CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

CPA Common Final Examination

BOARD OF EXAMINERS' REPORT

PART B — The Day 1 Report

May 2023 and May 2024
Examinations

CPA EVALUATIONS

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THE BOARD OF EXAMINERS’ REPORT ON THE MAY 2024 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 May 2024 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, two vice-chairs, 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 a time that is satisfactory to them.

The chair is responsible for the supervision of the evaluation process. A CFE subcommittee, made up of nine members of the board, is actively involved in the preparation of the CFE simulations, the preliminary marking guides, and the setting of the initial passing profile. The members of that subcommittee participate in the Preliminary Evaluation Centre where the marking guides are tested against candidate responses and finalized, and in the start-up of the marking centre. The BOE chair and vice-chair provide oversight throughout the entire marking process, consulting with subcommittee members as required. The full board is responsible for equating the difficulty of the examination to prior years' examinations and establishing the passing standard.

THE CFE

Preparation and Structure of the CFE

The board staff works in conjunction with authors to ensure that the simulations presented to the board achieve the overall intent and design objectives set by the board, while adhering to the competencies and 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. The CFE subcommittee reviews and refines the simulations that make up the three-paper evaluation set.

Nature of the Simulations

The CFE comprises a set of simulations which 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, unless special circumstances require that a third version be provided. 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. The versions of the exams are calibrated to ensure the difficulties of all versions are comparable. For the May 2024 CFE, a Version 1 and a Version 2 were offered. The Version 2 case relates to KTI, for which a Version 1 was offered in May 2023.

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 vice-chair, selected member(s) of the CFE subcommittee 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 KTI Day 1 simulations and related capstone case, KTI marking guides, and KTI 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 (NPF), Day 2 and Day 3 simulations can be found in **Part A** of the CFE Report.

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 chair of the board and vice-chair in charge of the examination monitor the 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 passing 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 (set using a scale: Easy, Easy to Average, Average, Average to Hard, or Hard)
- The level of difficulty of each Assessment Opportunity (set using a scale: Easy, Easy to Average, Average, Average to Hard, or Hard)
- 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 (i.e., those BOE members not on the CFE subcommittee and therefore not directly involved) 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 assesses technical **depth** in one of four unique roles (that reflect the four CPA Elective choices) and also provides **depth** and **breadth test** 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** and **breadth** tests in the common core areas of Financial Reporting and/or Management Accounting, and also provides **breadth** test opportunities for all other 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 on the Assessment Opportunities presented on Day 2 and Day 3 (Level 1).

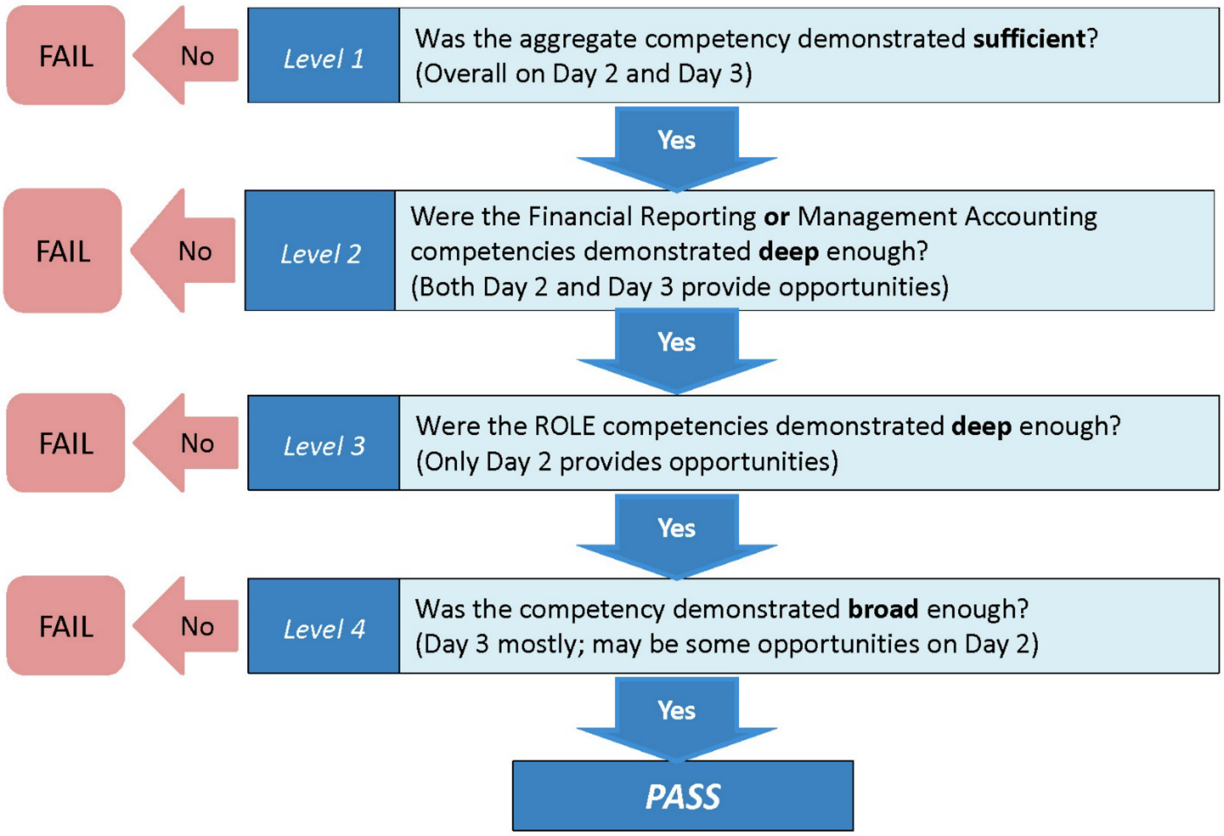
2. The response must demonstrate **depth** in the common core area of Financial Reporting or Management Accounting (Level 2).

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).

The BOE is responsible for equating the results from one examination to another to ensure that candidates have an equal chance of passing whichever examination they write. The BOE uses the factors listed above under setting the passing standard, in order to equate the examinations.

EXHIBIT I
DAY 2 AND DAY 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 the marginally failing candidates to confirm 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 pass/fail standing for Level 1, Sufficiency. A decile ranking is provided for failing candidates.
- 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 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.

Jonathan Vandal, CPA
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, and meet the two depth standards and the breadth standards.

Introduction

The May 2024 CFE Report, Part A and Part B combined, presents detailed information on all candidates' performance for all the examination cases, except for the Day 1 linked case, NPF Version 1. Detailed commentary on the performance of candidates on the NPF cases (Version 1 and Version 2) will only be available after NPF Version 2 is written in May 2025. The simulations, marking guides, marking results, and Board of Examiners' (BOE) comments on the Day 2/Day 3 portion of the examination are found in Part A of the CFE Report. Similar information on Day 1 KTI simulations (Version 1 and Version 2) can be found in Part B of the CFE Report.

The intent of this message from the BOE is to help candidates improve their performance on future CFEs by drawing their attention to the most common detracting characteristics observed in candidate responses to the May 2024 CFE. The BOE's comments are based on the feedback of the marking teams, who see the entire candidate population, and reflect the broad themes noted by the markers that apply to all candidates who wrote this sitting of the CFE. More detailed AO-by-AO commentary on candidates' performance can be found in the BOE's comments in Appendix F of Part A, or Appendix H of Part B, of the CFE Report.

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 analysis that is relevant and critical to strategic decision-making, professional judgment, and ability to synthesize information. Day 2 allows candidates to demonstrate their technical competence in the common Financial Reporting and Management Accounting competencies and in their chosen role, which is tied to one of the four elective areas. Day 2 typically, but not always, 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 further demonstrate depth and breadth in the common Financial Reporting and Management Accounting competencies, and provides multiple opportunities to demonstrate breadth in all the other core technical competency areas. Day 3 is typically time constrained, requiring candidates to prioritize the issues and manage the amount of time spent on each issue.

Both Day 2 and Day 3 require candidates to integrate the information found in the simulation in order to demonstrate competence. All three days require candidates to clearly communicate their thought process.

Strengths and Weaknesses

Time management

Overall, candidates demonstrated good time-management skills. The Day 1 simulation was not time constrained in any way and, generally, the amount of time that candidates devoted to their situational analysis and their issue analysis was appropriate. Most candidates were able to address all the strategic options presented, spending more time on the options that required more analysis and discussion. The Day 2 simulation was also not time constrained, and most candidates managed their time appropriately on Day 2, attempting all the AOs and appropriately balancing their time between the common section and the role section. On Day 3, which is designed to be time constrained and required time management on the part of the candidates, to ensure that all three simulations were completed within the four hours allotted, candidates seemed able to plan their time accordingly.

Unrelated discussions

The BOE was pleased to see that there were relatively few unrelated discussions on this exam. Candidates addressed the requireds and generally did not provide any analysis that was not necessary.

Technical ability

The BOE has noted a trend of declining technical abilities. The pattern the BOE has seen over the past few CFEs has continued, with candidates generally avoiding the more complex topics. In addition, while candidates performed well on some of the more familiar, straightforward topics, there were also familiar topics where candidates struggled.

Candidates generally performed well on the very straightforward AOs, including: Day 2, Common, AO#5 (Privacy and data security) and AO#6 (Victoria store); Day 2, Finance role, AO#7 (Net present value analysis) and AO#9 (Financing options); Day 2, Performance Management role, AO#8 (Lab-grown diamonds – qualitative) and AO#12 (Diamond-tracking technology); Day 2, Taxation role, AO#9 (CCA and taxable income (quantitative) for Fancy); Day 3, Simulation 1, AO#1 (Break-even analysis) and AO#6 (Inventory); Day 3, Simulation 3, AO#2 (Strategic fit for engagements) and AO#3 (Risks and controls – JH-Cloud).

However, on certain of the remaining AOs, there was more variability in the quality of the responses, with some candidates demonstrating a very poor understanding of the required technical knowledge.

One area where lack of technical knowledge was evident was on AOs requiring Handbook or Income Tax Act knowledge. For example, on Day 2, Common, AO#1 (Warranty), many candidates did not recognize that the financial reporting for warranties is based on its type. On Day 2, Assurance role, AO#7 (Bond investments), many candidates did not identify the Handbook section relevant for analyzing the issue. On Day 2, Taxation role, AO#11 (Taxes payable for Fancy), many candidates did not understand how investment income was taxed and had errors in their capital grind calculations. Also on the Day 2, Taxation role, AO#13 (Taxes payable for Daiki), many candidates struggled with the treatment of donation credits and dividend tax credits. On Day 3, Simulation 2, AO#1 (Government assistance), many candidates only identified one of the two options available for the accounting of the capital portion. On Day 3, Simulation 3, AO#4 (Change in use), many candidates provided incorrect tax advice, such as suggesting that Ming claim the principal residence exemption on the rental property for the whole period it was rented.

There was also lack of technical knowledge shown on some of the AOs requiring quantitative analysis. For example, on Day 2, Finance role, AO#8 (Distribution centre offer price), many candidates struggled with the market-based comparable approach, showing evidence that they did not understand this approach. On Day 2, Finance role, AO#12 (Gold order quantity), many candidates made errors in the calculation. On Day 3, Simulation 3, AO#1 (Capacity for engagements), many candidates did not break down the calculation by position.

Candidates should expect to see a variety of issues of varying difficulty. The BOE encourages candidates to be balanced in studying, and to ensure that they have a sufficient level of technical knowledge in all competency areas.

Failure to consider the specific context of the simulations and integrate relevant case facts

Consistent with previous CFEs, candidates on the May 2024 exam seemed to struggle with applying the specific context of the simulation to their response, or with integrating relevant case facts into their analysis. For example, on Day 2, Common, AO#3 (Cash and cash equivalents), candidates struggled to apply case facts to the Handbook criteria, such as ones related to liquidity or risk of changes in value. On Day 2, Finance role, AO#13 (Investable funds), candidates often did not connect the target working capital and/or target current assets to the rest of their analysis, or only provided a brief assessment of the investment options without incorporating case facts related to the investment options. On Day 2, Performance Management role, AO#10 (Flagship store allocations), candidates did not appear to understand the case facts presented to them, often confusing case facts related to the allocation policy with how the costs had actually been allocated. On Day 2, Taxation Role, AO#8 (Tax administration), candidates often provided general technical knowledge on deadlines without considering the dates that would be relevant to Fancy. On Day 3, Simulation 2, AO#2 (Franchise fees), candidates struggled with adequately integrating case facts for the intangible assets discussion, often arriving at a conclusion without any analysis.

The BOE emphasizes that the ability to adapt to unique scenarios and integrate information into an analysis, as well as from various parts of the case, are important skills for an entry-level CPA. Candidates should ensure that they have a good understanding of the specific context for any requests before addressing them, and ensure that any analyses incorporate elements that are specific to the case presented.

Day 2 role

On the May 2024 exam, there appeared to be more candidates who did not seem comfortable with their chosen Day 2 role. Their familiarity with, and ability to address, the topics tested on the Day 2 roles were not up to the BOE’s expectations, and as a result, candidates seemed to provide responses that lacked the depth necessary at the Elective level. The BOE would like to remind candidates that the expectations differ on the Day 2 role AOs, which are tested at the Elective proficiency level. These expectations are higher than those of the remaining AOs on the exam, which are tested at the Core proficiency level. Given that all roles are equated, the BOE strongly encourages candidates to select their Day 2 role carefully, and to consider their ability to respond to that competency area at the Elective proficiency level.

For more detailed commentary, see Appendix F of Part A of the CFE Report.

Additional Comments Specific to Day 1 – NPF (Version 1)

Most candidates dedicated the first section of their response to a relevant situational analysis. Most used this information later in their response, making relevant links back to the company's global situation when analyzing the specific strategic options that were presented, and within their conclusions.

There were two crucial developments in NPF's industry that had major strategic implications. First, the annual allowable harvest limit for some cold-water species decreased. Second, a new international seafood trade agreement was signed between Canada and China. In addition, NPF's board had a specific objective to increase the number of species the company could harvest to at least five, and three corporate objectives aimed at improving NPF's financial performance, to best ensure that the company earned a specified return on any new investments made. The board had decided to limit NPF's upfront spending on any new investments to $10 million. Candidates were expected to integrate these crucial elements of the company's broader situation within their qualitative and quantitative analyses of each strategic option. Although most candidates included some of these elements, many did not adequately address how the industry developments (the harvest limit and new international agreement) would affect the strategic options discussed.

There were four strategic options to be analyzed in this case, both qualitatively and quantitatively: whether to sign the new distribution agreement with Entero or renew an existing agreement with AOISE; whether to enter into a partnership with Acadia and offer three new seafood types; whether to acquire Sunrise, a shelf-ready shellfish processing plant; and whether to acquire Oceanfin, a bluefin tuna quota licence and harvesting operation.

For each of the strategic options available to NPF, candidates were expected to conclude on, and recommend, a course of action that was consistent with their analyses. In this case, the strategic strength of the available investment opportunities partially depended on which distribution channel the company selected (Entero versus AOISE). Within their conclusions, candidates were expected to consider how the viability of each investment opportunity would be affected by the choice of distribution channel.

Within the analysis of the major issues, three main factors differentiated strong responses from weak responses. First, a strong response identified and provided an in-depth discussion of the most important decision factors for each issue, such as the warming waters of the North Atlantic Ocean. Weak candidates tended to list case facts, often failing to explain why those elements were important and how they affected the decision-making process. Second, strong candidates provided valuable quantitative analyses to help support their recommendations, such as by linking their calculations to the stated objectives of NPF. In contrast, weak candidates' quantitative analyses were often unstructured and unclear and, therefore, challenging to follow. Many failed to perform the correct calculation to assess the decision. These candidates often struggled to explain how the results of their quantitative analyses affected the decision at hand. Third, strong candidates recognized the integration between the various strategic options. Strong candidates incorporated discussions of whether one option would fit well with the other options presented, whereas weak candidates typically missed making these links altogether. Strong candidates also typically incorporated both industry developments in their discussion and conclusions. Weak candidates tended to only perform an issue-by-issue analysis without stepping back to consider the broader perspective, and without integrating the key industry developments into their conclusions. As a result, they failed to make important links between the various aspects of each option.

On this sitting of the exam, the BOE noted that more candidates struggled with the "step-back" nature of the Day 1 simulation. There was more evidence in the responses of characteristics exhibited by weak candidates in the overall population. The BOE encourages candidates to take the time on Day 1, which is not designed to be a time constrained exam, to think through the bigger-picture issues presented in the simulation, and incorporate that analysis into their response.

Most candidates approached their response in a coherent and organized fashion. Only a few candidates struggled to effectively communicate their ideas. These candidates tended to use poor sentence structure, confusing syntax, and an unorganized approach to their response.

Additional Comments Specific to Day 1 – KTI (Version 2)

Similar to NPF Version 1, most candidates dedicated the first section of their response to a relevant situational analysis. Most used this information later in their response, making relevant links back to the company's global situation when analyzing the specific strategic options that were presented, and within their conclusions.

One of the significant constraints in the case was that KTI-branded tea had higher-than-expected demand, and as a result, KTI forecasted a shortage of raw materials in the coming years, which was made worse by the significant threat of climate change. In addition, KTI's board had an objective to grow the company's revenue and achieve a gross margin of at least 20% on both private-label and KTI-branded tea sales. Although KTI decided not to access any further debt financing, the company's investment capital was sufficient to afford all the presented opportunities, and therefore, there was no cash constraint. Candidates were expected to integrate the crucial elements of the company's broader situation into their analysis.

There were five strategic options that candidates were expected to analyze both qualitatively and quantitatively: whether to develop and offer a website and online store; whether to sign a supply agreement with TT; whether to renew a long-term, private-label customer contract with SaveCo; whether to sign a supply agreement with Mandala; and whether to sign a long-term KTI-branded customer contract with ABC.

For each of the strategic options available to KTI, candidates were expected to conclude and recommend a course of action that was consistent with their analyses. Given the board's objective to increase revenue and the forecasted shortfall in raw materials, candidates were expected to address how KTI could take advantage of its opportunities to grow the company's revenue while also mitigating the risk of being unable to fulfil the sales orders that it agreed to.

Similar to NPF Version 1, strong candidates recognized and discussed the most important decision factors for each issue, provided valuable quantitative analysis, and linked their analysis to the significant entity-level issues presented in the case. Strong candidates tended to identify and discuss the potential synergies between the five strategic options that KTI was considering, such as TT's raw materials being able to meet the requirements of SaveCo's contract once TT's tea farm obtained the relevant certifications.

Weak candidates generally did not identify and discuss in depth the most relevant aspects of each strategic option presented as part of their analysis. Rather than discuss the more pertinent implications, weak candidates' analyses tended to focus on the minor considerations, such as the strategic option's fit with the vision, mission, and key success factors, rather than on the critical raw materials shortfall issue. Weak candidates also tended to simply list the case facts they thought were relevant without explaining the importance of those case facts, and what impact they would have on the viability and strategic strength of each option presented. Also, weak candidates often did not step back and consider the entity-level issues within their analysis of the options, or the synergies between the options. Again, consistent with NPF Version 1, more candidates did not meet the BOE's expectations related to the discussions of the bigger-picture issues.

As was the case with NPF Version 1, only a few candidates struggled to effectively communicate their ideas. These candidates tended to use poor sentence structure, confusing syntax, and an unorganized approach to their response.

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 target a "board room and senior management" level of discussion, with high-level analytics and a strategic focus. There are typically two versions of the Day 1 case. Candidates pre-select the version they will write.

Day 2 is one case designed to be completed by an average candidate in three and one half hours that candidates are given five hours to respond. The extra one and one half 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, Performance Management, or Taxation). 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 in **depth** and in common Financial Reporting and/or Management Accounting areas in **depth** and **breadth**. 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 that evaluate the common Core competencies only. While the minimum allowable time for any one case is 45 minutes and the maximum is 90 minutes, historically the cases have ranged between 60 to 90 minutes. The Day 3 cases provide additional opportunities for **depth** and **breadth** in Financial Reporting and Management Accounting and **breadth** opportunities for all the other technical competency areas. Cases are time constrained and 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 is weighted equally.

The Development of Marking Guides and the Provincial Review Centre

Prior to the CFE being published, provincial reviewers, appointed by each region, 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 leaders and assistant leaders review the marking guides in the context of actual responses at the Preliminary Evaluation Centre.

The May 2024 CFE Evaluation Centre

The May 2024 CFE Evaluation Centre was run 100% remotely. Approximately 120 individuals were chosen from the pool of applicants to participate in the CFE Evaluation Centre. The marking was supervised by the CPA Canada CFE full-time CFE professional staff, with oversight by the CFE subcommittee vice-chair, and the chair of the BOE.

The Day 1 Version 1 linked case (NPF V1) was marked by a team of 11 people from June 17 to 28, 2024. The Day 1 Version 2 linked case (KTI V2) was marked by a team of three people from June 6 to 12, 2024.

The Day 2 Common assessment opportunities were marked separately from the role assessment opportunities by a team of 20 people from June 16 to 27, 2024. Day 2 Assurance was marked by a team of 18 people from June 15 to 27, 2024. Day 2 Performance Management was marked by a team of 15 people from June 15 to 27, 2024. Day 2 Finance was marked by a team of four people from June 4 to 10, 2024. Day 2 Taxation was marked by a team of four people from June 4 to 8, 2024. All three Day 3 cases were marked from June 18 to July 2, 2024. The Day 3 simulations were marked by a total of 43 people.

In advance of the marking centre, the members of the CFE subcommittee, staff, leaders, and assistant leaders participated in a three- to six-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 comments on the marking guides received from provincial reviewers.

The larger teams followed a set marking centre schedule, which included a start-up phase to train the markers. During the start-up phase, the leaders and the assistant leaders presented the marking guides to their teams, while staff and the BOE vice-chair monitored the discussions. 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 larger teams had a leader, and anywhere from one to three assistant leaders, and had both French-speaking and English-speaking markers. Each team had one or more markers who marked in both languages.

For smaller teams, all markers attended PEC, and moved directly from PEC to live marking. These teams had a leader, and two to three experienced markers, of which two were bilingual and marked all the French papers. These bilingual markers started in English and switched to marking in French once their marking was assessed as being consistent with the team. The bilingual markers arbitrated the French papers by discussing where there were differences in their markings.

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. Control papers were fed into the system daily to check marker consistency. 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. Additional audits were performed at the end of marking on any of the larger differences between markers.

Borderline Marking (Day 1)

Each candidate's paper was marked once. All candidates' responses that were assessed as clear fail, marginal fail, or 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, an assistant leader, or a senior marker) compared the two initial markings and determined the final assessment.

As an added measure to ensure that markers were consistently applying the marking guide, a two-day rule exists, which 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 guides due to marker interpretations during the first two days of live marking are stabilized before the second marking and arbitration process begin.

Borderline Marking (Day 3

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 Request for Remark of Results and Request for Performance Analysis

Failing candidates may request a remark of their examination results and/or a detailed personalized performance analysis for either Day 1, or Day 2 and Day 3 combined, or for all three days.

In an effort to provide failing candidates with more timely feedback, the Board of Examiners is providing an automated feedback report for Day 1 of the CFE. The report is automatically generated using the marking data collected for each response rather than being based on a personalized review of the response and is being provided at no cost to all failing candidates. This report is intended to allow for the identification of the key deficiencies in the candidate's Day 1 response, which then allows the candidate to decide whether to request the more detailed, and personalized performance analysis report noted above, for a fee.

Remarking of Results Approach

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

Under the supervision of the chair of the Board of Examiners and of CPA Canada CFE 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 that the markers have indicated that consideration has been given to all material submitted by the candidate.

The results are tabulated and a decision made as to whether any candidates have been treated unfairly and should be granted a pass on the examination. The results are then forwarded to the provincial bodies for notification of the candidates.

APPENDIX B

CAPSTONE 1
KTI BACKGROUND CASE

Capstone 1

Kingsdale Tea Inc. — Case (FOR REFERENCE ONLY)

It is April 28, 2023, and you are working as a CPA with F & W Consulting LLP (FWC). You have been assigned to develop a report for the board of directors (board) and management of Kingsdale Tea Inc. (KTI).

KTI has approached FWC with a request to assist them in strategic analysis and to set a new direction for the company. Based on past years' results, the board is concerned about the stagnant revenues and declining profits as well as reliance on existing customers. There are conflicting viewpoints among the three shareholders as to how the company should grow in the future, as well as many operational issues that they would like you to analyze and address.

You have been provided with the following information to review and analyze (all dollar values are in Canadian dollars unless specifically stated otherwise).

Kingsdale Tea Inc.

KTI, a privately held Canadian company, is a tea producer currently selling private-label products to four grocery retailers and three food service chains in Canada. KTI is 70% owned by Michael Galinsky and 15% each owned by his son Jason Galinsky and his daughter Sabrina McLean. Kathleen Galinsky, Michael's other daughter, works in the company but does not yet have any ownership.

An organizational chart is provided in Appendix I. KTI's most recent financial statements for the years ended December 31, 2020, 2021, and 2022 (prepared under IFRS) are provided in Appendix II. Industry benchmarks are provided in Appendix III.

Industry information

The coffee and tea production industry in Canada has total revenues of $3.1 billion, of which tea represents $1.27 billion.[1] The total industry is expected to grow at an annual rate of 4.7% until 2024, driven by increased exports and high profits.[2] A subcategory of this industry is tea production, which includes the processing and packaging of tea leaves for all categories of teas, as described in the next section. Excluded from this industry are companies that bottle or can ready-to-drink (RTD) teas and herbal tea producers.

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[1] Eva Koronios, "Strong brew: The world price of coffee as fostered strong revenue growth," *IBISWorld Industry Report 31192CA: Coffee and Tea Production in Canada*, April 2019.
[2] Koronios, 2019.

Product differentiation

Tea products can be differentiated by both category of tea and packaging.

Categories of tea

- There are three main classifications of teas made from the *Camellia sinensis* plant:
  - Traditional tea: This includes black, green, white, and oolong teas.
  - Specialty teas: These are high-quality, premium versions of traditional tea, often grown on small tea estates and carefully processed to maintain their quality and enhance their taste. Organic teas are also included in this category.
  - Flavoured teas: These are traditional teas that have been blended with spices and fruit to produce unique flavours.
- Herbal teas are made from herbs and not from the *Camellia sinensis* plant. They can also be flavoured with spices and additives.

Black tea is by far the most popular traditional tea, and will likely continue to be so in the future due to its health benefits from antioxidants and polyphenols.[3] Green tea is expected to have the highest year-over-year growth rate, both because of its related health benefits and because tea drinkers are becoming more educated about the benefits of different types of teas.[4] Herbal teas are often consumed in the evening to relieve stress and help induce sleep, since they are caffeine-free.

Within all these product categories, quality can also differ. High-quality loose-leaf tea can be identified by its looks, touch, aroma, and taste. The following characteristics distinguish high-quality tea:[5]

- It looks like dried tea leaves and is not crumbly or dust-like, and does not include stem fragments.
- It feels smooth and whole and does not feel overdried or disintegrate when handled.
- It has a distinct aroma that can be easily detected, no matter what type it is.
- It has a strong, pleasant, and recognizable taste.

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[3] Sumesh Kumar and Roshan Deshmukh, "Tea Market by Type (Green Tea, Black Tea, Oolong Tea, Fruit/Herbal Tea, and Others), Packaging (Plastic Containers, Loose Tea, Paperboards, Aluminum Tins, and Tea Bags), Distribution Channel (Supermarkets/Hypermarkets, Specialty Stores, Convenience Stores, Online Stores, And Others) and Application (Residential and Commercial)," Allied Market Research, June 2020, https://www.alliedmarketresearch.com/tea-market.
[4] Kumar and Deshmukh, 2020.
[5] "How to Identify Quality Tea," Pure Leaf, accessed January 22, 2021, https://www.pureleaf.com/us/how-to-identify-quality-tea.

Low-quality teas will lack some or all of these characteristics. The quality of the tea depends on the size of leaf, its placement on the plant, and how it is picked and processed.

Consumers who are concerned about ethical sourcing will purchase tea that has been certified as organic and/or Fairtrade. The demand for specialty tea is expected to increase for the foreseeable future, requiring producers to spend more on research and development.[6]

Packaging

Tea can be packaged, in order of popularity, in tea bags, as loose tea (sold in tins or cardboard packaging), or as individual serving pods. Tea bags are the least expensive and are the most easily disposed of. Loose tea is perceived to be of the highest quality and to steep the best tasting tea. Pods are used for convenience and for entertaining guests with single servings.[7]

Niche players are developing different kinds of bags that are more environmentally friendly or differently shaped to produce better steeped tea. Consumers are looking for environmentally friendly packaging made from sustainable materials that are recyclable on disposal. Eco-friendly packaging means there is little impact on the environment during the production, use, or disposal of the packaging.

Tea production industry value chain

The following are the steps in the value chain for the tea production industry for traditional, specialty, and flavoured teas (not herbal, and excluding further downstream tea products):[8]

1. Harvesting: Tea farmers grow and harvest (pick) the tea leaves.
2. Processing: Tea processing includes four stages:
    i. Withering: The tea leaves change physically and chemically.
    ii. Rolling: The tea leaves are crushed to allow their enzymes to mix.
    iii. Fermentation: The tea leaves are oxidized. White, green, and black tea all come from the same plant and differ based on the amount of oxidation. White tea is the least oxidized, green tea is next, and black tea undergoes the most oxidation. Oolong tea falls between green and black tea in terms of oxidation, but its twisted shape makes it unique.
    iv. Drying and sorting: Tea leaves are dried and sorted by grade. Tea grading generally depends on the size of the leaf and its location on the plant. However,

[6] Qing Zheng, "Freshly brewed: A growing emphasis on healthy living will drive industry revenue growth," *IBISWorld Industry Report 31192B: Tea Production in the United States*, December 2019.
[7] Louise Roberge, "Canadian Tea Market Overview," Tea Association of Canada, accessed April 14, 2020, http://www.o-cha.net/english/association/information/documents/Louise.pdf.
[8] Koronios, 2019.

this grading is not standardized nor is it an indication of quality, which is more influenced by the plant's origin, soil, rainfall, and elevation.[9]

Depending on the level of technology, these stages can be completed using equipment or by hand.

3. Production: Tea producers (such as KTI) take the processed tea leaves and may blend them with other teas or flavours, including fruit and spices. The tea leaves are then packaged and sold under a private label and/or the producers' own brand.

While some producers are also involved in processing the tea, most Canadian tea producers are not; they simply produce and package the tea for sale to distributors or directly to end consumers.

Further downstream in the value chain are the value-added products that incorporate the tea as a raw material. This includes drinks that are bottled and ready to drink, food items into which the tea is baked, and cosmetic products that use extracts from the tea leaves. These products can be manufactured either by the tea producer itself or, more commonly, by another manufacturer. The tea used in the manufacturing of other tea products is purchased directly from the harvesters and processors, rather than from tea producers.

Tea growers[10]

There are two varieties of the tea plant, Camellia sinensis: the small-leaf variety that grows in the high mountain regions in a cooler climate and the large-leaf variety that grows in moist tropical climates.[11]

Tea leaves are purchased mainly from India, Sri Lanka, Taiwan, Indonesia, China, and Japan, and Canadian producers rely on farms in these countries to provide the raw materials.[12]

Tea is cultivated primarily on large plantations, but also by small individual farmers. Smaller farmers often sell their harvested tea to the large plantations for processing and are paid low prices in comparison to what the large plantations will ultimately sell the processed tea for. However, there are other individual farms that will pay for processing or process the tea themselves. Globally, about 70% of processed tea is sold at auction centres, because there is no futures market for tea.[13] Large buyers can influence the demand and price of different types of tea sold at these auctions. To be successful, tea

[9] "Tea Grading," Imperial Tea Gardens, accessed January 21, 2021, https://www.imperialteagarden.com/pages/tea-grading.

[10] "Tea," Fairtrade International, accessed June 15, 2022, https://www.fairtrade.net/product/tea.

[11] "Tea Plant Varieties," Tea Source, accessed May 25, 2022, https://www.teasource.com/blogs/beyond-the-leaf/tea-plant-varieties.

[12] Koronios, 2019.

[13] "Certifying Fairtrade," Fairtrade Canada, accessed February 28, 2023, https://web.archive.org/web/20221214091519/https://fairtrade.ca/for-business/getting-fairtrade-certified/.

producers need long-term, reliable supply contracts with overseas suppliers of tea that, ideally, have guaranteed supplies.[14]

There are three main auctions for tea: Columbo for Sri Lankan teas, Mombasa for African teas, and Kolkata for Indian teas. Chinese teas are not auctioned. Historically, tea prices have ranged from just over US$2.00 per kilogram for lowland teas to over US$4.00 per kilogram for high mountain teas.[15] Prices depend on supply and demand, growth region, and quality.

The larger plantations not only grow the tea but also have factories to process the tea. Workers are hired to work in the fields and the factories, and although they are paid local minimum wage rates, the compensation is often not enough to feed their families. These employees work under harsh conditions and are not usually protected against job loss or discrimination. Buyers can help ensure that workers are treated fairly by stipulating that Fairtrade standards, or some other general standards, are adhered to in their purchase contracts for processed tea.

Customer segments

Canadian coffee and tea producers' revenue by type of customer is as follows:[16]

Customer segment	**Percentage of revenue**
Food service	56.8%
Exports (currently, 97.2% to the United States)	22.9%
Groceries and retail outlets	16.6%
Offices and other (drug stores, hotels convenience stores)	3.7%
	100%

Food service[17]

Food service includes quick-service restaurants (such as McDonalds), cafés (such as Starbucks), tearooms, and restaurants. This segment represents the highest proportion of revenues, because Canadians often stop at these establishments for their coffee or tea daily. Food service outlets, especially cafés, are increasing their selection of tea beverages in order to meet consumer preferences for traditional, specialty, and flavoured tea drinks.

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[14] Koronios, 2019.
[15] Dan Bolton, "World Bank Predicts Recovery of Tea Prices in 2020," World Tea News, November 18, 2019, https://www.worldteanews.com/Insights/world-bank-predicts-recovery-tea-prices-2020.
[16] Koronios, 2019.
[17] Koronios, 2019.

Exports

The amount of sales exported depends on the relative value of the Canadian dollar to the U.S. dollar, as 97% of exports are to the United States.[18] As the Canadian dollar depreciates, exports increase, and vice versa.

Groceries and retail outlets

As the end consumer begins to shift to making tea at home, sales to the grocery and other retail outlets are increasing. For this market, particularly for the mass merchandisers (such as Costco), the budget-minded consumer will purchase low-cost traditional black tea in bulk. This allows retailers to enter into low-cost supply contracts with tea producers. These bulk sales are usually for lower-quality teas that have lower processing and production costs and thus a lower selling price. Because of the bulk purchases and the lower cost of this type of tea, the selling prices for this segment are significantly lower per weight. The consolidation of major grocery retailers has intensified competition between producers to access retail premium shelf space, which is important for tea producers to be successful.[19]

Both the grocery and food service retailers continue to expand their mix of private-label products, reducing the demand for the tea producers' own brands.[20] These private-label brands are lower priced than comparable tea producers' brands.

Offices and other[21]

For the office segment, customers enter into long-term supply contracts with primarily coffee production companies. These coffee companies are contracted to deliver coffee and tea, as well as the equipment to make these hot beverages on site. Additional services such as restocking, machine repair, and catering are also provided, resulting in higher revenues (and margins) for producers. Tea producers can partner with these coffee producers to provide the required tea products.

Pricing

The selling price charged to the various customer segments depends on the quality of the tea sold, the volumes sold to each customer, and whether the tea is a private label for the customer or the tea producers' own brand. The lowest selling price is for tea that is packaged in bulk, is low quality, and is private label. Chain grocery retailers and chain food services companies (such as Starbucks and Tim Hortons) fall into this category. These customers have the buying power to set the tea producers' selling prices due to the high volume of tea purchased.[22] In addition, these chain customers have a loyal

[18] Koronios, 2019.
[19] Koronios, 2019.
[20] Koronios, 2019.
[21] Koronios, 2019.
[22] Koronios, 2019.

consumer base that will buy their branded products. Grocery retailers also have the power to decide whether the tea product is placed in a coveted spot on the shelves.

In contrast, sales to other customers will be at higher selling prices, as the product is not sold in large volumes, is usually of higher quality, and the tea producers are selling their own brands (as opposed to private-label brands).

Profit margins across the industry have increased to 10.6% because of greater demand and stable input prices.[23] Although selling prices can fluctuate with the cost of tea leaves, there is strong price-based competition in the market that can keep these prices in line.[24] Specialty teas and fruit and spice blends typically result in higher margins than the low-cost, bulk teas.

Online sales

Tea has been sold online for many years, by grocery food retailers, food services outlets selling their own brands, or directly by tea producers. Many tea producers have an online presence to promote their brand, build brand loyalty, and sell directly to end consumers. These companies can provide a wide offering of products, educate consumers on how their tea is produced, and obtain data analytics on consumer preferences.[25]

Competition

The four largest coffee and tea producers make up 46.5% of the total coffee and tea production industry in Canada: Restaurant Brands International Inc. (Tim Hortons) has 17.8% market share, Keurig Dr. Pepper has 11.1%, Club Coffee LP has 9.5%, and Mother Parker has 8%.[26] There are currently 309 producers, a number that is expected to grow with the entrance of smaller, niche competitors.[27] The large competitors with substantial resources are expected to continue to gain market share due to their continued product innovation, strong brand loyalty, marketing programs, and joint ventures with other key players.[28]

These joint ventures are with farmers, downstream manufacturers to produce tea-based products, or companies that distribute beverages within the same distribution channels. These large competitors use their significant purchasing power to reduce the raw material costs paid to the tea farmers. They can also obtain premium shelf space in stores because of their large size and brand recognition. To further achieve economies of scale, these companies invest significant amounts in technology, such as information systems and software, to make blending teas and flavours in the production process

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[23] Koronios, 2019.
[24] Koronios, 2019.
[25] Dan Bolton, "Follow the Leaders: Online Tea Stores," World Tea News, April 10, 2018, https://worldteanews.com/tea-business-resources/follow-the-leaders-online-tea-stores.
[26] Koronios, 2019.
[27] Koronios, 2019.
[28] Koronios, 2019.

more efficient.[29] For tea producers selling their own brands, strong brand recognition is important for success. This can be achieved by spending significantly on marketing and by having a reputation for delivering an exceptional consumer experience.

To be successful, tea producers need to be able to adapt their product to changes in consumer preferences, have a differentiated product to maintain market share, and have economies of scale and scope to keep per-unit costs low.[30] The higher the world price of tea leaves, the lower the profit margins, given the strong price competition in the industry. Producers need to be able to pass on any increases in raw material input costs to their customers. This may be difficult to do when they have long-term revenue contracts in place.

Large competitors use one of the following strategies:[31]

- Manufacture mid-to-low value, high-volume branded products.
- Manufacture high-value products with shorter production runs and lower volumes.

The smaller tea producers use a variety of strategies. Some are niche players that sell only specialty, premium tea to high-end tea and coffee shops. They may also specialize in organic and/or Fairtrade products (Fairtrade is discussed in more detail below). Tea producers are increasingly creating and marketing their own brands or securing large contracts with retailers to be their brand of choice. Smaller tea producers must differentiate by having innovative product offerings and packaging and by spending more on marketing.[32]

Consumers are price sensitive within a product category and will switch to a lower-priced alternative if they do not taste any difference, as is often the case for private-label products. Perceived quality, brand recognition, and loyalty will impact the price consumers are willing to pay.[33]

There is also competition for the best retail shelf space in stores. To ensure success, tea producers must establish good relationships with grocery retailers to receive premium retail shelf space in the store and be part of the in-store advertising. Increasingly, the smaller producers are expanding to non-traditional customers such as drug and discount stores, shopping mall kiosks, and other areas with high pedestrian foot traffic.[34]

If the Canadian dollar appreciates, the percentage of imports of teas will increase, increasing competition in Canada. As long as the Canadian dollar is low in comparison

[29] Koronios, 2019.
[30] Koronios, 2019.
[31] Koronios, 2019.
[32] Koronios, 2019.
[33] Koronios, 2019.
[34] Koronios, 2019.

to the U.S. dollar, exports to the United States will outweigh imports of tea products into the Canadian market.

Additional value-added products that use tea

Tea can be further manufactured into the following types of products:

- bottled RTD tea
- matcha powder
- cosmetic ingredients and dietary supplements

Bottled RTD teas have been increasing their market share in the convenience drink category as soda, bottled water, sports drinks, and juice decline in popularity.[35] Packaging the tea as RTD is seen as a downstream product to further boost revenues and margins. RTD teas include cold-brewed teas (which are touted to taste less bitter and retain more health benefits) and sparkling teas that are seen as a healthier alternative to sodas.

Matcha is a Japanese green tea whose leaves are crushed and then sold in powder form. Rather than steeping whole tea leaves and then removing them as with other teas, the matcha powder is dissolved into boiled water so that the entire leaf itself is consumed. As a result, matcha is more potent and its health benefits are enhanced.[36] Matcha can be used in baked goods, providing an alternative to drinking the tea.

In addition, the tea plant is a source of bioactive ingredients that can be extracted and used in making cosmetic products and dietary supplements.[37] As consumers demand more natural skin care products, extracts from green, black, and white teas have become important ingredients for the treatment of various skin conditions because of their positive effect on skin. Tea extracts are also used in a variety of dietary supplements that purport to boost energy and the immune system.

Ethical practices

Ethical practices in tea harvesting include social responsibility for the workers and environmental responsibility in farming the land.[38] For the workers, companies that practice social responsibility implement policies ensuring health and safety practices are followed, child labour is forbidden, fair and living wages are paid, working hours are

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[35] Dan Bolton, "Market Research Reflects and Predicts Growth," World Tea News, January 15, 2019, https://www.worldteanews.com/Insights/market-research-reflects-and-predicts-growth.

[36] Carol Neshevich, "Matcha, matcha everywhere," Food in Canada, December 8, 2015, https://www.foodincanada.com/features/matcha-matcha-everywhere/.

[37] W. Koch, J. Zagorska, Z. Marzec, and W. Kukula-Koch, "Applications of Tea (*Camellia sinensis*) and Its Active Constituents in Cosmetics," *Molecules*, December 2019, https://www.ncbi.nlm.nih.gov/pmc/articles/PMC6930595/.

[38] Sarah Roberts, "Working Collaboratively to Improve the Sustainability of the Tea Sector," Ethical Tea Partnership, September 8, 2016, https://www.ethicalteapartnership.org/working-collaboratively-improve-sustainability-tea-sector/.

reasonable, there is no discrimination (particularly toward women), and benefits are provided.

To demonstrate environmental responsibility, companies ensure that the farmers they work with follow practices to improve soil and crop quality, plant to create biodiversity, reduce the use of pesticides, and employ reforestation to reduce water shortages and droughts.[39]

Tea producers can require the implementation of these standards at the farmers' level by including these practices in their purchase contracts and visiting the farms to ensure the standards are being followed.

Many tea producers enter into collaborative arrangements with government agencies in the countries where their tea is grown. In these cases, government agencies provide programs to educate the tea farmers in best agricultural practices.

Climate change is a threat in tea-growing countries, and forward-thinking companies are incorporating the impact of climate change into their short- and long-term supply plans.[40] One initiative to combat the impact of climate change is to breed different varieties of tea plants that will be more resilient to climate changes.[41]

At all points in the value chain, tea producers that implement sustainable practices aim to reduce their water and energy usage, increase their use of renewable energy, incorporate recyclable materials into their products, and measure and report their greenhouse gas (GHG) emissions and water usage.[42] Key metrics for GHG emissions and water usage include calculating footprints by product for raw materials and packaging, for distribution, for use of the product (such as boiling water), and for final disposal after the product has been used.[43]

Producers that are serious about using and promoting eco-friendly packaging will disclose the exact proportion of the material that is made from recycled content. Additionally, these manufacturers will be able to trace the material back to its origins so that the content can be verified.[44] Using recycled materials in a product can increase production costs due to higher prices for the raw materials, changes required to the production processes, and specialized equipment needed to work with these recycled materials.

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[39] "Sustainable tea farming around the world," Unilever, accessed May 15, 2022, https://www.unilever.ca/news/2017/sustainable-tea-farming-around-the-world/.
[40] "The Hain Celestial Group Climate Change Statement," The Hain Celestial Group, March 2016, https://web.archive.org/web/20220120013605/https://www.hain.com/wp-content/uploads/2016/02/Climate-Change-HAIN-Statement-2016-2.pdf.
[41] "Sustainable tea," Unilever.
[42] "The Hain Celestial Group Climate Change Statement."
[43] "The Hain Celestial Group Climate Change Statement."
[44] "Sustainability and pricing," EcoEnclose, accessed April 25, 2020, https://www.ecoenclose.com/Sustainability-and-Pricing/.

