MANAGEMENT CASE STUDY FEBRUARY 2016 EXAM ANSWERS

Variant 1

The February 2016 Exam can be viewed at

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SECTION 1

Value chain

Our basic approach would be to work through the elements of the value chain, as identified by the consultant.

The starting point would be to understand what each link in the value chain contributes, if anything, to the creation of added value for Pizzatime. For example, inbound logistics is a complex area for our company. We buy fairly basic ingredients, that are more or less basic commodities such as flour, and convert those into dough at a central factory. The output from that factory must be transported quickly and efficiently to every outlet, with no interruptions to supply and no impairment of quality. We can add a great deal of value at this stage because we can focus on making good quality dough that will enable us to sell pizzas at a premium price.

Some of the links in the chain will be less important than others in our business. For example, there is very little in the way of outbound logistics in our business. Even our franchisees will be integrated into the basic inbound logistics model.

As far as staff are concerned, we need to be clear that every aspect of their jobs involves the creation of value for Pizzatime. One purpose of added value is to pay wages, so their livelihoods depend on that.

Staff need not be trained specifically on the value chain itself, but they do need to understand how their jobs impact on the business as a whole. For example, the staff in the dough factory need to ensure that they work at creating consistent output so that customers know what to expect when they order a pizza in one of our restaurants. One of the selling propositions of a business like ours is that customers are confident to eat in any of our outlets because they will know exactly what they will be getting, even if they have never eaten in a particular restaurant before.

The same logic could be applied to other aspects of the value chain. For example, staff in a customer-facing role can ensure that customers are given friendly and efficient service, thereby increasing the chance of repeat business.

Arguably, staff do not need to be trained in the results of this value chain exercise, but management should have a very clear understanding of the importance of each link. Knowing how each step contributes will enable management to ensure that attention is paid to the areas where there is the greatest scope for improvement.

Low-cost or differentiation

Once Pizzatime has a clear understanding of the ways in which it can create value, the question is whether it should aim to work towards reducing costs or increasing (or at least protecting) revenues at each stage.

Arguably, Pizzatime should focus on a differentiation strategy, thereby enabling it to maximise revenue from every sale and thereby enhance added value.

Pizza is a simple form of fast food. It is easy for actual and potential competitors to sell pizza and for them to compete on price. The principal ingredients are cheap and readily available and the creation of a basic pizza requires very little skill or equipment.

Pizzatime could views its competitors as including other fast food restaurants, including other pizza restaurants, and supermarkets (who sell readymade pizzas that can be heated up at home). If Pizzatime aims to compete on price then it may be open to competitors undercutting it and leaving very small margins in the process. Competing on price effectively leaves the initiative with the competition because there will be many ways to engineer costs out of the product. For example, independent restaurants might open in less expensive locations that are close to Pizzatime's restaurants. Or they could reduce portion sizes slightly or reduce the quantity of toppings in a helping.

If Pizzatime aims for differentiation then it may be able to do that partly through the quality of its product. For example, by selling through restaurants rather than home deliveries, customers will always receive hot and tasty pizzas straight from the oven. Better quality ingredients, such as olive oil rather than cheaper fats in the dough mix, will encourage repeat custom. Pizzatime can innovate with new toppings or other innovations, which cannot be copied easily without appearing to be a copycat.

Pizzatime can also differentiate through its presence. Customers will be familiar with the brand and the products and will be confident about eating in a Pizzatime restaurant if they find themselves in a strange town.

This market will also reward marketing and promotional activities. Brand names and trademarks are protected as intellectual property.

Section 2

Supply chain

We need to consider two links in the supply chain. There is the purchase of raw materials from third parties and there is the conversion of those materials into dough and other components at our factory.

Pizzatime buys large quantities of raw materials and these are essentially commodity items. The temptation will be to find the cheapest sources that are of an acceptable quality because customers will not necessarily taste any difference between cheaper or more expensive flour. Given the throughput from the business, it may appear to make sense to buy cheaper flour that is close to its best before date because purchases should normally be converted into dough and then resold as pizzas very quickly after acquisition.

