MANAGEMENT CASE STUDY FEBRUARY 2016 EXAM ANSWERS

Variant 5

The February 2016 Exam can be viewed at

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SECTION 1

Consistency with current strategy

Growth in revenue of at least 10% a year

Strategic objectives include a target of growth in revenue of at least 10% a year, which was not met in 2015 but opening years will definitely increase revenue. However, shareholders will be more interested in profit than revenue, so increases in revenue are not necessarily a good measure of increase returns to shareholders. The economy of I-land itself is not showing strong growth, with annual growth of just 2% a year in recent years; however, there has been growth in the market sector that is being targeted by all-day opening. There has been growth in the small business sector of I-land and the number of self-employed people requiring somewhere outside the home to work is increasing. There appears to be unsatisfied demand in that coffee shops tend to be overcrowded, without a free table that a business person would require.

Meet changing customer requirements

Strategic objectives include meeting changing customer requirements. The growing popularity of coffee shops indicates that this is an added service that customers would value and so serving coffee and snacks also helps satisfy the.

Efficient use of resources

Longer opening hours means that resources such as premises are being used more efficiently rather than being left idle for many hours each working day.

High returns on capital

Assuming the venture is profitable, when measured on a marginal basis, it will lead to higher returns on capital and from existing restaurants as stated in strategic objectives, effectively leveraging the use of capital assets.

Improve returns from existing restaurants

The impact on growth in profit is less clear than the impact on revenue and will depend on the added costs involved in such a venture. However, with premises and central support in place already, this can be regarded as 'sunk costs' and ignored in the assessment of improved returns from restaurants from this venture.

Accounting rate of return (ARR)

Explanation of why the project's forecast ARR in the first year is so poor

In the first year of the project there are likely to be some one-off costs which will not be capitalised and result in lower profits in the first year. For example, the costs involved with obtaining planning permission from local governments, initial advertising and marketing, which will result in lower profits in the first year than in future years.

The ARR is also heavily dependent on accounting assumptions made. For example, using a short timeframe to calculate depreciation would further reduce the ARR in the first year.

The project requires significant up-front investment, which will tie up cash resources until the investment is recouped by sales. The cost of these funds and the opportunity cost of tying up these resources in the project are not taken into account in the ARR figure.

Whether forecast ARR results are likely to give a good indication of the overall performance of the venture.

An ARR is based on profit rather than cash flow and so doesn't take into account the time value of money; the ARR result would therefore not give an accurate indication of the performance of the venture as this important element is ignored.

The ARR also does not take into account the impact of the venture on other parts of the business. For example, the possible impact on the lunchtime and evening restaurant trade. The project reduces the capacity of the restaurant by removing some tables and this may have a negative impact on the restaurant trade and so the ARR result may overstate the performance of the venture.

The ARR forecast also does not include any allocation of central overheads; these need to be taken into account when evaluating the overall performance of the venture.

In conclusion, ARR results are likely to give a distorted view of the value created by the venture and should not be used as the basis of the investment decision.

Section 2

Relevant costs

Relevance of the cash flows identified by Bilal

I am in agreement about including most of the costs shown, including the refurbishment cost, the cost of the new coffee machine, additional restaurant staff and recruitment cost as listed. However, I would suggest that we exclude the consultants' fee of $80,000 as this is a sunk cost and therefore not relevant to this appraisal. Also, I would recommend that the additional admin charge at the region of $25,000 is split evenly between the 10 restaurants; so only $2,500 (being 10% of of the total cost of $25,000) is charged per restaurant rather than the $3,000 shown.

Cash flows that are missing

There are some important cash flows missing from the analysis such as the cost of obtaining government approval for the project and the cost of refitting the kitchen area.

We should also take into account the impact that all-day opening might have on other parts of Pizzatime's business; it is likely that revenues from the sale of coffee at the end of a meal would increase with the arrival of the superior coffee machine. On the other hand, it is possible that lunchtime and evening revenues may affected by the reduction in the number of restaurant tables; this also needs to be taken into account.

We also need to take into account additional costs for running the premises for the extended opening hours such as heat, light and cleaning costs; it is important to keep the toys maintained to a high standard of cleanliness and safety to avoid any legal action in the event of an accident. There are also significant marketing and promotional costs that appear to be missing from the list provided.

Use of 12% WACC

Overview

A valid result can only be obtained if an appropriate discount rate is used in the investment appraisal analysis that reflects both the cost of funds used to finance the project and the riskiness of the project;.

WACC should reflect relevant funding costs

An arbitrary cost of capital figures is not appropriate, the figure should reflect the actual financing cost of Pizzatime on the assumption that project finance is drawn from a pool of funding resources. Pizzatime is funded by a combination of debt and equity finance and we need to determine both the cost and market value of each of these elements to calculate the weighted cost of capital, that is, the company's WACC to use as the base for the calculation of an appropriate discount rate.

Funding costs change over time depending on market conditions and so it is not appropriate to use the same base figure over a five-year period; calculations need to be updated as circumstances change.

WACC should reflect the project risk profile

Each project has a different risk profile which should be reflected in the discount rate used as risk also affects the cost of funding and so it is important to adjust the discount rate used for each project according to the risk profile of the project cash flows.

It is likely that all-day opening carries much greater risk than the underlying business and Pizzatime's WACC should there be increased to reflect this additional risk. It is this risk-adjusted rate used as the discount rate when evaluating the all-day opening proposal.