Regulations

Health Canada, under the Food and Drugs Act, regulates the concentration of water-soluble extractives in tea and the level of caffeine in decaffeinated tea (where caffeine levels cannot exceed 0.4%). Packaging and nutrition labelling are also regulated. The Pest Control Products Act tests for the level of pesticides in tea products.[45]

Organic

In order to label their food as "organic," processors, producers, and manufacturers are legally required to be certified in line with the Canadian Organic Standards.[46] The Canadian Food Inspection Agency appoints third-party auditors to examine all the processes from the farm to the sale of the product to ensure that producers have not used any prohibited substances. It can take up to three years to become initially certified, as producers must prove that prohibited substances have not been used in the last three years.

Fairtrade

For Fairtrade certification, Canada uses FLOCERT, which is based in Germany. FLOCERT is the largest Fairtrade certifier, certifying producers, traders, and licensees. It follows the requirements of ISO 17065. Auditors are used to ensure compliance with the internationally agreed Fairtrade standards.

Harvesters, processors, and producers must be audited before they can sell Fairtrade certified products. The auditor visits the fields and facilities and completes a physical audit. A report is prepared that identifies any non-conformities. The decision to certify is made by FLOCERT once any irregularities have been resolved. Once certified, producers are audited at least twice in a three-year cycle, along with additional unannounced audits.[47]

To be successful, it is important for tea producers to comply with government regulations for food production and, if applicable, with regulations for organic and Fairtrade certifications.

The tea consumer

The following are some significant statistics regarding the profile of an average Canadian tea consumer[48] (note that these statistics are for all types of tea):

- 55% are female.
- 35% live in three- to four-person households and 33% in two-person households.

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[45] Koronios, 2019.
[46] "Organic Certification," Canada Organic Trade Association, accessed April 14, 2020, https://www.canada-organic.ca/en/what-we-do/organic-101/organic-certification.
[47] "Certifying Fairtrade."
[48] Roberge.

- 35% are heavy tea drinkers (consuming 14.1 cups per week), 41% are medium drinkers (average of five cups per week), and 24% are light drinkers (1.4 cups per week).
- 64% of the surveyed 18- to 33-year-old age group indicated they were tea drinkers, preferring flavoured teas and specialty teas.
- Tea drinkers over 65 years old prefer black tea.

The following survey responses highlight why people drink tea:[49]

- I like the taste: 53%
- To relax: 40%
- For pleasure: 38%
- To warm myself up: 27%
- It makes me happy: 22%
- For health reasons: 21%
- Try new flavours: 15%
- After a meal / for digestion: 12%
- Out of habit: 10%
- To wake me up: 9%
- When in company: 9%

Studies indicate that in purchasing tea, consumers first look for the type, then they select taste, and finally they consider brand and price.[50] Even though price appears to be the last attribute considered, consumers are still looking for the best value for their tea. Consequently, many individuals like to sample the tea before purchasing it. People also often drink tea outside the home, in cafés, tea shops, or tearooms.[51] The café or tearoom becomes part of the experience of relaxing and enjoying a high-quality cup of tea. Tea is seen as a beverage to have with any meal or with a snack, and it is used as a base in some cocktails or mocktails (non-alcoholic beverages).[52] Food service companies may expand or change their tea offerings to meet consumers' changing preferences.

[49] Jan Conway, "Why do you usually drink tea?" Statista, March 21, 2019, https://www.statista.com/statistics/679635/reasons-for-drinking-tea-among-us-consumers/.
[50] Roberge.
[51] Roberge.
[52] Bolton, "Market Research."

Demand drivers[53]

- The higher the per capita disposable income, the higher the demand for specialty tea, flavoured products, and single-serving pods, which are more expensive.
- Because of the touted health benefits of tea, the demand for tea will remain high, as many consumers believe that tea can help with weight loss, reduce the risk of heart attacks and stroke, and boost the immune system.[54] Consumers are moving away from sugary soda drinks and are instead looking for healthier alternatives.
- Although food services is the most significant customer segment, consumers continue to purchase tea for home preparation, and demand for tea products by grocery retailers is expected to grow.
- The cultural shift to relaxing and socializing in cafés and tearooms has increased the demand for teas and specialty blends.
- Younger consumers (under 30 years old) have been exposed to marketing campaigns promoting the health benefits of tea and have increased their demand for tea. This sector is attracted to tearooms, which have become more visible and are seen as a popular trend.[55]
- The cost of substitutes, particularly coffee (including RTD coffee beverages) and energy drinks, may cause the demand for more expensive tea and tea-based products to decline, especially if the per capita disposable income declines.

Trends within the industry

- Spiced teas are growing in popularity due to changing consumer demographics, particularly for the 18- to 35-year-old segment of the consumer market.[56]
- There is an increasing demand for cafés and specialty tearooms as consumers look for ways to relax outside their homes.
- There is increasing demand for convenience in preparing tea and coffee, including the new coffee and tea makers that can make a single serving using specially designed pods. There is thus an increasing demand for instant single-serving pods/capsules for different types of teas.[57]
- As consumers become more educated about the treatment of tea farmers, there is an increasing demand for ethically sourced (Fairtrade) and organic teas.[58]
- Consumers' demand for specialty and gourmet teas will continue to increase. Due to the care that is taken in the processing of these premium-priced teas, there are

[53] Koronios, 2019.
[54] Zheng, 2019.
[55] Zheng, 2019.
[56] Koronios, 2019.
[57] Bolton, "Market Research."
[58] Koronios, 2019.

reportedly higher health benefits related to antioxidant properties that reduce cholesterol and increase metabolic rates.

- Producers are adding healthy ingredients into their teas that are designed to help people with diabetes, obesity, and heart conditions.[59]
- Demand is increasing for matcha tea–based baked goods due to the potential health benefits. Given its ability to be pulverized, the fine matcha powder can be used in products other rather than tea, such as cakes, cookies, muffins, and biscotti.[60]
- Producers are expanding their products beyond tea leaves and creating unique RTD tea products by partnering with energy drink manufacturers[61] or infusing their drink with cannabis to appeal to 18- to 35-year-olds.[62]
- A growing trend is the demand for artisanal tea — a tea crafted by a tea artisan and made almost entirely by hand (although a small amount of machination may be used). The demand for artisanal tea is driven by several factors: consumers wanting farm-to-table foods; a sober lifestyle trend away from bars and toward teahouses; certain demographics consuming as much tea as coffee; and gamers, who are high-end buyers, using tea as a natural stimulant to keep them awake and focused all night.[63]
- There is also an increasing use of tea in other products, including beauty and cosmetic products,[64] to capitalize on tea's natural health benefits.
- Online distribution direct to the end consumer is expected to increase due to the rise in popularity of online apps and easy product delivery.[65]

General risks in the industry

- Raw material risk: There could be a shortage of supply of tea leaves or a reduction of quality due to the impact of weather conditions, crop disease, or pests.

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[59] "Tea Market Size, Share & Trends Analysis Report By Product (Black, Green, Oolong, Herbal), By Distribution Channel (Supermarkets & Hypermarkets, Specialty Stores, Online), By Region, And Segment Forecasts, 2019 – 2025," Grand View Research, August 2019, https://www.grandviewresearch.com/industry-analysis/tea-market.
[60] "Enrichment of Biscuits with Matcha Green Tea Powder: Its Impact on Consumer Acceptability and Acute Metabolic Response," National Library of Medicine, February 1, 2018, https://www.ncbi.nlm.nih.gov/pmc/articles/PMC5848121/.
[61] "RTD Tea and Coffee Market Size Worth $116.13 Billion by 2024," Grand View Research, April 2018, https://www.grandviewresearch.com/press-release/global-ready-to-drink-tea-and-ready-to-drink-coffee-market.
[62] "2019 State of the Beverage Industry: Ready-to-drink tea, functionality drives demand in market," Beverage Industry, July 15, 2019, https://www.bevindustry.com/articles/92246-2019-state-of-the-beverage-industry-ready-to-drink-tea-functionality-drives-demand-in-market.
[63] Kevin Alexander, "Artisanal Tea in America Is Having a Moment," Thrillist, October 8, 2019, https://www.thrillist.com/eat/nation/american-artisan-tea-culture.
[64] "Tea Market Size."
[65] "Tea Market Size."

- Consumer risk: The demand for tea products is driven by consumer preferences for the taste, quality, and health benefits of tea.
- Regulatory compliance risk: Tea is a food product that must be produced and manufactured in compliance with strict health regulations. In addition, if the product is marketed as organic or Fairtrade, these certifications must be maintained.
- Exchange rate risk: Tea leaves are imported, and tea products are exported.
- Reputational risk: If a product must be recalled due to errors in production or contamination, this will negatively impact the reputation of the tea producer. In addition, if the tea producer works with a farm that contravenes human right standards, this will negatively impact its reputation.

Company background

Michael Galinksy started KTI in 2006. Before that, Michael worked as a buyer for a large national grocery retailer, Lakeside Food Inc. (Lakeside). He was heavily involved in sourcing new products and negotiating private-label supply contracts. At that time, Lakeside contracted with only the largest tea plantations. One of Michael's responsibilities at Lakeside was to visit the farms supplying the tea to the large plantations that processed and produced tea for Lakeside, primarily in Sri Lanka and Indonesia, to inspect where the tea came from and how it was harvested.

In discussions with the smaller farmers, Michael learned that these farms were forced to sell their crops to the large plantations at significantly below-market rates, leaving the farmers struggling to earn enough for their families. He felt there had to be fairer supply agreements that could be made with these smaller farmers, and this became the motivation for Michael to start KTI and become a tea producer. Michael's goal was for KTI to differentiate itself by being an ethical tea producer. He wanted to ensure that the tea farmers and their workers were treated and paid fairly, and sustainable and environmentally friendly growing practices were followed. KTI would use eco-friendly packaging and production processes that require less energy and water where possible.

Initially, KTI produced only black tea, and Michael was able to sign supply contracts with four farmers in Sri Lanka to provide the processed black tea leaves for KTI. He also convinced Lakeside to agree to purchase a higher-quality, specialty private-label black tea from KTI. During the next five years, Michael gained three more revenue contracts with various grocery retailers for private-label back teas and increased the number of farmers working with KTI to 10. Green tea was also added as a product to the customers' private-label contracts during this time period.

In 2011, two of his children, Jason Galinsky and Sabrina McLean, joined the company. Jason has a marketing degree and joined KTI as a marketing manager. Sabrina has a master's degree in food chemistry and convinced Michael to start a research and development (R&D) lab. She joined KTI as a research assistant working directly for the head of R&D.

Also in 2011, consumers' demand for organic and Fairtrade tea started to increase, and at Jason and Sabrina's suggestion, Michael decided to have KTI's product sold as organic and Fairtrade. Michael convinced the supply farmers he works with to become certified under both these standards, and certification was finalized in 2014. KTI's customers supported this transition, and KTI's teas became the first private-label organic and Fairtrade teas sold by these four customers.

The R&D division started the development of flavoured teas, infusing its existing teas with different spice combinations, and in 2015, KTI introduced a line of spiced teas. Michael and Jason decided that the spiced teas would be best sold by food service customers and approached three large food service chains about producing a private-label spiced tea. Initially, the customers purchased in small quantities to test the end-consumer acceptance for this product. By 2018, all three companies had agreed to long-term contractual arrangements with KTI to produce private-label spiced specialty teas.

In 2018, Michael's youngest daughter, Kathleen Galinsky, an attorney, joined the company as KTI's legal representation.

In 2021, Michael decided to transfer some ownership of the company to Jason and Sabrina, to help solidify their long-term commitment to the company. Michael gifted 15% of the shares in KTI to each of Jason and Sabrina, leaving him with 70% ownership. At that time, it was assumed that Kathleen would eventually also be given ownership, after having worked with the company for enough years.

Today, in 2023, KTI has maintained its private-label sales contracts with the four grocery retailers and three food service chains, but has not gained any new customers. As a result, over the past five years, sales growth has been minimal in both revenues and volumes. However, KTI has gained a reputation among its customers for its ethical sourcing and production of tea.

For the year ended December 31, 2022, the company had sales of $43.2 million. Net earnings for the company were $1.5 million. Five years ago, the company's net earnings had been as high as $3.5 million.

Company overview

KTI has two divisions: a manufacturing division and an R&D division. The manufacturing division has a single production facility in Ontario that produces the private-label tea for its customers. KTI spends very little on marketing, since it does not have its own brand. Any marketing dollars are spent solely on managing the private-label customers. Michael is the only person who communicates with these customers and negotiates the contracts. Michael is well respected in the industry and is known for his honesty and fairness. These customers continue to contract with KTI because of their long-term relationship with Michael and because KTI always meets its commitments for quality, quantities, and timing of delivery, while also following ethical practices.

KTI works with its customers to design packaging for their private-label products so that it is in line with KTI's sustainability standards while meeting customer specifications. All the tea currently sold is packaged in tea bags that are made from compostable cotton. The tea bags are then packed in recyclable cardboard boxes. Any changes to packaging design or graphics requested by the customer have to be approved by Michael.

Jason manages the supply contracts with the farmers, having taken over this responsibility from Michael in 2015. Jason has also visited potential new farms, some that are growing a superior-quality premium tea that is processed using traditional methods, mainly by hand.

KTI's R&D division researches and develops new tea products, including mixing different flavours (fruits, spices, and herbs), and packages for the tea. The R&D division has developed a variety of products over the years, but no new products have been introduced into the market since the spiced tea in 2015. At this point, KTI's existing customers are not interested in expanding into any new private-label specialty or flavoured teas because of their high price points, and Michael has stopped asking them.

KTI prides itself on ethical practices for sustainability and human rights. To comply with these ethical sourcing values, KTI has a set of standards that farmers agree to as part of the contractual arrangements. In addition, the packaging that is used for its private-label products must also comply with its standards regarding the amount of recyclable content. KTI monitors its use of energy and water in its production processes and is constantly looking for ways to reduce these inputs.

The company's sales and profits have been declining. As private-label contracts come up for renewal, the directors need to make decisions about the future direction of KTI. Michael wants to continue to focus only on private-label production. It has historically been a stable and profitable segment, and it is one that Michael has a lot of experience in. Additionally, Michael does not want to take any actions that might jeopardize KTI's long-term relationships with these customers.

Jason and Sabrina, however, want to create the company's own brand of specialty and flavoured teas to diversify KTI's customer base and reduce the company's reliance on its few existing customers. They both believe now is the time to capitalize on consumers' growing preference for high-quality premium teas and take control over any new products that are introduced.

Corporate vision and mission

KTI's vision and mission statements and core values, approved by the board in 2018, are:

Vision statement: *We envision an environment where a high-quality tea is produced by fairly compensated farmers, our customers enjoy a pure, complex, and pleasant experience every time they drink a cup of our tea, and everyone involved in the process is treated with honesty, fairness, and respect.*

Mission statement: *Do right by the farmers and our customers and far exceed consumer expectations daily. We produce our tea in an ethically responsible manner, and its distinctive taste and high quality inspire loyalty in our consumers. We strive to bring the health benefits of tea in all its forms to individuals.*

Corporate values

KTI has five core values:

1. Produce extraordinary organic, Fairtrade tea.
2. Build long-term relationships with farmers, suppliers, customers, and consumers.
3. Build a brand that is known to be ethical and respected.
4. Treat all employees with fairness, honesty, and respect.
5. Ensure ethical, sustainable, and environmental standards are adhered to and followed throughout all of our processes, from farm to table.

KTI also has a code of ethics and ethical standards that is incorporated into its contracts with farmers and customers.

Future plans and objectives

In early April 2023, the board met and set the following objectives:

- Increase the gross profit margin to 25% of revenues by 2026.
- Have 30% of revenues from non-private-label product sales by 2026.
- Have 50% of operating profits from non-private-label product sales by 2026.
- Promote the KTI brand and market it as a company that is known for its ethical standards at the consumer level.
- Increase control over its sources of tea leaves (raw materials) and diversify where the tea is grown.

Company structure

KTI has a board of directors that consists of Michael, Jason, Sabrina, and Kathleen. Each director has an equal vote on strategic and financial decisions. The board meets every month. At the meeting, the board discusses topics related to financial and budget reports, production issues, customer contracts, farmer contracts, new corporate policies, and election of the officers. However, Michael often makes daily operational decisions that are counter to the decisions made by the board.

There is one committee, the ethical standards committee. The committee is responsible for reviewing the existing standards employed by KTI, ensuring adherence to these standards at all levels in the company, and updating for changes as required. On this committee is Jason (the chair), Kathleen, Hans Meindl (the production manager), and Rashmi Gunapala (a tea farmer).

Management team

KTI's corporate management team is made up of the following individuals:

Michael Galinsky — chair of the board and chief executive officer (CEO)

Michael is 62 years old, has a business degree, and worked his way up to management in a large grocery retail chain before starting KTI. Michael's strengths are in customer relationships and understanding the needs of customers. This strength makes him a good contract negotiator and a problem solver. He works in partnership with the customers to exceed their expectations, and in return they have given KTI their loyalty since the first contracts were signed. His business philosophy is that by working together, any issue can be resolved. However, Michael prefers to make all of the daily operational decisions, and therefore the company has a very centralized structure. Having been in the business for many years, Michael has a lot of experience and an excellent reputation. Michael's primary responsibilities are in managing the current customer contracts and finding new customers. Michael has strong beliefs in sustainable and ethical practices, driving the company's focus in these areas, and he has passed along these beliefs to his children.

Michael wants KTI to remain focused on producing only private labels. He is convinced that this is a low-risk approach that has worked well in the past, and so there is no need to change. He believes that he can continue to negotiate the right price for KTI so that the level of profit seen in the past can be maintained. He believes that the decline in profit is simply a result of not yet renewing the terms of the existing contracts. He wants the company to look for new private-label customers to grow revenues and basically keep the current business model unchanged. He has fostered these customer relationships over a long period of time and does not want to do anything that will jeopardize this. He believes that KTI's existing customers must come first.

Jason Galinsky — VP marketing

Jason is 37 years old and has a business degree in marketing. Jason has worked in a marketing research company and also for a large, diversified food manufacturer that sold branded products in the coffee and snack food segments. In these companies, Jason designed and implemented marketing plans to promote existing and new products that were highly successful and innovative at the time. After joining KTI, Jason began managing the work involving the tea farmers and the supply of tea leaves. He is passionate about ensuring that the farmers KTI works with are treated fairly and working with the local governments to ensure they are planning for the impacts of climate change. As such, he has gained the respect of the farmers. As a tea connoisseur, he is constantly tasting competitors' products for quality comparisons. Jason is charismatic, highly creative, and a good listener. He considers himself a visionary capable of seeing what the future might look like and knowing the actions required to get there. However, he can also be stubborn and unrelenting in his ideas. These traits have caused Michael and Jason to have many arguments about corporate decisions.

Jason feels that Michael has stifled his creativity and innovation. Jason wants the company to create its own brand of products that will allow the company's name to become known. He thinks that the future of KTI lies in high-quality premium teas that have much higher margins than private-label products, and he believes that KTI has the people and resources to make this change. Jason wants to diversify away from private-label products, limiting the power of, and dependency on, these customers.

Sabrina McLean — VP research and development

Sabrina is 34 years old. After completing her university education, Sabrina worked for a government lab doing food research related to pesticide-free farming and crop yields. Since coming to KTI, Sabrina has worked only in the R&D department, which she now heads. Sabrina is a scientist at heart, always reading about new findings and keeping up with what competitors are doing with respect to product development. Her interests are in tea production yields, the health benefits of tea, how to enhance the taste of tea, and designing innovative products. She is very methodical and focused, and because of her experience in the industry, Sabrina has judged tea tasting events in the past.

Sabrina is frustrated because Michael refuses to introduce any of the new products the R&D department has developed over the past five years to his customers. Because the customers have not expressed any interest in new tea lines in the past, Michael has stopped introducing any new potential products to them in order to maintain his good relationships with them. Sabrina agrees with Jason that KTI now has the resources and expertise to create and market its own brand of premium quality tea. She believes that the talent in the R&D department is being wasted if the innovative products are not going to be embraced. Her R&D department has constantly been at the forefront of new product development, as it develops products about one year ahead of competitors' similar successful product introductions.

Kathleen Galinsky — VP legal and human resources

Kathleen is 32 years old. After graduating with her law degree, Kathleen worked for a small regional law firm specializing in corporate and contract law. She is now KTI's in-house lawyer and is involved in drafting the company's contractual agreements and ensuring compliance for organic and Fairtrade certifications. She is also responsible for the human resources department and all issues relating to employees. She is responsible for writing and updating the ethical standard protocols and the human resources policies.

Kathleen's main concern is compliance with laws and regulations, and also ensuring that profits are maintained and that the company continues to grow. As a lawyer, she can see both sides of any arguments put forth by Michael, Jason, or Sabrina. Her focus is more on the numbers rather than on strategy and its implementation.

Hans Meindl — VP production

Hans is 58 years old and has been with KTI since 2007. Before that, he oversaw manufacturing in a small cereal and bread company. Hans is very hands-on and is constantly on the production floor, overseeing the production processes and interacting with employees. He is adamant about quality control, meeting production timelines, and keeping costs down. It is because of his diligence that KTI is known for meeting its commitments to quality, quantities, and timely delivery.

Rashmi Gunapala — tea farmer

Rashmi is 45 years old and is now head of her family's tea farm in Sri Lanka. Rashmi's family farm was one of the first contracted by KTI. She now represents the tea farmers at KTI when needed. She is not an employee of KTI but is compensated as a committee member when she attends meetings. Rashmi wants to ensure that tea production remains sustainable and is concerned about land management and climate change.

Andrew Li — chief financial officer (CFO)

Andrew is 36 years old, has a master's degree in business administration, and has worked at KTI since 2015. He started in the accounting office and progressed his way to CFO in 2019. Before joining KTI, Andrew worked in the accounting department of a national food manufacturer. Andrew is responsible for all the accounting personnel and preparation of external and internal financial reports and flexible budgets. He reports directly to Michael, who reviews the monthly reports before they go to the other directors.

Human resources

The breakdown of employees is as follows:

Senior management — shareholders (paid $150,000 annually)	3
Other senior management	3
Production	46
R&D	5
Administration, marketing, IT, and head office	20
Total employees	77

Company operations

Revenue

KTI has contracts with seven customers to manufacture private-label products. It has four national grocery retailers that contract for organic and Fairtrade black and green teas, and three food service companies that contract for spiced organic and Fairtrade black and green teas. Two customers represent 35% of the company's total annual sales. For all the customers, the tea leaves are packaged in bags and then boxed in different quantities. There have been no new customers for the past five years, and volumes of sales from the existing customer base have grown very little during that period.

The revenue contracts are for three to five years in length. KTI has control and ownership of the product and its formulations under these contracts, but any major changes in the product related to quality and taste must be approved by the customer. Although the specifications for packaging and labelling of the product are provided by the customer, KTI purchases the packaging from its own suppliers. KTI has its name and address in small print on the label to identify the company that produced the product.

Under the terms of the customer contract, KTI is liable for any nonconformity in quality or appearance. Minimum orders each year are guaranteed by the customers. Selling prices are fixed for the contract period, increasing annually only for inflation rate changes. The grocery retail customers have agreed to give KTI premium shelf space, since sales of private-label products result in higher margins for the retailer. Customers are permitted to visit and inspect the plant at least annually, or more often upon request. When contract renewals are negotiated, KTI is under pressure to reduce or maintain its selling prices, and therefore it has to manage its input costs accordingly. There are no contractual terms allowing KTI to pass on increases in input costs to its customers.

Generally, KTI has at least 30 days of inventory on hand for each customer, and speedy delivery is one advantage for customers. In addition, since the quality and taste of the tea starts to deteriorate with age, it is critical that the number of days in inventory stays short. KTI is responsible for shipping to the locations identified by the customers at the time of order. Terms for payment of accounts receivable vary from 30 to 45 days, with the larger customers being allowed the longer credit periods.

Michael constantly communicates with the seven customers to ensure that KTI is delivering excellent customer service and products.

Farmers (the owners of the farms)

KTI has supply contracts with farmers in the highlands of Sri Lanka. The contracts vary in length from two to four years and require KTI to purchase the farmers' annual yield of tea leaves after they have been processed. The purchase price is in Indian rupees (INR, ₹), which is KTI's preferred currency, and is set annually by auction. The average exchange rate during 2022 was C$1 = ₹54.503, and the current exchange rate is C$1 = ₹52.6366. These contracts cannot be terminated early without significant penalties. Currently, KTI does not hedge these foreign currency payments.

During the past three years, the price of the tea leaves has remained stable. However, the price can be severely impacted if yields are low due to drought, pests, disease, or poor land and soil management. If the auction price is not seen to be sufficient in any year for the farmers, KTI will pay a premium (to be determined annually) to allow the farmers to earn an adequate return. In addition, in years when the premium may not be enough because the crop has been ruined by drought or disease, KTI has provided additional monetary support for the farmers it works with on a short-term lending basis

[66] Due to timing of authoring of the Capstone 1 case, the exchange rates here do not reflect actual exchange rates. Candidates should use the case facts as presented.

that is repaid in the following year. This support is in the form of a non-interest-bearing loan, but it has not been required during the past seven years.

The tea purchased by KTI comes from farms in Sri Lanka and is high-quality specialty tea grown on mountain slopes. High-quality tea produces a preferred taste that is not bitter, and consumers are willing to pay a premium for it. All the farms have been certified as organic and Fairtrade and are audited as required to maintain these certifications. Under the contracts, KTI is required to pay the farmers prior to shipment. As stipulated in their contracts, farmers agree to follow standards ensuring workers are treated fairly. Farmers are also required to follow standards related to land management and to maintain their organic and Fairtrade certifications.

KTI has a good relationship with the farmers, many of whom have worked with the company since it began and are very loyal to the company. Jason visits the farmers twice a year to ensure that KTI's standards for growing and processing, as well as standards for treatment of workers on the farms, are being adhered to, and also to listen to the farmers' concerns.

Currently, KTI uses all of the processed tea leaves that it purchases from the farmers, meaning that it is at production capacity given the current supply of raw materials. If KTI increases its volume of sales, new farmers will have to be contracted. Jason has been in discussions with some Sri Lankan farmers who might be interested in contracting with KTI if production volumes increase. These potential suppliers are already organic and Fairtrade certified. However, the additional supply from these farmers may not be sufficient to meet all the future demand. Since the quality of the product made by KTI is highly dependent on the quality of the tea leaves used, Jason is very selective about the farms chosen to supply KTI's raw material. This means that there might not be enough farms immediately available to meet all the supply needs if volumes of production increase significantly. It can take up to two years for Jason to find and approve farms that will meet KTI's stringent standards and also be organic and Fairtrade certified.

Cost of goods sold

Included in the cost of goods sold are purchase costs for the tea leaves, flavourings, packaging, all other production supplies and production wages, and other related production costs, including depreciation. Also, like industry practices, warehousing costs and shipping are included in the cost of goods sold. KTI uses eco-friendly packaging, which means that minimal harm is done to the environment in the production, use, or disposal of the packaging. KTI uses packaging materials that are at least 90% recycled content. KTI also uses suppliers whose products are traceable and verifiable. For the past three years, the input cost of this type of packaging has been more expensive than if new materials were used, resulting in higher unit costs.

In the production method itself, KTI has historically employed methods that reduce the use of energy and water. However, as the company has reduced its investment in equipment and technology, there has been no reduction in energy and water usage for the past three years.

Property, plant, and equipment

Asset	(in $'000s)	Depreciation policy
Land	250	
Buildings	1,930	Declining balance 4%
Manufacturing machinery and equipment	3,993	Declining balance ranging from 10% to 20%
Furniture, fixtures, and computers	1,109	Declining balance ranging from 20% to 25%
Total net book value	7,282	

KTI owns a single property that includes the manufacturing plant, the head office, and the R&D facilities. It leases three vehicles. On a square footage basis, 70% of the building is used for manufacturing purposes. There have been no additions or improvements to the building for the past five years. In 2020, the company spent $1.45 million on upgrades to the manufacturing machinery and equipment and to furniture, fixtures, and computers. During 2021 and 2022, KTI underspent on its upgrades and additions. Michael has been reluctant to spend any additional funds because he believes everything is working fine. He wants to conserve the cash or have it available to pay as dividends. Jason and Sabrina disagree with this and think that the company is currently underinvesting in its plant and equipment. Based on estimates, Jason believes that KTI should be spending at least $3 million annually for the foreseeable future to make up for years that were underfunded and to sustain its current capital assets.

Currently the manufacturing equipment is operating at 80% of normal capacity using two shifts a day. There is some excess space that is not being used.

Marketing and advertising

KTI's customers all do their own marketing for their private-label products. The only marketing costs are those incurred by Michael relating to promotional and marketing activities for the existing customer base (including travel).

KTI currently has no website or online presence. Because the existing customers have been with the company for many years and new customers are typically attracted in person, Michael does not see the need to spend any funds on a website.

R&D

The R&D department, made up of food scientists and assistants, analyzes and experiments with adding different fruits, spices, herbs, and other ingredients to change the flavour of the tea and to enhance its health benefits. The scientists also look at different ways to package the tea to retain its quality and improve its taste.

New products that the R&D department has been working on include a range of teas infused with botanicals that aid in digestion and more flavour-enhanced teas, including RTD products. The scientists keep up to date on industry research to ensure they are at the forefront of what competitors are doing and to keep abreast of the changes in consumer preferences. Even though the R&D department continues to successfully develop new products, often ahead of competitors, these products are not being embraced by the customers.

Data analytics

KTI has no consumer contact and therefore has no primary data on consumer preferences.

Financial reporting and budgeting

KTI prepares its financial statements using IFRS. To comply with its revenue contract with its largest customer, KTI is required to provide the customer with a copy of its audited annual financial statements. KTI has had the same auditors, Thorne & Ritter, LLP, since inception. Annual audited financial statements are also submitted to KTI's bank, H&Y Bank. The audit for 2022 was completed in March 2023.

KTI usually pays dividends, but not every year. Dividends were declared and paid in 2021 and 2022 because Michael is concerned about his retirement and wants to withdraw funds while there is excess cash available. Jason and Sabrina would have preferred to keep the funds in the company for growth opportunities.

Banking and financing

KTI has the following line of credit and a long-term debt outstanding:

1. Line of credit — H&Y Bank: Maximum limit of $2,500,000, bearing interest at prime plus 1.5% (prime is currently 2.0%). The line of credit is secured by the accounts receivable and inventories and is renewed annually in September. The line of credit has one covenant: the current ratio must be greater than 2.0.
2. Term loan — Keiser Investments Inc: The 6% term loan is secured by a general security agreement, subordinated to the line of credit. It is repayable in annual principal payments of $400,000 on November 1 and matures on October 31, 2040.

The company has found two alternative sources of funds for any new long-term investments. The terms and conditions proposed for each alternative are provided in Appendix IV.

Board meeting dialogue

The board met on April 25, 2023. Prior to the meeting, a briefing was distributed to the board members on the four new projects that had been discussed at earlier meetings:

- contract with Home Taste Koffee Inc. (Appendix V)
- produce a KTI branded tea (Appendix VI)

- pursue an investment in the Sleeping Hills Tea Estate (SHTE) tea farm (Appendix VII)
- manufacture RTD tea-based products (Appendix VIII)

The meeting's agenda was announced as follows:

1. Consider the four proposed strategic alternatives.
2. Discuss any other business.

Excerpts from the discussions that took place are detailed below.

Michael: Thank you all for coming. I wanted to mention that recently, one of our customers has been hinting that they may not renew their contract, which expires in October, unless their purchase price can be reduced. I am not sure how our negotiations will go, so I have been searching for a new customer, and have been in discussions with Frank Fullerton, the sole owner of Home Taste Koffee Inc. (HTK). As you know, HTK is the inventor and manufacturer of the new Cofte maker, which uses pods to make great-tasting tea and coffee. The Cofte maker is very popular and has been steadily gaining market share from other competitors, given its proprietary design that allows it to brew single, double, and triple servings using pods of different sizes.

Jason: I am familiar with the Cofte makers and have seen many news articles focused on the fact that the Cofte pods have only a small amount of recycled material — I think it is around 55%.

Michael: The pods are uniquely designed and patented to produce higher-quality premium tea and coffee than other comparable systems in the market. The pods are sold at a premium price, targeting the more discerning coffee and tea drinkers, who drink these hot beverages not only for the great taste but also for the experience. HTK produces its own coffee but is looking to contract with a tea producer that will supply a variety of teas in all three sizes of pods for its machines. The tea will be distributed by HTK primarily to hotels and offices. This will be a great way for KTI to diversify its products and customer base in a low-risk manner.

Sabrina: I have reviewed the proposal, and it looks like HTK wants eight different types of teas. What specifically are they looking for?

Michael: That can all be worked out later between Frank and me. I will continue to be the face of KTI in negotiations with Frank and ongoing relationships with HTK. For now, I think if we can come up with eight flavours using fruits and spices, that should be acceptable. Eventually, they want to have one or two herbal teas to include in the mix, alongside the current minimum of one milk-based product.

Sabrina: I have some issues with this. We have never worked with pods and have no idea how our tea will taste when made in these tea pods in a Cofte maker. We will need to do extensive R&D work to ensure that the product is up to our standards, which we may not be able to complete in time to meet the production schedule. We do not currently produce any herbal teas or milk-based teas and only one line of flavoured tea, so this will require a significant change in our operations and product development, if and when we have to produce these products.

Kathleen: As well, the contract is only for a year, but we are going to have to make a major investment in equipment. And where do we find the equipment supplier and the packaging supplier?

Michael: Frank assured me that the contract would be renewed as long as things went well. It is just that his practice has always been to start with a shorter contract initially and then increase at the time of renewal. HTK will let us know exactly which suppliers to use for everything — equipment, packaging, and so on.

Jason: It looks like we will have to find new farmers to get the amount of raw materials we require, since we are currently producing all of the processed tea that we receive. This new supply contract will have to be longer than one year to be consistent with our normal practices. Although there is no requirement for Fairtrade certification, I will want to ensure that any new farmers are certified, since we may need to use their tea leaves in other products in the future. Therefore, the costs of raw material inputs may be higher than forecasted.

Sabrina: We don't have any expertise running this equipment or any employees familiar with this process.

Michael: I asked Frank about that, and he said that we will be required to hire his approved production manager to run this new line, and this manager will hire his own employees.

Sabrina: But does this manager have any tea production experience?

Michael: Yes. Apparently HTK has attempted to partner with two other tea producers in the past, but they were not satisfied with the quality and so they are coming to us.

Jason: The rumours are that Frank can be very demanding and unreasonable and that his production manager is disrespectful and discriminatory.

Kathleen: Well, I do like the high profit margins this contract generates, and I think we should give it a try. Currently, for coffee, HTK is well recognized as having a premium brand. We can always terminate if we are not happy.

Michael: Your opinions are all noted. Let's move to the next item. Jason, can you expand on your idea?

Jason: As you know, I believe that the future of KTI lies in us producing our own brand of tea, to be called Kingsdale Teas. To do so, a product mix that includes teas grown in Sri Lanka and in Kenya is required. Kenya has become a leader in growing single-origin artisan teas, and I think KTI can capitalize on this. I have met several times with a group of tea farmers in Kenya who currently grow and process artisanal teas that are certified organic and Fairtrade. I have been in discussions with Dennis Mwangi, a farmer and representative of these farmers, and they are extremely interested in selling to KTI.

I have also been researching the market for high-quality, artisanal teas and have determined that tearooms and tea shops should be the target customer segment. Over the past year, I have met with many tearoom and tea shop owners across Canada, bringing them samples of some new products developed by Sabrina and some of the Kenyan artisanal tea. These owners are all excited about the products they have sampled, and there are at least 30 customers expressing an interest in buying these teas. A vital component of the plan is for the Kingsdale Teas to be exported to the United States. I have already been in discussions with a long-time friend, Alwynn Blackstone, who lives in the United States and currently works for a tea producer there. She is familiar with the U.S. tea market and will act as KTI's agent in the United States. Alwynn will be given responsibility for the entire U.S. market.

Kathleen: Why limit the sales to only tearooms and tea shops? Why not try to sell this brand everywhere?

Jason: This is a premium-priced, speciality tea. The tearooms and tea shops are very discriminating in the type of tea they carry, since that is what they focus on selling, and they are willing to pay the premium price. If we sell it everywhere, then the product really is not differentiated in any way. Also, being sampled and enjoyed in tearooms and tea shops is the best way to sell our tea, because the tea is brewed to perfection, the taste is phenomenal, and customers will have a pleasant experience.

Michael: But what about our private-label customers? One reason they have stayed with us for so long is that we do not make any competing products, except for other private-label products. I do not want to develop and produce the Kingsdale brand by sacrificing the private-label customers.

Jason: We can slowly move away from private labels, since I think we will be able to sell everything that we produce under our own brand. The margins are better for our own brand compared to private labels, and we are not subject to the constant pressure to reduce prices. To meet production demands, we can initially put on a third shift for the production equipment, and then later we could add another machine, since we have the space.

Michael: I do not like the idea. There are no guaranteed sales at fixed prices, since there are no long-term contracts. Producing private-label tea has allowed our revenues to be stable.

Jason: One of the reasons I chose this segment is that these customers do not purchase based on price, but instead choose based on the type, quality, and taste of the tea. They represent a small niche segment that I think we can appeal to based on our passion and commitment to making extraordinary teas. KTI will not be competing directly on price, and we can generate higher margins.

Sabrina: Well, I love this idea. I also think the timing is right. The R&D department has developed many different tea blends that we have not been able to produce for the private-label customers. With the addition of artisanal teas, we will have a nice broad selection of teas that will appeal to these tearoom and tea shop customers. Finally, we will have control over the type of product that we sell. I have tasted this new artisanal tea from Kenya, and it is some of the best I have ever had. Congratulations to Jason for securing the tea source.

Michael: I am concerned about selling to the United States. Have you done any market analysis specific to the United States? I know that the cultural trends can be quite different, and tearooms may not be trending upwards as they are here.

Jason: I have done limited research, but I have discussed it with Alwynn, who has extensive experience in that market. We both believe this proposal will be successful and that now is the opportune time to make this move.

Kathleen: The marketing spending is too significant and the proposal seems too aggressive. This isn't the best use of our limited resources.

Jason: I disagree. In addition to analyzing the proposal itself, I think we should have FWC complete some additional industry research into tearooms for us and provide us with a bit more background on this type of customer, to help us make this decision. I have provided a list of websites (Appendix VI) that might be helpful as part of this analysis.

Michael: Kathleen, I believe you also have a proposal you have been working on.

Kathleen: Yes. Amasha Bandars, who you all know, has been one of our largest contract suppliers for at least 10 years. Amasha owns SHTE along with her brother, who has been a silent partner for many years. Her brother now wants to sell his share of the farm. SHTE processes high-quality, premium tea. Amasha's brother wants to sell 45% of the farm to KTI, and Amasha has proposed that KTI and Amasha invest in a new company, S&K Inc. (S&K), to be incorporated in Sri Lanka. Having worked with Amasha, I know she is very trustworthy and extremely dedicated to her farm. She is risk averse, like me, so I think we should seriously consider this proposal. I have a lot of faith in Amasha, and this investment will give us control over the quality of the tea we purchase.

Jason: I like the idea. I have been to Amasha's farm many times over the years, and it is very well run. I think it would be great for us to be able to learn first-hand what it takes to run a tea farm, and this will give us better knowledge to negotiate our contracts with the other farmers we work with. As well, we might want to consider owning more tea farms in the future, and this opportunity will allow us to try it and see if it works with only a small investment.

Michael: I am not so sure about making this investment. We have never even acquired another company in Canada before, let alone in a foreign country. I think there is too much that can go wrong, especially when it is far away.

Sabrina: I am also not convinced this is the best use of our money. We already have a long-term supply contract with her, so I don't see why we have to buy into her farm.

Kathleen: This investment gives us a guaranteed supply with more control over cost and overall lower input costs when netted with the profits earned. We will be hedging our risk of the volatile auction prices by sharing in the profits. Keep in mind that at any time, the farmers may decide not to renew our supply contracts. Having an ownership in a farm guarantees us this supply.

Jason: I think owning a tea farm will give confidence to the farmers we currently work with that we know what we are talking about. I also think this experience will help to attract and select future farmers we want to contract with, as I will have a better idea of what to look for when I visit their farms and be able to discuss issues with them from their viewpoint.

Kathleen: Amasha is using up-to-date technology on her farm, and that is why her profits are acceptable. Again, it is good for us to understand what works and what doesn't so that we can have knowledgeable discussions with the farmers. The farm has been in Amasha's family for generations, and there are many relatives working in the business, which means a wealth of experience to utilize. Now, let's move on to discuss Sabrina's proposal.

Sabrina: I am really excited about this new RTD tea-based product. As you know, the R&D department has been experimenting with cold-brewed teas and blending flavours. We believe that we have some very innovative products compared to what is available in the market today. I have been talking to Conrad Bolton, our good friend, and he is interested in being involved in this new product. Conrad owns a bottling company, Bolton Drinks Corp. (BDC), located next to KTI's facilities. He recently approached me with the idea of KTI using BDC's plant and facilities to produce and warehouse a variety of RTD tea-based drinks, with KTI entering into a 10-year lease with BDC for the use of its bottling facilities and equipment. Conrad has a lot of experience in this sector, was successful in the industry for many years, and is now looking for something new and exciting. We all know that he has always been well respected locally and known to treat his employees fairly.

Michael: I don't know. I really like Conrad, but he is my age and was supposed to retire. How can we commit to a 10-year lease agreement with him, not knowing if he will still be interested in 10 years? I think we will be taking a large risk, since we will be relying heavily on him.

Jason: I think Sabrina and I can learn quickly about this segment from Conrad's experience in the industry. We can save time by initially using Conrad's contacts to get us started, and we can begin producing and selling a lot sooner than without him.

Kathleen: I think there are different regulatory requirements that we will have to follow, and so we will be relying on Conrad to comply with these.

Michael: This RTD market is incredibly competitive, not only from tea producers but also from substitutes. I have always stayed away from any branded products in the past, since it takes significant resources to build up the brand and tastes rapidly change in this market. I don’t think we have the resources to keep up with changing tastes and competitors’ new product introductions in this segment.

Jason: The RTD market is growing and there is demand for a premium-priced product, which I think we can deliver on. We should move forward with this proposal and act now while the demand is increasing and before the market is saturated.

Kathleen: Introducing this product will take time and resources that we cannot afford to waste. In the meantime, I think we should have the break-even volumes in 2024 to assess our risk of loss.

Michael: I am not convinced that you have produced a unique product that will be able to compete. It is a green tea that is infused with different flavours. How is this different from what has been sold for a few years now? Competitors are becoming more innovative than that.

Sabrina: This product is different in that there are not many organic and Fairtrade RTDs being sold. And the fruit flavours, spices, and herbs that we are adding have also not been used in combination. Believe me, I have tasted a lot of them. I really do think we have something unique and if marketed properly, it will sell.

Jason: I have done some market research and totally support Sabrina’s proposal. I want KTI to develop its own brand, which this will do. However, I think we should also ask FWC to perform some additional research on the RTD segment of the industry and provide us with key information on this area.

Michael: We have been successful to date, and I really cannot see why we would want to change. We are known and well respected in the industry.

Jason: No, our name is not known in the industry. It is known only to customers who require tea to be produced under their own label. The end consumer has no idea who we are.

Michael: I am nearing retirement, and the last thing I want to do is hand over a company to all of you that is losing money. I need cash flow for my retirement, and I am not willing to take any risk that the cash flow might not be there. You will just have to wait and do this when I am retired.

Sabrina: In the meantime, there is a risk that we will start losing our existing customers and we will have no plans to replace them. Both the Kingsdale Teas and the RTD products will take time to implement, and we will need the cash generated by the private label to do so. Besides, we have to grow the company if Jason, Kathleen, and I have to be able to buy you out, plus earn a good salary.

Michael: All good points. Now that all the ideas have been discussed, we need to decide how we will finance any of our strategic decisions.

Kathleen: Yes, I have been working on that and I have two options (Appendix IV). Conrad has offered to invest in the company, since he is looking for something new to do. I think we should have FWC assess these proposals. We should also have FWC provide a discussion of any accounting or tax implications related to any of the strategic initiatives we are asking them to assess. As well, I know that FWC are not our auditors, but I think they can comment on what type of report Conrad is asking for under the RTD proposal.

Michael: Agreed. Anything else we want FWC to discuss for us?

Sabrina: Yes. As you know, KTI has no consumer contact and therefore is not able to collect data on consumer preferences directly. However, there are market research studies available that collect this data. Data analysis can be used to reveal consumer desires for new flavours and new products and give insight into pricing and market communication opportunities. To help determine the future direction of the company — both strategically and from a product development perspective — KTI has purchased a subset of responses to a survey from the Hot Beverage Institute of America (HBIA), found in the accompanying “DataSet.xlsx” file. I have prepared some background on HBIA and the surveys (Appendix IX), and we should have FWC analyze these results for us.

Michael: Yes, good idea.

