Answers

Section 1

1 (a) The table below shows the ratios and other measures selected to form the basis of the assessment of easyJet plc's performance, as well as a brief explanation of the relevance of each:

Ratio/Measure	Justification
Return on capital employed	Investors will be concerned with how effectively funds are utilised and managed. ROCE allows an assessment of the return (profit), relative to the investment.
Net Profit/Sales % Expenses/Sales %	The rationale of the low cost model is that expenses will be tightly controlled. These ratios allow the effectiveness of cost control to be assessed.
Sales growth	As many costs are likely to be fixed, an important element in the success of the low cost model is generating a high volume of passengers, to reduce the impact of the fixed costs.
Revenue per customer	Although this information is not available from the statutory disclosures, passenger numbers are noted in both the Chairman's statement and the Chief Executive's review as well as the Operational and Financial Review. Although the model is 'low cost' the objective must be to maximise the revenue per customer, while maintaining the customer's perception of low cost and value for money.
Profit per customer	There will be little point in achieving greater numbers of passengers if the net result is to reduce the incremental profit which is obtained from additional passengers. This measure allows the extent to which growth continues to generate profit to be assessed.
Earnings per share	Investors will wish to ensure that having met its obligations, the company remains able to provide them with returns in the form of earnings.
Sales per employee Profit per employee	As the company grows, it will recruit additional staff. It is important to monitor this growth to ensure that the growth in business (sales) and profit is proportional to the growth in staff.
Gearing (see comment below)	Given that the current level of interest rates is low, it is particularly important to monitor external borrowing to ensure that the company is not exposed to undue or excessive risk due to its financial structure.
Fixed asset turnover (see comment below)	As a capital intensive industry, the need to utilise the major investment in fixed assets is obvious. This measure assesses how effectively fixed assets are being used in the generation of revenue.

Operating leases: as the company acquires aircraft under operating leases, the extent of investment in such assets is not apparent from the financial statements (as considered below). Consequently the assessment of both gearing and fixed asset turnover is affected. To some extent ROCE is also slightly distorted as the level of investment in the company is understated.

The results of the ratios and other measures, based on the financial statements of easyJet plc are:

Results

Ratio/Measure		2001	2000
Return on capital employed		9·7%	16·3%
Net Profit/Sales %		10·7%	10·9%
Expenses/Sales %		89·3%	89·1%
Sales growth		35·3%	unavailable
Revenue per customer		£50	£47
Profit per customer		£5·36	£5·09
Earnings per share	basic	15·2p	11·9p
Sales per employee		£223·2k	£231·3
Profit per employee		£23·84	£25·14
Gearing		19·8%	62·6%
Fixed asset turnover		1·6 times	1·1 times

Workings

		Source	2001	2000
Operating Profit (before interest and tax)		P&L Acc.	£38,123k	£28,660k
Expenses	Cost of sales	P&L Acc.	£265,648k	£191,291k
	Dist / Marketing	P&L Acc.	£ 31,692k	£ 25,868k
	Admin	P&L Acc.	£ 21,396k	£ 17,875k
			£318,736k	£235,034k
Profit after tax		P&L Acc.	£37,907k	£22,103k
Fixed Assets		Bal sheet	£216,587k	£205,322k
Capital Employed:	S'h funds	Bal sheet	£316,491k	£ 65,717k
	Cred > 1 yr	Bal Sheet	£ 76,289k	£108,315k
	Provn for Liabs/Chgs	Bal sheet	£ 1,920k	£ 1,854k
	Total		£394,700k	£175,886k
Revenue		P&L Acc.	£356,859k	£263,694k
No of customers		Op and Fin Rev	7,115,147	5,628,215
Average no of employees		Note 4	1,599	1,140
eps	basic	P&L Acc	15·2p	11·9p
	diluted	P&L Acc.	14·4p	11·9p

Mark allocation:

(a) 1 mark for each ratio correctly selected and calculated to a maximum of 8

(b) 1 mark for each valid comment which justifies the ratios selected by reference to the business models to a maximum of 7

Analysis of performance

Overview

As might be expected from a recently listed company, there are a number of indicators of growth. In particular the 35% growth in revenue, which was obtained through a 26% growth in customer numbers. This indicates that although the business model is 'low cost', it is possible to increase the revenue per customer.

