Final Level

Management Accounting – Business Strategy

12 FLBS

18 November 2003

Tuesday morning

INSTRUCTIONS TO CANDIDATES

Read this page before you look at the questions

You are allowed three hours to answer this question paper.
Answer the ONE question in section A: Answer TWO questions ONLY from section B.
Maths Tables and Formulae were provided within the question paper and are available elsewhere on the website.
Write your examination number, your contact ID and your name on a double-sided card, which must be attached to your answer book. Write FLBS on the line marked "Subject" on the front of the answer book.
Do NOT write your name or your contact ID anywhere on your answer book.
Tick the appropriate boxes on the front of the answer book to indicate which questions you have answered.

SECTION A – 50 MARKS

ANSWER THIS QUESTION – the scenario is given below and opposite and continues on the following page 5: the question requirements are also on that page, which is detachable.

Question One

Background

CG is a publicly-funded development organisation. It allocates money which it receives from the government to overseas organisations for the purpose of business development. The directors of CG do not aim to maximise profits. The government expects the directors of CG to make a return on capital employed (ROCE) of just 5%. This is the only directive given to CG by the government.

Strategic objectives

In its 20-year history, CG has provided development funds to many organisations around the world. Its main objective is to provide funds to organisations in poorer regions of the world so that they may use them to generate their own future growth and become financially self-sufficient. The main approach employed by CG is to provide start-up funds or loans and expertise to local businesses to the point that they are providing employment locally and contributing to their own national economy. CG's initial outlay is recovered from income derived from operations carried out by local businesses receiving the start-up funds. Once the project is viable without further support, it is passed over for the local business to continue to run. The only criterion set by CG for the type of business to be supported is that it must be engaged in legal activity. After the initial outlay has been made and the ROCE (relating to the period for which the funds have been committed) has been paid, there is no further payment to CG from the local business.

The directors of CG have employed the rational planning model in developing their strategic plans. In recent years, the directors have been criticised for being too inflexible in the provision of development funds by concentrating in business areas which are too narrow and focusing too frequently on particular areas of the world.

Performance measures

CG operates on a divisionalised basis with regional managers having responsibility for particular overseas regions. The regional managers have discretion to allocate funds up to a limit. In the event that they identify a funding proposal which exceeds their discretionary limit, the regional managers may make a business case and apply to the directors of CG for the larger sum to be made available. The directors measure the performance of the regional managers by determining their ROCE using the net book values of capital employed. The operating surplus or deficit is divided by the net capital employed to arrive at the ROCE. The method of determining the ROCE is in accordance with government regulations with depreciation being charged within the fixed administration costs. CG apportions its own headquarters costs across the regions on a flat rate which has worked out to be $300,000 in each region in the last reporting period. Regional divisions of CG provide technical services (for example advice on environmental pollution) to each other and make a charge accordingly. This avoids duplication of technical expertise within each of CG's regions. Income received from inter-regional transfers is included in the ROCE calculations.

The directors of CG are now considering the ROCE of two regions, M and Z. In addition, they are considering two possible development proposals, one in each region. Region M was established 9 years ago. Region Z is a new area of activity for CG and has just produced its first set of accounts. The performance of the two regions in 2002/3 is set out opposite.

	Region M	Region Z
	$000	*$000*
Income generated in regions M and Z:		
From development projects funded by CG within the region	3,500	700
From other CG regions	100	2,100
Expenditure incurred in regions M and Z:		
Variable service costs	450	200
Fixed service costs	380	600
Variable administration	250	80
Fixed administration	1,470	1,270
CG headquarters (apportionment)	300	300
Capital employed:		
Gross book value	12,000	10,000
Depreciation	9,000	1,000
ROCE	25·00%	3·88%

After another 3 years for region M and 9 years for region Z, the assets will be fully depreciated. In the next financial year, the depreciation charge will be $1 million for each region.

Development proposals

The details of the two development proposals are:

	Region M	Region Z
	$000	*$000*
Initial cost (to be added to capital employed)	300	400
Scrap value	0	10
Annual net cash inflow	100	
Revenue from annual production of 500 units		200
Annual cash costs incurred by region Z for 500 units		95
Estimated life	4 years	6 years

Depreciation is calculated on a straight-line basis. The development proposal for region Z involves the annual production of 500 units of a single product. Each unit of the product sells at the same unit price and each incurs exactly the same costs.

The nominal Cost of Capital for CG is 10% and the regional manager of M has calculated that his proposal has an NPV of $17,000. In addition, he has calculated the expected impact on ROCE in 2003/4 as follows (assuming all other revenues and costs remain the same next year).

	$000
Operating surplus without the proposal	750
Net operating surplus from the proposal (after depreciation)	25
Revised operating surplus	775
Net capital employed without proposal	2,000
Gross cost of proposal	300
Depreciation on proposal	(75)
Revised capital employed	2,225
ROCE	34·8%

Scenario continued from page 3

The regional manager for region M is concerned about the risk associated with the proposal. He has identified that any of the following situations could result in a zero NPV:

(i) the initial cost needs to rise by only 5·66% ($17,000/$300,000);

(ii) net cash inflows need to fall by only 5·36% [($17,000/3·17)/$100,000];

(iii) the cost of capital needs to rise to only 12·5%.

Therefore, he thinks the proposal is very sensitive to any of these situations occurring. The directors of CG are also becoming concerned about the high level of ROCE being achieved by region M given its target set by government.

IGNORE INFLATION AND TAX.

