Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY MAY 2017 EXAM ANSWERS

Variant 4

The May 2017 exam can be viewed at

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TASK 1

Competitive position

BES will be competing with both the traditional retailers on the retail park and other value retailers who may decide to locate there.

BES sells a range of items at a low price and so it is likely to be competing with several of the established retailers on any given retail park. For example, BES may sell canned goods at E$1 that are more expensive in the supermarket on site. That may not be a sustainable position because supermarkets often sell loss-leaders in order to attract customers. BES may find that its leading branded goods are on sale for 79 cents and that it is good business for the supermarket to maintain that price until BES stops selling that item.

BES may enjoy some benefit from being first to this particular market, but there is a risk that its success will attract other value retailers. Feedback from customers suggests that value retailers do not compete on service or reputation and so it would be foolish to rely on customer loyalty. There would be very few barriers to entry for other value retailers who decided to follow BES' lead.

Retail parks may be ideally suited to BES' business model. First of all, there will be a steady footfall of potential customers passing the store on a constant basis. These customers will have driven to the retail park to shop and may decide to browse in BES quickly in order to see whether there are any opportunities for savings. If BES is selling, say, tinned foods at a lower price than the nearby supermarket then customers may buy before going on to complete their weekly shop because they can leave these items in their cars.

BES may also be a good source of items that might be difficult to find in other shops. A customer might need, for example, a tube of glue for a household repair and may decide that BES is the most likely store in the retail park to carry such a thing. It may not even be necessary for BES to stock that item because the customer may buy anyway once in store.

Benchmarking

Benchmarking will help us to understand whether the pilot stores have reached their full potential in order to help us to understand whether to roll the idea out to other retail parks. We need to understand whether any problems or disappointing results at the pilot stores are due to the operating environment or whether they are matters that can be resolved. We are not necessarily keen to know whether retail park stores outperform town centre stores because the two are not mutually exclusive. We could, in principle, accept that a retail park store has a poorer performance than a town centre store provided both generated adequate returns.

We may look for town centre stores that are more comparable with the expected customer base at the retail park. For example, a town centre store that is close to a large and free car park may have lessons that can be learned at the pilot stores. It may, for example, be helpful to lay stores out differently when customers arrive by car. Special offers on bulky and heavy items such as soft drinks will be more attractive to customers who have only a short walk to the car park.

We might benchmark BES new stores against existing stores in that retail park in order to determine whether there are, say, processes that are worth adopting. For example, what are the processes involved in presenting and operating a store on a retail park, which may differ from a town centre location? Those questions can be considered by benchmarking the operations of the pilot stores with those of nearby stores and measuring factors such as footfall and observing the customer experience that is being offered. It may, for example, be important to focus more on cleanliness and keeping the stores tidy in a retail park.

We may be able to draw some insights from the analysis of the other stores' published financial statements. For example, we may be able to estimate sales per square metre using information relating to revenue and floor space. Even if the stores do not publish detailed segmental analysis showing the breakdown by type of store (e.g. town centre vs. retail park) we may be able to make some realistic estimates by analysing the numbers of store openings and closures and looking at the changes in revenue. The financial statements may also give us some insights into the cost of equipping new stores and whether we are operating efficiently in comparison to those benchmarks.

TASK 2

Justification of approach

One argument is that gross margin from each product line is not necessarily a good guide to the overall contribution and profit to be had from the store as a whole.

There is a risk that gross margin will give a misleading impression of the overall profitability of the product because it may not allow for all costs. For example, food items have sell-by dates that require additional time and effort to be invested in checking inventory and organising shelves so that fresher items are always towards the back. Ignoring those additional inventory management costs could lead to a product range that requires additional staffing and so is less profitable.

Given that BES tends to sell a range of basic goods, it is unlikely that many items will require such management. For example, canned drinks will have very long shelf lives and should have a rapid turnover. There is some logic to the argument that we should maximise the potential revenue from each metre of shelf space and so the product’s footprint could be a relevant issue. That could be fed into an optimisation model such as linear programming and might justify the analysis.