However there is no benefit in achieving growth at the expense of profitability. It has to be said that in this context, the results are more mixed. Although the net profit/sales ratio has remained a little under 11%, return on capital employed has fallen to under 10% from just over 16%. In addition, the amount of revenue per employee and profit per employee have both fallen.

It is worth noting that the results under review are for the period when the company achieved a listing. It would be expected that there would be additional costs associated with this process, and in that context the overall performance could be judged to be sound.

Further analysis of the results is set out below.

Growth

Growth is a critical element of the company's performance. As noted in the Chief Executive's Review the company's business model is 'based on high network density and high frequency'. This means that flights must be operated on attractive routes and each flight must have a high percentage of seats sold. This will have two beneficial effects. First, the fixed costs of operation (for example the costs of additional security measures following the terrorist attacks in New York and Washington) are spread over a high number of flights, reducing the cost per flight. Second, the fixed costs per flight are spread over a high number of passengers, reducing the cost per passenger.

Customers must believe that they are paying the lowest possible fare, while the company must balance simple growth in passenger numbers with revenue per customer and profit per customer.

On that basis, the fact that a 35% growth in customer numbers has been achieved while improving both revenue per customer (2001 £50; 2000 £47) and profit per customer (2001 £5·36; 2000 £5·09) indicates that the growth has been well managed.

As the company grows, it will naturally require more staff. A less successful aspect of growth has been that the recruitment of additional staff has not created the same growth. Sales per employee have fallen to £223,000 from £231,000, while profit per employee has fallen to £23·84 from £25·14.

It may be that the need for additional staff as a result of greater security measures and the administrative requirements of becoming a listed company have led the creation of staff posts which do not impact directly on revenue generation. This is borne out by closer examination of some of the information provided. Note 4 to the accounts gives limited analysis of staff numbers. The number of staff involved in sales and marketing has fallen by 17%. It has already been noted that sales growth, as measured by revenue, is 35%. The operating and financial review indicates that use of the internet as the booking medium has increased dramatically. This suggests that marketing activities are becoming more effective. The fact that distribution and marketing costs have fallen to 8·9% of sales (from 9·7%) supports this analysis.

However, staff numbers in operations and administration rose by almost 60% to 1,362. This is far greater than the growth as measured in routes, passengers or distance.

Before any detailed conclusions can be drawn, further analysis of staff roles would be required. It may also be that the growth in staff numbers is a 'one-off' allowing the company to achieve a critical mass, and that further growth in activity can now be achieved, without a similar increase in staff.

Profitability

The fall in ROCE is not a positive sign, but may be linked to the comments regarding growth. Given that the underlying profitability has remained steady at just under 11%, it can be seen that the fall in ROCE is due to a deterioration in the utilisation of assets. As the company finances its aircraft by operating lease, it is not possible to assess the value of assets actually employed. Nevertheless, available information indicates that asset utilisation has fallen. The main factor in this regard is the high level of cash held as a result of funds raised by the share issue. This cash has been raised to finance the company's future expansion plans, but was not used to generate returns during the year.

The fact that the net profit/sales ratio has remained steady is encouraging. As discussed above, there will have been additional costs due to the listing. Some of these (£3·8m) are disclosed as exceptional. If these were excluded the net profit sales ratio would be improved by 1%, thereby reinforcing the view that underlying profitability is sound.

As with the consideration of growth, more information would be required before detailed conclusions can be drawn. The fact that the company has taken delivery of additional aircraft and expanded the number of operating routes suggests that it is well placed to achieve further growth, which would lead to an improvement in asset utilisation and a consequent improvement in ROCE.

Solvency

The gearing ratio has fallen dramatically from 62% to 19·4%. There are two main observations here. The first is that as an unlisted company, growth would tend to have been financed by debt. The success of the growth strategy meant that seeking a listing would have been a natural progression. The second is that the equity base was considerably increased by the strong profitability during the year. It is interesting to note that the share capital at the end of the year is equal to the total shareholders' funds at the beginning of the year, while almost two-thirds of the closing shareholders' funds is now represented by share premium. This indicates that in the view of the market, the previous level of gearing, whilst high, did not indicate a major problem. The cash flow statement and the analysis of current assets indicate that the funds available to the company as a result of the share issue leave it well placed to achieve further growth.

