MANAGEMENT CASE STUDY AUGUST 2018 EXAM ANSWERS

Variant 4

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Section 1

Distribution arrangement

Montel will have to estimate the effects of this arrangement on the revenues from this range of cameras. At present, potential buyers may not be able to see and handle one of these cameras and so may be discouraged from placing an order. The difficulty is in knowing how many additional sales will be made because of this.

We are effectively tying up cash in inventory without necessarily knowing how long the inventory will take to sell. The finance costs of this arrangement will undoubtedly eat into the profits from all sales. Tracking those finance costs may be complicated, because some retailers will sell the cameras more quickly than others.

Paradoxically, the arrangement might give the retailers an incentive to sell other manufacturers' cameras in preference to Montel's if the retailers have their own cash tied up in the competitors' inventory. Once they have sold sufficient Montel cameras to retain their access to consignment inventory, the retailers might shift their advice to sell other makes. Montel may have to apply time and effort to investigating and preventing such dysfunctional behaviour. Having display models in retailers' shops could be a problem if customers are asked to take the display models, knowing that they have been used by various customers and could have sustained minor cosmetic damage. These cameras will be intrinsically less valuable because they are "open box". If Montel asks for a camera to be transferred to another retailer, then it may be that these "used" cameras will be selected first.

Consignment inventory

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The basic accounting requirements are set out in IAS 18 *Revenue*, which may have been superseded by IFRS 15 *Revenue from contracts with customers* if Montel has decided to apply this later standard before its due date. Both standards require Montel to account for the underlying substance of the consignment arrangements. Montel has to account for the inventory on the basis of who actually has control after delivery of the inventory.

Control is often best defined in terms of the transfer of risks and rewards of ownership. The fact that Montel remains the legal owner of the inventory is not particularly relevant to the decision as to how to account for the transfer to the retailers. The only real indication that the risks have passed arises from the fact that the retailers must either insure the inventory or bear the risk of any uninsured losses, which is hopefully not a material risk.

The risks and rewards of ownership clearly remain with Montel, because the company can request the return of the inventory at any time. If it wishes, Montel can also redirect goods from a retailer whose sales are slow to one who is more likely to make a sale. The retailers only benefit to the extent that they can sell the inventory while it is in their possession.

The fact that Montel has set sales targets to maintain the right to hold consignment inventory, further reduces the extent to which they benefit from the risks and rewards of ownership. Having accepted consignment inventory, they face the loss of that privilege if they do not achieve satisfactory sales figures. To an extent, they may also be exposed to competition from other retailers, who may be able to request the transfer of their inventory in the event that it does not sell quickly.

Section 2

Pricing strategy

The 5% retail discount will cost Montel at least F$120 for each eligible sale. That could be regarded as an expensive way to boost sales in the short term, especially as some of the sales would have occurred anyway and others could be displacements of future planned sales that had been accelerated to exploit the discount. The fact that these cameras are sold on the basis of quality may mean that the price reduction will do very little to encourage buyers.

The discount does have the advantage of encouraging customers to spend at least F$6,000 on a camera and lens, with is F$1,000 more than the cheapest combination and so is a form of product bundling. It also gives buyers an incentive to purchase a Montel lens, rather than possibly buying a Premium DSLR body and a competitor's lens. This will also prove a prompt and relevant reality check on the consignment inventory scheme. If the consignment inventory scheme does not increase sales when augmented by this discount then it should be abandoned.

The camera bag is unlikely to be a significant factor in any customer's purchasing decision. Its value is small when compared to the retail price of a Premium camera. Offering such a minor gift could risk alienating some customers if they feel patronised by such a small gift. The cost of planning and organising the logistics associated with his gift could outweigh the value of the gift itself and so there could be a disproportionate cost associated with earning a very small benefit.

If the bag is a limited edition or is in some way exclusive then customers could regard it as desirable, even if it has relatively little monetary value. At the margin, it could be sufficient to make some customers choose a Montel Premium camera instead of a competitor's. The bag offer would also give Montel an excuse to use email or some other form of communication to contact potential buyers, which could boost sales.

Ratio analysis

The biggest impact on Montel's accounting ratios will be the slowing down of the inventory turnover ratio. At present, Montel will have inventory on hand to meet orders from retailers and the inventory turnover will reflect the rate at which retailers sell premium cameras and order replacements. The consignment inventory will significantly increase the average number of days taken to sell a camera.

Montel's liquidity ratios may also be affected, although that will depend in part on the manner in which the investment was financed. If Montel borrowed the F$90m as a non-current liability, then there will be no net outflow of cash. In that case, the increase in inventory could create the impression that Montel is inefficient because it has too much tied up in inventory.

Retail strategy

Firstly, it is debatable whether the issue of consignment inventory constitutes a significant change of retail strategy. Montel continues to sell the same products through the same retailers. The only real change that has occurred is that Montel is providing what amounts to an extended period of credit in the form of the inventory that has been advanced.

There is a danger that the slowing rate of inventory turnover will create the impression that demand for Montel's products is declining. That would create a negative impression in the shareholders' minds about the viability of their company. Montel should ensure that the change is highlighted in the annual report, with a realistic explanation of the benefits that are being enjoyed in terms of increased sales.