Whether or not Matt should be concerned about the apparent contradiction in the results of the ratio analysis

Fall in operating profit margin

It is quite common for operating profit margin to fall as sales increase due to the increased costs involved in promoting and supporting the increase in sales. It is therefore not a mistake, or something to be overly concerned about, but a natural consequence of the effort required to achieve the increased sales, especially in the early years of the venture. However, it may be of concern that administrative costs and the costs of sales have increased to this degree and this should be investigated further in an attempt to reduce these costs.

Lower increase in asset turnover, below that of sales

The lower increase in asset turnover (of 16% against the 20% increase in sales) also has a logical explanation since some capital expenditure was required to adjust the premises and install additional equipment and this will have increased non-current assets. A slightly higher figure for non-current assets will have a negative impact on the asset turnover figure.

Impact of the results on operating profit

Matt should be most concerned about the impact on operating profit rather than the impact on operating profit margin.

Some quick calculations show that operating margin is expected to actually increase from I$ 135 million (as in the pre-seen) to I$ 143 million (being 20% x 120% x I$ 597 million). So there are no real concerns here, as long as the operating profit margin does not deteriorate further over time.

Section 3

Applying equality and diversity practices when recruiting new employees

Equality practices

When considering job applicants, it is important that the recruiters are fair and non-discriminatory. A positive approach is required to ensuring equal opportunities during the recruitment process. However, positive discrimination in favour of certain groups is NOT acceptable. Pizzatime should check that the recruitment agency understands and complies with these requirements.

Diversity practices

When recruiting new staff, Pizzatime needs to ensure that it employs the best person for the job regardless of nationality, religion or marital status. Applicants should also not be disadvantaged by age, disability, pregnancy or perceived likelihood of imminent pregnancy.

Gaining assurance that equality and diversity practices have been followed

Pizzatime should ensure that both its equality and diversity practices are carefully documents. And that staff are monitored and assessed as to compliance with the policies. And that any divergence from the policies is followed up and training or disciplinary procedures put in place to ensure that policies are followed more carefully in future.

Whether the statement on diversity groups in the advertisement is sensible

For Pizzatime it is hard to see how it would be safe for a person in a wheelchair or with a learning disability to work in kitchen or restaurant without falling short of health and safety regulations. It may therefore be misleading and hence unethical to advertise that all disability groups are encouraged to apply as many severely disabled applicants may need to be turned down on the basis of their disability being in conflict with health and safety considerations.

Setting targets for individual restaurants with respect to all-day opening

This is a new venture for Pizzatime and setting both motivational and achievable targets will be very difficult due to the uncertain outcome. It may therefore be sensible to set short term targets initially, until the situation settles down.

Ambitious targets can motivate managers to improve performance and encourage competition between restaurants. However, too ambitious a target can be demotivating if it is impossible to achieve.

Each individual restaurant will face different market conditions according to actual location and customer profile. For example, restaurants that are located in a business district are likely to be able to attract many more business people during the new morning and afternoon opening hours. Restaurants located near a school are likely to attract parents meeting up with young children after dropping older children off at school.

Restaurant managers have an important insight into the competitive environment and potential customer base for their own restaurant. This expertise can be drawn to set realistic budgets that reflect the local position.

Managers are more likely to be motivated to achieve targets if they have been involved in setting those targets.

However, setting different targets for different restaurants could result in arguments between restaurant managers as to who faces the most difficult morning market and should have the lowest budget.

Targets should allow some flexibility for managers to adapt to local conditions but still achieve goal congruence, encouraging managers to act in the best interests of Pizzatime as a whole.

Section 4

Customer value analysis

Benefits of the customer value analysis

Customer profitability analysis provides an indication of the relative profitability of each customer group.

Problems with the customer value analysis

The profitability of each customer group relies heavily on the basis used to absorb costs. Basing absorption of costs based on customer numbers may not work well.

Reasons:

- Different customer groups have a different average length of stay in the restaurant.
- For business customers, a single customer occupies a whole table whereas other types of customers are more likely to arrive in groups.
- Young mums and children are more likely to use the soft seating area that takes up more space in the restaurant and so should be allocated a greater proportion of restaurant running costs.

It is not reasonable to treat the coffee machine as a fixed cost and ignore this in the customer analysis of contribution. This is because a greater number of morning customers are likely to ask for coffee than customers later in the day.

Customer numbers within each customer group will change with the removal of the play area and the impact of this change cannot be predicted. It is the CHANGE in customer numbers and customer profitability that is relevant to the decision rather than the current customer analysis.

Removing the play area could damage the company's reputation. This could have an adverse effect on customer numbers at lunchtime and in the evening, many of whom are young families.

Influencing and persuading staff to improve service levels

Motivation of various forms could be used. For example, using non-financial measures such as service time and customer interaction to measure the performance of individual staff members. Performance levels could be linked to pay or to non-financial rewards such as 'employee of the month' awards. There could also be competitions between restaurants with rewards such as a day away.

Peer pressure could be introduced by starting 'round table' discussions amongst staff members to consider ways of improving service times and satisfaction.

Commitment to the project is important as employees will be motivated to perform well if they believe in the project. This can be increased by group briefings and communications about the importance of all-day opening to the future prospects of the company and employee security.

Deadlines should be set for certain targets to be met by all employees.

Training is important to ensure that staff are able to operate the coffee machine efficiently and taught how to engage customers in conversation where deemed appropriate.

Strong leadership is required to help improve standards. For example, the restaurant manager could join the coffee team and serve in the restaurant to set an example of good customer service. As a last resort, sanctions will need to be imposed if employees still fail to embrace new working practices.