Conclusion

There are several indicators (available funds, asset utilisation, staff numbers) from the financial statements that the company is well placed to achieve further growth. Given that a 35% growth has been achieved without sacrificing profitability and while improving gearing, it seems reasonable to conclude that any future growth will also be profitable. The aspects of performance which are potentially negative (asset utilisation, leading to a fall in ROCE) appear to be explained by the company's current position. Overall, these potentially negative elements are outweighed by the positive indicators, particularly with regard to profitability.

It would be helpful to be able to obtain the additional information which would allow the assumptions regarding ROCE and asset utilisation to be fully assessed.

Mark allocation:

Marks to be awarded according to the quality of the analysis subject to the following guidelines:

1 mark for each valid comment based on the ratios calculated to a maximum of	9	
Additional marks for depth of analysis (e.g. reference to additional information needed, linking ratios)	max 6	15

(b) Accounting policy

Note 1 to the financial statements provides information about accounting policies.

With regard to deferred tax it states 'Provision is made for deferred tax only to the extent that it is probable that an actual liability will crystallise.'

This indicates that the company is applying the partial provision method of providing for deferred tax, as set out in SSAP 15. Since the financial statements were prepared FRS 19 has been implemented. This standard requires provision for deferred tax to be made on a full provision basis.

Under the partial provision approach, deferred tax is only provided on timing differences which are expected to reverse. In assessing whether or not a difference will reverse, directors would have considered the effect of anticipated capital investment. This meant that the deferred tax liability was calculated on the basis of what management *planned to do in the future*. This is contrary to the Statement of Principles which defines a liability as arising 'as a result of past transactions or events'. In addition, the introduction of FRS 12 clarified the basis on which liabilities should be recognised and measured – when the entity has a legal or constructive obligation to transfer economic benefits *as a result of a past transaction or event*.

Therefore it follows that the liability for deferred tax should reflect the events and transactions which have taken place – not those which management *may* undertake in the future – i.e. on the full provision basis.

Under SSAP 15 the difference between the liability calculated on the partial provision basis and the liability calculated on the full provision basis was disclosed in a note.

Under FRS 19, this unprovided liability will be included in the calculation, and will be recognised in the financial statements.

In the case of easyJet, the unprovided amount is, in fact an asset. FRS 19 allows a deferred tax asset to be recognised 'to the extent that they are recoverable'. The assessment of recoverability should be based on 'all available evidence'.

FRS 19 was issued in December 2000 and is standard practice for financial statements with periods ending on or after 23 January 2002. The standard also states that earlier adoption is encouraged. This means that at 30 September 2001, easyJet had the option of adopting FRS 19.

Had the company chosen to do so, the effect would have been:

Decrease the tax charge in the profit and loss by £3·3m, leading to
Increase in profit after tax of £3·3m
Increase current assets by £3·3m.

The effect of this treatment would be to improve measures of profitability which are based on profit after tax, as well as the current and quick ratios. In the analysis above, liquidity has not been assessed, as the company's strong cash position renders such assessment irrelevant. Of the measures considered, only earnings per share and gearing would be affected. The effect is a marginal improvement in both measures, with eps improving to 16·5p (from 15·2p) and gearing falling to 19·6% (from 19·8%).

As both of these measures have improved considerably on the 2000 level, the additional improvement would not be considered to be material, and would therefore have no effect on the overall conclusion.

Note to candidates
Credit was also given for discussion of other accounting policies, for example the treatment of revenue earned.

selection of appropriate accounting policy		2	
analysis of effect of policy on individual items in FSs	max	4	
comments on effect on results	max	3	
recognising overall effect on conclusion	max	3	12

The accounting entries for an operating lease are straightforward – lease rentals are charged to the profit and loss account as incurred. The problem with this treatment is that the investment in fixed assets and the liability to make future payments under the lease agreement are excluded from the balance sheet.

If the asset was recognised on the balance sheet, it would be necessary to charge depreciation as is the case for other fixed assets. If the liability was recognised on the balance sheet, only the finance cost would be charged to the profit and loss account.

