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Rejuvenating Spa Inc. — Case

Capstone 1

In 2005, a group of ten friends and coworkers purchased a local day spa, Rejuvenating Spa Inc. (RSI) in Halifax. Effective January 1, 2014, RSI purchased the shares of Lavish Spa Inc. and recorded them in an investment account. The companies have continued to operate independently under their own brands and management. Financial statements and background information for the companies are presented in Exhibits 1 to 4.

RSI's shareholders think that now is a good time to expand further. They envision an expanded RSI that will be able to provide them with income in the future, and they also want to be in a position to sell the company when and if they choose to do so. In June of last year, Sally Rice, one of RSI's shareholders, retired from her day job as the CEO of the regional health authority and the shareholders hired her as CEO of RSI, in order to better organize the company and manage this expansion. Her mandate includes bringing RSI and Lavish's spas together to operate under the same brand identity and with the same administration, accounting, information systems (reservations), website and social media, and banking.

The plan for expansion is focused on two initiatives:

1. Developing a franchise of day spas that provide a full range of services (massage, manicures and pedicures, facials and body treatments) and sell related products. Sally sees this as the quickest and easiest way to expand and increase the revenue and profitability of RSI. The franchise will be modeled after RSI's operation and image. As part of this process, RSI will bring Lavish Spa under the same brand identity by changing to the same name, decor, operating standards, etc.

2. Partnering with Forevermore Fit Limited (FFL), a privately owned corporation and the largest fitness chain in Atlantic Canada. FFL wants to add massage therapy to the services it offers its members and approached RSI with the idea of opening Massage Therapy Centres (MTC) in its fitness centres. The massage centres will operate as a separate entity with its own name, logo, etc. The proposal is that FFL and RSI will each contribute expertise and the new entity will hire management/administrative staff and therapists as required. FFL will make space available and RSI will provide expertise in management of the massage service. Details need to be worked out on how to proceed in terms of the structure and the contributions of each of the parties. The process has been started, including writing a draft agreement and collecting data on prices and costs.

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These two expansions are seen as ways for RSI to exploit opportunities in different areas of the marketplace, serving different clients and meeting different consumer needs. The proposed franchises will be full-service spas focused on self-indulgence, while the massage facilities in the fitness centres are aimed at health-conscious and fitness- and sports-oriented clients.

In addition to these initiatives, another opportunity has presented itself. The owner of Pure Substance Inc. (Pure), a manufacturer of spa products, has approached RSI with an offer to sell the company. It is important to the owner that the purchaser of Pure has similar values and will continue to operate the existing facility employing local people, and he believes RSI will do this. RSI has used Pure Substance products for the past few years and found that the company is reliable and consistent (in terms of both product quality and on-time delivery). The potential purchase is in the exploration stage.

Rubinoff & Rubinoff LLP (RR), a professional services firm providing public accounting, tax and consulting services to small businesses, has been hired by RSI to help with the expansion plans and other related issues. Jacob Rubinoff attended the most recent quarterly shareholder meeting of RSI to obtain an understanding of exactly what RSI wants the firm to include in the engagement (Exhibit 5).

You, CPA, work for RR. It is now February 14, 2016, and you are a member of the engagement team assigned to this project. The team is to perform the necessary analysis and prepare a draft report that will be presented to RSI's shareholders for consideration and action. The report should include an analysis of the current position of RSI and Lavish and evaluation of the plans for expansion as well as other issues raised in the quarterly shareholder meeting. Sally and the other shareholders are eager start the expansion and would like RR to include in the report a recommended course of action.

Exhibits

Exhibit 1
Rejuvenating Spa Inc.
Statement of financial position (Note 1)
Non-consolidated
as at December 31

Assets		**2015**		**2014**
Current assets				
Cash	$	12,401	$	3,000
Accounts receivable (Note 2)		63,012		45,430
Prepaid expenses		3,150		2,181
Supplies and linens		7,562		9,540
Inventory (Note 3)		62,125		45,430
Other		1,000		1,000
Total current assets	$	149,250	$	106,581
Property, plant and equipment net of accumulated depreciation (Note 4)	$	950,000	$	986,873
Investment in Lavish Spa Inc. (Note 5)		1,000,000		1,000,000
Total assets	**$**	**2,099,250**	**$**	**2,093,454**
Liabilities and shareholders' equity				
Current liabilities				
Accounts payable and accruals (Note 6)	$	60,295	$	74,613
Income tax payable		8,678		4,544
Current portion of long-term debt		93,839		93,839
Total current liabilities	$	162,812	$	172,996
Long-term debt				
Mortgage on building (net of current portion $25,714; 2014 $25,714) (Note 7)	$	488,566	$	514,280
Term loan bank — purchase of Lavish (Net of current portion $68,125; 2014 $68,125) (Note 8)		545,000		613,125
Due to shareholders — Lavish shares (Note 9)		250,000		250,000
Total long-term debt	$	1,283,566	$	1,377,405
Total liabilities	$	1,446,378	$	1,550,401
Shareholders' equity				
Common shares	$	200,000	$	200,000
Preferred shares		200,000		200,000
Retained earnings		252,872		143,053
Total shareholders' equity		652,872		543,053
Total liabilities and shareholders' equity	**$**	**2,099,250**	**$**	**2,093,454**

Exhibit 1
Rejuvenating Spa Inc.
Statement of earnings
for the year ended December 31

	2015	2014
Revenue		
Spa services	$ 504,100	$ 454,300
Product sales	248,500	227,150
	$ 752,600	$ 681,450
Expenses		
Wages and benefits	$ 191,054	$ 177,177
Cost of products sold	124,250	109,032
Administration and other expenses	142,103	131,694
Marketing	37,630	30,665
Depreciation	55,873	58,968
Interest — mortgage	29,314	32,400
Interest — Lavish shares	48,431	61,313
	$ 628,655	$ 601,249
Earnings before other income	$ 123,945	$ 80,201
Other income — dividends Lavish	99,619	-
Earnings before income tax	$ 223,564	$ 80,201
Income tax	18,592	12,030
Net earnings	$ 204,972	$ 68,171
Earnings as % of revenue	0	0
Retained earnings, beginning of year	143,053	74,882
Dividends	95,152	
Retained earnings, end of year	$ 252,873	$ 143,053

Notes to financial statements

1. These financial statements are prepared for internal management reporting and for income tax filing purposes.

2. Accounts receivable

	2015	2014
Client accounts	$6,842	$8,330
Insurance (direct billing)	53,920	35,900
Shareholders and employees	7,250	6,200
Subtotal	68,012	50,430
Estimate uncollectible	5,000	5,000
Net	$63,012	$45,430

3. Inventory — cost estimate is based on retail selling price and markup

	2015	2014
Pure Substance organic products (resale)	$34,605	$23,280
Pure Substance organic products (bulk)	7,540	6,200
Cosmetics and other beauty products	14,500	10,410
Miscellaneous	5,480	5,540
Total	$62,125	$45,430

4. Property, plant and equipment
RSI's building is being depreciated at the same rates and methods used for income tax purposes.

