MANAGEMENT CASE STUDY NOVEMBER 2017 EXAM

ANSWERS

Variant 4

The November 2017 exam can be viewed at

https://connect.cimaglobal.com/resources/november-2017-management-case-study-variant-4

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Task 1

Competitor analysis

It is worth analysing our competitors as they will potentially impact on the profits of our business and have implications on our choice of strategy as we compete for market share in Verlan.

We need to understand the size of the market and how much share of the market we have. The larger the share we have the better as this will allow us to influence prices and reduce costs through economies of scale. This information can be obtained from professional organisations at a cost, but we can find some of it for ourselves by analysing other companies' turnover and margins. This can be quite challenging as the market may not be easy to define from the external information we have on our competitors.

We need also to understand how many competitors we face. If we are in a crowded market, it may be difficult to stand out and attract customers. The competitors we face currently include the likes of RiPlan, AID and NAS who have well-branded products and are already in Verlan. This could be a very difficult marketplace to be successful in.

We should though look at our competitors' strategies as suggested by Porter's competitive analysis framework. It could be that they are not as focussed on selling in the capital. We can only do that by looking at our competitors' press releases and statements in their annual accounts. RiPlan have just opened their sales-room so it seems we will be competing at least with them.

We may, however, have some competitive advantage in terms of our ability to supply for our new customers in Verlan. It may be that through our analysis we may spot weaknesses in our competitors that we can take advantage of. For example, they may be heavily reliant on debt, their product offering could be old, or they do not manufacture in Kordia.

Business risks in creating a new showroom

These risks are those which businesses face because of the nature of their operations and products. In ZX's case we are entering a new marketplace (Verlan), relying on a small key group of staff trying to launch a new environmentally friendly product to new customers. This business risk should be managed and there should be strategies for dealing with it.

The first specific risk strategic – whether or not to open the new showroom in the first place. This could be a success, but it also could easily fail. Wages and overheads are potentially more expensive as it is the capital and this could easily be a very big financial mistake. This showroom may not be the best place to launch our new product. It may be better to launch our product in the north at our factory, rather than in a new showroom.

ZX has decided to launch an environmentally friendly product range. Although this is an admirable thing to do, to try to recycle products, it could be that the market is not ready for such products. The risk should be identified and assessed at senior management and board level. The market should be thoroughly researched before the product is launched to make sure that demand is there.

Another risk is that of customers not wanting to buy our new environmentally friendly products (this is known as product risk). There is also the threat that this new product threatens the demand for our current products and services. Demand for our old products will decline over time. Whilst this is better for the environment, it may have a negative effect on our profits and production volumes. A new product launched onto the market might fail to achieve the expected volume of sales, or the take-up will be much slower than expected. The risk of failure of new product launches or loss of interest in existing products would be very costly to ZX.

ZX could also be exposed to commodity price risk. Although recycled material should cost less than the raw material, sometimes due to high demand, it could actually be faced with increased prices for recycled products such as the plastic or metal that goes into our new products.

There is also a risk of a change in product's reputation or image. This can easily be damaged by the new product offering. As the product range is made from recycled materials, it may not have as good a finish as the other products in the range. If this is the case, customers may be put off buying from us. Also, if the product is not as hard-wearing as the rest of the product range, the furniture may come apart and customers will again not return to buy our products.

As Verlan is the capital and the demand for office furniture is rapidly growing, it is this sales office that must maintain high levels of customer service. If it does not, it could severely ruin its reputation.

There is a risk that our processes may fail (operational risk). If the showroom makes a sale of the environmentally furniture, but the factory cannot make the furniture to the difficulty of making with recycled materials, then they have let the customer down. This will lead to contractual indequacy risk, whereby the showroom will have agreed to deliver the recycled office furniture by a certain date. If ZX does not complete on time, ZX will have to pay compensation to the customer.

Task 2

Non-financial considerations for buying or leasing the showroom in Verlan

There are several non-financial considerations we need to take into account when deciding whether to buy or lease this property in Verlan. It can be very rare to find a suitable property to buy.

Growth

How do we expect ZX to grow over the next five to ten years and what level of factory or sales space is required for our future business? The vision and strategy will impact significantly on the decision as to whether we buy or lease. If we believe that future sales will come from having face-to-face contact with our customers, then buying a salesroom makes sense. If more sales are likely to come from other sources such as the internet, ZX should consider leasing the property. However, a lease of 10 years is probably too long. There should be negotiation with the landlord for a break clause.

Location

Location is always important. The showroom has very good access to mass transportation in the form of two subway stations. Henry Lund has already pointed out that there is a good opportunity to gain a lot of customers in Verlan. It should make sense to purchase the property in such a good location. However, there is a risk that that we do not want the property if this new showroom does not work. Therefore we will be stuck with a property that is miles away from our current base of operations, which will quickly become derelict. We may end up having to sell this property, which would take up a lot of time and effort.

