TGP is performing poorly with another year of losses. This is making it very difficult to reach the Board's net earning goal.
- FVT has not been investing in any new technology whereas other industry players have which puts FVT significantly behind its competition and will lead to a continuing drop in attendance.

Opportunities (new information from Day 1)

- The film club membership is growing giving FVT a unique advantage over its competition.
- Attendees are willing to pay a premium price for unique, independent films (as seen with the increased number of film club memberships). Leveraging these unique films will help with profitability and reaching FVT's earnings target.
- The Canadian-U.S. dollar exchange rate is expected to improve slightly. This will lower the cost of films denominated in U.S. dollars.

Threats (New information from Day 1)

- Interest rates are increasing and are expected to continue to increase in the short term, which could raise FVT's interest costs significantly.
- The province of Quebec has increased the minimum wage, causing wages in the Quebec theatres to be significantly higher than in the past. Competitors have increased their prices but CLR has not yet done so.
- Consolidation is increasing, allowing the large national and global competitors to negotiate more favourable supplier contracts for film costs and food and beverage purchases.
- A declining industry growth rate for film exhibition has resulted in declining regular viewing attendance.
- To keep up with technology, industry players continue to invest in new technology putting them further ahead of FVT.
- Plant closures and layoffs, with indications of further declines in the next 12 months, have reduced the market size in southwestern Ontario.
- Competitors are showing more films produced by the smaller, independent filmmakers which is a threat to FVT's film club.

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

Candidates should compare the financial results of 2019 to 2016 and to the 2019 industry benchmarks, using the financial ratios provided in Appendix II and financial statements in Appendix III, specifically identifying areas where the company has improved or worsened. They also need to calculate the loan covenant [Link-CAP 1].

Candidates are expected to provide a high-level assessment of FVT's financial results (i.e., box office admission revenue per attendee, concession revenue per attendee, liquidity ratio, solvency ratio, profitability ratios).

Revenue analysis and comparison with 2016 operations

	2019	2016	2019 Benchmark	2016 Benchmark
Average box office revenue per attendee (Note 1)	$8.25	$8.67	$8.75	$9.10
Average concession revenue per attendee (Note 2)	$5.02	$4.95	$5.15	$5.25
Film costs as percentage of box office revenue	56%	59%	54%	52%
Concession costs as percentage of concession revenues	27%	25%	24%	23%
Current ratio	0.1	0.3	0.75	0.67
Operating margin	3%	5%	7%	9%
Net profit margin	1%	3%	3%	6%
Return on assets	2%	4%	4%	5%
Total debt to equity	1.8	1.69	1.5	1.2

The debt covenant for the long-term loan is that the ratio of long-term debt (including current portion of long-term debt and excluding preferred shares) to EBITDA cannot exceed 2.5. In 2019, total long-term debt (including current portion debt and excluding preferred shares) is $22,336 ($11,486 + $3,750 + $3,000 + $1,200 + $1,275 + $625 + $1,000); EBITDA = $2,978 + $6,492 = $9,470 (note: foreign exchange loss is ignored). Covenant = $22,336 ÷ $9,470 = 2.36, which is still below the maximum of 2.5 [LINKED to Capstone 1].

- The average box office per attendee is $8.25($60,525,000 ÷ 7,336,364), which is lower than industry and 2016.
- The average concession revenue per attendee is $5.02($36,826,000 ÷ 7,336,364), which is higher than 2016, but lower than industry of $5.15.
- Film costs as a percentage of film revenues has increased to 56%, which is lower than 2016 but still higher than the industry average – due to loss of volumes and higher unit-supplier costs.
- Concession costs as a percentage of concession revenues has increased to 27%, which is higher than 2016 and industry – due to loss of volumes, less favourable supplier contracts and higher U.S. dollar exchange rates.
- The current ratio has worsened to 0.10, lower than 2016 and the industry average of 0.75. With only $20,000 of cash on hand, FVT has a serious short-term cash problem.
- The debt-to-equity ratio has increased to 1.8, higher than 2016 and the industry average of 1.5. The company is over-leveraged at this point, due to the debt taken on for the purchase of CLR, the opening of TGP and the new short-term debt for working capital.

- The operating margin, net profit margin and return on assets have all deteriorated from 2016 and are below industry averages.
- Working capital ($1,540 - $14,883 = -$13,343) is at a dangerous level (in 2016, it was $2,505 - $8,277 = -$5,772) unless debt can be refinanced.

Conclusion

FVT’s financial results appear to have deteriorated since 2016. As well, the balance sheet is more leveraged due to the purchase of CLR, a new short-term loan to finance operations, and the opening of TGP. In addition, FVT has little cash on hand per the balance sheet. Although the company is still able to meet this term loan covenant, there is little room to take on more debt or for EBITDA to further decline. However, Kent and Sheila have suggested that they might be willing to lend the company funds if they support the investments they want.

In addition, if the loan for the CLR purchase is renegotiated, a total debt to EBITDA margin of 4.0 must be maintained. Currently, this ratio is 4.3, so either debt must be reduced or EBITDA increased to meet this covenant. The company must make decisions to immediately increase operating income, net earnings and cash flows and reduce its debt.

Summative Assessment #2 – Analyzes the Major Issues

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

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

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

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

Competencies
2.3.3 Evaluates strategic alternatives

Enabling:
2.1.3 Performs appropriate analyses.
2.1.4 Integrates information to investigate each potentially viable solution or conclusion.

This summative assessment is based on Assessment Opportunities #2 to #6.

Assessment Opportunity #2 (Strategic Issue #1 – The candidate discusses whether to keep or sell CLR.)

Competent candidates will complete both a qualitative and quantitative assessment of the significant factors related to deciding whether to keep or sell the net assets of CLR. Since CLR represents $1.2 million of FVT's operating income and has a $1million payment due, this is the most significant decision to be made and should be prioritized as such.

Quantitative: The candidate should determine the impact on EBITDA and earnings under either option, the amount of cash available if sold, and whether the new covenant can be met if CLR is kept.

Qualitative: Candidates are expected to identify that the investment in CLR has been mismanaged to this point, and that selling now, before Kent and Sheila can determine what CLR is capable of generating, may be premature.

The candidate is expected to draw conclusions and/or make recommendations based on a combination of the quantitative and qualitative analyses.

Quantitative Analysis

Key tools candidates could use or recognize:

- Cash flow analysis
- Impact on financial statements

Objectives and impact on EBITDA, earnings, cash flows:

If FVT keeps CLR:

- Currently, CLR contributes $4 million to FVT's EBITDA and $1.2 million to operating income which is a significant portion (40%) of FVT's total operating income.
- FVT will need to renegotiate the bank loan and require a total debt to EBITDA ratio of 4.0 or less. Currently, the ratio is 4.3. To obtain a ratio of 4.0, assuming the debt does not change, EBITDA must be $40,919,000 ÷ 4.0 = $10,230,000. This is $760,000 higher than the current amount of $9,470,000. This might be achievable with some improvements in CLR, and by implementing some of the other alternatives noted below.
- The interest rate on the renewed bank loan will increase from 5% to 8%, and based on a balance of $3,750,000 being refinanced, this will increase interest expense from $187,500 ($3,750,000 × 5%) to $300,000 ($3,750,000 × 8%); an increase of $112,500 before tax.
- Marcel has agreed to defer the $1 million payment due in 2020 for one year, so this will be due in 2021, giving the company some extra time to raise the cash it needs.
- However, Marcel will increase the interest rate on the $4 million note payable from 2% to 5%, so interest will increase from $80,000 to $200,000, an increase of $120,000 before tax.

- Therefore, if no improvements are made in operating income, keeping CLR will incur additional interest expense that will cause net earnings to decline by $174,375 [($120,000 + $112,500) (1 - 0.25)] which moves FVT further from the board's goal of a 10% increase to net earnings.

If FVT sells CLR:

- FVT would lose 40% of its operating income and 42% of its EBITDA.
- There will be a one-time loss before taxes of $1,100,000 ($13,000,000 book value - $11,900,000 proceeds) in 2020, which will significantly reduce EBITDA and net earnings for the one year. However, FVT may be able to convince the bank to not include this unusual loss in the covenant calculation.
- Cash received on the sale will be 70% × $17,000,000 = $11,900,000. FVT will use this cash to repay the note payable to CLR of $4 million and the long-term loan outstanding of $3,750,000 (assuming the $625,000 has already been paid before the sale). This will leave $4,150,000 ($11,900,000 - $7,750,000) available for other purposes like the Tillsonburg renovation.
- If the debt is reduced by $7,750,000, and the EBITDA is reduced by $4 million, the covenant on the term loan is: ($22,336,000 - $7,750,000) ÷ ($9,470 - $4,000) = $14,586,000 ÷ $5,470,000 = 2.67, which is slightly higher than the 2.5 now required.
- FVT will sell CLR for $11,900,000, which is below the estimated current market value of the assets of $13,000,000 and would result in a significant loss.

Qualitative Analysis

Key points from Cap 1 that could be integrated:

- The investment in CLR allows FVT to be diversified geographically but remain true to its current business [Link to KSF].
- Higher volume discounts may be lost if CLR is sold, resulting in higher costs to purchase concession food and drinks and other supplies [Link to SWOT].
- CLR still has the subscription model for unique monthly films, which provides steady revenues.
- CLR is a good fit with FVT's mission to provide film entertainment that appeals to local communities [Link to mission].
- There may still be synergies that can be realized especially if Kent and Sheila become involved and the transition is better managed.

Key points from Day 1 that could be integrated:

- Stakeholders do not agree:
  - Viktor has not been able to communicate effectively with CLR employees and therefore wants to sell.
  - Stephanie wants to sell to get the cash and reduce the company's debt.
  - Lanny wants to give the new manager another year to improve the results before making any decisions to sell.
  - Kent and Sheila believe there is a lot of potential and want to keep CLR and properly manage it.