Jason: Agreed. I also have an additional concern to discuss. I know that our centralized structure has worked well in the past. But there are now many capable managers in the company with lots of experience, and as we move forward and grow, I would like us to consider a decentralized structure to relieve Dad from making all the decisions. I think we should have FWC provide us with the pros and cons of a centralized versus a decentralized structure.

Sabrina: Good idea. As well, with all these potential changes, we really need to ensure our performance management system is robust enough. Let’s ask FWC for advice on how to improve our performance measurement tools. We can ask them to provide a framework to use for performance management and the key metrics that should be tracked.

Jason: While we are on this topic, let’s ask their advice on succession planning and how it can work for our organization, ignoring any tax implications. Dad, we need to start planning for this, so that all is in place once you do decide to retire.

Michael: I know. But I don’t want to think about retiring just yet.

Kathleen: Dad, you know it is the sensible thing to protect the value of the company that you have built. It doesn’t mean it has to happen tomorrow, but it is always good to prepare and have a plan in place.

Michael: Well, I guess since we all are being open about our opinions, I should bring you up to date on an issue that has become more serious over the past few weeks. A few months ago, one of our employees came to Hans and complained that he had started having respiratory issues and his doctor felt that it was work related. He said that he had started having coughing fits regularly in the plant, which seemed to get better when he got home. Hans took the first complaint and came to me with it in early February. We decided to ignore it at the time and wait and see what happened, since this employee has been a chronic complainer in the past. In February, the employee came in again and said that he had gotten worse and his doctor felt that it might have to do with dust particles in the air. I walked around the plant with Hans and couldn't see anything, so again we decided to ignore it.

Jason: This sounds serious.

Michael: In March, the employee came in again and threatened to refuse to work if something wasn't done. Hans again came to me with this, and we decided to test for dust particles in the air one evening when there was no one around. We found that the concentration of dust was within acceptable guidelines, but at the highest end of the range, so I asked Hans to investigate what might be causing it. Hans determined the cause a few weeks later and said that it was due to the way the machine was designed and operating. He said we could fix it at a cost of $1,000,000 by replacing the parts and improving the ventilation system. Since we had only had the one complaint and we were still within an acceptable range, I said we would put off the expenditure until we got another complaint. We didn't think we needed to spend the money right now, since it would increase our unit costs.

Jason: This does not sound good. What are the implications for us, you think?

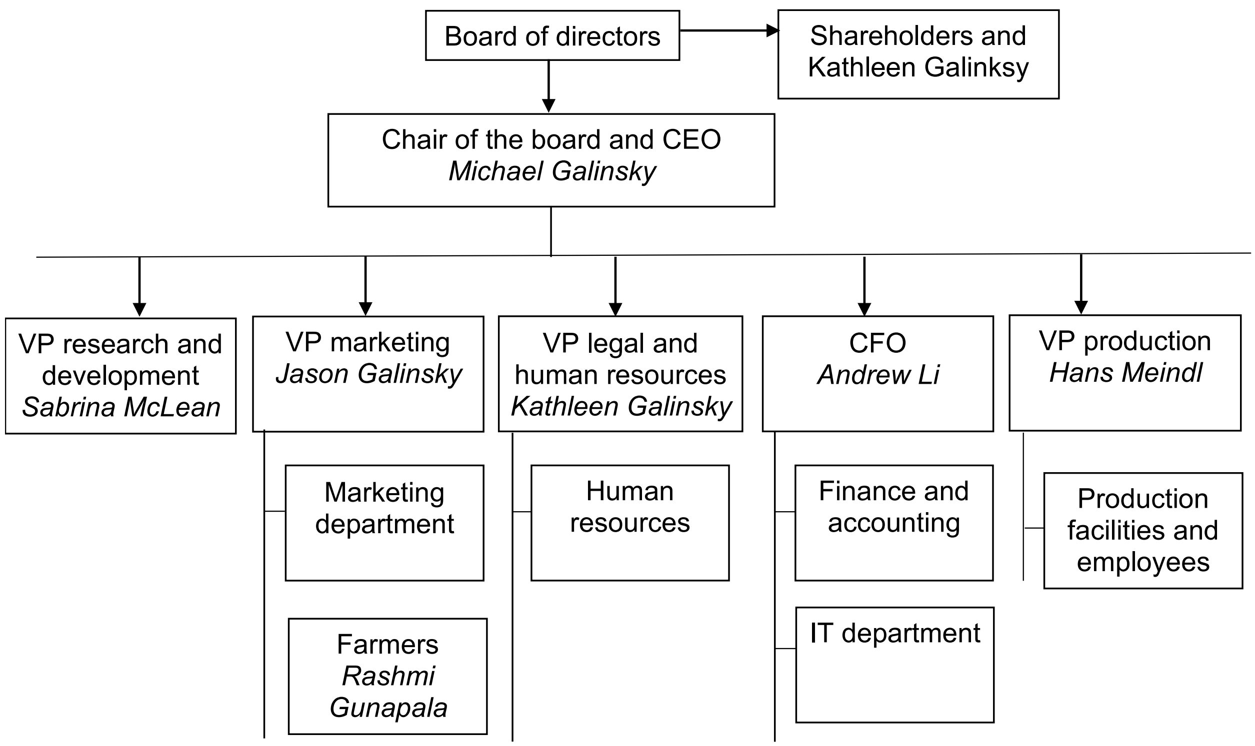
Kathleen: If this gets out to our employees, suppliers, or customers, our reputation — which is based on ethical practices — may be jeopardized. I think we need some guidance on what we should do about this and, hopefully, FWC can help us.

Michael: All right, that might be best. If there is nothing else, we are adjourned.

Table of appendixes

Appendix I
Organizational chart

Prepared by Kathleen Galinsky



Appendix II
KTI financial statements
Prepared by Andrew Li

Kingsdale Tea Inc.
Partial statement of profit or loss and comprehensive income
for the years ended December 31
(under IFRS)
(in C$'000s)

	AUDITED 2022 $	AUDITED 2021 $	AUDITED 2020 $
Revenue	43,200	42,180	40,854
Cost of sales	34,769	32,950	31,980
Gross profit	8,431	9,230	8,874
Expenses			
Research and development	775	770	730
Marketing	265	235	225
General and administrative	4,938	4,790	4,526
Total expenses	5,978	5,795	5,481
Operating income	2,453	3,435	3,393
Finance expense	473	496	518
Income before taxes	1,980	2,939	2,875
Income taxes	515	770	753
Profit and comprehensive income for the year	1,465	2,169	2,122

Kingsdale Tea Inc.
Partial statement of changes in equity
for the years ended December 31
(under IFRS)
(in C$'000s)

	AUDITED 2022 $	AUDITED 2021 $	AUDITED 2020 $
Retained earnings			
Balance — beginning of year	4,947	4,098	1,976
Comprehensive income	1,465	2,169	2,122
Dividends	(1,620)	(1,320)	-
Balance — end of year	4,792	4,947	4,098

Appendix II (continued)
KTI financial statements
Prepared by Andrew Li

Kingsdale Tea Inc.
Statement of financial position
as at December 31
(under IFRS)
(in C$'000s)

	AUDITED 2022 $	AUDITED 2021 $	AUDITED 2020 $
Assets			
Current assets			
Cash and cash equivalents	1,023	1,954	984
Accounts receivable	5,314	4,851	4,494
Inventories	3,094	2,768	2,718
Prepaid supplies and expenses	1,450	1,212	1,203
Total current assets	10,881	10,785	9,399
Property, plant, and equipment — net	7,282	7,540	7,671
Total assets	18,163	18,325	17,070
Liabilities			
Current liabilities			
Line of credit	650	570	545
Trade payables and accrued liabilities	3,853	3,408	3,010
Income taxes payable	164	331	64
Current portion — term loan	400	400	400
Total current liabilities	5,067	4,709	4,019
Long-term debt — term loan	6,800	7,200	7,600
Deferred income taxes	1,204	1,169	1,053
Total liabilities	13,071	13,078	12,672
Shareholders' equity			
Share capital — 300,000 common shares outstanding	300	300	300
Retained earnings	4,792	4,947	4,098
Total shareholders' equity	5,092	5,247	4,398
Total liabilities and shareholders' equity	18,163	18,325	17,070

Appendix II (continued)
KTI financial statements
Prepared by Andrew Li

Kingsdale Tea Inc.
Statement of cash flows
for the years ended December 31
(under IFRS)
(in C$'000s)

	AUDITED 2022 $	**AUDITED 2021 $**
Operating activities		
Net profit	1,465	2,169
Depreciation	1,098	1,141
Interest expense	473	496
Interest paid	(473)	(496)
Income tax expense	515	770
Income taxes paid	(647)	(387)
Change in working capital balances		
Accounts receivable	(463)	(357)
Inventories	(326)	(50)
Prepaid supplies and expenses	(238)	(9)
Trade payables and accrued liabilities	445	398
Total cash flow from operating activities	1,849	3,675
Investing activities		
Investment in property, plant, and equipment	(840)	(1,010)
Financing activities		
Line of credit	80	25
Repayment mortgage payable	(400)	(400)
Dividends paid	(1,620)	(1,320)
Total cash flow from financing activities	(1,940)	(1,695)
Change in cash	(931)	970
Opening cash and cash equivalents	1,954	984
Closing cash and cash equivalents	1,023	1,954

Appendix III
Industry benchmarks
Prepared by Andrew Li

Industry benchmarks	Industry average
Revenue growth	4.7%
Current ratio	2.5
Total debt-to-assets ratio	0.4
Return on assets (net return)	10.0%
Days in receivable	37.0
Days in inventory	45.0
Gross profit margin	24.0%
Operating margin	10.6%
Profit margin	7.0%
Marketing expenses as a percentage of revenue	2.6%
Research and development as a percentage of revenue	2.0%
General and administration as a percentage of revenue	14.0%

Appendix IV
Financing alternatives
Prepared by Kathleen Galinsky

Keiser Investments Inc. term loan

Keiser Investments Inc. has offered to lend a term loan in the amount of $6,000,000, which would be subordinated to all other loans. The loan bears annual interest at 10%, with the interest payable monthly. In addition to the annual interest rate, KTI will pay bonus interest. The bonus interest will be payable in any year that KTI's EBITDA is greater than $3.0 million. The bonus interest will be equal to 5% on the excess EBITDA above the base of $3.0 million. KTI will be required to submit quarterly unaudited statements and annual audited statements. Dividends are limited to $500,000 annually during the term of the loan, and salaries to shareholders are fixed at the current levels for the term of the loan. The principal is due three years after issue of the loan.

Preferred share investment by Conrad Bolton

Conrad Bolton has offered to purchase 80,000 preferred shares in KTI for $8,000,000. These preferred shares are non-voting and fully participating, with a cumulative annual dividend of 5%. The shares are redeemable by the issuer at a price of $100 per share any time after January 1, 2027. One requirement is that Conrad gets a seat on the board of directors and has some say over the operations of the company.

Appendix V
Contract with Home Taste Koffee Inc.
Prepared by Michael Galinsky

HTK has been in business for 10 years, starting as a coffee producer and then inventing and beginning to sell the Cofte maker four years ago.

HTK has contracts with major national hotel chains and many large office complexes, where it provides its Cofte makers at a significantly discounted price and sells its coffee and tea pods as required. It has multi-year contracts to supply these pods to its customers. HTK also has contracts with grocery retailers to sell its pods in bulk for home use. As part of its agreement with most of these retailers, HTK has negotiated premium shelf space.

The following is an excerpt from the proposed co-branding contract, provided by Frank. He is not interested in negotiating different terms, as this is the standard that he uses with all of his coffee and tea suppliers.

Terms and conditions:

- HTK and KTI agree in this contractual arrangement to co-brand tea pods that will be distributed by HTK.
- The initial contract will terminate in one year, on December 31, 2024, and, if agreed by both parties, will be renewed for another four years.

Production and shipments:

- HTK acknowledges that KTI will formulate and produce tea pods based on KTI's proprietary formulas, which will always be owned and controlled solely by KTI and remain the sole property of KTI.
- KTI will initially provide eight different flavours of tea, including one milk-based product, and the tea leaves used will be certified as organic. HTK will have the final say on the eight flavours to be produced as part of the arrangement.
- Annually, KTI must produce two new innovative flavours of tea pods, replacing two of the existing products.
- KTI will be responsible for ensuring that quality of the product is always maintained.
- KTI will be required to provide 10 samples of product for testing by HTK. HTK agrees to pay $1,000 for these 10 samples in advance, before any production commences.
- KTI agrees to test for product quality, stability, and consistency on a regular basis.
- KTI will be responsible for ensuring that the product complies with all regulatory requirements.

Appendix V (continued)
Contract with Home Taste Koffee Inc.
Prepared by Michael Galinsky

- HTK agrees to provide all label and packaging specifications. The product will be co-branded by HTK and KTI, and KTI will have its name displayed prominently on the product's label as approved by HTK. KTI may also provide a descriptive phrase on the front of the package that will help to promote its product. HTK will approve this marketing phrase.
- If HTK, a customer, or a consumer should find KTI's product defective in any way, HTK will provide notice of the alleged nonconformity in writing within five days and KTI will be required to replace the defective product at its own cost.
- HTK will require KTI to hire a production manager of HTK's choice. This production manager will have the sole responsibility of running this production line, as well as hiring the employees to be part of this production team.

Payment and inventory:

- HTK agrees to pay in full, within 45 days of shipment, for all co-branded product produced under the agreement.
- KTI will be responsible for ordering the packaging and labels and for their payments, but must purchase the packaging only from an HTK approved supplier.
- KTI must maintain a finished goods inventory representing a minimum of 30 days of sales worth of product, ready for immediate shipping on notice.
- If in any year the volume of product shipped by KTI is 120% greater than the volumes forecasted, HTK will be entitled to a volume discount on all product purchased in that year of 12%.
- HTK maintains data on how often each product is sold, providing it with an indication of consumer preferences. HTK will share this information with KTI monthly.

Other items:

- HTK agrees to not disclose, provide, or otherwise make available to another third party any KTI confidential and proprietary information. Similarly, KTI agrees not to disclose any HTK confidential and proprietary information.
- The agreement may be terminated by HTK with 30 days' notice, for no cause. KTI may also terminate the contract giving 60 days' notice, with no cause.
- KTI agrees to purchase the required equipment to package the tea pods from a supplier approved by HTK. This equipment is state-of-the-art, incorporating robotics for blending and mixing, and requires minimal labour.
- KTI cannot produce and sell Cofte tea pods unless under contract with HTK or otherwise approved by HTK.

Appendix V (continued)
Contract with Home Taste Koffee Inc.
Prepared by Michael Galinsky

- HTK agrees to pay the prices as detailed below. HTK agrees to purchase, at a minimum, 80% of the forecasted volumes detailed below.

Based on Frank's experience with previous tea producers, he has provided the following estimates for costs and sales. He believes that sales could start in January 2024.

	2024	**2025**	**2026**	**2027**	**2028**
Single-serving pod					
Volume of sales	6,500,000	6,800,000	6,900,000	6,900,000	6,900,000
Selling price per pod	$0.425	$0.425	$0.425	$0.425	$0.425
Double-serving pod					
Volume of sales	6,100,000	6,300,000	6,500,000	6,500,000	6,500,000
Selling price per pod	$0.755	$0.755	$0.755	$0.755	$0.755
Triple-serving pod					
Volume of sales	4,600,000	4,800,000	4,900,000	4,900,000	4,900,000
Selling price per pod	$1.092	$1.092	$1.092	$1.092	$1.092

Frank also states that historically, the packaging costs have represented 3.2% of revenues. The cost of the new equipment will be $6,500,000 and will be purchased near the end of 2023, with production started before the end of the year. For tax purposes, the equipment would be assigned to Class 53. At the time of disposal, at the end of five years, the equipment can be sold for $1,350,000 and there will be other assets remaining in the class at this time.

Hans and I have prepared some estimates of additional costs (with input from Frank), as follows:

- There will be an addition required to the warehouse to increase the space. The cost of this addition will be $900,000, and it will qualify for capital cost allowance (CCA) at 6% declining balance. At the end of five years, the salvage value of this addition will be nil but could be used by the company beyond five years, if the contract is extended.
- Direct labour will equal 4% of revenues.
- Tea leaves and other ingredients will equal 51% of revenues.
- KTI will invest and maintain a specific working capital equal to 16% of the next year's revenue.

Appendix V (continued)
Contract with Home Taste Koffee Inc.
Prepared by Michael Galinsky

Annual fixed costs for KTI's operations are estimated as follows, excluding depreciation:

- production costs: $375,000
- warehousing costs: $80,000
- marketing costs: $50,000

It is estimated that there will be one research assistant required at an annual salary of $75,000 including fringe benefits, plus additional supplies of $25,000 annually. There will be no new administrative staff required, but I have determined that 10% of the existing general and administrative costs should be allocated to this new product line. Sabrina estimated that it would cost $1,500 in materials to produce the test samples requested.

KTI's cost of capital for this project analysis is 18%, and the corporate tax rate to apply is 26.5%.

Appendix VI
Develop branded tea — Kingsdale Teas
Prepared by Jason Galinsky

I have approached Dennis about exporting their tea, and Dennis and his group are very interested in selling their artisanal and other black and green teas in Canada. If the proposal is accepted, the farmers' contracts will be initially for four years, with the price set annually by mutual agreement, which will vary based on annual yields. Since the artisanal teas are unique and hand processed, their price will be much higher than the auction prices for the non-artisanal teas.

My vision is that the Kingsdale brand will represent high-quality premium, organic, and Fairtrade teas in a variety of types and flavours. The teas will be known for being ethically sourced and will be sold as loose-leaf tea, not in bags. The tea will be sold only to tearooms and tea shops at a premium price and in small batches to retain the quality and freshness of the tea. No long-term customer contracts will be signed, but I expect to have monthly orders to ship product to these customers. The value proposition for the Kingsdale Teas brand is to have a product that is extraordinary, is unique, has distinctive flavours, and is available only in limited quantities to very discriminating tea drinkers. Sabrina and I will have total control selecting and developing the teas that will be sold under this brand.

To meet the projected customers' orders, the company will use tea from the Kenyan farmers and from the new Sri Lankan farmers, with whom I have already started discussions. If any current private-label contracts are not renewed, I suggest that any excess raw materials from the existing contracted farmers be used for the Kingsdale brand. I believe I can sell as much tea as can be produced. The current projections assume that 50% of the tea is sourced from Kenya.

I will continue to be responsible for the marketing and sales of Kingsdale Teas in Canada. The personal marketing approach is the most effective method for this type of product, and I will personally visit each customer's premises at least every six months.

Production equipment modifications will be required to be able to package the tea as loose leaf. New warehousing equipment will also be needed to improve the efficiency of shipping given the multiple daily shipments that will be required. The total cost of the modifications and new state-of-the-art equipment will be $2,500,000. There will also be an addition to the warehouse required to increase the space that will cost $1,200,000. For tax purposes, the equipment would be assigned to Class 53, and the warehouse addition will qualify for a CCA rate of 6% declining balance. There will also be an initial working capital investment of $500,000.

Appendix VI (continued)
Develop branded tea — Kingsdale Teas
Prepared by Jason Galinsky

Currently, the exchange rate is US$1 = C$1.35, but historically, the exchange rate has been as low as US$1 = C$0.98. Forecasts of sales in Canada and the United States are as follows:

	2023 (Oct to Dec)	2024 (Jan to Dec)	2025 (Jan to Dec)	2026 (Jan to Dec)
Number of Canadian customers	30	75	100	125
Units sold per Canadian customer	300	1,200	1,250	1,300
Selling price per unit sold for Canadian customer	C$110	C$110	C$110	C$115
Number of U.S. customers	10	60	85	110
Units sold per U.S. customer	300	1,200	1,250	1,300
Selling price per unit sold for U.S. customer	US$95	US$95	US$95	US$100

The cost per unit sold is $66.70. Shipping costs are 4% of Canadian sales and 6% of U.S. sales. The commission paid to the U.S. sales agent is 7% of U.S. sales.

Marketing costs in Canada will be $725,000 for 2023 and $1,450,000 for 2024 and onwards. In the United States, marketing costs will be C$1,375,000 in 2023 and then C$2,150,000 for 2024 and onwards.

Annual expenditures will be R&D $550,000, warehousing costs $800,000, and general and administration $540,000.

KTI accepts projects of this size that pay back within three years.

To help understand how tearooms operate and how customers are served, I have found two sources that I suggest the other directors review:

- Melanie Luff, "How to Run a Tea Room: A short guide to the complex blend of written and unwritten rules in the refined realms of tea," BusinessesForSale.com, https://canada.businessesforsale.com/canadian/search/tea-rooms-for-sale/articles/everything-you-need-to-know-about-running-a-tea-room.
- Tina Jesson, "10 Tips for Tearoom Success," World Tea News, November 1, 2017, https://worldteanews.com/tea-industry-news-and-features/10-tips-tearoom-success.

Appendix VII
Ownership in tea farm — SHTE
Prepared by Kathleen Galinsky

Amasha would own 55% of S&K, and KTI would own 45%. (Sri Lanka laws do not allow companies with local ownership of less than 50% to buy property in Sri Lanka.) Amasha would contribute 55% of SHTE's assets and operations to S&K, and KTI would contribute cash of $3,100,000, which would be used to buy 45% of SHTE's assets and operations from Amasha's brother.

In 2022, KTI purchased tea from SHTE totalling $2,600,000, which is approximately 9% of KTI's total tea purchases in 2022, with none of it remaining in ending inventory. Amasha's contracts with KTI are currently for a four-year period. Excerpts from SHTE's last four years of operations is provided below. SHTE reports under IFRS and has no outstanding debt.

Since there have been no recent sales of comparative companies, it has been decided that the best approach to use to value SHTE is the capitalization of net profits. In discussions with experts, I have gathered the following current information related to cost of capital for tea farms in Sri Lanka:

- The target capital structure is a debt-to-asset ratio of 10%, with debt having a current cost before taxes of 5.2%.
- The current risk-free rate in Sri Lanka is 3%, and the beta for similar sized companies is 3.5. The market risk premium is 5%.
- The last four years of financial information should be weighted at the following percentages: 2023 at 40%, and each of the other years at 20%.

In discussions, Amasha provided the following additional information:

- Normally each year, a portion of the tea plants need to be replaced at a cost of ₹450,000. However, in 2022 and 2021, due to low revenues, this replanting was not done.
- Amasha has been paid a low salary from the business for each of the years provided. Based on the management work that she does, a comparable annual salary would have been higher by ₹2,000,000.
- There are some small amounts of personal expenses related to travel that have been included in each year, as follows: 2023 — ₹150,000; 2022 — ₹350,000; 2021 — ₹750,000, and 2020 — ₹650,000.

Appendix VII (continued)
Ownership in tea farm — SHTE
Prepared by Kathleen Galinsky

Amasha has proposed the following contractual arrangement, which she is not willing to negotiate at this point:

- S&K will be formed for the specific purpose of carrying on the business of growing, harvesting, and processing tea at SHTE.
- Amasha and KTI are each a party to this agreement.
- Assets will be owned by S&K, and liabilities will be the obligation of S&K.
- Amasha and KTI will have rights to the net assets of S&K.
- Any tea processed will first be sold to KTI in the quantities requested, and only after those sales will any remaining product be sold to outside parties.
- The board of directors will consist of four directors; Amasha will appoint two directors of her choice, and KTI will appoint two directors of its choice.
- All business decisions will be made unanimously, regardless of proportion of ownership.
- Annual profits of S&K will be allocated as follows: 55% to Amasha and 45% to KTI.
- Amasha will manage the operations on a daily basis and be paid a salary as mutually agreed by both parties for this work.
- KTI will continue to purchase processed tea as required under the current arrangement and will pay the prevailing market (auction) prices to S&K.
- In any year where losses occur and a cash deficit results, each party will be required to contribute sufficient cash to cover the losses, in proportion to their ownership.
- The anniversary date will be the date on which the agreement is signed and becomes enforceable.
- Each party has the right to terminate this agreement. After the initial year, the agreement will automatically renew annually on its anniversary date, unless written notice is provided to the other party of the desire to terminate the arrangement. This written notice must be provided 30 days prior to anniversary date. Only by mutual agreement can this agreement be terminated any time other than the anniversary date.

Please note that I have validated the Sri Lankan financial and tax information included in this proposal, and FWC should not perform additional research on this topic at this time.

Appendix VII (continued)
Ownership in tea farm — SHTE
Prepared by Kathleen Galinsky

Sleeping Hills Tea Estate
Statement of profit or loss
For the years ended March 31, 2020, 2021, 2022, and 2023
(under IFRS)
(unaudited)

	2023	**2022**	**2021**	**2020**
	₹	**₹**	**₹**	**₹**
Revenue	193,108,600	180,560,700	170,564,120	198,041,200
Costs				
Fertilizer	25,557,600	26,557,600	28,996,540	26,996,540
Harvest and processing	62,810,000	54,810,000	65,743,000	54,743,000
Other	25,000,000	22,300,000	22,300,001	26,781,020
	113,367,600	103,667,600	117,039,541	108,520,560
Operating profit	79,741,000	76,893,100	53,524,579	89,520,640
Income taxes at 14%	11,163,740	10,765,034	7,493,441	12,532,890
Net profit or loss	68,577,260	66,128,066	46,031,138	76,987,750

Appendix VIII
RTD tea-based product
Prepared by Sabrina McLean

Bolton Drinks Corp. (BDC) is located next to KTI's manufacturing facilities, and has been for many years. BDC bottled fruit juices and had customer contracts with convenience stores, gas stations, vending machine companies, and small independent grocery stores. After being in business for 30 years, Conrad decided it might be time to retire and slowly wound down his business. However, he has now changed his mind and decided he is not ready for retirement.

BDC has an automated production line that can package product in a variety of container and bottle sizes. For now, this line is not used. The equipment is about five years old. KTI would pay BDC rent for sole use of the facility and equipment and a management fee to manage the production line and warehouse. KTI would be responsible for all other costs.

Conrad would provide his experience and supply the names of customer and supplier contacts. He would also set up initial meetings with his previous customers to make the introductions and start the discussions. In the past, Conrad had one-year supply contracts with these customers. I plan for Jason to be involved in the sales and marketing of the new product. Conrad also has supplier contacts for bottles that he is happy to share with KTI. I have asked Conrad to be responsible for the purchase of packaging and labelling, but with input from Jason and me.

I want these new RTD products to be premium high-quality green tea drinks, certified organic and Fairtrade, and packaged in recyclable bottles. They will be premium priced and targeted to 18- to 35-year-olds. My R&D department has been researching various cold tea drinks and experimenting with unique fruit, herb, and spice blends to create bold new flavours. I believe that by late November 2023 we should have at least four different varieties ready to produce and sell. In the meantime, I can work with Conrad to prepare sample products to make sure that after bottling, the taste is still of high quality.

KTI would enter a 10-year lease with BDC at a monthly rate of $77,714, payable at the beginning of each month, starting January 1, 2024. The annual rate implicit in the lease is 6%, compounded monthly. The economic life is 10 years for the equipment and 15 years for the facilities. (The equipment and facilities have a combined fair market value of $12 million.) BDC will be responsible for upgrading the equipment to handle the packaging specifications, once selected, and maintaining the equipment in working condition.

Appendix VIII (continued)
RTD tea-based product
Prepared by Sabrina McLean

KTI also agrees to pay BDC an annual management fee of $250,000, payable monthly, starting July 1, 2023. In addition, KTI will pay BDC an annual bonus equal to 2% of all RTD product sales. Assuming production starts January 1, 2024, the 2% bonus will be based on total sales from January 1 to December 31 and be payable by January 21 of the following year. Conrad will require an annual audited report on the total sales and the amount of bonus paid to be provided no later than February 15 of the following year.

From discussions with Conrad, I have decided that there will be two sizes sold: single bottles and six-bottle packs. The products will be marketed under a new brand name still to be determined. For this tea product, I suggest using tea grown in the lowlands of Sri Lanka. Jason will therefore have to contract with new farmers to meet the increased supply requirements.

Conrad and I have prepared forecast assumptions below:

Sales: selling price per single bottle: $2.75; selling price per six-pack $12.90

	2024	**2025**	**2026**
Volume of singles sold	1,200,000	1,300,000	2,100,000
Volume of six-packs sold	650,000	800,000	950,000

Variable costs per unit

	Single bottles	**Six-pack**
Direct materials	$0.40	$2.50
Direct labour	$0.25	$0.90
Other production costs	$1.10	$5.35
Shipping and distribution	$0.21	$1.03

Additional annual costs:

- wages for additional office staff: $210,000
- marketing costs: $600,000
- general and administrative costs: $85,000 fixed, plus $0.16 per item sold
- warehousing costs: $350,000

Appendix VIII (continued)
RTD tea-based product
Prepared by Sabrina McLean

I have also done some preliminary research into the RTD industry and have provided a summary of my research below[67] (although it's from the United States, there are assumed to be similarities with the Canadian industry):

- The RTD tea-based industry is growing as consumers turn toward healthier choices than sweetened soda and fruit juices.
- Demand is driven by consumers' health concerns and product innovation.
- Consumers are looking for a variety of flavours and differentiated tea offerings with unique blends that can be sold at premium prices.
- Distribution of sales by major markets is as follows: gas stations and convenience stores 15%; vending machines 5%, warehouse clubs and big-box stores 21.7%, grocery stores 45.5%, and exports 12.8%. A significant proportion is sold in non-traditional distribution channels. Vending machines, gas stations, and convenience stores are expected to increase their market share, and grocery stores are increasing their retail space for these types of beverages, while the share sold through warehouses and superstores is shrinking.
- Key success factors are strong distribution networks to gain access to premium shelf space, economies of scale, control of distribution arrangements to minimize logistical costs, production of goods favoured by the market based on consumers' shifting preferences, brand name recognition, and aggressive marketing.
- Competition is high and based on price, branding, and quality. The large operators have economies of scale and power to negotiate lower prices with suppliers. Smaller operators can be successful if they are selling a premium-priced RTD.
- The barriers to entry are medium, but new smaller entrants can be successful by entering a niche market and selling a unique product. These niche markets are less price sensitive.
- Automated equipment is used, and the trend is toward packaging in glass bottles, which are better for the environment and also better preserve the flavour. Other packaging is in cans and polyethylene terephthalate (PET) bottles. In addition, companies continuously invest in new capital equipment to optimize production and lower costs.

[67] Anna Amir, "Strong tea: Health-conscious consumers and product development will drive industry demand," *IBISWorld Industry Report OD4297: RTD Tea Production in the US*, December 2018.

Appendix VIII (continued)
RTD tea-based product
Prepared by Sabrina McLean

I have also found the following three other good sources of industry information:

- "RTD Tea and Coffee Market Size Worth $116.13 Billion By 2024," Grand View Research, April 2018, https://www.grandviewresearch.com/press-release/global-ready-to-drink-tea-and-ready-to-drink-coffee-market.
- "2019 State of the Beverage Industry: Ready-to-drink tea, functionality drives demand in market," Beverage Industry, July 15, 2019, https://www.bevindustry.com/articles/92246-2019-state-of-the-beverage-industry-ready-to-drink-tea-functionality-drives-demand-in-market.
- "Tea Trouble: How Formulations Meet Packaging Needs, Not Consumers'," Nosh, October 16, 2014, https://www.nosh.com/news/2014/tea-trouble-how-formulations-meet-packaging-needs-not-consumers.

Appendix IX
Consumer data

Prepared by Sabrina McLean

Hot Beverage Institute of America (HBIA) is a marketing and lobby group for tea and coffee producers. It uses various methods to engage with the public, including contests, social media promotions, and consumer quizzes. In exchange for entries into these engagement activities, HBIA collects some personal information from participants, including name and email address. HBIA then uses this information to distribute its bi-annual online market survey, a portion of which KTI has purchased.

The survey is sent to all users in HBIA's public engagement database and includes anyone who has identified as having an interest in tea or coffee in Canada and the United States. The survey, which is voluntary, has an 8% response rate.

KTI purchased the responses of Canadian participants. The responses are included in the DataSet.xlsx file.

The following personal information is collected from respondents (though not all of it has been included in the information purchased by KTI):

- First Name (not included)
- Last Name (included)
- Street Address (not included)
- City (included)
- Email Address (included)
- Gender (included)
- Age (included)
- Annual income (included)

Respondents are then asked a series of questions about their hot beverage habits. The following questions were included as part of the 2021 survey:

- What is your preferred beverage?
- How much of your preferred beverage did you drink daily five years ago?
- How much of your preferred beverage did you drink daily one year ago?
- How much of your preferred beverage do you currently drink daily?
- What is your favourite variety?
- What is the country of origin of your favourite variety?
- Where do you most frequently purchase your preferred beverage?
- What is the average price that you pay for your preferred beverage?

Appendix IX (continued)
Consumer data
Prepared by Sabrina McLean

Consumers were also asked to rank on a scale of 1 to 5 how important the following factors are in their buying decision, where 1 is “not important” and 5 is “very important”:

- the health benefits of their preferred beverage
- the use of organic ingredients in their preferred beverage
- the use of sustainably sources ingredients
- the use of Fairtrade practices by the producer
- the producer being Canadian

The other board members and I would like to have the information analyzed and presented visually at the next board meeting. We want to gain a better understanding of the “end-user” in KTI’s market. Some of the things we are most interested in are:

- consumption patterns
- consumer demographics
- buying considerations

As well, I have been doing a lot of reading about data acquisition recently, and I would also like FWC to evaluate the quality of the data received, the method used to collect it, and identify any biases that it may contain.

Finally, I would like to begin storing consumer data onsite at KTI. Eventually I believe that it would be beneficial to begin collecting data directly. Please provide us with some guidelines on collecting and storing personal data.

APPENDIX C

THE COMMON FINAL EXAMINATION
DAY 1 KTI VERSION 1 BOOKLET – MAY 30, 2023

COMMON FINAL EXAMINATION
MAY 30, 2023 – DAY 1

Case (KTI-Version 1) **(Suggested time: 240 minutes)**

It is March 31, 2025, and you, CPA, are still working at F & W Consulting LLP (FWC). Kingsdale Tea Inc. (KTI) has again engaged FWC to assist with KTI's strategic analysis and planning.

Michael retired in 2023. Upon retirement, he gifted 45,000 KTI common shares to Kathleen, and his remaining 165,000 shares were repurchased and then retired by KTI. Each child—Jason, Sabrina, and Kathleen—now owns an equal amount of KTI (45,000 common shares each). In return for his 165,000 shares, Michael accepted an interest-free loan of $5 million, which will be repaid in equal annual instalments over a 10-year period. Michael no longer sits on KTI's Board of Directors (the board), but still provides advice to KTI on a periodic basis. Jason is now KTI's CEO, and Conrad Bolton was hired as KTI's VP of marketing. In late 2023, Conrad invested $6 million for 60,000 preferred shares that are convertible into common shares on a one-to-one basis.

Since the last engagement, KTI has begun to sell a new product line of its own branded tea, which has a total of 10 products. KTI now has two distinct product lines: private-label and KTI-branded teas. Since joining KTI, Conrad has been instrumental in the successful rollout and sales growth of KTI-branded tea. KTI's current strategy is to sell the new, KTI-branded teas in tea rooms and tea shops (where tea can be purchased for at-home consumption). KTI used a portion of the funds received through Conrad's preferred-share issuance to finance the necessary equipment and initial marketing costs associated with offering KTI-branded teas. With the remaining funds, KTI upgraded its dust-elimination equipment, which has resolved the respiratory issues that some KTI employees were experiencing. Since 2023, KTI has made no other major investments, such as the investment in Sleeping Hills Tea Estate (SHTE), and did not pursue the proposals from Home Taste Koffee Inc. (HTK) and Bolton Drinks Corp. (BDC).

To date, KTI has chosen not to sign any long-term contracts for its KTI-branded teas.
Fortunately, orders for KTI-branded teas have increased each month since their launch.

Despite the launch of KTI-branded tea, the company still relies on its private-label sales (which come from four remaining private-label contracts) for approximately 70% of its sales. All four contracts are set to expire over the next two years, and KTI has not yet approached these customers about beginning the contract renewal process. As the private-label contracts expire, KTI's strategy to date has been to reallocate the supply of raw materials to producing KTI-branded teas.

Over the past two years, Sabrina has continued to build a strong R&D team, which has been successful in developing popular and innovative products. This has gained KTI the reputation of being an industry innovator of new tea products. Part of this success is owed to running focus groups with tea shop owners to test new tea flavours. At present, KTI's R&D team creates five new tea flavours each year. In addition, KTI was just granted its first patent as a result of the R&D team's efforts. The patent protects the process by which theanine, an amino acid naturally found in green tea, is extracted from the tea plant. KTI's R&D team pioneered a new process that greatly increases the quantity of theanine that can be successfully extracted from each tea plant.

Since 2018, KTI has not changed its mission, vision, or core values. However, because Michael retired from active management of KTI, the board decided to update the company's objectives.

At a recent board meeting, the directors agreed on the following objectives:
1. Increase the operating profit margin to 12% by 2028.
2. Increase revenues by 10% annually.

For any new strategic investments, KTI has $4 million of cash available for investment and no access to further bank financing.

KTI's board has asked you to review the information provided and draft a report in which you analyze and make a recommendation for each proposal presented. The board would also like you to comment on KTI's overall strategic direction and on how each proposal might affect that direction. For this engagement, please ignore any tax implications within your analysis and recommendations.

INDEX OF APPENDICES

APPENDIX I
BOARD MEETING WITH CPA IN ATTENDANCE

March 31, 2025

Jason: Thank you, CPA, for coming today.

To date, we're happy with how KTI-branded teas have been received by our customers. Not only have sales for KTI-branded tea grown steadily, but we also enjoy a higher margin on these sales, given the higher sales price we can charge. Although our profits have been somewhat hampered by high marketing costs, this is not much of a surprise, as we are building a new brand, which costs money.

At the same time, our R&D department is exceptional. Just recently, KTI was awarded the company's first patent! Sabrina, congratulations on a job well done.

Sabrina: Thank you so much, Jason. Honestly, I think we have the best R&D team in the business. We are just getting started in our pursuit of creating high-quality, niche products.

Jason: Excellent, Sabrina.

CPA, given the company's transition from private-label sales into KTI-branded tea sales, we must decide how best to reallocate the supply of raw materials that will come available once the remaining private-label contracts expire.

Kathleen: I think we need to start accepting long-term sales contracts for KTI-branded tea, to secure our revenue stream. To date, sales of our KTI-branded teas have grown quickly, but that growth has recently slowed. With our current sales strategy, and in comparison to the amount of KTI-branded tea we sold in 2024, we expect to sell an additional 750,000 kg of KTI-branded tea in 2025, 800,000 kg in 2026, and 850,000 kg in 2027.

Sabrina: I disagree. The company would be best served if we focus our resources on the development and distribution of new, niche products.

Jason: As a board, we can only make an informed decision about KTI's strategic direction after we have analyzed our options. On that note, we have several strategic alternatives to consider. For the first alternative, we are being joined via telephone by none other than the founder of KTI, Michael Galinsky.

APPENDIX I (continued)
BOARD MEETING WITH CPA IN ATTENDANCE

March 31, 2025

Michael joins the meeting via telephone.

Kathleen: Dad, I thought you were supposed to be retired!

Michael: I am, but I have something very exciting to share with the board. As you know, KTI was built through the acquisition and retention of strong relationships with the company's private-label customers. Well, after 10 years of targeted marketing and relationship building, I am overjoyed that Beau Foods Inc. (BFI) is finally ready to sign on with KTI.

Conrad: Do you know what changed for BFI?

Michael: Yes, KTI-branded teas! BFI saw how well the public received KTI-branded teas, and they now want to sell them within their vast network of stores across Canada and the U.S. This would be the biggest contract in KTI's history!

Jason: Looking at the notes provided, this is indeed a huge contract (Appendix IV). Given its size, we would need to allocate KTI's entire supply of raw materials to service it adequately. In fact, by the contract's third year, we would likely need to increase our supply by roughly 50% to meet the requirement.

Michael: Accepting this contract would reduce KTI's risk profile.

Kathleen: I agree. BFI's long-term contract will secure KTI's revenue stream for the foreseeable future.

Sabrina: I am not convinced. Given that BFI requires 10 new unique tea flavours each year, R&D would have no time left to develop other products.

Jason: Plus, the profit margin from this contract would be lower than a typical KTI-branded sale.

Michael: Contracts like this are rare — I recommend that you accept it. Anyway, I need to run.

Michael leaves the meeting.

APPENDIX I (continued)
BOARD MEETING WITH CPA IN ATTENDANCE

March 31, 2025

Kathleen: Wow, what a surprise. This certainly gives us more incentive to expand KTI's supply of raw materials. On that note, Jason, can you tell us about the Hilly Side Tea Farm (Hilly) proposal?

Jason: Sure. Hilly was founded 30 years ago by Frans Mendis, who retired in 2024. The farm is now 100% owned by his son, Ivaan Mendis, who operates the farm alongside Hilly's long-time manager. Although KTI has never purchased raw tea leaves from Hilly, I am familiar with their operations. I know they have been certified as Fairtrade and organic for more than 10 years.

Kathleen: Ivaan has offered to sell 40% of Hilly to KTI for $6 million. I have compiled additional information for this potential investment (Appendix V).

Sabrina: Next, I am excited to introduce a fantastic opportunity. Grant McGuire, a long-time friend of mine, recently suggested that KTI and his company, Relaxing Leaf Company Limited (Leaf), team up to open a series of unique tea rooms.

Leaf is a popular cannabis retailer with a well-known brand in many Canadian provinces where privately owned cannabis retail outlets are allowed. With KTI, Grant wants to open three tea rooms as a pilot project for what could become a national chain. Grant's vision is to attract a younger demographic of tea drinkers, who want to experience the health benefits associated with cannabis-infused tea products within a community atmosphere.

Jason: This is an interesting idea.

Sabrina: Very! And in addition, Grant wants to co-create a new line of cannabis-infused, ready-to-drink (RTD) beverages. Leaf does not have the R&D expertise required to do this. I have provided more details (Appendix VI).

Jason: Wow. If R&D can successfully develop a cannabis-infused product line, KTI would enter a new niche marketplace.

APPENDIX I (continued)
BOARD MEETING WITH CPA IN ATTENDANCE

March 31, 2025

Sabrina: Given our R&D team's track record, I am confident in our success. In addition, Grant is very familiar with the cannabis industry and will be instrumental in guiding this project through the complicated regulatory environment.

Kathleen: I am not sure. Do we want KTI's new brand associated with a substance that was illegal not so long ago? I worry about our reputation. Plus, this is an unproven product in an unproven market.

Conrad: From my knowledge, the demand for cannabis-related products is rising. Plus, for a reduced fee, my bottling company's facilities would be available to produce and store these RTD products once they have been developed.

Jason: Wonderful, Conrad.

Next, we must discuss our new theanine extraction patent. We have received a $6 million offer to sell it.

Sabrina: Sell it? That seems short-sighted. The patent offers KTI significant opportunities and a competitive advantage, because in the future, theanine will be added to more products than tea.

Kathleen: Maybe, Sabrina, but we need the money to grow and secure KTI's supply of raw materials, given that we currently use all we have.

Sabrina: I think we should go in the opposite direction. At a recent focus group, we received excellent feedback from several tea room owners who tried one of KTI's new theanine-infused products. Each participant commented on how relaxed they felt after a couple cups of the tea. We should commercialize this new product line as soon as possible. I have compiled some additional information (Appendix VII).

Conrad: Sabrina has a point — the stress-reduction benefits associated with theanine will likely attract a high demand. This new product line has the potential to really do well.

APPENDIX I (continued)
BOARD MEETING WITH CPA IN ATTENDANCE

March 31, 2025

Kathleen: I don't doubt the potential, but we need to allocate our raw materials wisely. On that note, we have received many requests from both our U.S. and Canadian customers, who want to sign long-term contracts for KTI-branded tea, all of which we have so far declined. To secure our revenue stream, we should reconsider our decision not to sign long-term contracts for KTI-branded teas.

Conrad: I will admit, the absence of long-term contracts makes the entire sales and production process more burdensome. Currently, for each one-off sale order we receive, we must go through the entire paperwork process. It also makes production planning and forecasting more difficult.

Sabrina: That may be, but the current system works. Why would we reduce our flexibility around pricing and volumes by signing long-term contracts, especially when the cost of raw materials is expected to increase?

Kathleen: Because without a long-term contract, we can't be certain that a customer will continue to purchase our products. This increases our risk substantially.

Conrad: On that note, we just received yet another long-term contract offer from one of our customers, Fresh Fare Foods (FFF). This well-known grocery chain in the U.S. wants to sign a five-year agreement with us for KTI-branded tea. I have compiled more information about this contract offer (Appendix VIII).

Jason: How big is the contract, Conrad?

Conrad: Based on the preliminary information, it would absorb roughly 8% of our total current supply of raw tea leaves in Year 1 of the contract.

Jason: Okay, CPA, could you look at all the information provided and let us know what you think? Thanks, everyone, for meeting today.

