

## **CGMA FEBRUARY 2016 EXAM ANSWERS**

### **Variant 5**

**The February 2016 CGMA exam can be viewed at**

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#### **SECTION 1**

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

#### **Analysis of the areas of activity affecting Rio's business performance**

##### **Impact of design team problems**

The area of the value chain affected by the design team co-ordination problems is 'Inbound Logistics'. For Rio, this is a critical success factor, as it is here that the products we sell are designed and any errors in this part of the value chain will have a serious impact, in both the 'Operations' and in the 'Sales and Marketing' activities further on in our value chain.

The duplication of designs by different design teams will inevitably increase our costs and waste resources. Ultimately, this will impact on our bottom line if the design process is inefficient.

Design modifications being missed by design teams will result in requested modifications not taking place, leading to a lack of customer satisfaction, if we do not respond. Our business model is built around the concept of fast fashion, and if we are slow to respond to customer trends (or we do not respond at all), then this could have serious reputational implications.

Our ability to respond to trends in the market is a key activity in our value chain and one which is a driver of business performance. It is also our competitive advantage. If we fail to satisfy customer demands then we may lose our competitive advantage. If we do not respond to important design modifications then we may lose customer confidence.

Inter-team rivalry should be fostered and Rio should create an environment of creativity, but only if this is undertaken to the benefit of Rio as a whole and not the individual designers or teams. In this case, rivalry is resulting in dysfunctional behaviour and affecting Rio's business performance and overall competitive advantage and this must not be allowed to continue.

##### **Recommendations to overcome design team co-ordination problems**

Firstly, an investigation needs to be undertaken by the IT department into the communication and data transfer which is occurring between the tablet devices / POS system and the design database. If there is some technical error which is occurring, preventing accurate and complete communication of all design modifications to the design database, then this needs to be rectified.

We should undertake a review of how the feedback and design modification information is received and actioned by design teams. Is there a well understood and practised system whereby modifications and new designs are checked and monitored by a senior designer who then allocates the work to individual teams? Some system of allocation and authorisation of design work must be undertaken and some form of control mechanism be introduced in order to check that all design work which is in the system has been assigned to a specific design team.

It is also important that controls are instigated, either via an automatic check within the design system itself or through an external management control to ensure that only one team can work on one design, to ensure no duplication of work takes place. Similarly, the system must include an automatic check to alert design team management if a design or modification has not been actioned within 24 hours. This should avoid the problem of design modifications being missed.

Veronique LeFevre should call a meeting with the design teams to explain the importance of working effectively and to explain the potential negative consequences for Rio of sub-optimal inter-team rivalry. It is important that design teams should not be stifled in their creative activities but they must understand the impact upon business performance of their current behaviour.

### **Impact of poor responsiveness on Rio's business performance**

Rio's fast fashion business model is based upon the needs of our customers and the need to maintain our competitive advantage in a highly competitive industry. The value chain model is designed to assist organisations to identify those activities which are valued by our customers, so that these activities can be focused upon in order to enhance business performance, be that in terms of increased sales or greater profit margins. All of the activities within our value chain are linked; poor performance in one area will have consequences in other areas of the value chain.

As stated above, a lack of responsiveness by designers will impact negatively upon our design process and thus our 'inbound logistics'. Poor design of products, or lack of responsiveness to customer requirements will then impact upon other areas of the value chain, such as 'Operations' and 'Sales and Marketing', in that customers will be dissatisfied with the products we sell and store managers will also be unhappy that design feedback is not being actioned effectively.

Customer bargaining power is high in the fashion business, as products are relatively inexpensive and customer loyalty is difficult to maintain as switching costs are extremely low. Therefore customer dissatisfaction is likely to occur quickly, as customers want the latest trends and fashions immediately and if Rio does not give them these, then they can easily shop elsewhere. Overall, business performance in terms of overall profitability and customer satisfaction and retention is likely to reduce if we continue to be unresponsive to our customers and store managers' feedback.

### **Proposal for new performance bonus for designers**

The proposal for a new performance bonus for designers to encourage their creativity and to help overcome the current dysfunctional behaviour needs to be carefully considered.

Financial incentives can often result in a greater degree of dysfunctional behaviour if they are not established in the correct way. Therefore, to merely implement a bonus system in

itself would not encourage creativity or overcome dysfunctional behaviour. Any bonus system implemented by Rio, **must** be wholly focused on encouraging creativity and team co-operation.