We should have allowed for likely demand in determining profitability. There is very little point in having almost all of our range of cosmetics on display in the pilot store unless there is likely to be sufficient demand to justify that decision. If, for the sake of argument, cosmetics products move relatively slowly and there is a higher demand for food items then it may yield more contribution per square metre to have bulky food items in place of cosmetics.

There is a danger that our analysis will prove too simplistic with regard to making the best use of the space in our stores because we could change some of our operating procedures in order to deal with the different retail environment. For example, some products may attract customers, who then buy other items while in store. These popular items should be sold even if they are not particularly high margin. If we organise the logistics carefully it may be also be possible to have a fuller range of products on display in a smaller store by displaying fewer units of each product line. If we arrange frequent deliveries so that shelves can be replenished quickly then the overall capacity will be increased.

There is a further issue here in that the objective of this pilot study is not necessarily to maximise contribution or profit. We are trying to gather as much useful information as we can in order to understand whether this is a viable business idea and so we should be aiming to experiment with different product lines. The real constraint is not the capacity of the shop, but the time that is available to gather information before a decision has to be taken on whether or not to proceed.

Marketing department

Our first decision has to be the purpose of the marketing department. We need to be clear about what the department is expected to add to the business in order to select a suitable marketing team. The discussion suggests that BES is generally quite reactive in terms of the product decision, buying items that can be sold at a profit. Perhaps there would be value in appointing experts who can apply a more proactive approach to identifying products that might attract customers.

The second key decision is the economic decision as to how much we will spend. We need to decide how to balance the costs of paying experienced professionals against the benefits of having their expertise. That decision has to be taken early because the marketing manager will wish to know about staffing before accepting any offer that we make. We also need to make a reasoned business case for this investment and so we should make a formal decision on resourcing, leaving some scope for adaptation in the event that we need to spend a little more to secure a promising applicant.

The joint reporting idea suggests that BES is not sufficiently committed to marketing to make a further board appointment. That would possibly deter some potential applicants for the role of Marketing Manager. That said, it could also encourage ambitious applicants who relish the challenge of taking charge of a quoted company's marketing efforts before they are at a stage where they might be considered for a seat on the board. It could also address the realistic concern that formal marketing management is less important to BES' business model than cost management and so it is unlikely that there will be a need for a board appointment.

The joint reporting structure could lead to serious problems because the two departments have very different objectives. Supply Chain is all about managing the relationship with existing suppliers and so any proposals made by the Marketing department could prove disruptive. The Business Development department may feel slightly threatened because their role in special projects could be seen to be at risk. The fact that Marketing is not directly answerable to either director means that neither will have any particular reason to support Marketing or encourage the Marketing Manager.

TASK 3

Project appraisal

First of all, Peter is undoubtedly incorrect in stating that there will be no initial investment in this project. There are bound to be legal expenses associated with agreeing the leases and other contracts, costs of staff recruitment and so on. There will be deposits and initial lease payments before the store keys are handed over. There will be an initial investment in inventory of approximately 6% of cost of sales (based on last year's financial statements), which is a further E$3.9m for the 50 stores.

This is a massive undertaking, increasing store capacity by 21% in terms of number of outlets. It would be ridiculous to have no formal investment appraisal for such a venture. Even if it is clearly a positive NPV project, we need to know what assumptions are being made and risks taken before we can decide whether that NPV justifies the risks.

The future cash flows are not necessarily mutually certain. If a store is a failure then the revenues will diminish or possibly stop altogether. There could be an influx of other value retailers which dilutes the scope for earning revenue. BES will still be liable for lease payments and staff costs even if the stores are closed.

The venture will lead to a major commitment of resources and capacity that will not be available for other purposes. The project appraisal will ensure that we have considered the implications of tying up those resources. We need to ensure that this is the best use of those resources, even if we do so using a fairly unsophisticated technique.

