

Final Level

**Management Accounting –
Business Strategy**

12

FLBS

25 May 2004

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 are provided which can be downloaded separately from the CIMA website.

SECTION A – 50 MARKS

ANSWER THIS QUESTION

Question One

Background

MW and FS are both supermarket chains which operate in different parts of a country. Both are listed on the country's Stock Exchange. MW operates in the north of the country while FS stores are located predominantly in the south. Recently the Chairman of FS has approached the Chairman of MW and suggested that MW may wish to present a take-over bid for FS. The Chairman of FS has indicated that such a bid would be favourably received by his Board of Directors and would pre-empt a bid being made by other less desirable predators in the industry. According to the Chairman of FS, there would need to be some staff rationalisation and about 10% of the total number of stores of the combined group would need to be sold as a result of demands which would be made by the country's competition regulatory organisation. However, he believes that there would be increased profitability for the combined group as a whole which would lead to improved shareholder value. At this stage, no public announcement of the possible take-over has been made and all the information relating to it is being treated as strictly confidential.

MW

MW was established over 100 years ago by Mr W. His son (KW), who is now over 70 years old, is the Chairman of the company. The W family has maintained strong control over the business and still owns nearly 40% of its shares. The main principle established by Mr W was that of offering quality products at a reasonable price and this principle has been rigidly maintained throughout the company's history. Organisationally, MW stores are split into two operating areas – the North West and the North East, although it is controlled from its Head Office by KW and his management team. Each individual store is managed locally by a Store Manager and an assistant. In addition, there are supervisors, till checkout staff, store keepers and shelf stackers working in each store. Other skilled trades staff are also employed including butchers, bakers and fishmongers.

Recent results have shown that MW has increased its sales by 8% and its net profit by 15% over the previous year. MW has become a popular share as a result of the company's ability to cut its operating costs and increase its profitability each year. MW's current share price is \$3. Its market capitalisation is \$4,500 million. Two years ago its price/earnings ratio was 10.

KW follows the sound principles of business development established by his father. He prefers to rely on a capital structure which is low geared and has generated organic growth rather than undertaking large take-overs. The last time MW undertook a take-over was 25 years ago when it bought six supermarkets. If a bid is made for FS then it is most likely that KW will wish to offer a share exchange rather than pay any cash. He is acutely aware of competition in the industry within the country and has been advised by the Finance Director that there are two other main competitors which may put forward counter-bids if MW makes an offer for FS.

FS

FS's stores operate within the South West and South East of the country. Approximately 55% of its shares are held by ten major institutional shareholders which have been disappointed in recent performance. These institutional shareholders have been impressed by the success of MW and instructed the Chairman to begin take-over negotiations with KW. FS's share price currently stands at \$2 with a market capitalisation of \$4,000 million. Two years ago its price/earnings ratio was 30.

Performance of both companies for the last financial year

For simplicity, the data supplied below represents the average *for each store* in the relevant area. All stores for each company are built to a standard layout. On average, FS stores are 20% smaller in terms of area than MW stores.

	<i>MW</i>		<i>FS</i>	
	<i>North West</i>	<i>North East</i>	<i>South West</i>	<i>South East</i>
	<i>\$ million</i>	<i>\$ million</i>	<i>\$ million</i>	<i>\$ million</i>
Turnover	10.0	8.0	6.0	5.0
Cost of sales (excluding wages)	4.0	3.0	2.0	1.8
<i>Overheads:</i>				
Managers' and Supervisors' salaries	1.0	1.0	0.7	0.6
Non-supervisory staff wages	1.0	0.7	0.7	0.6
Other overheads	1.0	1.1	1.1	0.9
Local taxes	<u>1.0</u>	<u>0.8</u>	<u>0.7</u>	<u>0.6</u>
Net profit	<u>2.0</u>	<u>1.4</u>	<u>0.8</u>	<u>0.5</u>

<i>Additional information:</i>	<i>MW</i>		<i>FS</i>	
	<i>North West</i>	<i>North East</i>	<i>South West</i>	<i>South East</i>
Total square metres per store	6,000	6,000	4,800	4,800
Average number of customer visits per store	0.3 million	0.2 million	0.15 million	0.1 million
Managers and supervisors per store	15	12	14	12
Total staff per store	69	56	56	51

The profit attributable to ordinary shareholders in the last financial year was \$225 million for MW and \$200 million for FS. Stock is held centrally by each company in its own secure warehouse. It is issued on a daily basis to each store. On average, each MW store has a stock turnover of 2 days while each FS store has a stock turnover of 3.5 days.