The problems currently being encountered with the design team consist of intense rivalry leading to a lack of co-operation and dysfunctional behaviour. We need to ensure that the design teams split their time between designing new products and also updating and redesigning existing products based on sales data and customer feedback data provided by store managers. Re-designing existing products may be less appealing to our creative designers than preparing new products. However, updating existing products must be seen to be an important part of Rio's stated aim to be responsive to customers.

If Rio were to implement a bonus system based upon the number of new designs produced per team, then this would likely increase the current dysfunctional behaviour as it would encourage design teams to create as many new designs as possible, regardless of quality or priority in terms of customer feedback.

Co-operation between design teams could be encouraged by offering bonuses based upon departmental targets rather than team based targets.

Awards could be presented to individual designers for their creativity in new designs and these could be publicised throughout Rio's stores. Additionally, awards could be created by store managers to be given to the design teams for responding to specific requests to update or redesign existing products.

In summary, bonuses could be established for designers achieving departmental targets and not for individual design teams to encourage team co-operation and overcome the current dysfunctional behaviour. In addition, awards could be given to recognise individual design teams responses to store managers and customer feedback comments.

## Section 2

### **Report on Proposal to sign Lacey Ace**

#### **Financial aspects of the proposal**

The forecast NPV for the three year period is €97 million, excluding fees payable to Lacey Ace. Therefore the proposal is financially viable but the level of fees paid will affect the net cash flows and the request of a fee as high as €50 million will result in an overall net NPV of around €47 million, depending on the timing of the payment of the fees. However, if Rio were to be able to negotiate this down to €20 million, then this will increase the overall value of the proposal. This is a potentially large contract, which would increase Rio's sales, profits and net cash flows in a positive way. The future cash flows are based on two aspects which are:-

- Profits from the sale of Lacey Ace products.
- Increased sales due to increased footfall in Rio stores, due to people coming into stores to view the Lacey Ace products or due to the publicity generated from the marketing of Lacey Ace products.

The increased footfall is forecast to generate an extra 1% in sales of Rio's normal products. Using Rio's 2015 accounts, this could generate additional sales revenue of €25.6 million (€2,557 million x 1%) each year. Based on Rio's latest gross margin percentage of 56.3% (based on 2015 accounts), this could generate additional gross margin of €14.4 million each year for the next three years.

As both Veronique LeFevre and Carly Edmonton consider that the association and design of Lacey Ace products will be successful and profitable, I recommend that negotiations should continue as this proposal is financially viable.

#### **Level of fees which should be paid and the timing of these fees and what I consider should be paid and when**

The demands of Lacey Ace's agent is for a fee of €50 million over the three year contract period and that this fee should be paid on signing the contract is totally unreasonable. There is a risk that Lacey Ace will not co-operate and not fulfil all aspects of the design work for the six collections, two collections each year, over the three year contract period. There are three aspects to be negotiated:-

- level of fees
- timing of fees
- whether the €1 million fee for negotiations to continue is included in total fees or not.

Negotiations should take place on the fees, explaining that Rio's designers, manufacturers and marketing support will be a large expense and that a fee of €50 million is too large. If Carly Edmonton considers a fee of €20 million is reasonable, then the range to negotiate is between €20 and €50 million, but with a view to negotiating a fee closer to Rio's consideration of a reasonable level of €20 million. The other aspect to negotiate is the €1 million upfront fee that is payable now for negotiations to continue, but to negotiate whether this forms part of the overall fee if the contract is signed or whether it is an additional fee. If no contract is signed, the negotiations will cost €1 million for the Lacey Ace fee. Therefore, it is in everyone's interests to negotiate a contract at a reasonable level of fees, as Rio will otherwise incur a fee of €1 million for nothing.

In respect of the timing of fees, the payment of the entire contract fee on signing the contract is NOT acceptable to Rio. The fees paid should be linked to the design and delivery of the six collections, spread over the three year contracted period.

My recommendation is that Rio should try to negotiate a fee as low as possible, but could be between Rio's suggested fee of €20 million and Lacey Ace's requested fee of €50 million. Therefore, I recommend a fee of a maximum of €35 million. My recommendation on the timing of the fees is that a fee of €5 million per collection is payable, after each of the six collections are delivered and finalised with Rio, plus a final end of contract payment, payable on the delivery of the sixth and final collection. Therefore, Year 1 would be €10 million (two collections), Year 2 €10 million (two collections) and Year 3 €15 million (for final two collections).

### **Factors affecting the sensitivity of the financial impact of the proposal**

There are many variable factors that will affect in a positive or negative way the financial impact of the proposal. The success of the newly designed Lacey Ace products and whether they sell out as expected for all six collections, over the three year contract period.