APPENDIX II
2024 SEGMENTED INCOME STATEMENT

	Private-Label	KTI-Branded	Total
Revenue	$ 36,540,000	$ 15,660,000	$ 52,200,000
Cost of goods sold	(29,049,000)	(10,179,000)	(39,228,000)
Total gross profit	7,491,000	5,481,000	12,972,000
Research and development			(1,210,000)
Marketing			(2,350,000)
General and administrative			(5,649,000)
Total operating income			3,763,000
Finance expense			(425,000)
Income before taxes			3,338,000
Income taxes			(760,000)
Net income			$ 2,578,000
Supply required *(in thousands of kilograms)*	8,638	2,710	11,348
Percentage of total supply	76%	24%	

Additional information for private-label contracts:

Company	**Expiry**	**Revenue**	**Supply Required** *(in thousands of kilograms)*
Alcona Grocery Limited	May 2025	$ 6,213,000	1,316
Natures Foods Limited	November 2025	$ 11,542,000	2,854
Neighbourly Groceries Inc.	January 2026	$ 13,834,000	3,398
P&Y Food Services Inc.	June 2026	$ 4,951,000	1,070
Total		$ 36,540,000	8,638

APPENDIX III
INTERNAL MEMO – INDUSTRY UPDATE

Demand for specialty teas, especially organic and Fairtrade products that confer health benefits, continues to grow. This trend is most evident in tea rooms and tea shops, where sales are increasing beyond expectations. However, given increasing inflation, the price of all consumer goods has risen, and this has led some tea drinkers to purchase specialty tea in grocery stores, where it is cheaper than in tea rooms and tea shops. To meet this increased demand, many grocery retailers are expanding their selection of specialty teas.

The supply of raw tea leaves continues to be an industry-wide concern. The ongoing effect of climate change, combined with two growing seasons with poor harvests, has resulted in an increase in competition for fertile land on which tea can be reliably grown. As supply starts to decline, the price of tea is expected to increase.

Recent research has uncovered the significant health benefits of teas supplemented with the amino acid theanine. Theanine, which naturally occurs in tea plants, provides benefits such as relaxation and reduced anxiety. Currently, all research indicates that theanine is safe for human use, although no studies on long-term effects have been performed. As theanine is classified as a natural health product rather than a pharmaceutical, there is little regulation regarding the production and sale of products that contain it.

Similarly, the health benefits associated with products infused with cannabis derivatives, such as THC and CBD, have led many Canadians of all ages to include them in their wellness routine. THC has been found to reduce stress in some people, whereas CBD has been found to improve sleep and reduce pain and inflammation. Unlike theanine, however, cannabis derivatives face considerable regulation. At present, few cannabis-infused products have been authorized for sale by the applicable government agencies. This has led to an increase in black market sales.

APPENDIX IV
BEAU FOODS INC. CONTRACT PROPOSAL

BFI is a multinational food retailer that sells premium products.

Extracts from BFI's proposed agreement are as follows:
- The contract's term is 10 years and begins on August 1, 2025.
- BFI will purchase all KTI-branded teas produced by KTI.
- The contract is exclusive; therefore, KTI will be prohibited from selling KTI-branded teas to any other vendor.
- BFI will be responsible for the marketing expenses to promote KTI's products throughout the term of the contract.
- BFI commits to purchase a minimum of 11 million kg in Year 1 (August 1, 2025, to July 31, 2026), 13 million kg in Year 2, and 16 million kg annually, in years 3 through 10.
- BFI will pay $4.63 per kilogram of KTI-branded tea purchased.
- If KTI cannot meet these minimum supply requirements, BFI will charge KTI a penalty.
- BFI will pay for any capital expenditures necessary for expanding KTI's production capacity in order to meet the requirements of the contract.
- BFI's product development team will work closely with KTI's R&D division to develop the flavours that BFI's marketing team has determined will be bestsellers.

KTI's cost of goods sold currently equals approximately 80% of the total selling price, and KTI will be able to reduce its annual administration costs to $2.56 million for each year of the BFI contract.

APPENDIX V
INVESTMENT IN HILLY SIDE TEA FARM INC.

Hilly had $8 million of revenue in 2024 and an operating margin of 45%.

Currently, Hilly has only one long-term sales contract, which expires in early 2026. If KTI agrees to purchase 40% of Hilly, Ivaan has agreed to grant KTI the first right to purchase whatever quantity of raw materials KTI requires. Only after KTI has purchased its required level of raw materials will Hilly be allowed to sell to other companies. At Hilly's current level of production, if KTI purchased 100% of Hilly's raw tea leaves, KTI would expand its current supply by 30%. However, Hilly expects to increase its production capacity in the future.

KTI will be able to purchase the raw tea leaves for their cost plus a fixed percentage rather than at the market prices at the time of purchase.

In 2022, there was a complaint made concerning the working conditions of Hilly's workers. According to Ivaan, these issues arose at the time his father was retiring and management was in transition. Ivaan has assured us that the situation was immediately rectified and that no further complaints have been filed since the transition period.

Depending on the quality of the tea produced, recent sales transactions for similar Sri Lankan tea farms have had valuations within a range of 3.5 times to 5 times operating profit. These multiples are expected to increase over time.

APPENDIX VI
AGREEMENT WITH RELAXING LEAF COMPANY LIMITED

At the onset of the agreement, a separate entity will be established: Canna Relaxation Rooms. KTI and Leaf will each invest $1 million to cover the initial opening costs of the first three tea rooms, which will be named Canna Relaxation Rooms. Grant will be responsible for this part of the project.

Although the onsite consumption of cannabis-infused tea is currently illegal, Grant is confident that future legislation will allow for it. In the meantime, the Canna Relaxation Rooms will only offer KTI-branded teas.

Leaf will manage the three locations. In return, KTI will sell KTI-branded teas to Canna Relaxation Rooms at KTI's cost. The profit from the Canna Relaxation Rooms will be split equally between KTI and Leaf.

Sabrina has prepared the following sales estimates:

Estimate	2026	2027	2028
Revenue (total for three locations)	$2,100,000	$2,500,000	$3,000,000

The cost of goods sold for the annual relaxation room revenues will be 42%, and other operating costs will be $350,000 annually. KTI's required rate of return for this project is 12% on operating cash flow. In the first year, KTI estimates that this project will require an 80,000 kg supply of raw tea leaves.

For the development of the cannabis-infused RTD product, Leaf will supply KTI's R&D team with the cannabis required at the same price as Leaf pays. Once developed, these products will be sold in Grant's existing cannabis dispensaries and, if future legislation allows, directly within the Canna Relaxation Rooms. KTI's R&D team would begin research on the cannabis-infused RTD product right away.

APPENDIX VII
COMMERCIALIZATION OF THEANINE-INFUSED PRODUCT LINE

With its new theanine-infused tea beverages, as well as a significantly increased supply of theanine (given R&D's new patented extraction process), KTI is ready to begin producing this new niche product line. If KTI decides to move ahead with production, it will take an estimated 18 months before the products are ready to be sold.

The market for theanine-infused tea beverages is growing, although it has been difficult to quantify demand due to a lack of research on this emerging market. Kathleen and Sabrina have estimated a range of annual sales for the new theanine-infused beverages.

Item	Low	High
Cases sold per year	17,000	80,000
Selling price per case	$140	$140
Kilograms of raw tea required	220,000	1,035,000
Total revenue	$ 2,380,000	$ 11,200,000
Cost of goods sold (55%)	$ (1,309,000)	$ (6,160,000)
Shipping costs	$ (71,400)	$ (336,000)
Initial marketing costs	$ (250,000)	$ (250,000)
Additional R&D costs	$ (50,000)	$ (50,000)
Operating profit	$ 699,600	$ 4,404,000

Given its new patented process, KTI will be able to increase production of these products even if demand exceeds the high estimate of cases that might be sold. To sell this product line, KTI will initially target drug and health food stores.

The estimated cost for a necessary equipment upgrade is $2.5 million. This will be depreciated on a straight-line basis over a 10-year period.

APPENDIX VIII
U.S. SALES AGREEMENT WITH FRESH FARE FOODS

The agreement will have an initial five-year term and a five-year renewal option if both parties agree.

Extracts from the proposed agreement, which would commence on September 1, 2025, are as follows:

- FFF agrees that KTI-branded tea will be the only premium tea brand that FFF will sell in its grocery stores.
- FFF agrees to include KTI in its marketing promotions at least twice annually.
- FFF will pick up all purchases directly from KTI's warehouses and will be responsible for all shipping expenses and logistics.
- FFF guarantees to purchase 850,000 kg of KTI-branded tea in Year 1 (September 1, 2025, to August 31, 2026), 950,000 kg in Year 2, and 1,050,000 kg annually, in years 3 through 5.
- FFF will pay KTI US$4.10 per kilogram of KTI-branded teas. The current exchange rate is 1 USD = 1.35 CAD.
- FFF will require three new tea flavours in each year of the contract.

KTI's cost of goods sold is forecast to be CA$3.75 per kilogram.

APPENDIX D

DAY 1 (KTI VERSION 1) – MAY 30, 2023
MARKING GUIDE AND SAMPLE CANDIDATE RESPONSE

DAY 1 MARKING GUIDE
KINGSDALE TEA INC. (KTI)
VERSION 1

Summative Assessment #1 (Situational Analysis)

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 KTI.

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

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

Based on the 2022 Competency Map:
Technical Competencies
2.3.2 Evaluates the entity's internal and external environment and its impact on strategy development
Enabling Competencies
1.4.1 Performs work carefully, thoroughly and competently in accordance with relevant technical and professional standards
2.1.1 Applies knowledge of the organization's competitive environment and strategic direction when performing assigned work
2.1.3 Identifies the strategic impact of internal decisions and external influences on project plans and initiatives
6.1.1 Identifies and articulates issues within areas of work responsibility
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

The candidate is expected to complete an appropriate situational analysis.

The candidate should draw upon their situational analysis when analyzing the major issues facing KTI: (1) Go with a low-risk, stable strategy that is based on long-term relationships, or (2) Continue with KTI's new strategy of developing unique tea for niche markets and phasing out the last of the private-label contracts. Currently, KTI's revenue is at risk, given that the remaining four private-label contracts will expire in 2025 and 2026, and these represent the use of 76% of the current tea supply and 70% of the total revenues. The candidate should also identify that: there is a tea supply constraint; the R&D department has been successful, is gaining a reputation, and has just received a patent; and KTI's reputation and brand recognition are growing and have been successful.

The focus should be on updating the situation since Capstone 1 and describing the factors that have changed, and the key factors that are relevant to the decisions to be made. Recapping parts of the vision/mission and relevant KSFs, and presenting relevant elements of the SWOT, is appropriate. The candidate should draw upon their situational analysis when analyzing the major issues facing KTI.

The strategic proposals include the following: enter into a large contract with Beau Foods Inc.; purchase 40% of a tea plantation in Sri Lanka; partner with a cannabis retailer to pilot unique tea rooms; commercialize and sell the new theanine tea products; and expand the KTI brand to the US with a distribution agreement.

Overall – The key concern is that, over the next two years, the company will lose its private-label sales, which currently represent 70% of revenue. How does the company replace this revenue, to ensure that KTI can meet its objectives?

The second issue is whether the company begins to sign long-term sales arrangements, to lock in sales and provide some security, or keeps its short-term contracts, which provide full flexibility in prices and volumes sold. Historically, the company has been able to rely on the private-label contracts, to provide the stability it needs in order to spend on R&D and develop new products. KTI has received many requests from both its US and Canadian customers, who want to sign long-term contracts for KTI-branded tea, all of which it has so far declined. However, this may not be the most prudent approach, given that KTI is losing the security of the private-label revenue and will want to replace it with other secured revenue streams. Therefore, the company needs to reconsider its willingness to sign this kind of contract for KTI-branded teas.

Current strategy – Historically, KTI's success has been accomplished by acquiring and retaining private-label customers, and is based on strong relationships and long-term contracts with a few key customers. These contracts stipulate minimum volumes and prices, to ensure stable and reliable cash inflows. Currently, these long-term private-label contracts, all of which will expire over the next two years, represent 70% of total revenue.

KTI is currently moving toward its strategy, as envisioned by Jason and Sabrina. This includes offering a well-recognized, successful tea branded with the KTI name, developing unique product offerings, and producing premium and niche products. These products generate high margins and have considerable upside, although this is not guaranteed. This strategy allows KTI to differentiate itself based on its R&D team of experienced researchers, who develop unique tea products with enhanced health benefits. This strategy requires many small customers and short-term contracts, giving KTI flexibility in the volumes and prices of its sales to each customer. Under this strategy, the remaining private-label contracts will not be renewed.

Therefore, one of the key issues is how quickly the revenue from KTI's private-label contracts can be replaced, since these contracts expire in 2025 and 2026. As the private-label contracts expire, how will KTI allocate its supply of raw materials, to ensure that the company's revenue does not rapidly decline?

The supply of raw tea leaves that KTI can use for its products has become a constraint, as climate change continues to negatively affect the availability of raw tea. KTI's board will need to address these potential supply issues as part of the company's strategic planning process.

Vision/Mission

There have been no changes in KTI's vision, mission, and core values. As approved by the board in 2014, they are as follows:

Vision statement: *"We envision an environment where a high-quality tea is produced by fairly compensated farmers; our customers enjoy a pure, complex, and pleasant experience every time they drink a cup of our tea; and everyone involved in the process is treated with honesty, fairness, and respect."*

Mission statement: *"Do right by the farmers and our customers and far exceed consumer expectations daily. We produce our tea in an ethically responsible manner, and its distinctive taste and high quality inspire loyalty in our consumers. We strive to bring the health benefits of tea in all its forms to individuals."*

Core values

KTI has five core values, which have not changed since Michael's departure:

1. Produce extraordinary organic, Fairtrade tea.
2. Build long-term relationships with farmers, suppliers, customers, and consumers.
3. Build a brand that is known to be ethical and respected.
4. Treat all employees with fairness, honesty, and respect.
5. Ensure that ethical, sustainable, and environmental standards are adhered to and followed throughout all of our processes, from farm to table.

KTI also has a code of ethics and ethical standards that are incorporated into its contracts with farmers and customers.

Current Margin on Products

The gross profit percentage of the private-label tea is 20.5% (7,491,000 ÷ 36,540,000).
The gross profit percentage of the KTI-branded tea is 35% (5,481,000 ÷ 15,660,000).

Objectives

1. Increase operating profit margin to 12% by 2028 (currently at 7.2%: $3,763,000 ÷ 52,200,000).
2. Increase revenue by 10% annually.

Available Cash Flow /Financing

KTI currently has up to $4 million available for any new strategic alternatives. In addition, it has received an offer to sell the theanine patent for $6 million. Therefore, the total available funds are $10 million if the patent is sold. Without the sale of the patent, only $4 million is available.

Only the Hilly farm investment has an upfront cost ($6 million) that exceeds KTI's currently available investment capital of $4 million. Therefore, if KTI chooses to purchase the farm, the only way to do so without taking on further debt would be to sell the theanine patent.

The candidate is NOT expected to recap KSFs and SWOT in detail. However, they must draw upon these in their analysis of the strategic options presented.

Key Success Factors

KSFs in the tea production industry include the following:

- Effective product development, to adapt to changes in consumers' preferences – Tea producers must constantly innovate their products, to keep up with changes in consumer preferences. Companies need a broad selection of teas in their product mix.
- Product differentiation, to maintain market share – Differentiation is based on quality and type, price, brand recognition, and product innovation.
- Economies of scale and scope, to keep per-unit costs low.
- Ability to pass on raw material input price increases to customers.
- Long-term, reliable supply contracts with overseas suppliers, to ensure a guaranteed supply of tea leaves.
- Strong relationships with retailers, to ensure premium shelf spacing is provided in their stores.
- Strong brand recognition, achieved by spending significantly on marketing and by having a reputation for delivering an exceptional consumer experience. Brand is part of the selection criteria used by the consumer. Brand recognition will also influence where a competitor's product is found on retail shelves, and how visible it is to consumers.
- Compliance with government regulations for food production, and for organic and Fairtrade certifications (if used).

SWOT Analysis

Strengths:

- KTI is gaining brand recognition in Canada, and has limited penetration in northern US.
- R&D recently patented the extraction of theanine from tea. Theanine, an amino acid that naturally occurs in tea, has shown to be effective in improving mental function by lowering stress and anxiety. The new extraction results in a higher amount of theanine obtained from the tea plant, increasing the supply of theanine that KTI can use in its products.
- KTI has introduced its own line of branded products, so the KTI brand is now being built. So far, this endeavour has proved successful.
- Branded teas sell at a higher price and provide a higher gross profit than the private-label sales.
- A strong and innovative R&D team is now in place, and has been experimenting with new and innovative products. They just received their first patent for the theanine extraction process, which was a real success for the team. The R&D team is confident of their future success in creating more desirable products.

- KTI uses its existing tea-shop-owner customers as a focus group, to test new products and receive immediate feedback.
- With the short-term contracts, KTI has flexibility in volumes sold and prices charged to its customers. This will be important, since tea supply prices continue to increase and KTI needs to pass along these increases to its customers.

Weaknesses:

- Only four private-label contracts remain, of which two (representing 34% of total revenues [($6,213 + $11,542) ÷ $52,200]) expire in 2025, and two (representing 36% of total revenues [($13,834 + $4,951) ÷ $52,200]) expire in 2026. If KTI does not find a way to replace these sales, the company will lose the majority of its revenue in the next two years.
- KTI's branded tea is only sold in tea rooms and tea shops at a premium price; therefore, its scope is limited.
- No long-term customer contracts have been signed for KTI-branded teas. Rather, KTI only accepts one-off sales for the branded products. There is a risk that these sales orders will not be renewed. In addition, the time and costs to constantly renew these orders is burdensome for the company.
- At present, KTI only has $4 million of cash available for investment, and no further access to bank financing. Therefore, the company's ability to make strategic investments is restricted.

Opportunities:

- Demand is increasing for Fairtrade and organic tea products, especially those with health benefits.
- Sales within tea shops and tea rooms continue to increase beyond expectations.
- Due to increased inflation and an increase in the cost of all consumer products, tea drinkers are purchasing more branded teas in grocery stores. Currently, KTI does not sell its branded teas in grocery stores, although this is a potential new market for the company.
- Recent research has found that theanine, which occurs naturally in tea, helps with anxiety and stress, in the right doses. Demand for this amino acid as a supplement is expected to increase, and its use may even expand into products other than tea. Therefore, KTI has the opportunity to use its theanine patent to expand into other product areas.
- Products that include enhanced levels of theanine are classified as natural food products and not pharmaceuticals, so regulatory requirements are low for production and sales.

- There is an increasing demand from consumers for drinks infused with cannabinoids such as CBD and THC, due to their therapeutic benefits, which has resulted in a large array of beverage products to choose from.
- Many Canadians are adding cannabis-infused beverages to their wellness routines, as THC can help with stress reduction, among other things, and CBD can help with improved sleep, decreased pain, and reduced inflammation.

Threats:

- The supply of raw tea leaves continues to be a concern for the industry, as climate change starts to have a negative impact on some tea-growing areas. This has caused increased competition for fertile land on which tea can be grown. Having access to supply will be critical, for KTI to be able to produce its tea and meet customers' contractual commitments.
- As supply starts to decline, the price of tea is expected to increase. If KTI is locked into long-term sales contracts with fixed pricing, it will not be able to pass along price increases to its customers.
- With increasing inflation, consumers may start to drink less in tea rooms and more at home. Therefore, these consumers may reduce their purchases in tea rooms and purchase more tea for home.
- Grocery stores continue to expand their selection of branded and specialty teas, to meet increasing demand from consumers. The implication for KTI is that consumers may now purchase their specialty teas at the grocery store instead of in the tea rooms and tea shops, where the KTI-branded tea is available.
- There is an increasing array of beverage products to choose from that are infused with cannabinoids such as CBD and THC.
- Cannabis-infused products are heavily regulated, and few cannabis-infused products have been approved for sale by the government. This has led to an increase in black market sales, as this allows the producer to avoid the costly process of adhering to the government's regulations. KTI would be forced to compete with the black, market should the company decide to develop the cannabis-infused ready-to-drink (RTD) beverage.

Conclusion on the Situational Analysis

The key concern is that, over the next two years, the company will lose its private-label sales, which currently represent 70% of KTI's revenue. How should the company replace this revenue, and how would it reallocate the supply of tea, representing 8,638,000 kilograms, that was used to fulfill these contracts? There appear to be two possible strategic pathways.

Option 1: Proceed with a strategy that guarantees a consistent return with little risk, and results in stable cash flows.

Option 2: Take a chance on the expansion of KTI's branded sales, and leverage the strength of the R&D department, to focus on developing new niche projects that have considerable (but not guaranteed) upside.

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 KTI.

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

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

Technical Competencies
2.3.3 Evaluates strategic alternatives
Enabling Competencies
1.1.3 Exhibits ethical behaviour by complying with laws and regulations, organizational policies, societal norms and personal ideals
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues
6.2.3 Questions the relevance and tests the quality of information and assumptions in own analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

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

Assessment Opportunity #2 (Strategic Alternative #1: Accept contract from Beau Foods Inc.?)

The candidate is expected to complete both a quantitative and qualitative assessment of the proposed contract from BFI.

Quantitative analysis: The candidate should complete a projection of the estimated operating income generated from this contract, and compare it to existing gross profit and operating margins.

Qualitative analysis: The candidate should discuss the advantages and disadvantages of signing this contract with BFI for 10 years, and using all the available supply of tea to meet these contracted volumes. The candidate should also discuss how accepting this option impacts the acceptance of the other alternatives.

Conclusion: The candidate should offer a conclusion that incorporates and logically follows from their quantitative and qualitative analyses.

Michael recently received an offer from Beau Foods Inc. (BFI), a global food retailer of premium food. Many of BFI's products are organic and Fairtrade. BFI wants to offer KTI-branded teas as its prime tea product in all its Canadian and US stores. The amount of tea required will use KTI's entire existing capacity, plus require an estimated increase in current levels of tea supply of 50% by 2028. This would create the need to increase KTI's supply of raw tea.

Quantitative Analysis

		Year 1 Aug 1, 2025 – July 31, 2026	Year 2 Aug 1, 2026 – July 31, 2027	Year 3 Aug 1, 2027 – July 31, 2028
Kilograms required		11,000,000	13,000,000	16,000,000
$/kg		$4.63	$4.63	$4.63
Revenue		$ 50,930,000	$ 60,190,000	$ 74,080,000
Cost of sales	80%	40,744,000	48,152,000	59,264,000
Gross profit	20%	10,186,000	12,038,000	14,816,000
		20%	*20%*	*20%*
Expenses				
Research and development		1,210,000	1,210,000	1,210,000
Marketing		0	0	0
General and administrative		2,560,000	2,560,000	2,560,000
Total expenses		3,770,000	3,770,000	3,770,000
Operating income		$ 6,416,000	$ 8,268,000	$ 11,046,000
Operating margin		*12.6%*	*13.7%*	*14.9%*

<u>Additional considerations:</u>

- Overall, the profits for the next three years are stable and low-risk for KTI, given that BFI will commit to purchase the amounts described above.
- The gross profit margin on these sales is only 20%, compared to 35% on the current sale of KTI-branded tea. In addition, this is even lower than the gross profit margin on the current private-label contracts, which is 20.5%. This does not leave much room if tea input costs increase, as is anticipated.
- The estimated amount of tea required to satisfy this contract in the first year is 11 million kilograms. That is essentially all of KTI’s current supply. Therefore, if KTI accepts this contract, it will have no available supply of raw materials to dedicate to other contracts or projects.

<u>Objectives:</u>

- Increase operating profit margin to 12% by 2028 – This proposal results in an operating margin that increases from 12.6% to 14.9% over the first three years of the contract. As a result, the 12% objective is met.

- Increase revenue by 10% annually – In the first year of the BFI contract, KTI's sales will drop by 2% when compared to KTI's current revenues. Therefore, in the first year, the objective is not met. However, in years 2 and 3 of the contract, KTI's revenue will increase by 15% and 42%, respectively.

Conclusion on quantitative analysis

The BFI is both lucrative and low-risk for KTI. Although the company's objectives are not met perfectly, the contract still offers the company a significant financial benefit. In addition to an increase in the company's overall revenues, given that BFI will pay for KTI's marketing expense, and because the company's annual administrative costs will be reduced, KTI's overall expense will drop. By accepting this contract, KTI could improve the company's financial situation while also reducing its overall risk level.

Qualitative Analysis

Vision/mission/core values

Acceptance of the BFI contract still allows KTI to meet its vision statement, as long as management believes that BFI deals with its customers honestly and fairly.

Accepting the contract also allows KTI to comply with its mission statement, since the product will be sold under the KTI brand name. In addition, the last part of the mission statement—bringing the health benefits of tea in all its form to individuals—can also still be accomplished. However, under this alternative, KTI would not develop other new and innovative health products (i.e., theanine and cannabinoid products), and would have no ability to sell these using the company's KTI-branded label.

Pros:

- BFI would purchase all KTI-branded teas that are produced. This means that KTI would not need to spend additional time finding new customers. This contract would reduce KTI's administrative and marketing workload significantly.
- The contract would provide KTI with a way to penetrate the US market, given that BFI would sell KTI's products in both its American and Canadian stores.
- It would help to build the KTI brand, as the tea would be available in more retail outlets across Canada and the US.
- This contract represents the biggest contract in dollars and volumes that KTI has ever received, and one that Michael has been working for many years to get as a customer. As Michael mentioned, this type of contract is rare, so if KTI turns it down, it may not receive a contract of this size again.

- KTI-branded teas would now be sold in grocery stores, which is an advantage, given that tea sales in grocery stores are expected to increase, as consumers want to purchase more for in-home consumption.
- With higher profits due to the reduction in marketing and administration expenses, KTI's free cash flow would increase. Therefore, the company would be able to meet debt obligations and pay dividends more easily.
- BFI would pay for all the expenses required to expand capacity, leaving more free cash available to pay Michael's loan payable, and pay dividends on both the preferred and common shares, and other cash needs.
- This long-term contract would provide KTI with revenue stability for 10 years. This represents a significant reduction in KTI's risk.

Cons:

- The contract uses all the existing tea supply and, based on forecasts and Jason's comments, KTI would need to increase the company's overall supply of tea by 50% by the third year of the contract. This may be hard to accomplish, given that supplies are declining due to climate change.
- The long-term contract also fixes the selling price for KTI. Given that the price of tea is increasing due to anticipated declining supplies, profit margins may decline over time as the cost of tea leaves increases. KTI should build in a stipulation to the contract whereby any increase in the supply of raw tea would be reflected in an increased price that BFI would be required to pay.
- KTI would be forced to pay a penalty if minimum sales were not met. There is no detail about the penalty. Prior to signing the contract, KTI should clarify the penalty, and determine whether it is reasonable.
- The contract is exclusive, meaning that KTI-branded tea would be sold only in BFI stores. Therefore, KTI would need to forgo re-signing any contracts with the company's existing customers. This could negatively impact KTI's reputation.
- KTI would no longer sell its teas in tea rooms and tea shops, where it has been accepted, and is doing well and gaining a reputation.
- BFI's product development team would work with KTI's R&D team to develop the flavours they want. Therefore, the R&D team would no longer have autonomy to work on what they think is important.
- As noted by Sabrina, given the number of new flavours that BFI requires each year, KTI's R&D team would no longer have the capacity to work on developing new innovative, niche products. This disadvantage is especially important, given the R&D department's apparent ability to develop potentially valuable assets and products for KTI.

- The length of the contact (10 years) would lock KTI's business to BFI for many years. Although this might reduce risk, it also greatly limits KTI's ability to adapt the business. KTI's board may want to consider negotiating the term down, or introducing an option to renew after the first five years of the contract.

Integration

- Since all the tea supply must be used for the BFI contract, KTI would not be able to develop and sell the enhanced theanine tea product for its niche market, nor would the KTI R&D team have the time to further develop this product.
- In addition, KTI would not have enough supply or R&D time to develop the cannabinoid product, or enter into the US distribution contract for the KTI product.
- This option would have to be done in conjunction with the investment in Hilly's farm, which increases tea leave supply initially by 30%, in order to have sufficient tea supply available to produce the volumes required.

Conclusion/Recommendation

This option represents a low-risk strategy that would secure the company's revenue for the next 10 years. The contract starts on August 1, 2025. It also represents the biggest contract KTI has ever received, and one that Michael has been working for many years to secure. The forecasted volumes required under this contract currently cannot be met with the existing supply, but with the investment of the farm, the supply would increase by at least 30%, which alleviates this problem for the next few years. However, two risks cannot be quantified: 1) If the price of tea leaves increases, the profit margins will decline, since there is no ability to change prices in the contract; and 2) If KTI cannot get the supply it needs for the minimum quantities, as per the contract, it must pay a penalty. Given that supply is declining across the industry, this might become a concern. If KTI decides to move ahead with the BFI contract, it should consider protecting the company by adding stipulations into the contract that reduce these risks.

Although the gross profit margins are low for this alternative, BFI would pay for all the marketing and there would be a significant reduction in the G&A, resulting in an improved operating margin of 12%, increasing to over 13% in the first year of the contract. In addition, further cash flows are saved, as BFI would pay for all capital expenditure upgrades.

However, this option does not fit with KTI's new strategy. BFI would take control of the KTI brand and market it accordingly, so the success of the brand would be out of KTI's control and in the control of BFI. KTI would no longer be developing new and innovative products and using the expertise and passion of its R&D team. KTI would not be selling any niche products that enhance the health benefits of tea, and R&D would concentrate on flavours wanted by the BFI team rather than on developing the types of products they deem important.

Assessment Opportunity #3 (Strategic Alternative #2: Purchase 40% of Hilly Side Tea Farm Inc. (Hilly)?)

The candidate is expected to complete both a quantitative and qualitative assessment of the investment of 40% ownership in Hilly Side Tea Farm, a tea farm in Sri Lanka.

Quantitative analysis: The candidate should complete a valuation of Hilly through a market-based approach using a multiple of net income, and they should discuss the valuation and offer price, and why there might be differences.

Qualitative analysis: The candidate should discuss the advantages and disadvantages of acquiring 40% of a Sri Lankan tea farm.

Conclusion: The candidate should offer a conclusion that incorporates and logically follows from their quantitative and qualitative analyses.

KTI is considering the purchase of 40% of the equity of Hilly Side Tea Farm (Hilly), a tea farm in Sri Lanka, to ensure the supply of tea required for the KTI product, at a price of $6 million. The remaining 60% will be owned by Ivaan Mendis, the son of the original founder of the company, who recently retired in 2024. This will increase KTI's supply of raw materials by 30% relative to the company's current tea supply (which Hilly expects to increase in the future).

Quantitative Analysis

To determine a fair value of the equity of Hilly at date of sale:

	Low Range	High Range
Hilly's 2024 revenue	$ 8,000,000	$ 8,000,000
Operating margin	45%	45%
Operating profit	$ 3,600,000	$ 3,600,000
Op profit multiplier range	3.5	5
Implied value of Hilly	$ 12,600,000	$ 18,000,000
KTI's % ownership	40%	40%
Value to KTI	$ 5,040,000	$ 7,200,000
Asking price	$ 6,000,000	$ 6,000,000
Difference in value	$ (960,000)	$ 1,200,000

Additional considerations:

- The company will have to spend $6 million for this investment. Currently, the board has made $4 million available for investments. Unless Hilly is willing to allow KTI to make that payment over time, the other $2 million would have to be raised by selling the theanine patent for $6 million (as has been proposed).
- Based on the following uncertain issues, more due diligence needs to be performed before an informed investment decision can be made:
  - The asking price of $6 million is above the low-end range of value by nearly $1 million when using the provided market comparables. Why is the asking price above the lowest range estimate? KTI should negotiate a lower price, if possible.
  - In addition, Hilly generates an operating margin that is higher than the 40% for the Sleeping Hills Tea Estate that was considered in 2023. Are these operating margins in line with competitors, and if not, why? Is the company cutting costs related to its workers, as per the complaint made in 2022?
  - Are Hilly's farming practices aligned with the values of KTI, based on the previous complaints?
  - Ivaan has just taken over from his father in 2024. Is there a risk that Ivaan may not know what he is doing, or may improperly manage the farm, now that his father is retired? If KTI accepts this proposal, the company would be relying on Ivaan to properly manage the plantation. The farm's long-term manager is still there, so some of the risk is mitigated.
  - Is the company still in compliance for organic and Fairtrade certifications?

Conclusion on quantitative analysis

Given the range of possible valuations provided above, it seems that Hilly's asking price is reasonable. Although this investment does not directly impact the company's stated objectives, it would be necessary, to increase the company's supply of tea in order to satisfy the BFI contract (which does align somewhat well with the board's objectives). Therefore, this proposal may be a good way for KTI to increase its supply of raw tea and allow the company to enter into the BFI contract. However, KTI may be forced to sell the theanine patent in order to secure the financing required. That would eliminate the company's ability to proceed with that potential product line.

Qualitative Analysis

Vision/mission/core values

This investment is in line with KTI's vision to ensure that farmers are fairly compensated for the tea produced. It is also in line with its mission, which is to ensure that the company does right by the farmers and that tea is produced in an ethically responsible manner. By being an owner of a farm, KTI can ensure that these values are upheld.

If the 2022 claims regarding the working conditions and lack of sustainable practices have not been rectified, this would be counter to KTI's core values #4 and #5, which relate to treating employees with fairness, honesty, and respect and ensuring that ethical, sustainable, and environmental standards are adhered to. KTI should closely examine the operations and working conditions of Hilly before agreeing to the investment, to ensure that the operation complies with KTI's values.

Pros:

- The opportunity would provide a guaranteed supply that would also help fulfil the volumes predicted for the new BFI contract. This investment would increase KTI's current supply of raw tea by 30%. Further, Hilly expects to increase the farm's production capacity in the future. Given the increased competition for supply and anticipated increase in prices, this investment represents a hedge against future supply and pricing issues.
- KTI would be able to purchase the tea for prices at cost plus a fixed percentage rather than at the prevailing higher market prices. Therefore, input prices would be lower and not subject to auction prices, given that tea prices are expected to increase. This investment would help ensure that the operating margins can be maintained.
- The farm is currently certified as organic and Fairtrade, and has been for more than 10 years, and there is still demand for these certified teas.
- The offered investment price appears reasonable, and lower than some comparable market valuations.

- Only after KTI has purchased its required level of raw materials will Hilly be allowed to sell to other companies. This aspect of the contract would help provide KTI with the flexibility to match its supply of raw materials with the amount needed to satisfy the company's demand.

Cons:

- There were complaints about worker's conditions in 2022. Although Ivaan has assured KTI that these have been resolved, more investigation is required before a decision can be made. KTI needs to ensure that the farm's operations align with KTI's vision and mission.
- KTI would also want to ensure that the farm is adhering to all of KTI's core values, so again, due diligence is required. For example, are the working conditions acceptable, and is the company following sustainable practices (core #4 and #5)? Consideration should be given to visiting the farm unannounced, to determine its current state.
- The quality of the tea produced also must be tested, to ensure that it is of high enough quality to be used in KTI teas.
- Hilly is not one of KTI's current suppliers; however, Jason knows of Hilly and its current owner. Since KTI has not worked with this owner before, it could result in issues arising after the investment, and conflicts in decisions and objectives.
- With only 40% ownership, how much influence would KTI have over Hilly's processes? Would Ivaan be receptive to discussions and suggestions, or would there be constant conflicts over objectives and decisions?
- Ivaan has just recently taken over the farm, on the retirement of his father. This increases KTI's risk, given that Ivaan will be making the decisions for Hilly because he has majority ownership and control.
- One of KTI's directors will have to be involved in the management of this investment, which would take time away from their other responsibilities.
- As Hilly is located in a foreign country, the success of this investment could be affected by any political instability that occurs within Sri Lanka or the surrounding region.

Integration

- This investment would provide the supply required to meet the volume demands expected from the BFI contract. Therefore, this alternative can be accepted in conjunction with the BFI contract.
- However, since it may require the sale of the patent, this alternative cannot be accepted along with the development and sale of the theanine-enhanced tea option.

Conclusion/Recommendation

Given the need to complete further due diligence and investigation, KTI cannot agree to this investment until the company confirms the claims regarding the farms' working conditions and sustainable practices. In addition, KTI has to be confident in Ivaan's management expertise. The asking price seems reasonable, and these areas of concern may be overcome with some additional due diligence. The purchase of Hilly will increase KTI's supply of tea, which represents a hedge against future supply and tea price increases. The key concern is that this investment will use all of the available cash and require the sale of the patent; therefore, some of the other alternatives cannot be accepted if this one is. KTI may want to negotiate a more advantageous payment schedule for the $6 million cost. If it can delay a portion of this payment until future years, it may be able to make the investment while also retaining the rights to the new patent, an asset that provides KTI with potential significant competitive advantage.

Assessment Opportunity #4 (Strategic Alternative #3: Partner with Relaxing Leaf Company Limited to build a network of Canna Relaxation Rooms?)

The candidate is expected to complete both a quantitative and qualitative assessment of the proposal to partner with Leaf in a pilot project of three Canna Relaxation Rooms.

Quantitative analysis: The candidate should complete an NPV analysis of the cash flows related to this investment.

Qualitative analysis: The candidate should discuss the advantages and disadvantages of investing in the partnership with Leaf.

Conclusion: The candidate should offer a conclusion that incorporates and logically follows from their quantitative and qualitative analyses.

KTI could partner with a cannabis retailer—Relaxing Leaf Company Limited (Leaf)—to build a network of Canna Relaxation Rooms. The vision for these tea rooms is as a space where customers can gather, consume cannabis-infused drinks, and enjoy a unique experience. Leaf has cannabis retail outlets across Canada. Leaf also wants to have KTI develop a cannabis-infused RTD beverage. KTI and Leaf would each initially invest $1 million to finance a pilot project for three initial tea room locations.

Quantitative Analysis

Net present value analysis for the Canna Relaxation Room partnership:

		Year 0	2026	2027	2028
Net cash flows from the Canna Relaxation Rooms (in total)					
Annual tearoom revenue			$ 2,100,000	$ 2,500,000	$ 3,000,000
Cost of goods sold	42%		(882,000)	(1,050,000)	(1,260,000)
Other operating costs			(350,000)	(350,000)	(350,000)
Operating cash flow			$ 868,000	$ 1,100,000	$ 1,390,000
			41.3%	*44.0%*	*46.3%*
Cash flows earned by KTI					
Profit split with Leaf	50%		434,000	550,000	695,000
Total cash flow to KTI			$ 434,000	$ 550,000	$ 695,000
Initial investment		$(1,000,000)			
Present value factor at 12%	12%	1.0000	0.8929	0.7972	0.7118
Present value		(1,000,000)	387,519	438,460	494,701
Net present value		**$ 320,680**			

Additional considerations:

- The investment requires an upfront investment of $1 million. This could be financed from the $4 million that KTI has available for new strategic investments.
- Since the NPV is positive, this project should be accepted from a quantitative perspective.

Objectives:

- Increase operating profit margin to 12% by 2028 – The partnership is projected to increase KTI's annual operating profits by approximately $434,000 in the first year of operations. This would help KTI achieve its operating profit margin objective, but is too small to achieve the 12% increase on its own. However, any additional sales of the new cannabis-infused tea to other customers, or the proposed new RTD cannabis-infused products, which have not been included in this analysis, will result in further increases to the operating profit margin.
- Increase sales by 10% annually – This would increase revenue and, therefore, contribute to the objective to reach 10% annually. In addition, any additional sales of the new cannabis-infused tea to other customers, or the proposed new cannabis-infused RTD products, have not been included in this analysis and will further increase revenues.

Conclusion on quantitative analysis

For a relatively minor upfront investment of $1 million, KTI can enter an arrangement with a significant amount of potential upside. For example, if the pilot project is a success, this could lead to an increase in the number of Canna Relaxation Rooms. This would benefit KTI in several ways. In addition, the potential to produce a new cannabis-infused RTD would also provide KTI with another significant opportunity.

Qualitative Analysis

Vision/mission/core values

The acceptance of this partnership still allows KTI to meet its vision by allowing customers to enjoy a pure, complex experience while drinking tea. It also aligns with the mission statement to bring the health benefits of tea in all its forms to individuals.

Pros:

- The opportunity would provide another market for KTI-branded teas, in the Canna Relaxation Rooms, and help to further promote the KTI brand name.

- The proposal for a cannabis-infused RTD represents a significant opportunity, although more information is required, to properly assess it. Conrad has also suggested that, for a reduced fee, his bottling company's plant and facilities would be available, to produce and store these RTD products.
- There is an increasing demand for cannabinoid-infused drinks, so there is significant upside potential, given that this is an emerging market.
- Research studies have concluded that teas supplemented with cannabis can have many health benefits, so there is increasing demand for these supplemented teas. Production of a new cannabinoid tea product would allow KTI to access this customer segment.
- This would allow KTI to sell its products in a different distribution channel, through cannabis stores, and access a new target market.
- A large upfront capital investment is not required; only $1 million is required for this initial investment, which is well within the company's available cash.
- If successful, this pilot project could be expanded nationally, so there is potential for large upside opportunities.
- Sabrina knows Grant, Leaf's owner, well, as they are long-time friends. This pre-existing relationship may help ensure a smooth partnership.
- Leaf has already established its name in the cannabis retail market, and is experienced in the market, and in dealing with the constantly changing regulatory environment. This experience could be used to assist KTI with a successful product, and new product strategy.
- This opportunity would build on the strength of two well-known brands: Leaf and KTI. Combining the strengths and experience of these two companies means there is a higher probability of success.
- Supply is less of a concern with this investment option, since it only requires about 80,000 kilograms of tea annually. This could be easily met with the private-label contracts that are set to expire. The supply of tea required for this could be obtained from the company's existing supply.

<u>Cons:</u>

- The sale of cannabinoid products is highly regulated, so there is a risk that government regulations may not allow cannabis products to be consumed in public tea rooms. If that turns out to be the case, this project's attractiveness is significantly reduced.
  - Prior to entering this partnership, KTI should seek the third-party counsel of a professional with experience in this area, to ascertain the likelihood that future legislation will allow for the onsite consumption of cannabis-infused products.
- KTI has no experience working with cannabis, and may not be able to develop a tea-infused product that will be successful.
- Since this is a new product, the demand is not known or guaranteed.

- Spending R&D time on this product development will take away time and resources from other product developments. Some discussion with R&D over the feasibility of this venture should occur before an investment decision is made.
- The return is not fixed, but would depend on the profits of the Canna Relaxation Room itself. One of the KTI employees would have to be involved in management decisions, to protect this investment.
- Cannabis, not too long ago, was illegal, so becoming a producer of cannabis-infused products could have a negative impact on KTI’s reputation.
- There may be a requirement to invest more than the initial investment of $1 million in this venture, if more cash is required for opening than initially estimated.

Integration

- This alternative cannot be done in conjunction with the BFI contract, since there would not be sufficient tea leaf supply to meet these requirements, and because BFI’s contract stipulates that KTI does not sell its KTI-branded teas to any other vendor.
- This alternative could be completed along with the theanine-enhanced products, since there is sufficient cash and supply for both. In addition, both support a similar strategy of developing new niche products from the R&D department’s innovations, and selling to new markets.

Conclusion/Recommendation

If the board’s strategy is to produce niche products that attract different customer segments and are sold in a variety of distribution channels, the partnership with Leaf and development of the new cannabinoid product should be accepted. Leaf appears to have the necessary experience in the cannabis retail market to help navigate the process through current and future regulations.

This alternative allows for the development and distribution of a new, unique product that can be sold at a premium price and with premium margins. It represents another product that has lots of upside potential for KTI. It also provides for a new customer segment for its existing KTI-branded teas. It allows KTI to capitalize on the expertise of the R&D department, which has proven to be very effective. In addition, there is a large potential for significant sales in this emerging market, since there are expectations for national expansion if the three pilot rooms are successful. As well, the proposal for a cannabis-infused RTD tea represents a significant opportunity, although more information is required to properly assess this. In summary, there are large upside opportunities in this new market.

However, there is also risk, in that this is a highly regulated industry where changes in the laws may impact how this cannabinoid product is developed, produced, and sold. Prior to entering the partnership, KTI should hire an independent third-party to discuss the current, and potential future, regulatory framework, to assess how this risk is likely to impact the success of the investment. There are also risks that KTI will not be able to develop a saleable cannabinoid product that meets the dosing, and other, requirements. Finally, as this is a new market, there is the risk that acceptance is not as high as the initial expectation.

Assessment Opportunity #5 (Strategic Alternative #4: Commercialize the new theanine-enhanced tea product?)

The candidate is expected to complete both a quantitative and qualitative assessment of whether KTI should commercialize and sell the new theanine-enhanced tea product.

Quantitative analysis: The candidate should review the operating margin calculations, and discuss the reasonability of the assumptions used.

Qualitative analysis: The candidate should discuss the advantages and disadvantages of commercializing this product for sale.