It can be seen therefore, that the overall effect on the profit and loss would be minimal, as the capital element of payments will be materially the same as the depreciation charge.

It is the balance sheet which is affected by the treatment of the lease.

Under an operating lease, fixed assets, current liabilities, net current assets and long term liabilities will be lower.

This means that gearing will be lower, while return on assets and ROCE will be higher.

Mark allocation: 1 mark for each valid point to a maximum of 8

Section 2

2 (a) The basic choice which needs to be made is between centralisation and decentralisation. Which model should be implemented will depend on the nature, structure and culture of the organisation.

At the simplest level, the traditional (centralised) approach will be effective when:
- operational decisions are mainly 'programmed'
- operations are low skilled
- employees do not seek responsibility
- the environment calls for 'emergency' responses

Perhaps the biggest problem in deciding on the appropriate model for Newflight is that there are conflicting pressures.

The pressures towards centralisation are likely to be:
- the need for a set pricing policy
  - customers must have certainty that the price they are paying is the lowest price available
  - a key element in the strategy is that customers will use the internet as the booking medium
  - this means that the pricing policy must be a clearly programmed process
  - for example, easyJet seat prices increase as each block of 20 seats are sold
  - this encourages early booking by customers, and assists in planning journey loadings
- centralised booking is a key element in the strategy

  - customers must be sure that whatever booking point they use, there will be no difference in prices
- marketing to create a strong brand and corporate image
  - customers must be confident that the service will be consistent at all locations
- high level of fixed non-controllable costs
  - the operational review in easyJet's financial statements indicates that ground handling, airport charges, fuel and crew costs comprise 45% of the cost base
  - these costs are either fixed in the short term or are largely non-controllable
- need to fill all seats on both 'legs' of an aircraft's journey
  - passenger volumes are critical to the success of the operation
  - there is little point in a aircraft flying out with say a 90% load, and returning with a 40% load
  - thus any decision to consolidate or cancel flights must be made centrally so that the effect on other flights can be assessed
- security and safety issues require strong policies
  - while passengers do not relish the inconvenience of airport security, most recognise that it is ultimately beneficial
  - by having centrally set (and monitored) policies, there is less chance of the company suffering bad publicity (or possible fines) through ad-hoc (and unsatisfactory) procedures

pressures for decentralisation:
- need for flexibility in dealing with customers face to face
  - there is a need to allow staff a degree of flexibility when dealing with particular needs
- need to motivate and retain staff
  - as noted above, centralisation is most effective in a programmed decision making environment
  - such an environment reduces the scope for staff to exercise initiative, and may reduce motivation
  - reduced staff motivation will tend to adversely affect the relationship with customers and increase staff turnover
- ability to respond to local market needs
  - there may be situations in which policies need to be adapted to local customs and culture
- IT systems will be critical to operational success, thus a focus on information needs will make it easier to provide relevant management information, which will assist empowerment
- strong brand will create clear sense of mission and values, which tends to assist in decentralisation
- Newflight will be 'market led' and success will be dependent on response to market pressures

To some extent, the conflicting pressures can be reconciled by using organisational culture to create a strong sense of values.

It should be observed that the term 'low cost' no longer means that customers will accept poor service – low cost does not equate with 'cheap and nasty'.

Nevertheless, customers do know that low cost means that certain aspects of the service will not exist so that the cost base is reduced. An example of this is the provision of in-flight catering and newspapers. If customers are aware at the point of booking that these services are not provided, they will not perceive their absence as a reduction in quality. However customers will not accept poorly trained or discourteous staff.

Consequently the following observations can be made regarding the choice of budgeting and planning model:

Benefits of decentralisation:
- Staff will be more motivated, as they will perceive that they are trusted and have a degree of freedom in carrying out their duties
- There will be opportunities to benefit from adapting practices to local situations
- The freedom which staff feel they are afforded will assist in creating and fostering a 'problem solving' culture
- The high level of personal customer contact means that staff must be perceived by the customer as motivated

Problems of decentralisation:
- The industry is highly regulated, so policies and procedures must be consistent at all points
- The need to observe common policies, while allowing a degree of empowerment to staff, may lead to confusion regarding the boundaries of individual staff authority
- Any confusion regarding such boundaries will reduce motivation and lead to conflict, resulting in a reduction in the quality of service

Conclusion
The choice between centralisation and decentralisation is not simple. A range of factors as discussed above must be taken into account.

