Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY AUGUST 2015 EXAM ANSWERS

Variant 2

The August 2015 Exam can be viewed at

https://connect.cimaglobal.com/resources/management-case-study-exam/august-2015-management-level-case-study-exam---scent-variant-number-2

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Section 1

Assumptions

The most obvious problem is that the revenue figures seem rather unrealistic. The airport's passenger numbers are expected to be low in the first year, but to grow rapidly. The first year's sales are based on the sales made by a high street shop that has a significant footfall, which is unrealistic. It would be far more logical to show a realistic figure for the first year, with a rapid growth to reflect the anticipated growth in customer numbers.
The mix of sales made at an airport shop may differ from that in a more traditional retail environment. Duty free stores may tend to stock more expensive lines because the freedom from sales tax means that those lines are available at a bigger saving.
Revenue is shown as increasing to allow for the rate of inflation, which is likely to be defensible given the discount rate. If inflation is to be taken into account then it should also be applied to other costs, particularly wages.
The discount that would normally be granted to retailers is not a valid measure of the cost of goods sold. The figure shown for net contribution is the amount at which the goods would normally be sold to retailers, which deducts an irrelevant sales discount from the gross sales and also ignores the production costs. The marketing department should estimate the cost of the goods that will be sold, based on assumptions that go into the revenue figures in terms of the mix of sales.
The cost of the shop deposit is an outflow, but if the analysis is restricted to the first three years then we should see some or all of that payment being refunded at the end of the initial contract period.
The wages figures seem unrealistically low. Airports generally operate seven days a week throughout the year. If six members of staff are required when the shop is open then no allowances is being made for staff rest days.

WACC

The cost of capital should reflect the risks associated with the venture. To an extent, the risks associated with Scent's normal manufacturing activities are affected by factors such as consumer demand for fragrances. Those factors could be viewed as being roughly in line with the risks associated with retailing perfume and so it may not be ridiculous to use Scent's WACC in this way.

Having said that, the cost structure of a retailer will always differ from those of a manufacturer, even if they are in the same line of business. It is unclear whether that suggests that Scent's WACC is too high or too low, but it could be very different from the rate that would apply to a retailer.

It would make more sense for the cash flows from this venture to be discounted using the rate appropriate to another retailer, preferably one that operates in the duty free market.
There are some very specific factors that might affect the rate at which this venture should be discounted. The first is the potential for synergy between the manufacturing and retail side of the business. The profits earned by Scent in manufacturing a bottle of perfume and retailing it through its own store are very different from those that will be earned when Scent manufactures a bottle for resale to a retailer or when a retailer buys from Scent and retails the perfume by itself. For example, Scent may decide to offset an increase in the cost of an ingredient in manufacturing a bottle of perfume against the retail profits in its store.
The cash flows have been discounted at a rate of 9%. Our latest annual report states that our WACC is 12%. Perhaps our cost of capital is too volatile to justify the use of WACC for such an important investment because the rate could revert to 12%, or increase even further, after we are committed to the project.

The discount rate should also allow for the motives behind investing in this venture. Scent is not just attempting to generate a return from this venture, it is also attempting to ensure that it excludes a competitor from a major business opportunity. If that is a significant concern, then it could be argued that Scent does not necessarily have to consider the net present value of this investment in too much detail because it would proceed even if the NPV was negative.

It is also possible that this venture is a precursor to investing in a new retail venture and so the real benefit is in terms of gathering knowledge and experience and so the direct cash flows are almost incidental.

Section 2

Wider risks

The basic danger is that Scent's retailers will start to reconsider their relationship with the company. If Scent appears to be planning to enter the retail business then the retailers may feel that they cannot regard their current business relationship as viable. They may be concerned that Scent will expand into retail in a much more ambitious way and undercut the prices charged by existing retailers.