Conclusion: The candidate should offer a conclusion that incorporates and logically follows from their quantitative and qualitative analyses.

KTI was just granted its first patent as a result of the R&D team's efforts. The patent involves the process by which theanine, an amino acid naturally found in green tea, is extracted from the tea plant. KTI's R&D team pioneered a new process that greatly increases the quantity of theanine that can be successfully extracted from each tea plant. In addition, KTI has a new line of theanine-infused products that have so far received strong reviews. This option is to commercialize this new product as soon as possible. The product can now be legally sold and will be made available in tea rooms, but also in health food stores and drug stores. The production process will be more complicated relative to current products, as theanine processing will require some equipment upgrades and specialized processes.

Quantitative Analysis

Operating margin analysis for the theanine product:

	Low	**High**
Cases sold per year	17,000	80,000
Selling price per case	$140.00	$140.00
Kilograms of raw tea required	220,000	1,035,000
Total revenue	$2,380,000	$11,200,000
Costs of product at 55%	(1,309,000)	(6,160,000)
Shipping costs	(71,400)	(336,000)
Initial marketing costs	(250,000)	(250,000)
Additional R&D costs	(50,000)	(50,000)
Depreciation – $2,500,000 ÷ 10	(250,000)	(250,000)
Operating profit	449,600	4,154,000
Operating profit margin	*18.9%*	*37.1%*

Analysis of assumptions:

- Based on data provided, the gross profit margin is forecasted to be 45%, which is higher than that of the current KTI-branded tea of 35%. Although it is reasonable to assume that this margin might be higher, given the niche nature of the product, further research should be conducted to ensure that it is accurate.
- Estimated costs for the new equipment are $2.5 million, and will be straight-line depreciated over a 10-year period.

Additional considerations:

- An upfront investment of $2.5 million is required. KTI has enough investment capital on hand to support this investment. Moreover, KTI would still have enough capital to proceed with the Leaf partnership as well. These two investment opportunities may offer synergies (such as the potential health benefits associated with both proposals), so KTI may strengthen its strategic position by moving forward with both.
- There is a significant range of potential unit sales per year. Apparently, this is due to the current lack of information regarding the market for this new product line. This increases KTI's challenge in assessing the option's potential. However, even at the lower end of the range, this option would still contribute to meeting both of the company's stated objectives: to increase the company's profit margin to 12%, and increase the company's revenue by 10% annually.

- Depending on the number of product sales, KTI would need to allocate 220,000 kilograms of tea at the low end of the projection, and 1,035,000 kilograms at the high end. Given that 4,170,000 kilograms of tea (1,316,000 + 2,854,000) will be available from the private-label contracts that expire in 2025, the company would have the available supply necessary to proceed with this proposal.

Objectives:

- Increase operating profit margin to 12% by 2028 – As seen from the forecast above, the operating margin on this new product is 18.9% for the low end of the range, and 37.1% for the high end. These are much higher than KTI's existing operating margin, so this product contributes to increasing the operating margin, to meet this objective.
- Increase sales by 10% annually – This will increase revenues by 5% ($2,380,000 ÷ $52,200,000) in 2026 at the low end of the range, or 21% ($11,200,000 ÷ $52,200,000) at the high end.

Conclusion on quantitative analysis

This alternative appears financially promising. Both of KTI's stated objectives would be met through this option, and the company would enter a new market. However, there is a significant amount of uncertainty relative to the number of unit sales that can be expected. This may increase the complexity of the operation, as KTI would be challenged with allocating a sufficient supply of raw materials to the new theanine-enhanced products while not ignoring the other important aspects of the company's business.

Qualitative Analysis

Vision/mission/core values

The acceptance of this alternative still allows KTI to meet its vision of allowing customers to enjoy a pure, complex experience while drinking its tea. It also aligns with its mission to bring the health benefits of tea in all its forms to individuals.

There is a high level of potential for a product line that emphasizes theanine.

Pros:

- Research studies have concluded that teas supplemented with amino acids can have many health benefits; as a result, there is an increasing demand for supplemented teas, such as those with this theanine product. Producing and selling this new product would allow KTI to access this new customer segment.

- The combination of the KTI brand and a new discovery could lead to explosive growth. This would be KTI's first enhanced health product. As indicated by the high end of the estimated range of annual sales, there is a significant potential for this market.
- This would allow KTI to sell its products in another distribution channel—health food stores and drug stores. This will help KTI diversify its sources of revenue.
- The product would also sell at a premium to the KTI-branded teas, which would help improve operating margins.
- These products are not regulated by the government, since theanine is not classified as a pharmaceutical. This would allow the project to operate with less complexity and less risk.
- Experts consider theanine to be generally safe, with multiple health benefits. This should translate into a new emerging market for this product.
- This opportunity would allow KTI to test and enter into the market of enhanced health-benefit products. If successful, further R&D work could be done on other enhanced health-related products that would appeal to a new consumer market, and allow KTI to differentiate itself further.
- This would give the R&D department a sense of achievement, as they would see their hard work rewarded with a new product being sold to a new customer segment. This would ensure that the employees continue to be motivated by their successes.

Cons:

- There is little research on the market size of this product. As more competitors enter this market, which is not regulated, competition may increase and selling prices may decline. Therefore, it is a challenge to accurately project the profitability of the venture. This increases KTI's risk.
- KTI would have to spend substantial amounts on marketing to promote the new product, and the current estimates may be too low in comparison to what actual costs may be.
- No long-term studies have been completed on theanine. Although there is no indication of long-term harm, KTI would still be taking a risk that future research may uncover something negative about theanine. If that were to be the case, the product line may no longer be viable.
- The production process would be more complicated relative to current products, as theanine processing requires new equipment and specialized processes. KTI would have to learn this expertise or may need to hire some expertise, if required.

Integration

- If KTI does not develop a product in-house, the patent could be sold for $6 million to another producer, which would bring in upfront cash to use for other investments. This $6 million could be partially used to acquire 40% of the tea farm, to guarantee tea supply.
- In-house development of the theanine product cannot be done in conjunction with the BFI contract, which would use all of the existing supply of tea as well as Hilly's potential new supply, and because BFI's contract stipulates that KTI does not sell its KTI-branded teas to any other vendor.
- The development of this niche product integrates well with the development of the cannabinoid products for sale in the Canna Relaxation Rooms, since both represent niche products that enhance the health benefits of tea.

Conclusion/Recommendation

This investment alternative represents a significant opportunity for KTI to expand its product line into a promising new market. KTI has a competitive advantage with its patent, and can take advantage of R&D's good work by commercializing the new theanine-enhanced tea product line. However, there do appear to be some significant risks associated with this alternative. Given that this is a new product line, it is uncertain whether the market will accept it. If, for whatever reason, the product is not as desirable as it appears, its success would be in jeopardy. In the worst case, the product line may be totally unsuccessful (perhaps due to competition or future research indicating something harmful about theanine's long-term use).

However, given the promise of the project and KTI's competitive advantage due to its new patent, this alternative would be a good one to proceed with if KTI's board finds the related risks acceptable.

Assessment Opportunity #6 (Strategic Alternative #5: Accept US sales agreement with Fresh Fare Foods?)

The candidate is expected to complete both a quantitative and qualitative assessment of the US sales agreement with FFF.

Quantitative analysis: The candidate should complete a quantitative analysis of the gross profit margin of the US customers, and compare it to current branded tea margins and the BFI contract.

Qualitative analysis: The candidate should discuss the advantages and disadvantages of signing a long-term sales agreement with FFF.

Conclusion: The candidate should offer a conclusion that incorporates and logically follows from their quantitative and qualitative analyses.

There is an opportunity for KTI to sign the company's first long-term sales agreement for KTI-branded tea. FFF has guaranteed its sales volume, and the contract would use about 8% of KTI's current supply of raw materials.

Quantitative Analysis

	Year 1	**Year 2**	**Years 3–5**
	Sept 1, 2025 – Aug 31, 2026	**Sept 1, 2026 – Aug 31, 2027**	**Sept 1, 2027 – Aug 31, 2030**
Kilos required	850,000	950,000	1,050,000
$/kg (USD)	$4.10	$4.10	$4.10
Annual sales in US dollars	$ 3,485,000	$ 3,895,000	$ 4,305,000
Exchange rate for 1 USD in CAD	1.35	1.35	1.35
Annual sales in Canadian dollars	$ 4,704,750	$ 5,258,250	$ 5,811,750
Costs of product (per kilo)	(3,187,500)	(3,562,500)	(3,937,500)
Shipping costs	0	0	0
Gross profit	$ 1,517,250	$ 1,695,750	$ 1,874,250
Gross profit %	*32%*	*32%*	*32%*

Additional considerations:

- The gross margin of the contract is 32%, which is currently better than KTI's gross margin for its private-label sales (20.5%), but lower than KTI's current gross margin from sales of KTI-branded teas (35%). However, the trade-off for this lower gross margin is the fact that the contract is for five years. This reduces KTI's risk by securing this revenue for the next five years.
- This selling price depends on the Canadian-to-US dollar exchange rate. If the Canadian dollar should strengthen, the exchange rate will fall, and the gross profit margin would also decline.

- Sales start in September 2025, so KTI would be able to reallocate the supply from the Alcona Grocery Limited private-label contract that expires in May 2025.

Conclusion on quantitative analysis

The contract represents a trade-off between a lower gross profit for KTI but also a reduced risk (given that the contract is for five years). Compared to the BFI contract, which has a gross profit margin of only 20%, the offer from FFF is by far the more attractive offer. However, this contract would use only 8% of KTI's existing supply of raw materials, whereas the BFI contract would use 100%. Also, the BFI contract includes more perks, such as the reduction of KTI's marketing expense.

If KTI decides to forgo BFI's offer, this contract should be closely considered.

Qualitative Analysis

Vision/mission/core values

The acceptance of this alternative allows KTI to meet its vision of allowing customers to enjoy a pure, complex experience while drinking their tea. It also aligns with its mission to bring the health benefits of tea in all its forms to individuals.

Pros:

- This would allow KTI to increase its sales to the US. Since there are no exclusivity restrictions, KTI could continue to sell through its normal US distribution channels.
- The guaranteed sales volume would help secure revenue for the next five years, with the option of an additional five-year renewal period if both parties agree to it. There is the possibility that annual volume sales will be even higher. This may increase revenues and profits.
- No upfront cash investment is required for this option.
- This contract also allows KTI-branded tea to be sold in grocery stores, rather than just in tea rooms and tea shops. Since more consumers want to purchase tea for at-home consumption, this contract would provide KTI with an opportunity to sell to this market.
- FFF would include KTI in its marketing promotions at least twice per year. This would further promote KTI's brand in the US, without KTI needing to incur the expense.
- FFF would pick up directly from KTI warehouses, so shipping costs to the US would be eliminated.

- KTI has had some other long-term contract offers from both US and Canadian customers, so this could be the first of many more long-term contractual arrangements. KTI may want to compare this contract offer to the others that the company has received before making a decision.

Cons:

- Currently, the FX rates are favourable, at 1 USD = 1.35 CAD, but these could change during the term of the contract. If the US dollar falls, the margins would decline.
- The contract fixes the volumes sold and the selling price for a five-year period. If the price of tea increases, the gross margin would decline, since the selling price is fixed.

Integration

- Due to the volumes required under the BFI contract, this agreement could not be done in conjunction with signing of the BFI contract. There is not enough available supply to satisfy the requirements under both contracts.
- However, this contract could be done in conjunction with the commercialization of the theanine product and the cannabis-infused products, since there is sufficient supply for all the forecasts and commitments to be met.

Conclusion/Recommendation

This contract provides KTI with its first long-term contract to sell its KTI-branded teas. Until now, all branded sales have been short-term, with burdensome costs to administer. This contract helps to sell the KTI brand in the US market, with reasonable profit margins and no exclusivity restrictions. The contract allows the company to secure revenues for up to a 10-year period, if both parties agree, starting in September 2025. Therefore, KTI would be able to reallocate supply used for the Alcona Grocery Limited private-label contract, which is expiring in May 2025. The risk is that this contract does not give KTI flexibility in volumes or selling prices. If tea input prices increase, the margins would decline. Finally, there is also risk with this contract due to the US dollar exchange rate; if the value of the US dollar falls, there would be an impact on revenues and margins.

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.

Enabling Competencies
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.2 Articulates limitations to recommendations
6.3.3 Applies decision criteria to choose among viable alternatives
6.3.4 Ensures that decision criteria do not conflict with professional ethics and values

The candidate is expected to provide a logical conclusion that is consistent with their analysis and integrated with an overall recommendation of whether KTI should accept the BFI contract, acquire an interest in Hilly, enter into a partnership with Leaf, commercialize its theanine-enhanced teas, and/or enter into the agreement with FFF for sales in the US.

The candidate should draw logical conclusions and make a recommendation on the strategic direction KTI should take. The candidate's analysis should integrate the analyses for all five major strategic opportunities into a coherent overall strategy. The recommendations should be strategic in nature and display good professional judgement and logic, recognizing the interconnected influence of each option. Suggesting that further information is required is acceptable where justified and consistent with the analysis.

At present, KTI is in a risky situation because 70% of the company's current revenue is tied to four contracts set to expire within the next two years, and it does not appear that the board has any intention of renewing those contracts. Therefore, KTI must ensure that the raw materials that will become available from the expiring contracts (which represent 76% of the company's total supply of raw materials) are used in an advantageous way.

The offer from BFI would eliminate this risk, given that the contract would use all of KTI's current supply. However, there are trade-offs associated with this option, as the contract's margin is below the margin KTI currently can achieve on its KTI-branded tea sales, and the margin offered by the FFF contact. In addition, to adequately service the contract, KTI would need to expand its supply of raw materials. Therefore, if the board decides to accept this option, the Hilly partnership should also be seriously considered. If KTI accepts BFI but forgoes Hilly, the company will need to find an additional source of raw materials supply. This may be a challenge, given the increase in competition for fertile land on which tea can be reliably grown.

As an alternative to the BFI contract, KTI could pursue a strategy that relies on R&D's ability to develop new and attractive tea products, such as a cannabis-infused RTD and the theanine-enhanced tea products. The upside of these options is greater than the BFI contract, but there is no guarantee of success (whereas the revenue from BFI would be guaranteed).

KTI could also take a blended approach, whereby a certain amount of raw materials is allocated to new products and a certain amount is allocated to more secure contracts, such as the FFF contract. For example, the partnership with Leaf would require only 80,000 kilograms of raw leaves, whereas the theanine product supply requirements are less clear. To navigate this, KTI could allocate a specified amount of raw materials for the theanine products (such as 500,000 kilograms) during the product's first year. This would allow KTI to get a sense of the demand for the new product, and the company would still have a significant amount of supply to allocate to contracts such as that with FFF.

Regardless of the approach that KTI's board decides to take, it is recommended that the company begin to accept long-term contracts for KTI-branded teas. Although the company would need to accept a lower margin, this decision would greatly reduce the risk that the company is unable to sell all its supply through one-off contracts for KTI-branded tea.

If the board decides to take the less risky approach and accept the BFI contract, the company would also likely have to sell the theanine patent, to ensure that it has enough capital to expand its supply. At present, the company does not have sufficient investment capital to purchase Hilly, so the only alternative would appear to be selling the theanine patent. If KTI decides to move forward with BFI, the competitive advantage associated with KTI's R&D department would be lost.

Conversely, if it declines the BFI contract, the company has enough investment capital and supply to proceed with the Leaf partnership, the commercialization of the theanine products, and the FFF contract.

Given the strength of the R&D department and the promise associated with tea products that promote health benefits, it is recommended that KTI forgo the BFI contract in order to pursue the Leaf partnership, the theanine products, and the contract with FFF.

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 clearly 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 labelling or illogical ordering.
- There is an excessive amount of spelling and grammatical errors.
- Unprofessional language is used.

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 the underlying key concepts were there.

Marginal Fail – Overall, the candidate provided an attempt at a response, one that contained several errors or where the analysis was incomplete.

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

To be assessed a Pass, the candidate is expected to perform adequately in all the summative assessments and demonstrate that, overall, they addressed the issues of all of the shareholders.

Markers considered 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 (current 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 – KTI VERSION 1

Below is an actual passing candidate response.

Role - CPA, Consultant with FWC

Date - Mar 31, 2025

Users:

- Michael - Retired 2023

-Sabrina - 33.33%

-Kathleen - 33.33%

-Jason - 33.33%

-Conrad - 60,000 preferred shares - convertible 1-1

Situational analysis

Mission, Vision, Values (MVVs)

Mission - unchanged from CS1:

"Do right by the farmers and our customers and far exceed consumer expectation daily. We produce our tea in an ethically responsible manner, and its distinctive taste and high quality inspire loyalty in our customers. We strive to bring the health benefits of tea in all forms to individuals"

Vision - unchanged from CS1:

"We envision an environment where a high quality tea is produced by fairly compensated farmers, our customers enjoy a pure, complex, and pleasant experience every time they drink a cup of our tea, and everyone involved on the process is treated with honesty, fairness and respect."

Values from CS1

-Produce extraordinary tea

-Fair trade

-Building long term relationships

-Building a bran that is known for ethical and respected

-Treating all employees fairly, honestly, and respect

-Ensure ethical, sustainable, environmental standard throughout processes

Key success factors (KSFs) from CS1

- Strong brand recognition

-Adaptability in the market

- Product differentiation

- Economies of scale

- Retail shelf space is premium

Quantitative analysis

See exhibit 0 - FS analysis for calculations.

- Michael is owed a $5M interest free loan over 10 years repaid - 8 years remaining

- Current operating margin for KTI is 7.2%,per exhibit 1, which indicates that to reach the target of 12% by 2028, KTI need to either increase revenues or decrease costs. As costs are expected to increase due to external factors (interest rate), increasing revenues is important.

- KTI will have 4170 KG of tea leaves available by the end of 2025 and ready for 2026, as two contract expire.

Targets/Objectives

- Selling KTI-branded teas to tea rooms and tea shops for at home use

- Reallocating the supply of raw materials to producing KTI branded teas

- Increase Operating profit margin to 12% by 2028

- Increase revenues by 10% annually

SWOT - Strengths

- KTI has manged to roll out a new KTI branded teas, which was a previous goal for KTI to achieve. As it has been successful and had strong growth it indicates successful management and profits.

- Conrad has been a new addition as the VP of marketing and has supported and been successful in the roll out of the new products and achieving growth.

-KTI has resolved the employees concerns over dust in the production factory which aligns with KTIs focus of ensuing employee fairness and safety

- The R&D team has made great success as they have acquired a patent and are producing 5 products per year. This shows research for new products is going good.

SWOT - Weaknesses

-KTI did not choose to pursue other opportunities, which provides less diversity and reduces future opportunities.

- KTI has not signed any long-term contracts. As KTI is primarily revenue from private labels (70%), and the non renewal of contracts set to expire soon, this indicates that revenues may decrease if they are not secured.

- Michael has retired, as he was the centre and primary decision maker for KTI, this leaves other shareholders/ managmenet to pick up the reins.

SWOT - Opportunities

- The cannabis industry is growing in Canada as it has been legalised, opportunity to provide a niche and be an innovator by being one of the first to sell cannabis infused drinks would be an opportunity for KTI to increase revenues and product differentiation.

- Securing long term contracts would help mitigate risks associated with revenues decreasing as KTIs private label contracts are set to expire in 2025/2026 and they have not made any moves to renew.

- Demand for speciality teas, especially organic and fair trade products that have health benefits is continuing to growth. This provides a growth opportunity for KTI if they continue to focus on niche teas. Growth in tea rooms and shops has risen beyond expected.

- To meet demand, grocery stores are increasing purchases of speciality teas. This provides KTI the opportunity to reduce marketing costs and aligns with premium shelf space KSF.

SWOT - Threats

- Inflation rates are increasing, this reduces spending power for consumers, suppliers, and would increase borrowing costs for KTI to expand.

- The supply of tea leaves, due to climate, inflation, poor harvest and growing seasons over the past 2 years. This makes obtaining a supply for tea related expansion harder should KTI need to increase supply. Could result in decrease sales and increase COGS.

- Few long-term studies regarding amino acid theanine, KTIs patent, have been conducted on health impact. This could pose a concern should KTI pursue future expansion based on it.

1. Beau Foods Inc proposal

Quantitative analysis

See exhibit 2. Based on the calculations, the OP% would be at least 15% and increase to 17% after 3 years. This would help KTI achieve their target of 12% by 2028. This also aligns with KTIs objective to increase revenues by 10% in 2025/2026. However, would not improve significantly in the following years.

There would be no issue with supply constraint in KG if KTI does not renew the May 2025 contract, then KTI would have excess supply of 1.6M KG.

As there is no upfront cost, this would not impact any other covenants from E&Y of 2.0 current ratio.

Qualitative analysis

Pros:

- This opportunity will provide KTI with a long term contract for 10 years, which helps mitigate many risks and offsets reduced revenues

- KTI would have no marketing costs for KTI branded tea, thus increasing the operating profit margins. This aligns with KTIs targets and objectives of 12% by 2028.

- KTI would also not have to incur costs related to expansion of the production capacity, which would help ensure KTI is able to support other opportunities as supply of KG becomes a constraint due to the current market conditions and growing concerns.

-BFI would also support KTIs R&D team, which would allow KTI to pursue other opportunities that have a constraint on the research side. This would further increase KTIs competition advantage in the research field.

Cons:

- KTI would be in an exclusive contract with BFI. This reduces KTIs ability to sell KTI branded teas to other markets. This would go against KTIs primary objective of sellingKTI branded tea to tea shops. This would reduce opportunities for KTI.

-KTI would be charged a penalty if supply minimums are not met. This would impact KTIs operating profit. As there are concerns over continuing to obtain supply due to the external issues and poor harvest yields, this is a concern.

- If KTI does renew contracts, then there would be a KG supply constraint, as supply also needs to increase by 50% by the third year, this could be an issue. This would restrict KTI in pursuing other opportunities.

Conclusion

Based on the analysis above, although it is profitable and would help KTI achieve their targets for Operating%, this proposal does not align with KTIs objective of shifting towards KTI branded KTIs being a high % of revenues due to the exclusivity deal.

I would not recommend that KTI pursues this opportunity.

Strategic direction alignment

This proposal, does not align directly with a primary focus as mentioned above, as KTI plans to focus more resources onto KTI brand and building a strong brand reputation. The exclusivity deal would restrict KTI for years in selling to other suppliers.

2. Investment in Hilly Side Tea Farm Inc

Quantitative analysis

See exhibit 2. Based on the analysis, the 3.5-5 times operating margin and 40% ownership by KTI would result in a valuation of $5-7.2M for HSTF.

Qualitative analysis

Pros:

- KTI would be able to secure 30% increase supply of tea leaves, which would help KTI pursue other opportunities, thus increasing revenues.

- This aligns with KTIs objective to increase operating profit margin % as the decrease in raw tea leaves to be purchased at cost plus fixed % would mitigate some of the external threats that KTI is going to face in regards to obtaining supply due to harvest yields and increasing interest rates.

- HSTF is already certified as fair trade and organic, which aligns with KTIs MVVs (mission vision values) as this has been an important aspect of KTI. This would allow KTI to use the tea leaves.

- As they also expect to increase supply in the future, have a first right to buy would benefit KTI by reducing costs ensuring supply for other opportunities.

Cons:

- There was a complaint made in 2022 regarding concerning working conditions, as KTI prides itself in treating employees fairness, honestly, and with respect, this goes against KTIs values

- There is a risk as KTI would have 40% ownership that KTI does not have control over any decisions being made by the company. They could change processes without KTIs approval which is a concern.

- KTI would not be first in line for supply of tea leaves until early 2026 due to a current long term contract. This could reduce revenues for 2025 and would impact the targets.

Conclusion

Based on the analysis above, I recommend that KTI does proceed with the purchase of 40% of Hilly Side. This proposal aligns with KTIs objective to increase revenue by increasing supply as also decreasing costs of raw materials to increase operating profit. The employee environment concern was ensured to be resolved and KTI would have input as a shareholder in the future.

Strategic direction alignment

As KTI is primarily focused on increasing revenue and KTI branded sales, this aligns with as KTI would be able to use the fair trade and organic tea leaves that Hilly produces.

3. Relaxing leaf Company Limited

Quantitative analysis

See exhibit 3. Based on the calculations this proposal exceeds KTIs target return on investment of 12% in all 3 years. KTI is expected to have a 1.68 return on this investment. It also aligns with KTIs OP% margin of 12% by 2028 as all 3 years exceed 21%. It also meets KTIs rev 10% increase goal annually by ~ double.

The supply of 80,000 KG would be achievable if KTI does not renew the two 2025 contracts.

Qualitative analysis

Pros:

- In the meantime, prior to cannabis products, KTI would be increasing their sales of KTI branded teas, which aligns with KTIs objective to increase sales in this area of their business. This would result in increased revenue for KTI.

- The effects of cannabis, THC and CBD, are shown to help reduce stress and improve sleep, as KTI is focused on providing customers with health benefits this is a opportunity to increase sales and expand into a new market.

- The demand for cannabis products is increasing, which KTI could capitalise on. Conrad has also mentioned that KTI could use his bottling facility, which would align with KTIs goals to decrease operating costs and thus improving the ratio and helping achieve the target.

Cons:

- As cannabis products are currently illegal to sell, this offering may not be possible unless legislation changes. There is a risk that this opportunity never occurs and any research would be wasted. Resulting in R&D time and spending.

- There is little market research into cannabis sales as the product and market are both unproven. There is a risk of the product not being marketable and therefore impact sales.

- As cannabis was only recently legalised, there is a large black market and considerable regulation. This would increase time spend on overcoming the legal hurdles and thus decrease operating margins as costs for be incurred for marketing and legal fees.

Conclusion

Based on the analysis, I recommend that KTI does proceed with the Relaxing leaf proposal to create the "Canna Relaxation Rooms". As it aligns with KTIs goals and objectives to pursue speciality teas and increase sales of KTI branded products.

Strategic direction alignment

This opportunity does align with KTIs strategic objectives, as the focus on moving towards KTI branded products and researching unique and speciality flavours and drinks would fit with creating the cannabis tea rooms.

4. Commercialisation of the Theanine-infused product line vs sale

KTI has received an offer to sell KTIs patent for theanine-infused production process for $6M, or to commercialise it.

Quantitative analysis

See exhibit 4. Based on the analysis, commercialising vs selling the patent:

Commercialisation would provide KTI with increased revenues, helping achieve targets. It would increase the operating profit as it has at least an operating profit of 29%, which is higher than current of 7%. KTI would lose out on the sale of value of $6M and it would cost KTI $2.5M, which could potentially breach covenants

There is also a potential supply constraint if it ends of being on the high side as it would required 1M KG.

Qualitative analysis

Pros of commercialization:

- The growth in the infusion market is growing, which aligns with KTIs objective to increase revenues annually.

- The product provides health benefits and relaxation to customers, which aligns with the situational analysis as selling KTI branded teas is an objective.

- As KTI is currently a market leader in R&D, as seen by their achievement and the patent, this would help KTI increase its brand recognition and aligns with the KSF of building a strong brand. It also aligns with product differentiation or KTI.

Cons:

- The lack of research provides a concern over the validity of the estimates for high and low expectations. This is a risk that the market does not grow and thus decreasing sales for KTI, as well as losing out on the sale of the patent.

- The products would not be available for at least 18 months, which does not align with KTIs objectives to increase revenues and operating % by 2028. This would leave ~ 1 year to achieve the targets.

-The unpredictable supply required of tea leaves poses a challenge for KTI, as KTI would either risk under purchasing or over purchasing, resulting in loss of revenue opportunity or wasted money on excess.

-There are currently no long term studies regarding amino acid theanine, which if provides to be negative in the long term would reduce sales and revenues.

Conclusion

Based on the analysis above, I recommend that KTI does pursue this opportunity as it aligns KTI increasing KTI branded sales and focusing on utilising their competitive advantage of the R&D team.

The opportunity cost of $6M in the sale of the process patent would not be a direct cost, and any benefits from the competitive advantage would be lost if KTI sells the product.

Strategic direction alignment

Commercialising aligns with KTIs strategic objectives as focusing on KTIs brand and increasing tea room and shop sales is a facet of KTIs current long term goals.

The sale of the patent does not align with KTIs strategic objectives as it does not provide revenues or increase any ratios for profitability. It would only provide funding.

5. US Sales agreement with Fresh Fare foods

Quantitative analysis

See exhibit 5. Based on the analysis, this proposal would exceed KTIs targets of % annually increasing revenues for the first 3 years, however would not increase from years 3-5, this would have a negative impact in 2028 when achieving targets. A GM% of 32% would also increase KTI overall Operating % objective.

Qualitative analysis

Pros:

- This is a 5 year contract, which would help KTI mitigate any concerns and threats over the new 5 years in regards to cash flow. As KTIs private label contracts are ending this would help support KTIs objective of OP%.

- This opportunity aligns with KTIs goals to increase sales of KTI branded tea and allows KTI to expand into a new market to increase KTIs brand awareness and market recognition which is a KSF.

- KTI branded teas would be the only brand that FFF would sell, this would be an favourable exclusivity deal for KTI and would also increase KTIs brand recognition in the US market.

- FFF will provide semi annual marketing promotions, which would save KTI money as currently KTI is spending a large portion on KTIs brand to gain recognition.

- FFF would also front the costs for shipping, which aligns with KTIs objectives to reduce operating costs and improve margins.

Cons:

- As cost of raw material are expected to increase due to rising inflation rates, the fixed sales price of the contract would decrease profitability and therefore have a negative impact on KTI reaching future targets.

- This proposal requires 8% of KTIs total current supply of raw leaves, KTI may run into a supply issue, resulting in a decrease in sales and negative impact to KTIs relationships, which goes against KTIs KSF and values.

-Another concern is regarding the USD to CAD exchange rate, as this would further reduce KTIs operating margins and impact reaching objectives for op margin %.

Conclusion

Based on the analysis above, I recommend that KTI pursues this opportunity given there is no constraint with supply, which will be analysed below. This provides KTI with a new market to have their KTI brand exposed, the risks of raw material costs can be mitigated with the Hill Side opportunity above.

Strategic direction alignment

Pursuing the US market for KTI branded tea does align with KTIs objectives as increasing revenues, decreasing operating costs and economises of scale are all tied into expanding.

6. Other issues

Overall strategic directive

Overall, the strategic direction that KTI has taken since Michael retired in 2023 has been a shift in focus from private labels towards KTI branded teas. The issues discussed above have been decided based on the alignment with this shift in focus towards KTIs brand and gaining further brand recognition, which is a KSF.

Reallocation of tea supply for transition

As supply concerns are a major concern due to the opportunities presented, it has been analysed in exhibit 6. Assuming supply required for 2024 amounts can also be obtained in 2025 onward at minimum in analysing the constraints of each opportunity.

Based on exhibit 6, KTI would not exceed the constraint of tea supply, as KTI would have an excess of 3.6M KG, assuming the high end for the commercialisation proposal.

KTI can mitigate this issue of excess by purchasing less from the Hill side proposal, and this allows for KTI to continue expansion and expected sales demand in the future.

Overall conclusion

Overall, it is recommend that KTI first declines the Beau Foods proposal as the exclusivity deal would restrict KTIs ability to market and sell KTI branded teas or pursue other opportunities.

Second, KTI should pursue the investment into Hill side, as this will ensure that KTI has a secure and lower cost supply of tea leaves available for purchase. It should be determined first if this breaches the current ratio covenant of 2.0 with E&Y (from CS1) if a loan is still outstanding given the upfront purchase cost.

Third, KTI should pursue the relaxing leaf company proposal to create the cannabis tea room as it provides a great opportunity for KTI to market and sell KTI branded tea in the meantime before legalisation and aligns with KTIs KSF of product differentiation and using KTIs competitive advantage of their R&D team.

KTI should then commercialise their theanine-infused tea line and use the patent. Utilising their competitive advantage and increasing KTIs product differentiation with a focus on health benefits aligns strategically with KTI overall.

Then KTI should pursue the US sales agreement as it provides a unique opportunity to expand and gain more brand recognition in the states with KTI branded tea sales.

KTIs main constraint of tea supply, even if Hilly side is not pursued, KTI would be able to support the demand for tea leaves while pursuing the other opportunities.

As for KTIs strategic direction, it has shifted away from private labels and based on the board meeting, the objectives of focusing on KTIs brand also aligns with KTIs original KSF and MVVs.

Exhibit 0 - FS analysis

Purpose

To analyize the margins of KTI.

Operating income		3,763,000.00	
Revenues		52,200,000.00	
OP%		7.2%	< target of 12% by 2028

Supply		Revenue	Supply
	May-25	6,213,000.00	1,316.00
	Nov-25	11,542,000.00	2,854.00
	Jan-26	13,834,000.00	3,398.00
	Jun-26	4,951,000.00	1,070.00
Available 2026		17,755,000.00	4,170.00
Available 2027		18,785,000.00	4,468.00
Total		36,540,000.00	8,638.00

	Revenue	Years
Revenue	52,200,000.00	
10% increase	57,420,000.00	2,025.00
10% increase	63,162,000.00	2,026.00
10% increase	69,478,200.00	2,027.00

Exhibit 1
Purpose
To determine the operating profit of the Beau Foods proposal

	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10
Purchase in KG	11,000,000.00	13,000,000.00	16,000,000.00	16,000,000.00	16,000,000.00	16,000,000.00	16,000,000.00	16,000,000.00	16,000,000.00	16,000,000.00
Price Beua pays	4.63									
Revenues	50,930,000.00	60,190,000.00	74,080,000.00	74,080,000.00	74,080,000.00	74,080,000.00	74,080,000.00	74,080,000.00	74,080,000.00	74,080,000.00
COGS	40,744,000.00	48,152,000.00	59,264,000.00	59,264,000.00	59,264,000.00	59,264,000.00	59,264,000.00	59,264,000.00	59,264,000.00	59,264,000.00
GM	10,186,000.00	12,038,000.00	14,816,000.00	14,816,000.00	14,816,000.00	14,816,000.00	14,816,000.00	14,816,000.00	14,816,000.00	14,816,000.00
Other admin costs	2,560,000.00	2,560,000.00	2,560,000.00	2,560,000.00	2,560,000.00	2,560,000.00	2,560,000.00	2,560,000.00	2,560,000.00	2,560,000.00
Operating profit	7,626,000.00	9,478,000.00	12,256,000.00	12,256,000.00	12,256,000.00	12,256,000.00	12,256,000.00	12,256,000.00	12,256,000.00	12,256,000.00
OP%	15%	16%	17%	17%	17%	17%	17%	17%	17%	17%

Supply constraint in KG		
August - July 2026	11,000,000.00	
2025 Supply required	4,583,333.33	5 months of 2025 - aug dec
Supply availalbe	6,213,000.00	No supply issue
Excess	1,629,666.67	

Conclusion
The beua proposal would be profitabile and help KTI achieve 12% OP% by 2028 as it is greater than 12% for all years.

Exhibit 2

Purpose

To evaluate Hilly Side tea farm and determine if the investment is worth it

Revenues	8,000,000.00	
Operating margin	0.45	
Operating profit	3,600,000.00	
Multiple	3.50	
VAluation	12,600,000.00	
40% offer	5,040,000.00	<Offer of $6
Multiple	5.00	
VAluation	18,000,000.00	
40% offer	7,200,000.00	>offer of $6

Conclusion

The offer of 6M would be over valued at 3.5x and under valued at 5x. As they are expected to increase this would be be
Increases supply by 30%

Exhibit 3

Purpose

To determine the rate of return on this proposal for relaxing leaf company

		2,026.00	2,027.00	2028	
Revenues		2,100,000.00	2,500,000.00	3,000,000.00	
			0.19	0.20	> target of reveneus
COGS					
	42%	882,000.00	1,050,000.00	1,260,000.00	
GM		1,218,000.00	1,450,000.00	1,740,000.00	
Other opp costs		350,000.00	350,000.00	350,000.00	
Op margin		868,000.00	1,100,000.00	1,390,000.00	
KTI 50% split		434,000.00	550,000.00	695,000.00	
OP%		0.21	0.22	0.23	> target of 12%
Annual ROI		0.43	0.55	0.70	
Total op profit		1,679,000.00			
Upfront cost		1,000,000.00			
Return rate		1.68			
Supply constraint		80,000.00	KG per year		

Conclusion

Per above, the Return rate exceeds the required 12% and has an overall return of 1.68 over 3 years.

Exhibit 4

Purpose

To analyize the proitability of the commercialization of the theanine-infused product line.

Per App VII

Item	Low	High	
Cases sold per year	17,000	80,000	
Selling price per case	$140	$140	
Kilograms of raw tea required	220,000	1,035,000	Supply constraint
Total revenue	$ 2,380,000	$ 11,200,000	
Cost of goods sold (55%)	$ (1,309,000)	$ (6,160,000)	
Shipping costs	$ (71,400)	$ (336,000)	
Initial marketing costs	$ (250,000)	$ (250,000)	
Additional R&D costs	$ (50,000)	$ (50,000)	
Operating profit	$ 699,600	$ 4,404,000	
OP%	0.29	0.39	>target of 12%

Upfront cost	2,500,000.00	
ROI annually - low-high	28%	176%
Sale price	6,000,000.00	

Conclusion

The ROI is higher than rquired of the other opporunitiy of 12%. The OP% is greater than the target, therefore this would

Exhibit 5

Purpose

To determine if the US sales agreement FFF, is viabile

	Y1	Y2	Y3-Y5	
Purchase quantity	850,000.00	950,000.00	1,050,000.00	
FFF price USD	4.10	4.10	4.10	per KG
FFF price CAD	5.54	5.54	5.54	1.35 exhange rate p
Revenues	4,704,750.00	5,258,250.00	5,811,750.00	
Rev %		0.12	0.11	> target of 10% ann
COGS Rate	3.75	3.75	3.75	per KG
COGS	3,187,500.00	3,562,500.00	3,937,500.00	
GM	1,517,250.00	1,695,750.00	1,874,250.00	
GM%	0.32	0.32	0.32	
Supply of TEa	8% of totoal			

Conclusion

Meets revenues goals annually and would require 8% of total supply of tea leaves

Exhibit 6

Purpose

To review the supply constraints

	Supply required low	Supply required high	Proposal recommen
Beau Foods Inc proposal	4,583,333.33		Not recommended
Investment in Hilly Side Tea Farm Inc	30% increase		Recommended
Relaxing leaf Company Limited	80,000.00		Recommended
Commercialisation of the Theanine-in	220,000.00	1,035,000.00	Commercialization
US Sales agreement with Fresh Fare	691,040.00		Recommended
Supply available 2026	4,170,000.00		
Supply increased (HIlly)	1,251,000.00		
Total supply for 2026	5,421,000.00		
Expected (recommended proposals)	1,806,040.00		
Excess supply	3,614,960.00		

		in 000's
Supply		Supply per app 2
	May-25	1,316.00
	Nov-25	2,854.00
	Jan-26	3,398.00
	Jun-26	1,070.00
Available 2026		4,170.00
Available 2027		4,468.00
Total		8,638.00

Conclusion

There will be excess supply of tea leaves whether or not KTI proceeds with the investment in Hilly Side.

Row 200 - Cad # 4053560

APPENDIX E

THE COMMON FINAL EXAMINATION
DAY 1 KTI VERSION 2 BOOKLET – MAY 28, 2024

COMMON FINAL EXAMINATION
MAY 28, 2024 – DAY 1

Case (KTI-Version 2) **(Suggested time: 240 minutes)**

It is January 2025, and you, CPA, are still working at F & W Consulting LLP (FWC). Kingsdale Tea Inc. (KTI) has again engaged FWC to assist with KTI's strategic planning. You have been forwarded the following update from Kathleen Galinsky, who became KTI's CEO after Michael's retirement in early 2024. At that time, he passed control of KTI to his three children, Jason, Sabrina, and Kathleen, who each now hold one-third of the common shares of KTI, and form KTI's Board of Directors.

At the end of 2023, KTI expanded beyond only selling private-label products by launching its own brand of tea. These new products are branded as Kingsdale Tea (KTI-branded tea), and currently sell exclusively in tea rooms and tea shops. To date, no long-term contracts have been signed for KTI's new branded products. This is mostly because the tea rooms and tea shops wanted to test the demand for KTI's tea before agreeing to something long-term.

So far, KTI-branded tea has been well received, due to the superior quality of the raw tea leaves used in production. Purchasers of KTI-branded tea are typically knowledgeable tea drinkers with sophisticated taste. The KTI-brand launch was promoted by tea rooms eager to showcase the unique story behind KTI's tea farmers. This has had a surprisingly positive impact on sales, with several popular tea rooms sharing the stories via social media. Overall, the demand for KTI-branded tea has exceeded expectations, despite KTI not directly marketing the new KTI-branded products.

KTI's financial results have improved due to the increase in cash flow generated from the sale of KTI-branded tea products. KTI currently has $4.5 million available for investments, and has decided not to access any further debt financing.

The global supply of raw tea leaves continues to be a significant threat across the industry. Uncertain weather patterns caused by climate change threaten crops, particularly in high mountain environments, where the highest-quality teas are grown. Currently, the average price that KTI pays to purchase raw tea is $3.64 per kilogram, while the company's average sale price per kilogram to customers is $4.23 for KTI's private-label tea, and $5.78 for the new, KTI-branded tea. Since FWC's last engagement, KTI has expanded its supply of raw tea leaves by securing a contract with a group of tea farmers in Kenya. So far, the Kenyan raw materials that KTI has received are of even higher quality than those of KTI's Sri Lankan supplier.

Since taking control of KTI, Kathleen, Sabrina, and Jason have become a cohesive team, and are dedicated to upholding the mission and vision that KTI was founded upon. If possible, the board would like to maintain the long-term relationships that have been built over the years with KTI’s private-label customers. In addition, the board believes that KTI’s rich history of building relationships with traditional, ethical, and organic tea farmers sets the company apart from other tea companies. The board is convinced that this provides KTI with a competitive advantage.

KTI’s board is focused on growing the company’s revenue each year. Currently, the majority of KTI’s revenue is still generated from its private-label contracts. However, KTI would like a gross margin of at least 20% on all sales, which is becoming increasingly difficult to achieve from private-label sales, as these customers continue to put downward pressure on pricing during contract negotiations.

KTI's board has asked you to review the information provided and draft a report that discusses KTI's main strategic considerations, including strategically analyzing and making a recommendation for each proposal presented. For this engagement, please ignore any tax implications within your analysis and recommendations.

INDEX OF APPENDICES

APPENDIX I
BOARD MEETING DIALOGUE WITH CPA IN ATTENDANCE

January 9, 2025

Kathleen: Thank you, CPA, for assisting with our strategic planning. We are excited to build on the early success of KTI-branded products.

Jason: Yes, Kathleen. We have developed a three-year forecast for both KTI's expected sales demand and our supply of raw materials. The sales forecast is much higher than we originally anticipated. Given that we have a limited supply of raw materials, before we accept any sales order requests, we should revisit our strategy for how KTI will sell and market our new KTI-branded tea products.

Sabrina: I agree. Supply is a concern. If we cannot fulfil the sales orders that we agree to, our reputation will be harmed, and we will face penalties.

Jason: At this point in the company's evolution, I think KTI needs a website and online store where our customers can purchase tea directly from us. The website would put us in control of our marketing narrative, and the online store could help alleviate KTI from the strict supply requirements that are attached to most of the long-term sales contract offers that we have received.

Kathleen: But Jason, that might upset our existing customers. I don't think that's wise, especially because KTI's brand is still so young.

Sabrina: If we want to compete and maximize growth, an online store might be necessary. This would also allow us to leverage the unique origin stories and traditions of our tea farms. We should at least explore the idea.

Jason: I have put together some information for KTI's potential website and online store.

Kathleen: Opening an online store would only worsen our existing supply concern and would complicate our current operations. I think it makes much more sense to continue our focus on tea rooms and tea shops.

Regardless, we need to expand and secure our supply of raw tea, not only because the demand is there but also because we do not know how secure our current supply is, due to the ongoing threat of climate change.

APPENDIX I (CONTINUED)
BOARD MEETING DIALOGUE WITH CPA IN ATTENDANCE

Sabrina: Well, the good news is that we have an offer from Tea Taiwan Ltd. (TT). TT claims to be meeting the organic and Fairtrade production standards, but say they lack the experience required to complete the applications and audit processes necessary to become officially certified. TT would therefore like to collaborate with KTI. They want us to help with the certification process in return for a fixed-price raw material supply contract.

Jason: Interesting. If TT is already meeting the standards, we could certainly help them get certified. TT, which has been in operation for four years, is a modern tea processing farm with a good reputation and automated processes.

Sabrina: As long as TT is able to produce a consistent-tasting crop of black tea, it would likely satisfy the needs of KTI’s private-label customers. However, for our KTI-branded tea, TT’s tea is not likely to produce the unique flavours our customers have come to expect from our tea that is farmed in Sri Lanka and Kenya, so it probably won’t work for our branded tea products.

Jason: I agree, Sabrina.