- Attendance and revenues have been increasing at the CLR theatres indicating future potential for increased profits which will help FVT achieve its financial goals [Link to Cap 1 objectives].
- Management of the integration of CLR appears to have been poorly executed. First, the manager appointed to do this has now been removed and a new manager hired. Second, since Lanny has been underperforming his duties all year, the first manager might not have been helped by Lanny. Therefore, part of the poor performance may be due to lack of FVT management, which can be fixed by having Kent and Sheila involved.
- FVT's revised vision is to provide a premier entertainment experience that is unique – does CLR provide a premier entertainment experience? If there are ensuing problems, this may no longer be the case [Link to vision].
- Profits have been declining due to poor integration and wage increases, due to an increased minimum wage. Kent has suggested that CLR may be able to increase prices to be in line with competitors and thereby increase profits.
- Sheila and Kent believe that, with proper, hands-on management, the profits can be significantly increased. Kent and Sheila have the experience and are ready to move to Quebec to actively be involved to improve the operations.
- The CLR managers appear willing to work with FVT making it more likely that Sheila and Kent's involvement will improve operations.

Recommendation:
CLR contributes a significant amount to FVT and should not be sold. FVT should look at other alternatives to improve its cash flow.

Assessment Opportunity #3 (Strategic Issue #2 – The candidate discusses whether to keep The Games Place open with leasing the games, or to close it.)

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

Quantitative analysis – The quantitative analysis includes a discussion of the impact on FVT operating income, net earnings and cash flows under two different scenarios – closing TGP, or leasing, rather than owning, the games and keeping TGP open.

Qualitative analysis – Candidates should consider whether TGP provides a premier entertainment experience and whether something needs to change in order to meet the vision. They should note that the experience is unique to the area. TGP also diversifies the revenues for FVT.

Candidates are expected to draw conclusions and/or make recommendations based on a combination of the quantitative and qualitative analyses.

Quantitative Analysis

- Currently, in 2019 (Appendix IV):
  - TGP has caused an operating loss of $436,700.
  - However, TGP appears to have a positive EBITDA and a positive pre-tax cash flow of $323,300 (-$436,700 + $760,000 amortization).
- To remain open, FVT can enter into a lease agreement with the games supplier, resulting in:
  - An operating income of $34,700. This is a net increase to operating income of $471,400.
  - An improvement in net earnings of $353,550 [$471,400 from above × (1 - .25), which represents a 27% increase ($353 ÷ $1,279)] helping FVT achieve its 10% increase in net earnings target. (This does not include the one-time loss on the sale of the current games.)
  - A positive (pre-tax) cash inflow of $302,700 ($34,700 + $268,000 amortization) which is slightly less than the current cash flow of $323,300.
  - The one-time proceeds on sale of games of $500,000, which will help improve its cash position. However, there would be a one-time loss on disposal of games that will reduce net earnings for 2020 by $976,000 ($500,000 pre-tax proceeds on games - $1,476,000 NBV of games).
- If TGP closes, the impact on financial statements is as follows:
  - Operating losses (assumed to be before tax and interest) will not be incurred, so operating income before tax will improve by $436,700, which represents a 15% improvement ($436,700 ÷ $2,978,000).
  - A decrease in annual cash inflows of $323,300.
  - One-time proceeds on sale of games, furniture and fixtures of $1,250,000 ($500,000 + $750,000), which can be used for other business purposes (like the renovation of Tillsonburg) or to repay debt (like the upcoming $1,000,000 payable due to Marcel).
  - A one-time loss on disposal of assets that will reduce earnings in 2020 by $2,329,600 ($1,250,000 total proceeds - $1,476,000 NBV of games - $2,103,600 NVB of furniture, fixtures and equipment).
  - A one-time lease termination payment would have to be made as well as severance pay for employees which could be substantial, however, information is not currently available.

Summary (ignoring one-time items)

	Status Quo	Lease Games	Close TGP
Annual operating income	$ (436,700)	$ 34,700	$ 0
Net earnings (loss) (assuming a tax rate of 25% on earnings)	$ (327,525)	$ 26,025	$ 0
Pre-tax annual cash flow	$ 323,300	$ 302,700	$ 0
One-time impact on cash flow	$ 0	$ 500,000	$ 1,250,000
One-time impact on earnings	$ 0	$ (976,000)	(2,329,600) + $ terminations

Tie-back to objectives (i.e., impact on cash flow, earnings, etc.):

- Leasing the games or closing TGP both improve operating income, which will help FVT work toward the goal of increasing operating income to 5% of revenue in the longer term; it also improves net earnings and would therefore help the company meet its objective of increasing net earnings by 10% in 2020.
- If TPG is closed, the annual operating cash inflow of $323,300 would be lost.
- Leasing the games and keeping TGP open will provide annual operating cash flows of $302,700, which, although not as high as closing, is still strong.

Qualitative Analysis

Key insight: Candidates should pick up on the fact (stated by Kent) that, although it is a unique experience, TGP does not currently meet the vision of producing a premier entertainment experience because customers tire of the games quickly. It is also not profitable, and therefore the status quo is not acceptable.

Key points from Cap 1 that could be integrated:

- A KSF is diversifying revenue away from film exhibition, which TGP does for FVT [Link to KSF].
- TGP is a unique entertainment venue in the London area (no similar establishments in London [Link to Cap 1].
- A KSF was to achieve high returns on capital investments. From Cap 1, this investment should have returned 18% [Link to Cap 1– Candidates had to calculate WACC from inputs] or more, based on its risk, which it has not [Link to KSF].
- The company entered into a 20-year lease, with termination penalties [Link to Cap 1].

Key points from Day 1 case that could be integrated:

- TGP is a unique form of entertainment as it is the only type of establishment in London [Link to vision].
- TGP is not seen as a premier form of entertainment because the games become outdated quickly and are not being replaced [Link to vision].
- TGP's financial results have been poor due to the games not being replaced more regularly and consequently customers losing interest.
- The games supplier, AGI, has offered a lease arrangement whereby the supplier will take on the responsibility of changing the games every six months. This transfers the risk of outdated games and ultimate disposal of old games from FVT to the supplier.
- The proposed lease arrangement also includes maintenance of the games. As a result, the risk of asset deterioration and maintenance costs are with AGI and not FVT.
- It appears that TGP is attracting new customers, as there does not appear to be any adverse effect on attendance at the theatres [Link to mission].

- The trend is for regular film exhibition to continue to decline, forcing companies to look for alternative sources of revenue and TGP provides this alternative for FVT [Link to trends].
- TGP is not impacted by increasing film costs due to the U.S. exchange rate and FVT's low supplier power to negotiate favourable contracts [LINK to situational analysis and economic conditions].
- Because it wants a success story in southwestern Ontario in order to encourage further expansion in the region, AGI is willing to negotiate on its lease terms which could make the lease proposal even more profitable.

Assessment Opportunity #4 (Strategic Issue #3 – The candidate discusses the investment in Tillsonburg renovations for live stage productions.)

Competent candidates will complete both a qualitative and quantitative assessment of the issues related to converting two screen auditoriums to a live stage auditorium in Tillsonburg.

Quantitative: Candidates are provided with information on the proposed cash flows related to these renovations. Candidates should calculate the impact on cash flows, net earnings, and a payback period to support their recommendation.

Qualitative: Candidates should recognize that the stage renovations tie directly to the vision and mission to provide a premier and unique entertainment experience to the local community. At the same time, the success of this venture is very dependent on the success of the theatre group. Also, Kent is willing to provide FVT with all financing required for this venture, with very favourable repayment terms.

Candidates are expected to draw conclusions and make recommendations based on a combination of the quantitative and qualitative analyses.

Quantitative Analysis

Key tools candidates could use or recognize:

- Annual cash flows
- Payback period
- Impact on net earnings under each proposal

Incremental impact on cash flows and net earnings

Theatre rental income and revenue share	$ 188,000
Concession revenues	43,200
Rental income from others	106,000
Lost film admission and concession profits	(93,670)
Net additional cash flows before tax	243,530
Less tax impact (at 25%)	(60,883)
Estimated net additional cash flows after tax	$ 182,647

Total initial investment: $650,000. Payback period is 3.56 years ($650,000 ÷ $182,647). Therefore, if five years is the cutoff, as suggested by Lanny, this project should be accepted. As requested, this ignores the tax benefit of the CCA, which, if included, would further reduce the payback period.

Impact on net earnings:

Net cash flow before taxes	$ 243,530
Less amortization (650,000 ÷ 8)	(81,250)
Operating income before taxes	162,280
Less taxes at 25%	(40,570)
Increase in net earnings	$ 121,710

Link to objectives, impact on earnings, etc.:

- This increases operating cash flows [Link to objectives].
- This investment increases net earnings by 9.5% ($122,000 ÷ $1,279,000), so it would contribute to the objective to increase net earnings by 10% [Link to objectives].
- Operating income (currently at $2,978,000) would increase by $162,280 getting FVT closer to the $3,516,000 target.

Additional comments on the quantitative analysis:

- Rental income from other renters of $106,000 is a very rough estimate, with no evidence to support it. If actual rental amounts come in well below this estimate, the net earnings generated by this project could be less than $45,000.
- There are few details on the costs, which allows for the possibility that costs are understated.
- Currently, the two auditoriums to be closed generate a positive cash flow of $93,670, which may not be lost if, as Kent suggests, customers move to the remaining auditoriums.
- The analysis is based on the theatre group being able to provide $150,000 toward the renovations. If the theatre group is unable to raise $150,000, FVT will have to make up any shortfall. If FVT has to pay more than $650,000 for the renovations, this will reduce operating and net income and the payback period will lengthen.

Conclusion on quantitative analysis:

The renovations meet some of the objectives but do not have a significant impact on the operating income and net earnings. The amount of revenue will be very dependent on the theatre group's success which makes this a risky investment.

Qualitative Analysis

Key insight: Candidates should recognize that, although it would diversify revenues and profits away from film exhibition, this is a risky investment. The revenues are predominantly dependent on the theatre group having six successful plays per year. The success of the plays is dependent on the types of plays selected and whether people like them. Unless they build something into the agreement, FVT will not be able to influence this.

