Answers

1 This indicative solution is intended to demonstrate the approach a successful candidate may have taken in their solution. It is not intended to be comprehensive or restrictive. In the context of the marking scheme, marks were awarded to candidates who provided other valid answers.

(a) Candidates would be expected to discuss the key requirements for a cohesive mission and strategy. This would normally include a consideration of:

core values;
organisational culture;
clear objectives – which lead to goal congruence;
and clear performance measures which emphasise the culture and objectives.

From the information provided, the following points are relevant:

– The company's current focus is on cost control.
– This has been a key factor in its success to date.
– The management style is participative.
– There is a share-based incentive scheme, but there is no market for the shares.
– The current customer base is retail groups.
– The customer base for the new product is totally different.
– The customers for the new product will have different needs (quality rather than cost).
– The current market is mature, with little opportunity for growth.

Discussion of each of the alternatives is likely to be based on these factors, and the extent to which each alternative will provide a 'fit' with as many as possible.

Discussion of the possibility that the mature market may mean that the company needs to consider a change of direction, and the part that the participative style and currently cohesive culture will play in successfully managing this change is also relevant.

Mark allocation:		
Report format	1	
1 mark for each comment to a maximum of	13	14

(b) (i) Based on the analysis above, the company will need to ensure that both the existing business and the new business are managed through setting appropriate objectives. Consequently, it may be appropriate to consider objectives of three types:

Integrating objectives for the business as a whole
Specific objectives for domestic products
Specific objectives for industrial products.

Potential objectives may include:

Integrating objectives
Given that the decision to manufacture and sell the product will mean that the company will have two apparently conflicting customer requirements, there will be a clear need to pay attention to integration.
The existing credo will be a good starting point. This already emphasises the need to focus on the dual goals of customer requirements and low price.
Achieving customer requirements is therefore likely to become the overall corporate objective.
A secondary corporate objective will be overall cost control.
Candidates were expected to define each of these objectives. Possible examples are:

Identifying key customers with whom the volume of business transacted should be at least maintained, and possibly expanded;
Maintaining customer complaints below a specified target level;
Maintaining, or reducing, the production cost per unit produced.

Domestic products
Objectives for this aspect of the business should have recognised that this is the company's established business and that the market is mature. The existing customers' main requirement is to obtain low cost products. Thus objectives should reflect this fact, and be consistent with the integrating objectives.
The logical starting point is to set objectives which will encourage production efficiency and control costs. As the market is mature, and retailing is becoming concentrated on a reducing number of retailers, there will be little opportunity to obtain new customers. The focus therefore must be on retaining customers.

Industrial products
Objectives for this aspect of performance should recognise the potential for growth, and the opportunities that are available. The fact that quality is a key customer requirement should also be reflected. Therefore, objectives should focus on quality, but should not ignore costs. It would also be valid to set targets for expanding the customer base.

Mark allocation:

1 mark for each valid objective identified to a maximum of	4	
1 mark for each comment which explains the relevance of the objective to a maximum of	4	
2 marks for recognition of the need for objectives to both differentiate and integrate	2	10

(ii) The most important aspect of answers to this question was the extent to which the ratios and measures selected were justified. The ratios and measures selected by each candidate depend on the analysis already provided, but well developed answers identified the specific needs and future orientation of both existing and potential investors.

No marks were awarded purely for the identification of ratios and measures or for comments on performance based on the measures. Rather marks were awarded for the extent to which the choice of measures was informed by the preceding analysis, for the identification of the investor group, and for justification of the measure selected. An example of how the selection of a measure might be justified is that the company's inventory turnover ratio indicates that, in each of the last two years, it took longer than the industry average to sell all of its inventory. This is supported by the fact that the current ratio is higher than the industry average, yet the acid test ratio is lower. In addition, Cleenup is paying suppliers more quickly than the industry average. Taken together, these measures indicate that the company needs to pay particular attention to the management of working capital, and particularly inventory. Any failure to control these aspects of operations will have an adverse effect on the company's funding. For this reason it would be appropriate to monitor the working capital cycle (inventory turnover + receivables collection period – suppliers payment period). The current owners/managers are likely to have access to detailed information, and may therefore be aware of specific reasons for the differences between the company's performance and the industry averages. This would mean that they may place less reliance on this measure of performance. Future investors, on the other hand, are likely to be less involved with the company's day to day management and therefore may place greater reliance on a measure such as this to guide their investment decisions.