Also, if we agree to the collaboration with TT, we could purchase some of their oolong or green tea to augment our current product line.

Kathleen: Speaking of contract offers, we have a big renegotiation coming up with our largest private-label customer, SaveCo, for their long-term contract renewal. SaveCo represents a large portion of our overall revenue, and they want to continue to offer our products.

Jason: Excellent news!

Kathleen: Certainly. However, this is my first contract negotiation without Michael, and I am already feeling the pressure from SaveCo—their first offer seems low. I don’t want to agree to a long-term contract with this low of a profit margin.

Sabrina: If we are not happy with the margin, why renew SaveCo’s contract? Why not use our limited supply of raw tea to make products for KTI-branded tea, which produce a higher margin?

Jason: Good point, Sabrina.

APPENDIX I (CONTINUED)
BOARD MEETING DIALOGUE WITH CPA IN ATTENDANCE

Kathleen: Okay, but we cannot ignore that most of our revenue still comes from private-label contracts. Michael worked hard to build KTI's long-term relationships, and they provide KTI with security and stability. We have already agreed that maintaining these relationships would be ideal for KTI.

Sabrina: I guess I am just a little disappointed that we use our supply of Sri Lankan tea to satisfy our private-label contracts. It seems like a waste of these high-quality raw materials.

Kathleen: SaveCo's contract requires that they approve any changes in quality or taste, but replacing the raw materials we use to satisfy the contract is a possible negotiation tool.

Jason: We have another opportunity. As you know, some of the world's best black, green, and white teas are grown in Nepal. However, the Himalayan mountains have always presented logistical challenges, as many regions are not accessible by road. But for the Manang District, that recently changed when a newly-constructed road was opened. Vehicles can now access the remote region. In Manang, there is a tea farm called Mandala Farms (Mandala) that would like to expand operations. Mandala has proposed an agreement whereby KTI will provide its expertise in exchange for the exclusive purchasing rights to Mandala's raw tea leaves.

Sabrina: Wow, Nepali tea would be a dream to work with! Remote farms in Nepal have very traditional production processes. Everything is done by hand and the farmers' knowledge has been passed down for generations. Are these farms organic and Fairtrade certified?

Jason: Unfortunately, no. The purpose of the agreement is for KTI to help Mandala meet these standards. The process will be a challenge. However, if Mandala's current operations are high quality, I am confident that the farm will eventually meet the requirements for certification with our help. This will take at least two years, maybe more.

Kathleen: It sounds like exactly the type of raw materials we want to secure for KTI-branded tea. However, the contract's purchase price for raw materials is slightly higher than KTI's current average, and Mandala requires both an upfront and an annual payment to support their operations.

APPENDIX I (CONTINUED)
BOARD MEETING DIALOGUE WITH CPA IN ATTENDANCE

Sabrina: It would be wonderful to have another supply of high-quality raw materials that R&D could work with, to produce desirable new tea blends and flavours. Mandala's tea might be able to provide this.

Kathleen: Next up, we recently received a proposal from a tea room company, AuthenticiTea Brewing Company (ABC). In the past, ABC has purchased batches of KTI-branded tea, and their customers want more! ABC now wants to sign a long-term purchase contract.

Jason: It is great that KTI-branded tea is gaining popularity, but I am not sure that selling through tea rooms and tea shops is the best strategy. It limits KTI's scope. If we commit long-term, we will have less supply to devote to other sales channels.

Kathleen: I don't agree, Jason. ABC is a big player in the tea room segment. They only sell the highest quality tea from exclusive brands. This contract would secure our position within ABC's stores for years to come.

Sabrina: KTI-branded tea is clearly in high demand. We have received many proposals from both existing customers and potential new customers that want to sell KTI-branded tea within their stores. Some of these proposals are long-term, like ABC's, whereas others are more like the one-off batch sales that we have made for KTI-branded tea products in the past year.

Kathleen: That's true, Sabrina. But I particularly like ABC's offer, given how well known and popular their tea rooms are. ABC mentioned an interest in expanding our contract in the future to include KTI-branded tea within their entire global network of tea rooms. That is an amazing opportunity!

Jason: The margins from long-term contracts are typically lower than those from shorter term contracts. Is that the case here?

Kathleen: Yes, but that is customary. The trade-off is that we would reduce our risk by securing some long-term revenue for KTI-branded tea, something we have yet to do.

We clearly have much to consider. Meeting adjourned.

APPENDIX II
EXCERPTS FROM KTI'S FINANCIAL STATEMENTS AND FORECAST

Kingsdale Tea Inc.
Partial Income Statement
(in thousands of Canadian dollars)

	2024 Draft
Revenue	
Revenue – private-label	$ 44,945
Revenue – KTI-branded	16,446
Total revenue	61,391
Cost of sales	
Cost of sales – private-label	38,675
Cost of sales – KTI-branded	10,690
Total cost of sales	49,365
Gross profit	$ 12,026

APPENDIX II (CONTINUED)
EXCERPTS FROM KTI'S FINANCIAL STATEMENTS AND FORECAST

Kingsdale Tea Inc.
Sales Demand and Supply Forecast
(in thousands of kilograms)

	Actual	**Forecast**		
	2024	**2025**	**2026**	**2027**
Private-label	10,625	10,838	11,055	11,276
KTI-branded (Note 1)	2,845	4,268	6,402	9,603
Total sales	**13,470**	**15,106**	**17,457**	**20,879**
Current supply (Note 2)	15,000	15,000	15,000	15,000
Over/(short)	1,530	(106)	(2,457)	(5,879)

Note 1 – The forecast for KTI-branded tea is based on sales orders that have already been requested by tea rooms and tea shops. These orders have yet to be accepted.

Note 2 – KTI's current supply of raw tea leaves comes from Sri Lanka and Kenya.

APPENDIX III
WEBSITE AND ONLINE STORE DETAILS

Prepared by Jason Galinsky

Given that KTI lacks the knowledge and expertise required to both develop and maintain the proposed website and online store, these functions would need to be outsourced. The initial setup costs are estimated to be $800,000.

Once the website and online store go live, KTI will need to pay approximately 5% of online sales revenue to the service provider for things such as ongoing maintenance and website upgrades. KTI would also need to set up an internal team that would handle any customer support issues—this will cost an estimated 2% of sales. Shipping costs are estimated to be 3% of sales, and all other operating costs associated with the project are estimated to be 2% of sales. KTI would also likely need to hire several new staff members to manage this new aspect of KTI's business. KTI would like to use a 4.5% discount rate when assessing the potential value of this project.

	2026	**2027**	**2028**
Online sales forecast *(in thousands of kilograms)*	2,500	4,000	6,000

This forecast only includes the expected demand for the highest quality KTI-branded tea that we can offer. This demand can only be satisfied with the best raw materials. Based on market research, an estimated selling price of $5.80 per kilogram seems reasonable for these products. Also, it would be a great advantage to showcase the special and unique way each tea was developed, as this would help KTI gain more notoriety on social media. However, it is also likely that KTI could sell lesser-quality teas via the online store, although these tea types would need to be sold at a lower price.

If KTI were to run out of stock for a product offered on the online store, the item would be marked as "SOLD OUT," and customers could then sign up for alerts for when that item once again became available. Showing our products as sold out may help KTI's brand grow a reputation of being exclusive, because our products have limited availability.

Finally, the more variety that we can offer via the online store, the better—our research shows that the typical consumer of KTI-branded tea has a strong desire for diverse options.

APPENDIX IV
TEA TAIWAN LTD. CONTRACT DETAILS

Prepared by Sabrina McLean

Details of TT's Offer

- KTI must commit to purchase a minimum of 2,500,000 kg of black tea per year, for $3.26 per kilogram. However, as TT's certifications are not likely to be received until the end of 2025, TT will waive the minimum purchase requirement in the first year (2025).
- TT will grant KTI the option to purchase up to an additional 4,500,000 kg of black, green, and/or oolong tea per year, at the same price as above.
- KTI will prepare and file TT's Fairtrade and organic certification applications, oversee the initial audit process, and pay any applicable certification fees. These costs are estimated to be $2 million.
- The contract's initial term is for five years, with an option for KTI to extend the contract for another five years, at KTI's discretion.

Other Information

TT is a large tea farm close to Taipei that has taken their naturally productive, lower elevation tea farm and automated its processes, to allow for efficient tea farming. TT is mostly known for its oolong and green tea, but the farm was recently expanded to grow black tea, to meet the export demands of this popular variety.

TT's farm has withstood several extreme weather events in the past several years, which did not greatly impact TT's annual crop yield. As TT is located close to a major city and airport, the farm is well situated from a logistical perspective.

APPENDIX V
SAVECO PRIVATE-LABEL CONTRACT RENEGOTIATION

Prepared by Kathleen Galinsky

Contract Renewal Offer from SaveCo

SaveCo was one of KTI's original customers, and currently provides 16% of KTI's overall annual gross revenue. SaveCo's current contract, which is for 2,300,000 kg of tea annually, at $4.33 per kilogram, expires on December 31, 2025.

SaveCo's initial offer is as follows:

- A term of ten years.
- SaveCo will purchase 2,500,000 kg of private-label tea annually, for $4.31 per kilogram.
- SaveCo will only accept Fairtrade and organic-certified black tea.
- Packaging specifications will be updated to require 100% recycled cardboard.

Negotiation Notes

- Although KTI has the reputation of being a reliable source of quality Fairtrade and organic certified tea, there are several other suppliers that could satisfy the SaveCo contract.
- SaveCo has expressed interest in potentially expanding the contract beyond just private-label tea in the future, to include an assortment of KTI's new branded products. SaveCo has indicated that, given the two companies' long-standing relationship, our KTI-branded tea would be displayed on premium shelf space.
- The required new packaging is not available through our current packaging supplier, so KTI will have to find a new supplier in order to fulfill this aspect of the contract.
- KTI's other private-label customers are eager to know the outcome of this negotiation, so they can prepare for their own renegotiations. Most of KTI's existing private-label contracts are due to be renewed within the next three years.

APPENDIX VI
MANDALA FARM AGREEMENT DETAILS

Prepared by Jason Galinsky

From the sample of teas provided by Mandala, it is evident that the farm's current farmers have incorporated their culture's traditional knowledge of tea cultivation. The quality of Mandala's raw materials is very high. I would be proud to use it for KTI-branded tea. The issue is ensuring that Mandala earns the organic and Fairtrade certifications, which, given the remote location of the farm, could make the process more challenging.

Mandala has not begun the certification process and currently lacks an awareness of what is required to become certified. Therefore, it is likely that many steps will need to be taken before Mandala's operations meet the standards. Further, the applications need to be signed by the Nepali government, and we do not have experience working in that jurisdiction. There could be additional fees and tariffs.

Mandala's tea is grown and processed using traditional methods that have been used for hundreds of years. Mandala farms black, green, and white varieties of tea.

Agreement Terms

- KTI will provide a one-time, upfront payment of CA$1.5 million upon signing the agreement. These funds will pay for the necessary infrastructure upgrades and certification administration assistance, over the next two years.
- Starting in the second year, KTI will provide an annual fixed payment of CA$425,000, to fund export costs.
- Over the ten-year contract term, KTI must purchase 100% of Mandala's annual crop production (which will not exceed 3,000,000 kg per year, given Mandala's land size).
- KTI's cost to purchase Mandala's raw materials will be set at $3.88 per kilogram for the duration of the contract.

KTI would like to use a 15% discount rate when assessing the potential value of this project.

APPENDIX VI (CONTINUED)
MANDALA FARM AGREEMENT DETAILS

Mandala Farm
Organic and Fairtrade Tea Crop Forecast
(in thousands of kilograms)

	2025	**2026**	**2027**	**2028**	**2029**
Tea production	0	0	1,500	2,000	2,500

APPENDIX VII
AUTHENTICITEA BREWING COMPANY PROPOSAL

Prepared by Sabrina McLean

AuthentiTea Brewing Company (ABC) is a popular tea room chain. ABC's target market is the younger tea-drinking demographic that is willing to pay a premium for a unique and ethically-sourced product. ABC was drawn to KTI's new branded products, given their superior taste and quality, and because of the unique traditions and stories behind KTI's suppliers in Kenya and Sri Lanka.

ABC has proposed a contract to purchase KTI-branded products, for resale in ABC's North American tea rooms and online store.

The contract proposal is as follows:

- The contract is for five years, beginning in 12 months, whereby ABC will purchase a guaranteed minimum of 1,500,000 kg of KTI-branded tea per year.
- KTI must provide four blends of tea, changing them annually. KTI will be responsible for creating the new blends; however, there must be two spiced, one black, and one other type of tea per year.
- ABC will pay $4.88 per kilogram.
- ABC will be responsible for paying for shipment of the product.
- If KTI is unable to meet the guaranteed purchase minimum, ABC will charge KTI a penalty equal to 20% of the contract's annual value for each year the minimum is missed.
- All tea must be Fairtrade and organic certified.
- Each tea type must also include a marketing story, detailing the origin, production methods, and tasting notes of the blend; ABC will require this information to be included on product packaging.
- ABC does not require the exclusive sales rights to the teas they purchase from KTI; therefore, KTI retains the right to sell any teas produced to other customers.

APPENDIX F

DAY 1 (KTI VERSION 2) – MAY 28, 2024
MARKING GUIDE AND SAMPLE CANDIDATE RESPONSE

DAY 1 MARKING GUIDE
KINGSDALE TEA INCORPORATED (KTI)
VERSION 2

Summative Assessment #1 (Situational Analysis)

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 KTI.

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

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

Based on the 2022 Competency Map:

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

Enabling Competencies
1.4.1 Performs work carefully, thoroughly and competently in accordance with relevant technical and professional standards
2.1.1 Applies knowledge of the organization's competitive environment and strategic direction when performing assigned work
2.1.3 Identifies the strategic impact of internal decisions and external influences on project plans and initiatives
6.1.1 Identifies and articulates issues within areas of work responsibility
6.2.1 Maintains an objective and questioning mindset to avoid biased analyses

The candidate is expected to complete an appropriate situational analysis. The candidate should draw upon their situational analysis when analyzing the major issues facing KTI (development and offer of online store, supply agreement with Tea Taiwan Ltd., private-label contract renegotiation with SaveCo, supply agreement with Mandala Farm, and long-term contract with AuthenticiTea Brewing Company). The candidate should also identify the major issue of the lack of supply for meeting forecasted demands, and the impact that may have on their choices of strategic options.

The focus should be on updating the situation since Capstone 1 and describing the factors that have changed, and the key factors that are relevant to the decisions to be made. Recapping parts of the vision/mission and relevant KSFs, and presenting relevant elements of the SWOT, is appropriate.

Current Situation

A major change has occurred since Capstone 1. Michael is no longer involved in KTI and has given control of the company to his three children. Michael was a major influence in the company, and his children now have the ability to take KTI in a new direction. Although they are not interested in changing the values of the company—they are still very much dedicated to upholding them—they see the potential to leverage the high-quality, organic, and Fairtrade teas that Michael worked so hard to secure, to produce products that showcase the quality of KTI's tea and demand higher selling prices. Overall, KTI's board would like to grow the company's revenue and achieve a gross margin of at least 20% on all sales.

Since Capstone 1, KTI has launched a highly successful branded-tea product called Kingsdale Tea (KTI-branded tea), which was promoted by tea rooms eager to showcase the unique story behind KTI's tea farmers. This has increased the visibility of KTI-branded tea products and driven demand above expectations. KTI has built a sales forecast for the next three years and is forecasting a shortage of raw materials, beginning in 2025. This will make it challenging to meet the expected sales demand of the new branded products while still satisfying KTI's existing long-term customer base of private-label contracts.

Although the shareholders are excited about the KTI-branded tea sales and its initial success, most of the company's revenue is still generated from private-label contracts. However, most of these contracts will be coming up for negotiation shortly, and the customers continue to demand lower prices, squeezing KTI's shrinking margins even further. With the rising cost of raw materials, it will be increasingly difficult for KTI to meet its gross margin objectives for private-label contracts. KTI also has the opportunity to sell KTI-branded teas at higher prices relative to the private-label products because the consumer demographic is willing to pay more for these high-quality products. However, with KTI-branded tea sales, the overall revenue volume is still low, and is more unpredictable than the security that the long-term private-label contracts offer.

Vision/Mission

KTI's vision, mission, and core values, approved by the board in 2018, are as follows (no change from Capstone 1):

Vision statement: *We envision an environment where a high-quality tea is produced by fairly compensated farmers; our customers enjoy a pure, complex, and pleasant experience every time they drink a cup of our tea; and everyone involved in the process is treated with honesty, fairness, and respect.*

Mission statement: *Do right by the farmers and our customers and far exceed consumer expectations daily. We produce our tea in an ethically responsible manner, and its distinctive taste and high quality inspire loyalty in our consumers. We strive to bring the health benefits of tea in all its forms to individuals.*

<u>Core values:</u>

1. Produce extraordinary organic, Fairtrade tea.
2. Build long-term relationships with farmers, suppliers, customers, and consumers.
3. Build a brand that is known to be ethical and respected.
4. Treat all employees with fairness, honesty, and respect.
5. Ensure ethical, sustainable, and environmental standards are adhered to and followed throughout all of our processes, from farm to table.

New Objectives

KTI's stated objectives are to:

- increase revenue.
- ensure a suitable supply, to meet the sales demand.
- obtain a gross margin of at least 20% on all sales.
- if possible, maintain the long-term relationships with the company's private-label customers.

KTI has several existing long-term contracts with the company's private-label customers, and there is a growing demand for KTI-branded products. However, the company's growth is limited by a forecasted shortage in raw materials. This constraint will determine whether KTI can leverage the higher margins and potential growth of KTI-branded tea sales while maintaining the large revenue source from its long-term, private-label contracts. Navigating the supply shortage will require consideration of how to meet demand without compromising the company's values and profit-margin objective, or by taking on too much risk.

Available Cash Flow /Financing

KTI's financial results have improved, due to the increase in cash flow generated from the sale of KTI-branded tea products. KTI currently has $4.5 million available for investments and does not want to access any further debt financing.

Candidates are NOT expected to recap KSFs and SWOT in detail. However, they must draw upon these in their analysis of the strategic options presented.

Key Success Factors (KSFs)

KSFs in the tea-producing industry include the following:

- Effective product development, to adapt to changes in consumers' preferences
- Product differentiation, to maintain market share
- Economies of scale and scope, to keep per-unit costs low
- Ability to pass on raw material input price increases to customers
- Long-term, reliable supply contracts with overseas suppliers, to ensure a guaranteed supply of tea leaves
- Strong relationships with retailers, to ensure premium shelf spacing in their stores
- Strong brand recognition, achieved by spending significantly on marketing and having a reputation for delivering an exceptional consumer experience
- Compliance with government regulations for food production and for organic and Fairtrade certifications (if used)

SWOT Analysis

Strengths:

- KTI has good relationships with farmers who supply high-quality, organic, and Fairtrade-certified raw materials, which allows KTI to set higher prices and achieve higher gross margins.
- The research and development department is high-performing and has the ability to offer new and interesting teas, to meet the demands for branded products.

- The board is a cohesive team, interested in moving forward to meet the company's objectives. They recognize that the company has significant strengths it can leverage, to increase revenue and gross margin.
- The recent launch of branded tea was successful, and increased sales demand is forecasted for future years.
- The board remains dedicated to KTI's vision, mission, and values, which have been a stronghold of their success since the company was founded.
- KTI has experience with helping farms meet the organic and Fairtrade standards and prepare for certification audits.

<u>Weaknesses:</u>

- The gross margin target of 20% will be difficult to achieve on private-label contracts because customers continue to put pressure on pricing during contract negotiations.
- Demand forecasts due to branded growth are outpacing the current tea supply. In 2025, there will be a shortfall of supply, which increases each year thereafter. Unless resolved, this will limit KTI's ability to grow its revenue.
- Michael has retired. He was the point of contact, and the person who built KTI's successful long-term relationships with customers over the years. Without him, there may be difficulty with negotiations. Some customers appear to be trying to receive lower-priced contracts.
- Currently there is no marketing in place for the branded-tea products. The launch was successful because it was promoted by popular tea rooms that enjoyed the tea and its story. A marketing strategy is needed, to ensure continued and reliable demand.

<u>Opportunities:</u>

- KTI is at a stage of the company's development where having a website and online store seem like an important addition. Most tea producers have a website, and KTI has the opportunity to follow suit by offering its own.
- The research and development department is doing excellent work that can be leveraged for selling a variety of branded teas as part of the industry trend. This allows for more creativity in research and development, to diversify the types of tea offered.
- There is an opportunity to support the organic and Fairtrade certification of the Tea Taiwan farm and secure the ongoing purchase of larger volumes of tea (black, green, and oolong). KTI could then use this organic and Fairtrade tea to produce lower-priced teas and satisfy the price-conscious private-label contracts.
- To satisfy supply requirements, there is the opportunity to reallocate tea used in long-term contracts to branded sales, where higher margins can be obtained.
- KTI's strengths and experience in obtaining organic and Fairtrade certifications with farms can allow it to obtain exclusive purchase contracts with tea farms, and better control its future tea supply.

- All KTI's small farms produce tea using traditional methods that create the type of stories and history in which discerning branded-tea customers are interested. KTI has the opportunity to leverage these stories when marketing its branded teas, to engage customers with the brand and satisfy those demands of the branded-tea-purchasing demographic.

Threats:

- With a forecasted shortfall of raw material supply, KTI must consider how to uphold its values and supply its customers with suitable tea products, if it is going to meet its objectives of growth in revenue and uphold its objective margins.
- Climate change and associated volatile weather events continue to harm tea production, particularly at high-elevation farms. This may affect the supply of raw materials, especially from small, high-elevation farms.
- The new sales stream of branded sales is not yet based on long-term contracts with customers; therefore, the sales demand forecasted for future years is uncertain.
- Kathleen will be negotiating the first of the long-term sales contracts that have expired since Michael retired. There is the potential to cancel the SaveCo contract, to reallocate the tea to KTI-branded tea sales at a higher margin. However, other long-term customers may be concerned about their relationship with KTI if this contract is not renewed, which could impact KTI's relationship with all private-label customers, threatening the majority of the company's revenue.
- Teas grown at high mountain elevations and using traditional processes are more often affected by climate change and weather events, which could significantly affect the sustainability and predictability of KTI's supply.
- Obtaining a new contract for supply from a small farm (such as the Mandala Farm) can take several years, due to requirements for meeting the organic and Fairtrade standards for certification. This could leave KTI short of the "right" supply for the next two years, or longer if the certifications are not achieved.

Conclusion on the Situational Analysis

KTI is looking forward to a new direction of branded sales with its KTI-branded tea; however, the long-term, private-label contracts currently make up the large majority of its revenue. To meet the objective of a higher percentage of KTI's revenue coming from the higher margin of KTI-branded tea sales, the company will need to ensure that it has a sufficient quantity of raw tea to supply each sales contract in place, and enough supply to meet its entire sales demand. It will also need to pay attention to the company's overall strategy, to ensure that it maintains growth without jeopardizing any quality standards and values in tea production and sales. With a long-term focus on increasing margins, and highlighting the excellent quality of its tea to customers, the company must work within its current supply constraints to build its strategy.

Summative Assessment #2 (Analysis of 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 KTI.

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

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

Technical Competency
2.3.3 Evaluates strategic alternatives

Enabling Competencies
1.1.3 Exhibits ethical behavior by complying with laws and regulations, organizational policies, societal norms and personal ideals
6.1.2 Uses qualitative and quantitative techniques to clarify the nature of problems
6.1.3 Demonstrates skepticism, objectivity, due care and persistence when identifying issues
6.2.3 Questions the relevance and tests the quality of information and assumptions in own analyses
6.2.4 Completes thorough quantitative and qualitative analyses to identify and evaluate potentially viable alternatives

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

Assessment Opportunity #2 (Strategic Issue #1: Develop website and offer online store?)

The candidate is expected to complete both a quantitative and qualitative assessment of whether KTI should develop a website and offer the company's products via a new online store.

Quantitative analysis: The candidate should calculate the NPV of the website/ online store proposal, and discuss whether the project meets the board's objectives of increasing revenues and achieving a gross margin of at least 20% on all sales.

Qualitative analysis: The candidate should discuss the advantages and disadvantages of the website/ online store proposal, and discuss how the proposal could affect the company's supply constraint.

Conclusion: The candidate should offer a conclusion that incorporates and logically follows from their quantitative and qualitative analyses.

KTI is considering the best alternative for selling the company's new branded teas. To date, these products have only been sold through tea rooms and tea shops. Jason thinks that it might be time for KTI to develop a website and offer an online store, where KTI's customers can purchase KTI-branded tea directly. If the company decides to move forward with this option, it will need to allocate a portion of its supply of tea, which is already forecasted to run out in the current year, 2025. Therefore, if KTI chooses this option, the amount of tea it can allocate to other sales channels—such as long-term contracts for KTI-branded tea—will be decreased.

Quantitative Analysis

Based on the information provided by Jason in Appendix III, the following projection was calculated.

Net present value analysis for the website/ online store:

		Initial Cost	2026	2027	2028
Net cash flows from online sales					
Annual sales (in kilograms)			2,500,000	4,000,000	6,000,000
Selling price per kilogram	$ 5.80		$5.80	$5.80	$5.80
Annual revenue			$14,500,000	$23,200,000	$34,800,000
Cost of goods sold	$ 3.64		9,100,000	14,560,000	21,840,000
Gross profit			5,400,000	8,640,000	12,960,000
Service provider costs (% of sales)	5%		(725,000)	(1,160,000)	(1,740,000)
Customer support (% of sales)	2%		(290,000)	(464,000)	(696,000)
Shipping costs (% of sales)	3%		(435,000)	(696,000)	(1,044,000)
Other operating costs (% of sales)	2%		(290,000)	(464,000)	(696,000)
Operating cash flow			3,660,000	5,856,000	8,784,000
Initial cost		$ (800,000)			
Present value factor	4.5%	1,0000	0.9569	0.9157	0.8763
Present value		(800,000)	3,502,254	5,362,339	7,697,419
Net present value		$ 15,762,012			

According to this projection, the investment appears to be a strong one. The project has an attractive net present value and a gross margin percentage of 37%, which far exceeds the company's objective of 20%. The project would also help to grow the company's revenue—more so than any of the other options available, given that KTI can sell its branded products for $5.80/kg in the online store. (The other options have lower selling prices, such as the $4.88 that ABC is offering KTI with its long-term contract proposal.)

However, as Jason noted, KTI lacks the knowledge and expertise required to develop the website and online store. Therefore, it might also be possible that the data Jason provided for the forecast is not accurate. Before KTI decides to move forward with this project, someone with knowledge about this type of project, and of online marketplaces, should assess whether the projection is accurate. It is possible that there are missing costs and that the projection is overly optimistic, given that KTI has not engaged in much marketing for the branded tea.

From a quantitative perspective, this option should be accepted, since KTI has the investment capital required and the project meets the company's stated objectives. However, it is also important to note that, at the moment, KTI does not have the supply necessary to fill all the orders that Jason expects to receive in any of the three years projected above. If KTI moves ahead with this project and does not expand its current supply, it would need to find some other source of supply (such as through the expiring SaveCo contract).

Qualitative Analysis

Advantages:

- Relative to KTI's current supply constraint, this option appears to offer an attractive amount of flexibility. If KTI were to run out of stock for a particular product, that product would be marked as "SOLD OUT" on the company's website. This might enhance the exclusivity of KTI's branded teas, and would also help the company avoid the penalties for shortages that some of the company's other sales channels have (such as the penalty attached to ABC's proposed long-term contract). This degree of flexibility is very important, given KTI's supply constraint.
- With a website, KTI would be able to take control of its marketing narrative, which would help to grow its brand. A website would also allow KTI to leverage its competitive advantage of having unique and traditional sources of high-quality and ethically-sourced tea.
- It is customary for companies to have websites today. As Sabrina mentioned, an online store is likely necessary if KTI wants to compete and maximize the company's growth.

- Jason also mentioned that the more variety KTI can offer on its online store, the better. This requirement may already be filled by KTI's existing suppliers of high-quality tea. In addition, KTI has the opportunity to expand its supply and number of tea types even further by deciding to work with either TT or Mandala.
- Opening an online store would allow KTI to carry out both its vision and mission in a more effective way, given that the company would be selling directly to the end consumer.

Disadvantages:

- Because KTI is challenged by a supply constraint, the company may not have an adequate amount of product to sell on this new platform. KTI's plan is to simply mark a product as "SOLD OUT" on the online store, but if this happens too frequently, customers could be dissatisfied, and may not return to the company's website. Therefore, the company should ensure that it has enough product to offer in the online store before moving ahead with this option.
- The company's existing customers for KTI-branded tea (tea rooms and tea shops) may be upset because the tea drinker would no longer need to go to the tea rooms/shops, and would instead be able to purchase the product directly. This may harm KTI's existing relationships.
- As Kathleen pointed out, the existing supply constraint could get even worse if KTI opens an online store. Therefore, if the company decides to move forward with the project, a requisite amount of analysis will need to be done, to ensure that it can still meet its existing obligations.
- KTI has no experience in this area and would need to outsource the development and service requirements of the website and online store. Therefore, the success of the project is dependent on the strength of whomever KTI contracts with to complete the work. If the contractors do not perform at a high level, the project may not be as successful as the projection indicates.
- This project represents a significant new aspect of the company's business, and may take the board's attention away from other important areas, such as keeping current customers happy and alleviating the company's supply constraint. This option would move KTI into the retail tea market, which is different from what the company has done in the past.

Conclusion/Recommendation

If KTI can mitigate the company's existing supply constraint and have enough product to open an online store, this project is recommended. Even if KTI cannot find enough supply to offer via the online store, the company should still move ahead with developing a website. Because this has become so customary, it might inhibit KTI's growth if customers are unable to locate the company online.

This option appears to provide KTI with a flexibility no other current option provides because no penalties or strict supply requirements are attached to this project. In addition, the project appears to meet all of the board's objectives. At this time, it is recommended that KTI move forward with this project. The company has the available funds and incentives to do so.

Assessment Opportunity #3 (Strategic Issue #2: Tea Taiwan Ltd. proposal)

The candidate is expected to complete both a quantitative and qualitative assessment of whether KTI should accept Tea Taiwan Ltd.'s supply contract offer.

Quantitative analysis: The candidate should calculate the impact this contract could have on KTI's gross margin, and the payback period for the certification fees. The candidate should also discuss whether the contract would help KTI meet the board's objectives of achieving a gross margin of at least 20% on all sales.

Qualitative analysis: The candidate should discuss the advantages and disadvantages of the contract offer, and the option of using TT's tea to satisfy KTI's private-label contracts.

Conclusion: The candidate should offer a conclusion that incorporates and logically follows from their quantitative and qualitative analyses.

TT is a modern tea farm and producer close to Taipei that has taken its naturally productive, low-elevation tea farm and automated its processes to allow for efficient tea farming. TT has proposed a collaboration with KTI whereby KTI would help TT obtain the organic and Fairtrade certifications. In exchange, TT has offered KTI a fixed-price, raw material supply contract.

Quantitative Analysis

Analysis of contract offer:

TT is offering KTI a 10-year fixed price contract to purchase tea at $3.26 per kilogram. The minimum purchase amount is 2.5 million kilograms per year, except for the first year (2025), which has no minimum, since the certifications are not expected to be received until the end of the year. In return, KTI will be responsible for applying for the organic and Fairtrade certifications and overseeing the audits, which will cost the company an estimated $2 million.

Currently, KTI's average purchase price per kilogram of raw tea is $3.64, while the company's average sale price is $4.23 for private-label tea products, and $5.78 for branded-tea products.

TT's offer has the advantage of a locked-in tea price for the next 10 years. The cost to purchase TT's raw material supply is lower than KTI's current average tea purchase price. The difference between the TT purchase price and KTI's current average tea purchase price is $0.38 per kilogram ($3.26 - $3.64).

		GM %
Avg. selling price – private-label	$4.23	23%
Avg. selling price – KTI-branded	$5.78	44%

Given the average selling prices of KTI-branded tea and KTI's private-label tea, the lower cost of TT's tea would allow KTI to obtain a gross margin of at least 20% on both private-label tea sales (23%) and KTI-branded sales (44%). However, as Sabrina mentioned, TT's tea is not a good candidate to use for KTI-branded tea because the quality may not be high enough to satisfy the sophisticated taste of the typical KTI consumer. Nevertheless, KTI may be able to use TT's tea to satisfy the private-label contracts. This would allow KTI to earn a gross margin above the company's objective, while also allowing the company to reallocate its highest-quality raw materials, to produce KTI-branded tea.

Payback Calculation

Compared to sourcing KTI's supply needs at the current average purchase price, the upfront costs of the certification applications (cost estimate of $2 million) would be paid back in Year 3 of the contract.

	Payback Period				
	2026	2027	2028	2029	2030
Price of TT's tea	3.26	3.26	3.26	3.26	3.26
KTI's current average tea cost	3.64	3.64	3.64	3.64	3.64
Savings over average price	0.38	0.38	0.38	0.38	0.38
Kilograms purchased	2,500,000	2,500,000	2,500,000	2,500,000	2,500,000
Annual savings	950,000	950,000	950,000	950,000	950,000
Cumulative savings	950,000	1,900,000	2,850,000	3,800,000	4,750,000
Consulting fees paid in Year 1	2,000,000	Paid back in Year 3			

However, it is important to note that this analysis assumes that TT will obtain the organic and Fairtrade certifications by the end of 2025. This timeline could be overly optimistic, and should be assessed for reasonability by KTI before an investment decision is made. If it takes longer to achieve the certifications relative to the assumption, it would also take longer for KTI to pay back the initial $2 million upfront investment.

In addition, prior to making a final decision, KTI should determine the most appropriate discount rate to use for this investment, and then perform an NPV calculation. This will provide a more precise estimate of the contract's expected value, and a more comprehensive evaluation of the investment's potential

Quantitative Conclusion

This proposed contract offers KTI the opportunity to increase both its supply of raw materials and the gross margin it earns from private-label contracts. However, this outcome is only possible if KTI’s current private-label customers agree to switch the raw materials used in the private-label products. From a quantitative perspective, KTI should proceed with this proposal if the company’s private-label customers agree with this change.

Qualitative Analysis

<u>Advantages:</u>

- This option will help KTI achieve a gross margin of at least 20% on all sales (a KTI objective), since the price of the tea is lower than the cost of the tea KTI currently uses to satisfy its private-label contracts.
- Purchasing tea from TT will allow KTI to obtain a large amount of supply, and will help reduce the current supply constraint.
- Purchasing TT tea may help KTI shift more of its revenue to KTI-branded sales, since TT’s tea could be used to fulfill private-label contracts, freeing up the higher-quality teas for KTI-branded tea sales.

- TT is dedicated to becoming organic and Fairtrade certified, which is an important part of KTI's mission. To maintain KTI's company values, these certifications will need to be obtained prior to beginning to purchase this tea.
- Entering a long-term supply contract with TT satisfies the industry KSF of building long-term relationships with tea suppliers.
- By purchasing TT's tea for lower prices and replacing the higher-priced teas in the long-term private-label contracts, KTI is meeting the industry KSF of passing on the increased costs of tea supply to consumers, since the higher-priced teas will be sold for higher prices to branded customers.
- Taiwan is historically known for Oolong tea production, and also for producing green tea. KTI could purchase these teas, in addition to black tea, for use in research and development, to expand its product offerings for branded sales.
- Climate change impacts are not as volatile for this low-elevation farm with modern processes and systems in place. Therefore, the supply of TT's tea may be more reliable. The farm has been able to withstand some extreme weather events and still produce a consistent crop each year. Signing this agreement will therefore likely help to stabilize KTI's supply.

<u>Disadvantages:</u>

- Although TT claims that their tea farm meets the criteria necessary for obtaining the organic and Fairtrade certifications, this remains to be verified by KTI. It may be that TT's tea farm still requires some degree of effort to obtain these certifications, and it is also possible that the tea farm may never obtain the certifications. Any delay in the certification timeline (which is currently estimated to be complete by the end of 2025), would further hinder KTI's raw material supply constraint.
- Given that TT's operation is relatively new and utilizes automated processes, TT's tea likely does not have a good story to share with consumers, which will limit its ability to be used for branded-tea sales. This supply does not offer KTI the same competitive advantage that the company's supply of tea from Sri Lanka and Kenya provides.
- TT's tea does not align with KTI's competitive advantage of having long-term relationships with tea farmers that use traditional processes, since TT is a modern farm that uses automated processes and lacks the history of KTI's current suppliers.
- TT's teas are grown at low elevations, which typically produce tea of lesser quality than the high-elevation teas that KTI typically purchases. This could affect KTI's customer satisfaction, and the price it can command for this tea.
- The tea produced by TT is likely only suitable for private-label sales, given the production methods and lower quality relative to KTI's current suppliers. Private-label contracts require any change in raw materials to be approved. There is a risk that it may be difficult to convince KTI's long-term customers to substitute this tea.

Integration

- If KTI renegotiates the private-label contracts to include TT's tea instead of the teas that are more appropriate for branded sales, KTI will benefit in both segments because branded teas command a higher price than private-label teas. Using the lower-cost TT tea for private-label contracts will allow KTI to consider a lower price as part of the negotiations with customers while also meeting its gross margin objective of 20%. The high volume of TT tea available to purchase will allow the same amount of higher-quality tea purchased from KTI's current suppliers to be reallocated to KTI-branded tea sales growth, which will let KTI maintain the revenue from its private-label contracts and satisfy the growth forecasts for KTI-branded tea, to support overall company growth.
- KTI's forecasted 2025 demand for its private-label contracts is nearly 11 million kilograms. It is important to note that, even if all of KTI's private-label customers agree to use TT's tea to fulfill their requirements, KTI would still need to use roughly 4 million kilograms of the higher-quality raw materials to satisfy these contracts (under the assumption that KTI purchases the maximum amount of tea possible from TT, which is 7 million kilograms). Prior to making an investment decision, it is crucial that KTI verify whether its current private-label customers would allow for this switch in raw materials. If not, this investment would not make good strategic sense.

Conclusion/Recommendation

TT's offer could be an excellent opportunity for KTI to alleviate both the supply constraint and the poorly performing gross margins of its private-label contracts. However, it is important for KTI to recognize that the TT tea does not meet the standard required for KTI-branded tea. On that basis, if KTI accepts this offer, it would need to allocate the TT tea for fulfilling KTI's private-label contracts. The tea will still meet KTI's requirements of organic and Fairtrade certification, but it may not have the unique flavors that KTI's current supply provides. However, TT's tea may be a more reliable source of raw materials, given the farm's low elevation and seeming resilience to climate events. Nevertheless, it is critical that KTI establish whether its current private-label customers would allow for this switch in raw materials before a final investment decision is made.

Assessment Opportunity #4 (Strategic Issue #3: SaveCo private-label contract negotiations)

The candidate is expected to complete both a quantitative and qualitative assessment of the company's renegotiations for SaveCo's private-label contract.

Quantitative analysis: The candidate should calculate the contract's expected gross margin and discuss whether the contract would help KTI meet the board's objectives of increasing revenues and achieving a gross margin of at least 20% on all sales.

Qualitative analysis: The candidate should discuss the advantages and disadvantages of SaveCo's offer, and discuss how the option could affect the company's supply constraint.

Conclusion: The candidate should offer a conclusion that incorporates and logically follows from their quantitative and qualitative analyses.

SaveCo was one of the original customers that Michael built a relationship with after founding KTI, and is currently KTI's largest private-label customer, making up 16% of the company's revenue. SaveCo's private-label sales contract has come up for renewal, and KTI must now decide whether to accept SaveCo's initial offer, renegotiate the offer, or decline the offer altogether.

Quantitative Analysis

Contract length	10 years
Volume of tea (kg)	2,500,000
Offer price per kg	$ 4.31

	Using Current Supply	**Using TT's Supply**
Annual revenue	10,775,000	10,775,000
COGS (per kg)	$ 3.64	$ 3.26
Total COGS	9,100,000	8,150,000
Gross margin	1,675,000	2,625,000

Gross margin	**Average Tea Cost**	**TT Tea Cost**
SaveCo offer price of tea	4.31	4.31
Cost of raw materials	3.64	3.26
GM%	15.55%	24.36%

At the current average cost of tea, the gross margin percentage of the proposed contract is only 15.5%, which is much lower than the company's 20% target. If KTI decides not to pursue the contract with TT, it will be difficult to quantitatively justify continuing the long-term contract with SaveCo, since the gross margin from the contract will be well below the company's objective of 20%. However, the SaveCo contract represents 16% of KTI's overall annual revenue. Therefore, declining this offer will considerably reduce KTI's current revenue, and will not meet the board's objective to grow the company's revenue.

Regardless of whether KTI accepts the contract from TT, KTI should negotiate with SaveCo to increase the purchase price per kilogram of tea. As this is SaveCo's first offer, it might be possible to increase the price to a level where KTI could use its current supply of raw tea (which costs KTI $3.64 per kilogram) and still earn a positive margin on this contract.

Quantitative Conclusion

The strength of this contract largely depends on which supply of raw materials KTI uses to satisfy it. If SaveCo allows KTI to use TT's tea, KTI should move forward with the contract. However, if not, KTI may need to forgo the contract, given that it will not meet KTI's gross margin objective. In any event, KTI should also propose that SaveCo pay a higher price for each kilogram of tea that KTI provides.

Qualitative Analysis

Advantages:

- If this contract renegotiation requires KTI to use the high-priced Sri Lankan tea used in the past, it would not help the company meet its objective of obtaining a gross margin of at least 20% on all sales contracts. However, if raw material with a lower purchase price, such as tea purchased from TT, were used for this contract, the margins would be within KTI's target.
- Of KTI's current gross revenue, 73% comes from private-label sales. Although the company has launched KTI-branded tea products, KTI still relies on private-label sales for the majority of its revenue. The SaveCo contract alone makes up 16% of KTI's revenue, which is a large number of sales to have to replace with KTI-branded tea in order to maintain revenue. Currently, KTI-branded tea sales make up only 27% of revenue and 52% of its gross margin. Forgoing the renewal of SaveCo's contract (as Sabrina mentioned as a possibility) would free up supply of raw materials for KTI-branded sales in the future. However, KTI could experience a short-term decline in revenue until the freed-up supply is absorbed by KTI-branded sales.
- Negotiating the contract with SaveCo reflects KTI's value of building long-term relationships with customers. This could enhance KTI's relationship, not only with SaveCo but also with the rest of KTI's customers.

- Maintaining this contract enables KTI to fulfill its mission to provide high-quality, Fairtrade, and organic tea to it consumers on a large scale over the long term.
- Having a 10-year contract for a large amount of tea will help secure demand for KTI's tea, which will help support the company's long-term revenues.
- SaveCo is interested in discussing purchases of KTI-branded tea if the private-label contract is renewed, and is offering to place KTI-branded tea on premium shelf space, which is an industry KSF for selling teas. This contract renewal, therefore, offers KTI the potential to increase its branded sales.

Disadvantages:

- Given KTI's good reputation and long-term relationships with its customers, renegotiating this contract may influence the upcoming negotiations of its other contracts. Cancelling this contract may lead to other companies looking elsewhere for their contracts, and a potential loss of an even larger portion of KTI's reliable revenue.
- Private-label customers have always demanded low prices, despite KTI's high-quality, organic, and Fairtrade teas, for which KTI must pay a premium price. This is against the industry KSF of passing raw material prices onto customers.
- Forgoing the contract renewal would increase the risk of having excess tea in the next two years. Fulfilling this contract requires a significant portion (2.5 million kilograms) of KTI's entire raw materials, and per the current forecasts, there is a high risk that it will not be able to sell all the excess tea to other customers for the next two years.
- As part of SaveCo's contract renewal offer, KTI must update its packaging to 100%-recycled cardboard. As KTI's current packaging supplier is unable to provide this, KTI must find a new supplier. As this could increase the cost and complexity of the arrangement, KTI should investigate the options it has for satisfying this new condition prior to moving forward with the contract renewal.

Integration

- Both quantitatively and qualitatively, maintaining this contract is a relatively poor decision if KTI must use the current high-priced raw material supply from Sri Lanka or Kenya. If so, the contract's margin would be below the company's objectives. There would also be an opportunity cost of selling this high-quality tea, since it could attract a higher price as KTI-branded tea than under lower-cost, private-label contracts. The TT tea would be a suitable substitute for this contract because it will meet the Fairtrade and organic certification requirements but be less expensive to purchase, leading to better margins from the contract. However, SaveCo must first approve this switch in raw materials before a decision can be made. In addition, this strategy assumes that TT's tea will indeed obtain the necessary certifications by the end of 2025. This timeline may be overly optimistic, and if it takes longer than expected, KTI would still be forced to use its current supply of raw materials to satisfy the SaveCo contract.
- Substituting the less expensive tea from TT risks not satisfying KTI's mission of far exceeding its customers' expectations, since there may be a change in the tea's taste and quality with the change in raw materials.

