Answers

Indicative Solution

This indicative solution is provided for study and tutorial purposes. It indicates the content which may be expected from an answer which is a clear pass, but is not intended to include all the material for which candidates would obtain marks. Candidates and tutors should note the requirements detailed in the marking scheme.

1 (a) The process of managing performance requires appropriate measures to be selected, reported and assessed in order to identify areas of strength and weakness.

By exploiting strengths and resolving weaknesses, performance will be improved. An assessment of performance will only be meaningful if the actual performance is assessed against an appropriate benchmark. For example, many organisations regard market share as an important measure of performance. If two organisations have market share of 20%, we are unable to assess the relative performance until we consider the context. For example, are they operating in the same industry? What other competitors are active in the industry? How does the 20% market share compare to that of competitors? Is 20% an increase or decline on the previous year? In essence, these are questions which managers will answer in order to assess the strategic choices open to the organisation.

Having considered such questions, the managers will develop a strategy which will be communicated to both staff and shareholders. This is usually done through the mission statement. Once the strategy is agreed, action plans will be developed, and specific objectives will be set for each aspect of performance. For example, if the strategy is to build market share, the action plan will consider how to develop the range of products or services, how to win new customers and retain existing customers, and how to enter new markets, among other things. Very often, a reduction in gross profit margin will be accepted as one of the costs of achieving such growth. The overall objective is to improve net profit by achieving an increase in volume which compensates for the fall in margin.

On the other hand, if the existing market share is considered to be the optimum that can be achieved given the competitive environment, the plans referred to above are unlikely to be appropriate. In such circumstances, it will be more appropriate to consolidate. This will often mean that gross profit margin will be held at the current level, or possibly improved.

From the above it can be seen that it would be incorrect to regard a fall in gross profit margin as always being a sign of a decline in performance.

This leads to the conclusion that, if we accept that the strategy which has been developed is appropriate for the company's environment, this will be the correct starting point for an assessment of performance.

Put simply, when assessing performance, we are seeking to ascertain the extent to which management have been successful in achieving their own objectives. The question of whether the objectives are appropriate is a question concerning strategic choice, not performance.

(b) On page 9 of the Group's report, two key strategic objectives are noted:

– maximisation of shareholder value
– profitable growth (both organic and through acquisition)

These are by no means surprising. It is widely accepted that maximisation of shareholder wealth (or shareholder value) is the over-riding objective for a listed company. In addition, the directors' assessment that growth opportunities exist will naturally lead to a desire to exploit such opportunities. In addition, growth is often a key factor in maximising shareholder wealth. Finally, it is unlikely that many companies would seek unprofitable growth (although a reduction in profit may be an acceptable short term consequence of a growth strategy).

Given these objectives, the following measures will be used to assess performance:

Return on Shareholders' Funds (ROSF)

Given the growth objective, the group will require ongoing investment and new funding. If the growth is to be profitable, the return obtained must show continual improvement. This ratio measures the effectiveness of the use of the funds invested to earn profit.

Profit margin

The level of profit earned is a component of the return on shareholders' funds. By assessing the change in the level of profit, we can establish if any improvement or deterioration is due to a change in profitability. From the interaction of this ratio and the ROSF, we can derive a measure of asset utilisation. (It is the combined effect of asset utilisation and profitability which creates the ROSF.)

Turnover per employee
Profit per employee

As the group grows, it is inevitable that staff numbers will grow. It is essential that the growth in staff numbers is managed. This will ensure that staff continue to be utilised effectively. By assessing turnover per employee, we obtain an initial measure of the success in managing headline growth. The measure of profit per employee indicates the ability of the group to manage the business as a whole.

EBITDA Margin
The measure of earnings before interest, tax, depreciation and amortisation is widely scrutinised as it provides a measure of the underlying ability of the company to generate earnings through its primary trading activities. The stated intention to achieve *profitable* growth means that this measure will indicate if the company is successful in this objective.

