# Answers

**This solution is intended to assist candidates by providing an indication of the possible content of an answer. In using the solution for study purposes candidates should note that other relevant material would also be awarded marks.**

**1** **(a)** When the company was in private ownership the ownership of shares was not widely distributed. In addition, the major shareholder was in day to day control of the business. This meant that he, and by extension, his family were well informed. As the most senior manager, Malcolm Sayles would have had access to any information held by the company. In addition, he would have been fully informed as to the needs and objectives of the shareholders. This combination of involvement, control and information would have led to less reliance being placed on the annual financial statements.

In contrast, the shareholders of a listed company are not involved in the day to day management of the company. This means that they will place greater reliance on formal communication channels. In addition, as there will be a wider range of shareholders, there is likely to be less consensus about the objectives of the company than would have been the case under private ownership. The emphasis on more formal reporting is underlined by the increased reporting requirements for listed companies.

As the investors in a listed company are less involved in the business, they are likely to have less knowledge of the business, and this means that they will need to receive more general information about the company's plans and performance. An example of the way this type of information can be made available to shareholders is through the operating and financial review.

However this can create a dilemma for managers. When the shareholders were closely involved in the day to day running of the business, there was less risk of competitors obtaining commercially sensitive information. As the need to communicate externally increases, so does the risk of this occurrence. This will mean that managers will need to take care over what information is communicated, and how it is communicated.

It is also likely to mean that shareholders will also focus on 'headline' indicators of performance, for example earnings per share and P/E ratio.

Inevitably this will mean that managers will also focus on such measures, and will manage the business so that these measures indicate satisfactory performance.

This may lead to a greater focus on short to medium term measures of performance.

**(b)** Assessment of the company's performance can be made using the following measures:

Sales growth
Malcolm's stated strategy was to achieve growth. If growth is achieved, the sales volume, both in terms of the number of units sold, and the sales revenue generated, will increase. Sales growth is of critical importance as it is essential to achieve the volume targets set by the manufacturers in order to earn volume bonuses.

Earnings per share
As noted above earnings per share will have taken on greater significance now that the company is listed. This will be one of the major changes resulting from a listing. As shareholders are more detached from the company they will wish to see strong earnings per share.

Price/earnings ratio
While earnings per share is an important measure, and provides a comparison from one period to the next, it does not allow a comparison to be made against other companies. By comparing the earnings per share to the share price, it is possible to assess performance relative to other companies. This will be an important measure for shareholders as it provides an indication of the extent to which their investment in the company has been justified.

Return on capital employed
The overall responsibility of managers is to utilise the funds invested by the shareholders to obtain a return. By measuring profit earned as a percentage of funds invested, we can obtain a measure of how successfully this has been done. This is also an important measure of the success of the company's growth strategy. As the company grows the funds invested will grow. There will be little point in achieving growth if such growth is not profitable. This will be of greater importance to a listed company as compared to a private company, as shareholders in a private company may be prepared to accept a short term fall in returns in order to achieve greater returns in the future.

Profit margin and Asset utilisation
Any change in return on capital employed will be a result of a change in the profitability or asset utilisation. As already noted, unprofitable growth is unlikely to be acceptable to shareholders in a public company. Therefore it is important to assess the reason for any change in ROCE.

**Profit per unit**
The overriding objective of growth and the need to meet manufacturers' volume targets may lead to a focus on growth and volume to the exclusion of profitability. By keeping profit per unit sold under constant review this pitfall can be avoided. The measure will also ensure that decisions to achieve sales even though the profit on the individual sale may be low are justified on the basis of volume bonuses earned.

**Comments**
**Sales growth**
The sales growth of 22·4% indicates that the company has achieved strong growth in real terms as this is considerably greater than the rate of inflation. Given that growth was the key strategic objective, this is fairly convincing evidence that the strategic objective has been achieved. Measured against growth of 14·72% for the industry as a whole, the performance is strong, and the initial conclusion of success is confirmed.

