MANAGEMENT CASE STUDY MAY 2017 EXAM ANSWERS

Variant 3

The May 2017 exam can be viewed at

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TASK 1

Value chain

At present BES buys from a range of suppliers and the inbound logistics will be arranged in a manner that reflects buying patterns. For example, the supplier of some goods may arrange delivery of each separate purchase. Under these new arrangements, BES is likely to be buying items ordered as own-brand in larger quantities in order to ensure that cost prices are economical and to obtain economies of scale in shipping. That may affect buying patterns because BES may be aiming to buy in fewer orders but in larger quantities, which could increase the risk of a stock-out. Greater attention will have to be paid to inventory management.

BES may have to pay greater attention to capacity of the warehousing facilities at its distribution centres. That is not just the maximum capacity, but also the ability to handle incoming deliveries. It may prove expensive to split deliveries between the Northern and Southern distribution centres if that would require container loads to be split, so BES may reorganise its process. It may become cost-effective to have certain goods delivered to just one centre for onward distribution across the country in order to minimise inbound logistics costs.

Outbound logistics are unlikely to change significantly with respect to the actual delivery of goods to shops. The inventory will originate in the distribution centres and will then be transferred on to the stores as before. There may be a longer lead time to replace certain items because suppliers will have to make, or at least package, own-brand goods and will require greater notice than if we order generic goods from whichever supplier happens to be cheapest. We may have to use a different algorithm for inventory management to allow for more complicated replenishment procedures.

Marketing will have to focus on the values attached to the BES brand name. At present, only 4% of shoppers regard the retailer's reputation as important while 87% care about affordability. Building a sense of brand identity will be important, perhaps at the expense of profit in the short term. For example, it may be necessary to spend a little more than the minimum on own-brands so that customers start to perceive BES brands as offering high quality.

Five forces

Many of the products that BES will be buying will be simple and highly generic. There are likely to be many suppliers competing for BES' business on any given product. BES simply requires suppliers to produce goods to an acceptable quality and at a low enough price to meet their E$1.00 price point. BES will be ordering in large enough quantities to attract the co-operation of any given supplier.

Once a relationship is established, BES may wish to remain with suppliers who have proved reliable, but switching costs will be low. If a supplier starts to pressure BES in any way then it will be a simple matter to find another supplier to produce that same generic item in that price range. BES will not be transferring any intellectual property or proprietary information, other than the logos and information that will appear on the product and packaging and there would be nothing to prevent a switch to an alternative.

The biggest threat faced by BES is that of substitutes. BES sells a wide range of goods that will always be essentially generic in nature. There will always be competitors who can sell virtually identical goods for a very similar price and so customers will not have any reason to compare products or shop around. A customer who is looking at an item in another shop will have virtually no incentive to defer a purchasing decision before checking whether BES' offering is superior.

The creation of a strong brand image may go some way to reducing that threat. If customers begin to associate BES with the BES own-brand, which is perceived to offer a good price/quality trade-off then they may start to shop there in preference to other value stores. The danger is that the creation of a successful own brand may prove to be easily replicated by competitors. BES' fixed price point may put it at a disadvantage to competitors who attempt to differentiate on quality and perhaps charge a few cents more in order to spend a little more on the basic product.

TASK 2

Goodwill

The first issue that we have to decide is the value of the consideration that we will give to the present owners. BES is a quoted company, so it should be a simple matter of using the share price as at the date of acquisition. We also need to consider how we will treat the non-controlling interest as at the date of acquisition, which may be shown at its fair value. The easiest way to avoid that problem would be calculate NCI on the basis of the proportion of the book value of Makesure's equity.

The second issue is that we need to determine the fair value of the assets that are being acquired. That could be complicated because Makesure has a single large asset in the form of an office building, which may prove to be controversial in terms of valuation. The only response to the difficulties associated with valuing property is to engage an independent expert to value the assets and to compare the resulting valuation with observable prices in the market for the sake of a reality check.

Impairment reviews are always difficult because they require predictions of the future. Goodwill cannot be sold separately and so there are never any observable transactions that would indicate that the fair value of goodwill might have changed. The net present value of future business cash flows may also prove difficult because they could be affected by so many unpredictable events, including the threat of economic or other forms of disruption affecting international trade.

The proposals for the company further complicate matters. Makesure will be reorganised significantly, which could have the effect of encouraging the consultants and professionals who make up the company to leave. The company will be very different after the acquisition and so it may not be appropriate to even consider carrying some of the goodwill forward.

Change management

Makesure will lose its autonomy. At present, the company exists to find clients and serve their needs and, in the process, to provide the shareholders with acceptable profits. That will change once they are a 90% subsidiary because they will be directly accountable to BES' board, especially as they are being acquired in order to serve BES' needs with respect to manufacturing. Makesure faces the threat of losing its board members, if they decide to move on in order to avoid being affected by the takeover.

BES may address this concern by meeting with Makesure's board at the earliest opportunity, with a view to reassuring them that they are valued and will have a role to play once the acquisition has been completed. If the proposals sound attractive then hopefully Makesure's directors can be persuaded to stay. If not then they can at least be encouraged to remain for long enough to allow for an orderly handover.

The other staff at Makesure will be concerned because acquisitions frequently involve rationalisation and redundancy. That will be a particular problem in this case because the sales staff and some of the designers have ready been identified as surplus to requirements. Staff will often prefer to look for jobs before they are dismissed because they may feel that they have more chance of finding new employment while they are in work.