Key points from Cap 1 that could be integrated:

- In Cap 1, FVT's mission and vision was (and still is) to provide a premiere entertainment experience, which adding the stage will do [Link to mission and vision].
- FVT's mission is to support arts and entertainment in the local community. Adding a stage auditorium and working with the local theatre group would help accomplish this [Link to mission and vision and values].
- A KSF is to diversify revenues and profits and the stage theatre diversifies revenue away from film exhibition [Link to KSF].
- A KSF is for low and competitive operating costs. Adding the stage auditorium, which is rented out, will result in no additional costs for FVT, which will keep costs down [Link to KSF].
- A KSF is to have a high return on capital investments. In this case, although there is currently less than a five-year payback period, this is a risky investment because it is highly dependent on the theatre group [Link to KSF].

Key points from Day 1 that could be integrated:

- The new vision is to ensure that every guest has a premier and unique experience. As there is no other theatre currently in Tillsonburg (other than a school auditorium), providing live theatre will be premier and unique [Link to mission and vision].
- The theatre group will help finance some of the renovations, estimated to be $150,000, but the actual amount will depend on the success of its fundraising.
- Kent and Sheila are willing to provide all the funds required with very favourable repayment terms: no interest and no fixed repayments. Kent has also stated that they may forgive the loan at some future date if required. (There is no indication of what “if required” means, but this may be if there is insufficient cash generated from this venture to repay the debt.) However, this loan will increase the covenant and likely breach the maximum amount currently allowed.
- Kent and Sheila are very much in favour of this investment and it is supported by the local community. They appear more interested in supporting the community than in how profitable the investment is. This investment aligns well with the mission to support entertainment and arts in the local community.
- Viktor doubts that this will be profitable as it is dependent on the theatre group’s ability to put on good performances and sell tickets. He also sees it more as a charitable donation than as a viable business venture.
- Sheila believes that this could increase the number of film club members by drawing from a new customer base, that of live theatre goers. Increased film club members will increase revenues and profits, particularly since customers are willing to pay a premium for these independent films. Additionally, there could be cross-marketing to further increase the number of film club members.
- This is a high-risk investment as FVT has no control over how well this investment will do. Success depends on the plays the theatre group picks and how well they do.
- This investment will increase the workload for the accounting staff, who seem to already be very overworked.
- Attendance at films has declined and this investment would provide an alternative source of revenue reducing FVT’s reliance on film attendance [Link to industry trends].
- This revenue is not tied to film costs, which have been increasing [Link to industry trends].
- This type of revenue is not affected by the U.S. dollar, so the exchange rate between the Canadian and U.S. dollars will not affect these revenues [Link to economic trends].

Assessment Opportunity #5 (Strategic Issue #4 – The candidate compares the concession supplier proposals and makes a recommendation.)

Competent candidates will complete a quantitative assessment of the factors related to the supplier contract proposals – one from TBG (the buying group of peers) and one from KC, the current supplier.

Quantitative: Candidates can attempt to compare the rates and calculate the impact of the savings on FVTs profit objectives.

Qualitative: Candidates should discuss the advantages, disadvantages and risks of each option. Link to situational analysis – particularly concession costs as a percentage of concession revenues.

Candidates are expected to draw conclusions and make recommendations based on their analysis. Although the analysis of this issue is more operational, candidates should integrate this issue with the broader cash flow issue, to understand its strategic impact.

Quantitative Analysis

TBG – Concession costs would be reduced to 23% compared to the current rate of 27%
KC - KC says it can bring costs down to 25%.
Note that the current benchmark is 24%.
One of the objectives is to improve the operating margin.

Currently, concession revenues are $36,826,000 and concession costs are $9,943,000. Assuming the same revenue levels, TBG would reduce costs to $8,469,980 which is a cost savings of $1,473,020. KC would reduce costs to $9,206,500 which is a cost savings of $736,500. These savings are significant as compared with the current operating income of $2,978,000.

Reducing the concession costs will improve the margin on concession revenue and the operating margin. By choosing either supplier, FVT can achieve its operating income goal of $3,516,000. [Link to objective].

Net earnings, using either supplier, would also achieve the target [Link to objective]:

Current income before taxes	$ 1,706
Cost savings (KC)	736
New income before taxes	2,442
Taxes	(610)
New net earnings	$ 1,832

Qualitative Analysis

- Concession costs as a percentage of revenue in 2019 are 27%, which is higher than the industry average of 24% and substantially higher than in 2016, due to loss of volumes, less favourable supplier contracts and higher U.S. dollar exchange rates [Link to situational analysis - ratio analysis].
- FVT has been harder hit than most competitors as its declining attendance has resulted in lower purchase volumes and higher negotiated supplier costs for food and beverages. Entering into a supplier contract with lower prices will help alleviate this specific problem for FVT.
- Both contracts require a minimum purchase volume. The risk is that FVT may not require this volume of purchases if attendance further declines, but would have to pay for the minimum amount anyway. Attendance is expected to further decline [Link to Industry trends].
- If FVT sells CLR or converts two Tillsonburg auditoriums, there will be a smaller volume of purchases of concession items required, and this may impact the two contract proposals and their analysis [Link to other alternatives and their impact].

<u>Key points specific to the TBG proposal:</u>

- An annual membership fee of $25,000 is required which is a problem given FVT's current cash situation.
- There is a three-year commitment for a minimum amount of purchases, which is shorter than the KC contract. However, minimums are based on the previous year's sales volumes. With declining revenues and attendees, the shorter the contract term, the less risky.
- Financial information on concession revenues must be provided annually. This is confidential information that will be available to competitors who are members of the group. There is a risk that competitors will use this information to their advantage.
- Payment terms are net 10 days, which is 20 days sooner than under the current payment terms. Since the company has little cash on hand, this will have to be financed in some way, further deteriorating any debt ratios [Integration with ratios].
- The TBG proposal means that all competitors in the buying group will be selling the same items in the concession stands and therefore, in this case, FVT will not be unique [Link to vision].
- The TGB proposal may not allow FVT to maintain a high standard and provide a premier experience if the food is of a lower calibre than the current food [Link to vision].
- FVT will receive competitors' information, which may help them to better monitor and manage their operations and margins.

Key points specific to the KC contract proposal:

- The Canadian dollar is expected to strengthen, thereby making U.S. products cheaper. This would mean that the supplier contract proposal might be cheaper in the long term [Link to economy].
- FVT takes on the risk of exchange rate changes between U.S. and Canadian dollars, which may reduce or offset any cost savings.
- There is no upfront membership fee, so no immediate cash outflow.
- No financial information is to be provided and made available to other competitors who are members which makes KC more attractive, particularly for Kent.
- Since the contract is totally dependent on FVT's results, if revenues continue to further decline, the discounts provided in later years may not be as large.
- There is a five-year commitment with minimum purchase volumes but KC has not specified the amount yet and is willing to negotiate. This is longer than TGB's three-year contract and, given the changes taking place in the industry and the further declines expected, this is a long time [Link to industry trends].
- This allows FVT to provide unique types of food, particularly if it wants to offer more at the premium end.

Both contracts will help the company achieve FVT's objective of increasing the operating income, net earnings and improving the operating margin, the KC contract brings the concession costs as a percentage of revenue down to 25% whereas the TBG brings them down to 23%, which is in line with the industry amounts. However, because the TBG contract payments will be required 20 days earlier, FVT may incur additional interest charges to finance these extra days. On the other hand, the foreign exchange rate associated with KC needs to be considered. Either of these may offset some of the savings. Before committing to anything, FVT needs to consider the purchase volumes they will likely have in the next few years.

While first an operating decision, it is more important to note that the cost savings are significant and greatly help FVT with its current cashflow problem and achieving the Board's new goals. [Link to strategic issues]

Assessment Opportunity # 6 – Additional Issues – Governance

Competent candidates will complete a qualitative assessment of the current governance issues and provide reasonable ways to resolve the problems.

Governance Issues

1. Kent's pressure tactics – Kent is trying to pressure the common shareholders to accept his recommendations by withholding cash for items that he considers are bad investments and providing cash for those investments he believes are good investments. For example, he wants to close TGP and has stated that he will not be providing any cash to keep it open. On the other hand, he will provide cash with very favourable terms for the Tillsonburg renovations. He is also maneuvering to keep CLR; he and Sheila have stated that they are moving to Quebec for four months to properly manage the CLR operations. As well, Kent spoke to Marcel about renegotiating the terms of the CLR note payable without his children's knowledge.

   It is likely that Chris may have to speak to Kent about his tactics. Kent must accept that he no longer controls the company and the three children have paid for the right to be able to have control over company decisions.

2. Lanny – About a year ago, Lanny decided that he wanted to spend less time at the company and work only four days per week. He now only works about one day per week yet is paid a full salary. The staff appear to be overworked and Lanny is opposed to most of the proposed investment opportunities because they will add to his staff's workload. The company appears to be feeling the effects of Lanny's lack of involvement. The other shareholders believe that the poor financial results are partially due to his lack of interest and seem to begrudge him having time off. He did not do the proper research required for the stage investment and did not adequately oversee supplier concession costs. Lanny does however, continue to attend the management meetings and voice his strong opinion on things. Lanny has also mismanaged the integration of CLR with FVT, causing further friction between the shareholders.

The following should be discussed with Lanny:

- Why is Lanny working so few hours? Talk to Lanny to find out what is going on. Are there reasons that he has not told everyone? It appears that the company cannot continue to pay Lanny a salary commensurate with full-time work (five days per week) when he is only working one day per week.
- What are his intentions for the future—does he intend to come back to work on a full-time basis? Is he still interested in being a shareholder in the company?
- Does he have any suggestions for how to reduce the workload for his staff, given that the company has limited funds with which to hire staff to do Lanny's work. Lanny appears to understand that his staff are overworked since he uses this as a reason for not making certain investments. Lanny appears to want to make very few changes because he does not want to put more pressure on his staff.
- What is the impact on the staff of Lanny not coming to work? How do the accounting staff feel about this added workload? Are they thinking of quitting or looking for other employment? How is their morale and is this affecting their jobs?

- Lanny needs to understand that the shareholders are not happy with his performance, which has deteriorated over the year.

Depending on what Lanny says, some possible solutions are as follows:

1. Lanny could be asked to take a significant reduction in salary (to match the hours he is working) and these savings could be used to hire additional staff to help with the workload. Alternatively, Lanny could be encouraged to come back to work full time.
2. Stephanie and Viktor could buy out Lanny's share. This would require Stephanie and Viktor to use some of their own personal funds to buy Lanny's shares. Do they have enough personal cash available, given the company's poor financial results and lack of bonuses paid?
3. FVT could buy back Lanny's shares. This would require cash that the company currently has little of. Ask Lanny if he wants out completely, or what other solution he suggests.