We need to investigate the reasons for buying flour that is close to its expiry date. If it is, indeed, cheaper to do so then we will have to set a policy for such purchases. We will also have to ensure that the inventory management systems within the dough factory can cope with best before dates, because we may not necessarily wish to rotate inventory on the basis of first in first out if flour is purchased with different life expectancies.

Clearly, if our suppliers have been selling us flour that is close to the expiry date then we should make it clear that we are more interested in quality than price and we should renegotiate contracts to allow for acceptable dates.

We also need to consider the motivation of the factory management. Part of the problem appears to be that the factory preferred to use inventory that was a little too old because the alternative would have been to have scrapped it. We need to ensure that the factory is monitored and evaluated in such a way that the factory manager does not feel that there is an incentive to compromise quality.

Ethics

It will be difficult and possibly counterproductive to argue that we have behaved ethically. We have sold food that could, potentially, be harmful and that will always be difficult to excuse. Any defence that we offer might be interpreted as implying that we intend to continue to do this, which could further harm sales.

While we do not wish to deny wrongdoing, we could engage in damage limitation by offering some mitigation. Firstly, the “best before” date on food does not necessarily mean that the food will suddenly become inedible when that date has passed. The date has no legal significance and our behaviour has not broken the law. We could argue that we believed that the flour was still perfectly safe and edible. The food technologist interviewed in the documentary had not tested the flour and was, therefore, talking about potential infestation of the flour rather than actual tainting.

The safest response would be to accept that the best before dates are indicative of quality and that we should always aim to use good quality ingredients in our pizzas. We have failed our customers to some extent in the past, but we will improve our standards in the future.

Accounting issues

The basic issues are covered in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

We can make a provision for these claims if there is a present obligation from a past event. It has to be more probable than not that there will be an outflow of resources and there will have to be a reliable estimate.

The fact that we have probably not actually harmed anyone is almost irrelevant because we are faced with claims and it may be in our commercial interests to settle them rather than to attract more publicity through defending them in court.

The most difficult accounting issue will be determining the value of future payments. Hopefully, we will have a clear understanding of the numbers of claims made against us by the time that the financial statements are finalised, which will be after the year end and so could be even further into the future. Experienced legal advice should enable us to make an informed estimate of a realistic settlement for the majority of these claims.

There may be a small number of significant claims arising in respect of serious medical reactions and they may be difficult to predict. In those cases, we may have to disclose them as contingent liabilities.

Section 3

Relax targets

We need to remember that the purpose of these bonuses is to motivate the managers. It could be argued that relaxing the criteria will create a dangerous precedent. There will always be risks that demand for Pizzatime's products will falter. If there is an expectation that the targets will be relaxed then managers might start to game the system whenever there is a concern that targets are difficult to achieve.

In this case, the downturn in revenues has been really pronounced because of fears about Pizzaland's hygiene. It would be difficult for managers to do much, if anything, to stimulate sales at restaurant level. Thus, the motivation associated with an easier target would have a very limited benefit to the company.

The mangers will still have an incentive to do their best. The company is going through a difficult period and any manager whose performance is deemed inferior to the rest is at risk of losing his or her job. This pressure is unhealthy, but it should still give managers an incentive to maintain the standards within their restaurants.

Another argument against relaxing the bonus target is that Pizzatime is going through a difficult period. Taking the bonuses from managers will constitute a cost saving that may assist with the company's recovery. Perhaps we could compromise by paying a token amount in lieu of a full bonus.

Realistic targets

The hope is that sales will revert to previous levels after some time has passed and we have adequately dealt with this crisis. We have a number of data points since the documentary aired and we could attempt to extrapolate the trends back to normal sales.

There may be other cases of health scares affecting consumer confidence and so we may be able to draw upon past experience, either our own or that of other companies. We may be able to link the rate of change to factors that we can observe, such as the number of press comments or comments on social media sites. The sooner these cases slip from public consciousness, the sooner sales will return to normal.