	2015			2014		
	Cost	Acc. deprec.	Net book value	Cost	Acc. deprec.	Net book value
Land	$140,000	$0	$140,000	$140,000	$0	$140,000
Building	900,000	210,000	690,000	900,000	181,250	718,750
Equipment	225,000	105,000	120,000	206,000	77,877	128,123
	$1,265,000	$315,000	$950,000	$1,246,000	$259,127	$986,873

5. Investment in Lavish Spa Inc.
The investment is recorded at cost.

At the time of purchase it was estimated that Lavish's customer list had a value of $100,000 and its brand identity had a value of $100,000.

6. Accounts payable and accrued liabilities

	2015	2014
Accounts payables	$55,514	$70,723
Wages and benefits payable	4,781	3,890
Total	$60,295	$74,613

7. Mortgage

   20 years, 6%, $25,714 per year
   Security is land and building.

8. Loan for purchase of Lavish Spa Inc.

   9%, $68,125 per year.
   Security is shares of Lavish and personal guarantees of shareholders.

9. Due to shareholders

   Non-interest bearing, no set terms of repayment.

(in dollars)

Payable to	Amount	Payable to	Amount
Sally Rice	40,000	Trent Carle	20,000
Richard Brown	40,000	Joanne Gibb	20,000
Bob Gallant	35,000	Janique Theroux	15,000
Lisa Wiley	25,000	Marilyn Cote	15,000
Dave Conyers	25,000	Cary Gammon	15,000

Exhibit 2
RSI background material

Our mission is to run a profitable business by providing affordable massage and other spa services in a warm and welcoming environment. We offer a variety of massage services, including deep tissue massage, sports massage and Swedish massage, as well as facials, body treatments, manicures and pedicures. Our staff is professionally trained. We provide individualized treatments tailored to our clients' needs, and clients are encouraged to provide feedback to help us improve our services and to encourage repeat business and referrals. We are mindful of the overall experience and use quality products. We aim to be respectful of the environment.

Space

We have 2,500 square feet, which includes private treatments rooms and an area used to provide facials, manicures and pedicures. We have a reception area that includes a display area for the products we sell.

Location

Our building is in downtown Halifax close to many universities and hospitals. There are many retail boutiques close by as well as medical clinics and other services. Limited off-street parking is available.

Hours

We are open Monday to Thursday 10 a.m. to 6 p.m. and Friday, Saturday and Sunday 10 a.m. to 9 p.m.

Customer profile

Based on our observations, customers are 70% female, but this is gradually decreasing. The average age is 40, but ranges from late teens to mid-seventies. Customers are mostly middle class, many with health insurance coverage for massage treatments. We had approximately 7,100 visits last year, up about 600 over the year before.

Prices for 2015 averaged $75 per massage, $80 per facial, $85 per body treatment and $35 for nail treatments; prior year averages were $74 per massage, $80 per facial, $85 per body treatment and $35 for nail treatments.

Exhibit 3
Lavish Spa Inc.
Statement of financial position (Note 1)
as at December 31

	2015	**2014**
Assets		
Current assets		
Cash	$ 14,600	$ 2,500
Accounts receivable (Note 2)	15,125	11,377
Prepaid expenses	3,781	2,617
Supplies and linens	27,500	26,935
Inventory (Note 3)	59,400	55,798
Other	1,000	1,000
Total current assets	$ 121,406	$ 100,227
Leasehold improvements (net of accumulated depreciation $145,833; 2014 $116,667) (Note 4)	$ 204,167	$ 233,333
Equipment (net of accumulated depreciation $248,000; 2014 $174,000) (Note 4)	338,000	334,000
Net book value	$ 542,167	$ 567,333
Website (Note 5)	58,500	38,500
Total assets	**$ 722,073**	**$ 706,060**
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable and accruals (Note 6)	$ 58,275	$ 55,125
Income tax payable	2,865	2,725
Current portion of long-term debt	80,000	80,000
Total current liabilities	$ 141,140	$ 137,850
Long-term debt (net of current portion $80,000) (Note 7)	$ 350,000	$ 400,000
Contingent liability (Note 8)		
Total liabilities	$ 491,140	$ 537,850
Shareholders' equity		
Common shares	$ 1,000	$ 1,000
Retained earnings	229,933	167,210
Total shareholders' equity	230,933	168,210
Total liabilities and shareholders' equity	**$ 722,073**	**$ 706,060**

Exhibit 3
Lavish Spa Inc.
Statement of earnings
for the year ended December 31

	2015	2014
Revenue		
Spa services	$ 1,375,000	$ 1,282,600
Product sales	440,000	424,000
	$ 1,815,000	$ 1,706,600
Expenses		
Wages and benefits	$ 618,750	$ 538,692
Cost of products sold	198,000	199,280
Administration and other expenses	257,119	254,775
Depreciation equipment	74,000	66,800
Depreciation leasehold improvements	29,167	29,167
Marketing and promotion	116,875	102,608
Rent	300,000	300,000
Interest	30,100	33,600
	$ 1,624,011	$ 1,524,922
Earnings before income tax	$ 190,989	$ 181,678
Income tax	28,647	27,252
Net earnings	162,342	154,426
Retained earnings, beginning of year	167,210	12,784
Dividends	99,619	-
Retained earnings, end of year	$ 229,933	$ 167,210

Notes to financial statements

1. These financial statements are prepared for internal management reporting and for income tax filing purposes.

   Costs of the loyalty program, discounts and gifts are included in the marketing and promotion expense line.

2. Receivables

	2015	2014
Client accounts	$17,625	$13,477
Allowance for doubtful accounts	2,500	2,100
Net	$15,125	$11,377

3. Inventory

   Inventories are measured at the lower of cost and net realizable value, with cost determined using the weighted average cost method.

	2015	2014
Pure Substance organic products (resale)	$31,998	$31,098
Pure Substance organic products (bulk)	6,802	5,980
Cosmetics and other beauty products	11,500	9,000
Clothing	6,250	7,520
Miscellaneous	2,850	2,200
Total	$59,400	$55,798

4. Equipment

   Equipment is recorded at cost and amortized on a straight-line basis over six to eight years.

   Leasehold improvements are being written off over the term of the lease plus the renewal (12 years).

5. Lavish’s website provides information on its services, packages, special offers, etc., and offers online booking and gift cards. It was updated in 2015. The update included the addition of a feature that allows online tracking of the reward program for members.

6. Accounts payable and accrued liabilities

	2015	2014
Account payables	$17,755	$26,175
Salary and bonus	16,700	12,500
Gift cards	23,820	16,450
	$58,275	$55,125

7. Long-term debt

   Equipment financing: Equipment is financed over a term of three to seven years at interest rates from 3% to 8%, with the equipment financed being pledged as security.

   Leasehold improvements: Improvements were financed over a five-year term.