Further analysis of the number of units sold shows that the growth in each of the company's major areas of business was:

| | | |
|---|---|---|
| Volume | new vehicles | 27·5% |
| | used vehicles | 8·4% |
| Specialist | new vehicles | 46·8% |
| | used vehicles | 94·2% |

Without the figures for the industry, it is difficult to draw conclusions, but further investigation of the reason for the relatively low growth in the sale of used volume vehicles is clearly required.

As was noted in the introductory comments, growth is only worthwhile if it is profitable, and this aspect of performance is considered below.

**EPS**
Earnings per share has grown by 9·2%, which although less than the growth in sales volume is a commendable performance. This is an indication that the growth has been successful. The relatively high earnings per share is influenced by the low par value of each share relative to the market value. The fact that the company has been able to undertake acquisitions by issuing shares at values considerably in excess of the par value is indicated by the fact that the ratio of share premium to share capital is around 4:1. This suggests that the market has confidence in the company's ability to use the funds invested to obtain strong returns, and this is confirmed by the strong rise in the share value during the most recent year.

**P/E ratio**
The P/E ratio confirms the observations regarding eps. An increase of almost 46% in the current year is a result of the combination of the growth in eps and the growth in share price.

This might be regarded as the most significant indicator of success. The market appears to be endorsing the company's plans, and placing confidence in the directors to achieve such plans.

**ROCE**
The company's performance as assessed by this measure is better than the industry average. However, the fact that this measure has shown a slight decrease is a matter of concern. While growth has been achieved, and the additional funds appear to have been used well, there may be a warning beginning to emerge. The aggressive growth which has been achieved to date may not be possible in the future. This may give rise to the need to revise, or at least tweak, the strategic objectives. While there is no immediate cause for concern, it must be noted that the company is not as far ahead of the market on this performance indicator as it is on others.

A possible explanation is that the potential for growth has been fully exploited. This can be investigated by considering the profit margin and asset utilisation of the company. It would also be useful to consider the average profit on each sale.

**Profit margin/profit per unit**
The profit margin has fallen slightly to 2·83% from 2·90%. While this may not appear to be of great significance, it is worth noting that if the margin had been maintained at 2·90%, profit would have been just over 2% higher or just over £$^3/_4$m would have been earned. This observation supports the view noted above that there may be a need to reconsider the strategic goals.

The other factor to be noted regarding profitability is that the profit per unit sold has fallen by £2 per unit. Once again, this may not seem significant, but on a total volume of almost 110,000 vehicles, it represents almost £$^1/_4$m of profit. This is further evidence that it will be difficult to continue to deliver growth in both volumes and profit. Given that a key element in profitability is success in meeting the volume targets set by manufacturers, it may be that potential volume bonuses have not been earned. This must be investigated, and careful attention paid to ensuring that all possible bonuses are earned.

**Asset utilisation**
It is encouraging to note that asset utilisation increased. Measured against the industry average of 6·57 times, this indicates that the assets continue to be well utilised. Continued efficiency in this area also suggests that the preliminary warnings about profitability noted above are justified.

Gearing

Although the company's level of gearing remains well below the industry average, it has increased almost threefold. At first this may seem to a matter for concern, but a closer examination of the working capital indicates that in 2005 there was a bank overdraft of £22·62m. By 2006, this has been replaced by a long term bank loan. If the overdraft is included in the 2005 calculation, the level of gearing is 27·76. Thus the increase during 2006 is of less significance. It is also worth noting that the interest cover has fallen slightly from 10·94 times to 9.84 times. There has been a slight increase in the cost of the finance, but overall, this is not significant.

Conclusion

There can be no doubt that the company's performance has been very encouraging. If we accept the normal objective for a listed company – maximisation of the shareholders' wealth – we have sufficient evidence. However there are signs emerging that if action is not taken to redefine the strategic objectives, the share price performance in the future may not be as strong as in the last twelve months. The implications of this are considered below under the section on the proposed mission statement and key performance indicators.

**(c)** Employee incentive scheme

The background information on the company indicates that staff have long been regarded as a key factor in the company's success. There can be no doubt that in a service led industry, the ability of staff to build relationships with customers and to understand and meet customer needs will add value and build shareholder wealth.