Gearing
As noted above, growth will need to be financed. This leads to the key decision as to whether such finance should be debt or equity. Despite the theoretical arguments, there is considerable evidence that in most cases, it is not appropriate for gearing to be excessive. By assessing the level of gearing we can obtain an indication of the level of risk to which shareholders are exposed as a result of the group's financial structure.

(c) ROSF
The most obvious comment is that over the five years for which data is provided, the Group's performance has been volatile, with the return being negative in two years. This suggests that the overall achievement of *profitable* growth has not been achieved. This initial view is confirmed by two other pieces of data. The first is that the key (but unidentified) competitor has maintained a reasonably steady ROSF at a rate over 30%, apart from 2002. This indicates that the reasons for the volatility in the Group's performance is not a result of environmental or industry factors, but is likely to have been influenced by internal decisions and policies.

Secondly, the group's turnover has actually fallen in the most recent year, suggesting that growth has not been achieved.

Profit margin
It is hardly surprising that the volatility in ROSF is matched by volatility in the profit margin. It is difficult to assess the reasons for this volatality, as no information is provided in the financial statements. However, if we accept the chairman's statement that the restructuring of the Group's operations in North America has been completed, and that as a result, the Group has 'excellent potential to deliver good returns for shareholders', there is some justification in considering the most recent result to have the most significance. While it is usually not a good idea to base an analysis on one year in isolation, we can see that in 2004, the Group delivered a return of 6·38%, which is almost 30% greater than the profit margin of the competitor. This suggests that the optimism has some basis in fact, but any final judgement must be reserved until results are available for at least one further year. If we link this result with the ROSF, to derive asset utilisation, we find that the Group's use of assets has improved over the five years (from 1·38 times to 3·84 times). However this is still considerably below the level achieved by the competitor (7.4 times in 2004).

Turnover per employee
On this measure, the Group has consistently outperformed the competitor for the last four years. In the 2000 year, there was virtually no difference between the two companies. However, whereas the competitor's performance on this measure has fallen from the 2000 level, the Group's performance has improved year on year. With staff costs comprising some 50% of total costs, the need for efficiency in this area is critical. The level of efficiency achieved by the Group may be a key element in the optimism expressed by the chairman and chief executive. Indeed, the Chief Executive refers to the contribution of staff in putting the Group 'firmly back on track'.

Profit per employee
This result is, once again, heavily influenced by the volatility in the Group's profitability. In 2000, the Group's performance (£4,200) was considerably better than that of the competitor (£2,900). If we accept that the intervening period was difficult for the Group, and that the restructuring has been successful, we can see that while neither company has managed to generate profits at the same level in recent years, the Group's most recent performance, which is almost 1·75 times that of the competitor, is extremely encouraging.

EBITDA Margin
The fact that this is a further measure of profitability means that the volatility already noted is apparent. It is worth noting however, that the volatility in this measure is less pronounced than in the other measures of profitability, suggesting that the volatility was produced to a large extent by the restructuring. This is underpinned by the fact that in the most recent year, the Group's performance is slightly better than that of the competitor. This confirms the impression noted above (that the claim that the Group is well placed to benefit from the restructuring) has a reasonable foundation.

Gearing
The observation that there is no absolute benchmark for any measure of performance is particularly applicable here. While the Group's level of gearing is significantly above the 'safe' level noted in some textbooks, it has remained below the competitor's level throughout the period under review, apart from 2003. The chairman has commented that the restructuring has 'contributed to a very significant reduction in Group debt'. This is borne out by the fall in gearing from 311% to 190%. The level of gearing in 2003 would have contributed to the negative measures of profitability. However, the fact that the EBITDA margin was also negative in 2003, indicates that the underlying business activities were not carried out successfully in that period, and the level of gearing worsened, rather than created, the problem.