8. Contingent liability

   Organic Spa Products (a former supplier) sued Lavish in 2012 for non-payment of amounts owing of $138,900 plus interest. Lavish's position is that the product was not up to standard and it was returned to Organic. Lavish has filed a lawsuit against Organic for return shipping costs of $5,100. Lavish's lawyers' assessment of the loss is that it is only a 20% likelihood that Lavish will have to pay.

Exhibit 4
Lavish Spa Inc. background material

Vision

“Our philosophy focuses on creating an atmosphere to help rebuild your strength, recapture your energy, and reflect on what’s truly important in your life. Taking time for yourself is crucial; otherwise your health, family, work and spiritual needs will suffer. We're proud to offer you what your body and spirit need most: relaxation, revitalization and a chance to heal from the intensity of your daily routines. A visit to the Lavish Spa is an investment in yourself and your future well-being. We provide you with the latest in treatments and the highest quality in products. By means of innovation, the passion of our employees, exceptional personalized service in a truly regenerating environment as well as informative teaching on wellness and prevention, we provide you with the pampering you truly deserve to improve your overall health and well-being.”

Services and space

Lavish Spa occupies 10,000 square feet and features four individual treatment rooms and two side-by-side treatment rooms. We provide a large lounge space for clients to relax in before, between and after treatments. We also have a dedicated product area where clients can view and sample our products before purchasing to use at home. We were fortunate in signing a multi-year lease for this location when we first opened, as the market rates increased substantially two years later. The rate has been stable for the last few years, but the market rate today is about $8 higher per square foot than when we signed the lease. The original lease was for seven years with an option to renew for an additional five years (with the rate to be negotiated on renewal).

Lavish Spa offers a complete selection of spa treatments, including massage, facials, reflexology, body wraps and polishes, and manicures and pedicures. We also offer packages such as Relaxation Time, Bridal packages, Couples, and Mother and Daughter specials. Each season, therapists at Lavish Spa work together to create a “Treatment of the Season” designed, and only available, for that time of year. We offer a reward program (at no cost with initial treatment package) that provides our loyal customers with rewards. Members earn five points per hundred dollars spent, and each 150 points can be redeemed for a $100 gift card.

Products

We are pleased to offer high-quality, contemporary spa products to enhance the experience and to purchase for enjoyment at home between spa visits. We sell Pure Substance products, manufactured in Prince Edward Island from organic ingredients combines the intelligence of science with a holistic and sensorial approach, to achieve the ultimate balance between skin, body, and mind. Nutrient-rich seaweed, harvested off the island, combined with other natural ingredients, is transformed into certified organic Pure Substance Skincare and Pure Substance Mineral Cosmetics.

Location and hours of operation

We are located on the top floor of the Opal Hotel, a five-star hotel in the downtown core of the city. Parking is available in the underground lot. Our lounge has a panoramic view of Halifax harbour. We are open weekdays from 7 a.m. to 9 p.m. and weekends 9 a.m. to 9 p.m. Reservations are required.

Customer profile

Data gathered from the membership reward program:

	2015	2014
Average age	50	52
Ratio male/female	30/70	26/74
Income level	High average and above	High average and above
Local versus visitor	40/60	42/58
Visits per year	11,000	10,600
Average $ per visit	$125	$121
Average retail $ per visit	$40	$40

Prices for the current year averaged $120 per massage, $125 per facial, $130 per body treatment, and $55 for nail treatments (manicures and pedicures); prior year averages were $118 per massage, $123 per facial, $130 per body treatment, and $55 for nail treatments (manicures and pedicures).

Exhibit 5
Transcript from quarterly shareholder meeting

Date: February 14, 2016

Location: RSI (after retail hours, in Sally's office)

In attendance:

Sally Rice, CEO and shareholder
Bob Gallant, shareholder
Lisa Wiley, shareholder
Jacob Rubinoff, Rubinoff & Rubinoff LLP

In attendance for part of meeting:

Emily Blais, Manager RSI
Michael Bernard, Manager Lavish Spa Inc.

Sally: Welcome to the meeting Jacob. Bob, Lisa and I act on behalf of the shareholders for RSI. We generally meet quarterly and review the financial results and other issues related to the operation of the company. All the shareholders attend our annual general meeting. We have our annual general meeting at the spa, which is convenient for all and helps with attendance. Shareholders can come to our quarterly shareholder meetings too if they choose, but this doesn't happen often — everyone is so busy these days, and any of the shareholders can call one of the executive members if they want to discuss any issues. I have compiled some information on our shareholders for you, Jacob, to help you get to know us better (Exhibit 6).

Bob: It is nice to meet you Jacob. Now that we are embarking on an expansion plan for RSI, it will be good to have a professional services firm to help us get off to a good start. One of the things that motivates me is for our businesses to contribute to the community in terms of healthy living, and I believe that making spas more available to the average consumer is a step in the right direction, keeping in mind that we also want to promote social responsibility and environmental sustainability and, of course, earn a return on our investment.

Lisa: I agree that it is a good idea to pursue a growth strategy, but I want to make sure we do it sensibly. I have heard of businesses growing too quickly and don't want us to fall in to that trap.

Bob: Good point, but growth has been very strong across the spa industry. Sally has put together some data on the spa industry (Exhibit7).

Sally: Let's start with a discussion of the Forevermore Fit Limited Massage Therapy Centres. I have given each of you a copy of the background information (Exhibit 8) and the draft agreement with FFL (Exhibit 9). There are details that RR will need to advise us on, including the tax implications and any potential problems with the agreement, but I think we are essentially ready to sign the agreement and get started. From my perspective, I think this is a relatively easy project. It will not take much time from us once it is established and will not require much, if any, financing. One thing I do want you to consider, Jacob, is the organizational structure of this venture. Right now, it is set to operate as a partnership but maybe incorporating would be better?

Lisa: It sounds too good to be true and to me it seems that FFL will get more benefit from this project that we will. FFL will benefit by providing this extra service to members and I expect this will provide them with a competitive advantage that will enable them to retain existing members and attract new members. What benefit will we get from it? Although I know that FFL has been in business for close to twenty years and appears successful, we don't have any information on its financial position, for example. Should we have more information before getting into business with them?

Sally: The partnership will expand our operations in a new market segment (health and fitness) and geographically (across Atlantic Canada). If we go ahead with the purchase of Pure, which we'll discuss in a bit, we will be able to sell products in FFL's Massage Therapy Centres. We will also be providing training to massage therapists in the centres and will earn revenue on this.

Bob: Perhaps we should include in the agreement some identification of RSI with the massage centres as a way to promote our brand?

Sally: That might be worth considering. To sum up, RR will analyze the work we have done on this, and review the information to make sure it is accurate from a financial perspective. It will be good to get a fresh look at it from someone not directly involved. RR may identify improvements to the agreement and areas where we may need more information.

Anything else on this? … OK, let's move on to the franchise plan. I am really excited about this and have put lots of time and effort into it. I would like Jacob to hear your views on it as well as mine.

Lisa: One question I have is the amount of work that will be involved. It will depend on the number of franchise applications we get and how many we approve. We should consider this in the approval process and not overdo it in the beginning.

