

CGMA FEBRUARY 2016 EXAM ANSWERS

Variant 2

The February 2016 CGMA exam can be viewed at

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SECTION 1

Strategic benefits of the proposal to expand Rio's e-business activities

Access to more customers and customer satisfaction

The first strategic benefit is the access to a wider market for Rio. Not only will an extended website offering allow existing customers the opportunity to purchase our products online, but it also opens up the opportunity to reach customers who do not currently shop in Rio's stores. These potential customers can now buy Rio's products without having to visit one of our stores.

Customer satisfaction levels for our existing customers should increase, as they will now have an alternative way of accessing our products. This should encourage increased sales, as customers will see products online and purchase them online, as they will be aware that if they delay the purchase it may not be in the store on their next visit.

Enhanced Customer Relationship Management

An online facility for our customers should also enhance customer relationship management. Rio can use the website to offer customer discounts, display promotional offers and present a unified and consistent branding message. This should increase customer purchases and should also result in long term customer loyalty. For the customers, the obvious benefit is the flexibility it offers them in buying Rio's products. It allows them to view and purchase our products wherever and whenever they choose.

Reduced Marketing Costs

In the longer term, this investment in Rio's website should result in significantly lower marketing costs as there is likely to be less need to use alternative media such as magazines and billboards, as customers will have access to and respond better to online forms of marketing. It also means that Rio will be able to speed up its communication to customers.

Improved communication

In terms of the proposed extranet, the first benefit is the improved communication with the design teams which should reduce potential communication errors and also reduce the time taken to submit and agree designs with the appropriate outsourced supplier. This should reduce design delays and ensure that products are manufactured and delivered to the distribution centres more swiftly. Overall, productivity and customer satisfaction should be enhanced.

Increased supplier efficiency and productivity

The extranet system should bring outsourced suppliers closer to Rio, making them feel an increasingly valued part of the Rio team, as they will have access to Rio's Procurement and Logistics systems. They will be able to co-ordinate their activities more effectively, as they will not have to wait to be told by Head Office when deliveries of raw materials are arriving or scheduled pick up of finished goods. This will allow them to plan better and should reduce any errors or delays in the manufacturing process. Improved efficiency and productivity, in low margin, fast moving products are critical success factors for a business such as Rio.

Strategic risks of the proposal to expand Rio's e-business activities

Cost of the investment

There could be cost overruns in the development, testing and implementation of the two proposals. The investment in IT systems is renowned for time and cost over-runs. It is forecast to cost €40 million, but there is always a danger with IT projects that costs can rise.

Risks of expanding internet sales

There could be a lack of staffing and procedures in Rio's distribution centres to cope with the logistics for the delivery and return of products to individual customers in these new 16 countries.

There is a risk that the internet shopping culture in some of these 16 countries is not sufficiently advanced, which may not encourage the use of online shopping. This would result in few internet sales customers and low revenues, despite the investment in an expensive IT expansion. There is a further risk that developing the internet sales to all countries could detract from sales revenues in Rio's stores.

Risks of new extranet system proposal

The largest risk is the security of the designs and security of access for the outsourced suppliers. The system should not allow all outsourced suppliers to be able to access all designs.

Whilst all of Rio's designs are protected by intellectual property rights, all of its designs should be kept secure so that they cannot be hacked into and the electronic version of the designs stolen. If designs were stolen, then this could potentially allow the designs to be copied by competitors or by an outsourced supplier stealing a design and selling these to Rio's competitors.

There is a risk that other outsourced suppliers, especially others that may have tendered unsuccessfully for the manufacturing contract, could possibly have access to the design.

IT risks

There is the risk of failure, cost over-runs and time delays until the systems are fully implemented. Additionally, these new proposed IT systems will need to be linked and integrated into all of Rio's existing IT systems.

In respect of the expansion of internet sales, security over customers personal data, including payment methods, need to be held securely with the confidence that customers data cannot be hacked into or leaked.

