Chartered Institute of Management Accountants

MANAGEMENT CASE STUDY MAY 2017 EXAM ANSWERS

Variant 5

The May 2017 exam can be viewed at

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TASK 1

Profitability of venture

The first question we need to address is how we might determine the impact on revenue. The bulk sales themselves will be relatively easy to separate out because they will be processed and recorded separately. The problem is that they may displace some retail sales and that effect will be difficult to identify. A potential customer who buys a lipstick from a local shop or from an internet auction site is costing BES revenue.

It will be difficult to measure the impact of selling inventory to retailers who may compete with BES. One approach would be to study the profitability of the stores that had extensive bulk sales before the introduction of wholesaling. If their revenues were in line with other stores that did not make bulk sales then there may be an argument that BES has nothing to fear from resellers. We should monitor the ongoing sales of products that are frequently ordered in bulk in order to establish whether there is any reason to be concerned that retail sales are being affected.

The costs associated with this venture may also be difficult to measure. At present, the distribution centres have to fulfil the inventory requirements for 240 shops. The wholesaling venture will increase the number of picking lists and orders. We may find a significant increase in the number of orders, with wholesale buyers buying smaller quantities. There may be marginal costs associated with processing orders and delivering goods, which may not stand out as marginal because we are unlikely to have additional delivery runs just to handle wholesaling.

We should update any ABC evaluation of the cost of processing orders, with greater emphasis on the impact of the size of the order and whether it is for a reseller. The same is true of distribution costs, given that we will have to make more delivery stops with additional part loads to meet resellers' needs. We should also attempt to identify the need for expansion of the workforce or the delivery fleet in order to establish whether the additional costs will be fixed or variable.

Strategy development

Emergent strategy is essentially unintended, in the sense that it did not emerge from a specific, formal development. The wholesaling development arose from an opportunity that presented itself, it was not part of a formal strategic plan. BES' board did not set out to find a new source of revenue and did not even identify this opportunity until they read a news report about a successful business that was created by a customer who decided to resell BES products.

It would be preferable for strategy to be developed as a formal, intended strategy because the emergent approach could turn out to be haphazard and ineffective. The board of directors is essentially paid to provide strategic direction for the company. The company should have a clear mission statement and strategy should be developed and updated in order to put that into effect.

That said, there can be no reason to reject opportunities that present themselves just because they do not follow on from a formally developed strategy. The decision to capitalise on the latent demand for a wholesale service is essentially evidence that BES' board can innovate. It would be foolish and irresponsible to reject an opportunity to increase shareholder wealth just because the board had not developed the idea independently.

It might also be argued that emergent strategies are consistent with intended strategies provided they do not create conflict. The board has a clear strategy in place for the development and expansion of retail and that has been successful and will continue. There is no reason for the shareholders to be informed that the wholesale venture was added alongside the retail and so the board need not admit that this was essentially a windfall.

TASK 2

Boxlift

Evaluating Boxlift's performance as a going concern suggests that the company is highly profitable. Return on capital employed is high, bearing in mind that the company requires significant investment in property, plant and equipment and in software. Return on equity is high, suggesting that the company is highly geared. Indeed, more than half of the company's long-term finance comes from borrowing.

The company's revenues have declined since 2015, but costs have increased slightly. Perhaps the founder is keen to sell because the company's performance has been declining. The fact that revenues have declined may indicate that the industry is volatile, which wold not be a problem. We need to investigate this further in case Boxlift has lost customers because of poor service or incompetent staff.

The fact that non-current assets are declining suggests a lack of recent investment in both tangible assets and software. Perhaps the declining profits have been due to under investment and any new owner is going to be faced with the need to restore the asset base to a viable level. The numbers are not enough on their own and so we should discuss the question of investment with Boxlift's staff in order to establish whether the company's technology is current and effective.

The issues arising from gearing and the volatility in profitability are less important to BES than they would be to the current shareholders.

Risks

As an investment project, we know what we are buying if we invest in Boxlift because there is a going concern that has been established and we can see it in operation. If we create our own facility then we will need to obtain premises, equipment, software and staff and will have to ensure that everything works together. We know that the system is already operation if we buy Boxlift, whereas, if we establish our own system we may find ourselves missing the launch date if there are any alterations that have to be made before we can go live.

The cost of the project will also be largely predetermined if we purchase Boxlift because we will have an agreed purchase price for the company. If we develop our own system, even using standard software and systems, there is a risk that we will overspend in order to get everything working correctly. It may also prove expensive to recruit and train suitable call centre personnel to staff the system.

There could be a risk associated with integrating Boxlift into BES' operations because there could be problems in having their systems communicate with ours. If it proves difficult to transfer orders to BES then the business will be disrupted and we might lose credibility in the eyes of customers. Building a system from scratch may make it easier to integrate it with BES' existing inventory and delivery systems.

Boxlift offers a real option in the event that the project starts to falter. The company has operated independently in the past and it may be possible for BES to sell it as a going concern in the event that it does not succeed. In theory, it might also be possible to sell off a call centre as a going concern, but Boxlift's sale could be supported by audited financial statements and other documents to create a real option.