The basic risk is that Scent could lose its distribution network if the retailers decide to cut back on Scent products, or even stop buying them entirely. It may prove difficult to win the retailers back if they develop closer ties to rival manufacturers such as LK.
The management of this venture may prove a distraction for the marketing department. The time that is spent managing the shop and monitoring its activities will detract from the more important matter of running the marketing department of a major quoted manufacturing company.

The marketing department's attitude could lead to them pushing to ensure that the project is a success, perhaps sinking additional funds into it in order to keep it afloat even if it is not generating sufficient revenue.

If the project is highly visible, then Scent could damage its reputation if it is an outright failure. If Scent cannot sell its own perfume then it could be argued that nobody can.
There could be an upside risk if Scent gathers some useful intelligence about the retail side of the industry. It may be possible to add some value to its product range or its promotional activities.

Negotiating strategy

Scent should ensure that it is aware what will suit both sides from this negotiation so that it can aim for a win-win agreement.

The main concern that the retailers will have is that they will not wish to go into competition with Scent because Scent will be able to undercut them on price and will be able to offer its own stores benefits such as priority in the availability of newly launched products. Scent should make its intentions clear and ask whether those plans would undermine the retailers in any way. If Scent has no intention of ever opening another retail outlet then that should be made clear, although the company will then lose a great deal of credibility in the event that the shop is a success and it decides to open further outlets.

Scent needs to pay particular attention to its discussions with Globalfly to ensure that the company does not perceive Scent as a direct threat in the duty free market. One approach would be to discuss running the proposed new shop as a joint venture with Globalfly.

It would be ideal if Scent could devise a retail strategy that did not involve any competition with existing retailers. If Scent was to plan to establish a chain of stores in countries where its products are not yet sold then existing retailers would have nothing to fear from this proposal. If anything, they may benefit if Scent is able to obtain economies of scale from increasing output to service these new markets and those are passed on in the form of lower prices.

If Scent plans to set up stores in competition with the existing retailers then it should attempt to address the matters that might raise particular concerns. For example, it may decide that the stores will only sell goods at the recommended retail price, so that the retailers are only at a disadvantage if they sell goods for more. In that case, Scent's shops might be viewed as another means of promoting the brand and so sales might be regarded as almost being secondary. Alternatively, Scent could use the stores to dispose of remainders and surplus goods, such as remaining inventories of fragrances that have been discontinued. That would provide a cost-effective way to dispose of unwanted products without interfering with existing retailers' sales.

Section 3

Balanced scorecard

Financial
We could use revenue from retailing as a measure of success.

The retail manager cannot be held accountable for return on capital employed in this venture because she will not be permitted to make investment decisions.

Revenue will demonstrate that Scent is capable of making sales through this channel. The prospective appointee has a background in retailing and so strong retail sales should be partly attributable to her leadership in this area.

Business processes

We could use the number of stores opened as a measure of success.

The retail manager will not have the final say in investment decisions, however we will have to rely on her expertise in order to identify suitable sites. Even if the manager has no direct responsibility for managing the store fitting, she will have to ensure that suitable staff are employed to manage and run the shops, and she will have to ensure that any local promotions are proportionate, in terms of attracting custom at a realistic cost.

Even though the retail manager will not be wholly responsible for the number of openings, her workload will be determined by the number of openings and her leadership will be tested by the number of openings under management at any time.

Customer

We could offer retail customers the opportunity to complete online surveys and use their stated opinions on the quality of service as a basis for evaluating customer satisfaction.
The retail manager will not be serving in shops herself, but she will have overall responsibility for developing standards for customer service and for ensuring that shop staff have procedures that are suited to the nature of the product and the type of clients who would be attracted.

The retail manager might not be given credit for high scores in any customer surveys, but she would be expected to demonstrate that any stores that had been flagged as having poor scores had been investigated and the reasons determined and action taken in response.

Learning and growth

The retail manager might be evaluated on the basis of store staff training.

Ideally, there should be a range of courses on offer, so that more experienced staff can receive more advanced training. That would then offer the basis for additional pay or increased responsibility, thereby offering some motivation.