It might help to be clear about the planned redundancies at the outset and to stress that they are only required in specific areas because of the new business model. Offering the outgoing staff favourable severance terms will show that BES does not take losing staff lightly. Clarifying the need for the remaining staff will make them feel valued and encourage them to stay.

TASK 3

Transfer prices

The specific challenges are that there are several stakeholders whose interests are competing with regard to transfer pricing. BES as a whole risks suffering losses due to any dysfunctional behaviour due to transfer pricing decisions. For example, adding a margin to Makesure's costs may make it appear cheaper for the buyers in BES' Supply Chain department to order from third parties instead of Makesure. At the same time, Makesure has stakeholders who wish to see its profit maximised, most notably the NCI and also the host country revenue authorities.

Makesure is based in a foreign country, which creates concerns that there could be manipulation of profits for tax purposes. Transfer prices could be open to manipulation in order to recognise more profit in the country that has the lower tax rate. We have the further complication that Makesure is not fully owned by BES, which means that the NCI will be entitled to a percentage of any profits earned by Makesure on sales to BES. If transfer prices could be set in line with market prices for these products, then both the revenue authorities and the NCI should be satisfied that they are not being abused.

There is a further challenge arising from the fact that BES buys such a wide range of goods that it will prove difficult to check that market prices are being used consistently, with transfer prices being kept up-to-date with changing market conditions. At present, BES has 400 own-brand items and the hope is to add as many as a further 900 items. Furthermore, BES buys in such bulk that even a small disparity in transfer prices could impact buying decisions.

It may be simpler and more cost-effective for BES to observe the pricing strategies in different product lines and to estimate market prices on the basis of cost plus a percentage if robust mark-ups can be determined from observations. It would then have to be stressed that the resulting mark-ups are very much surrogate market prices based on market observations. In that case, it would be a matter of setting a strict rule that the Supply Chain department could only order from a third party if Makesure was unable to meet its needs.

Balanced scorecard

We have a clear mission statement for Makesure, which could provide a basis for a range of specific tasks and objectives. Makesure is about to go through a process of change and development and so it would be useful to give the management team a number of specific objectives. The balanced scorecard (BSC) would reduce the risk of an undue focus on a single performance measure and would deter dysfunctional behaviour by Makesure's management team.

Makesure's new role will effectively require each of the four perspectives on the BSC to be revisited. For example, the financial perspective can no longer focus on making profits because that will not necessarily maximise shareholder wealth. It will assist Makesure's board to have a formal discussion concerning these objectives.

The BSC will also prove invaluable for evaluating performance. The feedback will show specific cases where performance is on track, ahead or behind. That will make it easy for BES to establish whether the overall integration of Makesure is on track. It will also enable us to direct the attention of specific managers to deal with issues that are behind target.

The BSC might encourage benchmarking of Makesure's performance against that of BES. It will be natural for Makesure's management team to look for ways to work towards the targets set in the BSC and BES would be a logical place to start. Setting targets for Makesure based on BES' requirements is likely to assist Makesure's management team in integrating themselves into their new setting as members of the BES Group.

TASK 4

Gil

Gil clearly saw a significant upside risk. We would have been unable to sell the same range of branded goods unless we reduced pack sizes. It may be desirable for us to do this in order to attract customers with tempting offers and familiar products. We will appear to be a higher quality retailer if we have brand names prominently displayed for sale.

There was, of course, a risk of adverse publicity thanks to stories and the inevitable comments on social media sites. In future, we may find that consumers comment online about further reductions in pack sizes and that newspapers regard this as an easy story to write from time to time. We may lose sales if customers start to feel that they are being cheated.

Gil's role as Supply Chain Director should mean that she can make most decisions relating to buying and enter into most discussions with suppliers without seeking board approval. If she did not have that flexibility then it would be very difficult to ensure that the company was responsive to the changing market. The need to maintain the E$1.00 price point forces us to be even more responsive than most retailers.

This decision was, however, almost strategic in scope. Gil effectively took a decision about a significant proportion of BES' business by commissioning a large number of products. Even ignoring the potential publicity associated with this decision, Gil should probably have consulted the board, at least to establish whether others wished to debate this matter.

Segments

BES' board has a duty to publish financial statements that present fairly. The financial statements do not provide any meaningful segmental analysis, which may make it difficult for the shareholders and others to interpret the company's overall performance. Arguably, BES has a variety of different product lines and so any meaningful analysis of the reported earnings will require the totals in the statement of profit or loss to be analysed.

The directors should reflect on their own understanding of BES' performance and how they understand that. For example, the board may feel that they need to break the figures down into broad categories such as branded goods versus own brand and generic. If the directors require such a breakdown then they should consider whether it is truly acceptable to withhold it from the shareholders.

The external auditors may be forced to report that our financial statements do not present fairly, due to a failure to adhere to disclosure requirements. That may result in a concern that we lack transparency and are unwilling to provide information because we have something to hide. Having said that, if the auditors have 'always' been unhappy then they have been willing to tolerate the lack of a segmental analysis in the past and they should be willing to continue to do so into the future.

The shareholders may be concerned that a full segmental report will furnish our competitors with useful information. The paradox is that informing the shareholders may also give our competitors and insight into our cost structures and attract others into markets where we are doing well. Our breach of the rules could actually be applauded by the shareholders.