Conclusion
The upbeat tone of the Chairman and Chief Executive may be reasonable, if the restructuring has been successful and their comments reflect the prospects for the future. However, the results for the last five years have been mixed, with indications that historic performance has been less positive that the expected future results. The swings in profitability have not been experienced by the competitor, and cannot be fully attributed to the level of gearing. This leads to the conclusion that the mixed results are the result of internal decisions and management policies. Overall, the Group needs to replicate the improved results over a sustained period, in order to provide convincing evidence that the optimism of the Chairman and the Chief Executive is justified.

(d) Limitations of published financial statements

Historic

The most significant limitation is undoubtedly the fact that the financial statements are historic. For a potential investor, the key question is 'how is the company I am considering investing in likely to perform in the future?'. While the past may be a guide to future performance, it is by no means conclusive. As has been noted above, the performance of Stagecoach has been mixed, but the most senior managers claim that steps have been taken to address this. A potential investor will need further evidence that these claims are well founded.

A specific issue in that context is the fact that the strategic objective is growth. However, there has been a fall in turnover in the last year.

The chairman and Chief Executive both refer to restructuring the North American operations, and Note 2 refers to discontinued activities as being Coach USA. The performance of the discontinued activities appears to be the main reason for fall in turnover. Indeed 87% of the fall in turnover is accounted for by the decline in turnover of the discontinued activities. However, the effect on profit cannot be assessed, as note 2 states that this is 'not clearly distinguishable due to certain shared costs.' This means that the overall effect of the discontinued activity is difficult to assess. Note 2 also states that the profit 'is not believed to be material in the context of the Group's operating profit as a whole'.

As a consequence, a potential investor has to trust the comments in the reports of the Chairman and Chief Executive or seek additional information. The matter for concern is that the internal management seem to be making decisions on the basis of incomplete information as their comment refers to belief, rather than fact.

Lack of data to establish a trend

As only two years data is available from published accounts, it is not possible to establish a trend in performance. In the case of the Stagecoach Group, this is perhaps of less relevance, as the Group's profitability is so volatile. Nevertheless it would be helpful if data for a longer period was made available, together with some explanation of major changes from one period to the next.

Lack of comparative data

It is important to have some external data to use as a yardstick in assessing performance. Unless such a standard is available, many of the measures calculated from the financial statements will be meaningless. For example, the gearing level of the Stagecoach Group appears to be very high, but when viewed in the context of the gearing level of the competitor, it does not appear to be as significant.

Lack of detail regarding statements in Chairman's/Chief Executive's report

The Chairman and Chief Executive will, quite naturally, seek to offer as positive a view of performance as possible. While these statements must have some basis in fact, there is often very little data to support them.

In the case of the Stagecoach Group, reference is made to the importance of overseas markets, but there is little data provided. Therefore the user is required to carry out additional research to assess whether the statements are reasonable.

(e) The balanced scorecard is designed to provide a clear link between the strategic objectives of an organisation and the performance measures which are monitored and controlled. On the basis that those aspects of performance which are measured and reported will be the focus of attention from operational managers, the technique provides a link between strategy and action.

One of the key features of the technique is to move the focus of performance reporting away from exclusively financial measures by incorporating non-financial measures.

It also seeks to overcome the problem of information overload, where managers are bombarded with results. Rather the intention is to provide data on performance by measuring those activities and results that are critical to successfully achieving the strategic objectives.

Where the technique develops the 'critical success factor' approach is to include the concept of balance. The balanced scorecard recognises that no one aspect of performance should be allowed to dominate managers' attention. For that reason, four 'perspectives' (customer, internal processes, learning and growth and financial) are used. Within each of these perspectives, a small number of objectives are set, based on those aspects of performance which are critical to success. Each objective will have a specific means of measurement, and a performance target.

The significance of this for Stagecoach is that it leads to a development of the strategic objectives. These are stated in the Financial Statements as being:

- maximisation of shareholder value
- profitable growth (both organic and through acquisition)

The danger of such objectives is that the focus will be on purely financial objectives. For example, maximisation of shareholder value will result, in large part, from achieving profitable growth. If the size of the company grows, and this growth is profitable, then the result is likely to an increase in shareholder value.