At the core of the decision is the tension between the need for clear policies (e.g. security, latest check in time before flight) and delivering a quality service through motivated staff.

This means that decisions must be taken as to which aspects of the operation will be driven by centralised decisions, and are therefore effectively not subject to individual judgement. Once these aspects are identified, the reasons must be clearly communicated to staff so that there is no confusion as to why they must adhere to the policies.

This leads to the observation that staff training will be essential. If staff understand the requirements of regulatory bodies, they will tend to understand and accept the resulting lack of empowerment. Also training will be a key factor in creating a strong brand image and corporate culture. (The directors' report in the financial statements of easyJet devotes a section to 'People and culture' and emphasises the importance of this as an element in achieving success).
Within that context staff will be empowered to operate as they feel is most appropriate – but within the security of clear

guidelines. It will also be important that there are clear lines of communication so that staff know they have the support of more senior colleagues to whom they can refer in the event of difficult situations.

In summary therefore, a balance between centralisation and decentralisation will be appropriate, with the following factors being important:

a clear explanation for the central control of certain aspects
creation of a strong brand image
creation of a set of corporate values
a commitment to staff training

Mark allocation

1 mark for each relevant point regarding centralisation/decentralisation to a maximum of			8	
1 mark for each potential benefit or problem to a maximum of			5	
For conclusion/overall statement of budgeting approach				
Brief conclusion		1		
Balanced consideration	+	2		
Clear final conclusion	+	2	which:	
follows logically from discussion	+	2		
			7	20

Basic approach (traditional vs devolved)/Extent of decentralisation

As discussed above, a basic decision must be made on the extent to which the planning and budgeting system will be centralised/decentralised. From that discussion, it can be seen that a mixture of the two is likely to be most appropriate. It was also suggested that a clear decision must be made regarding those decisions which should remain centrally controlled. The following are likely to be centrally controlled:

Routes served
Flight schedules
Pricing
Security arrangements
Overall staff allocation
Staffing structures
Salary scales

Subject to the policies in these areas, there will be scope for decentralisation. For example:

– operational managers should have authority to arrange staff rotas within the context of their section's overall staff allocation
– while salaries will be centrally set, there may be a place for local incentive or bonus schemes, based on achieving key operational targets

Involvement of staff/negotiation in setting budgets and targets

The extent to which staff will be involved in negotiating and setting budgets will be an important decision. At the very least, it is likely that it would be beneficial to seek the input of local staff in considering the likely opportunities for increasing passenger numbers – particularly on those routes and flights where utilisation is low or beginning to fall. As the need to control and reduce costs without a perceived reduction in service is an essential element in the success of the company, staff input in this area is likely to be effective.

As noted above the quality of information systems will contribute to success. It will be important to decide on how widely performance feedback will be circulated. The arguments for decentralisation would support the view that information on performance should be widely available. This would also assist in motivating staff. It would also mean that staff are more likely to be able to assess the effect of their efforts and can therefore contribute to continuous improvement.

Feedback mechanisms

The means by which staff are provided with information and are able to provide such feedback must be decided. While periodic reports are low cost, their long term effectiveness is questionable. Staff must be trained to understand the content and significance of such reports, and encouraged to actually read them. It is unlikely that all staff will be motivated to create the time to do this. A more effective approach may be for local managers to hold regular team briefings to highlight particular achievements and issues for improvement, and to solicit suggestions. These face to face meetings should be backed up by 'traditional' written reports, perhaps communicated via an intranet. Such an approach will encourage open, and two-way, communication.