The quality of the materials might be gauged by staff engagement. For example, feedback from staff who had completed a module, or the score in any online tests linked to online materials.

Any relevant measures would have been accepted.

Feasibility study

The basic question is whether the stores will make good business sense. Scent has a successful business that sells a wide range of products through a variety of different outlets. The crucial question is whether it will add value to the company to add direct marketing through branded retail stores to the marketing mix.

The basic question that has to be asked is whether Scent will sell any more perfume through this arrangement. Is the company simply diverts sales that would have been made anyway through existing retailers into its own stores then it will probably not be any better off. The stores will probably yield a higher margin than selling on a wholesale basis to retailers, but the running costs will be significant.

Scent will also have to conduct test marketing and possibly focus groups to determine whether opening its own shops will confuse the buying public. It is unlikely to benefit Scent if consumers are confused as to whether to buy perfume from a Scent store or their current outlet and end up deferring the purchase or switching to another brand. The features that customers wish would also have to be determined. Are they looking for a wider range of Scent products in one location, or the availability of expert advice or some other feature? It is basic marketing to establish a market need and to fulfil it.

The feasibility study will also have to consider the availability of suitable sites. Presumably, Scent will wish to open stores in prestigious locations and to capitalise on the proximity of potential customers. It may be that there are relatively few stores of an appropriate size and location that can be rented or purchased at an acceptable price.

Section 4

Communicating changes

The basic problem is that consumers are likely to be suspicious of any change to a popular product. For example, Coca Cola received complaints that its product did not taste as good when the company proposed a change in recipe even though the new product had not even been released.

Most products have both a practical function and an emotional one. It would appear that there has been little or no change to the practical product, which smells as it did before. The emotional appeal is probably more to do with the ethos of the product in terms of the manner in which it is presented and packaged and has little to do with the product's ingredients. On that basis, simply updating the product and updating the list of ingredients was almost certainly sufficient.

With hindsight, the fact that this is a long-established and prominent product has made it newsworthy and so the approach that was taken has proven to be counterproductive. If the company had made a low-key announcement that the formulation of this classic fragrance was to be updated very slightly in order to offer a better quality then it would probably have attracted little or no comment.

There has been no ethical breach because Scent has not made any misleading claims. The greater use of synthetics does not seem to affect the effect of the perfume.

It could be regarded as a little misleading to define the phrase "not tested in animals" in a very technical way that is undoubtedly being interpreted in a very technical way by Scent and other manufacturers and a very literal way by consumers. This is, indeed, common industry practice, but it would be desirable for Scent to be clearer about what it actually means.

Lifecycle

It is unlikely that individual fragrances do have a conventional lifecycle as such. They are developed by Scent's perfumers and will have to be launched, perhaps promoted using advertising. They should then either prove fairly popular and attract good custom or not, in which case they may have to be withdrawn. Once a product is launched, it should not take very long to reach a steady state in terms of sales volume.

Many of Scent's products have been on sale for many years and their popularity remains strong. It may be that the customer base for certain products renews itself. For example, Cinque Fleurs has been an enduring brand. Consumers may have to reach a certain age before they can afford to wear such an expensive brand. Scent can sustain demand by advertising and promotional activities.

Some products may have a lifecycle, although that may be as much because of promotion as anything else. Celebrity Fragrance produces products that are linked to individual celebrities whose fame may wane over time and for whom there is a very definite lifecycle. Arguably, it would require very little to change a fragrance slightly and relaunch it with a different name in the event that happens. Scent can track the popularity of these consumers by studying trends such as hits on social media sites or press articles.

Scent may not have a traditional product lifecycle as such, but the range should be kept under constant review. All products will take up space on retailers' shelves and that creates the opportunity to display an alternative that may be more popular. Products may be withdrawn in order to retain consumer interest and also to make way for products that may sell in greater volume. Developing a new fragrance is not particularly expensive and the manufacturing process is not particularly complex, so there is no reason to remain loyal to an existing product that is going into decline. As soon as Scent can see that it is time for a change they should have a new product ready for launch.