Required:

(a) Discuss the effect of the non-profit-maximising aim on the directors of CG in formulating future strategy. Advise the directors of CG on the method which is most appropriate for them to formulate strategy. Your advice should include a critical appraisal of the current method (rational planning model) employed.

(10 marks)

(b) Evaluate the performance of the regional manager for region Z (making whatever comparisons with region M you think are appropriate) and advise whether the development proposal for region Z should go ahead. Your advice should take account of the expected NPV of the proposal, its impact on ROCE in 2003/4 (assuming all other revenues and costs in 2003/4 are the same as for 2002/3 except for the effect of depreciation on any new proposals) and include calculations demonstrating its sensitivity to the possibility of returning a negative NPV.

(30 marks)

(c) As stated in the *"Performance measures"* section on page 2, the directors measure the performance of the regional managers by determining their ROCE using the net book values of capital employed. Discuss the method employed by the directors of CG to evaluate the performance of its regional managers and advise on alternative approaches which may be used. Your discussion should also take into account the effect on the performance of the regional managers of the government target ROCE of 5%.

(10 marks)

(Total = 50 marks)

SECTION B – 50 MARKS

ANSWER TWO QUESTIONS ONLY

Question Two

Don Mac is the world's largest and best-known foodservice retailing group with more than 30,000 "fast-food" outlets in over 120 countries. Currently half of its restaurants are in the USA, where it first began fifty years ago, but up to 1,000 new restaurants are opened every year worldwide. Restaurants are wholly owned by the group (it has previously considered, but rejected, the idea of a franchising of operations and collaborative partnerships).

As market leader in a fiercely competitive industry, Don Mac has strategic strengths of instant global brand recognition, experienced management, site development expertise and advanced technological systems. Don Mac's basic approach works as well in Kandy or Kuala Lumpur as it does in Kansas: although the products are broadly similar, menus are modified to reflect local tastes. Analysts agree that it continues to be profitable because it is both efficient and innovative. The group's vision is to be "the world's favourite" through service, cleanliness and value, and it is following three main strategies:

- to achieve profitable growth by building on key strengths;
- to "delight" every customer in every restaurant;
- to be a good employer in each community in which it has a restaurant. (Despite this, some critics claim staff are mainly unskilled and lowly paid.)

Don Mac's future plans are to maximise global opportunities and continue to expand markets. Don Mac has long recognised that the external environment can be very uncertain and consequently does not move into new locations or countries without first undertaking a full investigation.

You are part of a strategy steering team responsible for investigating the key factors concerning Don Mac's entry for the first time into the restaurant industry in the Republic of Borderland.

Required:

(a) Justify the use of a PEST framework to assist your team's environmental analysis for the Republic of Borderland.

(8 marks)

(b) Discuss the main issues arising from applying this framework, and highlight what more information is needed by Don Mac on Borderland.

(17 marks)

(Total = 25 marks)

Question Three

From the 1980s onwards, organisations have been increasingly conscious of the need to develop appropriate competitive strategies. More recently, competition has increased in many areas due to factors such as a more global dimension to trade and an opening of new markets. It follows that, in order to gain and maintain competitive advantage, it may be worthwhile for organisations to identify and carefully consider the present and likely future activities of its competitors.

Required:

(a) Evaluate the importance of competitor analysis, with reference to the benefits and potential dangers of undertaking such an exercise.

(10 marks)

(b) Discuss the key issues to be addressed when conducting a competitor analysis, including potential data sources and tools that may be helpful.

(10 marks)

(c) Explain the relationship between the product life cycle and competitor analysis.

(5 marks)

(Total = 25 marks)

Question Four

A supermarket company employs you as management accountant. The organisation is undertaking a comprehensive analysis and evaluation of its product and customer portfolio. You have been asked to help because of your knowledge (through study) of value chain analysis.

Required:

(a) Using the example of a supermarket (or similar large mainly food-retailing organisation), discuss the main components of the value chain. You should refer to the particular skills that you as management accountant can bring to an analysis of the value chain.

(17 marks)

(b) Discuss the contribution of value chain analysis in the effective implementation of generic strategies.

(8 marks)

(Total = 25 marks)

Question Five

Three months ago, the *RP Manufacturing Company*'s Board of Directors surprised the workforce when they announced a radical new strategy. The new "approach" was announced as being "a shared journey to be more responsive to an ever-demanding and fast-moving market while becoming more cost-conscious and thereby profitable". The agenda for the current year was outlined as being:

- To scrutinise all core and other activities and identify potential for cost reduction. Outsourcing should be progressed as a realistic alternative.
- To develop a range of "partner relationships" with customers and suppliers.
- To develop a more flexible, fluid workforce (including multi-skilled, part-time and temporary employees) leading to an organisational restructure.

More recently, the company announced a "comprehensive supply chain management solution" in partnership with a logistics company starting initially with a transport solution.

The Head of Finance has been asked to provide a briefing paper on the implications of these changes for management reporting systems within the *RP Manufacturing Company*. He has asked for your advice in this matter.

Required:

(a) Evaluate the way in which the *RP Manufacturing Company* is implementing strategy and comment upon the major challenges posed by the new strategy.

(8 marks)

(b) Given the major changes within the *RP Manufacturing Company,* explain why traditional management accounting approaches may **not** be appropriate.

(8 marks)

(c) Discuss the likely information demands upon the management accounting function given the changes within the organisation.

(9 marks)

(Total = 25 marks)

End of paper