Also will Lacey Ace remain a popular rock star for the next three years? There is a risk that the financial results will be lower if Lacey Ace does not help to design and deliver all six collections.

Furthermore, another factor is whether Lacey Ace will co-operate with Rio's design team and marketing people to create the required PR to make the Rio / Lacey Ace association successful.

Another important factor that will affect the sensitivity of the financials is whether the 1% forecast increase in footfall is correct or not, as this 1% increase in footfall potentially generates an addition €25.6 million of sales each year. If this 1% increase is wrong or overstated then this will have a huge impact on the financial success of this proposal. Is the 1% increase in customers buying additional Rio products really achievable?

### **The business and ethical risks of Rio's association with Lacey Ace**

#### ***Business risks:***

The business risks that Rio faces in being associated with Lacey Ace, is any damage to the Rio brand due to Lacey Ace being a famous rock star. However, Lacey Ace will only be involved with designing and launching six collections over a three year period which is not nearly as frequently as Rio's continuous launch of new products using the fast-fashion concept.

Rio faces the risk that Lacey Ace will not fulfil her part of the contract and not deliver all of the six collections over the three year period. There is a risk that Lacey Ace will not be prepared to negotiate down from the €50 million fee that her agent is insisting on. This would significantly reduce Rio's profitability on this contract. Additionally, the level of the fee is bound to be speculated on by the media and if Rio accepts the higher level of fee at €50 million, then this will affect Rio's ability to negotiate fees in future with any other famous stars.

Carly Edmondson considers that this is a good business arrangement but there will be always be a risk working with famous stars due to their managed 'image' and their availability due to their mainstream music activities.

Furthermore, there is a risk that the forecast 1% increase in footfall will not materialise. This will significantly affect the NPV of the proposal.

#### ***Ethical risks:***

Lacey Ace sounds like an arrogant person as she is quoted as saying that her fans love her irrespective of how long she performs on stage at concerts. This shows that she is 'detached' from the real world. Her fans would have paid a large price for concert tickets, only to find that she cut the concert performance short, which does not show **integrity** by

Lacey Ace. Rio faces the risk that Lacey Ace will not fulfil her part of the contract and help design and promote the contracted six collections over three years. This is why the fee paid should be linked to the delivery of each collection, as there is the concern that Lacey Ace will not act with integrity and give the Rio contract the time and attention it needs for the fees paid.

Furthermore, she is not acting with **professional behaviour** in cutting a concert performance short and it is hoped that in her business dealings with Rio, she will act in a more professional way.

## Section 3

### **Improving performance**

This email will cover a range of issues about how Rio could improve its business performance.

#### **Explaining how activities in the Value Chain can improve business performance**

The value chain is a method by which Rio can evaluate the activities both within and around the organisation in order to assess how these activities assist in building and developing our competitive strength and improve our business performance. Rio's activities should ensure that the fashion products we produce and sell are valued by our customers and importantly, help to create competitive advantage for Rio. The 'Primary Activities' of our value are those activities involved in the physical design and manufacture of our products, their transfer to our customer and also any after-sales services such as returns or refunds policies or home delivery services we operate. Our 'Secondary Activities' are those activities carried out which support and enhance the primary activities, such as, the infrastructure (stores and distribution centres for example), Human Resource management (training activities) and the Information Systems we use, such as our distribution Management Information System, our instore tablets and POS system and our design database.

The most important aspect of using the value chain is to identify the key activities within the business that add value to our end customer and then to design strategies that enhance and protect these activities. Additionally, it is equally important to identify the activities that do not add value to the customer. These activities could then be eliminated, saving Rio time and money. For example, within Rio's value chain, having sophisticated Information Systems, such as our POS Systems and tablets linked directly to the design database ('Technological Development' within the Secondary activities of the value chain) allow store managers to swiftly feedback design modification requests made in store to our designers, allowing the design activities within the value chain ('Inbound Logistics' within the Primary activities of the value chain) to be undertaken which are extremely responsive to customer needs.

Another example would be our well trained staff operating in our stores (Sales and Marketing activities in the value chain). Highly trained store staff ensure that customer service levels are high, which should result in added value to the customer and greater customer satisfaction. This training of store staff is directly linked to the activities taking place within the Human Resource Management activities of our value chain, which ensures that we focus training activities on store staff and their ability to satisfy customers. Therefore a focus upon our value adding activities should assist Rio in ensuring that it focuses upon those activities which add value to the customer and which will improve overall business performance.