Conclusion/Recommendation

The SaveCo contract is a large contributor to KTI's current revenue. As well, the result of this renegotiation could influence KTI's ability to maintain its other private-label customers. Losing all these customers in the next few years would mean losing 73% of the company's gross revenue and 52% of its gross margin, which goes against KTI's objectives. This is a large risk to consider. However, the private-label margins continue to be under pressure, and SaveCo's offer puts the margin well below the objectives for KTI if nothing is changed. This is a difficult decision, where a compromise in objectives must be made and justified. To solve this issue, KTI could recognize that the tea purchased from TT could meet the requirements for its private-label contracts, and the lower-priced raw materials are at a more suitable cost for what the private-label customers ultimately want: low-priced contracts. Therefore, KTI should present the change in raw materials as a compromise during negotiations with SaveCo in order to meet their price requirements, and potentially in future contract negotiations with other private-label customers.

Assessment Opportunity #5 (Strategic Issue #4: Mandala Farm agreement)

The candidate is expected to complete both a quantitative and qualitative assessment of whether KTI should accept Mandala's proposed agreement.

Quantitative analysis: The candidate should calculate the agreement's expected net present value and discuss whether the agreement would help KTI meet the board's objectives of achieving a gross margin of at least 20% on all sales.

Qualitative analysis: The candidate should discuss the advantages and disadvantages of the proposed agreement, and discuss how the agreement could affect the company's supply constraint.

Conclusion: The candidate should offer a conclusion that incorporates and logically follows from their quantitative and qualitative analyses.

Mandala Farms in the Manang District of Nepal has a new opportunity to expand their operations, now that a new access road has been built in the region. Mandala has proposed a collaboration whereby KTI would help Mandala obtain the Fairtrade and organic certifications, which will be challenging and will take at least two years. In exchange, Mandala will provide KTI with the exclusive purchasing rights to Mandala's raw tea leaves. If Mandala can obtain the certifications, KTI will likely be able to begin purchasing Mandala's tea in two years (2027). However, until then, Mandala will require an upfront payment, plus annual operating assistance payments, from KTI.

Quantitative Analysis

With the Mandala agreement, KTI will be able to purchase raw tea at a cost of $3.88 per kilogram, which is $0.24 per kilogram higher than the current average cost of tea of $3.64. In addition, there are annual fixed costs of C$425,000, and an upfront investment of C$1.5 million in the current year, that must be considered.

Capital required	$ 1,500,000
Annual fixed costs	425,000
Purchase price of tea per kg	3.88
Discount rate	15%

(000s)	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Yield in kg			1,500,000	2,000,000	2,500,000	2,500,000	2,500,000	2,500,000	2,500,000	2,500,000
Avg selling price for KTI-branded	5.78	5.78	5.78	5.78	5.78	5.78	5.78	5.78	5.78	5.78
Purchase price of Mandala tea	3.88	3.88	3.88	3.88	3.88	3.88	3.88	3.88	3.88	3.88
Margin from Mandala's tea	1.90	1.90	1.90	1.90	1.90	1.90	1.90	1.90	1.90	1.90
Gross margin ($)	0	0	2,850,000	3,800,000	4,750,000	4,750,000	4,750,000	4,750,000	4,750,000	4,750,000
Fixed costs to Mandala	1,500,000	425,000	425,000	425,000	425,000	425,000	425,000	425,000	425,000	425,000
Annual (loss) earnings	(1,500,000)	(425,000)	2,425,000	3,375,000	4,325,000	4,325,000	4,325,000	4,325,000	4,325,000	4,325,000
Present value factor	1	0.8696	0.7561	0.6575	0.5718	0.4972	0.4972	0.3759	0.3269	0.2843
Present value	(1,500,000)	(369,580)	1,833,543	2,219,063	2,473,035	2,150,390	2,150,390	1,625,768	1,413,843	1,229,598
Net present value	$ 13,226,050									

The net present value of the contract is approximately $13.2 million. The value of this contract may also increase if Mandala's annual crop yield exceeds 2.5 million kilograms (the size of the farm allows for a maximum annual yield of 3 million kilograms). The gross margin associated with this contract is 33%, which exceeds the board's objective of 20%.

From a quantitative perspective, this contract appears to be lucrative, and should be accepted.

Qualitative Analysis

Advantages:

- Pursuing a partnership that provides high-quality, traditionally-produced teas will contribute to increasing the percentage of revenue earned from branded teas while also growing KTI's sales, since this tea is the ideal raw material to use for commanding the high sales prices of branded teas.
- Pursuing this partnership would help ensure that KTI has a diversified supply of raw materials, as this would add another supplier of desirable tea for KTI-branded tea sales. Accepting that there are climate, and other, risks, KTI would have a steadier supply to meet its demand, given the exclusive purchase agreement offered by Mandala.
- Considering that the purchase price of Mandala's tea is close to the current average purchase price, and to the best quality, this tea would be able to command a selling price that would meet the board's objective of a gross margin of at least 20% on all sales.
- Provided that Mandala gains the Fairtrade and organic certifications, this partnership would align with the new competitive advantage identified by KTI's board, given that Mandala's tea uses traditional farming methods. In all aspects, the agreement is similar to KTI's past supplier relationships, and continues the small-farm legacy that Michael began.
- As long as Mandala obtains the Fairtrade and organic certifications, this is a high-quality tea that will be produced by fairly-compensated farmers, which is KTI's vision for all of its tea.
- Given that the Manang district is in the high-elevation Himalayas, it is likely to be a high-quality tea that is produced using traditional processes, which adheres to KTI's value of ethical, sustainable, and environmentally sound processes.
- The long-term, exclusive-purchase partnership aligns with the industry KSF of maintaining reliable supply contracts with overseas suppliers.

The Nepali tea is from a different location than KTI's current suppliers, which will add diversity. KTI can then develop a wider variety of KTI-branded teas to build its branded selection. Nepali tea is known for its quality and taste, and will be a fantastic addition to KTI's repertoire.

Disadvantages:

- Mandala's tea would not be certified Fairtrade and organic for at least two years, which will not help KTI meet its immediate demand forecasts. Therefore, this contract will not help KTI alleviate its supply constraint in the near future.
- The Himalayas are a high-mountain environment. Given the volatile climate, which is worsening due to climate change, Mandala's tea production is at risk of poor growing seasons and fluctuations in production yields. KTI has exclusive purchase rights but will risk not being able to purchase a reliable quantity of tea in years when the yield is poor.
- KTI will be responsible for guiding Mandala through the Fairtrade and organic certification processes, applications, and audits. This will take time and may be challenging, given KTI's lack of experience in working with farms in Nepal and adhering to their government requirements. This process may take more money and time than forecasted, which would interfere with tea pricing expectations and supply reliability in the next few years.
- The Fairtrade and organic certification applications may take longer than estimated, as the farm will just be beginning to work toward meeting the requirements upon starting the agreement. There may be unforeseen challenges that would add to the certification time.
- Mandala's tea will cost KTI more than its current average cost of sales, so it is important to recognize that this tea should not be used to fulfill KTI's private-label contracts, where it cannot command a high enough price to meet the board's gross margin objective.

Integration

- It is important to note that this option does not reasonably contribute to a solution to KTI's immediate supply issue and growth objectives, since the tea will not be certified to meet KTI's standards for at least two years. Potential challenges in gaining the certifications could result in that timeline being even longer.

Conclusion/Recommendation

The biggest risk of this option is whether Mandala will be able to obtain the Fairtrade and organic certifications. If this effort fails, KTI will have sunk both time and money into a project that is unable to provide the type of raw materials that KTI requires, for both its private-label and KTI-branded sales contracts. Therefore, before this project is accepted, KTI should conduct a thorough assessment of Mandala's operations, to determine the probability of obtaining the certifications. It should also determine how long this process is likely to take, given the need for the company to plan its supply and demand forecasts.

If KTI determines that the probability of achieving the certifications is favourable enough, it should pursue the project. This is because, from both a quantitative and qualitative perspective, this project is attractive, provided that Mandala receives the certifications. The additional quantity of raw materials will provide KTI with a hedge against future supply constraints, given the uncertainty surrounding climate change. Mandala's tea would also allow KTI to expand its KTI-branded product offerings, and would therefore allow KTI to further expand this new aspect of the company.

Assessment Opportunity #6 (Strategic Issue #5: AuthenticiTea Brewing Company proposal)

The candidate is expected to complete both a quantitative and qualitative assessment of whether KTI should accept the contract offered by AuthenticiTea Brewing Company.

Quantitative analysis: The candidate should calculate the contract's expected gross margin and discuss whether the contract would help KTI meet the board's objectives of increasing revenues and achieving a gross margin of at least 20% on all sales.

Qualitative analysis: The candidate should discuss the advantages and disadvantages of ABC's offer, and discuss how the option could affect the company's supply constraint.

Conclusion: The candidate should offer a conclusion that incorporates and logically follows from their quantitative and qualitative analyses.

ABC has approached KTI with a five-year contract offer to purchase KTI's branded teas, after being thoroughly impressed with the product ever since its initial launch. KTI's teas would be sold in ABC's trendy tea rooms across North America and within ABC's online store. The contract could also be extended in the future to include ABC's global network of tea rooms. The contract requires KTI to produce four different types of tea, changing them annually, including two spiced teas, one black tea, and one other type.

Quantitative Analysis

It is important to calculate the gross margin that would be achieved by the proposed pricing, to determine whether this contract will meet KTI's objective gross margin percentage.

Contract quantity per year	1,500,000 kg
ABC will pay (per kg)	$4.88
KTI's avg cost (per kg)	$3.64

	2026	2027	2028	2029	2030
Volume sold	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000
ABC will pay (per kg)	4.88	4.88	4.88	4.88	4.88
Total revenue from contract	7,320,000	7,320,000	7,320,000	7,320,000	7,320,000
Cost of goods sold	(5,460,000)	(5,460,000)	(5,460,000)	(5,460,000)	(5,460,000)
Gross profit	1,860,000	1,860,000	1,860,000	1,860,000	1,860,000

Potential Penalty for Supply Issues:

Annual contract value	$ 7,320,000
Penalty (%)	20%
Penalty ($)	$ 1,464,000

Overall, this option provides the security and volume of a long-term contract with a gross margin of 25%, which meets the objectives of KTI's board. However, it should also be noted that the gross margin associated with this contract offer is lower than what KTI expects to earn through the company's proposed online store (which is 32%). Therefore, given KTI's supply constraint, it would be more lucrative to sell KTI's branded products via its potential online store, should the company need to choose where to allocate its limited supply. Nevertheless, this contract meets the board's objectives and also confers other potential benefits, which are discussed in more detail below.

Qualitative Analysis

<u>Advantages:</u>

- Signing this contract would help KTI move toward its objective of increasing the percentage of revenue earned from KTI-branded tea sales, while also growing overall sales, since this is a long-term, large supply contract for the KTI-branded tea, something KTI does not have right now outside of its lower margin, private-label contracts.
- This contract would secure a reliable source of revenue, which would contribute toward the objective of revenue growth for KTI.
- Although there will be additional development costs associated with this contract, ABC does not require exclusive sales rights to the teas they purchase, so KTI could use these new tea blends within its other sales agreements.
- This contract aligns with KTI's value to produce extraordinary organic and Fairtrade teas, as the contract places value on the type of raw materials and unique farms KTI has partnered with.
- This contract could lead to a long-term relationship with ABC, which aligns with KTI's values of building long-term relationships with customers.

- Selling tea through ABC would allow KTI to take advantage of ABC's popular tea rooms. This is an opportunity to build its brand awareness within North America and potentially throughout all of ABC's global operations, should the contract be expanded in the future.

Disadvantages:

- Under the terms of the contract proposal, KTI would need to produce four new tea blends per year (two spiced, one black, and one other type). This will add an additional development cost to the contract, since KTI will be responsible for these new tea blends. KTI should estimate this expected expense, given that it was not included in the quantitative analysis.
- This contract is an excellent opportunity for KTI to secure a large-volume, long-term sales contract for the KTI-branded tea. However, it will be important to consider how KTI will meet the supply requirements to fulfill the contract. The contract requires tea with unique production methods and a story to tell customers, so using TT's tea would not be appropriate. Agreeing to this contract could further worsen KTI's existing supply constraint.
- Considering that the teas required to fulfill this contract are those that are most vulnerable to the impacts of climate change and volatile weather (small, high-elevation farms), there is a risk that the supply of these teas will be variable each season, making it difficult to fulfill such a large, fixed-volume contract.
- If KTI is unable to meet the yearly guaranteed purchase minimum, it will be forced to pay ABC a penalty of nearly $1.5 million, the contract's annual value. This is a significant risk, given KTI's current supply constraint, as well as the risks associated with climate change. Before agreeing to the contract, KTI should try to remove this clause from the contract altogether, or at least have it reduced.

Integration

- To supply this contract with KTI's highest-quality raw materials, either the SaveCo contract will have to be cancelled or TT's tea would need to be used to fulfill the SaveCo contract. This would free up the Sri Lankan tea that is currently used to fulfill SaveCo's contract. Mandala's tea is another option; however, those raw materials will not be available for at least two years, so it cannot be relied on for this contract.

Conclusion/Recommendation

The ABC contract is an excellent opportunity for KTI to consider because it aligns with the company objectives of revenue growth, meets the board's gross margin target, and aligns with KTI's vision, mission, and values of providing high-quality tea through long-term relationships with customers. Selling tea through ABC's popular tea rooms would give the KTI-branded tea further exposure, and by requiring that the farmers' stories are printed directly on the tea packaging, would help showcase the high level of Fairtrade and organic standards that KTI embodies.

The main difficulty with this contract is that it will further stress KTI's already short supply of raw materials, particularly those that KTI procures from its suppliers in Sri Lanka and Kenya. If KTI agrees to the terms of the contract ABC has proposed, the company will face the risk of having to pay a steep penalty if the yearly guaranteed minimum is not met. Before agreeing to the contract, KTI should either attempt to negotiate this penalty out of the contract or assess the likelihood of missing the guaranteed minimum.

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.

Enabling Competencies
6.3.1 Uses evidence and judgment to recommend and justify solutions or conclusions
6.3.2 Articulates limitations to recommendations
6.3.3 Applies decision criteria to choose among viable alternatives
6.3.4 Ensures that decision criteria do not conflict with professional ethics and values

The candidate's overall recommendation should integrate the analyses for all five major strategic options into an ultimate decision of how KTI could approach meeting the board's objectives, while also taking into consideration the company's supply constraint. The recommendations should be strategic in nature and display good professional judgment and logic, recognizing the interconnected nature of each option. Suggesting that further information is required is acceptable where justified and consistent with the analysis.

Strategic Alternatives

The option to develop a website and open an online store for KTI's products appears attractive. Not only would a website help promote the company's brand, but an online store would also provide KTI with an additional sales channel that has become customary within the industry. In addition, this option does not add an undue amount of risk to KTI's supply constraint because there are no penalties or strict supply requirements that come attached to this project. In fact, this appears to provide KTI with far more flexibility relative to the other available strategic options. At this time, it is recommended that KTI move forward with this project, if the company can satisfy itself that it has the requisite amount of raw materials to operate the online store. If not, KTI should consider postponing the launch of the online store until an adequate supply has been established.

The partnership option from TT seems like an excellent opportunity to achieve most of KTI's objectives: there is a plentiful supply of raw materials available for purchase; the price offered on the materials is much lower than KTI's current purchase price; and the tea supply will be available relatively quickly, since TT appears ready to apply for Fairtrade and organic certifications. However, despite TT's tea likely meeting the Fairtrade and organic standards, the farm is relatively new, is at low elevation, and uses modern tea growing processes, so it does not appear to share the competitive advantage associated with KTI's other suppliers. However, the availability and reliability of TT's tea gives KTI the opportunity to use this lower-priced tea to fulfill the company's private-label contracts, given that these consumers may not require the quality that KTI's current suppliers from Sri Lanka and Kenya provide. Therefore, KTI should move forward with this option if its private-label customers, such as SaveCo, will allow it to use TT's tea to fulfill their contracts. If so, this agreement would help KTI relieve its supply constraint.

SaveCo's upcoming contract renegotiations present an interesting opportunity for KTI in terms of supply. Private-label customers have always pushed for lower prices despite KTI's high-quality, organic and Fairtrade teas. This has always put stress on the company's margins. However, SaveCo's contract represents a significant portion of KTI's overall revenue, and there are indications that not renewing this contract could jeopardize the rest of KTI's private-label contracts. Overall, KTI would need to grow its branded sales very quickly to replace all the potential lost revenue from this contract. However, there appears to be an opportunity to allocate the lower-priced tea purchased from TT to SaveCo's private-label contract. This change in raw materials could be used as a negotiation tool, to allow KTI to offer a lower-priced contract. If SaveCo is unwilling to negotiate the terms of the current offer, KTI should refuse to accept it.

There is an opportunity to partner with Mandala, a tea farm located in the mountains of Nepal. This would provide KTI with a well-suited tea supplier in terms of quality, traditional production, and exclusive rights. However, given the delay between committing to the agreement and being able to purchase tea due to the lengthy certification process, this alternative will not contribute any raw materials—to help address KTI's supply shortage—for the next two years. There is also the question of whether Mandala's farm will receive the certifications, because KTI does not have a clear understanding of Mandala's current operations. The purchase price of the tea is also higher than KTI's current average, and there is a risk that the supply will be volatile, given the effects of climate change on the growing season in the Himalayas. If this alternative is pursued, it is important to recognize that Mandala's raw materials could only be used to mitigate KTI's supply concerns in the future and not right away. In addition, the tea purchased from Mandala should be used specifically in KTI's branded-tea products, where KTI's margin objectives can be met, given the higher cost of Mandala's raw materials. Finally, before accepting this agreement, KTI should conduct thorough due diligence procedures over Mandala's current operations, to ascertain the likelihood of certification.

The popular tea room, ABC, has proposed a contract to purchase KTI's branded tea for sales within its trendy tea rooms. This contract has a five-year term and would require KTI to produce four new tea types annually. The contract's price is lower than the current average selling prices for branded tea, but it does meet the gross margin objective set by KTI's board. With this contract, KTI could also rely on ABC's promotion of the KTI-branded tea products, to gain popularity as a brand. However, this is a fixed contract that requires an adequate supply of tea that has a story to tell about its production methods and origins, and KTI is currently short on supply for this type of tea. Before KTI decides to move forward with ABC's proposal, it is vital that KTI determine whether it can fulfill the contract's supply requirements, especially given the penalty associated with missing the guaranteed annual minimum. KTI's ability to meet this requirement will be heavily influenced by whether KTI decides to move forward with other strategic alternatives that have been proposed and discussed. One potential solution would be to accept TT's supply proposal and then allocate the raw materials procured from TT to KTI's private-label contracts. This would free up the higher-quality raw materials that KTI procures from Sri Lanka and Kenya for the ABC contract.

KTI should first ascertain whether using TT's tea to fulfill the company's private-label contracts is a viable option. If so, a significant amount of high-quality raw materials could then be allocated toward the proposed online store and ABC's proposed contract. If the company can use TT's tea for private-label contracts, KTI should sign the agreement with TT and get started right away. Next, KTI should conduct thorough due diligence of Mandala, to ascertain the likelihood of the farm receiving certification. If the likelihood is high, KTI should move forward with this project as well. Finally, based on the results of those two options, the company should complete a new supply forecast. If the forecast allows, KTI should first open its own online store (given the high gross margin and no penalty risk), and then ascertain whether the ABC contract is still viable. It may be the most prudent move to forgo the long-term ABC contract, to lower the risk of non-compliance.

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 clearly 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 in order 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 excessive amount of spelling and grammatical errors.
- Unprofessional language is used.

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 the underlying key concepts were there.

Marginal Fail – Overall, the candidate provided an attempt at a response, one that contained several errors or where the analysis was incomplete.

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

To be assessed a Pass, the candidate is expected to perform adequately in all the summative assessments and demonstrate that, overall, they addressed the issues of all of the shareholders.

Markers considered 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 (current 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 – KTI VERSION 2

Below is an actual passing candidate response.

To: KTI board of directors

From: CPA

Re: strategic issues analysis

Situational analysis

vision - unchanged:

we envision an environment where a high-quality tea is produced by fairly compensated farmers, out customers enjoy a pure, complex, and pleasant experience every time they drink a cup pf tea, and everyone involved in the process is treated with honesty, fairness, and respect.

mission - unchanged

do right by the farmers and our customers and far exceed consumer expectation daily. we produce our tea in an ethically responsible manner, and its distinctive taste and high quality inspire loyalty in our consumers. we strive to bring the health benefits of tea in all its forms to individuals.

core value -unchanged

1. produce extraordinary organic, fair trade tea

2. build long-term relationship with farmers, suppliers, customers and consumers

3. build a brand that is known to be ethical and respected.

4. treat all employee with fairness, honesty and respect

5. ensure ethical, sustainable, and environmental standard are adhered to and followed throughout all of our processes, from farm to table.

KSF

- **new one**: rich story of building relationship with traditional ,ethical, and organic tea farmers

- **old ones:**

1. strong brand recognition

2. differentiated product to maintain market share

3. have economies of scale and scope to keep per -unit cost low

4. establish good relationship with grocery retailers to receive premium retail shelf space

5. adapt product to changes in consumer preference

constraint:

- $4.5 million available for investment

- not to access any further debt financing

objectives

- gross margin of at least 20% on all sales

- maintain long-term relationship that have been built over the years with private-label customers

SWOT

strength

- superior quality of raw tea leaves used in production, this can build a good reputation among the customers who prefer high quality products.

- KTI has a group of tea farmers in Kenya, who can provide higher quaility than those in Sri Lanka, this can guarantee the high quality of raw tea leaves supply to KTI.

weakness

- privae-label customer continue to put downward pressure ton pricing during contract negotiation with KTI, which might result in KTI's profit margin decreasing.

- no long-term contract have been siged for KTI new branded products, this result in unsecure demand of the products, and the sales can go down if the customers switched to other competitors

opportunity

- customers like the showcase of unique strong behind tea farmer, which can boost the sales. this provide opportunity for KTI to capitalize on this by providing more unique stories.

threat

- global supply continue to be a significant threat across the industry, due to the uncertain weather patterns, the highest quality tea area are heavily impacted, this can result in lack of sufficient supply to meet KTI's demand of raw tea, and loss of sales eventually.

- other privatelaber customers are waiting to know the outcome of negotiation with Saveco, and their contract to be renewed within the next three years. if the negotiation did not go well as expected, the other customers might not want to renew the contract with KTI, and switched to other competitors. This will result in loss of sales on private-label line.

financial assessment

- see exhibit 1, the overall gross margin in 2024 is 20%, just reach the target, however the gross margin of private label only 14%, and gross margin of KTI brand is 35%. this indicate KTI brand product contirbuted more on higher gross margin. given that 73% of sales are from private label, KTI need to consider how to increase the gross margin in private label, by increasing sale price, or decrease cost of raw material and other variable costs.

Proposal #1

Jason proposed to launch website and online store to allow customers directly place order from KTI.

Quant

see exhibit 2.

the NPV at 4.5% discount rate is $15,762,296, which indicate the proposal can earn revenue to KTI, and is worthy to pursue in quantitatively perspective.

also, the gross margin % can reach 37%, due to the higher selling price, which can contribute to reach the board's objective of at least 20% gross margin rate.

assumption

the calculate is based on online sales forecast, as not mentioned the source of the data, if the data is too optimistic, and the actual sales cannot meet the forecast, then the total revenue will decrease eventually.

hire new staff member will cost more training expenses, which seems not included in the forecast. IF included, the NPV will be lower than current results.

Qual

pro

- website will be a great way to showcase the special and unique way each tea was developed, this align with the opportunities. as the customers like those background stories, and prefer to buy more products like that, this will help to increase the sales.

- showing products as sold out can help KTI's brand grow a reputation of being exclusive, with limited available products. this align with the one of KSF - strong brand recognition. customers might be eager to buy products when they are available, or back to in stock. this will eventually boost the sales as well.

- online store can help alleviate KTI from the strict supply requirement from long-term sales contract customers. this align with one of the weakness, that private-label customer continue to put downward pressure ton pricing during contract negotiation with KTI. Online store is 100% controlled by KTI on pricing, volume, and selections.

con

- this proposal might upset existing customers, this not align with KTI's core value - build long-term relationship with customers. as the existing customer's sales will be jeopardised by the online sales, the relationship with them can get worse.

- this might worsen existing supply concern. this not align with KTI's mission to far exceed consumer expectation daily. if online store go well as expected, this will make the shortage of supply issue even worse. and KTI might loss online sales because of many products out of available for a long period.

conclusion

based on the analysis above, I recommend to purse the offer, as the online store can help to earn more revenue, and have higher gross margin that current sales lines. also this will be a good opportunity to build good reputation of the brand among customers.

proposal #2

quant

see exhibit 3

the gross margin ratio is 20% in 2026, just reach the targeted margin rate.

assumption

the production of black tea is commited by KTI, however the product volume ca be impacted by extreme weather in the future. if the volume of supply go down, the supply might not be able to meet the demand, and KTI will loss sales eventually.

the calculation didn't consider shipping cost, which can be a factor to narrow the margin.

qual

pro

- TT farm has withtood several extreme weather event in the past several years, which did not greatly impact TT annual crop yield, this can guarantee certain amount of supply to KTI, this align with one of the treat of supply shortage due to extreme weather. This can help KTI to maintain the supply and will not loss sales in the future.

- TT is located close to major city and airport, the farm is well situated from logistical perspective. this can make the shipping more convenient, and might help to save costs and timing on shipping.

- TT can provide a fixed-price raw material supply contract, which can secure the supply with fixed cost to KTI, that can make the cost forecast more reliable for KTI, so that it can help KTI to make other investment decisions.

con

- TT started grow black tea recently, which indicate it might lack sufficient experience on the black tea plant, the quality of the black tea has not been tested on the market or by any other customers, so the quality and volume of the black tea cannot guaranteed.

- TT tea is not likely to produce the unqiue to meet KTI customers' expectation, this not align with KTI's mission to far exceed consumer expectation daily. if KTI'S customer did not like TT tea flavor, then KTI can only use them in the private-label products, which is lower margin line in KTI, compared to KTI-brand margin.

- TT lack the experience required to complete the application and audit process, which indicate TT's management and employees lack of the sufficient knowledge of the requirements, which might leave a concern to KTI that TT might not be able to meet the standard in the future, or take more time and cost to get the employee trained to acknowledge the requirements. this might increase the operating cost of the proposal.

conclusion

based on the analysis, I recommend KTI to purse the proposal, given that TT will help to solve the supply shortage issue in the coming years, and the gross margin meet the new target.

Proposal #3 - saveco

Quant

see exhibit 4

conclusion: the gross margin % is 16%, lower than the targeted 20%. therefore the proposal won't help KTI to reach the target, and are not worthy to purse in quantitative perspective.

assumption

the purchase is not included in the sales demand and supply forecast, therefore the increasing purchase of 200,000 kg will worsen the supply shortage. KTI will need to find new suppliers to meet the gap.

the cost is based on current cost of raw material price, if the cost of raw material increase in the future, the gross margin will decrease correspondingly..

qual

pro

- Saveco can display KTI brand tea on premium shelf space. this align with one of KSF - establish good relationship with grocery retailers to receive premium retail shelf space.
- replacng raw material can be negotiable, as long as it meet the requirement of contract, this can help to decrease the cost, and increase the margin, help to reach the board's objective.

con

- existing private-label contract are due to be renewed within the next 3 yrs, and other customers are eager to know the results. this align with one of the weakness that private-label customer continue to put downward pressure ton pricing during contract negotiation with KTI. If KTI agree with the lower price $4.31, then the other customers will ask for lower price as well, this will narrow down the gross margin of private-label products, make it harder to reach the targeted margin.
- KTI need to find a new supplier in order to fulfill the aspect of the contract. this leave a concern that if KTI cannot find qualified new supplier in time, then KTI won't be able to provide the required demands, and might meet the penalty. this not align with the mission to meet the customer's expectation.
- several other suppliers in the industry that can satisfy the saveco contract. therefore, if KTI won't agree with the demand or price, then Saveco might swtich to other competitors. this not align with KTI's core value - build long-term relationship with customers. given that Saveco is KTI's largest customers, if the negotiation cannot meet at the end, this will jeopardize the relationship with Saveco.

conclusion

based on the analysis above, I recommend not pursue the proposal, as the gross margin is relatively low, and will not help to reach the target. Also, the demand in the contract will worsen the supply shortage issue.

Proposal #4

Quant

see exhibit 5

the NPV of proposal is positive, indicate the proposal will bring in revenue more than cost.

also, the payback period is 2.75 month, indicate the upfront investment will be gained back in 2.3 years

assumption

- the production is forecast number, if the product volume cannot reach the forecast in the future due to extreme weather impact, then the NPV will decrease, and the proposal will be less profitable.

- $5.78 is used as sold price, given that Mandala tea has very high quality. however, if the price decrease due to some market factors, then kTI's sales will decrease as well.

qual

pro

- the quality of Mandala's raw material is very high, this align with KTI's vision to provide high-quality tea to the customers. this indicate the Mandala tea will be popular among the existing customers.

- the farm has very traditional production process, everything is done by hand. this align with the opportunity that the customer like to know the unique story behind the tea farmers. this can attract those customers, and KTI can capitalise on that trend.

- this align with the new KSF - rich story of building relationship with traditional ,ethical, and organic tea farmers. the farm is remote, and traditional production process.

con

- the location of farm is remote, and only a newly-constructed road was opened. this will increase the difficulty of shipping from the farm to the port or airport, which can be much more time consuming and inconvenient to visit farm and ship out products in the future.

- the farm is not organic and fairtrade cetified, this not align with KTI's core value to produce extraordinary organic, fair trade tea. If with KTI support, the farm still will not be unable to meet the standards, then KTI need to accept the sunk cost, and go to find other new suppliers.

- the certification process will take at least two years, which means KTI cannot purchase any raw tea from the farm within the next two years. this will not help to alleviate the weakness that KTI will have supply shortage issue since 2025.

conclusion

based on the analysis above, I recomend KTI to pursue the proposal, as the Mandland farm can provide high quality raw tea, and the unique story can attract more customers who like to know those info about tea farmers.

Proposal #5 - ABC long-term purchase contract

Quant

See exhibit 6

gross margin of the contract is 25%, over the target. however, if included the penalty in the gross margin, then the gross margin decreased to 5%.

assumption

current cost of raw material is used in the calculation, therefore if the cost of raw material increase, the gross margin will decrease correspondingly.

$4.88 is contracted price, which is lower than current average sale price $5.78 to KTI branded tea. the opportunity cost can be larger if the sale price of KTI branded tea increase in the future.

Qual

pro

- ABC only sell the highest quality tea from exclusive brand, this align with one of KSF -strong brand recognition, as cooperated with good reputation company like ABC in the tea room industry, will help KSF to build strong brand recognition with more target customer who are interested in high quality tea.
- the contract can reduce KTI's risk by securing some long-term revenue for KTI branded tea. this align with one of KTI weakness - no long-term contract signed in the KTI branded tea line.
- ABC are interested in expanding the contract in the future, that KTI-branded tea can be included in their entire global network of tea rooms. this align with one of KSF - Establish good relationship with grocery retailers to receive premium retail shelf space. KSF-label products will have the opportunity to show in the global team rooms, which will attract more customers in the global, and increase the sales.

con

- long-term contract with ABC will result in less supply to devote to other sales channels, this not align with the KTI's mission - far exceed consumer expectation daily. if KTI cannot guarantee sufficient supply to meet other existing customer's demand, this will jeopardise the relationship with those customers, and KTI will loss sales.

- ABC has specific requirement on the new blends of the product, this not align with the KSF - differentiated product to maintain market share. this will limit the R&D department to pursue new blends and flavours to differentiate products in the future.

conclusion

based on the analysis above, i recommend KTI to pursue the proposal, as this does not require any initial investment, and can secure some long-term revenue to KTI. however, KTI need to find new suppliers to meet the demand, otherwise the penalty will drag down the gross margin to 5%.

Conclusion and recommendation

based on the quantitative and qualitative analysis above, I would like to summarise my recommendation in the order of priority:

1. I recommend to pursue the contract with ABC, as this does not need any initial investment, and can guarantee some long-term revenue in KTI-branded product line. however, KTI will need to new suppliers to meet the demand.

2. I recommend to purse the website and online store, as the online store can help to earn more revenue, and have higher gross margin that current sales lines. also this will be a good opportunity to build strong reputation of the brand among customers.

3. I recommend KTI to purse the proposal with TT farm, given that TT will help to solve the supply shortage issue in the coming years, and the gross margin meet the new target.

4. I recommend KTI to pursue the proposal with Mandala, as the Mandala farm can provide high quality raw tea, and the unique story can attract more customers who like to know those info about tea farmers. however, the production will only be available in 2027, and help to alleviate the shortage of supply.

5. I recommend NOT pursue the proposal with Saveco, as the gross margin is relatively low, and will not help to reach the target 20%. Also, the demand in the contract will worsen the supply shortage. issue.

constraint

see exhibit 7, the total upfront investment for website, TT farm, and Mandala are $4.3 million, given that the available cash for investment is $4.5 million. it is affordable to pursue those three options. and KTI does not need to access any further debt financing.

supply shortage

see exhibit 8, TT can provide 7,000,000 kg black tea in 2026, and Mandala can provide 1.5 million kg tea in 2027, which can help to alleviate the supply shortage in 2026 and the following years.

However, KTI still need to find new suppliers to increase the supply to meet the increasing demand, and to ensure sufficient supply in case some farms production decrease due to weather issue in the future.

	9:00:00 AM	
1:00:00 AM	10:00:00 AM	9:45
12:20:00 AM	10:20:00 AM	10:06:00
12:25:00 AM	12:00:00 AM	10:40:00 AM
12:25:00 AM	12:25:00 AM	11:13:00 AM
12:25:00 AM	12:50:00 AM	11:35:00 AM
12:25:00 AM	1:15:00 AM	12:00:00 PM
12:25:00 AM	1:40:00 AM	12:25:00 PM
12:15:00 AM	1:55:00 AM	12:40:00 PM
12:20:00 AM	2:15:00 AM	1:00:00 PM
4:00:00 AM		

Exhibit 1
purpose: to analyze the financial position of KTI

	private label	KTI branded	total	private label sale / total s
reveue	44945	16446	61391	
COGS	38675	10690	49365	
gross margin	6270	5756	12026	
gross margin %	14%	35%	20%	73%

Exhibit 2
purpose: to analyze the NPV of website and online store proposal

	year 0	year 1	year 2	year 3	
initial setup	- 800,000.00				
online sold volume		2,500,000.00	4,000,000.00	6,000,000.00	
sellingp rice		5.80	5.80	5.80	
revenue		14,500,000.00	23,200,000.00	34,800,000.00	
COGS		- 3.64	- 3.64	- 3.64	
		- 9,100,000.00	- 14,560,000.00	- 21,840,000.00	
gross margin		5,400,000.00	8,640,000.00	12,960,000.00	
		37%	37%	37%	
cost					
maintaince and upgrade		- 725,000.00	- 1,160,000.00	- 1,740,000.00	5%
customer suppot		- 290,000.00	- 464,000.00	- 696,000.00	2%
shipping cost		- 435,000.00	- 696,000.00	- 1,044,000.00	3%
other operating		- 290,000.00	- 464,000.00	- 696,000.00	2%
total cost		- 1,740,000.00	- 2,784,000.00	- 4,176,000.00	
operating margin		3,660,000.00	5,856,000.00	8,784,000.00	
		25%	25%	25%	
PV @ 4.5%	16,562,296.31				
NPV	15,762,296.31				

conclusion: the NPV at 4.5% discount rate is $15,762,296, which indicate the proposal can earn revenue to KTI, and is worthy

Exhibit 3
purpose: to caluclate the gross margin of TT proposal

	year 0	2026 private label	2026 KTI branded	
initial cost	- 2,000,000.00			
sold forecast		11,055,000.00	6,402.00	app II
		4.23	5.78	
		46,762,650.00	37,003.56	
sales		46,799,653.56		
cost of sales		37,580,200.00		**note 1**
gross margin		9219453.56		
gross margin %		20%		

conclusion: the gross margin ratio is 20%, just reach the targeted margin rate.

note 1

black tea from TT	2,500,000.00	
black tea / oolong tea	4,500,000.00	
total supply	7,000,000.00	
TT supply	7,000,000.00	
price	3.26	
COGS	22,820,000.00	
remaining from current supply	4,055,000.00	total sale forecast minus TT supply
	3.64	
remaining COGS	14,760,200.00	
TOTAL COGS	37,580,200.00	

Exhibit 4
purpose: to calculate the gross margin of Saveco proposal

volume	2,500,000.00	
price	4.31	
sales	10,775,000.00	
cost	9,100,000.00	$3.64 per km
gross margin	1,675,000.00	
gross margin %	16%	

conclusion: the gross margin % is 16%, lower than the targeted 20%.

Exhibit 5
purpose: to calculate NPV of Mandala farm proposal

	2025	2026	2027	2028	2029		
unfront investment	-1,500,000.00						
production	0	0	1500000	2000000	2500000		
sales			8,670,000.00	11,560,000.00	14,450,000.00	$5.78	assumption 1
cost of raw material			-5,820,000.00	-7,760,000.00	-9,700,000.00	$3.88	
gross margin			2,850,000.00	3,800,000.00	4,750,000.00		
			33%	33%	33%		
fund export cost			-425,000.00	-425,000.00	-425,000.00		
net cash flow		0	2,425,000.00	3,375,000.00	4,325,000.00		
PV (@15%)	6,525,598.46						
NPV	5,025,598.46						
payback period	0.23 A/B						
	12 months per year						
	2.758367696 months						

assumption 1
$5.78 is for new KTI branded tea, as Mandala tea has very high quaility

conclusion: the NPV of proposal is positive, indicate the proposal will bring in revenue more than cost.
also, the payback period is 2.75 month, indicate the upfront investment will be gained back in 2.3 years

Exhibit 6

purpose: to calculate the gross margin % of ABC proposal

	2,026.00	2027	2028	2029	2030
volume	1,500,000.00	1500000	1500000	1500000	1500000
price	4.88	4.88	4.88	4.88	4.88
revenue	7,320,000.00	7320000	7320000	7320000	7320000
cost of sales	5,460,000.00	5,460,000.00	5,460,000.00	5,460,000.00	5,460,000.00
gross margin	1,860,000.00	1,860,000.00	1,860,000.00	1,860,000.00	1,860,000.00
	25%	25%	25%	25%	25%
penalty (20% of sales)	1,464,000.00	1,464,000.00	1,464,000.00	1,464,000.00	1,464,000.00
gross margin after penalty	396,000.00	396,000.00	396,000.00	396,000.00	396,000.00
	5%	5%	5%	5%	5%

conclusion: gross margin of the contract is 25%, over the target. however, if included the penalty in the gross margin,

exhibit 7

constraint	
website	800,000.00
TT farm	2,000,000.00
Mandala farm proposal	1,500,000.00
total needed	4,300,000.00

exhibit 8

supply shortage

	2026	2027
TT farm	7,000,000.00	
mandala		1,500,000.00

APPENDIX G

RESULTS BY SUMMATIVE ASSESSMENT OPPORTUNITY FOR DAY 1 VERSION 1 AND VERSION 2

Results by Summative Assessment Opportunity

Marking Results – Kingsdale Tea Inc. Version 1

Summative Assessment	Papers	Did not meet standard[1]	Marginal[1]	Yes, met standard
Situational Analysis	1429	0.14%	2.10%	97.76%
Analysis	1429	1.96%	29.81%	68.23%
Conclude and Advise	1429	2.59%	55.98%	41.43%
Communication	1429	0.00%	0.00%	100.00%

Marking Results – Kingsdale Tea Inc. Version 2

Summative Assessment	Papers	Did not meet standard[1]	Marginal[1]	Yes, met standard
Situational Analysis	339	0.29%	3.54%	96.17%
Analysis	339	3.54%	49.56%	46.90%
Conclude and Advise	339	4.42%	60.18%	35.40%
Communication	339	0.00%	0.00%	100.00%

[1] Clearly failing papers (i.e., did not meet the standard) were marked twice. All marginally failing or marginally passing papers were marked a second time to determine which ones met the passing standard. A selection of papers that were close to the margin were also looked at by third marker. The clear pass papers were marked only once, however, they were audited.

The BOE ensures that Version 2 difficulties are equated with Version 1. Any differences in the above statistics are attributable to the mix of candidates writing, which varies with each version.

APPENDIX H

BOARD OF EXAMINERS' COMMENTS ON DAY 1 SIMULATIONS
VERSION 1 AND VERSION 2

BOARD OF EXAMINERS' COMMENTS ON DAY 1 (KTI VERSION 1)

Paper/Simulation: **Day 1 – Linked Simulation, KTI V1 (on May 2023 CFE)**

Estimated time to complete: 240 minutes

Simulation difficulty: Average

Competency Map coverage: N/A; Enabling Skills

Examiners' comments by Summative Assessment Opportunity (SO)

SO#1 (Situational Analysis)

Candidates were expected to highlight the factors, both internal and external to KTI, that could have influenced the strategic decisions presented in the simulation. Since Capstone 1, several changes had taken place within KTI's management team: Michael retired and Jason was promoted to the company's CEO. Conrad Bolton was also hired as KTI's VP of marketing. KTI's R&D team had also become a strong positive force for KTI, given its recent success of developing both attractive new tea flavours and an extraction process for theanine, an amino acid naturally found in green tea, for which the company was granted a patent. Also since Capstone 1, in addition to private-label teas, KTI had begun to sell a new product line of its own branded tea. The initial rollout of KTI-branded tea was successful, and KTI's current strategy was to sell its branded tea products exclusively to tea rooms and tea shops. In addition, KTI had yet to sign any long-term contracts for its KTI-branded teas, and the company's last four remaining private-label contracts, which provided 70% of the company's sales, were set to expire within the next two years. Despite representing such a large portion of the company's sales, KTI has yet to approach any of these customers about beginning the contract renewal process. Although KTI was currently using all of its available raw materials, the expiring private-label contracts utilized approximately 70% of the company's overall supply of raw materials. Therefore, as part of their analysis within SO#2, candidates were expected to address how each strategic option would affect the company's available supply of raw materials, to ensure both that the company was able to meet its obligations and ensure that the raw materials, which would come available from the expiring private-label contracts, were put to good use. In addition to the importance of managing the company's supply of raw materials, the company was also faced with a limited amount of investment capital, given that KTI had only $4 million of cash available for investment and no access to further bank financing.

With that investment capital, KTI's board had the objectives to increase the company's operating margin to 12% by 2028, and increase the company's revenue by 10% annually. Candidates were rewarded when they made relevant links between their situational analysis and their analysis of the strategic alternatives in SO#2, and recommendations in SO#3.

Most candidates provided an adequate summary of KTI's internal and external situation at the beginning of their report. Candidates typically included an updated SWOT analysis that highlighted the changes in the company's situation that had occurred since Capstone 1, and identified the board's main objectives to be considered in relation to the strategic options presented in the simulation. Most candidates also recognized one of the biggest threats to KTI's future success: the company's remaining private-label contracts and the fact that those contracts would all expire in the near term. Despite recognizing this threat, many candidates failed to adequately discuss ways that the raw materials that would become available from the expiring private-label contracts could be reallocated to other aspects of KTI's business, such as by signing long-term contracts for KTI's new branded products.

Strong candidates provided a situational analysis that tended to highlight the most relevant macro-level factors of KTI's existing internal and external business environment. Strong candidates recognized that KTI was in a state of transition and that, although the launch of KTI-branded teas was successful so far, there were risks associated with moving away from the company's private-label contracts entirely. These candidates highlighted the two main limitations that KTI faced when deciding which strategic alternatives to pursue in SO#2: the company's limited investment capital and the company's supply of raw materials. Strong candidates would then consistently link their analysis of each strategic option to how that option would affect these limitations.

Weak candidates tended to simply list KTI's mission, vision, and key success factors from Capstone 1, without highlighting which of those aspects would play an emphasized role in their analysis, based on the information provided in the simulation. Other weak candidates simply restated the case facts that were provided in the simulation without identifying which of those items would have the most influence on their decision-making process. Weak candidates also struggled to link their analysis of the strategic options in SO#2 to the most relevant situational elements presented in the simulation, and instead attempted to link their discussions to less relevant aspects of KTI's governance policies (such as by making weak links between aspects of each strategic decision, and how well they did or did not fit with KTI's key success factors, as described in Capstone 1).

SO#2 (Analysis of the Issues)

Candidates were expected to analyze five strategic alternatives, both qualitatively and quantitatively. Candidates were also expected to integrate the key macro-level aspects of KTI's internal and external situation within their analysis of each strategic alternative (such as the strength of KTI's R&D department or the key limitations that would govern KTI's ability to make certain decisions—the company's raw material supply and limited available investment capital).