For that reason, any suggestion that may enhance employee motivation should be given serious consideration.

The suggestion of offering shares to employees has considerable merit. As noted above, a key objective for a listed company is to maximise the wealth of shareholders. This is a more widely accepted objective than can be pursued in most private companies. In a private company, particularly one like Motorsayles, there can often be a strong feeling of loyalty to a respected leader. Much of the history of Motorsayles indicates that Malcolm Sayles provided this type of leadership. However with Malcolm's retirement, we have lost that unifying leadership. This means that staff must be offered a new perspective, and a unifying goal. The dispersion of share ownership and the lack of proximity of the shareholders may lead to staff feeling alienated and not identifying with the needs of 'anonymous' shareholders.

By providing employees with a mechanism for acquiring shares in return for their contribution to meeting company – and therefore shareholder – goals, we can effectively create a common objective. This will be enhanced by future share price growth, reinforcing the link between employees and shareholders.

It is also worth noting that the correct accounting treatment will actually lead to a reduction in net assets (as the shares held on behalf of employees will be deducted from shareholders funds). This will have the effect of increasing return on capital employed, both in the short term, when the shares are issued, and also in the long term as the positive results of the motivation provided by the scheme become evident.

Therefore this initiative appears to be worthwhile, and will be investigated further, in the expectation that it can be put in place.

**(d)** Based on the consideration of performance, it can be seen that there is some evidence that the rate of growth achieved in the past will be difficult to maintain. In light of the fact that economic factors also suggest that consumer confidence is likely to reduce rather than increase, it would seem that the company's focus should shift to ensuring that the benefits of the growth achieved to date are consolidated. For that reason, it is suggested that the following strategic objectives should form the basis of future plans:

– to build customer loyalty and create 'customers who keep coming back';
– to maintain and increase the profit per unit sold by maximising the volume bonuses earned;
– to maintain market share;
– to maximise the benefits offered to customers through added value products and services.

This will be done by focussing on customer satisfaction, and offering a level of service which is unsurpassed in the industry. If these objectives are achieved, the company will also continue to meet the normally accepted objective for a quoted company – the maximisation of shareholder wealth.

Based on these objectives, the following Mission Statement is proposed as a starting point for our discussions:

We will put our customers at the centre of all our activities. Everything we do will be driven by our desire to offer unrivalled levels of customer satisfaction.

We will ensure that customers will have absolute confidence in our ability to exceed their expectations.

We will achieve this by:

maintaining and developing the services offered through our retail outlets
offering our customers a wide range of marques at every level of the industry
listening to our customers
keeping our promises
relentlessly pursuing opportunities to add value for our customers
driving down costs and maintaining quality, to deliver excellent value for money
delighting our customers and making them 'customers who keep coming back'

**(e)** The choice of responsibility centres is normally influenced by the following factors:

Objectives
Responsibility centres are used to link performance to responsibility. As performance is directed towards specific objectives, it follows that the objectives must be considered so that the actions for which a manager is responsible will be directed towards appropriate goals.

For example, the analysis above has indicated that we ought to redirect our attention away from unrestrained growth towards consolidation and improved profitability. For that reason we will be more successful if the company is organised into responsibility centres which emphasise outcomes which will contribute to these objectives.

Controllability
In order to be effective, the choice of responsibility centres must focus managers' attention on factors which can be influenced. More importantly, such factors must be capable of being influenced by the manager concerned. There is little point in identifying a variable which can be controlled by one manager, but placing it under the responsibility of another manager.

Comprehensiveness
If a manager is to be held responsible for managing a sector of the business, that sector must be selected so that all the aspects of performance which contribute to achieving objectives are included. This will avoid the possibility of important objectives being disregarded.

Consistency
Just as it is important to ensure that all relevant factors are included in the manager's responsibility, it will be important to ensure that there is consistency with regard to the factors the manager must focus on. This does not mean that there will be absolutely no conflict between the various factors under the manager's responsibility (indeed the need to manage such conflicts is a key responsibility for a manager). Rather it means that there must be consistency between the objectives the company is seeking to achieve, and the factors the manager must control.