Bob: Yes, but on the other hand I think having a larger number of franchisees is part of what we need to succeed — both in terms of covering costs and developing the brand and network. RR should help us determine the numbers on this one;

how many franchises do we need to sell to make it work? How much will we make per franchise? And overall? How much will it cost? What are the risks? On the upside, developing the franchise will allow us to spend more money on updating the Rejuvenating (RSI) brand or even creating a new one that combines RSI and Lavish. To assist RR, I have drafted up some expected revenues and expenses pertaining to the Franchise Development (Exhibit 10).

Sally: My expectation is that many of the franchisees will be massage therapists who are operating an independent massage clinic or spa. I expect that we will have from 5 to 15 new franchisees a year, with half of them being independents joining the network, and half being new entrepreneurs.

Bob: In my experience, franchisee brochures often have some certification on the contents to provide potential franchisees with confidence in the franchisor and the offer. We have this in the draft (Exhibit 11). Maybe we should also require some assurance on the information the applicants provide us?

Sally: That should be part of a process we put in place to award franchises. We will want to determine if an applicant has the necessary financial resources and experience.

Bob: I think you have made a great start on this Sally. I agree getting RR to take a fresh, unbiased look at this will be really helpful. They may identify issues or risks that we have not considered and advise us on how to deal with them.

Sally: The last area we need to consider in our growth plan is a potential acquisition of Pure Substance. This opportunity came up very recently and we have not had much discussion of it as a group. I don't know if any of you know Matthew Chung? He is the owner and manager of Pure. He is a fellow Rotary Club member and recently approached me at a meeting with the idea of RSI purchasing his company. I must say it came as a bit of a surprise that he is planning to sell.

I know we had not been thinking of going into manufacturing but, given that Pure is available; I thought it was worth considering. It may be a good fit with RSI and our other plans.

I met with Matthew and we had an interesting discussion around his plans. This is all very confidential at this stage, as he does not want his employees to be concerned. One of Matthew's main concerns is to retain the long-standing business in PEI and keep the current workforce. He is concerned about the economy of PEI. I have a copy of my notes from the meeting (Exhibit 12) for each of you, including the financials (Exhibit 13).

Lisa: It does sound interesting and although I can see it is related, it does seem a bit removed from what we have been doing to date.

Bob: True, but I think it is something that would create synergies and additional profit. More importantly, there is potential for growth. I have briefly looked at Pure's statements and see it is not making much profit. It may be in our best interest to retain the company in PEI for a few years until we fully understand in the production process as well as the product recipes, and then close the PEI production facilities and outsource the production to a larger company. A larger manufacturing plant will likely be able to save us money on the production as well as the shipping of the items. RR should analyze the financials and related information on this and report back to us.

Sally: Yes, while that may make better business sense, I cannot help feeling bad when a business leaves the East Coast. After all, remember what happened to the McCain business back in 2014.[1]

I think Michael and Emily are here now. Let's ask them to join us for a bit — it would be good for Jacob to meet them and for us to get our quarterly update on how things are going.

Managers join meeting at this point.

Sally: Welcome to the meeting Michael and Emily. As you both know we are working on expansion plans for RSI and have hired Rubinoff and Rubinoff, a professional services firm, to help us out. Jacob Rubinoff is with us for this meeting and we thought it would be useful for him to meet you and hear about any concerns and suggestions you have, as well some more details on the current operations of the spas. To start off, one area that we would like your thoughts on is staffing and the ideas we have been discussing about employee bonus plans and equity ownership.

Emily: I have been manager at RSI for almost 15 years. There have been many changes over the years, but the basics are the same. In order to provide quality service we must have great service providers such as estheticians, manicurists as well as therapists. It has always been a challenge to attract and keep good people and I think it is getting more difficult all the time. Being a therapist is a demanding job physically and I am not sure that providing equity to staff will help with retention. Providing this incentive to me, as a manager, would be good though. For our therapists, we need to be competitive in terms of the salary and benefits we provide. The work environment and professional development are also important, as well as a flexible work schedule.

Michael: We are a newer spa than RSI, and most of our staff has been with us from the start — but it has only been five years, and I can see that burnout could be an

[1] Stewart, Dave. "McCain Foods plant closure leaves people in shock." *The Guardian*, August 8, 2014. http://www.theguardian.pe.ca/News/Local/2014-08-08/article-3827856/McCain-Foods-plant-closure-leaves-people-in-shock/1

issue. We provide bonuses to staff based on revenue now. Changing this might be difficult, especially if it results in them earning less. Personally, I would welcome the opportunity to own part of the company, but there may be better ways to motivate and compensate therapists that would reward generating revenue, but also reward based on other measures, such as repeat business, new clients, and level of retail sales.

Emily: Sally has discussed with me the idea for developing a franchise and it sounds exciting, but I wonder how much time I would be expected to devote to this. I am already working full time, but I would like to be involved in the new venture. I have lots of experience and feel I could make a valuable contribution, but would there be extra help for the work I do now? Some of our experienced therapists might also welcome the opportunity to help with the manuals and training. It might make their work more interesting and help with retention, but then we would need to hire extra staff.

Sally: Thanks Emily — good ideas that we will consider in our plans.

Michael: From what I have heard on the franchise plan, I understand that Lavish will be required to change to come in line with the new image. I am not sure that this is a good idea. Our operation is quite different than that of RSI, and while I can see that things could be streamlined from an administrative side, I am not in favour of going beyond that.

Bob: Point noted.

Michael: I try to keep up on the trends and new developments in the spa industry so that we can offer new services to clients and market our services in a way that will attract new clients. One trend that is emerging, for example, is the concept of mindfulness, and we are developing a Mindfulness Package that includes a mindful massage and mediation session.[2] Other trends I am watching include an increase in male clients, urban wellness retreats and the rise in tourism-related spa visits.[3]

Lisa: Interesting — it is good that you are keeping up on the industry. We should make sure that we consider things like this in our plans. We would also like to get your views on pricing of services and loyalty and other promotional programs.

Bob: We have also been discussing how to compete — price versus quality service.

[2] SpaFinder Wellness, Inc., *2013 Trend Report: Top 10 Global Spas and Wellnes Trends Forecast*, http://www.spafinder.ca/newsletter/pt/trends2013/SFW_2013_Trend-Final.pdf (accessed Feb 26/15)
[3] Ibid.

Michael: Our prices are perhaps a little lower than the industry average for hotel spas, but we also cater to the local market and want to be competitive — keeping in mind that we offer a premium service.

We do offer a membership reward program. It is not a big cost to the company, and it rewards our loyal customers, which encourages repeat business and makes customers feel special. We also provide small gifts for referrals and for special occasions. We have been in business just over five years and have built up a loyal customer base among locals and regular visitors to the Halifax area.

Emily: Our prices are lower than Lavish’s, which is to be expected given that we cater to a different clientele and are in a more competitive environment, price wise.

We don’t have any loyalty programs, but maybe it is something we should consider. However, it might be an issue because our prices are already low and it could affect the bottom line.