The problem is that these objectives are 'macro' or high level. They may not mean much in terms of everyday activities.

The key to success is to develop a range of measures which focus attention on the activities which produce the desired results.

For example, growth is often a result of achieving high levels of customer satisfaction. In turn this is a result of providing the service customers require at a price which they perceive as value for money. One way in which customers will develop this perception, for example, is by being made to feel comfortable and safe when they use the group's buses and trains.

Therefore we can see a link between aspects of performance such as the welcome customers receive when boarding a bus, and shareholder value. By managing the detail (the welcome), the objective (shareholder value) is achieved.

The key to developing a usable and effective scorecard is to identify those objectives in each perspective which will contribute to achieving the strategy. From these objectives, measures are identified and targets are set. By making the achievement of such targets the responsibility of all staff activities are more closely aligned with objectives.

Specific objectives, measures and targets are considered below.

(f) In the case of Stagecoach, the following observations can be made.

Shareholder value is a result of profitable growth. Therefore there is consistency between the two key objectives of the group.

In simple terms, organic growth is achieved by maximising the number of passengers using the trains and buses. Therefore the strategy is to grow the number of passengers, relative to the number of vehicles. This leads to the question: 'What must we do to attract more passengers?'. The simple answer is 'meet their needs'.

Organic growth can also be achieved by developing new routes and services. The Group has also identified acquisitions as a means of achieving growth, but this is not considered here, on the basis that this is a strategic, not operational, issue.

Experience suggests that passengers seek a number of key factors:

Safety

Reliability

Convenience

Comfort

It therefore follows that an appropriate balanced scorecard may contain the following measures. The means by which each of these measures contribute to strategic objectives is also considered.

Perspective	**Objective**	**Measure**
Customer	Customer retention	% of repeat sales
	Customer growth	Number of first time customers
	Customer satisfaction	Number of complaints to Regulator: Number of complaints to Group
Internal	Capacity utilisation	% of available seats occupied
		Ratio of passenger miles: staff
	Reliability	% of arrivals within five minutes of scheduled time
	Vehicle availability	Passenger miles lost through downtime
Learning and growth	Staff capacity	Training hours per employee
	Route expansion	Number of new services/routes introduced
	Employee retention	Staff turnover
	Safety	Number of accidents per 1,000 passenger miles
Financial	Customer growth	Revenue earned per available passenger
	Operating costs	Cost per passenger mile

Link between measures and strategy:

Measure	Comments
% of repeat sales	If the Group is to achieve growth, the service provided to customers must be of at least the expected quality. If customers are satisfied, they will return to the Group. If customers are not retained, growth will be extremely difficult, perhaps even impossible.
Number of first time customers	Based on the foundation provided by retaining customers, growth will be a function of attracting new customers. The Group will need a constant flow of new customers.
Number of complaints to Regulator: Number of complaints to Group	It is almost inevitable that there will be some complaints from customers. The key issue is to manage these so that customers' satisfaction is enhanced. By managing and resolving complaints, there is an opportunity to turn a disaffected customer into a repeat customer. Therefore the ratio of complaints which the customer feels they must take to the regulator will provide an indication of the level of customer dissatisfaction. To achieve growth, this ratio must be constantly reduced.
% of available seats occupied	As already discussed, growth must be profitable, and a key element in this is ensuring that the available seats are occupied to as high a level as possible. The marginal cost of each additional passenger is nil, up to the capacity of each vehicle. Therefore if load factors, as measured by the % of seats occupied, are maximised, the effect on profitability will be positive.
Ratio of passenger miles: staff	With staff costs at around 50% of total costs, the need to ensure efficient and effective use of staff goes without saying. This measure will ensure that the staff resource is being used to the maximum benefit.
% of arrivals within five minutes of scheduled time	It is probably the case that arriving on time is second only to safety in terms of customer requirements. While there are factors outside the Group's control which may have some influence on the arrival times, it is essential to manage those factors which can be controlled, and to meet scheduled arrival times. If the Group can build and maintain a reputation for this outcome, customers are likely to both be attracted and to remain loyal. This will contribute to both growth and profitability, and therefore shareholder value.
Passenger miles lost through downtime	Operating efficiency is critical to maximising profitability. The capital cost and running cost of each vehicle is substantial, and therefore the need to ensure that the size of the fleet is minimised is a key element in achieving such efficiency. If too many vehicles are unavailable the Group is incurring unnecessary costs, with a detrimental effect on profitability.
Training hours per employee	A key element in achieving customer satisfaction is ensuring that staff are seeking constant improvement, and are aware of the corporate goals and requirements. If staff are well trained, and see such training as essential, customers will receive a better service. This will retain customers and create an environment in which both staff and customers feel valued.
Number of new services/ routes introduced	As noted above, growth can be achieved by introducing new routes. The group must constantly seek opportunities to attract new customers through new routes. This will, of course, be balanced by some of the other measures (eg cost per passenger mile) to ensure that new routes contribute to the goals of profitability and shareholder value.
Staff turnover	Low staff turnover indicates high levels of staff satisfaction. This will have a positive impact on the service experienced by customers, and will contribute to profitable growth and shareholder value via customer retention. Low staff turnover also minimises staff training costs.