Time span
It has already been noted that the time span over which the shareholders of a listed company will judge performance is likely to be shorter than would be the case for a private company. It is therefore important that managers are encouraged to focus on variables which will achieve the desired results within an appropriate timescale.

Structure
The company's activities indicate a somewhat natural division. There are fairly clear differences between the customer groupings who will purchase vehicles from volume manufacturers and specialist manufacturers. Equally the needs of customers in respect of vehicle sales activities and after-sales activities will be different. A further observation is that the products available through the finance and contract hire activities are complementary to vehicle sales.

It is worth noting that as we operate throughout England and Wales, there may be value in recognising regional differences.

For those reasons, it seems that the key decision is whether to organise the company on a functional basis, or on a regional basis.

To a large extent, this dilemma is resolved through the physical presence of our retail outlets.

By combining local outlets with our national presence, we can offer customers a local service, with the added dimension of the reliability and benefits of a national provider.

What this means is that the local outlet should be the foundation of our structure. These outlets are small enough to get close to customers and deliver on our strategic commitment to build customer loyalty. However, we should take every opportunity to ensure that customers know that this local service is provided by a company with considerable resources. This will give customers the confidence to accept our offer to become 'customers who keep coming back'.

Thus each retail outlet should be a profit centre. It is not appropriate for a retail outlet to be an investment centre, as decisions on capital investment should be made from a company-wide perspective.

Within each outlet, a general manager will have responsibility for achieving profit and customer satisfaction goals. The structure within each outlet should be that separate managers will be responsible for sales of new vehicles, used vehicles, and after-sales services. Each of these will also be profit centres. Other services, such as administration, human resource management will be cost centres, as the focus should be on ensuring that all the necessary support functions are carried out to an exceptional standard, within clear cost constraints.

The reporting structure above the outlet level should be on a divisionalised basis. Three divisions would be appropriate: Volume vehicles; Specialist vehicles; and Finance. On the basis that contract hire is a financing decision for the customer, it is appropriate to include contract hire within the finance division. Each of these divisions will be investment centres. Thus the divisional managers will be responsible for achieving profit targets through the retail outlets, and for ensuring that ongoing investment is carried out to ensure that the outlets are adequately resourced to continue to meet the highest standards of customer satisfaction.

**(f)** Within the structure discussed above, and notwithstanding the primary emphasis on profit, costs and return on investment, we will need to concentrate on a number of critical success factors.

Arising from the discussion above, the following critical success factors will form the basis of the internal reporting system:

| CSF | Significance | Measurement |
|---|---|---|
| Volume bonuses achieved | The fact that only a small profit is available on each unit sold, means that profit is almost entirely dependent on earning volume bonuses. Manufacturers set the volume targets, and we simply must meet them. In addition, as we sell more vehicles we increase the opportunity to add value through the sale of accessories and servicing. | Value of bonus earned as a % of bonus available from the manufacturer. |
| Customer retention | Our objective is to create 'customers who keep coming back'. This does not mean that customers need to be retained by a specific outlet, but rather they are retained by the company. By retaining customers we can shorten the sales cycle, and this will reduce our costs. The range of franchises we can offer means that the only reason a customer feels the need to buy from our competitors is that we have not satisfied the customer. | % of customers who purchased their previous vehicle from Motorsayles |
| New customers | While the overall objective of unrestrained growth is no longer appropriate, we need to continue to achieve growth. It goes without saying that we must attract – and then retain – new customers. | A headline measure of the number of customers who did not buy their previous vehicle from Motorsayles. This will be measured against periodic targets. |
| Sales of accessories | By selling accessories (e.g. satellite navigation systems), we can improve profitability. In many cases, such items do not require an investment in stock, as the lead time to acquire vehicles will allow time for the item to be delivered. | Sales of accessories as a % of sales revenue |
| Speed of throughput | Speed of throughput will be a key factor in customer satisfaction. This applies to both the speed of stock turnover (both vehicles and parts) and the speed of returning vehicles to customers following any service or repair work. There can be no doubt that the length of time a customer's vehicle is off the road is a major source of dissatisfaction. If we demonstrate an ability to minimise the disruption to customers, we will go a long way to retaining the customer. | Stock turnover ratios for vehicles and parts.<br><br>Index of time taken for service and repairs, based on manufacturer's standard time. |
| Non warranty services | If a customer chooses Motorsayles to carry out servicing, even though they are not obliged to do so under the terms of a manufacturer's warranty, this is a statement of confidence in our service. By creating such a demand, we are contributing to achieving our goal of customers who keep coming back. | Value of services carried out outside requirements of manufacturer's warranty terms as a % of total servicing revenue. |
| Warranty/ rework | The volume of warranty work is influenced by the quality achieved by the manufacturer. However, the customer perceives us as the manufacturer's agent. We must therefore take action to minimise the amount of work to be undertaken at either the manufacturer's expense (warranty) or our expense (rework). | Time spent on warranty and rework as a % of the average time spent on such tasks throughout the particular manufacturer's dealer network. |