This issue cannot wait. As CEO, Stephanie needs to have a frank discussion with Lanny immediately.

Summative Assessment #3 – Conclude and Advise

Competencies
Enabling – 2.1.4 Integrates information to investigate each potentially viable solution or conclusion.
Enabling – 2.1.5 Recommends and justifies a solution or conclusion based on an integrative view of information for the situation.

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

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

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

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

Competent candidates will complete a logical conclusion that is consistent with their analysis and integrate the overall picture of the company (i.e. objectives and cashflow problem).

The final recommendation should tie back to the financial objectives.

Some highlights to keep in mind are as follows:

The recommendation should be consistent with the analysis performed. As well, an overall conclusion should be presented to provide a sense of completion to the report (a wrapping-up and/or prioritization of the recommendations).

The recommendation should consider the key elements: FVT currently has a very weak financial position with little cash and high debt. Its main objectives are to increase net earnings, increase cash, not add any more debt, and maintain the total debt-to-EBITDA ratios required for the debt covenants.

Conclusions should be tied to specific objectives and to meeting the debt covenants, particularly on the renewed loan used for the CLR purchase (if the recommendation is to keep CLR).

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

A competent candidate should conclude the following:

- CLR – The decision to keep or sell CLR is complicated because the integration has been mismanaged by Lanny and shareholders do not know what earnings CLR would be capable of generating if properly managed. If CLR is kept, FVT must have an EBITDA for 2020 that will be high enough to meet the new debt covenant required on the renewed bank loan. Since CLR is profitable and makes up a significant portion of FVT's income, it would be best not to sell CLR. Keeping CLR gives FVT the best chance to achieve the board's goals. With Kent and Sheila willing to manage CLR, it would be prudent to wait to see the improvements they can make to the operations.

- TGP – It is recommended to keep TGP and proceed with the profitable leasing option. This will avoid the lease termination payments and allow the shareholders to see if this concept will work in the area. The numbers suggest that earnings and margins will improve and the supplier appears to be willing to assist with this for their own reasons. The profits are higher for the choice to remain open and lease the games rather than to close. This option also requires no upfront cash investment and improves the operating income. TGP also allows FVT to diversify away from film exhibition, aligns with the vision for a unique experience and attracts new customers.

- The Tillsonburg renovations – This is a risky investment since FVT is giving up low-risk profits for high-risk ones and the success each year will be dependent on the theatre group's ability to sell tickets. While Kent is willing to provide the $650,000, these funds will show as debt on the balance sheet and weaken its financial position and possibly cause a breach to the bank covenant. While this project aligns well with the mission and vision of FVT, the recommendation would be to not go forward with this investment at this time. FVT is not strong financially and needs to concentrate on increasing profits before venturing into this opportunity.

- Supplier contracts – FVT should accept either one of the supplier contractual arrangements, as both help the cash flow situation. The TBG contract appears to result in higher net profits and margins than the KC proposal. Also, the discounts for the TBG contract are solely dependent on FVT's concession sales volumes, not related to foreign exchange rates (which cannot be controlled). The commitment period is only three years and with the cost savings, FVT should be able to manage the 10-day payment terms. Given these advantages, it is recommended that FVT become a member of TBG. FVT should find out if members sign a non-disclosure agreement to protect each other's financial information.

- The governance issues related to Kent and Lanny each need to be addressed.

Summative Assessment #4 – Communication Hurdle

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

Yes – The candidate adequately communicated their response.

No – The candidate did not adequately communicate their response.

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

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

Summative Assessment #5 – Overall Assessment

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

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

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

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

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

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

In making their overall assessment, markers consider the following:

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

SAMPLE RESPONSE – FVT VERSION 2

Below is an actual passing candidate response.

Draft Report

From: CPA

To: Chris (for presentation to First View Theaters (FVT) Board of Directors

Date: May 5, 2010

Re: Various Issues

As discussed, I have drafted a report, which will ultimately be shared with FVT's management team and Board of Directors (BOD).

Situational Analysis

Qualitative analysis

Mission:

- There has been no change to FVT's mission statement

Vision:

- FVT's vision has changed from "ensuring every guest enjoys a premier entertainment experience each and every visit" to "ensuring that our guests enjoy a unique, premier, entertainment experience each and every time they visit"
- Key change is that FVT is now emphasizing offering a ***unique*** entertainment experience, in addition to a ***premier*** one

Key Success Factors

- Ability to offer a premium viewing experience, as evidenced by a decline in attendance for theatres not offering premium auditoriums
- Ability to offer diverse products and services
- Ability to maintain strong relationships with the local community, which has been a key ingredient in FVT's success historically

- Ability to secure good pricing and film rights from film distributors
- Ability to keep operating costs down, in order to offer reasonable pricing to customers
- Dedication of core management team

Strengths

- Experienced management team, which may allow FVT to better navigate the challenges facing the industry
- FLL has waived its annual redemption rights on preferred shares, which assists FVT with its cash flow management
- FVT has been able to expand beyond theatres, by opening the games place, for example; this may allow FVT to differentiate itself from its competitors and drive higher market share
- FVT was able to purchase CLR locations without taking on new shareholder debt, allowing it to branch into a market that is growing
- Well respected amongst local communities in which it operates
- Games and concession vendors willing to work with FVT to drive cost savings

Weaknesses

FVT has suffered more than its competitors from declining attendance, leading to lower profits and operating cash flows

- Due to cash flow constraints, FVT has not been able to continue to invest in technology, which links to key success factors of offering a premium viewing experience and diverse products and services
- Bonuses were not paid in prior year, which could lead to lower employee morale and difficulty in retaining top talent
- Bank loan is at its maximum, which means FVT may not be able to draw on this to fund further expansion or operational improvements
- FVT has had a difficult time integrating CLR with FVT
- FVT is generating losses, driven by games costs and maintenance costs
- Lanny seems to have a lack of commitment to FVT, as evidenced by his not being able to investigate the auditorium option and his passing off TGP repsonsibilities and oversight to his staff; he has also not visited the Quebec operations

Opportunities

- Demand for independent films that cannot be viewed at home has been increasing; this could be a profitable area of film offerings for FVT to focus on, as attendees are willing to pay a higher price for this offering
- The film club concept was successfully launched in Ontario; this may be a sign that the concept can be expanded to other geographic areas
- More theatre closures are expected in Ontario, which could increase the available pool of experienced resources for FVT. This may also enable lower labour costs in the Ontario market
- FVT was able to launch TGP and film clubs - it may be able to expand these offerings to continue to differentiate itself from competitors
- There may are opportunities to keep concession costs down, by working with the current supplier or a becoming part of a new buying group
- Attendees and revenues at Quebec theatres have been growing - FVT may be able to leverage its CLR locations even further

Threats

- Quebec government has increased the minimum wage to 30%, leading to an increase in wages in 2018 and 2019 - FVT may have a difficult time keeping costs down in the Quebec market, where CLR operates
- Small operators have been closing due to a further decline in attendance, enable large competitors to negotiate favourable supplier contracts. These larger competitors may be able to more easily secure favourable pricing and rights to key films than FVT, making it difficult for FVT to compete
- FVT may be a target for buyout, as the industry is dominated by a small number of larger players and consolidation has been common
- Industry faces competition from other film viewing options, such as online streaming

Quantitative Analysis

- FVT's revenues, profits and operating cash flows have been declining over the past few years
- FVT's financial results are currently not in line with hte bank's new convenant of debt to EBITDA of 4.0

- Cash and cash equivalents is currently only $20K; FVT may have a difficult time meeting its short term obligations and this casts doubt on its ability to continue as a going concern
- Current ratio is currently .10. This is a sign of poor liquidity and FVT might be challenged to meet its short term obligations as they become due. This is much lower than the 2019 benchmark of .75, which suggests FVT has much higher liquidity concerns/risk than its competition
- Operating margin has declined by 6% over the past 3 years to 3% and is below the 2019 benchmark of 7%. This suggests might be due to declining revenues and attendance at FVT in addition to rising costs (i.e. labour costs in Quebec and high TGP operating costs)
- Return on assets is 2% vs. industry benchmark if 4%. This suggests FVT is not able to generate as well of a return on its assets as its competition, which could be indicative of operating inefficiencies
- FVT has higher debt to equity than the industry benchmark, which suggests FVT funds its operatings wtih a higher proportion of debt and is more highly leveraged
- Net earnings as a percentage of revenue is currently only 3%, which is below management's target of 5%
- Keith and Sheila have indicated they would not be willing to assist with financing expansion of TGP
- Due to the decline in small operators and increased competition from larger players, FVT is forced to pay relatively higher film licensing costs for all types of films (vs its larger competitors)
- Average box office revenue per attending and concession revenue per attendee are below industry benchmark, which suggests FVT is not able to charge the same pricing as some of its competitors
- Film costs as a percentage of box office revenue have increased since 2016 but are higher than the 2019 benchmark. This may be a result of FVT not be able to negotiate as favourable terms with the suppliers as its larger competitors

FVT's/user objectives

- Expanding services which require minimal capital investment
- Increase net earnings by 10% in 2020
- Increase operating income to 5% of revenue in longer term

- Offering a unique entertainment experience is now part of FVT's vision
- Board of Directors (BOD) would like employee bonus amounts to return to 2016 levels within the next 3 years
- Bank wants to ensure covenants and loan requirements are met - debt to EBITDA of 4.0
- AGI is motivated to keep TGP open as it's the first location supplied in Southwestern Ontario
- Pay back period of 5 years for investments similar to the Tillsonburg auditorium investment option
- FVT holds a significant amount of PPE, which could be used as a way to generating additional financing for future initiatives
- Overall, FVTs net asset position is positive, which suggests the company still has value overall

Strategic Analysis

1. Assessment of whether to accept new lease arrangement with AGI and keep TGP open, or close TGP immediately

In order to assess whether to accept the new lease arrangement with AGI, I have developed the following decision criteria:

- Fit with mission and vision
- Contribute to ability to pay bonuses
- Increase of cash flows
- Increase operating income as a percentage of revenue to 5%
- Increase 2020 net earnings by 10%

Quantitative Analysis

- See exhibit 1 for quantitative analysis and key assumptions
- Closing FVT will provide cash flow savings of $1.2M in year one and $1.1M over 5 years after factoring in lost operating income
- Continuing to operate FVT only generates operating income of $35K per year. Additional capital improvements might be required over time on furniture, fixtures and equipment, which have not been factored.

