Answers

Diploma in Financial Management – Module A
Project DA2 incorporating subject areas:
Interpretation of Financial Statements and
Performance Management

Project Answers
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Introduction
This solution is intended to indicate the content which candidates may have included in their answers. It is not intended to be exhaustive, and other relevant comments and material, which addressed the questions and satisfied the criteria in the marking scheme, were also awarded marks.

1 Assessment of the Group's performance should have been based on the stated strategy. The cornerstone of this strategy – growth – was included in the question. There are numerous references to growth in the reports of the Chairman, the Chief Executive and the Finance Director.

Each report also includes various measures of growth. Candidates were not awarded marks for simply repeating these measures. However, this did not mean that these measures were irrelevant. Where an answer indicated a clear awareness of the relevance of the measure to the strategy and analytical comments which assessed the strategy were provided, good marks were awarded.

It is also worth noting that marks were maximised by careful selection, justification and application of measures, rather than for the number of measures included in an answer.

Starting from the overall growth objective, the measures may have been selected and justified as follows:

Sales growth
It goes without saying that if a company is seeking to grow, one would expect to see an increase in sales. Indeed, the Chairman's statement refers to 'improved sales' as an element of the growth strategy.

This would most obviously be measured at a headline level by comparing turnover from one year to the next.

Profitability
Clearly there is little point in achieving unprofitable growth. It is often the case that in order to increase sales, a company will have to accept a reduction in profitability. The need to ensure that growth is profitable is highlighted in the opening line of the Chairman's statement: 'improved sales and profits were achieved as we continue to deliver on our growth strategy'.

Two relevant measures of profitability are gross profit margin and net profit margin.

Shareholder returns
Ultimately, the benefits of any strategy must be seen by the shareholders, as this is the reason the company exists. Shareholders have the opportunity to influence the strategic direction of the company through communication with the directors, and ultimately by decisions regarding the level of their investments. As the chairman refers to the fact that the directors 'continue to deliver on our growth strategy' there is a strong indication that the shareholders have endorsed the strategy.

Shareholder returns may be measured in two main ways:
Income – earning per share
Capital growth – share price

Potential
It is widely acknowledged that a problem in assessing performance based on published financial statements is the fact that they are historical. Our investigation is limited to what has happened. Perhaps of greater significance is the need for information on what is likely to happen in the future. There will be little point in achieving objectives in the year under review, if such achievement is at the expense of potential achievement in the future. There are some indicators of the initiatives which have been implemented in the first few lines of the Chairman's statement.

Here he refers to:
'portfolio of collections', international brand presence, a major new store, a licensing agreement.
The financial statements do not provide sufficient information to allow us to assess these initiatives. Rather they will tend to indicate Critical Success Factors (CSFs) which should be monitored, and discussed in the second section of the project.

Assessment of performance
The measures selected should follow logically from the discussion above. Thus the following measures may have been selected:

Sales growth 2002 – 2003
as noted in the Chairman's statement the overall sales growth was 13%. This can be analysed further by reference to note 2 – Segmental Information.

Candidates might have commented on:
the sales mix by brand:
there has been virtually no change in the proportion of sales achieved by each brand, with menswear remaining the most significant brand at 51%. This suggests that any change in profitability has arisen due to a change in overall margins and expenses.

sales by region:
while the UK remains the Group's most important market, accounting for almost 99% of turnover, the year on year growth of 55% in other markets is also significant. However, this does mean that the Group is heavily reliant on the UK economy.

Profitability
Relevant measures would have included:

Gross profit margin
to assess whether the 13% increase in sales has been achieved at the expense of margin.
The results for each year are: 2003 59·75% 2002 56·25%
This indicates that the growth has been profitable, as there has in fact been an improvement in this measure.

Net profit margin
To assess whether the Group has incurred additional costs in an effort to achieve growth.