Section 3

Key operational risks

Montel's inventory management may be less responsive in the short-term because it will be necessary to use manufacturing output to create and maintain consignment inventory. That could make Montel less responsive in the event that one or more retails is experiencing high sales volume and Montel runs out of inventory in order to meet that demand. That risk might be mitigated by having Montel's salesforce maintain close ties to retailers and to ensure that we support forthcoming sales promotions. There also has to be clarity over the need for retailers to be responsive in the face of requests for inventory to be forwarded to other retailers.

There could be losses due to fraud by either staff or retailers themselves. Montel will have no way to conduct physical checks of the cameras on consignment to retailers. If a retailer sells a camera, then it would be possible to keep the cash in the short to medium term, at least until Montel asked for the camera to be returned or moved on. Even if the retailer admitted to the sale eventually, there would be delays in Montel's cash receipts. This risk could be addressed by tracking the serial numbers of all cameras out on consignment and linking those to customer registrations. Customers could be required to register their new cameras online in order to access software and other resources.

There could be an issue with updating products if Montel has a significant inventory out on consignment. The consignment inventory may, therefore, create a disincentive to update designs and introduce new features. Montel could address that risk by offering discounts to clear inventories of existing models when a new version is about to be launched. The company could work in conjunction with its retailers to manage the launch process to ensure that inventory is either sold or returned to Montel for sale.

Resistance to change

Resistance to change is generally due to a sense of being threatened. The sales managers may feel that the changes to the sales budget are potentially harmful to their interests. Before Montel introduced consignment inventory, actual sales were only F$270m per month, which was less than the budgeted figure of F$300m. The new sales target is higher still and is only a little smaller than the first full month in which the retailers had the impetus created by the introduction of consignment inventory.

The sales managers may be concerned that they will be open to criticism in the event that the new targets turn out to be unachievable in the longer term. If senior management hold them accountable, citing the additional support in the form of consignment inventory, then they may feel that their positions are threatened. The managers may feel that the increased target is beyond their control in terms of being able to deliver.

The most immediate response to this resistance would be to reassure the sales managers. The sales budget could be optimistic, but intended to give Montel as a whole a basis to plan for additional sales. There has to be a production plan in place, in the hope that the anticipated sales materialise, otherwise there would be little point in stimulating sales.

It would be potentially beneficial to meet with the sales managers to discuss the revised sales budget. The new targets will be far less threatening if the sales managers have had an opportunity to become involved in setting the targets and to explain the problems that might be encountered in achieving them. The discussion will also ensure that the managers are aware of the expectations of Montel's Board and of the need to make the most of this opportunity.

Section 4

Management by objectives

Management by objectives would lead to greater emphasis on setting achievable targets for all departments. The targets could be aligned to overall corporate plans, so that there were separate targets for each range of cameras in order to ensure that the company is as profitable as it can be. If managers are concealing the failure to achieving sales budgets for premium cameras by selling more mid-range cameras, then there is clearly a problem with the budgeting and reporting system.

Management by objectives would also involve regular discussion of progress, with associated feedback. In this case, the discussion could be to ensure that sales targets for all major product groups are being achieved. Given that different ranges are aimed at different markets, it may also be worth incorporating a discussion of the ways in which the sales targets for mid-range cameras ought to be increased to reflect the fact that the sales managers feel comfortable with their ability to achieve favourable variances.

Management by objectives should really be considered as a coherent approach to planning that is intended to create objectives for all departments. Finance would be ideally suited to working with other departments, including Sales, to ensure that there is an overall commercial logic that results in making Montel more profitable. That suggests that all departments should communicate and collaborate, perhaps with Finance taking the lead in reflecting the other departments' plans in terms of financial outcome.

Finance would also be suited to assist in the development of controls and feedback mechanisms. There is very little point in setting goals through management by objectives, if Montel cannot measure progress towards achieving those goals effectively. Apart from offering expertise in systems, Finance will be able to offer a more objective view on what would constitute a realistic basis for measuring success or failure by managers.

Budgetary control

Montel's problems appear to be more a reflection of the application of budgetary control, rather than budgetary control in itself. The sales managers have budgetary targets for broad categories of cameras and they should be evaluated on their ability to meet those targets. The problem is that the managers appear to be combining and offsetting variances, which is effectively dysfunctional behaviour because it is motivating them to change the emphasis of their sales management.

It could be argued that traditional budgetary control could be a perfectly acceptable basis for managing the sales function. All that needs to happen is for the variances to be broken down according to product range and discussed separately. The sales managers should be held accountable for their failures, while being recognised for their successes. It is not necessarily a contradiction to seek an explanation for the adverse variances, even if there are favourable

variances to offset against them. It could be argued that the problem is a failure to apply traditional budgetary control properly, rather than an overemphasis on budgets.

Cost of equity

It could be argued that the shareholders determine the cost of equity in terms of the discount rate that is applied to future dividends. The share price reflects the market's assumptions concerning future dividend payments and the discount rate that reflects the risk attaching to those dividends. The more confident the shareholders are in the dividends, the lower the cost of equity.

Introducing a new approach to internal decision making and monitoring could affect the cost of equity, but only in the long term. If Montel is able to report more consistent dividend payments over time, then the share price will increase in recognition of the expectation of lower risk associated with future dividends. That reaction is, however, unlikely to be a short-term phenomenon, if only because the shareholders are unlikely to be aware of the change or sufficiently certain of its potential impact to lower the cost of equity in response.