Sally: We plan to offer some kind of loyalty program as a feature of the franchise.

Michael: It might be useful for Jacob to visit our spas so he can see firsthand what we offer.

Lisa: Yes, I think that would be an excellent idea! I will leave it to you, Michael and Emily, to arrange for Jacob to have a tour of the spas, meet some of the staff and try out some of our services.

Sally: Thanks again for coming to our meeting, Michael and Emily.

Managers leave the meeting.

Sally: We have also discussed the need to develop an overall strategy for RSI. I think it would be useful to review this with Jacob.

When we purchased RSI, we created a mission and vision statement and have reviewed it at our annual general meeting each year.

Our vision is “to provide exceptional client-centered spa services in an atmosphere that is relaxing and in a manner that is environmentally friendly and sustainable.” Our mission is “to provide professional quality services while developing relationships with our clients, our community and the environment.”

Now that we are planning to grow RSI, we need to keep the mission and vision in mind.

Bob: We need to establish and build on what makes our spas unique, and then ensure that this is conveyed to potential franchisees and any other businesses we invest in — that they have the same principles and values.

Lisa: One key area is hiring and keeping quality staff. I think this has been difficult at times, as Emily in particular noted.

Sally: One of the ideas we started discussing earlier ties in here: employee ownership through an equity compensation plan. Maybe the compensation could be linked to different measures. I think that this would help attract and keep great employees and encourage them to think like shareholders and focus on the same things — customer satisfaction and profitability. I understand the bonus plan in place at Lavish is based on revenue, but perhaps this should change to a different measure. There may be better ways to encourage employees to focus on the same goals as our shareholders.

Bob: We also need to consider how best to organize and monitor the business.

Sally: I agree. We meet quarterly and review financial reports and discuss any matters the managers bring to us, but our meetings and reports will need more structure.

Bob: And we shouldn't ignore the ownership and corporate structure of the companies. It is important for tax purposes, and to facilitate financing and the future transfer of ownership to family members or others.

Sally: Once we decide on the details of our growth and expansion plans, we will need to obtain financing. I have talked with our bank and gotten some preliminary information on the terms they can offer and the requirements we will have to meet to secure financing for our expansion from them (Exhibit 14).

I have also been researching the possibility of arranging private financing debt financing, as an alternative. I met with a business broker, who introduced me to a potential lender, Blair Cummings. My understanding is that private lenders are more open to negotiation and will consider a wider range of options for fees, repayment terms, collateral and other requirements. I agreed with Blair that we would prepare an information package for him as a starting point for negotiations, including a description of the use of the funds, range of fees we would be willing to pay, interest rate we anticipate getting, financial information we will provide (when and what), performance benchmarks we are willing to track, repayment terms we would like, and collateral we can provide. Jacob, please add this to what we require from RR.

Based on my preliminary discussions, the shareholders will have to provide some funds as well, which seems reasonable — if we want to grow the business we need to be willing to invest and assume some of the risks.

Depending on how we decide to proceed, we may need to invest significant amounts and need to consider the best way to structure the investment; it may be that some of us will be able or willing to invest more than others, and we may even consider bringing in additional shareholders.

Bob: I hope we haven't overwhelmed you, Jacob. You have listened very patiently to all of our discussions. We look forward to receiving RR's report.

Exhibit 6
Shareholder Information

The core shareholder group comprises Sally, Bob, Lisa, Cary and Richard. This is the group that organized the purchase of RSI initially. They recruited the other investors (friends and family).

Sally Rice	60 years old, family physician, retired CEO of Regional Health Authority, member of Halifax Rotary Club, Chair of the Halifax Progress Club, member and frequent visitor of Spa Traveler Club
Bob Gallant	47 years old, family physician in private practice, chair of the Nova Scotia Wildlife Conservation Association, active in sports and a member of the Halifax Golf and Curling Club
Lisa Wiley	52 years old, registered dietician and department head, Regional Health Authority, President of Nova Scotia School Breakfast Clubs, member of Forevermore Fit Limited
Cary Gammon	40 years old, professional social worker, Children's Health Authority, Chair of the Halifax chapter of the Optimist Society, active volunteer in several community groups promoting healthy living and environmental issues
Richard Brown	43 years old, chiropractor in private practice, cross country runner, member of the Halifax Rowing Club, adventure travel lover
Trent Carle	59 years old, physiotherapist Regional Health Authority
Joanne Gibb	70 years old, widow of a cardiologist who formerly practiced with Dave Conyers
Janique Theroux	62 years old, lawyer in private practice, Sally Rice's sister
Dave Conyers	38 years old, cardiologist in private practice, close friend of Bob Gallant
Marilyn Cote	55 years old, registered nurse, Regional Health Authority, Bob Gallant's cousin

Exhibit 7
International Spa Association (ISPA) 2013 U.S. spa industry study

	Average				Median			
Metric	All	Day	Resort/Hotel	Other	All	Day	Resort/Hotel	Other
Revenue per spa	$ 701,000	$ 616,000	$ 1,524,000	$ 664,000	$ 439,000	$ 350,000	$ 1,000,000	$ 450,000
Revenue per visit	87	78	127	111				
Revenue per square foot	180	203	119	213				
Revenue per employed person	40,711	39,406	44,004	44,041				
Visits per spa	8,040	7,930	11,970	5,980	4,854	4,476	7,500	4,000
Square footage per spa	3,890	3,030	12,790	3,120	2,500	2,400	10,000	2,000
Total employees per spa	17.2	15.6	34.6	15.1	14.0	14.0	28.0	9.0
Full-time employees	7.6	6.9	15.6	6.2				
Part-time employees	7.3	6.5	16.8	5.8				
Contract employees	2.4	2.3	2.2	3.1				
Prices per service								
Per massage	87	82	129	n/a				
Per facial	94	89	133	n/a				
Per body treatment	97	90	136	n/a				
Per hair service	66	67	72	n/a				
Per nail service	42	39	57	n/a				
Per service	82	76	112	n/a				
2012 prices showed a 2% increase over 2011, slightly below the CPI increase of 2.1%.								
Offerings percentages								
Special discounts for the spa's social media audience	51%							
Loyalty programs	47%	51%	37%					
Online option to book treatments	45%	49%	33%					
Treatments using organic ingredients		41%	65%					
Treatments using local products		7%	20%					
Retail								
Retail purchases per guest	$ 35	$ 31	$ 38	$ 66	$ 22	$ 20	$ 28	$ 36

Exhibit 7 (cont'd)
Excerpts from the International Spa Association (ISPA) 2013 U.S. PWC study[4]

Spa establishments

In 2012, the number of spa establishments is estimated to have increased for the first time since 2008. The rate of new spa openings (an estimated 5.2%) was slightly in excess of the closure rate (an estimated 4.6%). Consequently, the number of spa locations increased from 19,850 in 2011 to 19,960 in 2012 (+0.5%). Reflecting the modest increase, the 2012 number remains lower than the estimated peak number of spa locations (21,310), which was reached in 2008. Nonetheless, the reversal of the declining trend in the number of spa locations marks an important milestone in returning to growth.