How we might deal with these risks

Cost of the investment

Rio needs to establish an IT project management team to oversee and manage the development of these two new IT system proposals. The project implementation team needs to have Rio's IT experts involved so that they can identify and overcome any unforeseen problems or cost over-runs at the earliest opportunity.

Risks of expanding internet sales

The three ways in which risks could be minimised by Rio are:

1. To ensure compatibility to Rio's existing internet sales systems and to ensure that all customers' data is secure, and that all information for each sale flows across Rio's existing Information Systems, so that the supply chain is fully updated.
2. When the internet sales system is available for customer use, there should be marketing and promotional activity to encourage customers to use the new internet sales system in the remaining ten European countries as well as in the six Asian countries. Education on the use of internet sales could be done, including training of Rio's store employees and having iPads available in stores for customers to browse and place orders whilst in store.
3. Promotional marketing could be undertaken offering special promotional prices for products ordered online, rather than in stores, for a limited period. This could encourage customers to go and look at products in store, but in order to get a better price, they could order them online.

Risks of new extranet system proposal

The system should only allow specific outsourced suppliers to access only the designs that they have been contracted to supply. All communication on each design between Rio's Head office design team and the specific outsourced supplier should be done through the new IT system thereby eliminating phone calls, emails and other communications that cannot be tracked if there were to be a problem. Therefore, security of designs and access to designs is the main risk to be eliminated by secure access to the data by only authorised outsourced suppliers.

IT risks

The project team should include Rio's own IT specialists as well as the use of any contracted IT industry experts, to ensure the smooth implementation, testing and handover of the two proposals.

Rio's staff and outsourced suppliers would need to be trained in the use of the new systems, especially the outsourced suppliers, as Rio is insisting that all communication in respect of the manufacture of products contracted to them are done through the new extranet system.

Risks of growth

The capacity of the two new proposed systems need to be specified to ensure that they meet Rio's planned growth of 109% in sales revenues over the next 5 years.

Section 2

From: Senior Finance Manager
To: Stella Erikson, Finance Director
Date: xx February, 2016

Dear Stella,

Below are my thoughts on the issues requested in your email earlier:

The comparative strengths of the two IT suppliers

In considering the '**Suitability**' of each IT supplier, the first consideration would be whether the IT suppliers' proposals offer a strategic fit with our current mission and objectives and whether the proposals build upon our strengths and exploit our market opportunities. Clearly, both IT suppliers would assist Rio in achieving its mission and objectives and both offer a fully developed system. Therefore both IT suppliers are clearly suitable

In terms of '**Acceptability**', both IT suppliers' proposals are within the expected total cost limit set of €40 million. Both proposals should be acceptable to shareholders and the Board from this perspective.

SDE can commence the project immediately and can complete within the required 12 months and therefore complete by February 2017, an aim set out in the original proposal by Diana. X-Max Systems cannot commence immediately and although development duration is three months less than SDE, it would be completed 15 months from now, which is three months later than SDE. This may be less acceptable to the Board, Rio's customers and outsourced suppliers.

Rio has used the services of SDE previously, and it intends to use Rio's own IT staff within the project development team and this is likely to be more acceptable to Rio's IT staff, who will feel more motivated towards the new development if they are part of this process. X-Max Systems do not intend to use any of Rio's own IT staff within the project development team which may cause resentment and de-motivation amongst Rio's IT staff.

In terms of the '**Feasibility**' of the IT suppliers' proposals, Rio has stated that the expected cost for the proposal should not exceed €40 million. The overall cost for both proposals is very similar. The post implementation costs for X-Max Systems are higher than SDE Solutions but overall, both proposals are likely to be feasible financially.

The internal and external skills and competences required to develop these e-business proposals should be available by both IT suppliers. In addition both suppliers have worked for our competitors so they have experience of working on similar systems for competitor retail organisations. Therefore, both are feasible based upon the previous experience they have demonstrated although SDE have the advantage of the experience of working previously with Rio.