Control

Control is important when it comes to making decisions related to the showroom. When leasing space, ZX will have to depend on the landlord for all the building services. As an owner occupier, ZX will be managing the up-keep of the building or hiring a third party property management company. This means that we can do what we like to the property and any modification will not be scrutinised by a landlord, whereas if we leased it, we may be restricted in terms of modifications. However, any repairs and maintenance would then have to be done by the landlord, so we would not have to find contractors to maintain the property.

Focus

ZX must consider the allocation of time, resources, and expertise to the showroom. Staffing the new showroom in Verlan will be difficult. It will be hard to recruit the right type of person who embodies the values of ZX and retaining staff might even be more difficult as they will have a greater potential ability to join our competitors who are also operating out of Verlan. It might be better to ask one or two sales staff to travel to the capital to meet and greet new customers. However, they may end up tired of the travel or may not want to relocate. This might mean that good staff will leave.

Treatment of the lease in the accounts

Treatment of the lease should follow IAS 17: Leases. This states that there are two types of lease, a finance lease and an operating lease. One of the things that must be decided by ZX is whether the lease is a finance lease or an operating lease. In order to decide this, ZX must first determine if the risks and rewards associated with owning the asset are with ZX or the person leasing the building. If the risks and rewards lie with the ZX then it will be a finance lease; if not it is an operating lease.

The main reward of a finance lease is where the lessee has the right to use the asset for most of, or all of, its useful economic life. The primary risks are where ZX also pays to insure, maintain and repair the asset. When the risks and rewards remain with ZX, the substance is such that even though the lessee is not the legal owner of the asset, the commercial reality is that they have acquired an asset with finance from the leasing company and, therefore, an asset and liability should be recognised in the statement of financial position.

As the lease is an operating lease the treatment of the lease is relatively straightforward. Lease payments are charged to the statement of profit or loss on a straight-line basis over the term of the lease, unless another systematic basis is more appropriate. Any difference between the amounts charged and amounts paid will be recognised as prepayments or accruals in the statement of financial position.

NB candidates referring to IFRS 16 instead of IAS 17 were given credit for this approach.

Task 3

Delegation

Advantages

There are many practical reasons why Henry Lund should delegate. As he is chief executive he is now potentially responsible for running four large divisions. Due to ZX's size he does not have the time and ability to run the complete business successfully, hence the decision to delegate to managers.

This should not be something for managers to be afraid of; in fact it should allow them to enhance their careers. It will allow them to think not just about managing costs, but also to consider how to create profits. The idea is to enable managers to develop real entrepreneurial and innovative ways to run their divisions.

This should enable managers to make better decisions for the business as a whole. They will be closer to the problem and can make the decision, allowing Henry and other members of the board to spend more time on strategic issues. Managers should therefore have more interesting work, increased job satisfaction and motivation, which should in turn lead to increased productivity and profits.

Disadvantages

Despite his apparent enthusiasm for delegation, Henry may find it difficult to give up some of his previous jobs, perhaps feeling that he is losing touch with what is happening. This could lead to two de-motivating factors for divisional managers: they could view Henry as interfering, or could feel that they are perceived as not able or experienced enough to perform the tasks required of a ZX divisional manager.

One major issue of delegation is goal congruence. The new divisions will aim to maximise their own individual profit. This has to be achieved without adversely affecting the overall performance of the organisation. In circumstances such as this, it is often the case that one division's profit centre's performance depends purely on the performance of those other divisions. One potential problem is that managers can make decisions to improve the performance of their division whilst adversely affect other division’s profits and ZX's long term profit.

In summary, divisional managers should not be worried about delegation. Henry is allowing delegation to include and motivate his managers. There must however be training to ensure that the managers are capable of managing the change to profit centres. Divisional targets and reward mechanisms must be focused on goal congruence and the profitability of ZX as a whole.

Cost and profit centres

In responsibility accounting, a specific manager is given the responsibility for a particular aspect of the budget, and within the budgetary control system, he or she is then made accountable for actual performance. Managers are therefore made accountable for their area of responsibility.

If a manager is responsible for a particular aspect of operating costs, the responsibility centre is a cost centre: ‘a production or service location, function, activity or item of equipment for which costs are accumulated.’ A cost centre could be large or small, such as an entire department or the activities associated with a single item of equipment.

If a manager is responsible for revenue as well as costs, the responsibility centre is a profit centre, and the manager responsible is held accountable for the profit of the operations in their charge.

Each cost and profit centre should have its own budget, and its manager should receive regular budgetary control information relating to the centre, for control and performance measurement purposes.

The effect on ZX’s four different divisions

The objective of each division (Sales, Design, Manufacturing and Fitting) will now be to act as a profit centre to maximise profit or achieve a profit target. The manager of the profit centre is allowed to make decisions concerning both the resources used and output (in terms of both quantity and price) achieved.

There needs however to be goal congruence. Each division must not make a profit at the expense of each other or diminish ZX's overall profitability. Management need to create an internal transfer pricing system that enables a fair price for the movement of goods between each division.