Substance over form

Note: candidates' answers to this question could be based on the assumption that the leases will be accounted for under IAS 17 Leases *or IFRS 16* Leases *(which does not become effective until accounting periods beginning on or after 1 January 2019, but which permits early adoption).*

The concept of substance over form is a key issue in the preparation of financial statements for the shareholders. Transactions and relationships are often structured in a manner that proves misleading when they are accounted for very literally. For example, the use of consignment stock in some industries means that inventory held by a retailer does not belong to the retailer in any legal sense, but the retailer still has all of the risks and rewards associated with ownership. Accounting for this literally would leave the retailer showing no assets or liabilities, but accounting for the economic substance would show both the asset and the liability.

Accounting for economic substance is about accepting responsibility for providing a fair presentation or a true and fair view in the financial statements. It involves making some very delicate decisions about what the substance of a transaction actually is, which may be complicated when the legal form differs. One problem is that there is a whole industry devoted to ‘financial engineering’, whereby third parties develop schemes to offer scope for misleading accounting through the reflection of legal form in the financial statements.

Leasing is a classic example of accounting for substance over form. The basic logic behind a lease is that a lessee obtains the use of an asset, usually for a specified period. Leases can be long-term and can even run to terms that equal the asset’s expected useful life. In that case, the legal form is potentially misleading because the lessee does not own the asset or have any formal liability to the lessor, beyond the ongoing lease payments, and so assets and liabilities are arguably understated when the legal form of a lease is accounted for.

Lease accounting is also an excellent example of the problems because it has proven difficult to identify leases that should be shown as liabilities in the financial statements. Leasing companies have proved adept at structuring leases so that it is unclear how the lease should be accounted for. There are complex ethical arguments about how best to treat leases in the financial statements.

TASK 4

Risks

There is a risk that the opening of the retail park stores will be delayed. That seems to have a high likelihood, but is also likely to have a low consequence. The opening itself is likely to be very low key and will not stimulate sales. The worst possible case is that BES will lose revenues because of any delay in actually opening the stores.

Customers may regard BES as unethical because of the plight of these employees. That could discourage customers from shopping at BES. That is arguably a low probability risk, although the consequence could be severe if it happened. Customers are attracted to BES by low prices and so they know that costs are all kept to the minimum. They may not be willing to forego savings because of a matter of conscience, especially if they are retired and have low incomes themselves.

BES may struggle to recruit shop staff because of this controversy. Again, that is a fairly low likelihood even though the consequence would be significant. BES offers relatively unskilled work to potential employees who may have relatively few alternatives. Many potential applications will be forced by their personal circumstances to apply for work with BES, even if they are not keen to do so.

Conflict

The most logical response to this conflict is to initiate contact with the workers or their representatives to obtain a better understanding of the problem. If BES' board understand the problem then there may be more chance of a peaceful resolution. BES should also seek the advice of other employers based at the retail parks to establish how they deal with the problem of staff working late and having to get home safely.

BES may discover room for negotiation with the employees. For example, some may be willing to work until 10:00 because of the extra 10% on the hourly rate and there may be sufficient volunteers to avoid imposing this shift. There may be a less expensive way to ensure that staff have suitable transport other than paying individual taxi fares for all. It may prove necessary to turn this refusal to work into a disciplinary matter in order to force the employees' hands.

The shareholders will have incorporated their expectations of the new stores into their estimates of future dividend payments. If the opening date is threatened then they may revise their expectations again and the share price could fall as a result. The likelihood would depend on the extent to which the shareholders believe future dividends will be affected, which may differ from the expectations of BES' board.

The shareholders may also consider the wider implications of this story for their confidence in the board. The workers' strike may mean very little in itself, but it could have implications for the understanding of the board's competence. The share price might fall because the shareholders are concerned that the board has failed to address a fairly obvious problem in the implementation of an important project.