Mark allocation:
For each ratio or measure:

for justifying how the ratio or measure could be used by either current or future investors to assess future performance	up to	2	
for demonstrating a clear link to the previous analysis		1	
		3	
x 6 ratios/measures		=	18

(iii) The major decisions regarding accounting policies are:
treatment of development costs for the new product;
treatment of investment in expansion of capacity.

Development costs
The directors have a choice of treatments for this item. As the product has been developed and brought to market, it would be reasonable to conclude that the criteria for the costs to be recognised as development costs have been met. This means that the costs may either be capitalised (and amortised over the expected life of the product) or written off as incurred.
Discussion could have included:

Capitalising will increase the company's asset base. This will reduce both measures of profitability such as ROCE or ROI, and asset utilisation.

Immediate write off will improve such measures in the future, but will lead to a deterioration in measures of profitability in the short term.

Treatment of investment in expansion of capacity
The directors' choices are more limited in this context. The investment should clearly be capitalised. Therefore it will be necessary to adopt a depreciation policy. However, the directors will still be required to make decisions regarding the period over which the cost should be depreciated. As this is a new product, there is inevitably a degree of uncertainty over the expected useful life of the product. Therefore, it is likely that prudence should apply, and a relatively short period should be chosen.
Discussion should have recognised that measures of profitability will be adversely affected by both the increased assets and the additional depreciation charge.

Mark allocation:

1 mark for each relevant issue identified, to a maximum of	2	
2 marks for each valid comment, to a maximum of	6	8

(iv) The choice of sources of funds will bring the need to balance the shareholders' desire to retain control and the fact that there is evidence to suggest that to date decisions have tended to avoid excessive risk. The company was founded with relatively modest investments from the founders, and the availability of grant aid appears to have been maximised. This suggests that the founders are not risk takers.

Obtaining finance through the issue of shares would be consistent with this relatively conservative approach, but may require the shareholders to raise additional funds if they wish to retain control. A further point is that as the company's shares are not traded, it may be difficult to set a price for the issue of shares. This may lead to difficulties in finding equity investors.

Raising loan finance will avoid the possibility of the loss of control, but increases the financial risk.

Each of the measures discussed in (b) should be considered and the effect of both equity finance and loan finance on each measure should be discussed.

Mark allocation:		
Discussion of needs of shareholders and/or relevance of methods of funding:		
$1^1/_2$ marks per valid point to a maximum of	6	
Discussion of measures from (b):		
1 mark for each valid comment re effect of equity on a measure, to a maximum of	6	
1 mark for each valid comment re effect of loans on a measure, to a maximum of	6	
Report format	2	20

(v) Discussion of the structure should be linked to issues identified in (a). Relevant points to refer to would be the similarity of production methods and the different customer bases. The former, with a separate customer base requiring a focus on quality rather than cost, would tend to suggest that the current structure may be suitable. The latter would tend to suggest the need for a new structure.

The most obvious choice of structure would be between a divisionalised form (i.e. a domestic division and an industrial division) and retaining the current structure, with separate marketing departments (domestic and industrial).

Answers should also have discussed the merits and drawbacks of each structure.

Mark allocation		
1 mark for each valid comment, to a maximum of	10	
1 mark for each possible structure identified to a maximum of	2	12

(vi) Marks were awarded for valid measures, but answers which clearly linked the proposed NFPIs to the objectives from part (a) were awarded more marks.

Mark allocation:		
1 mark for each valid NFPI identified to a maximum of	8	
Up to 2 marks for each measure linked to objectives to a maximum of	16	
subject to an overall maximum of		18