- Continuing with FVT but leasing the games will improved operating income by $471K. Even with the positive annual operating income from leasing, FVT's operating income as a percentage of revenue is still 3% - in other words, maintaining FVT isn't making much of a difference to this metric
- Leasing or selling will not acheive the 10% increase to net earnings. Given that the proceeds for the sale of assets are less than FMV, FVT would need to record a loss on disposition of these assets, which would reduce net income. However, assuming accounting depreciation is a proxy for CCA, it would also have a terminal loss for tax purposes, which would offset this gain. Further information on these assets (UCC, CCA etc) is required in order to calculate the actual impact on 2020 net earnings.
- Cash freed up would be enough to make the note payable payment to CLR

Qualitative factors:

- Having TGP fits with FVT's new vision of providing a unique entertainment experience, as not all operators provide this type of offering
- TGP fits with the key success factor of providing diverse offerings
- Sheila and Keith are not willing to provide any additional funding for TGP, which could be problematic if FVT is not able to improve its cash position and results are worse than anticipated
- Customers do not appear to be repeat visitors, which could suggest the model is not sustainable longer term
- TGP might be cannabalizing sales from theatres within the area, leading to lower attendance numbers and revenues for FV
- Closing FVT may be concerning to customers or FVT vendors, who may think FVT is in financial trouble
- It is unclear whether FVT will be able to get out of its newly signed lease, which should be negotiated with the lessor
- Lanny has not been able to spend sufficient time overseeing this operation, which has resulted in poor results not being communicated in a timely manner
- AGI wants to make the relationship work, so it's possible to negotiate more favourable lease terms, which would drive operating income higher than projected

Evaluation against decision criteria - lease option

- Fit with mission and vision - MET - TGP allows FVT to offer a "unique" entertainment experience which is different from many of its competitors
- Contribute to ability to pay bonuses - NOT MET - TGP's projected operating income is minimal and there is significant risk that projections will not transpire
- Increase of cash flows - MET, but only marginally. The closure of TGP generates significantly higher cash flows and should therefore be prioritized
- Increase operating income as a percentage of revenue to 5% - NOT MET - the lease option adds only a small amount of operating income, which does not have a material impact on this metric.
- Increase net earnings by 20%: NOT MET

Recommendation and conclusion:

- Maintaining TGP without the lease option is not recommended, as the operation is generating an operating loss each year. Leasing the games from AGI will convert this loss to income, but income is projected to only be $35K per year. Meanwhile, FVT can benefit greatly from the cash that can be freed up from the sale of the TGP assets. I believe solving FVT's cash flow problems is of paramount importance and I therefore recommend closing the operation, in spite of the fact that not all decision criteria are met. Negotiations should take place with the lessor immediately to determine if the lease can be terminated at little to not cost. Furthermore, it might be possible to get higher proceeds on the sale of the assets based on the current net book value - suitable buyers should be sourced out and negotiations should commence as soon as possible.

Impact on users:

- The free cash will contribute to FVT's ability to pay bonuses in the future and allow to make other strategic investments
- The difference between the proceeds and NBV of disposed assets might have an impact on the bank ratio to the extent these are recorded as a loss and not as a pick up to depreciation expense.

- New investments in the games of $860K are required in 2022, 2023 and 2024 (per Capstone 1) would be avoided, which aligns with management's desire to avoid new capital improvements

2. Analysis of renovating Tillsonburg location to create a stage for live performances (including impact on operating cash flows and net earnings)

Decision Criteria

- Improvement to operating cash flows
- Improvement to net earnings
- Fit with mission and vision
- Fit with management objectives

Quantitive Analysis

- See exhibit 2
- The Tillsonburg renovation, based on numbers provided, will generate incremental operating income of $91K. This is significantly higher than that generated by pursuing the TGP lease
- Incremental operating income of $91K helps with FVT's goal of increasing net earnings by 10%. However, it does not allow FVT to meet this target in the absence of other measures
- Kent and Sheila are willing to help finance FVT's costs on an interest free basis with no repayment terms, which might be forgivable at some future date. The investment provides an initial cash outlay of $650K in order to renovate the theatres, which FVT could not fund based on its current cash position. FVT could rely on Keith or Sheila to finance this entire intitative, and reap all the benefits of the upside

Qualitative analysis

- Contribution for local theatre group is tied to success of fundraising efforts - if these efforts turn out poorly, this would negatively impact FVT's cash flow
- FVT is allowed to use the stage for its own purposes when not used by the theatre group - which could allow FVT to generate additional revenues from the space (i.e. running its own shows or renting the space to others, providing this is agreed upon)

- The theatre group plans to run 6 shows, which is twice the amount it runs in other locations. Their estimates might be too high. As such, FVT might be able to generate higher revenue than projected from other use
- FVT has not done any research into renting the space to other groups and does not have experience in this area. As such, it might not be able to efficiently run this operation or might need to hire additional expertise, which would reduce the incremental cash flows
- Revenues from the theatre group are partially tied to a percentage of ticket sale revenue. If the theatre group is not able to meet its ticket sale projections, the revenue numbers should would be lower
- FVT does not appear to have sufficient staff to operationalize this new initiative, as evidenced by Larry's and his inability to effectively oversee other initiatives
- Projections for lost revenues of the existing theatres may prove to be low given that the Tillsonburg locations are two of FVT's most successful.

Recommendation and conclusion:

- Based on the projections provided, I recommend that this option be pursued. The fact that Keith and Shelly will finance this initiative on an interest free basis and may waive the loan in the future makes this a very low risk investment. Incremental operating income is projected to be $91K higher than current numbers, so even if the projections are off slightly, FVT will likely be better off from a financial perspective. This also fits with FVT's mission of offering a unique experience, as this type of offering is rare in the industry. It helps FVT diversify its revenue streams as well, which is important given the trend towards declining theatre attendance.
- FVT will not need to take on new debt as a result of Keith and Sheila's support and earnings is projected to increase, which improve the EBITDA to debt ratio, which the bank is concerned with.

Impact on users

- Increase to net earnings - partially MET
- Increase to operating income - partially MET; this increases the operating income to revenue ratio and will assist FVT in achieving its goal longer term

- Fit with mission vision: MET for reasons noted above.

3. Analysis of whether to keep operating Quebec theatres or sell back to CLR

Decision Criteria

- Improvement to operating cash flows
- Improvement to net earnings
- Fit with mission and vision
- Fit with management objectives

Quantitative analysis

- The Quebec theatres have contributed most to FVT's attendance and revenue numbers, representing more than 50% of revenues in 2019. If this operation were sold, FVT may have a difficult time staying solvent
- FVT will need to stat paying principal payments in July of 2019 - given its cash flow constraints this may be problematic
- Net assets could be sold for $13M, which would free up significant cash for FVT to pursue other strategic investments
- Labour costs are expected to increase, which could lead to lower operating income in Quebec now and in the longer term, which goes against management's objective of growing this number longer term.
- It is expected that pricing can be increaesd to offset the higher labour costs
- operational synergies are expected to be realized starting in 2020, which would lead to higher profits and lower costs for this operation
- The bank is willing to change the due date on the note payable to 2021 so long as the interest is paid
- The net assets can only be sold for 70% of what FVT paid for them. This does not seem to be worthwhile, given that the investment appears to be paying off by way of revenue and attendance numbers. If FVT can manage its costs and find synergies it its operations, the Quebec locations could prove to be highly profitable.

Qualitative analysis

- Keith and Sheila have committed to moving to Quebec for a period of time to get operational issues sorted out.
- FVT has experience in operating these types of theatres
- Sheila and Keith are impressed with the operations and believe there is lot of potential here

Recommendation and conclusion:

- FVT should not dispose of the Quebec locations. Although this would assist with cash flows, selling for such a discount would not be in FVT's long term interests given the proven success of the operations so far. FVT should continue to find cost savings and determine if prices can be increased to offset higher labour costs.

Analysis of Other Issues

Analysis of whether to engage TBG or continue working with KC

Quantitative analysis

- Please see exhibit 3
- Going ahead with TBG provides the most savings of the two options

Advantages of signing with TBG:

- Provides the greatest savings in concession costs, which will lead to higher net earnings and longer term operating income - Board objectives
- They only use Ontario suppliers - this aligns to mission and vision of working with local communities in which FVT operates
- Allows FVT to take advantage of the discounts that typically come with buying at larger scale, which may allow it to better compete with larger competitors
- Sharing of buying information may allow FVT to gain insights into purchasing trends and pricing achieved by larger competitors

Disadvantages of signing with TBP

- Invoices are due within 10 days of receive - this might not be possible given current cash flow constraints if some of the options above are not pursued (i.e. sale of TGP)
- Must share some financial information - this could allow competitors to gain advantage - larger vendors have more purchasing power and can use their influence on vendors to ensure pricing for smaller vendors are unfavourable
- Must sign a 3 year agreement - if this model proves to be problematic, it might be difficult to get out of the arrangement without incurring significant legal costs or termination costs

Advantages of continuing with KC with its proposed discount

- Have been working with this vendor for a period of time and have an established relationship
- Could potentially benefit from favourable FX rates
- Payment terms remain unchanged at 30 days

Disadvantages of continuing with KC with its proposed discount

- Could be harmed by negative FX rates - i.e. a declining Canadian dollar would make purchases more expense. It could enter into FX hedging arrangements to help mitigate this risk.
- Lower savings than TBG option
- Must commit to a minimum product volume - this could lead to increased waste if attendance numbers continue to decline

Lanny's lack of involvement

- Lanny as CFO is a key member of the team and his commitment to the organization is critical in ensuring his success.
- He should not be drawing a full time salary if he is only working part time hours
- Discussions should be had with Lanny as soon as possible to determine what his long term objectives are. It will likely make sense to recruit for a new CFO and perhaps Lanny can continue on supporting FVT on a part time, contract, or advisory basis. Further information is required.