Measure	Comments
Number of accidents per 1,000 passenger miles	All other measures will be irrelevant if the Group does not achieve the highest possible standards of safety. While an excellent safety record will not lead directly to growth and shareholder value, there can be no doubt that the converse is true. Therefore it is essential to promote safety as a key issue in all of the Group's activities.
Revenue earned per available passenger mile, and Cost per passenger mile delivered	There will be little point in growth in some of the measures discussed above, for example, customer numbers or routes offered, if this does not lead to a commensurate increase in revenue. By managing the revenue earned relative to the volume of passenger miles made available, the extent to which real growth is achieved can be measured. By combining scrutiny of this measure with the cost of each passenger mile delivered, a measure of profitability can be obtained.

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

Project Marking Scheme
Issue date August 2005

1	**(a)**	1 mark for each valid comment			4
	(b)	For each of the six measures selected, a maximum of 2 marks are awarded. The marks are based on the extent to which the measures are justified by reference to the strategic objectives of Stagecoach Group:			
		No reference to strategic objectives	0		
		Cursory reference to the strategic objectives	1		
		Clear link to the strategic objectives	2		
		X 6 to a MAXIMUM of			12
	(c)	For each measure selected, marks are awarded for: – demonstrating an awareness of the relevance of the measure to the strategy of the organisation – commenting on the performance as indicated by the measure and – developing the analysis of the organisation's performance by highlighting links between the measures.			
		Measure used to assess achievement of an identified objective	1		
		X 6 to a MAXIMUM of	=	6	
		1 mark for each valid comment on performance to a MAXIMUM of		18	
		Links:			
		Attempt to link two ratios to develop analysis	2		
		Attempt to link more than two ratios to develop analysis	2		
		Awarded for overall quality of discussion/visual aids	2	6	
					30
	(d)	For each limitation noted, 1 mark per valid point, to a maximum of	4		
		For each of these limitations which are illustrated by reference to the information in the annual report, a further mark to a maximum of	4		8
	(e)	General explanation of the balanced scorecard approach:			
		Some understanding of issues	2		
		Clear awareness of issues	+1		
		Link of strategy to actions/outcomes/measures:			
		Some understanding of link	1		
		Clear understanding of link	+1		
		Attempt to link objectives of Stagecoach to scorecard	3		
		Clear link of objectives of Stagecoach to scorecard	+2		10
	(f)	For each relevant measure of performance included in proposed scorecard, 1 mark to a MAXIMUM of		12	
		For each measure linked to strategic objectives:			
		Some link to strategic objectives	1		
		Clear link to strategic objectives	+1		
		X 12 to a MAXIMUM of	=	24	
					36
		Total			**100**