MANAGEMENT CASE STUDY MAY 2016 EXAM ANSWERS

Variant 5

The May 2016 exam can be viewed at

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Section 1

Project appraisal

Firstly, Jo needs to identify the relevant cash flows. For example, the inflows associated with conducting eye tests might extend beyond the fee paid by the government because customers may well buy their spectacles from the shop that conducted their eye examination. Arguably, the eye test is a means of attracting customers into the shop at no net cost to the business.

Jo is making some rather significant assumptions about the revenues that will be generated from online sales. Customers may be resistant to buying spectacles online, given the nature of the product in terms of the need to look good and function effectively . The closure of the shops may leave scope for competitors such as Specs4U to open shops of their own so that they can capture our business.

It is illogical to argue that the cash raised from the sale of shops can be applied to the investment without a formal evaluation. The investment in an infrastructure for online sales should be evaluated in net present value terms regardless of how the cash is to be raised. Strictly, we should compare the net present values of the alternatives that are available. We can either retain the shops or we can sell them and open an online facility.

It may be misleading to include the effects of the redeployment of equipment as a source of funds. Doing so will only be effective if IC Optical actually needs the equipment elsewhere. The cost of dismantling, transporting and rebuilding the equipment may prove significant. There will only be a genuine benefit to IC Optical if the equipment that has been redeployed would have been purchased anyway. There is a risk that we will simply displace older but serviceable equipment with newer items that have become available.

Conflict

It is inevitable that different board members will disagree from time to time and any debate that results from that is likely to be healthy. Perhaps one response would be to encourage both parties to speak their minds during board meetings and to ensure that both are satisfied that they have been free to express their opinions so that the entire board can reach an informed decision. The meetings will, of course, have to be chaired with some sensitivity to prevent the debate from becoming personal and divisive.

The CEO and the chairman should recognise that each executive board member represents a particular function and may have some loyalty towards that. Greta has a vested interest in maintaining the professionalism arising from the qualifications held by the optometrists and dispensing opticians, while Jo is primarily interested in making sales. While it can be constructive to support functions in this manner, the two directors should be reminded that their overall responsibility is to IC Optical and its shareholders.

All board members should participate in discussions and should keep the debate focussed on the business interests of IC Optical. Doing so will reduce the risk that either Jo or Greta will start to see this as a debate about personality. The final decision will have to be collective and the reasons behind it will have to be transparent so that it can be justified in the event that the shareholders raise any queries.

It should be made clear to Greta in particular that no director is more important than the company. If Greta believes that a reduction in the numbers of optometrists is unacceptable then she may have to consider leaving the company. Her background may have left her with an inflated understanding of the importance of the technical aspects of the product.

Section 2

Criteria for selection of shops for closure

<u>Financial</u>

The most immediate factors would be the contribution generated by each shop. Each shop has a natural catchment area and local markets may vary in terms of prosperity and willingness to spend more on spectacles.

The fair value of premises would be one consideration because that will determine the benefits to be had from their disposal. The fact that some are occupied through finance leases may mean that it will be difficult to raise cash from the shops' closures.

The age and condition of the shop itself and the equipment within are also a factor. It may be more cost-effective to close shops that will require significant outlays on refurbishment or replacement in the immediate future.

<u>Non-financial</u>

The number of local opticians is a factor because IC Optical will be unable to make online sales to customers who do not have access to an optician to write a prescription. The presence of a Specs4U franchise may also be a related factor because IC Optical's departure may make it more attractive to establish a franchise, thereby strengthening our largest competitor.

Demand for eye tests is an important consideration because even the smallest shop requires an optometrist and supporting dispensing opticians. The schedule shows that these salary costs will have a significant step function, with Arrtown paying just as much for professional staff as Elltown because both need a complement of staff just to open.

The age and background of the shop's customer base may also play a part. Older customers may have less scope for accessing and using the online software to order spectacles and so the closure of a shop with an elderly customer base could imply lost sales.

Criteria for selection of staff for redundancy

<u>Factors</u>

The optometrists can help by persuading customers to buy more expensive lenses where appropriate. Progressive lenses have the potential to generate a higher absolute contribution per sale because the margin is being applied to a significantly greater cost price. Individual optometrists can be ranked on the basis of the proportions of more expensive lenses sold

Similarly, dispensing opticians are in a position to sell more designer frames, which carry a greater contribution per unit. Customers can be guided towards these when they are selecting frames. It may also be possible to measure the average numbers of pairs sold to each customer, because some customers may be open to buying more than one pair for the sake of variety.

The dispensing opticians may also be able to persuade customers to pay for tints and coatings, which have significant markups. This is clearly an aspect that can really distinguish shops because Capital City seems to be far more successful than Central City in this respect.

Ethical issues

The CIMA Code of Ethics provides one useful starting point.

This suggestion appears to contravene the principle of integrity. IC Optical is not being straightforward and honest in its dealings with its employees because it is permitting them to disrupt their lives in order to make it easier to terminate their employment. Some staff may be inconvenienced by the change of branch, particularly if they have to move home, and they may feel aggrieved that IC Optical has withheld a material fact.

In terms of objectivity, the primary role of the business is to make profits for the sake of maximising shareholder wealth. While the directors do have a duty to their employees, they have to ensure that they do not allow that to compromise their independence in making business decisions for the sake of the company. This proposal would undoubtedly reduce the disruption associated with the selection of weak employees for redundancy.

