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MANAGEMENT CASE STUDY AUGUST 2015 EXAM ANSWERS

Variant 1

The August 2015 Exam can be viewed at

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Section 1

Activity-based management

Buying costs are a significant cost, amounting to 218/1,267 = 17% of total revenue. Our operating profit is only Z$ 69 million, so we should be aware of the amounts that we are spending on buying activities and the reasons for us doing so because an increase of 69/218 = 32% in our buying costs would eliminate our operating profit altogether.

The fact that there are significant variations in the proportions spent on buying is a concern. For example, if the buying cost in Fine Fragrance could be reduced to the same proportion as for Celebrity Fragrance then the buying cost would be reduced to 73/82 x Z$ 86 = Z$ 77 million, a reduction of Z$ 9 million.

Consumers buy our products because they enjoy the fragrance, which may bear no relation to the cost of sourcing the materials used in manufacture. The adoption of ABM may enable us to revisit our product range, either replacing unduly expensive materials or withdrawing unprofitable products.

The most obvious drawback to this approach is that it could be very difficult to identify and quantify the cost drivers. The buyers may not be inclined to cooperate fully because the ultimate result would be to reduce staffing in that department.

The greatest concern is that we may discover that the results do not enable us to make any meaningful savings. It may be that the materials that cost the most to procure are the very ones that create the commercial success of our products. In the same way, we cannot necessarily withdraw products from sale if they are integral parts of the Scent brand. Our legacy products may be part of the attraction of our brand, with consumers buying from across the Scent range because they associate their purchases with the values that we attribute to our older products. If we cannot withdraw products or increase selling prices then it may make sense for us to recover the overhead of buying costs in the manner that we do already.

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Change management

The first thing that we need to do is determine the extent to which change is actually necessary. At an anecdotal level, we have buyers who claim that the perfumers are keen to use materials that are difficult and expensive to obtain. We need to establish whether that is actually the case or whether there may be some misunderstanding. For example, do our more recently developed products actually use these materials? If they do, were the perfumers aware of the cost and insistent that they would not change the formulation or was the problem not communicated to them clearly?

If we establish that a change is necessary then we need to ensure that we communicate with our perfumers. They need to understand that their formulations have a serious financial impact. One way to simplify matters would be to furnish the perfumers with a schedule of cost prices that takes account of buying, delivery, storage and any other costs associated with using every one of the ingredients that they include in their products.

The objectives of the change have to be clarified. It would be a mistake to hamper the design process by setting target costs. Given the nature of their work, they need to be free to use more expensive items when the cost can be justified. An expensive ingredient may be the very reason that a new fragrance is distinctive and potentially attractive to consumers. If a newly developed product will be expensive to manufacture then it should be evaluated as such by Scent's marketing department and priced accordingly.

Training the perfumers in the commercial aspects of the business, introducing them to cost control, the need to offer buyers a discount from retail price, etc., could enable the perfumers to see their work in its commercial context. It would be ideal if they could be encouraged to see themselves as partners in the process of designing new products that make financial sense as well as being attractive to consumers.

The risk is that the perfumers will be reluctant to experiment when developing new fragrances because they feel that the materials that they are considering would render their designs uneconomic to manufacture. That could lead to a failure to innovate, which could lead to consumers becoming bored with the Scent product range. The perfumers may feel obliged to replace natural aromas with cheaper synthetics and competitors may gain an advantage in terms of the quality and sophistication of their products.

The perfumers may also feel demotivated by the fact that they feel forced to work within financial constraints and some may leave to work for Scent's competitors.

A fixation on the cost of materials could cost Scent the opportunity to innovate. For example, it may be possible to address the fact that a particular material is difficult to obtain by offering suppliers a contract to grow the necessary plant.

Section 2

Potential costs and benefits

At first glance, there appears to be scope for rationalisation. There are only three separate manufacturing locations and two of the divisions share a factory. There is undoubtedly some duplication of effort that could be dealt with through rationalisation.

The number of common items is very high, which implies that there could be two or more buying departments placing orders for materials independently. Combining orders for the company as a whole could enable Scent to order those items in larger quantities and so take advantage of discounts.

Merging the inventory control systems could also lead to Scent having better control over inventory. It is ridiculous that one division is left short of a vital ingredient that is held by another.

Merging these departments could lead to indirect costs. Firstly, each of the divisions requires a number of unique items. Their respective buying departments will have the experience and contacts to obtain these.

