Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY AUGUST 2015 EXAM ANSWERS

Variant 4

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-4

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Section 1

Risks of success or failure

There could be a clash of cultures between the two companies. LK is very much about organic products and offering employees a fair deal and we are more concerned with making a profit. We might find that the merged entity lacks a coherent approach to business.

Integrating the two companies could prove difficult because of different systems and approaches. The Scent systems might not work well when applied to LK, especially if the former LK staff resent the changes. It might not be possible to manage the combined entity effectively.

Both companies could lose key staff because of fears of rationalisation of loss of seniority. Managers and skilled staff such as perfumers might defect to competitors and could be difficult to replace. These losses could occur before we have an opportunity to reassure staff about Scent's intentions.

The flexible working arrangements at LK could be difficult to withdraw. Scent staff may wish to have similar schemes. Staff may be insecure and/or resentful until a satisfactory solution can be obtained.

Market domination

Having one key player in the celebrity fragrance market could mean that it will be difficult for competitors to enter this market in the future. Celebrities will be keen to be signed by Scent because that will be seen as the only meaningful presence in this market.

Celebrity endorsements also impose costs that may not affect other manufacturers. For any given fragrance, Scent will have to pay a royalty for the use of the celebrity name, which will increase the cost associated with making and selling a competing fragrance.

The question of costs and benefits will require careful study and research because it may be cheaper to make a sale by attaching a celebrity name to a fragrance than to advertise the product in any other way. The big advantage of dominating this market segment is that consumers will recognise the product names because they also belong to famous people who are in the public eye. Advertising can create a product awareness, but it requires a degree of maintenance.

The danger is that the celebrity endorsement could interfere with the point of the business. The intention is to develop fragrances that consumers will wish to wear or to use in their homes. Part of that desirability is emotional because fragrances can evoke senses and feelings and the celebrity endorsement can be part of the process of meeting the market's need. Ultimately, though, the celebrity endorsement is just one of many ways in which Scent could evoke a particular lifestyle statement.

It will be difficult to use the celebrity endorsement to block access to the market because there will always be celebrities who will be willing to attach their names to competitors' products even if Scent leads the market. It may be that Scent will lead the way in making it desirable to use celebrity endorsed fragrances only to discover that it is the celebrity who sells the fragrance regardless of whether it is manufactured by Scent or someone else.

Section 2

LK retained as a standalone division

The LK division will be competing with at least three of the other divisions because it sells celebrity endorsed fragrance as well as bath products and home fragrances. In the worst possible case, LK will continue to compete to almost the same extent as it does at present. The management and staff at LK will, with some justification, see themselves as part of LK and will not identify with Scent. Any requests from "head office" will be regarded as from "Scent" and may be acted upon in a very ineffective and dysfunctional manner.

LK staff may not feel any compulsion to change their procedures to comply with Scent's policies. That could mean that there are gaps left in internal controls, with the risk of fraud or error. It could also mean that Scent's board cannot obtain an accurate and comprehensive oversight of the business because the management reports will be difficult to combine and consolidate.

If LK remains an independent division then there will be very little scope for rationalisation of the existing product ranges. It would be preferable to merge the business and to identify the more profitable of any pairs of products that are viewed as competing directly.

The threat of competition could also arise in terms of new product development. Any trends or fashions in fragrances could see both divisions offering very similar products and so splitting the market while increasing the overall manufacturing cost. LK's division managers may well focus on what is best for the division and its staff and could have very little interest in the interests of Scent and its shareholders.

Board structure

The danger is that Paula Yin and Herdeep Sunter will see themselves as LK's representatives on Scent's board. In some respects, there could be a case for stating that all of LK's board will be asked to step down and that a divisional management team will be put in place.

The problem is made worse by the fact that we are leaving LK's former chief executive and chairman in place, albeit as part of the combined Scent board. The problem is that these are the two individuals who are most likely to embody LK's values and to wish to retain those in their new role. They may, for example, wish to champion the position of the LK employees and could argue to retain the benefits that have been granted as a direct part of the LK ethos. They could also wish to argue for resources that could have been better applied to the expansion and improvement of the Celebrity Fragrance division to go to LK.

There could be further problems associated with both individuals effectively being "demoted" from chief executive and chairman to simply being board members. They are both likely to be ambitious individuals and this si undoubtedly a backward step in their career progression. They may respond by attempting to assert themselves with a view to developing a reputation that they can use to obtain more senior positions with other companies.

The fact that Paula does not have a specific role, such as finance or operations will help to confirm the concerns described above. It would have been more sensible to have had one of Scent's former board members stand down to create a specific role that would have been in line with her expertise and experience.