<u>AO#2: Accept the contract proposal from BFI?</u>

Candidates were expected to analyze whether KTI should accept the large contract proposal from BFI, which would require KTI's entire supply of raw materials in order to meet the contract's minimum purchase guarantee. Qualitatively, candidates were expected to discuss how the contract would prohibit KTI's R&D department from developing any other products, given the number of new tea flavours that the contract required. Quantitatively, candidates were expected to calculate the contract's operating margin and then compare that figure to KTI's objectives. Candidates could have also compared the contract's gross margin to the gross margin of KTI's existing branded tea sales. In addition, candidates were expected to analyze and discuss whether KTI would be able to adequately service the contract's minimum purchase guarantee with the company's existing supply of raw materials.

Most candidates recognized several benefits of the contract, such as the fact that BFI would be responsible for the marketing expenses associated with promoting KTI's products, and that BFI would pay for the capital expenditures necessary for expanding KTI's production capacity. Most candidates also recognized that the contract would provide KTI with a steady revenue stream for the foreseeable future. In addition, most candidates recognized that KTI would have a difficult time meeting the contract's minimum supply requirements, and that failure to do so would cause KTI to have to pay a penalty; however, fewer candidates went on to suggest ways that KTI could meet the minimum supply requirements, and even fewer candidates suggested negotiating the penalty clause out of the contract, given the uncertainty of whether KTI would be able to meet the requirement. Quantitatively, most candidates attempted to calculate the contract's operating income.

Strong candidates recognized that accepting this contract would limit the company's ability to control the future of KTI-branded teas, given that KTI would be prohibited from selling KTI-branded teas to any other vendor if it agreed to the contract. Strong candidates also discussed how the contract would limit the R&D department's ability to create new products, given that their capacity would be fully utilized in the creation of the new tea flavours required by the contract. Strong candidates also highlighted how signing this contract would alleviate the significant threat posed by the company's expiring private-label contracts, given that the raw materials currently used by those contracts would be fully utilized by the BFI contract. Quantitatively, strong candidates calculated the contract's operating income as well as its operating profit margin, and then compared that figure to KTI's objective of achieving a 12% operating profit margin by 2028. These candidates also compared the contract's gross profit margin to the company's existing gross profit margin for KTI-branded teas, and concluded that KTI could likely earn more if it decided to forgo this contract and sign other contracts, such as the one offered by FFF.

Weak candidates tended to miss the exclusivity feature of this contract, and therefore failed to recognize how signing this contract would prohibit KTI from offering its branded teas to any other vendor. Weak candidates tended to focus their analysis on the more operational components of the contract (such as whether BFI would be able to effectively promote KTI's products) rather than on the more significant strategic components of the contract (such as whether KTI would be able to adequately satisfy the contract's minimum supply requirements). Quantitatively, although weak candidates still tended to calculate the contract's operating income, they routinely failed to translate that into an operating profit margin figure, to then compare it to the company's objectives. Weak candidates would often simply calculate the contract's operating income without discussing the relevance of their calculation.

<u>AO#3: Acquire a 40% ownership interest in Hilly?</u>

Candidates were expected to analyze whether KTI should acquire a 40% ownership interest in a Sri Lankan tea farm, Hilly. Qualitatively, candidates were to recognize that, although Hilly's tea was certified Fairtrade and organic, KTI had never purchased Hilly's raw tea leaves, and it was therefore important for KTI to perform more due diligence over the farm and its operations before an informed decision could be made. Further due diligence was especially important, given the working conditions complaint that the farm had suffered in 2022. Candidates were also expected to comment on how the acquisition of Hilly would affect KTI's supply of raw materials, and the best way to allocate the increased supply of raw materials (such as by using the increased supply to renew the company's expiring private-label contracts). Quantitatively, candidates were expected to calculate the implied value of Hilly and then compare that value to the asking price of $6 million.

Most candidates discussed how the acquisition would protect KTI from the industry-wide supply shortage that was caused by two growing seasons of poor harvests and the growing climate change concern. As part of the proposed agreement, KTI would be granted the first right to purchase from Hilly whatever quantity of raw materials that KTI required. Most candidates recognized this as a significant advantage, given the uncertainty around both the availability of raw materials and how much raw material KTI would need, to satisfy its customers. Quantitatively, most candidates attempted to value Hilly in relation to the operating profit multiplier provided in the simulation.

Strong candidates recognized the potential advantages of acquiring 40% of Hilly, especially in light of the industry's shortage of raw tea leaves, but also recognized the importance of conducting thorough due diligence procedures before an effective decision could be made. Strong candidates would integrate the increased supply of raw materials that KTI would obtain from this acquisition with the potential to sign the BFI contract, and therefore reduce the probability that KTI would be charged a penalty for failing to meet the contract's minimum supply requirements. Quantitatively, strong candidates used the information provided in the simulation to calculate Hilly's implied value at both 3.5 and 5 times the farm's operating profit. These candidates would then compare 40% of that implied value to the asking price of $6 million, to determine whether the asking price was reasonable.

Weak candidates tended not to integrate their analysis of whether KTI should move forward with this option with any of the other strategic options that were available. Instead, weak candidates tended to recommend this option simply because of the industry-wide shortage of raw materials. These candidates did not recognize the large amount of raw materials that would soon become available to KTI, given the four private-label contracts that were set to expire. Quantitatively, weak candidates tended to make errors within their calculation (such as by not applying the 40% ownership to their valuation), and/or would not compare the results of their valuation calculation to the asking price of Hilly, to determine whether it was reasonable.

<u>AO#4: Partner with Leaf?</u>

Candidates were expected to analyze whether KTI should partner with a cannabis retailer, Leaf, to open three tea rooms as a pilot project for what could become a national chain, and to develop a new line of cannabis-infused ready-to-drink (RTD) beverages. Qualitatively, candidates were expected to recognize that, along with the opportunity to enter a growing niche market, this strategic alternative presented a number of significant challenges before the project's potential could be realized. Quantitatively, candidates were expected to analyze the potential profitability of the tea room pilot project through the use of a net present value calculation. Candidates were also expected to comment on how the raw materials needed in order to proceed with the project could be procured from either new supply agreements or through the reallocation of KTI's existing supply of raw materials.

Most candidates did a good job of recognizing the various challenges that could limit the success of the pilot project, such as the fact that the onsite consumption of cannabis-infused tea was currently illegal, and that products that contained cannabis derivatives faced considerable government regulation. Most candidates also discussed the potential reputational risk of associating KTI's new brand with a substance that was once illegal. Quantitatively, most candidates attempted to assess the profitability of the tea room pilot project.

Strong candidates discussed both aspects of this strategic opportunity—the potential to create a new national chain of tea rooms and the potential to develop a new cannabis-infused RTD project. These candidates recognized that the apparent strength of KTI's R&D department would help to ensure that KTI would be successful in creating the new RTD product. Strong candidates also recognized that this strategic alternative had the potential to become very successful, and that KTI's limited supply of raw materials would not be a major constraint for this project, given the relatively low amount of raw materials that was initially required. Quantitatively, strong candidates provided a basic net present value calculation and concluded that, based on the information provided, the project appeared to be profitable.

Weak candidates tended to only discuss the merit of the tea room pilot project and did not give much attention to the opportunity of creating a new line of cannabis-infused RTD beverages. Weak candidates also tended to highlight KTI's limited investment capital as a main reason for not pursuing the project, even though the project's initial cost was within KTI's budget. Weak candidates also had a difficult time linking their analysis to the entity-level strategic considerations, such as how much raw material would be required for the project or whether the project would help or hinder the growth of KTI's new line of branded tea products. Quantitatively, although most weak candidates attempted a net present value analysis, their calculations often contained errors, such as not including the initial upfront cost or the 50% profit split between KTI and Leaf within their calculations. Weak candidates also tended not to discuss the results of their quantitative analysis in a meaningful way (such as by linking their analysis to one of the objectives provided by KTI's board).

AO#5: Commercialize the new theanine-enhanced tea product?

Candidates were expected to analyze whether KTI should utilize the company's newly-granted patent to develop a product line of theanine-infused tea beverages. Candidates were also expected to discuss whether KTI should forgo the development opportunity, and instead sell the patent for $6 million. Qualitatively, candidates were to recognize that the patent offered KTI a unique opportunity to develop a new niche product that appeared to have a good potential for success. Quantitatively, candidates were expected to calculate the opportunity's potential operating margin, at both the low and high estimated level of sales provided, and then compare the results of their analysis to KTI's objectives.

Most candidates linked the potential theanine-infused tea products with KTI's mission statement, which highlighted the company's desire to provide its customers with health benefits. Most candidates also recognized that the focus group providing excellent feedback for the new theanine-infused products was a good indication that the product would be well received once released to the public; however, fewer candidates recognized that the value of the patent extended beyond tea products, given that, as Sabrina mentioned, theanine would likely be added to products other than tea in the future. Quantitatively, most candidates calculated the opportunity's operating profit margin at both the low and high projection of potential product sales.

Strong candidates recognized that the development of the theanine-infused product line had the advantage of less government regulation when compared to the cannabis-infused products that the company was also considering. Strong candidates also recognized that this strategic alternative had the potential to become very successful, and that the company would likely be able to procure the necessary raw materials without much trouble (such as by reallocating the raw materials from one of the expiring private-label contracts to the development of the new line of theanine-infused tea products). Quantitatively, strong candidates included the depreciation expense within their operating profit margin calculations, and then compared the results of their analysis to the company's stated objectives, providing a more valuable quantitative analysis.

Weak candidates tended to highlight the length of time that it would take KTI to bring the new product to market (18 months) as a main reason to not move forward with the investment. Weak candidates also highlighted the large range of potential product sales as another main reason not to move forward with the investment. These two points were less valuable, because an extended development period and uncertain sales are two inherent aspects of bringing a new, niche product to the marketplace. Weak candidates also tended to recommend that KTI sell the patent so that the company could use the proceeds to procure an additional supply of raw materials, even though these candidates frequently failed to discuss whether KTI would actually need additional raw materials in light of the private-label contracts that would expire in the near term. Quantitatively, weak candidates failed to include the depreciation expense within their calculation of the investment's projected operating profit margin. Weak candidates also failed to link the results of their quantitative analysis to the company's stated objectives.

AO#6: Enter US sales agreement with FFF?

Candidates were expected to analyze whether KTI should agree to a five-year sales agreement with FFF, a well-known American grocery chain. Qualitatively, candidates were expected to recognize that the proposed FFF contract was far less restrictive when compared to the BFI contract, and that this contract would not constrain KTI's R&D department's ability to continue to develop niche products. This fact was especially important, given the R&D department's apparent ability to develop popular and innovative products. Quantitatively, candidates were expected to calculate the contract's gross profit margin and then compare that figure to KTI's existing gross profit margin. Candidates were also expected to comment on how the raw materials needed to satisfy the contract could be procured from either new supply agreements or through the reallocation of KTI's existing supply of raw materials.

Most candidates discussed how the contract with FFF would simplify KTI's sales and production processes. Most candidates also discussed how this contract would allow KTI to expand into the US market, and the benefit of being the only premium tea brand that FFF would sell within its grocery stores. Quantitatively, most candidates attempted to calculate the contract's projected gross profit.

Strong candidates recognized that this contract would provide KTI with the ability to reallocate a portion of the raw materials that would come available once one of the private-label contracts expired. These candidates recognized that the gross profit margin offered by this contract exceeded that of the private-label contracts, and therefore, this contract made good sense, given that it was the company's intention to transition toward more KTI-branded tea sales instead of private-label tea sales. Strong candidates also recognized that this option would allow KTI to secure a portion of its long-term revenue without limiting the R&D department's ability to develop new products. These candidates recognized that the FFF contract only required three new tea flavours a year whereas the R&D department was presently creating five new tea flavours each year. Quantitatively, strong candidates calculated the contract's gross profit margin and then compared that figure to KTI's existing gross profit margin.

Weak candidates tended to discuss the operational aspects of the contract, such as the contract's stipulation that FFF would pick up all purchases directly from KTI's warehouses, and how the contract would help eliminate the need for the currently burdensome one-off sales order system. These candidates often failed to discuss the more important strategic-level considerations of the contract, such as how the contract's raw material requirements would be satisfied or how the contract would fit into the company's strategy of moving toward KTI-branded tea sales. Quantitatively, weak candidates attempted to calculate the contract's gross profit but often failed to translate that result into the contract's gross profit margin in order to compare it to something meaningful, such as the gross profit margin of the BFI contract or the company's existing gross profit margin.

Overall

The focus of SO#2 was on the candidate's ability to recognize the importance of using KTI's raw materials wisely when assessing, and recommending, the various strategic options that were presented. As approximately 70% of the company's existing sales would be lost if the private-label contracts were allowed to expire, candidates were expected to discuss how each strategic option would affect the company's supply of raw materials. Candidates were also expected to integrate the various industry-level trends, such as the increasing demand for specialty teas that conferred health benefits, the increasing demand for specialty teas within grocery stores, and the threat of reduced raw material supplies, given the ongoing effect of climate change.

Most candidates addressed all of the strategic options available to KTI; however, many candidates did not provide a fulsome discussion for FFF. Often, these candidates provided a very detailed situational analysis, and therefore did not allow themselves sufficient time to respond more fully to the strategic options that came toward the end of the simulation. Most candidates also provided a sufficient quantitative analysis, given that the calculations required were basic in nature.

Within SO#2, there were three main differentiating factors between strong and weak candidates. First, strong candidates routinely provided the implications (the "so what?") of each case fact that they included within their analysis, whereas weak candidates tended to simply list the case facts they thought were relevant to each AO without explaining the importance of those case facts and what impact they would have on KTI's ability to meet its objectives. Second, strong candidates did a better job of comparing the results of their quantitative analyses to the company's objectives, the company's existing financial results, or the other available strategic options. Weak candidates tended to complete their calculations without providing an adequate level of discussion concerning the relevance and impact of their calculations on the decisions that needed to be made.

Third, strong candidates were able to integrate the entity-level strategic concerns within their analysis of each issue, whereas weak candidates tended to analyze each issue in isolation, without linking their discussions to KTI's overall strategic direction or the main constraints of the simulation—the company's supply of raw materials and the capital available for strategic investment.

SO#3 (Conclude and Advise)

Candidates were expected to conclude on each issue analyzed, and to provide an overall conclusion that integrated the entity-level considerations into a cohesive and logical recommendation. A logical overall recommendation was one that discussed and respected the main constraints of the simulation: the company's supply of raw materials and the capital available for strategic investment. These conclusions and recommendations were expected to be consistent with the candidate's analyses.

Almost all candidates provided issue-by-issue conclusions and an overall recommendation. What differentiated strong candidates from weak candidates in SO#3 was the candidate's ability to form a cohesive strategy for how the company should allocate its supply of raw materials and limited investment capital. Strong candidates also differentiated themselves from weak candidates by recommending to KTI's board which strategic direction (whether focusing on long-term contracts or instead, niche products) the company should take, given their analyses. Strong candidates also did a good job of discussing how KTI should approach the upcoming expiry of the company's private-label contracts (usually by recommending that this supply get reallocated to the recommended strategic options analyzed, or by renewing all or a portion of the expiring contracts). Weak candidates did not link their recommendations for each strategic option together into a cohesive overall strategy. Instead, weak candidates tended to make their recommendations for each strategic option in isolation from their other recommendations. Weak candidates also often failed to comment on how their recommendations would affect the company's supply of raw materials, and often failed to comment on how KTI should approach the upcoming expiry of the company's private-label contracts.

SO#4 (Communication)

Most candidates approached their response in a coherent and organized fashion. Only a few candidates struggled to effectively communicate their ideas. These candidates tended to use poor sentence structure, confusing syntax, and an unorganized response approach.

SO#5 (Overall Assessment)

Overall, candidates were expected to meet the minimum acceptable standards in each of the four summative opportunities in order to obtain a "Pass" on the Day 1 linked case. Candidates also had to demonstrate a minimum level of numeracy skills.

For each major issue, candidates were expected to provide a sufficient level of analysis, and then to provide a recommendation that was consistent with their analyses. Candidates were also expected to provide a reasonable amount of discussion on either how the company should manage its supply of raw materials or which strategic direction the company should take, and how best to allocate the company's limited investment capital in light of those discussions. Finally, the board sought evidence that candidates incorporated the important elements of Capstone 1, as well as the main elements of this simulation's situational analysis, into their analysis of the major issues.

BOARD OF EXAMINERS' COMMENTS ON DAY 1 SIMULATION (KTI VERSION 2)

Paper/Simulation: **Day 1 – Linked Simulation, KTI V2 (on May 2024 CFE)**

Estimated time to complete: 240 minutes

Simulation difficulty: Average

Competency Map coverage: N/A; Enabling Skills

Examiners' comments by Summative Assessment Opportunity (SO)

SO#1 (Situational Analysis)

Candidates were expected to highlight the factors, both internal and external to KTI, that could have influenced the strategic decisions presented in the simulation. Since Capstone 1, a major change had taken place within KTI's management team: Michael retired and Kathleen became KTI's CEO, and control of KTI was now split between Kathleen, Sabrina, and Jason, who each held one-third of the common shares of KTI and comprised KTI's Board of Directors. Also since Capstone 1, in addition to private-label tea, KTI had begun to sell a new product line of its own branded tea—Kingsdale Tea (KTI-branded tea). Since its initial rollout, KTI-branded tea was well received but was only available for purchase within tea rooms and tea shops. In addition to its superior quality, part of the initial success of KTI-branded tea was owing to the unique stories behind KTI's tea farmers. These stories had been shared via social media, which had a positive impact on sales for Kingsdale Tea. As a result, the demand for KTI-branded tea had exceeded KTI's original expectations. Given this higher-than-expected demand, KTI was confronted with a forecasted shortage of raw materials in the coming years. In addition, the potential severity of the shortage was made worse, given the significant threat of climate change, which was expected to particularly affect high mountain environments more prone to uncertain weather patterns. Therefore, as part of their analysis within SO#2 and their recommendations in SO#3, candidates were expected to address how each strategic option would affect the company's available supply of raw materials, to ensure as best as possible that KTI would be able to meet demand and fulfil the company's sales agreements for both private-label and KTI-branded tea. Candidates were also rewarded when they discussed how KTI could potentially allocate the company's supply of raw materials, which had varying degrees of quality, between KTI's private-label and KTI-branded products. Although KTI had decided not to access any further debt financing, the company's investment capital available was sufficient to afford all the presented opportunities that required an upfront investment; therefore, there was no cash constraint within the simulation. With KTI's available investment capital, KTI's board had the objective to grow the company's revenue and achieve a gross margin of at least 20% on both private-label and KTI-branded tea sales. Candidates were rewarded when they made relevant links between their situational analysis and their analysis of the strategic alternatives in SO#2, and recommendations in SO#3.

Most candidates provided an adequate summary of KTI's internal and external situation at the beginning of their report. Candidates typically included an updated SWOT analysis that highlighted the changes in the company's situation that had occurred since Capstone 1, and identified the board's main objectives to be considered in relation to the strategic options presented in the simulation. Most candidates recognized the projected shortage of KTI's raw materials within their situational analysis; however, many candidates failed to adequately address and mitigate the shortfall within their analysis and recommendations. Most candidates also recognized and highlighted the company's available investment capital as well as the board's stated objectives within their situational analysis.

Strong candidates provided a situational analysis that tended to highlight the most relevant macro-level factors of KTI's existing internal and external business environment. Strong candidates recognized that, because of the growing demand for KTI-branded tea, combined with the existing demand for KTI's private-label tea, KTI was projected to have a significant raw materials shortfall in the coming years. These candidates also tended to point out that the gross margin from KTI-branded tea sales was superior to that of KTI's private-label sales. Strong candidates would then consistently link their analysis of each strategic option to these more relevant aspects of KTI's global situational analysis.

Weak candidates tended to simply list KTI's vision, mission, and key success factors from Capstone 1, without highlighting which of those aspects would play an emphasized role in their analysis, based on the information provided in the simulation. Other weak candidates simply restated the case facts that were provided in the simulation without identifying which of those items would have the most influence on their decision-making process. Weak candidates also struggled to link their analysis of the strategic options in SO#2 to the most relevant situational elements presented in the simulation, and instead attempted to link their discussions to less relevant aspects of KTI's governance policies (such as by making weak links between aspects of each strategic decision, and how well they did, or did not, fit with KTI's key success factors, as described in Capstone 1).

SO#2 (Analysis of the Issues)

Candidates were expected to analyze five strategic alternatives, both qualitatively and quantitatively. Candidates were also expected to integrate the key macro-level aspects of KTI's internal and external situation within their analysis of each strategic alternative (such as the threat of climate change on the global supply of raw tea leaves or the key limitation that would govern KTI's ability to sign new sales: the company's raw material supply).

<u>AO#2: Develop and offer a website and online store?</u>

Candidates were expected to analyze whether KTI should develop and offer both a website and online store, where KTI's customers could purchase tea directly from KTI. Qualitatively, candidates were expected to discuss whether it made sound strategic sense for KTI to move beyond selling KTI-branded tea exclusively through tea rooms and tea shops by selling tea directly to the end consumer through an online store. Quantitatively, candidates were expected to calculate the proposal's gross margin, and then compare that to the board's stated objectives. Candidates were also expected to analyze the potential profitability of the online store, using a net present value calculation. In addition, candidates were expected to comment on whether KTI would have sufficient raw materials to adequately supply the online store.

Most candidates recognized that the website and online store would help KTI market its new KTI-branded tea products, which would likely translate into increased sales and brand recognition. Most candidates also discussed how the implications of KTI's limited raw materials may not be as severe with the online store, given the lack of strict supply requirements; however, fewer candidates recognized that, by allocating the company's raw material supply to KTI's online store, the company would have fewer supplies for servicing the existing private-label and KTI-branded sales contracts. Quantitatively, most candidates attempted to calculate the proposal's net present value, but fewer candidates discussed whether the sales made on the online store would meet the board's gross margin objective, and even fewer candidates recognized that the forecast included in the case included only KTI-branded tea, and that the online store would also sell lesser-quality teas, which would likely increase the proposal's profitability.

Strong candidates recognized the potential conflict between offering an online store where customers could purchase KTI-branded tea directly, and the tea rooms and tea shops that were currently the only outlets where KTI-branded tea could be purchased. Strong candidates emphasized this conflict by pointing out that, if KTI was unable to increase its supply of raw materials, the company may be unable to continue to supply the tea rooms and tea shops that currently sold KTI's products, and that this could harm KTI's business relationships. Strong candidates also discussed how, even if the company decided not to move forward with the online store, it still made good strategic sense to develop a company website, given the positive effect this would likely have on growing KTI's new brand of tea. Quantitatively, strong candidates provided an accurate net present value calculation for the proposal's first three years, and then compared the expected gross margin of online sales to the board's stated objective.

Weak candidates tended to recognize that this project would worsen KTI's existing raw materials supply concern, but did not discuss the implications of this (such as upsetting KTI's customers wishing to purchase KTI's products via the online store, because the products may need to be labelled as "sold out" too frequently). Weak candidates also tended to focus their discussion on the merit of offering a website and online store, without considering the potential negative impact this could have on KTI's existing relationships with tea rooms and tea shops. Quantitatively, although weak candidates attempted to calculate the proposal's net present value, they routinely did not calculate a gross profit margin figure to then compare to the company's objectives. Weak candidates would often simply calculate the contract's net present value without discussing the relevance of their calculation.

AO#3: Sign supply agreement with TT?

Candidates were expected to analyze whether KTI should collaborate with TT, to help TT obtain the organic and Fairtrade certifications in exchange for a fixed-price raw material supply contract for TT's tea. Qualitatively, candidates were expected to recognize that TT's raw materials would likely not be suitable to use within KTI-branded tea and that, at best, TT's raw materials could only be used in KTI's private-label products. Therefore, TT's offer would only help alleviate KTI's projected raw material shortage if the quality of TT's tea would be suitable for KTI's existing private-label contracts. Candidates were expected to recommend that KTI ensure that TT's tea could be used to service KTI's private-label contracts before KTI made a final decision on whether to work with TT. Quantitatively, candidates were expected to calculate the annual savings that KTI would obtain by using TT's tea instead of KTI's existing suppliers. Candidates were also expected to calculate the gross margin that KTI would earn on its private-label sales if TT's supplies were used instead of KTI's existing supplies, and to compare this figure to the board's stated objectives.

Most candidates discussed how the collaboration could help alleviate KTI's projected shortage of raw materials, but also that TT's tea did not currently align with KTI's quality standard, given that TT's tea was not Fairtrade and organic-certified. Most candidates also recognized the significant advantage to KTI if TT's tea farm was indeed meeting the Fairtrade and organic standards; however, fewer candidates suggested verifying whether this claim was accurate before KTI decided to move forward with the collaboration. Quantitatively, most candidates attempted to quantify the savings that KTI would obtain by using TT's supplies; however, many candidates struggled to calculate the potential gross margin that KTI could earn if KTI used TT's supplies to service its existing sales contracts.

Strong candidates recognized the potential advantages of the collaboration, especially in light of KTI's projected shortage of raw materials, but also recognized the importance of conducting thorough due diligence before an effective decision could be made. Strong candidates would also discuss how the location of TT's farm would help protect it from the more severe weather events that were common at high elevations, and how this was especially important, given the threat of climate change to the global supply of raw tea leaves. Strong candidates also discussed how the length of TT's proposed raw material supply contract, and the fact that its price was fixed, would help KTI secure a reliable source of raw materials for many years to come. Quantitatively, strong candidates calculated the gross margin that KTI would earn on private-label tea sales if TT's raw materials were used to service those sales. These candidates would then discuss how KTI would be able to achieve the board's gross margin objective on private-label sales (something the company was presently unable to do, given the cost of KTI's existing, higher-quality supplies).

Weak candidates tended to focus on the more operational aspects of this decision (such as the time it would take for KTI's management to help TT obtain the Fairtrade and organic certifications, and the proximity of TT's tea farm to an airport) rather than on the more impactful strategic elements of the decision (such as whether KTI would be able to effectively use TT's raw materials to service KTI's existing and future sales contracts). Weak candidates recognized that this collaboration would help alleviate KTI's projected shortage of raw materials, but did not recognize or discuss how the company would need to allocate TT's raw materials in order to ensure that KTI did not violate any of the company's existing or future arrangements (such as by verifying with SaveCo whether they would accept TT's raw materials for their upcoming contract renewal). Quantitatively, weak candidates struggled to provide a valuable calculation for this proposal, and often failed to integrate within their analysis the cost information that was provided on the first page of the simulation. For example, some weak candidates calculated the total cost of the raw materials that would be purchased from TT, depending on whether KTI only purchased the minimum requirement or whether KTI purchased the additional amount of raw materials that TT had offered.

AO#4: Renew long-term private-label customer contract with SaveCo?

Candidates were expected to analyze whether KTI should renew a contract with the company's largest private-label customer, SaveCo. Qualitatively, candidates were expected to recognize that KTI would ideally reach an eventual agreement with SaveCo on their private-label contract renewal, given the size of SaveCo's existing contract relative to KTI's annual revenue, and the fact that SaveCo was a long-term customer of KTI. Quantitatively, candidates were expected to assess whether achieving the board's gross margin objective was possible, given SaveCo's contract renewal offer in combination with KTI's current cost of raw materials. Candidates were also expected to comment on whether KTI would be able to adequately supply SaveCo's ten-year private-label contract, given KTI's projected shortage of raw materials.

Most candidates did a good job of recognizing that renewing SaveCo's private-label contract would help KTI meet its core values, and the board's desire to maintain the company's existing relationships. Most candidates also recognized the possible future expansion of SaveCo's contract to include KTI-branded products, and how these products would be displayed on premium shelf space. Most candidates also identified the potential implications on KTI's future private-label contract renegotiations, given that KTI's other private-label customers were eager to know the outcome of SaveCo's renegotiation. Quantitatively, most candidates attempted to calculate whether SaveCo's contract renewal offer would meet the board's gross margin objective.

Strong candidates recognized that the information provided in the case pertained to SaveCo's first offer, and that KTI had the ability to suggest renegotiation points in order to reach a mutually acceptable agreement. As such, strong candidates commented on the various ways that KTI could approach the renegotiation, to ensure that the contract both met the board's objectives and did not further exacerbate the company's projected raw materials shortage (such as by negotiating a higher purchase price per kilogram of tea, or by using TT's supply of raw materials to service the contract rather than the current tea leaves used in SaveCo's private-label products). Strong candidates also tended to comment on the importance of maintaining KTI's existing private-label contracts, given that the majority of the company's revenue was still generated through private-label sales. Quantitatively, strong candidates integrated their renegotiation points into their calculation, to determine the potential gross margin that KTI could earn on the SaveCo contract if SaveCo were to agree to the recommended renegotiations.

Weak candidates tended to take the information provided at face value without recognizing that KTI could present a revised offer prior to moving forward with SaveCo's new private-label contract. In addition, rather than focus on the more pertinent strategic issues of the proposal (such as how KTI could approach satisfying the supply requirement of SaveCo's new contract), weak candidates tended to focus their discussion on the more operational aspects, such as the need to find a new packaging supplier. Quantitatively, weak candidates tended to compare the annual revenue that KTI would generate from SaveCo's new contract to that of SaveCo's existing contract. Based on this, and the fact that SaveCo's new contract—as initially proposed by SaveCo—would not meet the board's gross margin objective, weak candidates tended to recommend declining SaveCo's new private-label contract.

AO#5: Sign supply agreement with Mandala?

Candidates were expected to analyze whether KTI should sign an agreement with Mandala, to help Mandala meet the organic and Fairtrade standards and eventually obtain those certifications, in exchange for the exclusive purchasing rights to Mandala's raw tea leaves. Qualitatively, candidates were expected to recognize that obtaining the organic and Fairtrade certifications would likely be onerous, and that the likelihood of success was currently unknown. Quantitatively, candidates were expected to analyze the potential profitability of the agreement, using a net present value calculation. Candidates were also expected to calculate the gross margin that KTI would earn if Mandala's supplies were used to service KTI's branded tea sales; this figure should have then been compared to the board's stated objectives. In addition, candidates were expected to comment on how well the agreement would help KTI alleviate the company's projected shortage of raw materials.

Most candidates identified and discussed several challenges with respect to helping Mandala obtain the organic and Fairtrade certifications (such as the fact that Mandala lacked awareness of the certification requirements, and that working within a foreign jurisdiction could introduce additional expenses and time delays); however, only strong candidates suggested exploring the process, and the likelihood of obtaining eventual certification, before KTI signed the agreement, whereas weak candidates tended to reject the proposal outright, given the aforementioned challenges. Most candidates also recognized the expected time delay between signing the agreement and obtaining the certifications, and how that delay could affect KTI's ability to alleviate the company's projected raw material shortage. Quantitatively, most candidates attempted to calculate the agreement's net present value, but fewer candidates discussed whether the sales made using Mandala's supplies would likely achieve the board's gross margin objective.

Strong candidates recognized the attractiveness of the Mandala agreement should Mandala's tea farm eventually obtain the organic and Fairtrade certifications, but also that achieving the necessary certifications would be difficult and there was no guarantee of success. Based on this recognition, strong candidates recommended various ways that KTI could reduce the risk of the agreement, such as by performing thorough due diligence, to ascertain the likelihood of obtaining the certifications, or by renegotiating the agreement so that the annual fixed payments would not come into effect until the certifications were obtained. Strong candidates also recognized that Mandala's farm appeared to match perfectly with KTI's ideal type of supplier, given Mandala's traditional production processes, which could help KTI market the company's new branded products. Quantitatively, strong candidates provided an accurate net present value calculation for the agreement's ten-year term, and then compared the expected gross margin that KTI would earn on sales, using Mandala's supplies, to the board's stated objective.

Weak candidates tended to highlight the length of time that it would take KTI to help Mandala obtain the organic and Fairtrade certifications (at least two years) as a main reason for not moving forward with the agreement. Weak candidates failed to recognize that KTI's projected shortage of raw materials extended into 2027, the year that Mandala's supplies would likely come available to KTI. Weak candidates also tended to recommend against the agreement because Mandala's tea farm was not yet organic and Fairtrade certified (which went against KTI's core values), even though it was made clear in the simulation that achieving certification was likely possible, albeit challenging. Quantitatively, weak candidates tended to make errors within their net present value calculation (such as by not including the fixed annual $425,000 payment to Mandala within their calculation), and/or would not compare the results of their calculation to the board's stated gross margin objective.

<u>AO#6: Sign long-term KTI-branded customer contract with ABC?</u>

Candidates were expected to assess whether KTI should sign a long-term purchase contract with ABC, an existing customer that operates a popular tea room chain within North America. Qualitatively, candidates were expected to recognize that the contract with ABC would ensure that KTI's branded products were sold within ABC's popular stores for at least the next five years, and that ABC's operations appeared to align well with KTI's vision, mission, and core value of providing high-quality tea through long-term customer relationships. Quantitatively, candidates were expected to assess whether ABC's proposed purchase contract would allow KTI to achieve the board's gross margin objective. Candidates were also expected to comment on whether KTI would be able to adequately supply ABC's proposed contract for KTI-branded tea, given KTI's projected shortage of raw materials. In addition, candidates could have also calculated the potential penalty that KTI would face if the company was unable to comply with the contract's guaranteed purchase minimum.

Most candidates recognized several benefits of the contract, such as the fact that ABC had expressed interest in a potential future expansion of the contract to include KTI-branded tea within ABC's entire global network of tea rooms, and that ABC would be responsible to pay for the shipping expenses associated with the contract. Most candidates also recognized that the contract would provide KTI with a steady revenue stream for the foreseeable future. In addition, most candidates recognized that, given the company's projected shortage of raw materials, KTI could have a difficult time meeting the contract's minimum purchase guarantee, and that failure to do so would cause KTI to have to pay a penalty; however, fewer candidates went on to suggest ways that KTI could meet the minimum purchase guarantee, and even fewer candidates suggested negotiating the penalty clause out of the contract, given the uncertainty of whether KTI would be able to meet the requirement. Quantitatively, most candidates attempted to calculate the gross margin that KTI would earn from the contract, but few candidates quantified the potential penalty that KTI would face if the company was unable to comply with the contract's minimum purchase guarantee.

Strong candidates recognized that, unless KTI was able to procure an additional supply of high-quality raw materials, the company would likely need to reallocate a portion of KTI's current raw materials supply away from its existing private-label contracts, to adequately service ABC's contract and avoid the threat of paying the noncompliance penalty. As such, strong candidates tended to discuss ways of navigating ABC's minimum purchase guarantee, to reduce the risk of noncompliance (such as by negotiating the noncompliance penalty out of the contract or by forgoing the contract until KTI was able to secure a new source of raw materials, such as those that could eventually be provided by the Mandala agreement). Strong candidates also tended to recognize that ABC planned to sell KTI's branded products within ABC's online store, which could cause a conflict if KTI were to move forward with developing its own online store. Quantitatively, strong candidates calculated the contract's gross profit margin, and then compared that figure to KTI's existing gross profit margin, as well as to the board's objective.

Weak candidates tended to focus on the more operational aspects of ABC's proposed contract (such as the need to include a marketing story on the product packaging and the need to change the four required tea blends each year) instead of on the more impactful strategic elements of the contract (such as KTI's ability to adequately service the contract's minimum purchase guarantee, given the projected shortage of raw materials). Quantitatively, weak candidates attempted to calculate the contract's gross margin, and then compared that figure to the board's gross margin objective. However, weak candidates often routinely failed to realize that the gross margin from ABC's proposed contract was significantly lower than the gross margin that KTI was currently earning on sales of KTI-branded tea.

Overall

The focus of SO#2 was on the candidate's ability to meet the board's objectives while also managing KTI's limited supply of raw materials. As KTI's forecasted demand was significantly higher than the company's current supply of raw materials, candidates were expected to address how KTI could take advantage of its opportunities to grow the company's revenue, while also mitigating the risk of being unable to fulfil the sales orders that it agreed to. Candidates were also expected to integrate and discuss how the various situational aspects of the simulation would affect the viability of each strategic opportunity. For example, given Kathleen's relative inexperience with negotiation, candidates were rewarded when they provided renegotiation points for the various contracts and proposals that KTI was considering. As another example, candidates were rewarded when they discussed how climate change might have affected the two tea farms that KTI was considering working with (Mandala would likely experience more extreme weather events, given that it was located in the mountainous region of the Himalayas).

Most candidates addressed all of the strategic options available to KTI; however, many candidates did not provide a fulsome discussion for ABC. Often, these candidates provided a very detailed situational analysis, and therefore did not allow themselves sufficient time to respond more fully to the strategic options that came toward the end of the simulation. Most candidates also provided a sufficient quantitative analysis, given that the calculations required were basic in nature.

Within SO#2, there were three main differentiating factors between strong and weak candidates. First, strong candidates were able to identify and discuss the potential synergies between the five strategic options that KTI was considering. For example, strong candidates recognized that TT's raw materials would meet the requirements of SaveCo's contract once TT's tea farm obtained the Fairtrade and organic certifications. These candidates would then suggest that KTI determine whether SaveCo would be okay with this change in raw materials. Weak candidates tended to analyze each issue in isolation, without recognizing the various strategic links between the investments and proposals that KTI was presented with. Second, strong candidates routinely recognized and discussed the more impactful decision factors within their analysis of each strategic option, whereas weak candidates tended to provide more generic links to KTI's governance directives, such as linking each strategic option to KTI's vision, mission, key success factors, and core values, regardless of whether those items were relevant to the decision. Third, strong candidates were more able to provide the implications of each case fact they included within their analysis, whereas weak candidates tended to simply list the case facts they thought were relevant without explaining the importance of those case facts, and what impact they would have on the viability and strategic strength of each option that KTI was presented with.

SO#3 (Conclude and Advise)

Candidates were expected to conclude on each issue analyzed, and to provide an overall conclusion that integrated the entity-level considerations into a cohesive and strategic recommendation. A strategic overall recommendation would first address KTI's anticipated shortage of raw materials and then attempt to mitigate that shortage as best as possible, given the candidate's specific recommendations. For example, because the quality of TT's raw materials would likely not suit the sophisticated taste of the customers who purchased KTI's new brand of products, candidates were rewarded when they recommended that KTI inquire whether its private-label customers, such as SaveCo, would agree to have TT's raw materials used to satisfy their sales orders. If so, the TT collaboration would greatly help alleviate KTI's projected raw materials shortage (assuming that TT would eventually achieve the required certifications). As another example, candidates were rewarded when they recognized and discussed how ABC's proposed purchase contract for KTI-branded tea would not be presently possible, unless KTI diverted a portion of its high-quality Sri Lankan or Kenyan supply of raw materials away from an existing private-label contract, such as SaveCo.

Almost all candidates provided issue-by-issue conclusions and an overall recommendation. What differentiated strong candidates from weak candidates in SO#3 was the candidate's ability to form a cohesive strategy for how the company could achieve the board's objectives while also maximizing the value that KTI could generate from both its existing and potential new suppliers of raw materials. Strong candidates also differentiated themselves from weak candidates by suggesting helpful ways that KTI could mitigate the risks of the various proposals under consideration (such as by offering various renegotiation points for the SaveCo and ABC purchase contracts, or suggesting that KTI do more due diligence over TT's and Mandala's tea farms prior to making a final decision about whether to move forward with those suppliers). Weak candidates did not link their recommendations for each strategic option together into a cohesive overall strategy. Instead, weak candidates tended to make their recommendations for each strategic option in isolation from their other recommendations. For their overall conclusion, some weak candidates would simply copy and paste their recommendations from each strategic option to the bottom of their response. Finally, rather than address KTI's limited supply of raw materials, weak candidates often focused on whether KTI would have enough investment capital to finance the candidate's recommendations, even though KTI had enough capital to finance all the options under consideration.

SO#4 (Communication)

Most candidates approached their response in a coherent and organized fashion. Only a few candidates struggled to effectively communicate their ideas. These candidates tended to use poor sentence structure, confusing syntax, and an unorganized response approach.

SO#5 (Overall Assessment)

Overall, candidates were expected to meet the minimum acceptable standards in each of the four summative opportunities in order to obtain a "Pass" on the Day 1 linked case. Candidates also had to demonstrate a minimum level of numeracy skills.

For each major issue, candidates were expected to provide a sufficient level of analysis, and then to provide a recommendation that was consistent with their analyses. Candidates were also expected to provide a reasonable amount of discussion on how the company could manage its limited supply of raw materials, and how KTI could best allocate that limited raw materials supply, in light of the company's sales forecast and current opportunities to enter into the long-term purchase contracts with SaveCo and ABC. Finally, the board sought evidence that candidates incorporated the important elements of Capstone 1, as well as the main elements of this simulation's situational analysis, into their analysis of the major issues.

APPENDIX I

CPA COMMON FINAL EXAMINATION REFERENCE SCHEDULE

CPA COMMON FINAL EXAMINATION
REFERENCE SCHEDULE

Present Value of Tax Shield for Amortizable Assets

Present value of total tax shield from CCA for a new asset acquired after January 1, 2024, and before January 1, 2028, other than those eligible for immediate expensing, which would normally be subject to the half-year rule.

$$= \frac{CdT}{(d+k)}$$

Present value of total tax shield from CCA for a new asset acquired after January 1, 2024, and before January 1, 2028, other than those eligible for immediate expensing, which would not normally be subject to the half-year rule.

$$= \frac{CdT}{(d+k)}\left(\frac{1+1.25k}{1+k}\right)$$

Present value of total tax shield from CCA for a new asset acquired after November 20, 2018, and before January 1, 2024, other than those eligible for immediate expensing.

$$= \frac{CdT}{(d+k)}\left(\frac{1+1.5k}{1+k}\right)$$

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

Selected Prescribed Automobile Amounts

Item	2023	2024
Maximum depreciable cost — Class 10.1	$36,000 + sales tax	$37,000 + sales tax
Maximum depreciable cost — Class 54	$61,000 + sales tax	$61,000 + sales tax
Maximum monthly deductible lease cost	$950 + sales tax	$1,050 + sales tax
Maximum monthly deductible interest cost	$300	$350
Operating cost benefit — employee	33¢ per km of personal use	33¢ per km of personal use
Non-taxable automobile allowance rates		
— first 5,000 kilometres	68¢ per km	70¢ per km
— balance	62¢ per km	64¢ per km

Individual Federal Income Tax Rates

For 2023:

If taxable income is between	Tax on base amount	Tax on excess
$0 and $53,359	$0	15%
$53,360 and $106,717	$8,004	20.5%
$106,718 and $165,430	$18,942	26%
$165,431 and $235,675	$34,208	29%
$235,676 and any amount	$54,579	33%

For 2024:

If taxable income is between	Tax on base amount	Tax on excess
$0 and $55,867	$0	15%
$55,868 and $111,733	$8,380	20.5%
$111,734 and $173,205	$19,833	26%
$173,206 and $246,752	$35,815	29%
$246,753 and any amount	$57,144	33%

Selected indexed amounts for purposes of computing income tax

Personal tax credits are a maximum of 15% of the following amounts:

Item	2023	2024
Basic personal amount, and spouse, common-law partner, or eligible dependant amount for individuals whose net income for the year is greater than or equal to the amount at which the 33% tax bracket begins	$13,520	$14,156
Basic personal amount, and spouse, common-law partner, or eligible dependant amount for individuals whose net income for the year is less than or equal to the amount at which the 29% tax bracket begins	15,000	15,705
Age amount if 65 or over in the year	8,396	8,790
Net income threshold for age amount	42,335	44,325
Canada employment amount	1,368	1,433
Disability amount	9,428	9,872
Canada caregiver amount for children under age 18, and addition to spouse, common-law partner, or eligible dependant amount with respect to the Canada caregiver amount	2,499	2,616
Canada caregiver amount for other infirm dependants age 18 or older (maximum amount)	7,999	8,375
Net income threshold for Canada caregiver amount	18,783	19,666
Adoption expense credit limit	18,210	19,066

Other indexed amounts are as follows:

Item	2023	2024
Medical expense tax credit — 3% of net income ceiling	$2,635	$2,759
Old age security repayment threshold	86,912	90,997
Annual TFSA dollar limit	6,500	7,000
RRSP dollar limit	30,780	31,560
Lifetime capital gains exemption on qualified small business corporation shares	971,190	1,016,836

Prescribed interest rates (base rates)

Year	Jan. 1 – Mar. 31	Apr. 1 – June 30	July 1 – Sep. 30	Oct. 1 – Dec. 31
2024	6			
2023	4	5	5	5
2022	1	1	2	3

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.

Maximum capital cost allowance rates for selected classes

Class	Rate	Additional information
Class 1	4%	For all buildings except those below
Class 1	6%	For buildings acquired for first use after March 18, 2007, and ≥ 90% of the square footage is used for non-residential activities
Class 1	10%	For buildings acquired for first use after March 18, 2007, and ≥ 90% of the square footage is used for manufacturing and processing activities
Class 8	20%	
Class 10	30%	
Class 10.1	30%	
Class 12	100%	
Class 13	N/A	Straight line over original lease period plus one renewal period (minimum 5 years and maximum 40 years)
Class 14	N/A	Straight line over 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%	
Class 54	30%	

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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