Overall Conclusion:

- Sell TGP operations - the funding can be used to cover the CLR payment becoming due
- Consider exploring the option of joining TBG and determine if some of the unfavourable terms discussed can be negotiated. If not, I recommend sticking with the current supplier but be sure to conduct amply analysis on projected FX rates. Also determine if this can negotiated.
- Proceed with the Tillsonburg renovations. Keith and Shelly will fully finance this initiative and FVT will benefit from the ongoing incremental operating income with minimal impact to cash flows in the near term.
- Engage Lanny to discuss a transition plan.

Exhibit 1
Lease arrangement with AGI
Purpose: To calculate the cash flow impact of entering into the Lease arrangement with AGI

Cash impact of closing FVT

	2020	**2021**	**2022**	**2023**	**2024**	**Total 5 Years**	**Notes**
Loss of operating income - assumes games leased	-34700	-34700	-35394	-35394	-35394	-175582	1
Proceeds on sale of games	500000					500000	2
Proceeds on sale of furniture, fixutres and equipment	750000					750000	2
Savings on required continued investments						0	3
Total incremental savings	**1215300**	**-34700**	**-35394**	**-35394**	**-35394**	**1074418**	

Assumptions
Operating losses continue at the same level as 2019
Operating income used as a proxy for cash revenues and expenses

Notes

1 Operating income increases by 2% in 2022 and beyond, based on 2% revenue growth per capstone 1
2 As given
3 Savings on continued investments not included, as it is assumed that if TGP were maintained, the lease option would be pursued

Conclusion:

Continuing with TGP with the lease option will generate operating income of $176K over 5 years based on current projections
The incremental cash flow effect of closing FVT is $1.2M in year 1 and $1.01 over years, after considering the lost operating income that would result

Purpose: To calculate impacto net earnings in 2020, assuming TGP is sold

Revenue		
Avoidance of loss from operations	23000	1
Loss on disposition of games	976000	2
Loss on disposition of furniture, fixtures and equipment	1353600	3
Net	2329600	

Exhibit 2
Tillsonburg renovation

Purpose: To calculate the incremental cash flow impact of the Tillsonburg renovation

Incremental revenues	**2020**	**2021**	**2022**	**2023**	**2024**	**Year 5**
Rental income		188000	188000	188000	188000	188000
Concession profits		43200	43200	43200	43200	43200
Rental income from other groups		106000	106000	106000	106000	106000
Incremental costs and opportunity costs						
Lost revenues	-170000	-170000	-170000	-170000	-170000	-170000
Lost costs	**-76330**	**-76330**	**-76330**	**-76330**	**-76330**	**-76330**
Costs of renovating auditoriums	-650000					
Total	-896330	90870	90870	90870	90870	90870

Assumptions: I have assumped renovations will take place during for the duration of the year, during which time not revenues for the new space will be generated and the lost net revenues from operating the existing theatres will be incurred in the first year while renovations are underway

Purpose: To calculate the incremental operating income associated with the Tillsonburg renovatoins

Incremental revenues	**2020**	**2021**	**2022**	**2023**	**2024**	**Year 5**
Rental income		188000	188000	188000	188000	188000
Concession profits		43200	43200	43200	43200	43200
Rental income from other groups		106000	106000	106000	106000	106000
Incremental costs and opportunity costs						
Lost revenues	-170000	-170000	-170000	-170000	-170000	-170000
Lost costs	**-76330**	**-76330**	**-76330**	**-76330**	**-76330**	**-76330**
Costs of renovating auditoriums	-650000					
Total	-896330	90870	90870	90870	90870	90870

Conclusion:
The Tillsonburg renovations would not increase net earnings by 10% in 2020 based on my above assumptions
Moving forward, the initiative will generate $91K in incremental operating income per year.

Exhibit 3
Analysis of concession options - buying group vs existing vendor

Option 1 - TBG

	TBG	Notes
Concession costs - current	9943000	
Concession costs - with TBG	8469980	1
Concession savings	1473020	
Less: Annual membership costs	-25000	
Net savings	1448020	

Conclusion: Going with TBG would provide savings of $1.4M in concession expenses

1 23% of concession revenues per FS

Option 2: Current vendor	KC
Concession costs - current	9943000
Concession costs - with TBG	9206500
Concession savings	736500

Conclusion: Going with TBG would provide savings of $736k in concession expenses

APPENDIX G

RESULTS BY SUMMATIVE ASSESSMENT OPPORTUNITY FOR DAY 1 VERSION 1 AND VERSION 2

Results by Summative Assessment Opportunity

Marking Results – FVT Version 1

Indicator	Papers	Did not meet standard[1]	Marginal[1]	Yes, met standard
Situational Analysis	6387	1.08	5.56	93.36
Analysis	6387	3.52	22.40	74.07
Conclude and Advise	6387	1.16	7.23	91.61
Communication	6387	0.09		99.91

Marking Results – FVT Version 2

Indicator	Papers	Did not meet standard[1]	Marginal[1]	Yes, met standard
Situational Analysis	762	8.66	24.67	66.67
Analysis	762	16.40	46.59	37.01
Conclude and Advise	762	9.45	31.76	58.79
Communication	762	1.05		98.95

[1]Clearly failing were marked twice. All marginally failing or marginally passing papers were marked a second time to determine which ones met the passing standard. Only the clear passes were marked once, however they were audited.

APPENDIX H

BOARD OF EXAMINERS' COMMENTS ON DAY 1 SIMULATION VERSION 1 AND VERSION 2

BOARD OF EXAMINERS' COMMENTS ON DAY 1 (FVT VERSION 1 AND FVT VERSION 2)

Paper/Simulation: **Day 1 – Linked Case, FVT Version 1 (on Sept 2017 CFE)**

Estimated time to complete: 240 minutes

Simulation difficulty: Average

Competency Map coverage: N/A; Enabling Skills

Evaluators' comments by Summative Assessment Opportunity (SO)

SO#1 (Situational Analysis)

Candidates were expected to recap the important decision factors and highlight significant changes from the previous situational analysis (e.g., mission, vision, trends, and objectives) that would influence the decisions FVT was contemplating and would help management identify problems where they were not apparent to FVT. Candidates were rewarded when they made links to the situational analysis in the body of their report in SO#2 and SO#3. A situational analysis should be used to identify the changes since Capstone 1 and identify which of those factors could affect the company.

The case provided additional information for the candidates to use in their situational analysis (e.g., theatre statistics and industry benchmark), and most used some of that information to perform a general financial assessment of FVT.

Most candidates were able to make good use of the situational analysis by including some links in their analysis of the specific issues. The most frequently used element of the situational analysis was the focus on new technology (e.g., the new mission and trends toward new technology).

Strong candidates also drew on their knowledge from Capstone 1 of the key success factors and financial covenant. Strong candidates calculated the covenant based on the internally prepared financial statements and recalculated it to incorporate their recommendations for financing.

Weak candidates spent a lot of time repeating case facts in the first section of their report, their situational analysis. However, repeating facts without discussing their relevance to the new issues facing FVT did not add value. Many weak candidates provided a full SWOT, essentially repeating information given in the case and information from Capstone 1 and creating lists that were not used further in their report. For example, some candidates recognized that Kent and Sheila Lightfoot had retired but still linked the analysis to their goals. This did not add value.

SO#2 (Analysis of the Issues)

There were five issues that candidates were expected to analyze from both a strategic perspective and an operational perspective. Four of them were investment opportunities, which candidates were specifically asked to analyze, and the fifth was an undirected requirement about the governance and ethical issues facing FVT.

Candidates were expected to provide a qualitative and quantitative analysis for each investment opportunity. The case provided them with sufficient information to adequately address both of these aspects for all of the issues.

Major Issue #1: Virtual Reality Tech Inc. (VRT)

Candidates were asked for an assessment of the investment opportunity using the information in Appendix V and the board's discussion. They needed to integrate case facts to be able to discuss the pros and cons of investing. They were expected to calculate whether the investment would meet the 30% return objective specified by Viktor. That could be accomplished by calculating an IRR or an NPV based on the information provided. Candidates should have considered that this investment was risky based on the fact that the technology was still at an early stage of development and that there was no guarantee of a return.

Strong candidates presented a simple but accurate calculation of NPV using the 30% rate and taking into consideration the 10% participation of FVT. They also presented a complete qualitative analysis supporting their recommendation, with links to the importance of being up to date and on the cutting edge of technology.

Weak candidates only listed case facts and did not explain the implication. For example, candidates referenced the past success of Yuxuan, but without explaining how this might indicate a chance of success in the future or how this new project differs from those Yuxuan worked on previously. Weak candidates also failed to identify what type of calculation was useful and limited their quantitative discussion to comparing the initial investment of $2 million to the potential return of $10 million.

Major Issue #2: Sarnia Locations

Candidates were asked to explain the impact of the four options listed in Appendix VI for what to do with the theatre in Sarnia. They needed to integrate case facts to be able to discuss the implication of the options for FVT as a whole. They were given financial and operational information for each option and were expected to use it in their analysis. Because most of the financial analyses were already completed and provided in Appendix VI, candidates were expected to interpret them and not do additional calculations.

Strong candidates addressed all four options, explaining the potential implications of each and including the impact on the reputation of FVT and the relationship with its customers and employees. They also used the calculations provided to compare the options. Some candidates were able to use the additional information provided to refine their quantitative analysis.

Weak candidates seemed to struggle to understand the financial information they were given and just restated it without adding any value through their commentary. Their analysis was often one-sided, focusing on the closing option.

Major Issue #3: Connery’s Bar and Grill (CBG)

Candidates were asked to give the value of CBG and to assess the three options that were presented to FVT in Appendix VII. They needed to understand the options, including the joint venture arrangement, and use the buyout formula to calculate the value of CBG and compare it to the McCain and Zobair offers. Candidates were expected to realize that the actual success of CBG was highly dependent on Fred and that his departure should be considered in the decision.

Strong candidates calculated the value accurately based on the buyout formula, recognized that Fred’s share was 25%, and made the appropriate comparison to the offers. They also recognized that CBG was meeting FVT’s objectives regarding net income and the key success factor of revenue diversification.