Sue faces a difficult time as a profit centre. This is because all the Fitting division can do is fit the product for the customer at a price quoted by the sales division. If that price is wrong, then not only will Fitting lose money, but so will the whole of ZX. This is a vital part of ZX's processes. If we get this wrong, Sue's workforce will have to potentially operate in a sub-optimal manner to maintain their profitability. This will mean that the job is not completed to the best of our ability, quality could be effected and therefore customer confidence will be eroded.

The sales division will deal with ZX's external customers. They will have the ability to make the decision on the prices to set the overall customer. They will be able to offer discounts to the customer. However if the transfer price of finished goods to the Sales division is too high, then they will not be able to offer high enough discount or incentive to external customers and will lose business for ZX.

For the Design division, they too will have access to external customers. They should now be focusing on bespoke design to incentivise the customer into using ZX. The problem here is that the tailor-made approach will affect efficiency and price in the manufacturing department.

The Manufacturing division’s profit will be generated by the sale of their product to the other divisions. The will also generate profits by keeping the cost of raw materials down and sourcing them as cheaply as possible.

Task 4

Monthly results template – guide for showroom managers

The calculations and ratios in this spreadsheet focus on the results for sales and the level of working capital created by this new business in Verlan. The first section shows the value of sales and the margin (sales - variable costs) that have been achieved in the month and for the year to date positions. The sales column is created by multiplying the sales price by the volume sold. This then is compared against the budget set. The margin is the amount of contribution made towards ZX's overheads (fixed costs). That too is compared against monthly and year to date budgets.

The working capital section focuses on how cash is created by the business. Most of our business is done via invoice and the outstanding amount that is owed to us (receivables) and the outstanding amount that we owe (payables) is shown in total amounts owed and in days. The days calculation shows on average how long it takes us to pay for receivables and how long it takes to pay our payables. Part of a working capital conversion cycle would also include inventory, but as we do not make or hold any inventory then this is only shown for completeness.

Showroom managers can influence these results in a number of ways. In terms of sales, this team needs to hit its budget. Managers need to be aware of these sales and margin targets and ensure that the right volume at the right price is sold. ZX as a whole has a sales and margin target and each showroom manager is part of that calculation. If targets are missed, then some other part of the business will need to compensate to achieve the overall ZX target set by shareholders.

It may even effect production and stock levels in the factory if the wrong volumes are sold. The factory will then struggle to meet the orders and there will be a problem with maintaining customer satisfaction as lead times will be increased.

In terms of working capital, this department does not hold inventory, but managers can influence both receivables and payable amounts. To maintain a steady cash flow both here and for the company overall, the Verlan sales department needs to have both low levels of receivables and payables. In an ideal world, it should not take too long for the department to either collect its receivables or pay its payables. However it should always the case that, on average, the receivable days is lower than the payable days.

The concern at the moment is that this department has over K$2 million of receivables still owed to them. This is really concerning and should be the main priority for the team to focus on and ensure payment for our debtors. If not we may struggle to get paid for sales and in the end we have to offer incentives, discounts or even resort to legal proceedings to get our money back. If we offer incentives to pay we will reduce our margin and we will need to sell even more to maintain our profits. If we need legal help to retrieve our debt then we really need to think about ensuring that we vet our customers before we make the sale to ensure that they are creditworthy and can pay our bills.

A balanced scorecard for the Verlan showroom

The balanced scorecard comprises four key perspectives that will allow ourselves at ZX to measure results and drive the business. Suitable measures for each perspective are as follows:

Financial perspective: the number of receivable days

I have chosen receivable days because sales staff can focus on the sale being invoiced rather than realising that a sale is not a sale until ZX receives the cash. This needs to be the key focus of the sales staff and if we set targets that can be achieved by the sales staff they will be motivated to follow the full raising and payment of invoices to ensure that the cash is bought in.

Customer perspective: customer satisfaction of 100%

I suggest that we measure customer satisfaction as again we are offering a new design service in the Verlan office. We could do this by getting every customer to fill in a questionnaire on our service. This satisfaction should range from 0 to 100 per cent. As we offer a high quality product and service, we should expect every client to reply with 100% satisfaction. We will encounter a lot of potentially new business and we need to make sure that we get this service right and keep our customer satisfied. If the customers are happy, they should come back and in return this should make our sales people happy because they are not chasing new business all the time.

Internal business process perspective: number of training hours of each sales employee

As this is a sales office, a lot of time will be spent externally focused on the customer. Therefore we must ensure that all of our employees are fully trained to look after our customers' needs. We should be training our staff for future management opportunities in the future. This should keep the staff motivated and focused on ZX's key goals. Staff will appreciate that we are providing them with training, helping them in their normal duties and also potentially training them for future positions. They should feel that we care for them.

Learning and growth perspective: employee retention

I would focus on this because this area is sales and we are recruiting in a very volatile and competitive market. Therefore it would be sensible to ensure that recruit the right staff, train them and pay them the correct wage to keep them at the sales office. If we have a high turnover of staff, there is a real danger that we will lose valuable customer relations and even worse, find our well-trained employees working for our competitors.