The best company for Rio

On the basis of this evaluation, I would recommend that Rio use SDE Solutions to undertake the development of our e-business activities. Although both proposals are suitable, the analysis of the two tenders would suggest that SDE Solutions offers a solution which is more acceptable and feasible to Rio.

Financing of the IT investment and possible short-term reduction in dividends

The two proposals are forecast to cost €40 million in total, which is not a huge investment for a company of Rio's size. Rio generated cash from operations in 2015 of €414 million.

Shareholders, particularly the institutional shareholders will not like to have Rio's dividend policy changed, especially for the rather small proposals costing only €40 million. Rio's dividend per share (DPS) for the year ended 31 December 2015 was €2.00 (€100 million dividends / 50 million issued shares). This represented a 35% pay-out ratio on Rio's post-tax profits for the period.

It is unlikely that shareholders would welcome a cut in dividends, especially as this investment in e-business systems is not for tangible assets, such as a new building or acquiring a competitor.

Recommendation on how Rio could finance the investment in e-business.

A suitable approach to finance the €40 million investment in e-business is for Rio to:

- secure additional debt funding, as its gearing ratio is low
- or to use cash generated from operations.

My recommendation is that the e-business investment should be financed with cash generated from operations. Rio is a cash generating business, with very low trade receivables (as all customers pay by cash / bank debit card or credit card, which is paid to Rio within days) and the investment of €40 million is rather small and could easily be met by the level of cash being generated. Rio had cash and cash equivalents at 31 December 2015 of €497 million.

The ethical issues relating to the selection of the IT supplier

It is a concern that Diana Templeman did not disclose her relationship with one of the directors of X-Max Systems at the recent meeting and neither did she mention this to you during your recent conversation. This could present a conflict of interest. If we were to use CIMA's Code of Ethics as an example upon which to consider the ethical principles which are being challenged, the first issue relates to 'Objectivity'. Any person must make sure that their business/professional judgement is not compromised because of bias or conflict of interest. This is likely to be challenged here, as clearly there is a risk of bias in the decision-making process by Diana, based upon her close relationship with one of the directors of X-Max Systems.

Secondly, the principle of 'Integrity' is being challenged. Integrity implies fair dealing and truthfulness and any person should not be associated with any form of communication or report where the information is considered to be incomplete, such that the communication is misleading by this omission. Although Diana has not been dishonest, she has omitted a relevant fact from the information she presented, which could be considered, by its omission, to be misleading.

Overall, the omission of this fact should not affect the overall decision made as from the information presented, it is unlikely that Rio will select X-Max Systems to undertake the proposal and therefore Rio cannot be accused of acting unethically in their choice of supplier. However, this situation does need to be addressed. It is recommended that Diana be asked to clarify the truth on this matter and to declare any knowledge or interests that she has in X-Max Systems.

Section 3

From: Senior Finance Manager
To: Stella Erikson, Finance Director
Date: xx February, 2016

Hi Stella

Below are my thoughts on the issues we discussed at our meeting earlier today.

Resistance to changes by IT staff

Firstly, Rio's IT staff are likely to resist the change due to the increased workload that this project is likely to cause them. The IT staff are currently already responsible for managing a complex and highly sophisticated integrated Information System, and this expansion will increase their workload both in the short-term and the long-term.

In the short-term, the IT staff will be involved in the project and this will significantly increase their workload. However, some resistance should be reduced by the fact that Rio has worked with SDE Solutions in the past and therefore the IT staff should be familiar with their methods of systems development.

In the long-term, the expansion of Rio's internet sales and a new extranet system will inevitably mean a higher workload for the IT staff of Rio. Many may feel that this added workload will increase the pressure of the job and may not want to take on such a degree of extra responsibility.