We may be able to gather information through focus groups on interviews with consumers. We could engage market researchers to contact suitable respondents, such as members of any customer loyalty scheme that Pizzatime operates or respondents to any previous incentive scheme or survey. The strength of any negative perceptions can be identified and used to inform our forecasts. This approach could also gauge consumer responses to any attempts that Pizzatime has made to repair its reputation.

Balanced scorecard

This would be a longer term question and one that has little to do with the present crisis.

At present, the bonus scheme has the advantage of simplicity. Managers are evaluated on the single target of shop profitability. If that is aligned with Pizzatime's overall best interests then that is a sound basis for rewarding performance.

The danger would be that managers might focus on profits to the detriment of other factors that might be in the company's longer term interests. For example, discretionary expenditure on sales promotions or staff training might be minimised in order to cut costs in the short term.

A balanced scorecard could be harmful if some of the performance measures are not best suited to a particular restaurant. For example, the manager of a busy city centre restaurant might focus on serving food quickly and encouraging customers to eat up and leave. That could create a less relaxed dining experience and could lead to poorer scores in surveys of customer satisfaction. On the other hand, it could also free up tables that will inevitably be taken by other customers.

By its nature, a balanced scorecard can only be linked to a remuneration scheme if there is an explicit weighting and combination of measures. Managers will have to aim for, say, a percentage score based on their overall performance and that could cause dysfunctional behaviour.

Section 4

Impact on financial statements

We will have to recognise a gain or loss on disposal, based on a comparison of two totals. On the one side we will have the consideration received, plus the fair value of the 10% that we are retaining. That will be offset against the group share of the subsidiary's assets plus goodwill, if any, at the date of disposal.

Realistically, any buyer is likely to argue that the subsidiary's reputation has been tarnished by this documentary and that we should sell it at a heavily discounted price in return for them giving it a chance to survive as a going concern. That will be compounded by the fact that the subsidiary will have no guarantee of ongoing sales. It will have to either bid for our business, in competition with other suppliers, or find itself a new outlet for its products.

We will not consolidate the subsidiary's profits after the disposal date. In the past, we would probably have based transfer prices on open market values because of tax law. The cost of dough purchased by the restaurant subsidiaries has always been shown at cost, but the consolidated statement of profit or loss has been credited with the dough making subsidiary's profit.

Supply chain

We will have to make the contract with the supplier conditional on satisfactory performance. We will have to address the hygiene and raw materials issues that led to this disposal in the first place. We might require that we are permitted to observe and inspect manufacturing processes at our discretion, or even have a group of quality control staff present at all times when dough is being manufactured for Pizzatime. We will also have to ensure that dough is supplied on schedule, otherwise restaurants will run out of pizza bases.

We will have far more influence if we are buying dough from a third party because there is a credible threat that we will switch our sourcing. At present, the company would find it difficult to stop buying from its own factory and so the managers of that factory may become slightly complacent. Conversely, Pizzatime will have to introduce far more stringent quality checks over dough bought in from a third party because it cannot claim that it has outright control over its own in-house factory.

One advantage is that we will not be forced to bear the factory running costs while sales are depressed, we can tailor our purchases to match our requirements. We will also be able to buy from more than one supplier or switch to a larger manufacturer in the event that sales expand.

Net present value

This will be an extremely difficult project to evaluate.

The overall effect of the transaction will be to inflate the cost of dough, which is a component of every pizza sold. We shold be able to determine the commercial cost price of buying prozen dough to our specification without too much difficulty. Indeed, we will be a major buyer and so potential suppliers will be happy to quote cost prices.

Offset against that, we will have the marginal revenue associated with increased consumer confidence. It could be argued that the upper limit to that is the difference between current sales and those that were being generated before the documentary. Sales could increase further, but that would be unlikely to be attributable to the disposal of the subsidiary. The lower limit could, effectively, be zero in the event that consumer confidence is not restored because of the increase.

The discount rate could be based on Pizzatime's weighted average cost of capital.