There could also be issues relating to confidentiality. The company may suffer if policies are changed and that signals a change to the business. Maintaining the steady rotation of staff between branches could be an important aspect of maintaining the confidentiality of this proposal.

Section 3

Cost of equity

The cost of equity is essentially the link between the cash flows generated by IC Optical and the share price. It is set by the capital markets, who respond to expectations of risk and return.

The capital markets look at expectations of future cash flows and implicitly discount those in setting the share price though supply and demand. The share price might increase if future cash flows are expected to improve. It may also reduce if the market assumes greater risk and discounts future cash flows at a higher rate. The directors cannot dictate the share price and so they cannot prevent the cost of equity from changing.

The calculation of the cost of equity requires assumptions because the market mechanisms are not directly observable. Market sentiment is created by the conflicting and complementary behaviour of individual market participants, so there is no one person who can be asked to justify the current cost of capital. The directors can only attempt to reflect the different assumptions that might prevail in the market generally in order to evaluate their perceptions in the capital markets.

The dividend growth model is basically a net present value calculation that links the current share price to assumptions concerning expectations concerning dividends. The figures calculated on the slides are based on two potential sets of assumptions, neither of which can be justified but both of which could be realistic. Both start with the assumption that the market is using past events as a basis for predicting the future.

Fairness

Is it fair to expect the Board to deliver a high return?

The output from this model is based on expectations concerning cash flows and no further expectation is being imposed. The rates of return derived from the market are based on assumptions of what the markets expect to happen and have nothing to do with setting targets for motivational purposes. If the markets set an expected rate of 21% and it starts to appear that the board cannot deliver on that then the share price will decrease in order to reflect anticipated returns.

The board should endeavour to understand the market's expectations in order to avoid uncertainties and volatility. Having said that, the board's performance may not be the most significant determinant of the cost of equity. For example, the share price could rise because the markets envisage a decrease in future costs that were not of the board's making.

Use of cost of equity for project evaluation

Ideally, the cost of capital used for a project should reflect the risks that are involved. Generally, the cost of equity is only ideal when the project is a direct expansion of the business itself. That would mean that the risks are identical to those of the company as it stands. This proposed project is actually more than a simple expansion. In fact, the intention is to reduce the capacity of the current sales and distribution network and replace it with an unproven alternative. The new proposal has the potential to cut costs significantly by passing the significant costs of eye tests on to competitors, but it assumes that IC Optical will be able to retain the sales that are normally linked to the eye tests.

Arguably, the project will be more risky than a continuation of the existing business, at least until the new sales system can be proven. The required rate of return may actually be greater than the IRR of 24% and that would suggest that the project should be rejected.

Section 4

Goodwill

The first value that we need to consider is the fair value of the consideration. IC Optical is a quoted company and so the shares that we have issued is essentially a matter of looking at the share price on the date that the transaction was agreed.

IFRS 3 *Business Combinations* further defines the value of goodwill in terms of the fair value of the separable net assets of the subsidiary. IFRS 13 *Fair Value Measurement* defines fair value in terms of market prices and not entity-specific values.

Working down the schedule:

- The property should be shown at its fair value on the open market, which will require a valuation on that basis. The fact that it is in a good location which makes it more valuable to IC Optical is irrelevant. The valuation may require the employment of an independent expert.
- The plant and equipment has been valued at net book value, which may be acceptable. That assumption should, however, be revisited before finalising the financial statements. The same arguments apply to
- The bespoke software will prove difficult. The asset itself is not the single copy of the software that is used by SmartSight or IC Optical. The fair value is the value of the intellectual property in the package. The market for this software will be very narrow because there are limited numbers of opticians who might be prepared to buy it. It might also be possible to create a new version by studying the IC Optical website and paying a programmer C$230,000 to replicate the features. Arguably, the fair value of this package is close to zero.
- Customer loyalty cannot be included because it is not separable from the business.

Finally, the 20% NCI has to be shown at its fair value. It may not be appropriate to calculate that pro rata to the value implied by the shares exchanged for the 80% holding, but that would be a good starting point.

Risks

IC Optical's board has no prior experience of dealing with NCI shareholders. There are a number of issues associated with ensuring that the NCI's interests are adequately addressed. For example, IC Optical is free to manage any of its current subsidiaries by focussing on the needs of the group, but such an approach may compromise the interests of SmartSight's NCI and that could elad to problems.

For example, there will be transactions between group members, with IC Optical supplying lenses. The NCI is SmartSight may claim that they are being overcharged and that could lead to tensions. That is in additional to more straightforward concerns, such as treasury management creating the potential for disputes over transfers of cash surpluses or disagreements over SmartSight's dividend policy. The NCI would be entitled to claim that any cash transferred to IC Optical should be treated as a loan with full interest paid at commercial rates.

The retention of the founders as a management team could create further conflicts because they will undoubtedly see their loyalty as being with SmartSight rather than the IC Optical Group. Having said that, each NCI shareholder has exchanged 80% of his or her SmartSight shares for shares in IC Optical and so they may have a significant incentive to consider the group's needs too.

IC Optical may be quite dependent on the NCI for the ongoing management of the online sales. For example, the updating and maintenance of the software will be difficult if its author leaves the company. The NCI will have contracts of employment that almost certainly have a no-compete clause, which would make it difficult for them to establish a new company to compete with IC Optical for online sales. They would also risk undermining the value of their shareholding in IC Optical.