MANAGEMENT CASE STUDY FEBRUARY 2016 EXAM ANSWERS

Variant 3

The February 2016 Exam can be viewed at

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SECTION 1

Predicting demand

This is essentially a new market for Pizzatime. We have no experience of the market and we have no presence that would enable us to conduct meaningful surveys of consumer opinion.

Pizza is a global product. The word pizza is used in virtually every language. It is quick and easy to make and is popular with consumers. It is almost certain that C-land has pizza restaurants already and so predicting demand is more about winning custom from C-land's existing restaurants. The challenge is in both developing a strategy for winning sales and in predicting the likely success of that strategy.

There are a number of different approaches that we might take to addressing this issue.

We could use Big Data techniques to hunt social media sites for comments in C-land's existing restaurants. We should analyse these to identify both positive and negative comments and specific comments on particular types of pizza. We may be able to identify changes to pizzas that sell well in our existing markets that might make them more palatable to the tastes of C-land's consumers.

We could aim to conduct focus groups in C-land to gather information about how consumers will perceive Pizzatime's brand at launch. It may be necessary to modify the ambience in a typical restaurant in order to appeal to local preferences or to alter the nature of the service provided. For example, home delivery or takeaway pizza may have different connotations in C-land.

Performance of C-land restaurant

This comparison is clearly misleading, for several reasons.

Firstly, it is unlikely that Pizzatime will have marketed this single branch aggressively because it would have been uneconomic to have done so. Thus, Eddie has almost certainly built this branch up on the basis of his own efforts and the work of the restaurant staff. The average in I-land is based on the fact that Pizzatime is a dominant player in fast food and in pizza sales, which will have little impact on making Eddie's C-land branch a success. That could imply strong motivation and effectiveness on his part.

Secondly, this branch is in a food court. That means that customers are not going to be offered the same experience as can be enjoyed in one of Pizzatime's restaurants.

Thirdly, Eddie seems to be paying poorer wages than are on offer in I-land. That is potentially surprising, because I-land has strong economic growth and it is likely to have a strong currency. If anything, one would expect wages to be higher when expressed in terms of I$. It may be that Eddie is underpaying and so attracting poor quality staff and so his management skills could be lacking here.

Eddie's return on capital employed may be overstated if the C$ is strengthening. The revenues will be converted to I$ at a higher rate than the initial investment in fittings and equipment. Thus, profits will be overstated in terms of the comparability of the numerator and denominator.

Section 2

Projections

The basic assumption is that there will be accelerating growth for four years, followed by a steady state that will be achieved in year 5. That assumption needs to be tested against the strategy for entering the market because it does sound rather unrealistic. It may imply a conservative strategy in terms of building critical mass in a gradual way, but it may be difficult to maintain the loyalty of the franchisees during the early period when Pizzatime is a relatively unknown brand with few outlets.

The advertising spend appears to be limited to the value of the franchise fees throughout. It seems strange to assume that it will be possible to generate significant interest in a new brand without incurring promotional costs in the early stages.

The royalties are increasing as a percentage of franchise fees, from 0.7/2.6 = 27% in year 1 to 18.7/11.4 = 164% in year 5. Franchise fees are an annual charge and so they reflect the cumulative total of restaurants. Royalties reflect sales revenue. This trend implies that the first franchises will have a relatively small revenue, which may be a conservative assumption, but it could also suggest that Pizzatime is expecting the early franchisees to remain loyal through a disappointing early stage. Pizzatime is assuming that it will be possible both to maintain that loyalty and to sell franchises to other franchisees despite the lack of evidence that there is a demand for Pizzatime's products.

If Year 5 is the steady state, then the inclusion of significant legal fees and the sale of new fixtures implies that the company will continue to open new franchised restaurants into the indefinite future. Perhaps this assumption is reasonable because growth is measured as an absolute number of restaurants rather than indefinite compound growth. Alternatively, the ongoing sales of fittings may be to replace worn fittings in existing restaurants.

Project management

The first issue is to break the project down into a sequence of tasks or steps. For example, we will have to start by establishing a presence in C-land, recruiting legal advisers and so on.

Once the project has been planned, we will have to identify a management team for the project. It may be necessary to establish a team of full-time staff who will handle the implementation of locating and negotiating with potential franchisees. It may also be useful to have a management team who will oversee this project, perhaps as an additional responsibility alongside their existing duties. We will have to ensure that all staff are suitably qualified, perhaps to the extent of recruiting C-land nationals who will have the necessary language skills and understanding of the culture.

We will need to ensure that the project is adequately resourced throughout. We need to ensure that there are sufficient staff and that they possess sufficient skills. We will also have to ensure that sufficient funds are available to permit the necessary recruitment activities, such as entertaining potential franchisees.

The implementation will have to be kept under constant review to ensure its success.

Firstly, we need to break the project appraisal down into various measureable targets. In the first instance, we will have to aim to make contact with a target group of potential franchisees and we should track progress towards that. That will have to lead on to identifying a target for the number of franchises to be signed on, say, a quarterly basis. Any deviation from target should be noted.

In this case, we also need to update the plan as the project progresses. For example, we should commission market research to evaluate the impact of initial advertising and we should consider modifying our approach in the light of findings. We should also evaluate the knowledge gained from initial franchisees. If they have enjoyed success then we can use that to underpin subsequent promotional activities. We should regard supporting newly signed franchisees as an important element of the project because these are people who might persuade others to sign up (or not) with Pizzatime. We may also benefit from changing our marketing strategy in that successful franchisees may be more open to taking additional restaurants in order to build on their success.