The Fine Fragrance division has more buying staff than Celebrity Fragrance despite having smaller sales revenue and, presumably, higher unit selling prices. That all implies that Fine Fragrance requires a smaller volume of purchases, which may mean that buying for that division is a highly specialised part of the business activities. Merging the buying departments may not enable rationalisation because each department could require different skills and knowledge. For example, Fine Fragrance almost certainly uses more natural aroma oils than the other divisions. Those are likely to be sourced differently than the synthetics used by the others, so it may not be practical to merge the Fine Fragrance buying department with the others.

Those problems could possibly be reduced by creating two buying departments, one for natural products and the other for synthetics.

The rationalisation of inventory management may be more logical, although the fact that there are three separate sites may create inefficiencies. Some materials may be common to all four divisions and be kept at all three factories. It may be more inefficient and expensive to transport materials between locations than it would be to manage inventory centrally.

It would appear that there is reasonable scope for merging the buying and inventory systems for Bath and Body Fragrance and for Home Fragrance because they are both at the same location and both have relatively small numbers of staff.

Communication issues

The initial focus should be on the implications for the buying staff themselves. Staff are unlikely to be interested in the potential savings or efficiencies that may arise from the changes that Scent intends to make.

If there are likely to be job losses then the number of posts that are likely to be shed will have to be clarified at the earliest possible opportunity to avoid speculation, which is likely to be demotivating. The basis on which staff are likely to be selected for retention should be made

clear, to reduce the risk that key staff will start to look for other positions and leave Scent just because of the uncertainty.
The merger may lead to the relocation of one or more of the existing buying departments, which could affect staff who have to change their commuting arrangements. It should be made clear where the new buying department will be located. If Scent intends to offer any compensation for additional travel or to organise alternative transport arrangements then that should be announced. It may be possible to offer some staff the ability to work from their present location for at least a while after the merge to soften the blow.

The rationalisation may reduce the need for supervisors and managers, which will concern those in promoted positions. All staff will be keen to know who the head of buying will be, presumably one of the four heads will be selected to take overall charge and that will lead to the other three being demoted to a lesser status. If this is not clarified as a matter of urgency then there could be a risk of competition between the four individual heads of buying, with each attempting to make a case for promotion at the expense of the other four and at the risk of Scent being harmed in the process.

Scent will have to make it clear that each of the four divisions is valued equally and that its contribution is recognised. Buying staff may become hyper-sensitive and defensive. For example, Fine Fragrance staff may worry that they are regarded as at greatest risk of cuts because they are the largest department, while the other three departments may view the fact that they are smaller as implying that they enjoy less status.

Section 3

Should the board be concerned?

It is very unlikely that Scent's competitive environment will remain constant and so the board should always consider the implications of any new developments.

The barriers to entry to the perfume industry are complicated. Perfume houses are effectively selling an image, which is evident from the fact that Scent's intangible assets have a much higher net book value than their tangible. Manufacturing a very specific fragrance requires a great deal of skill, but it should be possible for an inexperienced perfumer to create a simple but acceptable fragrance from basic ingredients using trial and error.

Valueshop has stripped some of that mystique away from perfume sales by selling a basic fragrance at a low cost, without celebrity endorsement. They are able to compete with established brands by promoting their fragrance aggressively through its placement in highly visible locations with high foot traffic in their stores. They have clearly managed the publicity very effectively, possibly using contacts in newspapers to place their story.

A significant proportion of those who wear perfume will have a favourite product and they may be reluctant to switch to a cheaper alternative. Scent may be able to retain its existing customer base and Valueshop may even create a sales opportunity if some consumers start to use perfume regularly after buying from Valueshop and subsequently start to use more sophisticated fragrances.

Much of the perfume sold by Scent is purchased as a gift. It is unlikely that many consumers would be willing to replace a gift of Scent fragrance with a bottle of perfume bought from a discount supermarket. These sales are only likely to be displaced if some consumers buy their own perfume from Valueshop and are given alternatives to perfume as gifts.

In the longer term, it is unlikely that Valueshop will continue to enjoy free publicity from press articles. They can continue to exploit the ability to set aside space in their shops to maintain brand awareness amongst their customers, although there is an opportunity cost associated with displacing other products. It is too early to tell whether Valueshop has significantly disrupted the retail market for perfume.

Pricing strategy

Scent will have to discuss this with its retailers, who will have to deal with the consequences of this decision.

