Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY MAY 2016 EXAM ANSWERS

Variant 4

The May 2016 exam can be viewed at

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Section 1

Business implications

From a strategic point of view, IC Optical is essentially a retail organisation that aims to attract sales through its extensive chain of shops. The LowPrice proposal offers scope to expand its branch network, which may have the effect of restoring some of the ground lost of Specs4U and Zeechem.

The use of supermarkets may also have the effect of opening up a new distribution channel for IC Optical. At present the company's main presence is on the High Street. Customers have to make a trip into town to have their eyes tested and another to collect their spectacles. Most of LowPrice's customers will make a weekly shopping trip and will be forced to pass these new opticians' shops.

Linking itself to LowPrice may undermine consumer confidence in IC Optical. Customers value their eyesight and may be reluctant to entrust it to an operation that appears to be about creating volume at the potential cost of reduced quality. Spectacles also have a fashion aspect that may also be undermined by the association with a supermarket chain.

The added convenience may expand sales. Having said that, however, there is a risk that these new stores will be overwhelmed with demand on busy shopping days, such as weekends. They may not operate at full capacity because it may be just as easy for customers to visit our existing shops at off-peak times.

There is a danger that the new shops will take a lot of their custom from existing shops in the vicinity. That would lead to a duplication of costs and effort, for no great benefit in terms of revenues.

LowPrice's figures

The figures are very much in LowPrice's favour.

Firstly, the capital costs associated with this venture will be close to zero for LowPrice. Their Leetown store has already been designed to leave a suitable space that can be enclosed simply using partitions and this is likely to be a feature of other stores. IC Optical is making a significant capital investment in equipment for the shop and also in branding. LowPrice could argue that they are offering the use of their property to the venture and so it is irrelevant that the property has a very small marginal cost or even opportunity cost, but we might still argue this point from a negotiating point of view.

IC Optical's average revenues per shop are C$1,890m/760 = C$2.48m. That makes the projected revenue of C$2.8m from this venture seem a little optimistic. At the very least, it seems likely that the new shop will draw a significant share of the revenue from the nearby town of Leetown, possibly taking sales from IC Optical's existing shop. If the projection turns out to be optimistic then LowPrice will be in the position of having an empty space at the front of its store filled at close to zero net cost. Even a small profit from this shop will be marginal profit to LowPrice in return for very little investment of time or money.

No provision appears to have been made for the cost of the support to be provided by the local Leetown shop. If the sales generated by the LowPrice venture prove to be significant then there will be a great deal of work involved in cutting single vision lenses to size and also delivering those lenses to the LowPrice store.

The apportionment of overhead on the basis of floor space is a rather generous approach for LowPrice. Firstly, most of those costs will be incurred in any case. For example, having the IC Optical shop in store will add little or nothing to the depreciation of the property and the operating plant such as heating. The percentage is also a little cheeky, given that the venture is being charged for the floor space set aside to permit LowPrice's supermarket customers free access to the main store.

Overall, there is room to negotiate this arrangement.

Section 2

Staffing the new shops

The first step is to determine the reasoning behind these concerns, otherwise we cannot really address the problem. We should analyse the emails from staff and should ask HR to meet with some in order to clarify the concerns.

If the concern is that staff working in these shops will be treated in the same manner as the shop workers identified in the documentary then we should argue that IC Optical will remain their employer. All terms and conditions of employment will remain exactly as before, regardless of whether the shop operates independently or is part of a LowPrice store.

There may be concerns that it will simply be unpleasant to work in this environment, alongside demotivated store staff. In that case, we might argue that IC Optical staff will be busy in their own area of the store, with little or no interaction with the store staff. The basis store environment cannot be particularly unpleasant, otherwise customers would be reluctant to shop there. Indeed, it is likely that IC Optical's staff have shopped there themselves and so we could encourage them to discuss their own experiences of being there.