There may be a degree of resistance due to IT staff resentment that an external IT supplier is being brought in, especially to develop an existing website. Many experienced IT staff may feel that their experience and knowledge is being undermined or undervalued and this could cause resentment. This may lead to difficulties when building an effective and coherent team that can work with and assist the staff of SDE Solutions.

The development of the extranet is a completely new aspect of Rio's Information System and there may be some resistance from IT staff who may feel that this is not necessary, or who may feel that they do not have the knowledge or experience to work with and develop such a system.

Resistance to changes by outsourced suppliers

This change may cause some degree of disruption to outsourced suppliers, particularly during the implementation phase. Many outsourced suppliers are likely to be concerned about the immediate impact upon potential delays or disruption to the manufacturing activities during this phase. Timing of deliveries and communication relating to deliveries and product orders is critical to outsourced suppliers and any temporary loss of contact with Rio could have consequences for the outsourced suppliers in terms of not receiving orders or missing deadlines.

Some outsourced suppliers may be resistant due to lack of understanding of the extranet system and the technology involved. Some outsourced suppliers may not be highly knowledgeable in the use of Information Systems and may not be comfortable with the system proposed. A new way of communicating with Rio's designers may not be welcomed by all users due to a technological fear of the new system. Rio should re-assure our outsourced suppliers that this development will not result in additional costs to them or require any long-term investment.

Recommendations of how resistance could be overcome

There are a number of activities Rio could undertake to overcome or at least reduce the resistance to these two e-business proposals.

Firstly, a detailed change management plan should be communicated to all of the IT staff and the outsourced suppliers. This will clearly highlight the timetable for the development project and will identify timings of their potential involvement. This should at least allow all of those involved and affected to be aware in advance of when the developments will be occurring.

Lewin's 'Three stage model' suggests that an important aspect of any change management programme is to 'Unfreeze' behaviour, that is, to communicate the need for change so that people can easily understand and accept it. Therefore Rio should ensure that IT staff are made aware of the increasingly competitive marketplace within which Rio operates, which is driving the need for an expansion to its online sales.

Also, communication should take place with outsourced suppliers about the benefits to them of using an extranet system in terms of speed and accuracy of communication and thus order processing.

In the 'Change' phase of Lewin's 'Three stage model', participation and involvement is encouraged. Therefore to overcome resistance, the knowledge and experience of the IT staff and outsourced suppliers should be considered and used wherever possible. Obviously, some of our IT staff will be involved in the project. It is unlikely that outsourced suppliers can be involved directly in the development but regular communication on its progress should help to make them feel involved and therefore motivated. Full training must also be given to outsourced suppliers before the system becomes operational.

It may be of benefit to Rio to employ a change agent. This could be an internal manager of Rio, such as a senior IT manager, who can lead and champion the e-business expansion project. In addition, bonuses could be offered to IT staff and outsourced suppliers who embrace the change.

Activities and costs to be transferred to the Financial Information System

The value of all new contracts placed with outsourced suppliers in the period will need to be transferred into the Financial Information System (FIS). This will identify the value of committed expenditure with outsourced suppliers that represents the value of orders placed in the period and is the value of 'work in progress'.

Additionally, the details of the contracted delivery period for contracts placed is required for the FIS. This will identify contracts that have a delivery period of greater than one year (although this is unlikely), so that Rio's short-term and long-term financial liabilities can be established.

Another group of data that should be transferred into the FIS is the actual deliveries made for each contract by each outsourced supplier. This will identify the value of new products being transferred to 'inventory of finished goods'.

Details of the contracted manufacturing cost per product is required by product in the FIS, so that these values can be used in costing of the 'Cost of goods sold' for each sales for each product code and also for calculating the cost to be invoiced to franchisees for inventory supplied to franchised stores.

The FIS will also need details of the contractual payment terms, so that payment can be made to each supplier on completion of manufacturing and collection of products by Rio, according to the contractual terms.