Weak candidates attempted a calculation, but with significant errors or misinterpretation of case facts (e.g., comparing 100% value to the 25% ownership by Fred). Their discussion was limited to either selling or not selling, or they did not address all three options. Weak candidates tended to focus more on the quantitative aspects and did not discuss the impact of qualitative factors, such as Fred’s importance and the fit with the mission and vision.

Major Issue #4: Premium Plus Viewing Technology

Candidates were asked for their opinion on the investment opportunity and suggestions on how it could be financed. Because they were told that the accounting department had provided the NPV calculation, candidates were expected to use only that information in their analysis. They were also expected to recognize that even though the technology had been implemented with success in the past, other technologies were in development, so PPV could become obsolete in the near future.

Strong candidates found a way to show some numeracy skills by calculating the payback period or challenging the NPV calculated by the accounting department. They were able to make useful links to the situational analysis, such as the mission, trends in the economy, and the objectives.

Weak candidates did not include any quantitative items in their discussion. Some assumed that FVT would proceed with the project and only addressed the financing question. Since this issue was addressed last, some discussions were very brief, while other candidates totally ignored the issue.

Ethical and Governance Issues

Candidates were not specifically directed to these issues but were given multiple indications of there being ethical and governance issues. Significant information on FLIXREWARDS was given in the board meeting discussion, and there were clues scattered throughout the board meeting discussion, as well as a description of Zobair’s actions and comments from Stephanie. Candidates were expected to integrate the information to recognize at least one of the issues and to recommend appropriate action.

Strong candidates provided a complete discussion on FLIXREWARDS, with appropriate recommendations to ensure that FVT maintained its reputation and relationship with its customers. They also recognized that some of Zobair's actions may have been unethical.

Weak candidates either did not recognize any of the issues or addressed the FLIXREWARDS issue from an accounting or legal perspective rather than an ethical perspective.

<u>Overall</u>

Overall, strong candidates provided a balanced response, with appropriate depth in the qualitative discussion on every issue and demonstration of some numeracy skill in most of the major issues.

Overall, weak candidates tended to list qualitative points that were mostly restated case facts and to focus on the operational factors. Some weak candidates were not able to use the quantitative information in a useful way for FVT.

SO#3 (Conclusion)

Candidates were expected to conclude on each analysis they completed. Conclusions were expected to be consistent with the analysis performed. Candidates were also expected to realize that FVT had financial constraints, such as the financial covenant and the limit on spending in investment ($2.5 million).

Strong candidates provided thorough conclusions for all the issues analyzed. There was no correct solution, but strong candidates provided a recommendation that was consistent with their quantitative and qualitative discussions. They took into account the constraint by either comparing the investment needed for each project with the spending limit or attempting to recalculate the financial covenant based on the projects recommended.

Weak candidates were hesitant to give a clear recommendation and did not explain what additional information was required before a final recommendation could be made. Weak candidates also ignored the financial constraints that FVT is facing.

SO#4 (Communication)

Only a few candidates struggled with effective communication. The approach most candidates took was well structured and the language used was clear. However, some candidates' presentation of the exhibit in Excel was hard to follow. The use of decision matrix and column format in Word is also not an effective communication technique because it is difficult to clearly communicate the thought process in this format.

SO#5 (Overall Assessment)

Overall, candidates were expected to meet minimum acceptable standards in each of the four assessment opportunities listed in this report in order to obtain a "Pass" on the Day 1 linked case. For each major issue, the Board expected a high-level analysis before candidates proceeded to a reasonable conclusion. The Board also sought evidence of candidates having incorporated information from Capstone 1 and the changes identified in their situational analysis.

BOARD OF EXAMINERS' COMMENTS (continued)

Paper/Simulation: **Day 1 – Linked Simulation, FVT Version 2 (on Sept 2018 CFE)**

Estimated time to complete: 240 minutes

Simulation difficulty: Average

Competency Map coverage: N/A; Enabling Skills

Evaluators' comments by Summative Assessment Opportunity (SO)

SO#1 (Situational Analysis)

Candidates were expected to recap the important decision factors and highlight significant changes from their Capstone 1 situational analysis (such as mission, vision, trends, and objectives) that would influence the decisions FVT was contemplating and would help management identify problems that were not apparent to FVT. Candidates were rewarded when they made links to the situational analysis in the body of their report in SO#2 and SO#3.

In the Day 1 case, candidates were told that FVT had decided to purchase Cinema LaRoche (CLR) and as a result had very little cash on hand (only $20,000). In addition, FVT has breached its bank covenant and had several debt payments coming up that it currently could not afford. To add to the problems, the viewing industry was in decline, smaller operators had closed, and FVT was facing increasing costs from suppliers and minimum wage increases. The case provided an appendix of industry benchmarks with FVT's comparable results to give candidates an understanding of the trend within the industry and how FVT was fairing (its performance was weaker). The case also provided new goals for net earnings and operating income.

Generally, candidates provided an appropriate situational analysis, recognizing some of these issues and integrating them into their analysis in SO#2 and SO#3. Most candidates recapped the mission and key success factors and framed the situational analysis in a SWOT. Some candidates still spent excessive time on this part of their response, with many spending nearly half of their total response performing a SWOT analysis and providing a detailed discussion of FVT's performance relative to the industry benchmarks.

Strong candidates provided complete thoughts in their discussions, stating a case fact and why it was relevant. For example, theatres that lacked premium auditoriums had experienced further declines in attendance, and since FVT had not had the funds to upgrade its theatres, it was inevitable that the company would experience further declines in revenues and profit. Strong candidates also highlighted key elements of FVT's performance versus industry benchmarks without going into excessive detail.

Many weak candidates spent an inordinate amount of time on their situational analysis, while others simply restated case facts that had little value; for example, that FVT had purchased CLR and was experiencing operating problems. Weak candidates also spent too much time on the industry benchmarks, with many discussing each of the nine benchmarks in detail. Some even recalculated the ratios (such as the current ratio) using the numbers from the financial statements, even though the calculated ratios were provided in Appendix II.

SO#2 (Analysis of the Issues)

Candidates were expected to analyze three major issues from both a strategic and an operational perspective. There was also an operational issue and a minor issue that candidates could discuss, but these discussions should have been in less depth. Candidates were expected to analyze the issues from both a qualitative and a quantitative perspective, and the case provided sufficient information to do both for all issues.

Major Issue #1: Cinema LaRoche (CLR)

In 2017, FVT decided to purchase CLR's net assets for $17 million, which included a $4 million note payable. CLR accounted for 40% of FVT's total operating income; however, the operations were not being managed well, and profits had declined. Now FVT was considering selling CLR back to the original owner for 70% of the price paid. Candidates were expected to see that this was the most significant decision to be made, even though it was presented last in the case, and were expected to complete both a qualitative and a quantitative analysis, discussing both the operational as well as the key strategic issues.

Most candidates struggled to provide an analysis that matched the significance of this issue. This issue was the fourth and last major issue presented in the case, and most candidates tackled the issues in the order they were presented. Consequently, the depth of discussion on this issue tended to be lacking, since most candidates spent the majority of their time on the first two issues presented.

Strong candidates understood the significance of this issue and prioritized it appropriately. Many discussed this issue first and provided a balanced qualitative discussion. Strong candidates highlighted the fact that CLR accounted for 40% of the operating income and linked how important CLR was in contributing to positive cash flow and staying close to the bank covenant. These candidates also understood the implications of the first portion of the note payable being due ($1 million) and of FVT not being able to repay it without doing something to generate more funds.

Weak candidates did not understand the importance of this issue, and most of them left this issue until the end of their response. Some did not leave sufficient time to address the issue fully and only included a few bullet points that were often restated case facts (e.g., Marcel was willing to buy CLR back). Many weak candidates were so focused on solving the cash issue that they made a recommendation to sell CLR, without considering what they were "giving up" through the sale (40% of operating income and the impact on meeting the other stated objectives). Other weak candidates did not address the issue at all. Since this was deemed a key issue, not addressing it prevented them from passing Day 1.

Major Issue #2: The Games Place (TGP)

At the beginning of 2018, FVT decided to open TGP in London, Ontario, in an attempt to diversify its revenues. After two years of operation, TGP was continuing to lose money. In 2019, it had an operating loss of $436,700. Now FVT was considering closing TGP or leaving it open and leasing its games. Alternatively, although not specifically mentioned, FVT could always maintain status quo. Candidates were expected to qualitatively and quantitatively analyze the options, keeping in mind FVT's current problems (cash flow and debt issues) and its new financial targets.

Most candidates discussed this issue first and, consequently, provided a good discussion of the pros and cons of at least two of the options, although many failed to consider the status-quo option. Many candidates provided a reasonable quantitative analysis, often comparing the operating income of the different options.

Strong candidates provided a more thorough quantitative analysis by determining the cash flows under each option and comparing the results against the targets of the Board of Directors. Stronger candidates linked in the cash flow problem they identified in their situational analysis and acknowledged that by selling TGP, FVT could resolve its current debt and cash problem with the proceeds.

Weak candidates restated case facts that provided little value or gave no explanation of the implications of the fact listed (e.g., games only last six months). Some weak candidates provided an entire page of pros and cons, all brief, restating case facts without providing reasons for why each was a pro or con. Weak candidates also either did no quantitative analysis or simply restated quantitative information within their qualitative discussion (e.g., proceeds would be $1.25 million).

Major Issue #3: Tillsonburg Theatre

FVT had been approached by the Tillsonburg theatre group to renovate part of its Tillsonburg theatre to accommodate live performances. This renovation would require FVT to invest $650,000 but would provide several financial and non-financial benefits. Candidates were expected to provide a qualitative and quantitative analysis with links to several elements, such as FVT's vision (a unique experience), key success factors (diversification, supporting the local community), and the lack of available cash.

Most candidates provided a good discussion, linking to vision, key success factors, and stakeholder preferences. However, fewer linked to the lack of available cash, since most candidates recognized the positive cash flow of the theatre but not how FVT would pay for the renovations.