It may help to organise a visit to the store for staff who are being transferred to this venture. That would enable staff to see where they will work and give them a better understanding of the fact that they will essentially be working in the same IC Optical environment as before. It may help to permit our staff to interact with their counterparts from LowPrice because the documentary is likely to have presented the most negative views possible of the supermarket's treatment of its staff. A meeting might offer a more balanced view.

Any benefits associated with the move should also be pointed out. For example, it may be easier to commute to an out of town supermarket or there may be staff discounts available for supermarket shopping.

Profit related bonuses

The most immediate problem is that the bonus will be unrelated to the behaviour that we are trying to encourage. We wish to motivate some of our staff to transfer to the new LowPrice shops. We do not appear to be under any particular pressure to motivate them to work harder or to strive for greater profits. Any remuneration scheme that does not align staff interests with those of the company could lead to dysfunctional behaviour. For example, staff could claim that their new working conditions are even more unpleasant than anticipated and so they might argue that they should receive a larger profit share. In the short term, they may act in a demotivated manner, while continuing to earn their salaries, in the hope of securing a larger bonus in the longer term.

This is a new venture, and so it may be difficult for us to negotiate terms for the bonus. If the new stores prove highly profitable then we may be paying significant absolute amounts in bonuses, simply to maintain staffing levels. We could, in principle, be forced to increase staffing if the new shops are a significant success, perhaps by extending opening hours and so requiring staff to cover additional shifts. Conversely, the staff may not value these bonuses before they agree to the move because the profits could be small or the shops could even be loss-making and so the bonus scheme could prove worthless.

Paying the LowPrice shop staff a bonus could prove divisive and could lead to ill feeling. The staff in the existing shops may resent the fact that their colleagues are paid a bonus while they continue as before. That could lead to the paradox of staff refusing to stay in the original shops because they could earn more for doing the same jobs if they move. It could also cost IC Optical the flexibility to transfer staff to other shops in response to promotions and other operational needs. A member of staff in a LowPrice shop might refuse to sacrifice the bonus in order to move back.

Section 3

Accounting issues

Accounting choices

The basic question is whether we should capitalise the cost of the brand name as an intangible non-current asset or whether we should write the cost off immediately as an expense.

The essential recognition criteria are that we should be able to measure the cost reliably and also anticipate future revenues to be derived from this acquisition. Of these, the future revenues will depend on the likelihood of the following possibilities.

Are we likely to change the names of the shops? If we cease to use a variation of Lowprice then we will derive no value from this investment.

Is there a risk of the venture being wound up? If it proves unpopular with customers then we may negotiate an early closure with LowPrice.

We will also have to decide on a period for the amortisation of the expense. We should probably assume that the most realistic “worst case” is that the project will run for the initial five years before being terminated, in which case the cost should be amortised over that period.

Shareholder reaction

There are two issues here. The most significant is the impact on share price, but there may also be the risk of the board’s credibility being harmed.

The share price is essentially a function of future cash flows generated from operations. The stock market will be aware that we are entering into an agreement with LowPrice and that will be factored into our share price. The capital markets will not be able to predict the net present value of this project with any precision, but there will be an implicit value that has been determined through market forces.

If we present the stock market with unexpected “bad” news, such as an admission that we do not anticipate a profit from the project, then the future cash flows will be re-evaluated and the share price will fall. Writing off the cost of the brand name will be seen as a very pessimistic signal from management and so it will possibly lead to a significant decline in the share price.

The shareholders may also work on the basis that they have entrusted the directors with their wealth on the understanding that their funds will always be invested responsibly. An impairment adjustment suggests that at some stage management has realised that a significant investment would not have been made on the basis of the information that has since become available. The shareholders might, therefore, misinterpret an impairment adjustment on a relatively recent acquisition as an admission of recklessness.

Complying with LowPrice operating procedures

There are a number of implications, both good and bad for IC Optical.

Even though we are in a joint venture, our interests might differ from those of LowPrice. Their focus in terms of quality will be whether customers are happy and whether they will continue to shop at LowPrice. That could lead to their procedures being unsuitable for IC Optical, such as rushing a customer's eye examination in order to reduce waiting times.