Spa revenues

Total spa revenues for 2012 are estimated at $14 billion[5], an increase of $0.6 billion (+4.7%) on the 2011 revenues. The estimated 4.7% increase in total spa revenues exceeded the rate of consumer price inflation (2.1%) by a margin of 2.6%. This would indicate growth equivalent to the nationwide expansion in economic activity over the course of 2012. Average revenues per spa rose to $701,000 in 2012, an increase of 4.1%. This marks the third year in a row that revenues per spa have increased, reversing the downward trend that had been evident through to 2009.

Spa visits

The total number of visits to spa establishments is estimated to have risen from 156 million in 2011 to 160 million in 2012, an increase of 2.8%. After declining to 143 million in 2009 in the wake of the economic downturn, spa visits have steadily recovered and, by 2012, had regained their 2008 peak (160 million). The 2.8% increase in spa visits was the main factor driving the 4.7% revenue increase. Average visits per spa rose to 8,040 (+2.3%). The 2012 level is the highest recorded since 2005.

Looking ahead: Confidence

Spas remain confident that revenues will increase over the foreseeable future. Almost four in five spas (78%) said they were "confident" or "very confident" of an increase in revenue within the next couple of years. The proportion of spas expressing confidence in their revenue prospects varied little by type of spa. Among day spas, 77% said they were "confident" or "very confident" of an increase in revenues. Slightly higher confidence levels were reported by resort/hotel (83%) and other spas (83%).

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[4] http://www.experienceispa.com/media/facts-stats/. Accessed Nov 5/14

[5] http://www.experienceispa.com/articles/index.cfm?action=view&articleID=706&menuID=0. Accessed Nov 5/14.

Looking ahead: Key challenges facing the spa industry

The following is a summary of responses made by spa business owners when asked what they think is the biggest issue facing the industry the future.

1. The economy
   Over one in four respondents (27%) expressed uncertainty regarding the outlook for the U.S. economy in 2013. The main concern was that the economy would slow down, leading to reduced disposable income and consumer spending on discretionary purchases such as spa services.

2. Discounting/competitive pricing
   Seventeen percent (17%) of respondents identified this as the main issue facing the industry. Spas were especially concerned about the impacts on consumer behaviour, such as shopping around for the lowest priced deal and the effect of that on customer retention.

3. Staffing
   Recruitment and retention of staff was seen as the most important issue by 13% of respondents. This is the kind of challenge that typically faces a growing industry.

4. Staff skills
   Almost one in 10 spas (9%) highlighted issues around staff qualifications and skills. Many of these spas (39%) linked the issue of staff qualifications to recruitment difficulties.

5. Consumer perceptions
   Tackling the public perception of spa services as pampering/luxury and educating the consumer on the health benefits of the spa experience was seen as the main priority by 10% of respondents.

6. Market
   Issues around change and competition in the marketplace were cited by 9% of spas, i.e. growth in the number of other spa providers as well as competition from providers of other related services.

7. Labor and operating costs
   These were cited as the main issue by 6% of spas; 3% of spas highlighted rising prices/inflation.

Other issues mentioned by spas included switching to a more wellness-focused orientation (4%), strategies to generate loyalty/retention (3%), and promoting new business (2%).

Type of operation

The majority of spas (68%) describe themselves as single location operations; resort/hotel spas are the main exception. More than one in three resort/hotel spas (35%) are affiliated with a national corporate headquarters. This can be compared with the average for all spas of 6%. Almost one in five spas (19%) said they are one of a number of locations within the same state or region and owned by the same owner/company. Operations with a franchise affiliation account for 7% of spas.

The study noted that “the most common ownership structure in the Canadian spa market is sole proprietorship at 43%, partnership at 19% and small corporations at 22%. According to the 2000 Spa Industry Study prepared by Price Waterhouse Coopers, stagnation is a frequent and understandable occurrence for the isolated spa owner.”

Canadian customer study

Reasons for selection/spa image

Convenient location (74%) is the reason most frequently cited by Canadian spa-goers as the reason for selecting the spa they chose on their last visit. Having friendly staff members (55%) is of critical importance, as is atmosphere of the spa facility (52%). Past quality of treatment (45%), professionalism (44%), price (42%), overall reputation (41%) and past experience (38%) also score at significant levels.

As 91% of spas in Canada are day spas, according to the ISPA 2002 spa industry study, Canadian respondents’ reasons for choosing a spa are compared to those of U.S. day spa visitors. Results are generally comparable, although Canadians report choosing spas because of special services not offered by other spas (4% U.S. vs. 20% Canada) and appear more concerned with employees having professional qualifications (19% U.S. vs. 34% Canada), a key point to emphasize in marketing materials. Nearly four times as many Canadians as Americans (19% Canada vs. 5% U.S.) indicate that they chose the spa they last selected because it is the only one they know. Further research is needed to establish whether this finding indicates room for more facilities and/or different types of specialties. Spa visitors view spas as a place to relax and gain health benefits. Non-spa-goers reveal ignorance of what spas offer, feel “out of place,” and are less comfortable with exposing their bodies. Marketers to potential Canadian spa-goers can exploit these findings in their promotional materials. In a growing market, it is essential to educate potential consumers on spa benefits so that non-spa-goers both understand their value and become comfortable with visiting them.

Exhibit 8
Information on Forevermore Fit Limited Massage Therapy Centres

Background information on Forevermore Fit Limited

Forevermore Fit Limited (FFL) was established in 1995 by a well-known personal trainer, Andy Johnson. Andy is a celebrity trainer, author and creator of online fitness training programs. FFL initially operated facilities in major cities in Atlantic Canada, expanding to smaller towns about five years ago. FFL operates full service fitness centres equipped with up-to-date equipment. Its facilities are open to members as well as to non-members who pay per session or for a set program. It provides personal and group training and fitness classes, as well as programs for weight loss and healthy living.

Partnership financial and operational information projections

	Typical large centres	Typical small centres	Notes
Number of facilities currently operated by FFL	7	18	
Number of members	2,500	1,000	
Membership growth rate	10%	5%	
Ratio male to female members	50/50	40/60	
Hours of operation	Weekdays 5 am to 11 pm Weekends 9 am to 10 pm	Weekdays 6 am to 10 pm Weekends 9 am to 10 pm	By appointment only in smaller centres; by appointment and drop in at larger centres
Massage hourly rates	$80	$75	Set in line with local market
Treatment rooms	4	1	
Equipment cost per room	$7,500	$7,500	
Uniforms and supplies per therapist	$2,000	$2,000	
Retail space (products)	Dedicated space Assume revenue @ 15% of therapy revenue	With other fitness centre retail products; assume revenue @ 15% of therapy revenue	Cost of sales 50%
Utilization rate for therapists	75%	70%	
Wages and benefits	45% of therapy revenue	45% of therapy revenue	
Marketing	5% of revenue	5% of revenue	
Supplies	5% of revenue	5% of revenue	
Administration/other expenses	$50,000	$50,000	

Exhibit 9
Draft agreement — Forevermore Fit Limited Massage Therapy Centres

Management

FFL and RSI will form a partnership, MTC, which will operate Massage Therapy Centres in FFL locations. There will be a management group comprising one member each from RSI and FFL and the manager hired for MTC. This management group will make all major decisions for MTC.