#### **Three Key Performance Indicators (KPI's) for Rio's Internal Business Perspective**

##### **1. Average time from collection of products from outsourced suppliers to delivery into distribution centres**

Justification of how this will drive improvement in performance: the speed to market is important in the fast fashion industry, so the average time taken for products to arrive into distribution centres from outsourced suppliers is key to getting new products into stores.

##### **2. Average time taken from identification of new store site to store opening**

Justification of how this will drive improvement in performance: Rio has ambitious expansion plans and has currently opened 1.5 new stores every week. The time taken from identification of a new store in a targeted town or city to the store opening will help drive new sales.

### **3. Number of products being despatched by each distribution centre each day**

Justification of how this will drive improvement in performance: it is important to get all newly manufactured product out to stores as soon as possible. Products sitting in Rio's three distribution centres are classed as inventory, but they cannot be sold until they reach stores. Therefore the number of products despatched each day will be a reflection on the efficiency of the distribution centres. It would be useful to compare the number of products despatched each day between the three centres to understand why any of them is more efficient than the others.

*Alternative KPI's could be:*

- *Average number of deliveries to stores each week*
- *Average number of internet sales orders despatched each day.*
- *Average time taken to despatch an internet order from placement of order to despatch from distribution centre.*
- *Average shipping time from despatch of products from Asian distribution centre to arrival at Central European distribution centre.*

### **Ethical risks to Rio of the alleged selection of outsourced suppliers and accusation of 'favouritism'**

Using CIMA's Code of Ethics, the main ethical principles which may be called into question by this alleged outsourced supplier selection activity are those of 'Objectivity' and 'Professional competence and due care'. Outsourced suppliers should be selected based upon clear and transparent selection criteria, based upon quality and their ability to complete the order to Rio's high standards and within the designated timeframe.

If the allegation of outsourced supplier favouritism is correct then the principle of objectivity, that is, professional judgement with no bias or conflict of interest, is clearly being compromised. The outsourced supplier Radwen, states that Rio's procurement staff may have accepted inducements of free holidays for awarding manufacturing contracts to his competitors.

In addition, professional competence and due care requires that applicable technical and professional standards must be applied when providing professional activities and judgement. Again, Rio could be considered to be in breach of this principle as technical and professional activities and judgement are not being applied in regard to outsourced supplier selection.

Clearly, the management and selection of outsourced suppliers is a complex task for Rio as we have over 350 outsourced suppliers and there will inevitably be some level of dissatisfaction amongst outsourced suppliers if they do not win orders which they had expected to do so.

### **Actions to take to overcome the ethical risks of supplier selection allegations**

Rio must be confident that its outsourced supplier selection policies are free from bias or favouritism, as alleged by some outsourced suppliers.

The feedback comments from suppliers in the annual performance review together with the letter from Radwen's fashion clothing, one of Rio's '4 star' outsourcers, is evidence that there is a problem on which company is chosen for each outsourced contract following submission of tenders. This is not good business practice.



The accusation of inducements in the form of free holidays for Rio's Procurement staff needs to be thoroughly investigated as this goes against Rio's principles of good ethical behaviour towards its suppliers. If this is found to be true then the employee (or employees) need to be disciplined or even their contract of employment could be terminated. This is a serious matter that should be investigated urgently at a senior level in Rio.

Rio must operate clear and transparent policies on supplier selection. When outsourced suppliers are asked to tender for an order then they must be given very clear and detailed order specifications. As and when orders are placed with alternative outsourced suppliers, then Rio must communicate this effectively to the outsourced suppliers who had submitted tenders together with the reasons why this order was not placed with them, demonstrating complete integrity and objectivity in our decision making process. If it is found that there is any evidence that favouritism of suppliers is occurring in Rio, then this a serious matter and must be dealt with swiftly by senior management in Rio.

We must investigate and respond back to Radwen clothing as soon as possible and award this company more work if possible to enable this manufacturing company to survive.

Regular training must be offered to outsourced suppliers to ensure that they have the necessary skills to meet our order demands. Rio's supplier selection staff must also be fully aware of the need to be objective and professionally competent when making supplier selection decisions. There may be some misunderstanding amongst outsourced suppliers in relation to the star rating system. It is highly likely that those suppliers with 5\* ratings will receive a higher proportion of orders from Rio, which may appear to be favouritism to those who are not 5\* rated suppliers. Therefore, training and communication to these suppliers on the importance and commercial value of achieving a 5\* rating may in fact incentivise outsourced suppliers to achieve higher standards and consequently win more orders.