If Scent launches a stand-alone range of cut price fragrances and undercuts Valueshop on price then it may arrest both Valueshop and any other potential entrants to this market. This could be a sustainable strategy in the short to medium term because Scent does not have to pay a margin to manufacturers, whereas Valueshop is unlikely to be manufacturing their own products and so they will have to provide the manufacturer with a profit. On the other hand, Valueshop is retailing its fragrances through its own stores whereas Scent has to provide its retailers with a discount from the retail price. Also, Valueshop may be willing to cut its selling prices even further and use a price war with Scent as a source of publicity while selling its fragrances as a loss-leader to attract customers into its stores.

There is a danger that Scent will undermine its own brand credibility if it sells a cut-price range of fragrances. Consumers may not wish to be associated with the brand and may defect to

other traditional perfume houses. Scent's retailers may also feel that the brand is being undermined and so may promote brands such as LK more prominently.
Scent may also alienate its consumers with this approach. They may feel aggrieved that Scent is attempting to prevent Valueshop from selling them an inexpensive product that they enjoy. Scent may be portrayed as greedy and insecure and consumers may interpret the response as a sign that it views Valueshop's products as being equivalents, so there could be a boost to the competition's sales.

Bundling the cut-price brand may enable Scent to retain the loyalty of its retailers because they will have exclusive rights to the new brand. That will avoid the sense that Scent is competing against itself by selling the cut-price products through more suitable outlets such as other discount stores or supermarkets. Linking the quantities sold to purchases of traditional products will enable Scent's retailers to develop their own retail strategy, which may enable them to limit the threat to the credibility of Scent's brand name. They may also see the new cut-price range as an opportunity to make a windfall gain from a high volume of low margin sales for the duration of this exercise.

Section 4

Accounting issues

The basic accounting requirements are set out in IFRS 2 Share-based payment.

The first accounting problem is that we will have to value the options at their grant date. That is a matter requiring considerable professional judgement because there are many different models available for the valuation of options, each of which will offer a different value. All of the models will also require us to make complicated estimates that are also potentially open to dispute and debate and all of which could have a significant impact on the reported value of the options.

In the absence of any similar financial instruments being available on the open market, we will struggle to determine whether the fair value that we attribute to the options is realistic.
The cost of the options has to be recognised over the course of the vesting period, taking account of the likelihood that the options will vest. That means that we need to decide on the likely number of perfumers who will remain with us for the duration of the vesting period. While the vesting period is intended to discourage them from leaving, many potential employers would be willing to compensate them for the loss of any rights.

The options will create the need for significant additional disclosures. We will have to explain the logic underlying our remuneration approach and will have to disclose significant amounts of additional information about the option scheme itself. Given that we are aiming to offer these perfumers an additional benefit without alerting the existing workforce, we may actually be drawing considerable attention to the rewards paid to these new members of staff.

The options will also create issues concerning the dilution of our earning per share figure. This is in response to IAS 33 Earnings per share. We will need to calculate the impact of the potential shares, even though they have not yet vested.

Risks

The most obvious risk is that the existing perfumers will be demotivated by the fact that their new colleagues are receiving a benefit that has not been offered to them. Scent may be forced to extent the option scheme to include the existing perfumers, which may then lead to other members of staff feeling that they have been excluded too.

The shareholders may not be happy to see options being granted because options have been associated a number of major corporate scandals. The shareholders may not consider the fact that the scheme is restricted to a narrow category of staff. They may also be concerned that their future returns will be diluted in the event that the options are exercised.
On the upside, there is a possibility that the new perfumers will be motivated by the fact that they can participate in any growth in the share price. Unfortunately, they will also benefit from gains that have nothing to do with their contribution to the business.

There could also be a risk of dysfunction behaviour by the perfumers. They may push for strange fragrances that will either prove disastrous or highly successful. In the event their recklessness pays off then their options will be worth more thanks to the additional sales and the growth in profits and so the share price. They will not be exposed to any downside, beyond the fact that their options will expire worthless. Thus, their interests are not necessarily aligned with those of the shareholders.

From an ethical point of view, this arrangement appears to have been motivated by a desire to mislead existing employees. The board is not under any particular duty to inform employees concerning the rewards offered to new staff and so it is debatable whether that is a serious ethical failure in itself. There could be a further ethical issue in the fact that the directors appear to be aiming to make their lives easy rather than designing a remuneration package that is a suitable basis for rewarding staff.

There may also be an ethical concern arising from the fact that an option may be viewed as a performance related payment, which is fine except the perfumers have little direct ability to manage the share price and so any performance related element is indirect.