Strong candidates were able to provide good qualitative discussions as well as link back to the cash shortage. They completed an accurate net present value (NPV) calculation for the theatre renovation and correctly determined the positive NPV. Strong candidates also integrated their analysis of the other issues in the case (e.g., by recommending selling TGP and using the proceeds to pay for the Tillsonburg renovation). These candidates also assessed the profitability of this project against the board's goals.

Weak candidates ignored the big picture when completing the analysis. They determined that the live theatre was more profitable and ignored the fact that FVT did not have the funds to pay for the renovation. Weak candidates also provided a biased analysis and tended to ignore any cons. Some presented the funds being loaned from Sheila and Kent as completely free. These candidates assumed the loan would be forgiven, which was only a possibility. Weak candidates also made errors in what were considered by the BOE to be easy calculations.

Major Issue #4: Supplier Options

FVT was considering switching suppliers for its concession sales. There were two choices to analyze. Candidates were expected to compare the two options qualitatively and quantitatively and make the appropriate recommendation. Candidates were expected to see that the savings would be significant, based on their calculations.

Most candidates attempted a reasonable qualitative comparison of the two suppliers. However, most candidates only restated case facts for their quantitative analysis (e.g., TBG would reduce cost to 23% of revenue, while KC would reduce it to 25%). By taking this approach, they did not get a sense of the magnitude of the cash savings.

Strong candidates calculated the actual amount FVT could save from the cost reductions. These candidates also compared the cost reductions with the target for supply cost spending and noted that TBG met the target. Strong candidates also suggested ways to mitigate the weaknesses and risks of their recommended supplier. For example, KC wanted to use prices fixed in U.S. dollars, so some candidates suggested using futures contracts to reduce the foreign exchange risk. Or, some linked the 10-day payment terms for TBG to the existing cash flow issue and understood this would not help the problem, comparing it with the 30-day payment terms of the current supplier.

As with previous issues, weak candidates tended to simply restate case facts underneath "pros" and "cons" headings. Weak candidates did not explain the relevance of the points listed; for example, they would state that TBG has a minimum purchase volume but not explain why that was relevant to the decision-making. Weak candidates also tended to ignore the quantitative information for this issue entirely.

Minor Issue

There was only one minor issue that candidates could address, that of Lanny and his mismanagement of the company. Lanny was the current CFO, a family member, a primary shareholder, and a board member. Many problems with the company had surfaced, and Lanny had not taken care of any of them. At the end of Appendix I, Stephanie stated her concerns with Lanny and the lack of time he had put into work, so this was a very directed issue.

Most candidates attempted to discuss the issue and offer ways to resolve it. However, most seemed to forget that Lanny was a family member, shareholder, and board member. They instead offered suggestions that would apply to a hired manager (e.g., fire him; put him on probation; etc.).

Strong candidates provided a good discussion while not spending excessive time on this issue. They understood Lanny's position with the company and made appropriate recommendations to try and resolve the issue. For example, the board needed to sit down with Lanny to discuss the concerns openly and find out why Lanny was not attending to all his responsibilities.

Weak candidates tended to spend too much time on this minor issue, sometimes using pages to recap all the problems and make several recommendations to resolve the issue. Some weak candidates suggested this was the biggest issue with the company and addressed it before all the major issues. Many weak candidates did not consider Lanny's position as a primary shareholder and board member and recommended unreasonable actions, like firing Lanny immediately.

<u>Overall</u>

Overall, strong candidates appropriately prioritized the major issues and provided balanced discussions that were linked to several elements of their situational analysis. Their quantitative analysis was generally good for at least one of the three major issues, and they planned sufficient time to address the issues.

Weak candidates tended to focus too much time on the less important elements of their response (the situational analysis and the issue with Lanny). Weak candidates also struggled to demonstrate numeracy skills on any of the major issues. Many weak candidates' qualitative discussions were brief bullet points that provided little value to their discussion. They failed to integrate their analysis across the issues.

SO#3 (Conclude and Advise)

Candidates were expected to conclude on each analysis they completed. Conclusions were expected to be consistent with the analysis performed. Candidates were also expected to realize that FVT had insufficient cash on hand to meet upcoming debt payments and needed to consider that in their recommendations. Candidates should have also considered the board's new goals and how the issues helped or hindered FVT in reaching those goals.

Strong candidates provided thorough conclusions for all the issues analyzed and integrated either the new financial targets or the cash problem into their recommendations. Strong candidates provided a recommendation that was consistent with their quantitative and qualitative discussions. Some strong candidates provided an overall recommendation that recapped all their recommendations and summed up how that recommendation would meet FVT's goals and address the cash problem.

Weak candidates made recommendations that ignored the big picture (namely, the cash/debt problem and the new board goals). Many weak candidates' recommendations were neither clear nor consistent with their analysis, and in many cases they were provided issue by issue, with no wrap-up. Some weak candidates neglected to even provide a recommendation and simply implied one.

SO#4 (Communication)

Most candidates used a structured approach, and the language used was acceptable. Often those who struggled with communication also did poorly on SO#1 and SO#2. Not only did these weak candidates struggle with their spelling and grammar, but it was also evident that their understanding of the case was not clear.

SO#5 (Overall Assessment)

Overall, candidates were expected to meet minimum acceptable standards in each of the four assessment opportunities listed in this report in order to obtain a "Pass" on the Day 1 linked case.

For each major issue, the BOE expected a high-level analysis before candidates proceeded to a reasonable conclusion. Candidates were also expected to integrate the big picture and analyze the issues with consideration for the company (i.e., its cash/debt problem and the new targets set by the board), and not just analyze the issues in isolation. The BOE also sought evidence of candidates having incorporated information from Capstone 1 and the changes identified in their situational analysis.

APPENDIX I

CPA COMMON FINAL EXAMINATION REFERENCE SCHEDULE

CPA COMMON FINAL EXAMINATION REFERENCE SCHEDULE

1. PRESENT VALUE OF TAX SHIELD FOR AMORTIZABLE ASSETS

Present Value of Total Tax Shield from CCA for a New Asset

$$= \frac{CTd}{(d+k)}\left(\frac{2+k}{2(1+k)}\right) = \frac{CdT}{(d+k)}\left(\frac{1+0.5k}{1+k}\right)$$

Notation for above formula:
C = net initial investment
T = corporate tax rate
k = discount rate or time value of money
d = maximum rate of capital cost allowance

2. SELECTED PRESCRIBED AUTOMOBILE AMOUNTS

	2017	**2018**
Maximum depreciable cost — Class 10.1	$30,000 + sales tax	$30,000 + sales tax
Maximum monthly deductible lease cost	$800 + sales tax	$800 + sales tax
Maximum monthly deductible interest cost	$300	$300
Operating cost benefit — employee	25¢ per km of personal use	26¢ per km of personal use
Non-taxable automobile allowance rates		
— first 5,000 kilometres	54¢ per km	55¢ per km
— balance	48¢ per km	49¢ per km

3. INDIVIDUAL FEDERAL INCOME TAX RATES

For 2017

If taxable income is between			Tax on base amount	Tax on excess
$0	and	$45,916	$0	15%
$45,917	and	$91,831	$6,887	20.5%
$91,832	and	$142,353	$16,300	26%
$142,354	and	$202,800	$29,436	29%
$202,801	and	any amount	$46,965	33%

For 2018

If taxable income is between			Tax on base amount	Tax on excess
$0	and	$46,605	$0	15%
$46,606	and	$93,208	$6,991	20.5%
$93,209	and	$144,489	$16,544	26%
$144,490	and	$205,842	$29,877	29%
$205,843	and	any amount	$47,670	33%

4. SELECTED INDEXED AMOUNTS FOR PURPOSES OF COMPUTING INCOME TAX

Personal tax credits are a maximum of 15% of the following amounts:

	2017	**2018**
Basic personal amount	$11,635	$11,809
Spouse, common-law partner, or eligible dependant amount	11,635	11,809
Age amount if 65 or over in the year	7,225	7,333
Net income threshold for age amount	36,430	36,976
Canada employment amount	1,178	1,195
Disability amount	8,113	8,235
Canada caregiver amount for children under age 18	2,150	2,182
Canada caregiver amount for other infirm dependants age 18 or older (maximum amount)	6,883	6,986
Net income threshold for Canada caregiver amount	16,163	16,405
Adoption expense credit limit	15,670	15,905

Other indexed amounts are as follows:

	2017	**2018**
Medical expense tax credit — 3% of net income ceiling	$2,268	$2,302
Annual TFSA dollar limit	5,500	5,500
RRSP dollar limit	26,010	26,230
Lifetime capital gains exemption on qualified small business corporation shares	835,716	848,252

5. PRESCRIBED INTEREST RATES (base rates)

Year	Jan. 1 – Mar. 31	Apr. 1 – June 30	July 1 – Sep. 30	Oct. 1 – Dec. 31
2018	1	2	2	
2017	1	1	1	1
2016	1	1	1	1

This is the rate used for taxable benefits for employees and shareholders, low-interest loans, and other related-party transactions. The rate is 4 percentage points higher for late or deficient income tax payments and unremitted withholdings. The rate is 2 percentage points higher for tax refunds to taxpayers, with the exception of corporations, for which the base rate is used.

6. MAXIMUM CAPITAL COST ALLOWANCE RATES FOR SELECTED CLASSES

Class 1……………………………….	4%	for all buildings except those below
Class 1……………………………….	6%	for non-residential buildings acquired for first use after March 18, 2007
Class 1……………………………….	10%	for manufacturing and processing buildings acquired for first use after March 18, 2007
Class 8……………………………….	20%	
Class 10……………………………..	30%	
Class 10.1…………………………...	30%	
Class 12……………………………..	100%	
Class 13……………………………..	Original lease period plus one renewal period (minimum 5 years and maximum 40 years)	
Class 14……………………………..	Length of life of property	
Class 14.1…………………………...	5%	For property acquired after December 31, 2016
Class 17……………………………..	8%	
Class 29……………………………..	50%	Straight-line
Class 43……………………………..	30%	
Class 44……………………………..	25%	
Class 45……………………………..	45%	
Class 50……………………………..	55%	
Class 53……………………………..	50%	

The CPA certification program prepares future CPAs to meet the challenges that await them. For more information on the qualification process, the common final examination (CFE), and the specific education requirements for your jurisdiction, contact your provincial/regional CPA body.

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