There will be little point in improving gross margin if this has been achieved by a substantial increase in overhead costs.
The measures for the two years are: 2003 14·12% 2003 16·03%

The fall in net profit margin is largely due to the increase in distribution costs from 29·7% of sales to 33·7%.

ROCE
to assess the extent to which the growth has been matched by an increase in the capital invested in the business.
The result for 2003 is 43·2%, down from 49·32% in 2002.
The major influence on the fall in ROCE is the substantial investment in fixed assets.
The cost of investment in property increased by 58·8% and the cost of the investment in fixtures and fittings increased by just over 30%.
Both of these investments could be considered necessary to maintain the Group's competitive position. Having incurred the cost in the 2003 year, it would be expected that the Group would see improved returns in the 2004 year.

Shareholder returns
Shareholders obtain their return through income (which can be measured by earnings per share) and capital growth (which can be measured by share price).
The basic earnings per share has remained static at 15·9. However the company has also chosen to report a figure for 'adjusted earnings per share'. This has increased by 12·7% to 18·6p. Note 10 indicates that the 'adjustment' is in respect of impairment of fixed assets. No further information on the nature of the impairment is given, but note 11 indicates that 80% of the charge relates to leasehold properties. This suggests that the value of some of the Group's outlets has fallen. This is a matter for concern as it may indicate that the location of the outlets is less attractive than had previously been thought. This may have a negative impact on future sales potential.

No information is provided in the supplement regarding share prices, although candidates may have obtained this information from other sources.

Potential is difficult to assess, although comments regarding the fact that the significant investment in fixed assets may have left the company well placed to continue growth in the foreseeable future. This potential is somewhat offset by the impairment charge discussed above.

Conclusion
The conclusion should follow logically from the comments on the various measures. Overall, candidates might have been expected to note that although a growth in sales and gross profit margin have been achieved, this has not been translated into net profit margin and earnings per share.

Overall therefore, it is difficult to conclude that the Chairman's statement that the results are 'strong' is totally justified. While the growth strategy has been successful on one level, more information – particularly regarding the increase in distribution expenses and the impairment charge – would be needed to justify this claim.

2 Comments on this question should be developed from the analysis in question 1.

Candidates would be expected to demonstrate an understanding of how the measures discussed in question 1 would be affected by a downturn in the UK economy.

One point to note is that while the Group's activities outside the UK might provide some protection against the effects of the downturn, the level of these activities remains very small in terms of the overall turnover, and these activities provide little protection.

As competition becomes more intense during a downturn, the Group is likely to find that results are affected as follows:

Lower sales growth, and possibly a reduction in sales levels;
Reduced gross profit margins due to downward pressure on sales;
Increased expenses as additional resources are required to generate sales;
Thus a further reduction in net profit margin, ROCE and earnings;
All of these factors would combine to produce a downward pressure on the share price.

Other measures which would be expected to be adversely affected would include:
- Interest cover
- Dividend cover
- Stock turnover period
- P/E ratio

3 Answers to this question should consider budgeting models, and discussion of the following would be relevant:

Fixed and flexible budgeting – flexible budgeting can be used to assess the outcome of different levels of demand. This may be of particular importance at the level of individual stores or local regions.

Decentralisation and empowerment can be used to allow local managers to respond to local trends (i.e. to consolidate if there is a downturn in local activity, but to seek growth if local conditions permit it).

Zero base budgeting will be an effective technique for ensuring that assumptions which are no longer valid are removed from the planning and budgeting process. Activity based management and budgeting can be used to coordinate the use of resources in response to local markets.

The competitive environment will lead to an increase in the use of external information. Such information will be used to ensure that trends are foreseen and responded to. The need to monitor the initiatives undertaken by competitors, and to highlight changes in consumer trends will be of particular importance.

External information is often used to assess the effect of changes in key variables and potential responses to such changes. Two techniques which may be of benefit in this regard are Scenario Planning and Sensitivity Analysis.