TASK 3

Pricing strategy

We might aim to continue to sell at E$1 per item, with or without a further charge for delivery. One argument in favour is that we are already seeing evidence that customers will pay that much to buy from us. If that price undercuts the competition then there is very little point in reducing prices further. Maintaining a unit price of E$1 would have the further advantage of making it impossible to undercut BES stores, even by a few cents. Sticking rigidly to that price point would make us vulnerable to a price war whereby existing wholesalers know that they only need to sell for less that E$1 in order to undercut us on anything.

Reducing prices by offering a discount would help us to penetrate the wholesale market, bringing more products under the prices charged by competitors. The fact that this will be a sideline for BES means that the company can afford to cover its overheads using its retail operations and can reduce wholesale prices to the bone. The danger is that it will be possible to learn a great deal from BES' wholesale prices. Competitors may discover that some products have a very high margin because they are keenly priced for wholesale customers, which could make it easier to compete directly with BES.

There could even be scope for price skimming because wholesale customers have been forced to pick their own goods and travel round BES stores. The convenience of having goods delivered and also the ability to buy more units than would typically be on display in a store mean that it will be even more convenient to buy from BES. That strategy could have the effect of highlighting one flaw in BES' business plan. The company sells only goods that can retail at a E$1 price point and so customers will always have to visit. The premium could take us back to having stores cleared out of popular items because small retailers may prefer to collect the inventory themselves in order to maintain margins.

Transfer pricing

Tax law often penalises companies who manipulate their tax liability by pushing profits to one group member or another through manipulating transfer prices. Revenue authorities usually insist on having transfers priced at their arms' length market prices. The goods that are being transferred from BES (Retail) to Boxlift may not have an observable market price because the issue here is the quantity in which the goods are being sold.

It may be that it would be relatively straightforward for a transfer pricing strategy based on negotiation to work. BES (Retail) operates on such narrow margins that there is very little discretion because the price will lie somewhere between the cost to BES (Retail) and Boxlift's selling price. That leaves very little scope for disagreement by the authorities. BES (Retail) can conduct a reality check by reviewing the gross profit reported by Boxlift.

The motivation of Boxlift's management team may be a more delicate matter because the slight leeway for discretion over the transfer price could have a significant impact on Boxlift's reported profit. That could make it difficult to ensure that the management teams of BES (Retail) and Boxlift can reach a consensus. It may be necessary for the board to intervene and impose a pricing strategy against the wishes of both teams.

The motivation of BES Retail's management team is less of an issue because Boxlift has no choice but to buy from BES (Retail), so there is no real risk of dysfunctional behaviour. Boxlift's profit will also increase with sales, so there will always be some incentive to sell more. There should be other ways to motivate Boxlift, such as setting sales targets and rewarding the management team when they meet or exceed those.

TASK 4

Redundancy

The first issue is to ensure that our HR department is up to date on the latest redundancy law. We need to ensure that we comply with the law, otherwise we could be faced with fines and employees may have rights to further compensation. We need to decide whether we will make the minimum payment required by law or whether we will aim to encourage employees to accept redundancy by paying more on a voluntary basis.

We should make it clear to all staff that redundancy is a necessary response to the poor performance of the company. There is no scope for avoiding redundancy because the work that paid for the workers' salaries no longer exists. The employees will be better able to accept their fate if they realise that BES has no alternative and that job losses are inevitable.

If possible, the employees should be offered the opportunity to volunteer for redundancy. That would make the prospect of redundancies less threatening because it would enable those who really need to retain their jobs to have a greater chance of staying with the company. The danger is that the more experienced employees who are entitled to higher pay-outs will leave and the less desirable staff will stay.

If it becomes necessary to have compulsory redundancies then it would make sense to have a clear criterion for selection so that the process seems fair. 'Last in, first out' is one approach, which will tend to save money by dismissing the least experienced staff. It will also require very little administrative effort to implement compared to, say, having staff apply for their jobs.

Goodwill

IAS 36 *Impairment of Assets* requires that goodwill is subject to an annual impairment review. The fact that Boxlift is making losses since it became part of the BES Group suggests that the goodwill on acquisition may be impaired. That should be verified by a detailed test, though, because this could be a temporary problem requiring some time to resolve.

Valuing the goodwill would be difficult, although the fact that the original customer base has been sacrificed to create capacity for other business suggests that BES may have lost a lot of the goodwill on acquisition already. The possibility that employees, whose skills and loyalty would be another element of goodwill, are being made redundant further suggests that goodwill is impaired. The loss will have to be written off as an expense, just like any other impairment loss.

The shareholders may be concerned that their money has been wasted. BES paid a lot of money for this goodwill and it will appear to have been either a poor investment or bad stewardship if it has to be written off immediately. The shareholders may not appreciate that it would have been impossible to have foreseen this loss.

If the impairment loss is viewed as a signal that future profits, and so future dividends, are expected to diminish then the share price may fall. That would have the effect of pushing up the cost of equity and the weighted average cost of capital. BES may find it more difficult to maintain a flow of funds for new projects.