This arrangement will also prove confusing for our shop staff. Which procedures should they adopt in the event that there is a conflict? There could be overlaps in areas, such as hygiene, where IC Optical's standards differ from those of LowPrice, which could be a problem if LowPrice's supervision led to a failure to meet a key requirement.

It may be demotivating for IC Optical staff to be made to comply with LowPrice procedures. As opticians, they hold professional qualifications and may feel that they are being devalued by any requirement to adhere to retail procedures devised for staff who do not hold equivalent qualfications. There is also the sense that the staff based at LowPrice stores may start to feel isolated from the rest of IC Optical if they are assessed as LowPrice staff.

IC Optical is accountable to professional bodies and other regulators for the care provided to customers. The very fact that the shops are under the direct supervision of LowPrice, which is not affiliated to these bodies in any way, could undermine IC Optical's accreditation. There may not even be an observable loss of quality, it could be enough that IC Optical is prepared to permit a third party to exercise oversight.

Section 4

Classifying IC Optical as an associate

If we are treated as an associate them LowPrice will be able to recognise 20% of our profits in their financial statements. If we are not an associate then they will be able to recognise only their share of our dividends as income, which may be both smaller and less consistent than our profits. Treating us as an associate will almost certainly make LowPrice appear more profitable than if we are counted as an investment in their financial statements.

Treating us as an associate will also mean that the LowPrice group will appear to have a more significant asset than if we are simply an investment. The ability to exert influence over a trading partner will demonstrate that LowPrice has obtained good value for its investment in our shares. Valuing the investment at their share of IC Optical's net assets may also have the effect of reducing LowPrice's gearing.

In order to treat us an an associate, LowPrice will have to demonstrate its ability to exert some influence over us. It is well known that we do not have any other major shareholders and so they can use that fact to argue that there are no other blocks of shares that might used to vote against any proposals that they might make.

The fact that we are likely to become a major trading partner through the IC Optical at LowPrice venture would demonstrate further ability to influence us. The terms of that arrangement may also prove crucial. It would, for example, be easier for LowPrice to replace IC Optical with a different retailer in the event that the venture drew to a close than for us to find an alternative location.

If LowPrice succeeds in placing a member on our board then that will almost certainly be enough on its own to demonstrate that they can exert significant influence. Our response to that proposal could be sufficient to demonstrate significant influence, even if we do not finally agree to those terms. The fact that the discussion is seen to be taking place demonstrates that we do not feel that we can dismiss the proposal out of hand.

Giving LowPrice a seat on the board

The two issue raised should be addressed separately.

<u>Risks</u>

The most obvious risk is that the board member will be a disruptive influence. The new board member will be present seen to be represent LowPrice's interests, both in terms of the joint venture and in wider terms. We may find it difficult to manage IC

Optical with a view to maximising the wealth of the whole body of shareholders if we have a board member working to address an agenda.

Offset against that, the new board member will have to declare an interest in any discussions directly affecting the relationship with LowPrice. Any overt attempt to benefit LowPrice at our expense will be unacceptable and could even prove a breach of the director's contractual duties. The fact that board meetings are minute and that there will be a formal record of all discussions will constrain any abuse of this position.

Ethical implications

The fundamental principles set out in the CIMA Code of Ethics provides a good starting point.

The most pressing principle is likely to be professional competence and due care. There is a risk that the share price will fall if we admit LowPrice's director. The stock market might be concerned that the new appointment will have the effect of transferring wealth to LowPrice. We have a duty to maximise shareholder wealth, which means the wealth of all shareholders as a body.

Objectivity might be an issue. The present board might be seen to be admitting this director in order to prevent LowPrice from using its 20% holding against them in the event that the seat on the board was blocked. We should, at the very least, allow the shareholders as a body to offer a view on whether this appointment would be desirable from their perspective.

The admission of this board member may compromise confidentiality. It will be extremely difficult to prevent the newly appointed board member from taking information back to LowPrice. Given that we have to renew the contract at the end of five years, we might be at a disadvantage in any renegotiation of terms.