Frequency of reporting

A balance must be achieved between regular reporting and information overload. The key performance targets are considered below, and the most effective approach is likely to be:

Identify key performance targets
Schedule targets for daily, weekly, quarterly reporting depending on the extent to which staff actions over these periods can influence performance

Budget period
The choice of budget period will be influenced by the operational cycle. Although financial reporting is carried out on an annual basis, this does not necessarily mean that an annual budget period is always appropriate. Factors to be considered include the extent to which passenger numbers are seasonal, and the cycles within which numbers rise and fall. As considered below, there is likely to be a link from one business cycle to the next, so that the time frame within which strategic decisions will take effect must be considered. For example, a new route is not introduced without a number of negotiations and decisions being successfully concluded (landing slots, aircraft availability, marketing, pricing, staffing). These will take time, and once concluded, will affect the short term budgeting and planning decisions. Therefore, it will be appropriate to have a longer term strategic planning period (say five years) which is broken down into shorter managerial periods (say one to three years) with operational budgets prepared for six to 12 month periods.

Rolling or periodic budgets
As the activities of one period affected subsequent periods, and based on the comments above, a rolling approach to periodic budgets is suggested. This would allow a degree of flexibility in planning, set within the context of the key strategic decisions.

Fixed or flexible budgets
Given the high level of fixed costs, the choice is fact less problematic than in theory. The key issues for the business will be controlling the fixed costs, managing the risks associated with non-controllable costs (e.g. fuel costs) and maximising passenger numbers. The level of activity is decided in advance when flight schedules are published. For these reasons, the approach will be to apply fixed budgets.

Responsibility centres
A combination of responsibility centres will be appropriate.

As already noted, almost half of the cost base comprises fixed and non-controllable costs. These must be centrally managed to achieve efficiencies. This will give rise to the central cost centres. At the local level, the task for managers is to maximise passenger numbers and therefore revenue. Consequently local centres will be revenue centres.

Mark allocation		
1 mark for each valid point to a maximum of	5	
Remaining marks allocated depending on extent to which points are applied to the business under consideration and developed:		
for each point applied and developed, a further mark to a maximum of	5	10

The analysis above has indicated that the business model requires high passenger volumes, at prices which are both competitive, but also allow revenue per customer to be maximised. Along with this, the fixed cost base must be strictly managed, and policies implemented to reduce the impact of non controllable costs – and to reduce these over time. However the fact that a high proportion of costs are fixed and/or non controllable emphasises the primary importance of high passenger volumes.

The choice of operating routes will be critical to the success of the venture. Given that this is a strategic decision, it will not be possible to change the outcome in the short term, and the measures to be monitored must allow short term success to be maximised, as well as facilitating ongoing reviews of the choice of routes.

As it is essential that the maximum number of seats are filled on each flight, this will therefore be the priority measure.

Goal	**Measure**
Passenger volumes:	
capacity utilisation per flight	% of seats sold
capacity utilisation per route	% of seats sold
relative market share	% share, compared to competitors
repeat purchase	% of returning customers
customer transfer	number of new customers
The ability to build and sustain passenger volumes will be driven by a number of factors, which should be monitored:	
punctuality of flights	% flights on time
safety record	number of accidents/emergency landings
price (relative to competitors and substitutes)	comparison of fares on specific routes
Maximising revenue per customer:	
Increase revenue per customer	revenue per customer
Reducing the impact of the cost base:	
Cost reduction	cost per flight cost per customer

Mark allocation		
1 mark for each relevant goal to a maximum of	5	
1 mark for each relevant measure of the goal	5	
1 mark for each measure justified in context of business	5	15

(b) It is important to note that outsourcing is most effective when used for non-core activities, or activities which require specific skills.

As has been noted above, there are a number of important aspects of the business which must remain centrally controlled. Nevertheless, opportunities for outsourcing do exist. The main aim of any outsourcing will be to provide certainty of cost (and also cost reduction) while maintaining the quality of service.

Thus, benefits may be obtained by outsourcing:

Aircraft maintenance
Ground operations
IT systems development

Activities which will be outsourced must be subject to strict controls through clear performance measurement targets.

Whether the activities considered above can actually be outsourced successfully will depend on whether they are considered to be non-core. For example, it could be argued that maintenance is of such importance to safety (and punctuality) that outsourcing effectively removes a critical success factor from the control of the company. However the requirement for specific skills, the fact that safety standards are centrally set (by aviation authorities) and the need to reduce the impact of the infrastructure costs of maintenance are likely to mean that, on balance, this activity can be successfully outsourced.

Mark allocation:

Awareness of key issue in outsourcing (non-core)	1	
Possible activities for outsourcing maximum	2	
Overall quality of discussion	2	5