NB Marks were awarded for other relevant CSFs and discussion.

## Appendix — Calculation of key ratios

| | | 2006 | 2005 |
|---|---|---|---|
| Sales growth | Turnover | £1,298·36m | £1060·35m |
| | Increase | 22·4% | |
| P/E ratio | Share price | 223p | 140p |
| | eps | 12·45p | 11·40p |
| | P/E ratio | 17·91 | 12·28 |
| | Increase | 45·8% | |
| ROCE | Operating profit | £36·8m | £30·74m |
| | Capital employed | £210·11m | £158·67m |
| | ROCE | 17·51% | 19·37% |
| Profit margin | Operating profit | £36·8m | £30·74m |
| | Turnover | £1,298·36m | £1,060·35m |
| | Profit margin | 2·83% | 2·90% |
| Asset utilisation | Turnover | £1,298·36m | £1,060·35m |
| | Net assets | £156·74m | £138·81m |
| | Asset utilisation | 8·28 times | 7·64 times |
| Profit per unit | Units sold | 109,848 | 91,090 |
| | Operating profit | £36·8m | £30·74m |
| | Profit per unit | £335 | £337 |
| Gearing | Debt | £48·41m | £15·19m |
| | Equity | £156·74m | £138·81m |
| | Gearing | 30·9% | 10·94% |
| Interest cover | Operating profit | £36·80m | £30·74m |
| | Interest charges | £3·74m | £2·81m |
| | Interest cover | 9·84 times | 10·94 times |

| | | | | *Marks* |
|---|---|---|---|---|
| **1** | **(a)** | Needs of shareholders/implications for management: | | |
| | | 1 mark per comment, to a maximum of | | 4 |
| | | Clear contrast between private/public ownership: | | |
| | | 2 marks per comment, to a maximum of | | 4 |
| | | | | **8** |
| | **(b)** | For each measure: weak justification | 1 mark | |
| | | clear justification | 2 marks x 6 = | 12 |
| | | For each comment on performance: | | |
| | | 1 mark per comment, to a maximum of | | 18 |
| | | For linking ratios in analysis | | |
| | | 2 marks for each linkage, to a maximum of | | 4 |
| | | | | **34** |
| | **(c)** | For each comment: | | |
| | | 2 marks per comment, to a maximum of | | **8** |
| | **(d)** | For statement of strategic intent, up to | | 3 |
| | | For mission statement, up to | | 5 |
| | | | | **8** |
| | **(e)** | Factors influencing choice of responsibility centre: | | |
| | | 1 mark per comment, to a maximum of | | 6 |
| | | Choice of appropriate structure, up to | | 6 |
| | | | | **12** |
| | **(f)** | For justification of importance of each critical success factor: | | |
| | | brief justification | 1 mark | |
| | | fair justification | 2 marks | |
| | | clear justification | 3 marks x 6 = | 18 |
| | | For how each CSF will be measured | | |
| | | attempt to specify measurement | 1 mark | |
| | | clear specification of measurement | 2 marks x 6 = | 12 |
| | | | | **30** |
| | Total for project | | | **100** |