Profits will be shared equally between FFL and RSI. Operating cash flows from the partnership will be distributed to the partners quarterly.

Identity, image and branding

The centres will be called Forevermore Fit Limited Massage Therapy Centres.

Locations

FFL will decide where to set up the Massage Therapy Centres (MTC). It plans to start by opening two MTCs in larger facilities and two in smaller centres. FFL expects to have massage centres in all of its fitness centres within five years.

FFL will provide the space in its facilities at no charge. MTC will pay the costs of renovating the space where required and lease the necessary equipment. FFL will provide funds required for renovation and charge MTC interest on the borrowing at prime plus 2%.

FFL and RSI will invest $15,000 per small centre and $60,000 per large centre that is opened to cover opening costs and provide initial working capital (including uniforms, linens and supplies). FFL and RSI will also guarantee any financing required by MTC.

Human resources

RSI and FFL will jointly hire the manager for MTC and the manager and RSI will work together to hire the staff for the MTC locations. RSI will provide the initial training for therapists (for no charge). Subsequent professional development will be provided by RSI at a fee. Only qualified massage therapists will be hired.

In the larger centres there will be a separate receptionist and multiple therapy rooms, but in the smaller centres the receptionist for the fitness centre will handle the MTC as well and there will be only one therapy room.

Services

A range of different types of massages will be offered, but no other services. The focus will be on deep tissue and similar types of massage related to sports and fitness. Direct billing to insurance companies will be provided and promoted.

FFL members will receive a 10% discount off the regular price for services and products. Members will also earn “points” for massage treatments and for reaching their fitness goals that they can redeem for massage treatments, product purchases or personal fitness consultations. A process will be put in place to track where points are earned and spent.

Exhibit 10
Information on franchise development
Analysis of proposed franchise network from RSI's perspective

Revenue		
Startup fees — new entrepreneurs	$	40,000
Startup fees — existing businesses transitioning to RSI spa franchisee		25,000
Assume percentage new		50%
Ongoing franchise fee		6%
Advertising fund		0.25%
Other		
Total revenue		
Expenses		
Marketing material development	$	200,000
Marketing material (annual updating starting in year 2)		-
National advertising — equal to the total assessed franchisees		
Operating manual and training material development		-
Operating manual and training material (annual updating starting in year 2)		5,000
Training costs per franchise unit (per year)		2,500
Quality control per franchise unit (per year)		2,500
Sales, administration and other		40,000

Exhibit 11
Draft promotional material — RSI franchise

Why join Rejuvenating Spa?

Opening a spa or converting your existing operation to a Rejuvenating Spa can help you in your pursuit of a profitable independent business operation. We have the expertise and resources you need and will support you all the way. Belonging to a network of spas will increase your business and reduce your expenses.

Our philosophy

- Provide the best value and a unique experience, with the client being the focus of the experience. Provide attention to detail; for example, develop and maintain a client file that includes client preferences: treatments, music, therapist, skin type, etc.
- Operate a spa that is involved in the local community through participation and support of groups and activities that promote healthy living.
- Be environmentally friendly.

Qualifications for a franchisee and the process required from application to acceptance

- Agree with philosophy.
- Pass a net worth test to ensure sufficient financial resources (minimum $100,000 assets that can be used as collateral for a loan, plus $100,000 cash or liquid securities).
- For existing spas[6] that want to become part of the franchise, the net worth test is replaced by a successful track record in business.
- Have a background and experience in a personal service business and/or sales, and an entrepreneurial mindset.
- Be in an area with sufficient population base — exclusive area for each franchisee (based on population and right to open others in the area).

RSI provides the following:

Startup assistance and support

- Provide guidance in all phases of the startup process, including site selection criteria, assistance with facility design, exclusive equipment purchasing and grand opening promotion planning.
- Financing resources — help arrange financing for equipment and general supplies.

[6] Existing spas converting to a franchise will be required to close for a minimum of two weeks to make the transition.

- Human resources — help recruit qualified massage therapists, hire and train staff members, and provide professional development (training seminars and workshops).
- Supplies — source and provide criteria for linens and supplies.

Comprehensive marketing program

All franchises will have the rights to use the Rejuvenating Spa name, logo and other intellectual property. Advertising and promotional material is supplied (media costs are the responsibility of the franchisee in local media).

Multiple revenue opportunities

We maximize sales through additional potential revenue sources, including gift cards, and retail sales of skin care and related products.

Training

- complete classroom training program
- on-site training at your facility (pre-opening)
- marketing and sales training
- use of confidential training and reference manuals
- periodic refresher training (as part of the franchise fee, and additional professional development for a fee)

Operations

RSI provides fully computerized operations; Rejuvenating Spa clients will have the ability to book appointments with any Rejuvenating Spa location through the company's online booking system. A gift card system that is common to all locations will be used, and Rejuvenating Spa will offer an optional membership reward program to clients.

Franchisee obligations (ongoing requirements)

- For new spas: provide startup fees of $40,000.
- For existing spas becoming franchisees: provide transition fee ($25,000), ongoing franchise fee (6% of gross revenue) and marketing fee (0.25% to advertising fund for development of promotional material).
- Marketing on local media (minimum of 1.75% of the revenues received from spa services).
- Maintain specified insurance coverage.
- Hire only registered massage therapists[7] and other treatment providers with appropriate education and experience, including certification where applicable.
- Use standard decor and equipment.
- Use standard linens, robes and sandals, and other specified products.

[7] In provinces with regulations. In other provinces, require education and experience.

- Use standard pricing, within range given local market.
- Participate in marketing program specials and packages.
- Be a member of and participate in a franchisee “group.”
- Perform quality assurance procedures — franchisees must have a yearly audit done by an independent professional, and report to RSI on meeting standards established by RSI.

Exhibit 11 (cont'd)
Sample pro forma statement for franchisee

Numer of Therapists	per therapist		1	3	5	
Revenue						
Average rate	70					
Number of hours	1,920					
Utilization rate	70%					
Spa services	94,080		$ 94,080	$ 282,240	$ 470,400	
Product sales	28,224	30%	28,224	84,672	141,120	30%
Other						
Total revenue	$ 122,304		$ 122,304	$ 366,912	$ 611,520	
Expenses						
Wages and benefits	37,632	40%	$ 37,632	$ 112,896	$ 188,160	40%
Cost of products sold	14,112	50%	14,112	42,336	70,560	50%
Administration and other costs	24,000		24,000	60,000	96,000	16%
Franchise fee	5,645	6%	5,645	16,934	28,224	5%
Marketing fund	235	0.25%	235	706	1,176	0.19%
Marketing — local media	1,646	1.75%	1,646	4,939	8,232	1.75%
Occupancy and communication costs	22,000		22,000	55,000	88,000	14%
Depreciation						
Interest						
Other						
Total expenses	$ 105,270		$ 105,270	$ 292,811	$ 480,352	
Earnings before income tax	$ 17,034		$ 17,034	$ 74,101	$ 131,168	
% of revenue	14%		14%	20%	21%	

Minimum investment required. Signage $5,000; equipment $7,500 per therapist; linens and uniforms $2,500 per therapist; working capital $15,000.