MW's strategy

KW has recognised the need to obtain support from shareholders and therefore will need to maintain enhanced shareholder value. The Finance Director has acquainted him with the seven value drivers which Rappaport believes affect shareholder value. These are as follows:

- (i) sales growth rate;
- (ii) operating profit margin;
- (iii) the planning period;
- (iv) the rate of cash income tax payments;
- (v) incremental fixed capital investment;
- (vi) working capital investment;
- (vii) the cost of capital.

Required:

- (a) Produce (i) a SWOT analysis for MW and (ii) explain how such an analysis can assist the company in achieving its organisational objectives.

(13 marks)

- (b) Discuss the usefulness of Rappaport's seven drivers to the directors of MW in helping the company to improve its shareholder value.

(10 marks)

- (c) In your capacity as Management Accountant for MW, produce a report to KW which outlines the benefits and risks of acquiring FS. Your report should include:

- an analysis of the data provided in the scenario by making whatever calculations you think appropriate;
- an analysis of the potential impact of the take-over on shareholder value;
- a statement regarding any strategic issues which you think should be considered by the Board of MW before a bid is made.

*(17 marks are available for the calculations and
10 marks are available for the narrative part of this requirement)*

(Total for requirement (c) = 27 marks)

(Total = 50 marks)

SECTION B – 50 MARKS

ANSWER TWO QUESTIONS ONLY

Question Two

A political party has recently been elected to govern the island nation of Breakland after a long period in opposition. The new government wishes to bring about lasting change within an economy that suffers from high unemployment. It has established a "think tank" in which government advisers, specialists and experts explore implications of ideas and advise on various alternative courses of action.

Breakland is a multi-cultural country with free elections and a mixed economy. Its industrial base is relatively well-established but it has no truly world-class industry or experience. Past government policies mean there is little in the way of product safety legislation. Spending on education and training for those aged over 16 years old is low. In addition, Breakland has traditionally discouraged foreign competition in home markets with threats of tariffs, quotas and other protectionist measures. As a consequence, a few American and Japanese companies have set up high-technology manufacturing plants on the island.

The government is keen to consider ways in which they can make the country's industry more competitive internationally; specifically they wish to identify policies they should pursue over the next ten years to make this happen.

Required:

- (a) Advise the members of the "think tank" on the components of *Porter's Diamond* framework and why it might assist their deliberations.

(12 marks)

- (b) For each element of *Porter's Diamond*, discuss potential government policies that might help encourage Breakland's industries to compete more effectively abroad. Provide an explanation for the suggestions you make.

(13 marks)

(Total = 25 marks)

Question Three

Strategy involves planning ways in which the long-term objectives of the organisation can be achieved. An important part of such a process is the analysis of the external environment to determine future potential factors that are most relevant to the organisation.

Some believe that the external environment within which organisations operate has become increasingly uncertain and therefore wholly unpredictable. This raises important issues for strategy development, with some questioning the value of past approaches.

Required:

(a) Discuss how environmental uncertainty might affect strategic thinking within organisations.

(12 marks)

(b) Assess the usefulness of scenario planning in strategy formulation, particularly under conditions of extreme uncertainty.

(13 marks)

(Total = 25 marks)

Question Four

Organisations are reporting a growth in the sophistication, volume and nature of data that is regularly collected and interpreted for strategic purposes. This data collection supports a number of strategic approaches. Some firms regularly monitor customer expectation and market conditions for instance, while others prefer to attempt to stay in touch with their competitors' methods of doing business, strategies and future intentions.

Required:

(a) Compare and contrast competitor analysis and competitor benchmarking, and evaluate the importance of each process.

(17 marks)

(b) Discuss how benchmarking might be successfully applied in the public sector. You may use examples drawn from any area of the public sector to illustrate your answer.

(8 marks)

(Total = 25 marks)

Question Five

Over the past few years, there have been a number of high profile financial scandals surrounding the reporting of company performance, and the associated role of accountants. As a consequence, organisations have been urged to consider future practice carefully. Some feel that an overemphasis by a company on market expectations and profitability may be detrimental to its long term well-being. Such thinking has implications for the objectives of a company and the range of performance measures used both externally and internally.

Required:

- (a) Discuss the functions that organisational objectives should fulfil strategically and the main disadvantages of using only profit related performance measures.

(12 marks)

- (b) The balanced scorecard approach has been described as relating an assessment of performance to choice of strategy through four categories of measurement. It is used by many organisations in monitoring performance. Evaluate the use of the balanced scorecard in meeting stakeholder needs and determining objectives.

(13 marks)

(Total = 25 marks)

End of paper