Section 3

Sensitivity analysis

Any potential franchisee will be keen to understand the risks associated with entering into a franchise agreement. To that end, there is a need to understand the variables that might have an impact on overall performance.

Taking our figures as a ‘most likely’ projection, the franchisee might start to think about the impact of different variables.

Starting with revenue, there are two costs that are likely to be variable: ingredients and the royalty. Total contribution = 1,500 – 450 – 45 = C$ 1,005,000, which is 67% of revenue. A decrease of 165 / 0.67 = C$ 246,000 or 16% of expected revenue would eliminate the whole of the expected profit.

Currency changes could also have an impact on profit. Costs totalling 450+ 130 = C$580,000 are priced in I$ and settled in C$. A 5% decrease in the C$ against the I$ would increase those costs by $C 580,000 x 5% = C$ 29,000. It is unlikely that currency movements could push the franchisee into a loss, but it could be a significant source of overall volatility in returns.

The best way to motivate our franchise development staff would be to train them to understand the volatility measures and the potential impact of sensitivity analysis. It would be highly discouraging for staff to be confronted by concerns that they were not briefed to address, so such training should be motivating.

It might also be pointed out that the volatility has an upside as well as a downside. For example, every C$ 100 increase in revenue will increase profit by C$ 67.

Consolidation issues

The subsidiary will prepare its financial statements in C$. Many of the figures in its financial statements will be priced in terms of C$, certainly revenue from franchisees, wages and the running costs of vehicles and premises. The only significant outlay priced in I$ will be the cost of purchasing ingredients and disposables from Pizzatime in I-land.

The subsidiary’s statement of profit or loss would be translated to I$ using the average rate in force throughout the year. The use of such average rates would tend to smooth out the impact of any volatility in exchange rates, so the impact on the consolidated financial statements would be reduced. A steady weakening of the C$ would, however, tend to reduce the overall value of the figures when expressed in terms of I$, so the group might appear to be slightly less profitable that it would be if the C$ was strengthening provided the subsidiary is making a profit on its sales.

The nature of the work undertaken by the subsidiary is likely to mean that it will have fairly significant investment in property, plant and equipment. These will be translated to I$ using the closing rate at the end of each financial year. That creates the possibility of gains and losses on translation, depending on the size and direction of any changes in rates. We will also have to determine goodwill on acquisition and retranslate that at each year end, with a further potential for a gain or loss on translation.

Converting C$ to I$ using a weaker rate for C$ would tend to reduce the value of assets and so there would be a loss on translation.

These translation losses would go to group equity rather than being shown in the consolidated statement of profit or loss. That could affect the group's gearing, but it would have no direct impact on the reported earnings.

Section 4

National culture

Culture can affect business practices in many different ways. Culture is essentially a matter of attitudes that prevail throughout a society. For example, some cultures are more law abiding than others.

Culture essentially affects relationships and dealings with other people. This means that almost any business interaction will be affected by culture. For example, attitudes towards the health and safety of employees can differ between countries because of cultural issues.

Culture can be difficult to understand from the perspective of an outsider, which can make the impact on doing business far more far-reaching. For example, in some cultures a business contact may find it difficult to refuse a request but may agree in a manner that a local would interpret as a polite refusal. In this case, it is clear that an outsider could be seriously misled through ignorance of the local culture.

Frankly, our behaviour in this case was unethical. Our stated policy is to treat all employees fairly and to ensure that our franchisees match that commitment. It should have been obvious to us that the franchisees in C-land were likely to offer less attractive terms than those that we offer. We appear to have made no attempt to explore that further and establish just how the franchisees would treat their staff. If we evaluate our behaviour against the guidance in the CIMA Code of Ethics then we could be viewed as being in default of the principle of Professional competence and due care in terms of our attitude towards the staff whom we knew would be employed in restaurants that will bear our name and will be expected to reflect our values. This could also involve a breach of integrity because customers may be drawn to our franchised restaurants in C-land in the mistaken belief that all staff are treated fairly.

Budgeting and reporting

We could start by introducing a monthly reporting package that tracks factors that could indicate whether the franchisee is treating staff in an acceptable manner. The monthly reports might, for example, show staff numbers and the average rate paid to each member of staff. There could also be an analysis showing the range of payments, from low to high, in case the average is masking some cases where staff are poorly paid.

We should also seek information about the hours worked, showing the average hours worked by each member of staff during each month, with details of the range of minimum and maximum hours. This should be accompanied by a commentary to indicate whether any staff working significantly more or less than a norm of, say, a 40 hour week had done so through choice. The news story highlights the possibility that franchisees are prepared to have staff work excessive hours to cover busy periods and to reduce their hours to unacceptably low levels when staffing requirements fall.

Indirect statistics such as labour turnover will also be very relevant in terms of communicating overall staff welfare. We should also ask for details of discretionary expenditure on staff costs such as training and personal development.

There are various ways in which this system might be monitored.

One of the most obvious mechanisms would be for the managers in charge of liaising with franchises to take these reports seriously and to query any anomalies. That will send a message that the reports are read and acted upon and so the reports might encourage positive behaviour.

We might make a point of meeting with restaurant staff. It is very likely that we will conduct regular visits and inspections of restaurants to ensure that standards are maintained and Pizzatime's reputation is maintained. These visits would offer the opportunity to spend some time talking to staff about their experiences.

We could supplement the formal reporting from franchisees with informal reports from staff. We could, for example, create an email inbox at head office that can be used by staff to express any dissatisfaction with their terms and conditions.