To be signed off by RR:

Assurance statement on the contents of the brochure by CPA firm We have reviewed the information contained in this brochure and are satisfied that it is reasonable and contains the information necessary for users in assessing the franchise opportunity. CPA firm date and location

Exhibit 12
Notes from Sally Rice's meeting with Matthew Chung (Pure Substance owner)

- According to Matthew, Pure has been profitable and has contributed to the community by providing good jobs and financial support for worthwhile causes.
- Matthew wants to sell and pursue other interests. He is promoting Pure as a great investment with lots of potential for growth. It has a great reputation in the industry.
- Pure is one of the larger employers in Cavendish, Prince Edward Island, and has been operating for about 25 years.
- It manufactures organic products for use and sale in spas across the country. It customizes labels with the Pure Substance brand and the spa name for resale to spa customers. The products that are used by the spas are provided in bulk.
- Right now, Pure is solely a wholesale operation, but there is potential to expand. Matthew says large retail chains have expressed interest in carrying Pure's products.
- Both RSI and Lavish use and sell Pure's products, and are completely satisfied with the products and the company. Approximately 75% of product sales are products supplied by Pure, and spas use Pure products almost exclusively.
- Matthew performed a valuation of the company using free online resources, and he thinks that somewhere between eight and nine million dollars is a reasonable asking price for the shares of the company.
- Selling shares is his preference, as he thinks it will be the easiest option for him and provide him with tax advantages.
- He will consider an asset sale, but would expect RSI to pay additional costs, including any additional professional fees and tax costs.
- Matthew has provided financial information on Pure (Exhibit 13).
- Matthew said he has been receiving dividends in lieu of salary.
- The trend on the revenue seems good, but the bottom line is suffering. Matthew explained that the biggest issue is cost of goods sold, and within that the shipping costs, both shipping in and out.
- Alternatives he has been considering include price increases and/or charging for delivery.
- He also mentioned that Pure is facing increasing competition from imported products. Matthew mentioned that one thing that has been helpful has been government aid. Apparently, there are programs available to help with upgrades to equipment and job creation and retention. Pure has received grants, loans and low-interest financing in the past; there are often strings attached, but there have been no real issues. Matthew promised to fill us in on the details and introduce us to his contacts.
- Another thing that Matthew credits with contributing to Pure's success is its employees. Many have been with the company from the early years; they work hard and often have good ideas on how to improve efficiency and the product. In return, the company pays them well and looks after them in tougher times.
- I told him that we would need time to study the financials in more detail and that we will have more questions and may require additional information.

Exhibit 13
Pure Substance Inc.
Summary of financial and operating data
December 31 (000's)

		2014	2013	2012	2011	2010
Earnings before income tax plus depreciation		$ 1,499	$ 2,165	$ 2,590	$ 2,413	$ 2,011
Five year average	$ 2,136					
Multiple	3.5					
	7,475					
Net assets						
Book value	4,815					
Market value of capital assets in excess of book value	2,000					
Intangibles — brand, customer base and goodwill	2,000					
	$ 8,815					
Average of above methods	$ 8,145					

Financial information	**2014**	**2013**	**2012**	**2011**	**2010**
Product revenue	$ 19,500	$ 18,720	$ 17,784	$ 16,539	$ 16,043
Cost of goods sold	14,235	13,104	12,093	11,247	10,909
Administration	3,120	2,808	2,489	2,316	2,567
Marketing	195	187	178	165	160
Community support — % of prior year net earnings	61	82	78	67	75
Other	390	374	356	331	321
Depreciation on building	16	17	18	18	18
Depreciation on equipment	695	1,050	1,104	1,003	788
Earnings before income tax	788	1,098	1,468	1,392	1,205
Income tax	158	220	294	278	241
Net earnings	$ 630	$ 878	$ 1,174	$ 1,114	$ 964
Dividends	$ 335	$ 486	$ 573	$ 534	$ 442

Exhibit 13 (cont'd)
Pure Substance Inc.
Summary of financial and operating data
December 31 (000's)

Current assets	**2014**	**2013**	**2012**	**2011**	**2010**
Cash	$ 38	$ 62	$ 82	$ 40	$ 100
Accounts receivable	2,438	2,340	2,223	2,067	2,006
Inventory	2,373	2,184	2,016	1,874	1,818
Other	138	154	134	142	131
Total current assets	$ 4,987	$ 4,740	$ 4,455	$ 4,123	$ 4,055
Land	100	100	100	100	100
Building	2,310	2,310	2,310	2,310	2,310
Accumulated depreciation	1,918	1,901	1,884	1,866	1,848
Equipment	10,425	9,825	9,005	8,210	7,500
Accumulated depreciation	9,850	9,156	8,106	7,003	6,000
Net book value	$ 1,067	$ 1,178	$ 1,425	$ 1,751	$ 2,062
Total assets	**$ 6,054**	**$ 5,918**	**$ 5,880**	**$ 5,874**	**$ 6,117**
Current liabilities					
Accounts payable and accruals	$ 842	$ 772	$ 708	$ 659	$ 713
Income tax payable	13	18	24	23	21
Current portion of long-term debt					
Total current liabilities	855	790	732	682	734
Long-term debt due to shareholders	384	608	1,020	1,666	2,437
Total liabilities	1,239	1,398	1,752	2,348	3,171
Shareholders' equity					
Common shares	100	100	100	100	100
Retained earnings	4,715	4,420	4,028	3,426	2,846
Total shareholders' equity	$ 4,815	$ 4,520	$ 4,128	$ 3,526	$ 2,946
Total liabilities and shareholders' equity	**$ 6,054**	**$ 5,918**	**$ 5,880**	**$ 5,874**	**$ 6,117**

Exhibit 14
Financing alternatives

Purpose of financing: fund expansion

Funding available: maximum $15 million, in increments of $100,000

Interest rate: variable — prime plus 2.5%

Fees: 0.5% of amount borrowed

Repayment: Interest is due annually. Principal is due at the end of five years. There is no pre-payment option.

Collateral: cross-guarantees of the relevant companies involved; personal guarantees from RSI shareholders to total 80% of amount borrowed

Requirements:

- consolidated financial statements prepared in accordance with ASPE
- financial statement audit required if debt exceeds $10 million, otherwise review engagement acceptable
- debt to equity maximum 1:1
- debt to assets maximum 1:2
- no payments to shareholders if interest coverage ratio is below 10 times
- in the event of default on payments, the bank may demand payment in full immediately