It may also have made more sense to have brought in more than just two “token” board members from LK. That would then have given the sense of a true merger, with all directors more inclined to feel responsible for the merged entity.

Section 3

Goodwill

Valuing the non-controlling interest will be a complicated undertaking because a block of 20% of the shares held by a small number of investors could have a disproportionate value. This 20% holding will give LK and the founders a degree of control and they may be able to assert their interest more forcefully, so the shares may be worth a premium. We would need to consider the extent to which these shareholders will collaborate because three or four non-controlling shareholders who owns 20% between them will have far less scope for using that voting power than a block of 20% that always collaborates.

LK's property could be difficult to value because it is in a fairly depressed area. There may not be a particularly strong market for industrial property and so a fair value may be difficult to estimate and it could have a fair value that is less than cost. The equipment is unlikely to be particularly specialised and so it may be reasonably easy to value, although there is also a concern that it would have to be moved to a more prosperous part of the country in order to sell it.

LK's subsidiaries will also raise questions of valuation. How much are their net assets worth? The most significant challenge will be over the valuation of LK's brands and intangibles. The brand names will not have an observable fair value that can be compared to market valuations. There is, however, a cost less amortisation for the right to use a particular name. The problem is that the merger will have changed the relationship with the celebrities who provided their names. Their initial interest was motivated partly by the involvement of the actors who founded the company. In future, celebrities may be less willing to support the fragrances because their friends are no longer heavily involved in managing the company. The rights could, therefore, be impaired when their fair value is determined in comparison to the unamortised cost.

Non-financial implications

The most immediate threat is to Scent's reputation. It will effectively be making a group of workers redundant in an area of high unemployment. There will be considerable adverse publicity associated with the move, because this will be a very evocative story that will appear to news editors**.**

We could offer LK's former employees the opportunity to relocate to Scent's factory, although that would be viewed as a rather empty gesture because it would be costly for them to do so. This is all at odds with the values that LK had in the past, which could have been a factor in stimulating sales demand. Customer satisfaction could decline. Scent could also lose the support of the celebrities who have endorsed the company's products because they will not wish to be associated with such a negative human interest story.

Scent's other employees are likely to regard the company's willingness to shed jobs in order to cut costs as a sign that their positions are not necessarily completely secure. Staff will be less loyal to the company if they feel insecure in their jobs and they may become less productive as a result.

Product quality may be impaired slightly because the two factories used different types of material, with LK using more natural products and Scent more synthetic. There could be difficulties in asking Scent's workers adapt to handling natural products. The company will also have to deal with an inflow of new staff, who will also have to settle into their new roles and that could led to further product issues.

The new factory will be making more products, which will lead to more changeovers and setups and that could lead to inefficiencies and/or machinery breakdowns.

Section 4

Change management

The new system will require change to employees' terms and conditions. We will need to ensure that employees are informed that their working hours will change. In theory, they could refuse to accept the change and we may then be forced to make them redundant if we cannot reach agreement. We may have to offer some compensation for the argument that the new working arrangements will lead to working unsociable hours.

We will also need to increase the staff complement so that we can staff both shifts. The new staff will have to be trained and inducted.

We will have to schedule the new shift-work arrangements. That will involve developing a pattern, presumably with employees alternating between shifts on a weekly basis. We will need to schedule rest days so that we can avoid staff leaving for home at 22.00 one night and having to arrive at work at 6.00 the next morning.

We will also have to break up established work teams because it would make sense to split the new employees across both shifts. Doing so would ensure that there was a mix of experienced and inexperienced staff so that there were always experienced people on hand. We might have to make some practical arrangements to facilitate matters such as transport. Staff may find it difficult to get to and from the factory at the new shift start and finish times.

Pricing decisions

Customers won't necessarily be aware of any significant cost saving and they may not expect us to cut our prices.

We need to be certain first of all that there actually will be a cost saving, otherwise we may cut our costs only to discover that we have eaten into our profit. We need to be certain that our costings are accurate and that we have actually achieved the savings in practice before we even consider reducing our selling prices.

We need to understand the impact of any price cut on our sales volume. We sell our product to retailers, who may simply take the reduced price and earn a larger profit from every unit that they sell. If we are to reduce our selling price we should do so on the basis that we will give a discount for additional volume. That way, we can be certain that we are actually likely to sell more. We should also discuss the possibility that the retailers will sell more Scent products so that the additional volume is sustainable. It may be that they will agree to promote our products more aggressively. For example, Scent products could be given a more prominent place in the shops.

If the retailer is going to reduce retail selling prices then we need to determine whether our sales demand is elastic. Customers may not buy any more of our product just because it is a little cheaper. We should study factors such as the impact of past price increases or our selling price in comparison to our competitors'.