The above techniques may lead to the re-assessment of the planned growth strategy in specific markets, leading to a series of local strategies.

4 Answers to this question should consider CSFs which are based on the Group's strategy. It is important to justify each CSF, and to explain how it will actually be measured. For example, there can be little doubt that customer satisfaction is an important target, but candidates must clearly explain why it is important – and how it will be measured.

Possible CSFs, rasons for selecting these and measurement bases are:

CSF	Relevance	Measurement basis
Footfall	The number of customers entering the store provides an indication of the success of the store display in attracting customers. If customers are not attracted into the stores, sales cannot be generated.	The number of customers entering the store. Measured on a store by store basis.
Returns to manufacturer	If goods are not of the required quality, the Group's image will suffer, leading to a loss of reputation and sales. By measuring the number of items which do not meet the required standard at the goods inwards stage, the quality standards of each manufacturer can be assessed. This will lead to an improvement in the overall quality, which will increase customers' satisfaction, leading to increased sales.	Number of items returned as a % of items received from manufacturers.
Customer returns	Measuring the volume of returns by customers will assess whether the Group's quality standards are meeting those of customers.	Number of items returned as a % of items sold.
Sales per square metre	This will assess whether the store space is being used effectively. A comparison between products lines and between stores will highlight good practice and areas of underperformance.	Value of sales ÷ floor area for each product line.
Stock turnover period	In the fashion industry, the need for a fast turnover of stock is vital. In this way, customers perceive a fresh proposal each time they enter the store.	Stock x 365/Cost of sales By product line and by store
Time to bring new products to store	The need to respond quickly to changes in customer trends is of critical importance. By ensuring that the time between agreeing a new product idea, and having the product in the store is minimised will ensure that the Group can respond to such changes	Number of days between agreeing a new product design and the product being on display in store.
Stock sold at less than full retail price	If stock is being sold at less than full retail price, it is either out of date, or approaching the end of its retail life. Monitoring such occurrences will allow the effectiveness of design and purchasing to be assessed.	Gross profit foregone by selling stock at less than full retail price.
New product lines introduced	A key issue in the fashion industry is to maintain customer expectation. This can be done by constantly introducing new product lines. This encourages customers to return to the store in the expectation of finding something new.	Number of new lines introduced per week.
New customers	To achieve growth, the customer base must be expanded.	Number of customers buying for the first time.
Gross profit margin	Growth must be profitable, thus growth profit margins must be maintained and improved.	Gross profit as % of turnover.
Cost containment	When pursuing growth it is easy to allow costs to spiral out of control, thereby reducing profit.	Costs as % of turnover, analysed by major cost categories.
Impact of advertising	Effective advertising will assist in generating additional sales.	Advertising as % of turnover.

5 Candidates will be expected to revise the CSFs in line with the suggested revised strategy or indicate why each CSF remains valid. Possible comments on each CSF include:

CSF	Comments
Footfall	This will remain an important measure, as the need to attract customers into the store does not diminish. However, in assessing the results, it will be important to acknowledge that the number of customers may fall, compared to previous periods. Thus it will be important to obtain external data against which to benchmark the Group's performance.
Returns to manufacturer	The need to maintain quality and customer satisfaction is independent of the strength of consumer demand. Consequently this measure remains important. However the lower level of activity that will result from any downturn, may provide more time to examine the underlying reasons for returns. Thus the downturn may provide an opportunity to improve quality and to reduce the incidence of returns.
Customer returns	The same comments as above 'returns to manufacturer' apply here.
Sales per square metre	The need to utilise floor space effectively does not reduce, although the level of sales is likely to reduce. This increases the importance of external benchmarks.
Stock turnover period	Lower customer activity will lead to an increased need to ensure that stock is turned over quickly. Unsold stock means reduced profit. This measure will therefore remain important.
Time to bring new products to store	A downturn in activity will increase the level of competition. Customers will be less inclined to accept long standing lines, but rather will seek unique product. The need to continually 'freshen' the proposition in store means that new product development becomes more important, and the need to reduce lead times increases.
Stock sold at less than full retail price	Customers will tend to be more selective in the event of a downturn. Monitoring the items which must be sold at marked down prices will allow poor purchasing and/or mechandising decisions to be identified, and corrective action taken.
New product lines introduced	As discussed above, the need to 'freshen' the proposition in the stores, increases the importance of new product lines.
New customers	The possibility of attracting new customers in a downturn is perhaps reduced, as customers may not seek out new providers. Therefore customer retention may be more important than new customers.
Gross profit margin	The need to maintain sales levels will put a downward pressure on margin. By constantly monitoring gross profit margin, the trap of maintaining sales, but reducing profitability can be avoided.
Cost containment	This will assume greater importance in the event of a downturn, as lower sales will result in lower gross profit. Unless costs are contained, overall profitability will suffer.
Impact of advertising	The need to ensure that advertising is effective is enhanced when the overall level of demand is reduced.

Additional measures

Relative market share

If the overall market is reduced, the need to ensure that the Group is maintaining sales at as high a level as possible is extremely important. By monitoring relative market share, it is possible to ensure that any fall in sales levels is due to a reduction in the overall market, and not due to a transfer of customer allegiance to competitors.

Cash flow

When activity levels are reduced the need to manage cash flow effectively assumes greater importance. By managing for cash, the Group can ensure that survival in the short term, without compromising long-term competitiveness.

Section 1

1 As noted in the marking scheme below, candidates were given credit for selecting and calculating relevant ratios and using these to assess performance. Further marks were awarded for:
specifically justifying why a ratio has been selected, based on the stated strategy;
linking comments on performance back to the strategy;
using links between ratios to develop the analysis

For each ratio, up to a maximum of five:

selection of a relevant ratio and correct calculation of each one for two years		2
for justification of each ratio selected	up to	2
for comments on performance, based on ratios	up to	3
for comments which refer to objectives or link to other ratios, additional		1
		8
	x five ratios =	40

2 The marks for this question were awarded on the basis of the development from the first question.

Candidates were therefore expected to discuss how the ratios considered in question 1 might be affected, if the Group is affected by the downturn (e.g. lower sales leading to lower activity ratios; a fall in profitability as margins are reduced to encourage sales, leading to a fall in ROCE and interest/dividend cover and eps; a fall in share price, leading to a fall in the P/E ratio).

1 mark per valid comment, to a MAXIMUM of	10
Total section 1	**50**

Section 2

3 Answers to this question should have considered budgeting models, and discussion of the following was relevant:

Fixed and flexible budgeting – to assess the outcome of different levels of demand;
Decentralisation and empowerment to allow local managers to respond to local trends (i.e. to consolidate if there is a downturn in local activity, but to seek growth if local conditions permit it);
Zero base budgeting, to ensure that assumptions which are no longer valid are removed from planning and budgeting;
Activity based management and budgeting, to coordinate the use of resources in response to local markets;
An increase in external information to ensure that trends are foreseen and responded to;
Possible re-assessment of the planned growth strategy in specific markets, leading to a series of local strategies.

1 mark per valid comment, to a MAXIMUM of	15

4 Marks in this section were based on the extent to which CSFs are based on the strategy, and candidates were expected to develop their analysis by stating both how the CSF should be measured, and why it is deemed to be important.

For each CSF, up to five			
selection of a relevant CSF			1
indication of how the CSF will be measured			1
justification of CSF up to			2
			4
	x five CSFs	=	**20**

5 Candidates were expected to revise the CSFs in line with the suggested revised strategy.

For each CSF, up to five			
weak discussion of relevance			1
development of discussion +			1
logical decision on relevance or revision			1
			3
	x five CSFs	=	**15**
Total section 2			**50**
Total for project			**100**